FME

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2011

FJÁRMÁLAEFTIRLITIÐ

THE FINANCIAL SUPERVISORY AUTHORITY, ICELAND

Annual report of the Financial Supervisory Authority 2011

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Content of the Annual Report

The content of the Annual Report of the Financial Supervisory Authority (FME) covers generally the period from 1 July 2010 to 30 June 2011. The report addresses the principal tasks undertaken during this period. Also addressed are the position and outlook in the credit market, the securities market, the pension and UCITS markets and the insurance market. The introduction of the Financial Supervisory Authority's policy and its principal objectives are also described. Separate shaded texts provide an account, among other things, of the Financial Supervisory Authority's investigations, domestic and cross-border co-operation and changes in the internal work procedures of the Financial Supervisory Authority.

The Annual Report includes an overview table of the number of regulated entities at mid-year 2011 and shows highlights from the Authority's Annual Accounts for 2010. The Annual Report will be published in English and both versions are available at the Financial Supervisory Authority's website, www.fme.is. Also available on the website is diverse information relating to the financial market and the arrangement of public supervision of financial activities.

Board and management of the Financial Supervisory Authority

A three-member Board of Directors exercises overall management of the Financial Supervisory Authority. The Board's role is to formulate operational priorities and monitor the activities and operation of the Financial Supervisory Authority. Major decisions are submitted to the Board of Directors for approval or rejection. The Board of Directors appoints a Director General who is in charge of the day-to-day activities of the Authority. The Board of Directors consisted of the following members in November 2011: Adalsteinn Leifsson, assistant professor, Chairman of the Board (from 1 June 2011), Ingibjorg Thorsteinsdottir, associate professor, Vice-Chairman of the Board (from 1 June 2011) and Arnor Sighvatsson, Deputy Governor of the Central Bank of Iceland, (from 1 January 2011), appointed by the Central Bank of Iceland.

Alternate Board members are Halldor S. Magnusson, managing director (from 1 January 2011), Sigurdur Thordarson, auditor, and Tryggvi Palsson, managing director (until 21 October 2011), appointed by the Central Bank of Iceland.

In addition, during the period from 1 June 2010 to October 2011, members of the Board of Directors of the Financial Supervisory Authority have been: Lilja Olafsdottir, District Court Attorney, who was Chairman of the Board from 26 February 2010 to 31 May 2011, Kristin Haraldsdottir, attorney, LLM, who was a member of the Board from 5 February 2009 to 31 May 2011 and Jon Th. Sigurgeirsson, managing director, who was a member of the Board from 5 February 2009 to 31 December 2010.

Director General of the FME
Gunnar T. Andersen

Deputy Director General
Ragnar Haflidason

Directors of divisions

Credit market
Gudmundur Jonsson

Information technology
Jon Andri Sigurdarson

Pension market and UCITS
Halldora E. Olafsdottir

Insurance
Runar Gudmundsson

Operations
Ingibjorg S. Stefansdottir

Securities
Gudrun Jonsdottir

Forensic accounting
Maria Ruriksdottir

Senior attorney
Unnur Gunnarsdottir

Investigations conducted by the Financial Supervisory Authority

Immediately following the financial collapse in Iceland in the fall of 2008 the Financial Supervisory Authority (FME) appointed specialists to investigate trading in the securities markets and the activities of financial institutions in the period leading up to the collapse. In time it became clear that the investigations would prove much more extensive than the Authority had envisaged and for this reason two investigative teams were established. Today there are 17 legal and financial experts at work in the investigative teams. The investigations focus on the trading of the three largest banks prior to the collapse, and in addition transactions of various other financial undertakings, investment companies and individuals come under scrutiny. The investigative teams have built up an extensive expert knowledge base in the FME with regard to investigations in a number of different fields.

The FME investigative teams work in close co-operation with the office of the Special Prosecutor, which was established in the wake of the banks' collapse. The FME has now opened 169 investigation cases relating to the financial collapse, and a considerably greater number of investigations may be expected next year. A total of 124 investigations have now been concluded; 75 of those have been forwarded to the Office of the Special Prosecutor for further investigation, and 44 cases have been closed without further action. Several investigations were concluded by other measures, such as administrative fines. The cases that have been referred to the Office of the Special Prosecutor span the entire range of financial crimes, including market abuse, breach of fiduciary duty, insider trading, false disclosures, embezzlement, forgery, accounting irregularities, theft, money laundering and fraud. Many of the investigations extend across borders and the investigative teams are working with the FME's international sister organisations, both through partnership agreements through ESMA, the European Securities and Markets Authority, and IOSCO, the International Organisation of Securities Commissions, and through bilateral agreements with other organisations.

1. Activities of the Financial Supervisory Authority

1.1 Director General's overview

At the start of the period covered by this annual report, the Financial Supervisory Authority (FME) and the Central Bank of Iceland (CBI) had recently sent to financial undertakings a recommendation regarding currency-linking provisions in loan agreements. The recommendation proposed that financial undertaking should replace currency links and links to foreign interest rates with interest posted by the Central Bank of Iceland based on the lowest interest on new general unindexed loans, or, in the event of indexation, the lowest interest on new general index-linked loans, which is used when there is uncertainty regarding lending terms.

This recommendation came under some criticism when it was issued, but it proved well in line with the judgment subsequently handed down by the Supreme Court. Had the judgment categorically declared currency-linked loans to be illegal and ordered a recalculation of the loans based on foreign interest rates this would have threatened financial stability, and the hit taken by the financial undertakings could have been on the order of ISK 350 billion.

The Financial Supervisory Authority put a great deal of effort into scrutinising and analysing these loans. Among other things, currency-linked loans were divided into seven categories depending on their nature and types of loan classes. This was done in co-operation with a law firm, which assessed the likelihood of each category being in compliance with law, and this assessment has withstood the test of time. This proved to be an enormous task and required the time and effort of a large part of the FME's staff; in addition, the Authority obtained outside assistance, both from a law firm and the consultancy firm Oliver Wyman. The work extended from July 2010 into the fall.

In late 2010 an Internal Capital Adequacy Assessment Process/ICAAP was begun in Arion Bank, Íslandsbanki and Landsbankinn. The ICAAP covers the risk management processes and governance of the banks. It is based on two equivalent pillars: capital planning, designed to ensure the long-term profitability of the undertaking, and risk strategy, designed to identify and limit the risk inherent in the business plan. The business plan should include a detailed description of both these pillars. The FME's Supervisory Review and Evaluation Process (SREP) is designed to assess the compliance and quality of the business plan as a benchmark for a bank's strength. The bank's business and risk strategy are assessed in the SREP, together with financial strength and capital needs as well as governance and operating and monitoring processes.

In early 2011, a new co-operation agreement was executed between the Financial Supervisory Authority and the Central Bank of Iceland. The agreement provides for closer co-operation than before. One point of emphasis in the agreement is that in order for Iceland to have a sound, dynamic and secure financial system the respective responsibilities and division of tasks between the two organisations need to be defined in an unequivocal manner.

Under the terms of the agreement, the Director General of the FME and the Governor of the Central Bank will meet at least twice each year with the principal experts of both organisations in order to assess the systemic risk in the Icelandic financial system. The purpose of the agreement is to promote a sound, dynamic and secure financial system in Iceland, including its clearance and settlement systems. Based on the terms of the Agreement, four risk assessment groups were formed in the fields of currency, liquidity, macro-prudential policy and fund transfer systems.

On 1 January 2011, new regulatory bodies were launched in the European Union: EBA, ESMA and EIOPA, replacing the consultative committees CEBS, CEIOPS and CESR. The FME is an active participant in the supervisory work of these organisations.

The new regulatory bodies have different roles from their predecessors. The committees that were previously in place had only an advisory role, whereas the agencies that replaced them are actual financial regulators with extensive powers.

A three-member advisory committee was established at the beginning of 2010 to assess the eligibility of members of the boards of financial undertakings, insurance companies, insurance brokers and pension funds. It is made up of experts in the field, including one from the FME and two members specifically hired for this task. The committee assesses the eligibility and qualifications of board members and its conclusions are taken into account in the FME's determination of eligibility. The FME decides whether to seek the opinion of the advisory committee having regard to the scope of the activities of the regulated entity in question, including its operating license, operations and market share.

As reported earlier the deposits and assets of Keflavik Savings Bank were transferred to the new Spkef Savings Bank, fully owned by the State, in April 2010. The situation of Spkef had become precarious in March 2011, resulting in a merger with Landsbanki. Byr Savings Bank collapsed in April 2010 and its operations were transferred to a new bank, Byr hf., on a temporary basis. Negotiations were subsequently opened with creditors on converting the debts of Byr hf. into share capital, but without success. The bank was consequently placed in a divestment procedure and the FME has now approved the merger of Byr hf. with Íslandsbanki hf.

The FME granted a commercial banking licence to nb.is Savings Bank (now MP Bank hf.) on 11 April 2011 and on that same day, the Annual General Meeting of MP Bank hf. (now EA Holding Company hf.) approved the sale of MP Bank's general banking operations in Iceland and its operations in Lithuania to new owners. The bank was refinanced with the support of new investors.

An investigative team has been operating within the FME since the collapse in 2008. The team was strengthened in line with the increase in the staff of the Office of the Special Prosecutor. At the time of this writing 75 cases have been sent to the Special Prosecutor for further investigation and dozens of cases have been closed by the FME without further action.

In mid-August 2010, an agreement on financial stability between the Nordic and Baltic countries took effect. Its goal is to ensure financial stability and to coordinate responses to financial shocks affecting more than one state. The agreement provided for the establishment of the first European College of Supervisors on the basis of a memorandum of understanding between EEA states on cross-border financial stability. The agreement is not legally binding but will serve as a basis for strengthening cooperation and coordinating responses and work procedures in the event of danger, including through enhanced dissemination of information between organisations. Participants include representatives of the financial supervisory authorities, central banks and finance ministries of the countries concerned.

A new FME strategy was presented at its most recent annual meeting. It is based on three main pillars: Compliance and sound business practices; independent analysis and evaluation; and professional discussion and transparency. The focus has been on implementing this strategy and work is currently underway on developing the FME's information policy, which is intended to assist the FME in promoting informed debate and transparency.

This report addresses the financial services sector. There was much discussion about the banks' loan portfolios during the year and the perceived substantial profits made in challenging circumstances. It appears that bond issues may be picking up, albeit at a slow rate. The pension funds had net assets of approximately ISK 1,910 billion at year-end 2010, as compared to ISK 1,775 billion at year-end 2009, representing a year-on-year increase of 7.6%, or about 5% in real terms. Investments by pensions funds in bonds issued or guaranteed by the Icelandic State have risen dramatically in the past three years, primarily at the expense of other bonds and deposits. In the securities market, the bond market has been unusually active. Ever since the collapse of the banks in 2008 the Icelandic stock market has been characterised by large and irregular price changes, partly due to low liquidity. The insurance market has seen substantial changes, with companies striving to improve operational efficiency and new owners taking over Sjóvá-Almennar hf.

