securities market

credit market

pension market

insuarance market

Annual Report 2006

The Period July 1st 2005 to June 30th 2006

FJÁRMÁLAEFTIRLITIÐ
THE FINANCIAL SUPERVISORY AUTHORITY, ICELAND

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INTRODUCTION

The Annual Report of Fjármálaeftirlitið (FME), the Financial Supervisory Authority of Iceland, presented here gives a summary of the FME's activities from July 1st 2005 to June 30th 2006. The Report also covers trends and outlook on the Icelandic financial market and gives an account of areas which will be emphasized by the FME in coming months. It contains a list of parties subject to supervision as of June 30th 2006 and an explanation of changes in their operating licences during the period covered by the Report. Changes to financial market legislation and regulations during this same period are also summarized. Some main figures from the FME's annual accounts for 2005 are published in the final section of the Report.

As in previous years, the FME's Annual Report is published in Icelandic and English. Both versions are also available on the FME website, www.fme.is. The website also includes a variety of information concerning the Icelandic financial market and arrangements for the public supervision of financial activities.

FME Board of Directors:
Stefán Svavarsson, Certified Public Accountant, Chairman
Lárus Finnbogason, Certified Public Accountant, Vice-chairman
Ingimundur Friðriksson, Deputy Governor of the Central Bank of Iceland

Alternates:
Kjartan Gunnarsson, Head of Department, Ministry of Industry and Commerce
Þuríður I. Jónsdóttir, District Court Attorney
Sigríður Logadóttir, Chief Attorney, Central Bank of Iceland
(Lilja Steinþórsdóttir, Chief Auditor, Central Bank of Iceland, to August 31st 2006)

Director General: Jónas Fr. Jónsson
Deputy Director General: Ragnar Hafliðason

1 OVERVIEW OF FME ACTIVITIES FROM JULY 1ST 2005 TO JUNE 30th 2006

1.1 Transformations in the Icelandic Financial Market

The financial market in Iceland has undergone revolutionary changes in the last two years. Icelandic financial undertakings have considerably increased their activities abroad and to some extent paved the road for the overseas expansion of Icelandic businesses. The contribution of the financial sector to the national economy has grown correspondingly and in 2005 its contribution to the GDP exceeded for the first time the contribution of the fisheries sector. According to a survey conducted earlier this year by the Economics Research Centre of Reykjavík University, the contribution of the financial services sector to the national economy amounted to 8% of GDP. The Icelandic banks have grown fivefold since the end of 2002, and in 2005 alone they grew by 80%. This has brought about changes in the banks' revenue base and this year income from overseas activities is estimated to reach 60% of total income, compared with 25% in 2003. There has also been a dramatic growth in the Icelandic pension funds as their net assets grew by 22% in 2005. Since 2002 the Icelandic pension funds have grown by 115%. The assets of insurance companies have increased by 68% since 2002 and trading in shares at the Iceland Stock Exchange grew by 274% during the same period.

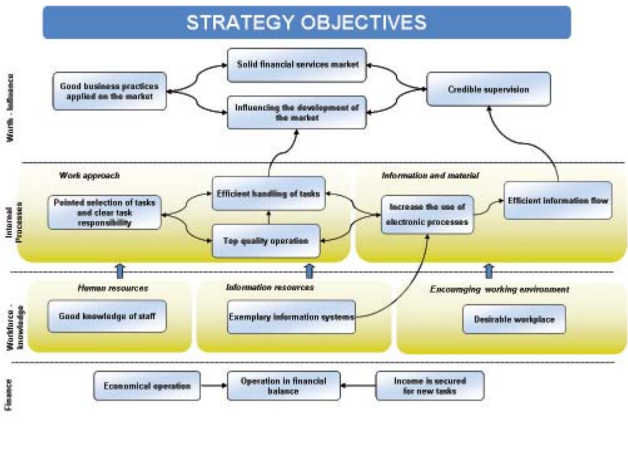
Parties subject to the FME's supervision are currently around 136 and many of them are involved in considerable business operations abroad. The flourishing activities of financial undertakings and insurance companies in international markets, together with the establishment of overseas branches and offices, have placed greater supervisory demands on the FME. To respond to this, the FME has restructured its strategy with an emphasis on more clearly defined goals and objectives, project prioritization and more strict performance requirements. A compliment to the FME's new strategy is a new organizational chart which is intended to minimize reaction time and provide a clearer overview of task responsibility. A considerable increase in the FME's budget has made it possible for the FME to recruit more specialists, but at the same time increased demands are being made regarding the professional expertise and experience of current employees.