The FME has collaborated closely with the International Monetary Fund ever since the Icelandic government decided to request the IMF's assistance following the collapse. In March and April of this year a foreign expert on banking supervision conducted an examination of the FME on the basis of the Core Principles for Effective Banking Supervision, consisting of 25 minimum standards for sound banking supervision. The purpose of the standards is, among other things, to coordinate banking supervision across different countries and enable supervisory authorities to conduct self-assessments of their activities. The examination concluded that the FME fell slightly short of meeting all of the standards. An action plan spanning just over two years to remedy these deficiencies has been prepared.

The FME relocated to a new building in September 2011. The new offices are located on the third and fourth floors of the tower at Hofdatorg. The move was first proposed more than four years ago but was delayed due to the financial collapse. As a result, it could not be finalised until the summer of 2011. The new building has lived up to expectations, although a few minor problems need to be addressed, as is to be expected.

The FME has grown rapidly of late and those of us entrusted with its management are aware that it is funded by contributions from regulated entities. We are under obligation to use those funds in the best possible way. With that in mind we have considered the possibility of making changes in the agency's organisation with the aim of maximising operational efficiency. It is important for the FME to be ideally sized in view of the tasks it is required to perform and the scope of the financial services sector.

New tasks have recently been assigned to the FME, including supervision of payment service companies and financial undertakings under the control of winding-up boards. With better organisation and more suitable offices, the management and staff of the FME are optimistic that the agency will be successful in its efforts to ensure a sound and trustworthy financial sector in Iceland.

1.2 New offices and staff matters

The FME recently relocated to new offices at Hofdatorg, where the emphasis is on open and well-lit spaces and on providing the staff with excellent working conditions. The new offices are ideally located in view of the FME's activities, in addition to offering various improvements with respect to security and facilities.

The staff of the FME increased over the past year as in previous years. Staff members were 103 around mid-2011, up from 93 in mid-2010. The number of staff members is expected to rise to 117 by year-end. The increase in staff has occurred in various departments of the FME, including IT and banking supervision and risk analysis, as well as in connection with the build-up of securities market surveillance.

The FME's activities relating to reform and development tasks and investigative work are expected to peak in 2012. A decrease in the number of staff is expected to follow. As seen in the table on the next page, it is estimated that an additional 26 staff members will need to be hired next year, followed by a decrease in staff in the period 2013 to 2015 down to approximately one hundred staff members at year-end 2015.

	Current	Additional number	Estimated requirement 2013	Estimated decrease 2014	Decrease 2015
Regular assignments	100				
Development tasks	0	9			9
Research	17		17		
New tasks	0	8		4	
Reform tasks	0	9		9	
Total	**117**	**26**	**17**	**13**	**9**

The FME has been successful in hiring personnel with extensive and diverse experience as well as younger employees. There are also large numbers of applications for each position, suggesting that the FME is now seen as an attractive place to work.

2010 saw the introduction of competency-based performance management at the FME with the aim of improving surveillance results through the focused development of employees. The competencies believed necessary for achieving results in each job are analysed, employee performance is assessed based on these competencies, goals are set and performance is managed having regard to these goals. Continuing training and staff development policies have also been reviewed and improved in accordance with the points of focus emerging from performance interviews and the FME's strategy. In this way, human resource management at the FME has been made more comprehensive and competence-based, both in respect of recruitment and performance management.

1.3 Operations and finances

In determining the proportional distribution of the costs associated with the operation of the FME between regulated entities, account is taken of the division of the agency's total available time between individual categories of regulated entities over the preceding three year period. The following table shows the division of total available time in 2009 and 2010:

Division of total available time in the FME by category of regulated entities *)	2009 %	2010 %
Credit institutions	55.7	57.7
Insurance companies and brokers	11.9	11.9
Pension funds	16.1	14.0
UCITS management companies	7.1	7.6
Securities firms and brokerages	0.9	2.6
Issuers of shares and bonds	5.6	4.2
Other	2.7	2.0
	100	100

*) Investigative work in connection with collapsed financial undertakings is not included.

The FME's time tracking also shows how its time is spent between different types of tasks or functions. The following table shows how the FME's time was divided in this respect in 2009 and 2010:

Division of FME's available time by core functions	2009 %	2010 %
Supervisory functions	67.7	69.9
Off-site supervision	25.3	25.1
On-site inspection	2.6	3.0
Other supervisory functions	39.9	41.8
Drafting of rules	4.0	3.3
Day-to-day administration	23.4	22.9
International co-operation/relations	4.8	3.9
	100	100

Continuous off-site supervision refers to various kinds of inspections, monitoring and market surveillance activities that are primarily based on systematic gathering of information and regular reporting to the FME. It also covers more specific inspections concerning the activities, business practices and procedures of regulated entities. On-site inspections cover supervisory tasks which are initiated through specific on-site visits. Other supervisory functions include all kinds of licensing, fit-and-proper assessments, imposition of penalties, dissemination of information, enquiries, and more. The majority of investigative work relating to the banking collapse also falls under this category. Day-to-day administration covers the FME's case and file management systems, IT, staff issues, educational activities and other matters relating to regular operations and office work.

FME operations in 2010 and estimates for 2011

In 2010 the FME's expenses, including equipment purchases, totalled ISK 1,220.6 million, while revenues, including interest income, totalled ISK 1,274.7 million. Income from supervision fees was ISK 1,143.2 million. The FME thus posted an operating surplus of ISK 54.1 million in 2010. Not included in the these figures are costs and revenues totalling ISK 12.7 million related to complaints committees hosted by the FME. Equity at year-end was ISK 242.9 million, as compared to ISK 188.7 million at the beginning of the year. The year-end equity will go towards reducing next year's supervision fees.

According to the agency's revised estimate for 2010, expenses, excluding complaints committees, are expected to total ISK 1,843.1 million. Revenues, including interest income, are projected at ISK 1,638.5 million in 2011, including ISK 1,632.0 million from supervision fees. This gives a budget deficit of ISK 204.6 million for the year. Taking account of the fact that equity at the beginning of the year totalled ISK 242.9 million, the Agency is expected to have a positive equity of ISK 38.3 million at year-end 2011.

In accordance with Act No. 99/1999 on the payment of costs for public supervision of financial activities, estimated operating surpluses or losses are taken into consideration in determining the supervision fees for the following year when preparing the agency's operating budget. However, the Act does allow the FME to accumulate a reserve fund within certain limits. Turmoil in the agency's operating environment following the banking collapse and the restructuring and strengthening of its activities in recent months have led to some divergences from its operating budget. The agency's operations are expected to become more settled in the coming months.

The FME's operating budget and comparisons between absolute figures and previous years figures is attached to the legislative bill introduced annually by the Minister of Economic Affairs to amend Act No. 99/1999 relating to the imposition of supervision fees. Key statistical information from the FME's 2010 annual accounts is reproduced in Chapter 5 of this Report. The annual accounts are published in their entirety on the FME website.

Domestic and cross-border cooperation

Cooperation, both domestically and internationally, is extremely important to the FME. At the beginning of 2011 a new cooperation agreement was concluded with the CBI which provided for more focused collaboration than the previous agreement. The aim of the agreement is to promote a sound, effective and secure financial system in Iceland, including payment and settlement systems.

The agreement stresses the need for explicitly defining the responsibilities of each of the two organisations as well as the division of tasks between them. Emphasis is placed on the need for the FME and the CBI to work closely together on defined tasks and for the collection and communication of information from financial undertakings and between the two organisations to be systematic. It is further noted that the analysis of stability must generate a clear picture of financial undertakings' strengths and weaknesses and their ability to respond to changes, both in the macroeconomic environment and in domestic and foreign markets.

Among the new provisions is a requirement that the Director General of the FME and the Governor of the CBI should meet at least twice a year, together with competent experts from both organisations, to assess systemic risk in the Icelandic financial system. The agenda of these meetings will include macroeconomic factors, risks of individual financial undertakings, the interplay of risk factors, both within the financial system and between it and the economy, the status of payment systems, the regulatory framework for financial activities, and improvements to contingency plans. Active participation in international cooperation gives FME staff members the best possible understanding of the foundations of international rules, in addition to giving the FME an opportunity to influence the development of the regulatory framework for the financial sector. Financial regulators everywhere in the world find themselves in a state of flux following the global financial crisis. The European regulatory system, to name just one, has undergone substantial changes. A new body responsible for macro-prudential oversight, the European Systemic Risk Board (ESRB), has been established. The ESRB's role is to issue recommendations and develop proposals regarding systemic risk.

Three independent regulatory bodies have replaced the committees that were previously in place within the European Union. These agencies have cross-border powers, although the chief responsibility for daily supervision will remain with the respective national supervisory authorities. In almost every area of financial supervision, regulatory changes are in the pipeline that will be enforced by the relevant national supervisory authorities. Supervisory functions and procedures for informing government authorities are being coordinated in a comprehensive manner. In addition, new information systems will be developed for the purpose of gathering and exchanging market information. These reforms to the regulatory international framework and cooperation place increased demands on the FME with respect to the size and qualifications of its staff. The FME will continue to have an observer in the new regulatory bodies, which include EBA, a banking supervisor, EIOPA, an insurance sector regulator, and ESMA, responsible for supervision of securities markets.

Changes in internal procedures

The internal functioning of the FME has undergone considerable changes in recent years as expected in view of the substantial expansion of its activities. From 2005 to 2011 the number of staff has more than tripled.

The main challenge confronting the FME in connection with its expansion is to increase efficiency through improving procedures, work methods and task management and to maximise the efficiency of human resource and finance management. The agency also needs to increase specialisation and strengthen its capacity for analysis. Naturally, the FME is expected to exhibit high standards of administrative practice, which is also important when dealing with the conflicts that will inevitably result from the various decisions made by the Agency. Furthermore, it is important for the FME to maintain its image and credibility in the eyes of regulated entities.

Work on refining the organisation of the FME began around the middle of last October. A group consisting of senior management and staff members of the FME reviewed the activities with the assistance of consultants. The agency's role and future vision were defined as a basis for setting goals and options were examined. The purpose was to further improve operational efficiency by establishing future points of focus and implementing corresponding changes. This work is ongoing and is expected to yield results in the coming months.