In 2006 the Icelandic financial market received considerable attention from foreign analysts and media. It is safe to say that Icelandic financial undertakings have, for the first time, come up against what is known as reputational risk, where foreign parties have not only been focusing their attention on the companies involved, but rather on the financial system as a whole. The FME has received its share of this overseas attention and has so far this year organized over 50 meetings with foreign analysts, representatives of international organizations, financial undertakings and journalists, or what amounts to a total of around 250 individuals. These meetings have generally resulted in a positive coverage of financial supervision in Iceland, even though commercial banks and credit undertakings were dealing with a somewhat more mixed reporting at that time. The FME anticipates that this part of its activities will continue to grow even more.

1.2 Organization and Strategy

At the end of 2005 the FME adopted a new strategy. The implementation of this new strategy in day-to-day activities began early 2006 together with work on ten principal action points that were considered necessary in order to achieve the strategy objectives. The FME has in recent years conducted evaluations of various aspects of its activities, but felt there was need for more clearly defined criteria by which to measure its value or impact, i.e. how FME work contributes to society. The Balanced Scorecard concept was used to formulate and communicate the FME's strategy, define objectives and manifest its value through performance evaluations. The year 2006 will be a pilot year where measurements and related activities will be fine-tuned. Actual measurements based on the new strategy will begin early in 2007 and the results will be published in the beginning of 2008.

The driving force behind the strategy and performance management is the ambition to sharpen the focus and prioritize and make the FME a more result-driven organization. The chart below shows the FME's Strategy Objectives based on the Balanced Scorecard concept. The chart is the FME's roadmap, which indicates where the FME is heading and how to get there. Furthermore, the FME has drawn up plans as to how to achieve its objectives and what yardsticks will be used to measure this achievement.



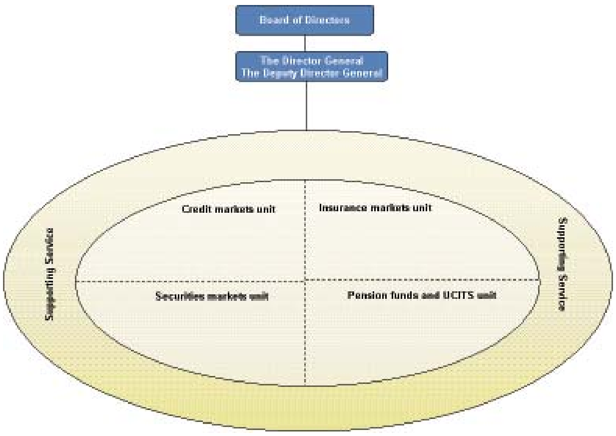
The ten action points are an integrated part of the FME's objectives for 2006 and therefore a part of the day-to-day activities of the organization.

Project status and individual tasks are regularly reviewed with each responsible employee, as well as in each project group, at division briefings, and at weekly staff meetings.

These action points involve the implementation of necessary changes for the FME to be prepared to meet increased requirements and to realize its vision. The development of a new IT strategy, which will be dealt with in later sections of this Report, is one example of the major action points that were initiated at the beginning of 2006 in order to improve operational efficiency by use of electronic processing. Another important action point is the FME's strategy concerning its increased responsibility and function relating to the overseas acquisitions of Icelandic financial undertakings.

A new organizational chart for the FME was introduced in September 2006. Built into this new chart is a more clearly defined task responsibility, delegation of power, reduced reaction time and better time management, which all help to give the FME greater scope to adapt to changing demands and requirements. The new organizational chart is also a reflection of the FME's strategy objectives of being more visible and having the capacity to promote and influence the development of a stable financial market.

The activities of the FME are divided between four operational units and a supporting service under the control of the Director General. The Director General decides which tasks fall under each unit and supporting service. The Director General may appoint one or more individuals as heads of units and delegate to them responsibility over certain tasks. The Deputy Director General is the alternate to the Director General. In addition, the Director General may delegate responsibility over certain tasks to the Deputy.



As a workplace, the FME can be described as an institution with open management styles, high level of employee education and a dynamic team spirit. There is a special emphasis on continuing education, clear division of responsibility and professional progress.

The work environment is characterized by variety, interdisciplinary cross-functional cooperation and participation in international projects. The average age of employees is 42 years. Staff turnover was 8.7% in 2006, compared with 17.1% in 2005. Around 40% of FME employees have postgraduate degrees from foreign universities and 26% have experience from working abroad.

The aim of the FME's human resources strategy is to create a positive work environment which fosters knowledge and respect for the individual. It also reflects the FME's endeavours to become an attractive workplace which encourages enthusiasm, harmony and responsibility. A positive team spirit is important as well as the opportunity for all employees to make the best use of their potential and to further their knowledge and skills. The objective is that FME employees have sufficient skills and knowledge to take on a range of different projects. In order to achieve this objective the FME offers its employees to attended courses and seminars both at home and abroad. A good example of such ongoing education at the FME is a course in project management and improved decision-making skills at Reykjavík University, which was attended by a number of FME employees.

The FME has operated an active education policy and education committee since the year 2000 with an emphasis on sound professional knowledge and lifelong learning. A good measurement of success in this area is the actual number of employees who continue to make use of the educational offers available. Career opportunities and staff exchanges are currently being developed in collaboration with other European supervisory authorities in order to give employees a better chance to improve their performance and professional growth.

At mid-year 2006 the FME had a staff of 45, including temporary employees.

- 14 Economists and business specialists
- 10 Lawyers
- 2 Actuaries
- 4 Computer specialists
- 5 Other specialists
- 4 Office staff
- 6 Temporary positions

1.3 Various Statistics on FME Activities

During the period, a total of 1123 new cases were registered with the FME. These cases vary as regards subject matter, scope and required processing time. Three major case categories are shown in Table 1 below. Communications received and submitted by the FME on account of these cases were equally varied and far greater in number, as also shown in Table 1. For comparison, figures for the preceding 12 months are also included.

Table 1

Some statistics on FME case processing	Period 1.07.2004-30.6.2005	Period 1.07.2005-30.6.2006
Cases opened during the period	1010	1123
Thereof: * Inspections based on queries to parties subject to supervision. *(A single inspection may in some instances include a number of parties subject to supervision at the same time)*	56	59
* On-site inspections	41	45
* Queries to the FME, complaints and consumer issues *(A number of informal queries is not included)*	180	167
Associated with the above cases are:		
Letters sent	3202	3222
Letters received	1792	2600
Reports from parties subject to supervision	2742	3340

Statistics on different actions provide an interesting insight into the FME's operations (Table 2). Licensing, various validations and registrations keep growing in number and totalled 336 during the period. Another large project category is remarks, comments and requests for corrective action, stated either in letters or reports. The total number of such communication during the period was 358. The Table also shows how often the FME imposed daily fines, administrative fines and financial penalties.

Table 2

Some statistics on FME actions (number of letters/decisions)	1.07.2004-30.6.2005	1.07.2005-30.6.2006
Licensing, approval, validations, registration	294	336
Thereof: Operating licenses, augmented operating licenses, validations of securities funds and investment funds.		25
Comments on the articles of association of pension funds.		19
Authorizations for qualifying holdings.		20
Remarks, recommendations, requests for corrective action *(number of letters)*	224	358
Daily fines	2	18
Administrative fines *(solely in a limited area of the securities market)*	14	15
Financial penalties	0	1
Referral to the National Commissioner of the Icelandic Police, cf. Act 87/1998, Article 12.	1	5

The FME's case record is linked to its customer relations management system, which provides information on the division of disposable time between project categories. Projects are divided into three main categories (Table 3) to obtain an overview of the nature of the Authority's activities in 2004 and 2005.