2. Market trends

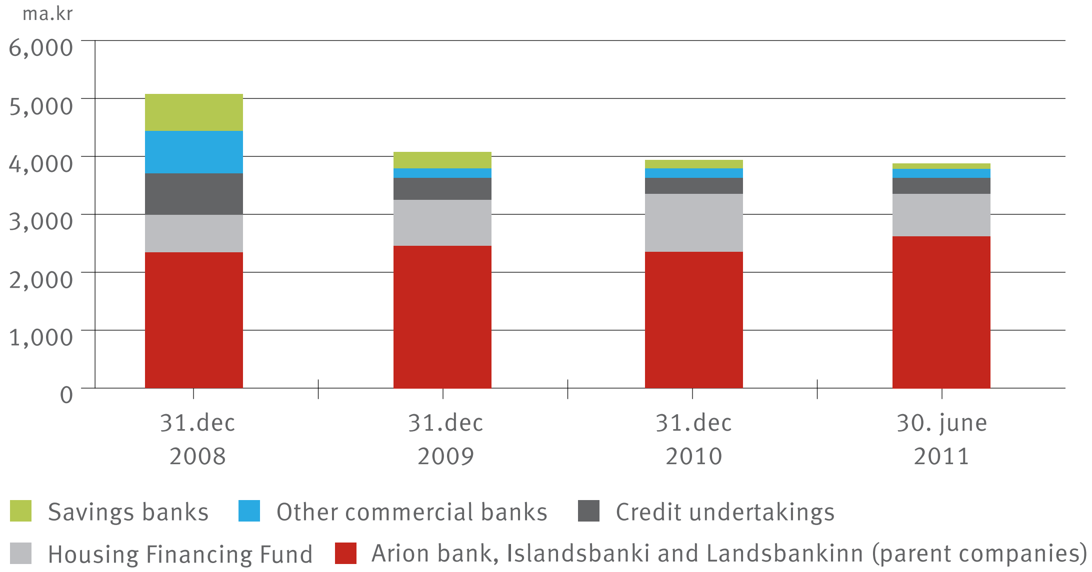
2.1 Credit market

Size of the banking system

Total assets of Icelandic credit institutions, i.e. commercial banks, savings banks and credit undertakings, have decreased in the wake of the setbacks which engulfed the Icelandic economy in the fall of 2008. At year-end 2008 the total assets of credit institutions were over ISK 5,000 billion, but at mid-year 2011 their total assets were approximately ISK 3,900 billion.

Figure 1

Total assets of operating credit institutions, including the Housing Financing Fund, from year-end 2008

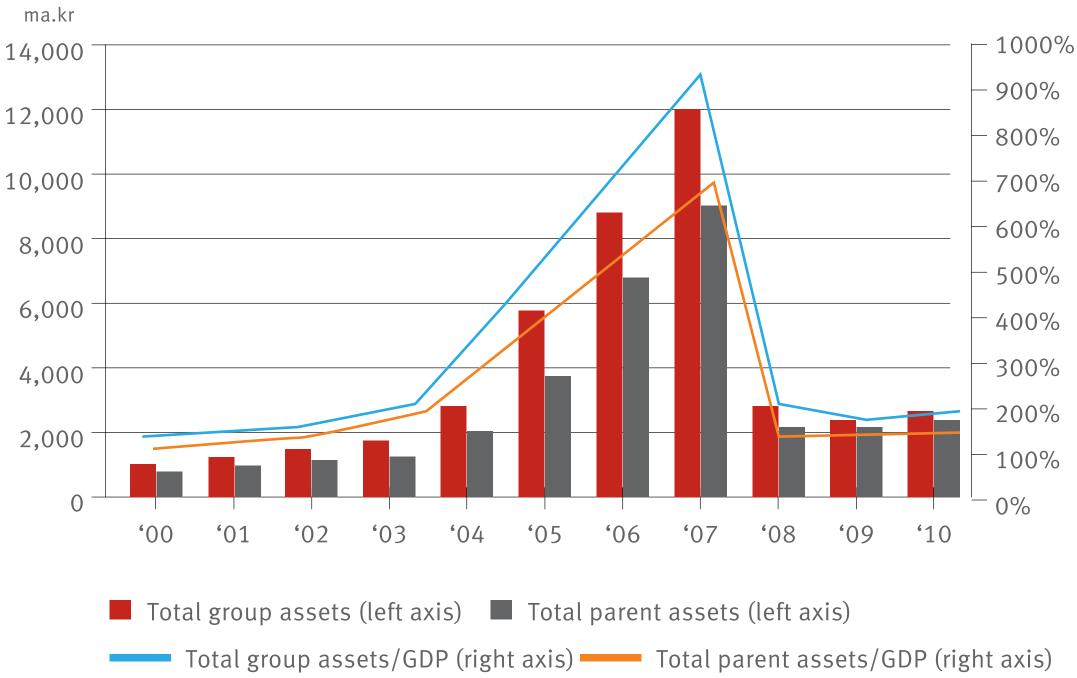


As the chart shows, the assets of the three large commercial banks, Arion banki hf., Islandsbanki hf. and Landsbankinn hf., have increased slightly during the period, while the assets of other commercial banks, savings banks and credit companies have decreased substantially. The explanation can be traced to the take-over of large credit institutions by the Financial Supervisory Authority in 2009 and 2010. These include,for example, Straumur hf., Sparisjodabankinn hf. (Icebank), SPRON hf., Frjalsi fjarfestingarbankinn hf., VBS fjarfestingarbanki hf., Askar hf. and Avant hf. In 2010 Byr savings bank was also taken over and its deposits were transferred to a new commercial bank, Byr hf. In addition, SpKef savings bank was merged with Landsbankinn during the first quarter of 2011. It is foreseeable that there will be further changes in the operations of credit institutions, including through mergers. For example, at mid-year 2011 a merger had not been formally completed between the parent company of Landsbankinn and the credit undertakings SP-financing and Avant, while Islandsbanki has reached a merger agreement with Byr hf. Although the three commercial banks have not grown substantially in size during the period, their weight among credit institutions has increased from almost 50% at year-end 2008 to 66% at mid-year 2011. At the same time the weight of other commercial banks and the savings bank system has decreased from 11% to 2%.

The total assets of the five commercial banks, Arion bank, BYR hf, Islandsbanki, MP bank and Landsbankinn in mid-year 2011 represented approximately 70% of the total assets of credit institutions and 98% of the total assets of deposit institutions. The size of operating commercial banks as a percentage of GDP, measured on a consolidated basis, was similar in mid-year 2011 to what it was in 2003, or approximately 180%. The percentage peaked at year-end 2007 or 937% of GDP.

Figure 2

Total assets of commercial banks - amounts in ISK billion and as a percentage of GDP.



The banks' loan portfolios and what many viewed as large profits under difficult circumstances were the subject of debate during the year. The Financial Supervisory Authority has monitored developments in the banks' loan portfolios closely, particularly whether the valuation of assets, which for the most part comprise loans, reflects their real worth. This is one of the major factors in the Authority's supervision of the banks' capital requirements, which is based on a supervisory review and evaluation process (SREP). The Financial Supervisory Authority also made an independent assessment of the capital requirements of the three commercial banks based on a risk analysis for each bank.

Alongside its supervisory tasks the Financial Supervisory Authority's Credit market division undertook an extensive review and analysis of the organisation and implementation of supervision. This work was guided by the Basel Core Principles for Effective Banking Supervision. In continuation thereof an effort was made to meet the requirements of the standards. In this connection the Financial Supervisory Authority arranged for four European financial supervisory authorities to give presentations on the implementation and arrangements of supervision in the countries concerned. The objective is to establish cooperation with one foreign financial supervisory authority in order to facilitate and expedite the formulation and development of future supervision in Iceland, a task which is both large in scope and time-consuming. At the same time it is clear that the staff of the Financial Supervisory Authority is ready to do its share in bringing it to completion.

The tasks in this field are complex, varied and numerous. The increase in the number of staff in the field during the past three years, from ten in 2008 to 30 in 2011, has opened up new possibilities for approaching and resolving them. It is clear, however, that 30 employees must prioritise carefully due to the large number of tasks. Sister institutions in the Nordic countries are struggling with the same problem despite those institutions are considerably larger (a total staff of 250-300). In this connection it may be noted that a supplementary budget allocation was recently approved for the Swedish financial supervisory authority when it appeared that a part of regulated entities would never be subject to special scrutiny by the authority based on the financial resources that were planned for the authority.

Concurrently with the greatly increased number of tasks in recent years, the number of credit institutions subject to supervision by the credit division has decreased. There are various reasons for this and it is foreseeable that this development will continue to some extent and will lead, among other things, to further concentration in the credit market. However, there have also been stirrings in the opposite direction and in April 2011 the Financial Supervisory Authority approved the transfer of a specified part of the operations of MP bank hf. (now EA fjarfestingarfelag hf.) to nb.is savings bank hf. (now MP bank hf.) which at the same time was granted an operating licence as a commercial bank. At summer's end the Financial Supervisory Authority also granted to Straumur IB hf. an operating licence as a credit undertaking. In contrast, the number of securities undertakings has increased, numbering 13 at end-June 2011, as compared to eight two years earlier.

A legislative amendment in the summer of 2010 laid down a clear requirement that, other things being equal, financial undertakings should not retain interests in unrelated activities any longer than necessary, with the reference period being 12 months. At the same time, the Financial Supervisory Authority was authorised to extend this period on a case-by-case basis. These amended legal provisions establish stricter limitations than before in respect of authorisations for financial undertakings to hold interests in unrelated activities. Considerable work has been done in connection with the collection of information and follow-up concerning temporary activities of financial undertakings. The present ownership share of financial undertakings in business operations is extensive and undesirable. In recent months the commercial banks have completed divestment procedures with regard to quite a few companies and are working on bringing others into saleable condition.

The post-collapse issuance of bonds has been limited. The bond market has been characterised by trading in government bonds and bonds issued by the Housing Financing Fund. That market seems to be slowly becoming more active. The Financial Supervisory Authority recently granted to Islandsbanki hf. permission for the issuance of covered bonds and an application for the issuance of comparable bonds is currently being processed.

There are various signs of positive developments among the financial undertakings. However, they are still working through the consequences of the collapse through measures which include reorganising their loan portfolios. Also, the financial statements of financial undertakings remain marked to a considerable extent by the events of 2008 and the transfer of loans between the old and the new banks, as evidenced by the scope of calculated revenues resulting from an estimated increased worth of loan portfolios.

Financial undertakings face uncertainty which may entail possible setbacks. The main uncertainty factors relate to the removal of capital controls, the volume of contributions to the Depositors' and Investors' Guarantee Fund and planned structural changes in the fisheries sector. It is also clear that court judgments related to fx-related loans and contracts could impact further the estimated worth of the loan portfolios of financial undertakings.

2.2 Securities market

Securities market trends

From mid-year 2010 the rise of the OMXI6 Selected Share Index on Nasdaq OMX Iceland remained steady until mid-year 2011, followed by a sharp downturn in the third quarter. The increase in liquidity over the period has been slight. Eight to twelve new listings and stock issues are anticipated in the coming eighteen months. The bond market has been extremely active over the last year and a half, and the unusually high bond yield is raising concerns of overheating in that market.

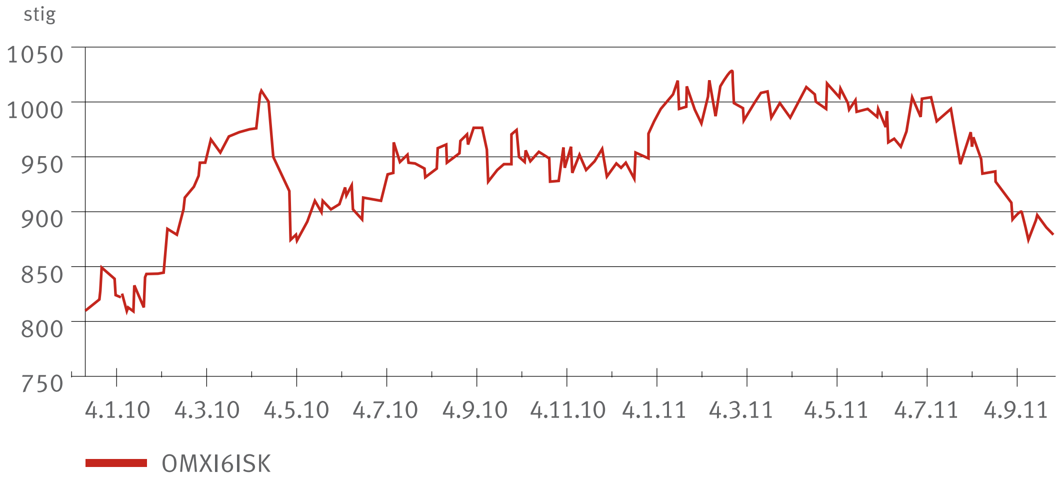
Stock market trends

Sharp and irregular price movements have marked the Icelandic Stock Exchange since the banking collapse of October 2008, reflecting the limited market liquidity. During the first four months of 2010 the OMX16 Selected Share Index, which is based on the six largest companies on the Stock Exchange by market value, rose by over 23%, peaking at the end of April 2010. This sharp increase in the index was mainly due to large increases in the shares of the three largest companies. The price of shares in Marel, which had a weight of 25% in the index at that time, rose by 50% during the period. In the first half of May there was a sharp fall, and on May 25 the index reached its lowest point in 2010 but rose thereafter for the remainder of the year. The value of the index at year-end was 933, as compared to 815 at the beginning of the year, an increase of approximately 14.5%. This represented a considerable turnaround from the previous year, when the index fell by 19%.

At year-end 2010 the total market value of listed shares on the Icelandic Stock Exchange was ISK 233 billion (equivalent to 15% of GDP), as compared to ISK 208 billion at the end of the previous year (14% of GDP), and the average monthly turnover declined by 50% between the years, i.e. from ISK 4 billion per month in 2009 to ISK 2 billion in 2010.

Figure 3

Performance of the Nasdaq OMX Iceland share index



The stock market got off to a good start in 2010, with the index rising by 7% during the first quarter and reaching its high point for the year in the second week of March. Icelandair Group and Marel were largely responsible for the increase, with their shares rising by 44% and 29% respectively. During the second quarter the index fell by 5% in quiet trading, with the volume of trading for June being only ISK 936 million, the lowest point since July of the previous year. By mid-year the shares of Icelandair Group were up by 58% and those of Marel by 21%, while the shares of other companies declined by 4% or more.

On 30 June 2011 the total market value of listed companies on the Icelandic Stock Exchange was ISK 274 billion (17% of GDP) and the average monthly turnover during the first half of the year was ISK 7 billion. The highest monthly turnover during the first half of 2011, ISK 19 billion, was recorded in March, which is the highest monthly average on the Icelandic Stock Exchange since October 2008. On 14 July 2011 Slaturfelag Sudurlands was listed on First North increasing the number of listed companies to 11, including 7 listed on the main list of Nasdaq OMX Iceland and 4 on First North. In mid-year 2011 Marel had the highest market value (ISK 89 billion) of any Icelandic company, with Ossur close behind (ISK 88.5 billion). The Icelandic Stock Exchange lists the shares of four companies with a home country other than Iceland: Atlantic Airways, Atlantic Petroleum, Bank Nordik and Century Aluminum Company. Market participants as well as analysts envisage from 8 to 12 new listings during the next 12 to 18 months, including as many as four companies with a market value of more than ISK 30 billion each.

Bond market trends

While the trading volume has declined in the Icelandic Stock Exchange after the collapse of October 2008, the bond market has recorded increased activity. The average monthly turnover in 2010 was approximately ISK 237 billion compared with ISK 227 billion in 2009, but the highest monthly turnover of the year was in September 2010, with a volume of ISK 487 billion. Most active during the year where non-indexed government bonds with ISK 1,690 billion volume traded. At year-end 2010 the total market value of listed bonds was ISK 1,721 billion (112% of GDP). The yield on government bonds and housing bonds decreased considerably in 2010, e.g. the one-year nominal rate of return fell by 486 points (cf. OMXI1YNI on the graph below). Thus, the total return on listed bonds was substantial and the 5-year non-indexed bond index, OMXI5YNI, rose by 22% or 10% more than the 10-year indexed bond index, OMXI10YI, which total return was the second highest. After the collapse the annual return of all bond indices has been considerably above the calculated average for the years 2003-2007.

Figure 4

Yield on non-indexed Nasdaq OMX Iceland indices

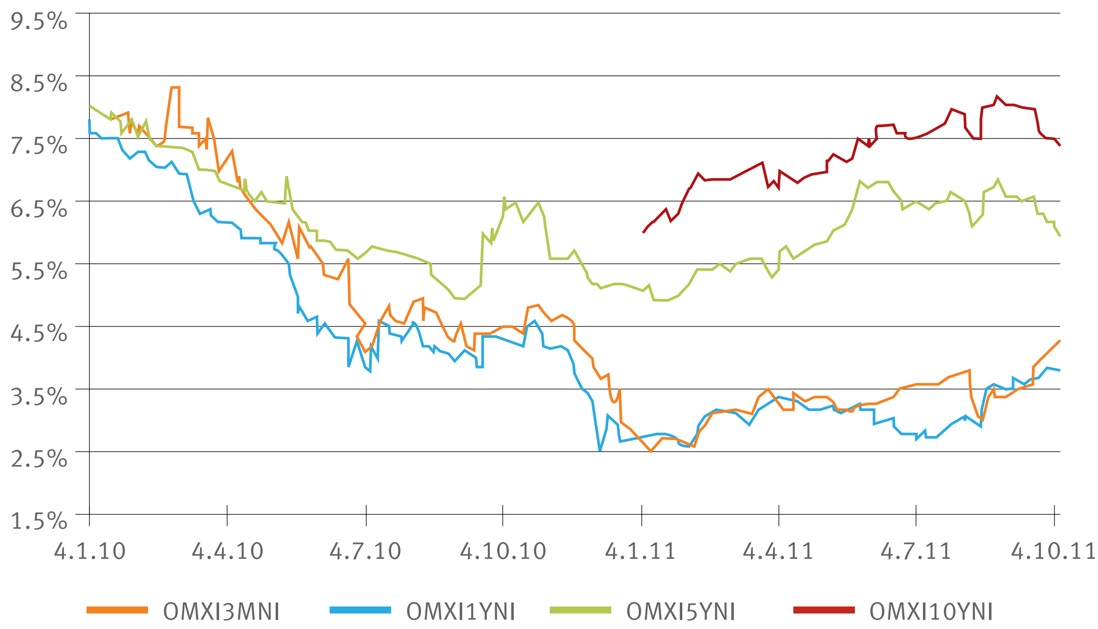
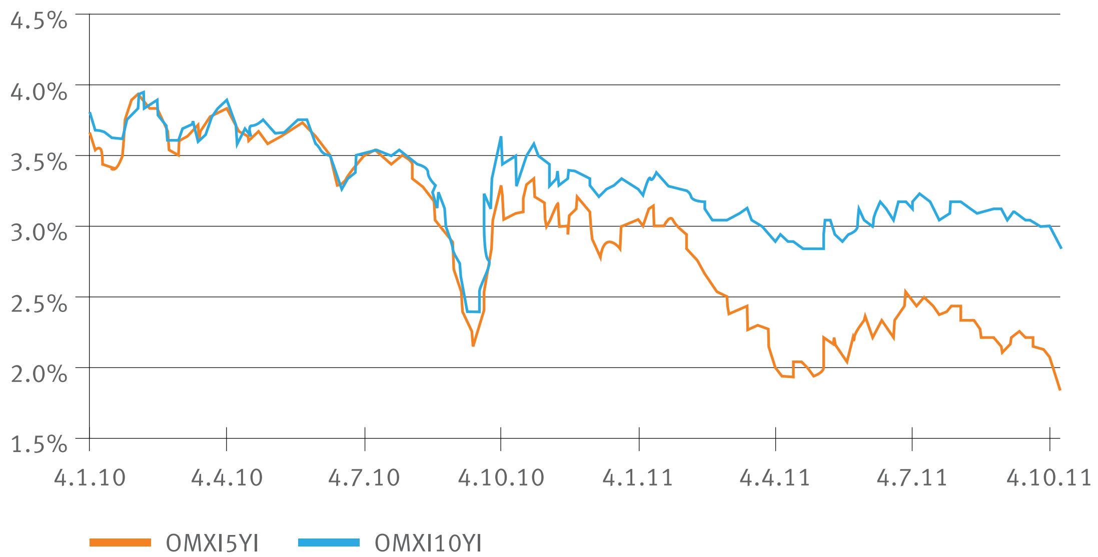


Figure 5

Yield on indexed Nasdaq OMX Iceland indices



Study of loan and lease agreements

In 2010 the Financial Supervisory Authority continued its studies of loan and lease agreements linked to the exchange rates of foreign currencies.

The studies have primarily focused on the impact of court rulings and decisions and amendments to the Act on Interest since 2010, and on the methodology which the Financial Supervisory Authority used in the classification of loan and lease agreements in its assessment in the summer of 2010. The studies have revealed that the Financial Supervisory Authority's assessment of the potential illegality of specific classes has not changed much and the effects of the amendments on the value of loans from the largest financial undertakings are negligible relative to the assessment in the summer of 2010.

Nevertheless, the Financial Supervisory Authority is of the opinion that certain elements of uncertainty remain, which are primarily connected to the contract forms and recalculation of loan and lease agreements linked to the exchange rates of foreign currencies.

The Central Bank of Iceland reduced the policy rate by 25 points to 4.25% in the first half of 2011, but inflation at the same time was 4.25, or considerably above the bank's inflation target. The policy rate was then raised by 25 points to 4.50% in August because of increased inflationary expectations and raised by a further 25 points at the beginning of November. In February 2011 Nasdaq OMX Iceland began to calculate a new 10-year bond index for non-indexed bonds (OMXI10YN1) at the request of market participants and analysts. During the first four months of the year the 10-year real yield decreased by 102 points and by 39 points for 5 years, but was on a rising trend in May and June. Since mid-July of this year to mid-October the real 10-year yield has declined by 38 points and by 54 points for 5 years. During the first half of the year the indices for 10-year indexed bonds showed a yield of 6% and 8% for 5-year indexed bonds. Both indices then continued to rise into the fourth quarter of this year, by approximately 5%. In contrast, the yield on non-indexed indices has risen steadily so far this year, with the cumulative rise amounting to 119 points on average. For this reason the yield on OMXI10YN1 has been negative by 5%, but even so non-indexed indices for 3 months, 1 year and 5 years have been positive, showing yields of 2.5%, 2% and 3% so far this year.

The average monthly turnover during the first six months of 2011 was ISK 202 billion, as compared to an average of ISK 203 billion during the same months in 2010. At end-June 2011 the total market value of all listed bonds was ISK 1,719 billion (109% of GDP).

Last 30 September the Financial Supervisory Authority granted Islandsbanki permission to issue specially secured bonds. The first bond issue by the large banks since the collapse at year-end 2008 is expected to be listed during the next 12 months.

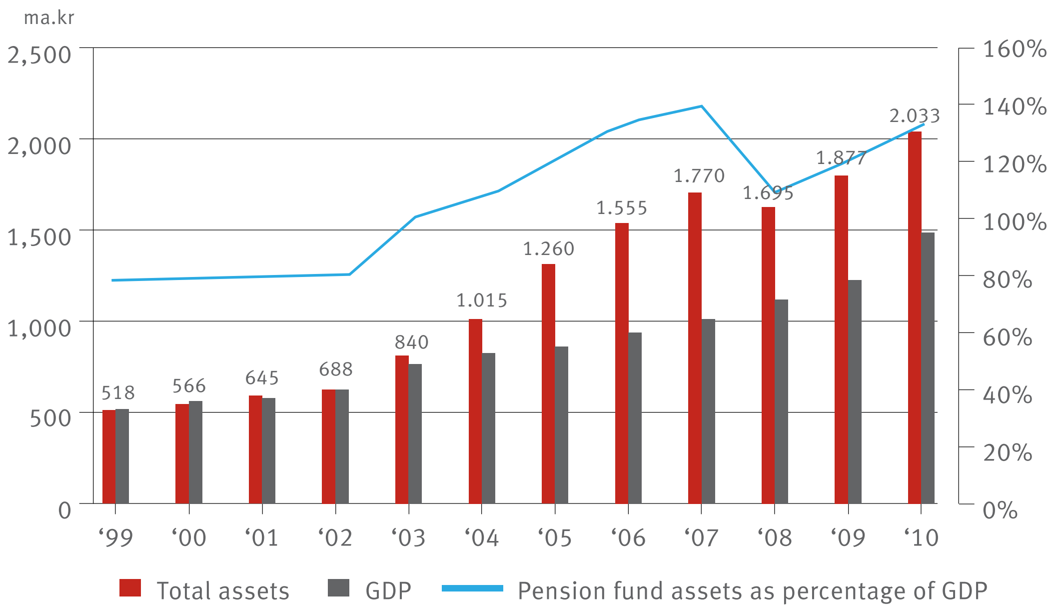
2.3 Pension market and UCITS

Pension funds

Net assets of the pension funds at year-end 2010 were ISK 1,910 billion, as compared to ISK 1,775 billion at year-end 2009. The increase between years was 7.6%, which corresponds to a real increase of 5% relative to the consumer price index. The assets of the pension funds at year-end 2010 as a percentage of GDP were 124% as compared to 118% at year-end 2009. The assets of the pension funds plus other personal pension savings are equivalent to 132% of GDP. Figure 6 shows the total assets of the pension system as a percentage of GDP from 1999 to 2010.

Figure 6

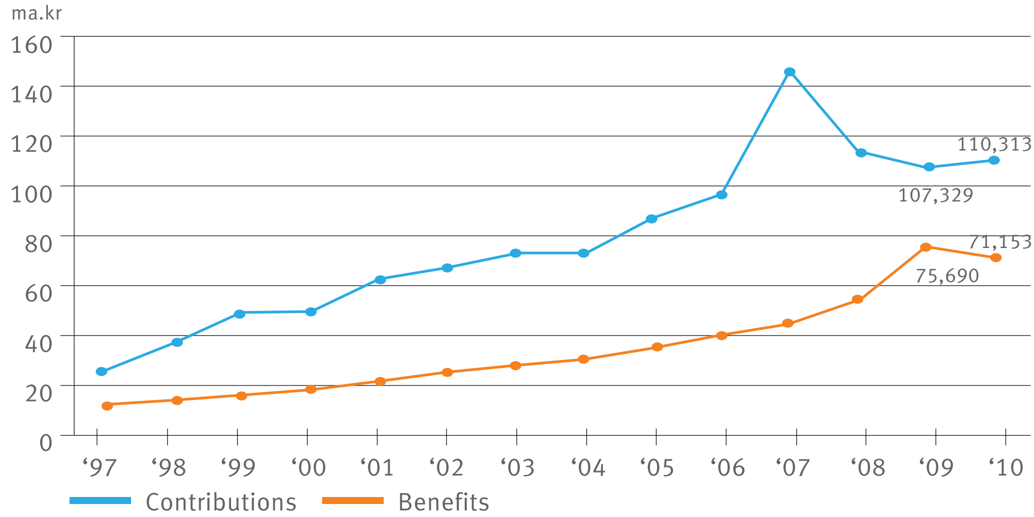
Pension fund assets and GDP



Contributions to the pension funds (mutual insurance and personal pension funds) were on a rising trend after the entry into force of the Act on Pension Funds through 2007, as shown in Figure 7, which depicts the development of pension fund contributions and payments since 1997. For the past two years, however, contributions have decreased from close to ISK 146 billion in 2007 to ISK 107 billion in 2009, as compared to ISK 110 billion in 2010. It must be borne in mind, however, that the high pension fund contributions in 2007 are partly due to a settlement by the City of Reykjavik of obligations to the Pension Fund of Employees of the City of Reykjavik. Contributions to the fund amounted to ISK 24 billion. Pension fund benefits, which have always been increasing, declined for the first time in 2010, presumably because benefits were at a maximum in 2009 due to a special authorisation to withdraw benefits out of the personal pension savings. The authorisation remained in effect in 2010, but its utilisation appears to have been less than in 2009.

Figure 7

Pension fund contributions and payments 1997-2010

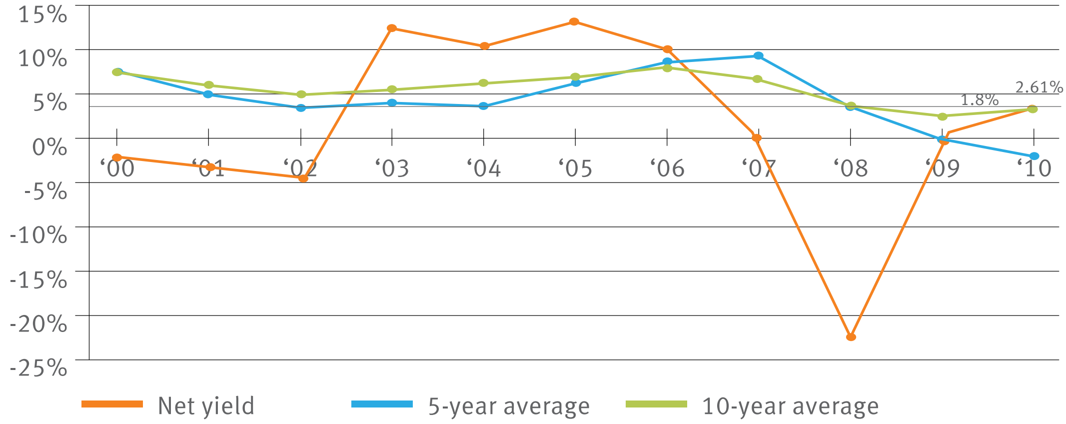


Yield

The net real yield of the pension funds rose between the two years to 2.6% in 2010, as compared to 0.3% in 2009. A pension fund's net real yield is the nominal yield adjusted for the consumer price index net of expenses from investment income. It must be borne in mind, however, that pension funds are long-term investors and it is important therefore to consider their long-term yield in assessing their performance. As can be seen in Figure 8, which shows the trend of the net real yield of the pension funds from the year 2000, the ten-year average real yield of the funds is still positive despite small or negative yields during the past four years. The five-year average real yield, however, is negative because the average includes only one year in which the real yield was satisfactory.

Figure 8

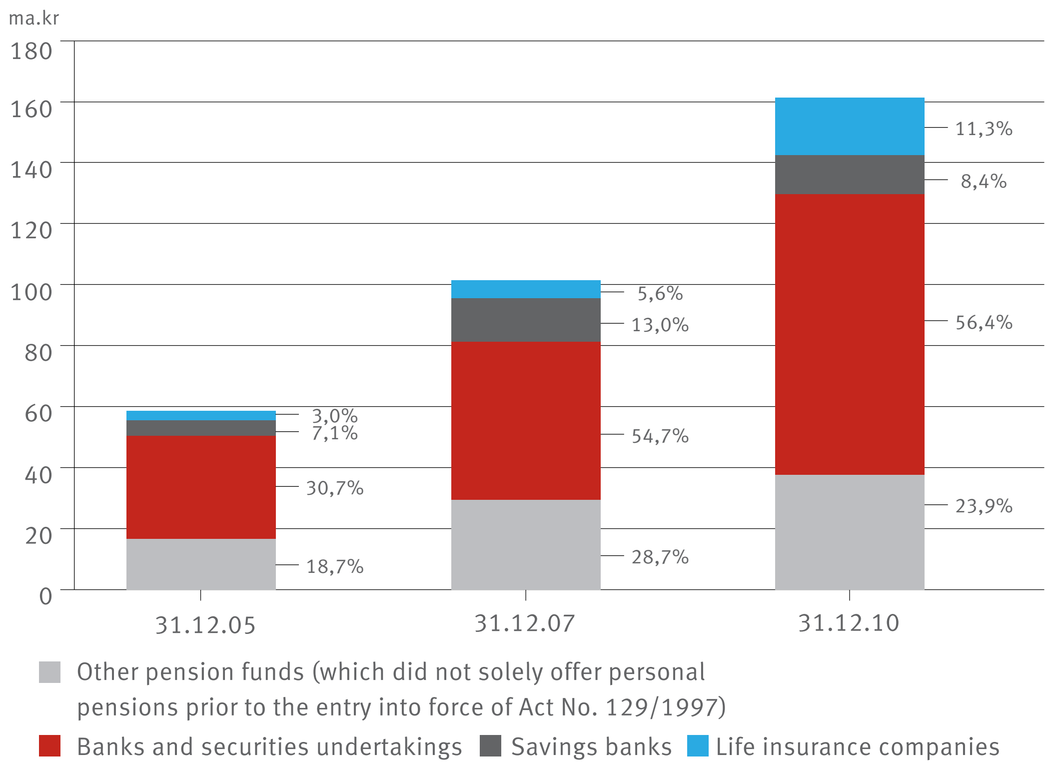
Net real yield of pension funds 2000-2010



As noted earlier, the net real yield of the pension system as a whole was approximately 2.6% in 2010. In this context it should be pointed out that the pension funds set their target yield at 3.5% based on a regulatory stipulation that the present value of prospective benefits and future contributions should be calculated on the basis of a target yield of 3.5% above the change in the consumer price index.

Figure 9

Accumulated personal pension savings (excluding pension funds solely offering personal pensions prior to the entry into force of Act No. 129/1997)



Additional insurance protection and personal pension savings

Pension funds, banks, savings banks, securities companies and life insurance companies are authorised to accept contributions to pension savings and additional insurance protection beyond the mandatory minimum insurance protection under the provisions of the Act on Pension Funds. The savings are personal pension savings, since they represent a separate property which is inherited in full at the death of the legal owner. With Act No. 171/2008, amending Act No. 129/1997, the investments of the custodians of personal pension savings were made subject to supervision but prior to that time only the personal savings divisions of the pension funds were subject to supervision. The Act entered into force on 1 January 2010 and it authorises more flexible investment options for that part of contributions which are marked for personal pension savings and additional insurance protection.

At year-end 2010 cumulative personal pension savings with pension funds and other custodians amounted to ISK 314.4 billion, as compared to ISK 288.4 billion at year-end 2009. Thus, these savings rose by 9% between the two years. Figure 9 shows the allocation of personal pension savings, at year-end 2005, 2007 and 2010, by custodians other than those who previously had operated as purely personal pension funds. Cumulative personal pension savings with parties other than pension funds, i.e. banks, securities companies, savings banks and life insurance companies, amounted to a total of ISK 124 billion and was divided between them as shown in the chart. If personal pension savings at year-end 2010 with custodians other than pension funds, in the amount of ISK 124 billion, are added to the net assets of the pension funds, it is evident that the total assets of the pension system amounted to ISK 2,033 billion, or 132% of GDP compared with 126% in 2009.

The pension funds' investment authorisations

The Act on Pension Funds contains detailed provisions on the pension funds' investment authorisations. The funds are required to formulate an investment policy and seek returns on their investments by taking into account the best terms available at any given time in respect of yield and risk. Therefore, the funds must consider the risks involved in investment options no less than the expected yield. The Act specifies all types of investments which are authorised for the funds. The investments include all principal types of transferable securities, deposits and hedging derivatives. At the same time, limits are specified in respect of individual types of investment, individual issuers of securities, foreign securities and unlisted securities, generally in the form of a percentage of the funds' net assets. The investment authorisations of the Act on Pension Funds are predicated on the exercise of caution in investment decisions and on the existence of clear legal authorisations for the allocation of the funds' financial resources. The legislation was designed to reflect the important interests which the funds are meant to safeguard, namely, mandatory pension savings to ensure minimum living standards in retirement. All decisions taken on investments and the funds' investment authorisations must incontestably be guided solely by the interests of their members. Rapid development and growth of the financial market entail increased competition and an ever-increasing variety of investment options which are available to the funds. The above has required, among other things, interpretations by the Financial Supervisory Authority as to whether investments undertaken by the pension funds, or in which they are interested, comply with the investment authorisations of the Act on Pension Funds.

Detailed legislation requires reasonable development in light of experience gained and changed circumstances. The investment authorisations for the personal pension savings of the pension funds were broadened when the custodians of personal pension savings were made subject to supervision, and now investment authorisations are the same for all personal pension savings. The personal pension savings of the pension funds and custodians are now known by a single name, custodians of personal pension savings, and increased equality has therefore been established among those parties who receive personal pension savings.

Broadened investment authorisations call for greater responsibility including, among other things, greater emphasis on a sound internal organisation, especially in respect of internal controls and risk management, and the professionalism and knowledge which the pension funds must possess. Knowledge of investment options and ability to analyse them becomes ever more important and the legislature has now demanded that as of 1 January 2011 the pension funds must employ a person who has been certified in securities transactions. Moreover, the legislation now imposes more stringent requirements on the directors and board members of the pension funds. This has come about following major changes in the financial market over the past few years. The expansion of the pension funds through mergers and rapid growth of the funds' assets will make it possible for more funds to meet such demands in the future.

Management companies of UCITS, securities and investment funds

Management companies of UCITS which are subject to supervision by the Financial Supervisory Authority were eight at end-June 2011, unchanged from a year earlier. The companies operate a total of 53 UCITS and divisions and 22 investment funds and divisions. The total assets of UCITS and investment funds at end-June 2011 amounted to over ISK 295 billion, of which UCITS accounted for over ISK 251 billion and the investment funds for over ISK 44 billion. Figure 10 shows the number of UCITS and investment funds of each management company and assets managed by them.

Figure 10

Assets of UCITS and investment funds - as at 30 June 2011.

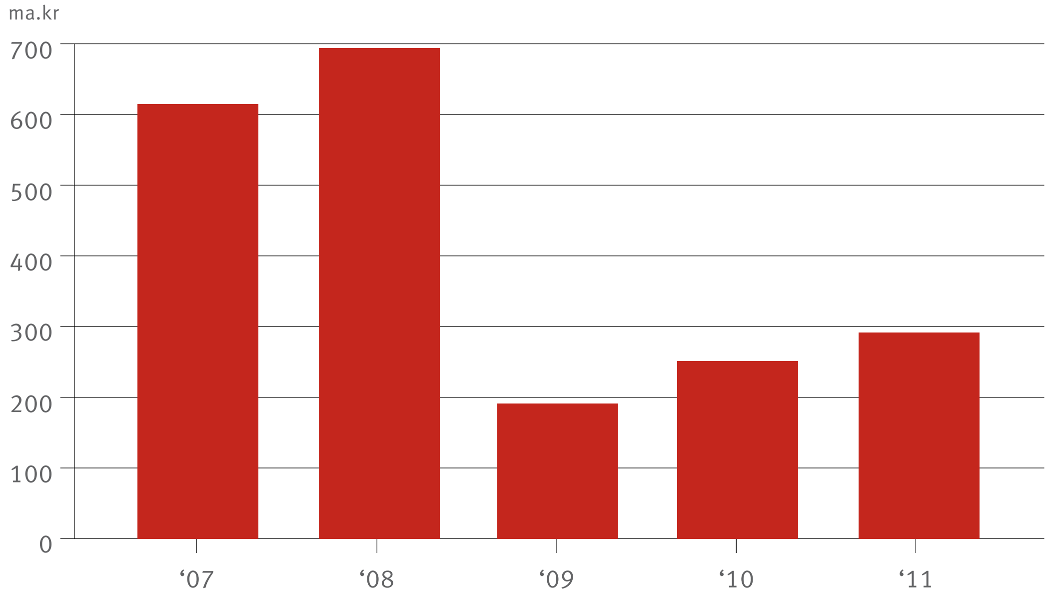
	UCITS	Investment funds	Assets in ISK billion
Islandssjoðir	10	2	118
Stefnir	11	12	103
Landsvaki	10	3	41
Rekstrarfelag verðbr. sj. IV hfl.	10	2	15
Rekstrarfelag Byrs hf.	5	1	2
GAM Management hf.	3	0	8
Jupiter rekstrarfelag hf.	4	2	8
Landsbref	0	0	0
Alls	53	22	295

Trends in the assets of UCITS and investment funds

The assets of UCITS and investment funds, according to Act No. 30/2003, on UCITS and investment funds, increased by 20% between the years 2010 and 2011. It appears that the decrease of the assets of UCITS and investment funds which took place in 2008 and 2009 is being partaly reversed. Figure 11 shows the trend in the assets of UCITS and investment funds during the years 2007-2011. As the chart shows, the assets of the funds decreased by 72% between the years 2008 and 2009 in the wake of the banking collapse of October 2008.

Figure 11

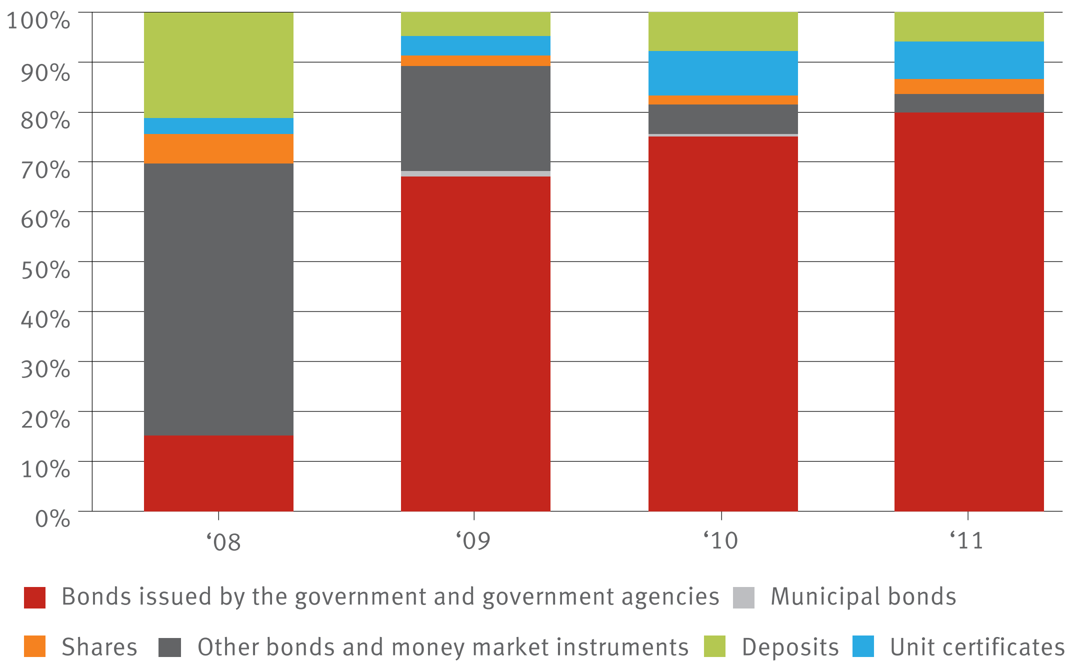
Assets of UCITS and investment funds - as at 30 June 2011



The majority of the assets of UCITS and investment funds is in the form of bonds issued by or guaranteed by the Icelandic State, or 78% of the funds' total assets. Investment in shares has increased slightly since 2010, with their percentage share of total assets at 4% as at 30 June 2011, as compared to 2% a year earlier. Figure 12 shows the asset composition of UCITS and investment funds for the years 2008-2011, as at 30 June each year.

Figure 12

Assets of UCITS and investment funds as at 30 June each year



As shown in Figure 12, investment in bonds issued by or with the guarantee of the Icelandic State has increased greatly over the past three years, with the main offset being in other bonds and deposits. Investment in unit trust certificates has also increased considerably, and in mid-year 2011 investment in unit trust certificates accounted for 8% of total assets, as compared to 2% at the same time in 2008.

2. 4 Insurance market

There have been major changes in the insurance market since the issue of the last Annual Report of the Financial Supervisory Authority. Sjova-Almennar tryggingar hf. (Sjova) is now in the hands of new owners, a change of managing directors was made by Vatryggingafelag Islands hf. last May and also by Sjova-Almennar tryggingar hf. in September.

The number of insurance companies remains unchanged from the previous year, i.e. seven non-life insurance companies and five life insurance companies. Four of the life insurance companies are either affiliates or subsidiaries of the non-life insurance companies and the fifth is a subsidiary of Arion banki hf. The Iceland Catastrophe Insurance, which provides mandatory insurance against natural disasters and covers direct loss of insured assets caused by volcanic eruptions, earthquakes and the like, is also subject to supervision by the Financial Supervisory Authority. Six insurance brokers operate in Iceland, acting as brokers for various types of insurance to domestic and foreign companies.

In 2009 Sjova received financial assistance from the government to avoid impending bankruptcy. A sales process was initiated for the company in early 2010 and, after the tender procedure was concluded, the company was sold in summer 2011 to a group of investors, both private entities and pension funds.

Sjova's competitors contend that the government's involvement has affected competition in the insurance market and have submitted a formal complaint to the EFTA Surveillance Authority (ESA). The complaint has not been acted on yet, but a ruling is expected later in 2011.

Various aspects of the operations of Vatryggingafelag Islands hf. during the period from February 2008 to February 2010 were reviewed by the Financial Supervisory Authority. The review concluded with a report in which several aspects of the company's operations were criticized and demands made for improvements in respect thereof. Moreover, the review concluded that it was appropriate for the company's Managing Director to give up his post, which he did in May 2011. Tryggingamidstodin hf. was also subject to a similar review. The review concluded with a report in which several aspects of the company's operations were criticised and demands made for improvements in respect thereof. Today most of these improvements have been made.

The Financial Supervisory Authority is working on the entry into force of the Solvency II Directive, which calls for solvency requirements to reflect to a greater extent all risk factors in an insurance company's operations in addition to stipulating more stringent requirements for the governance of insurance companies. In order to prepare the insurance companies for the directive's requirements the Financial Supervisory Authority in January 2011 issued guidelines No. 1/2011 on risk management by insurance companies. Their objective is to provide guidance to the companies on the most effective implementation of risk management, the guidelines being twofold: on the one hand, they address arrangements for coordinated risk management and, on the other hand, for the management of individual risk factors. The guidelines have resulted in a review of the insurance companies' procedures for risk management in order to ensure that the requirements set forth in Solvency II are met.

The Insurance division takes part in the foreign cooperation of the European Insurance and Occupational Pension Authority / EIOPA, and its staff serves on expert committees on the introduction of Solvency II and committees on insurance brokerage. The Insurance division also takes part in the activities of IAIS (International Association of Insurance Supervisors) where the Financial Supervisory Authority has been a member since its founding in 1994.

The Icelandic insurance companies participated in the EIOPA's fifth examination of the implications of Solvency II (QIS5), which took place in the fall of 2010. The results of the examination indicate that insurance companies are generally well prepared financially to meet the Solvency II requirements, but it must be borne in mind that companies differ in this respect. QIS5 also indicated that insurance companies need to act in a timely manner on the requirements in respect of governance, risk management and the provision of information, e.g. with improvements of information systems and staff training. Following the examination, the Financial Supervisory Authority held presentation meetings with the boards of insurance companies in the spring of 2011 to provide information on the Solvency II arrangements and the obligations entailed by the change in the legislative environment.

The new Act on Insurance operations No. 56/2010, which entered into force in June 2010, stipulated that the boards of insurance companies should in accordance with Article 54 (1) adopt certain internal rules in respect of internal control and audit, investment activities, loan provisions and transactions with related parties, and should submit them to the Financial Supervisory Authority for confirmation. All the insurance companies have submitted such rules to the Financial Supervisory Authority and work is now in progress on reviewing them and formulating the Authority's position and the preconditions for confirmation of the rules in question.

In early summer of 2011 EIOPA conducted a stress test on all insurance companies in the European Economic Area. In each market the largest life insurance and non-life insurance companies were selected, that is companies with a combined market share of over 50% in their respective markets. The largest Icelandic life and non-life insurance companies participated in the stress test and withstood the setbacks for which they were tested.

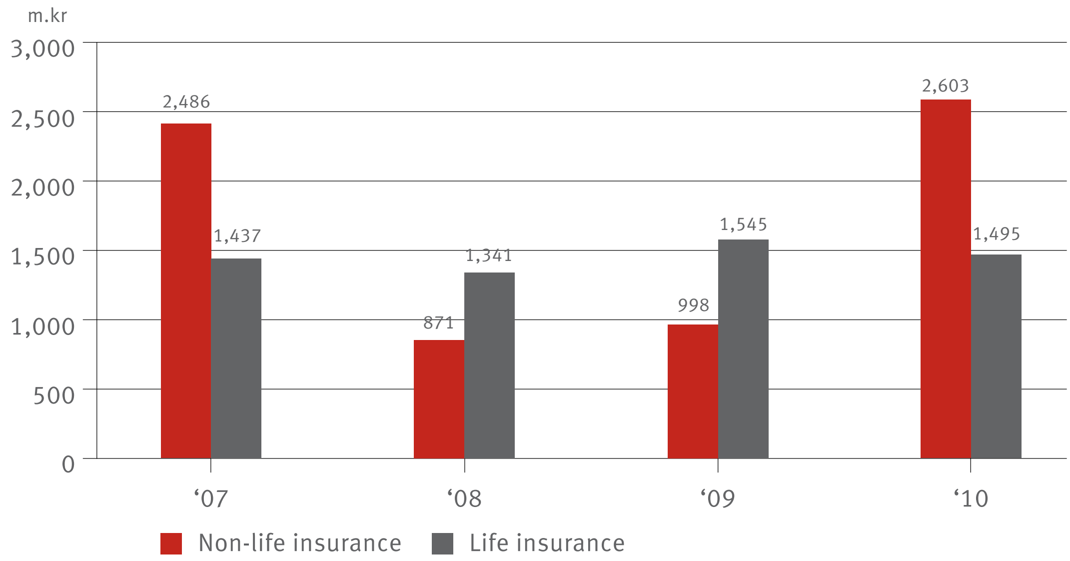
Insurance company performance in 2010

The impact of the financial crisis in October 2008 has left its mark on the activities of the insurance companies. All of them have been reorganising their activities with a view to reducing costs and increasing profits. Several of the insurance companies have achieved good results in reducing costs and increasing profitability.

Activities in the insurance market are divided between non-life insurance companies and life insurance companies. The operations of the non-life insurance companies are divided into insurance activities, which are the core activities of the companies, and investment activities which aim at earning returns on the assets which provide cover for insurance obligations. The profit of the insurance companies on non-life insurance activities almost tripled from ISK 1.0 billion in 2009 to ISK 2.6 billion in 2010. Profit on life insurance activities remained unchanged between years and has not changed much in recent years. Total profits on insurance operations amounted to ISK 4.1 billion in 2010. However, there was a loss of almost ISK 600 million on the companies' investment activities, due mainly to a change in the assessed value of investments which was reduced by a total of almost ISK 2 billion during the year.

Figure 13

Profits in the non-life and life insurance sectors (at 2010 price levels)



The assets of the non-life insurance companies increased by 5.7% over the year, amounting to a total of more than ISK 124 billion at year-end 2010, as compared to almost ISK 118 billion a year earlier.

The own funds of the non-life insurance companies increased by 8.5% over the year and now amount to a total of ISK 35 billion, excluding the Iceland Catastrophe Insurance. The own funds position varies between companies. With the entry into force of new legislation on insurance operations, minimum solvency requirements were increased substantially, to a level comparable to the euro amounts which are applicable under European directives. The minimum solvency of non-life insurance companies now must not fall below the equivalent of EUR 3.2 million, or approximately ISK 500 million based on the current exchange rate.

The assets of life insurance companies rose by 6.1% during the year, amounting to a total of ISK 14.3 billion at year-end 2010, as compared to ISK 13.5 billion at year-end 2009. The combined own funds of the life insurance companies were ISK 6.0 billion, increasing by 12.8% over the year. As in the case of the non-life insurance companies, the minimum solvency of life insurance companies must never fall below the equivalent of ISK 500 million. Islensk endurtrygging hf. and Trygging hf. have ceased issuing new insurance policies and, therefore, are exempt from this provision.

No financial requirements are specified for insurance brokers but they must be able to meet their obligations. Total fees of insurance brokers for 2010 amounted to ISK 568 billion and aggregate profits of insurance brokers after tax for the year 2010 were ISK 93 billion.

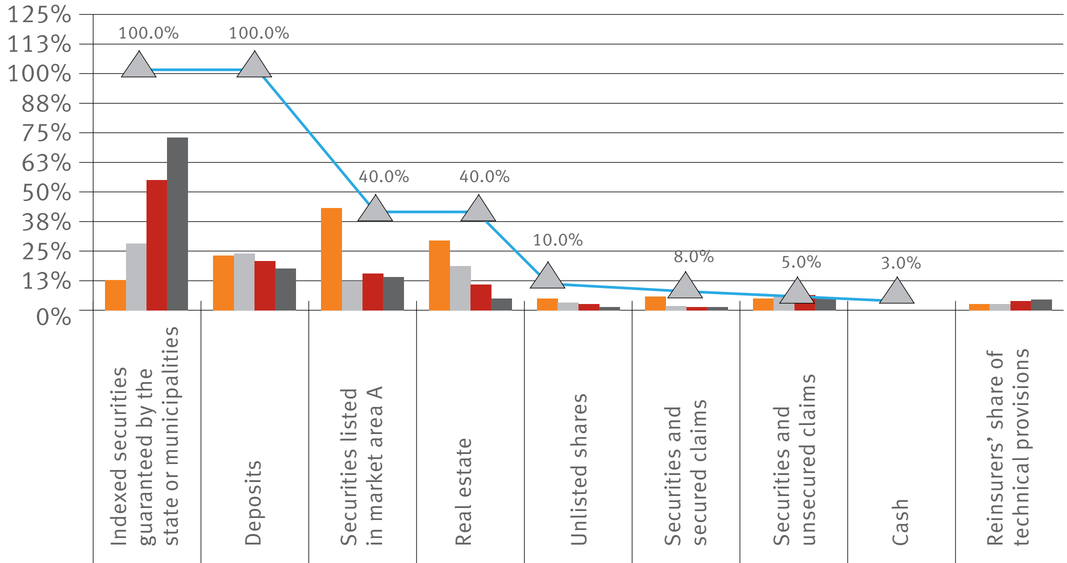
Assets to cover technical provisions at year-end 2010

There have been major changes in the asset composition of the companies, i.e. in those assets which are intended to meet insurance obligations (often called benefit funds), in recent years. Briefly, there has been a substantial decrease in the companies' holdings of shares and unit trust certificates. The investment opportunities of the companies are restricted, among other things because of foreign exchange restrictions and, therefore, their holdings of government guaranteed bonds have increased substantially.

The largest individual assets of insurance companies to cover technical provisions at year-end 2010 are listed securities guaranteed by the government or municipalities, i.e. public bodies; such assets amount to almost 72% of the insurance obligation with deposits in commercial banks and savings banks amounting to approximately 17% thereof. It is permissible for these assets to cover a company's entire insurance obligation. It is clear that the companies have increasingly been changing their asset composition by selling Icelandic shares from their asset portfolios and placing the sales proceeds in listed bonds, government bonds and bank accounts, reflecting to a large extent the situation in the financial markets.

Figure 14

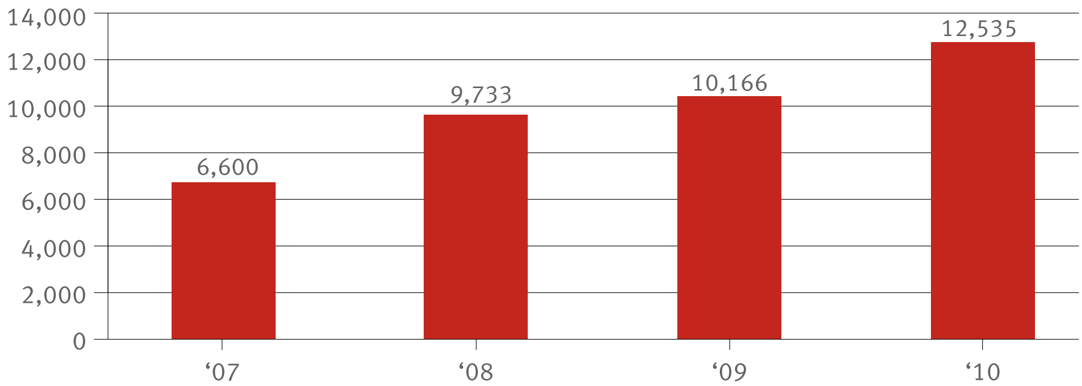
Investment of assets to cover technical provisions in 2007-2010



	Indexed securities guaranteed by the state or municipalities	Deposits	Securities listed in market area A	Real estate	Unlisted shares	Securities and secured claims	Securities and unsecured claims	Cash	Reinsurers' share of technical provisions
'07	13.3%	22.6%	45.0%	27.9%	5.2%	5.4%	4.2%	0.0%	2.4%
'08	30.1%	23.8%	11.8%	17.2%	3.3%	1.5%	6.1%	0.0%	2.7%
'09	54.9%	20.2%	15.0%	15.0%	3.9%	0.9%	6.3%	0.0%	3.5%
'10	72.7%	17.1%	13.7%	13.7%	3.2%	1.0%	5.7%	0.0%	4.2%
Limit	100%	100%	40.0%	40.0%	10.0%	8.0%	5.0%	3.0%	

The changed situation in financial markets is also reflected at the consumer level, and an examination by the Financial Supervisory Authority of cancellations of insurance contracts on the initiative of an insurance company reveals that there has been a large increase in the number of contracts cancelled by insurance companies due to late premium payments. During the period 1 January 2007 – 1 December 2010 the number of cancellations for this reason has been increasing year by year.

Figure 15 Number of cancelled insurance contracts due to late payments by policy holders



3. Looking ahead

3. 1 Strategy implementation

The board of the FME presented a strategy for the Agency at the annual meeting a little less than a year ago, focusing on three dimensions of supervision: Substantive supervision, forensic and preventive supervision, and formal supervision.

Substantive supervision involves monitoring compliance and sound business practices, which is the first pillar of the strategy, effective exercise of powers, developing legislation, enhanced analysis and special audits, dissemination of information and relations, and imposition of sanctions. Independent analysis and evaluation, which represents the second pillar of the strategy, enables the FME to carry out forensic and preventive control based on containing risk, examining the competency of officers and directors and micro-macro level analysis. The third pillar of the year-old strategy is professional discussion and transparency. The FME will strive to facilitate the free flow of information and informed and objective discussion on trends in the financial markets. It will also take the initiative in the dissemination of information and analysis and participate actively in the public debate.

Many of the tasks carried out in 2011 had the aim of supporting and implementing this strategy. The FME has developed a special information policy to strengthen and coordinate the supply of information. The information policy emphasises the importance of collaborating with regulated entities and disseminating information about key aspects of the financial sector to the FME's target groups. The FME further stresses the need for making the agency's role visible to consumers, regulated entities and other interested parties, for disclosing the measures taken by the FME to protect users of financial services and for sharing information about the agency's international collaborations in the area of financial supervision.

3.2 The future and main objectives

Over the past three years the activities of the FME have been adapted to the new environment created by the banking collapse. About a year ago the board of the FME approved an ambitious strategy that calls for a larger staff and effective information systems. It may be said that one of the agency's main objectives is to carry out detective and preventive control.

The Icelandic authorities' Letter of Intent to the International Monetary Fund (IMF) provides that the FME should draft a two-year action plan designed to ensure that the agency complies with the Basel Committee's Core Principles for Effective Banking Supervision. It has been established that the FME needs to improve its methods of assessing risk factors in the operations of financial undertakings. As a part of this plan, the FME has been working on selecting a partner country for the purpose of developing a permanent risk assessment system. This work is progressing well.

It is important for the FME to have sufficient statutory powers allowing it to fulfil its supervisory duties and follow up on decisions, in addition to ensuring its independence from outside interests. It is clear that the FME's responsibilities will expand in the near future. The agency has been entrusted with the supervision of winding-up boards and resolution committees of insolvent financial undertakings as well as oversight of payment service companies. The FME will furthermore take over the task of reviewing prospectuses from OMX Iceland.

4. Regulated entities

4.1 Number of regulated entities 30.06.2011

On 30 June 2011 the number of entities subject to FME regulation was as follows:

	Number 30.06.2011 *)	Governing law
Commercial banks	6	Act No. 161/2002 on financial undertakings
Savings banks	10	Act No. 161/2002 on financial undertakings
Credit undertakings	8	Act No. 161/2002 on financial undertakings
Co-operative deposit depts.	1	Act No. 22/1991 on co-operatives
Securities undertakings	13	Act No. 161/2002 on financial undertakings
Securities brokerages	3	Act No. 161/2002 on financial undertakings
Management companies of UCITS	8	Act No. 161/2002 on financial undertakings
UCITS -53**)		Act No. 30/2003 on UCITS and investment funds
Investment funds - 22**)		Act No. 30/2003 on UCITS and investment funds
Stock exchanges and other regulated OTC markets	1	Act No. 110/2007 on stock exchanges
Central securities depositories	1	Act No. 131/1997 on the electronic registration of title to securities.
Pension funds	33	Act No. 129/1997 on the mandatory guarantee of pension rights and the operation of pension funds
Insurance undertakings	13	Act No. 56/2010 on insurance
Insurance brokerages	6	Act No. 32/2005 on insurance brokerage
Debt collection agencies	6	Act No. 95/2008 on debt collection
Other regulated entities	3	Various acts of law
Total	**112**	

*) The table does not include financial undertakings in winding-up proceedings, i.e. Glitnir Bank hf, and Kaupthing Bank hf., whose licences were revoked on 19 July 2011. Also, Landsbanki Islands hf. is not included; its operating licence was revoked in part on 15 September 2011 and is now restricted to activities which are necessary fro the administration of the estate and disposal of its interests.

The operating licences of the following financial undertakings in winding-up proceedings were revoked in early 2011: Askar Capital hf., Byr Savings Bank, Frjalsi Fjarfestingabankinn hf., Sparisjodabanki Islands hf. (Icebank), Keflavík Savings Bank, Reykjavík Savings Bank hf (SPRON), VBS Fjarfestingabanki hf. In addition, the Myrarsysla Savings Bank, which had earlier entered into composition, was merged with Arion Bank hf. toward the end of 2010 and Avant hf., which had also entered into composition, was merged with Landsbanki hf. in 2011.

**) UCITS and investment funds are operated by management companies. The funds are not included in the total number of regulated entities.

4.2 Activities of foreign entities in Iceland

The following table shows the number of entities/companies having permission to offer services in Iceland in 2011 pursuant to rules that apply in the European Economic Area:

Non-established foreign banks	222
Undertakings for collective investment in transferable securities (UCITS)	47
Investment firms/brokerages	2113
Established insurance companies	2
Non-established insurance companies	405
Insurance brokerages and agents	5158

5. Highlights from the FME Annual Financial Report for 2010

Below are highlights from the FME Annual Financial Report for 2010
The annual accounts were confirmed by the board of directors of the Financial Supervisory Authority on 31 May 2011 and endorsed by the National Audit Office on the same day. The annual financial report is published in its entirety on the FME website: www.fme.is.

Profit and Loss Account 2010

	2010	2009
Income		
Income from supervision fees	1,143,217,311	777,588,000
Other income	124,788,106	13,803,467
	1,268,005,417	791,391,467
Expenses		
Salaries and related expenses	817,790,064	645,663,131
Complaints committees	12,723,784	8,453,303
General & administrative expenses	63,061,119	55,237,601
Travel and personnel-related expenses	36,034,988	32,555,141
Expert services purchased	162,872,402	314,370,880
Operation of equipment	26,723,935	22,499,314
Other operating expenses	36,902,693	31,407,204
Housing	66,437,068	62,288,290
Transfers	147.275	131,900
	1,222,693,328	1,172,606,764
Purchased assets	10,582,375	7.688.147
	1,233,275,703	1,180,294,911
Operating profit / (loss)	34,729,714	(388,903,444)
Financial Income	19,383,860	30,799,072
Profit / (loss) before Treasury contribution	54,113,574	(358,104,372)
Treasury Contribution *)	0	18,500,000
Profit / (loss) for the year	54,113,574	(339,604,372)

*) In 2009 a special allocation of ISK 18.5 m was paid out of the Treasury to the FME in connection with the FME's expenses resulting from actions taken on the basis of Act No. 125/2008 on authorisation for appropriations from the State Treasury in respect of the special circumstances in the financial market etc.

Balance Sheet 31 December 2010

Assets	2010	2009
Current assets		
State Treasury	0	14,180,002
Accounts receivable	91,903,206	179,235,046
Other receivables	8,414,554	2,563,937
Cash and Cash Equivalents	184,401,897	125,059,329
	284,719,657	321,038,314
Total assets	284,719,657	321,038,314
Equity and liabilities		
Equity		
Principal at the beginning of the year	188,739,387	528,343,759
Profit / (loss) for the year	54,113,574	(339,604,372)
Equity	242,852,961	188,739,387
Current liabilities		
State Treasury	5,418,748	0
Current liabilities	35,488,877	129,844,643
Other short-term liabilities	959,071	2,454,284
Liabilities	41,866,696	132,298,927
Equity and liabilities	284,719,657	321,038,314

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