The results of this analysis show that various mandatory licensing and validations, responses to queries and collaboration took up around 36% of the FME's disposable working time in 2005. Communication in this category is largely initiated by other entities than the FME. Around 41% of the working time was spent on individual supervisory projects initiated by the FME and just under 23% on projects relating to the collection of data, the development of supervisory activities and improvements in the transparency of the market.

Table 3

Proportional division of disposable hours between major FME project categories (previous two years)*	2004	2005
Communication: Approval/counselling	**40.8**	**36.1**
Licensing and validation	10.6	8.2
Applications for qualifying holdings, eligibility assessment for managers of parties subject to supervision	3.5	3.9
Responses to queries from parties subject to supervision and their customers	8.4	5.8
Co-operations with the Central Bank of Iceland / Iceland Stock Exchange / Icelandic authorities	2.4	1.2
Housing of rulings committees	2.8	3.0
International co-operation	13.1	13.9
Actions initiated by the FME: Operations analysis / corrective measures	**36.9**	**41.3**
Supervision based on regularly submitted information (off-site)	5.4	9.1
On-site inspection	15.9	14.0
Supervision based on queries to parties subject to supervision	6.2	7.9
Market surveillance, overview and examination of cases in the securities market	9.5	10.2
Inform/create an overview/develop	**22.2**	**22.6**
Overview / data collection	10.1	8.8
Formulation of supervision and framework for the financial market	8.6	8.8
Transparency, the FME website, introductory meetings, electronic publication of annual accounts, annual report, annual meeting	3.5	4.9
	100.0	100.0

**) Recorded hours for administration, office work and work scheduling are distributed between individual categories.*

The work record also provides information on the division of the FME's activities between groups of parties subject to supervision (Table 4). This information forms the basis for determining the proportional division of supervisory cost to be remitted by these parties.

Table 4

Proportional division of disposable hours between groups of parties subject to FME supervision (previous two years)	2004	2005
Credit undertakings	47.3	54.8
Insurance companies and insurance brokers	26.7	19.4
Pension funds	17.5	19.5
Management companies of UCITS	7.1	3.3
Securities undertakings and securities brokerages	0.4	0.7
Other	1.0	2.3
	100.0	100.0

1.4 Credit Markets Unit

Emphases for the period:

- *Stress testing of CAD ratios*
- *New capital adequacy rules (Basel II)*
- *Commercial bank refinancing*
- *Consolidated supervision and collaboration with host supervisors abroad*

The continuing expansion of the activities of Icelandic financial undertakings abroad has resulted in increased collaboration between the FME and parallel institutions in the countries, inside and outside the EEA, where these undertakings have their operations. Icelandic financial undertakings are currently operating directly in 13 countries while foreign subsidiaries of these undertakings spread their activities further afield. The term 'overseas activities' refers to foreign subsidiaries, branches and representative offices.

The FME placed increased emphasis on refinancing risk. Icelandic banks are to a large extent financed by foreign loan capital and are thus highly dependent on financial markets abroad. The FME increased its information requirements in this area and surveyed the banks' strategies for offsetting refinancing risks.

There have been further developments of stress testing on the capital adequacy requirements of financial undertakings. At the beginning of the year, the testing was made stricter by allowing for a 20% weakening of the Icelandic króna and an increased strain on domestic shares held at own risk. In line with the main objective of the test, which is to sustain trust and stability in the financial market, the results of the test were published on the FME website. The stress test has met with a positive response abroad.

Work continued on the introduction of new capital adequacy rules. An international standard, the Basel II framework, which was issued in mid-year 2004, entered into force within the EU this year through the publication of two Directives: 2006/48/EC and 2006/49/EC. The introduction of this standard demands a great amount of work, but it is expected to become law in Iceland later this year. The FME has worked closely with undertakings intending to avail themselves of the possibility opened up by the new rules to use their own risk assessment systems in order to determine minimum regulatory capital ratios. In this respect, the FME has also collaborated with financial supervisory authorities in the countries where these undertakings are conducting their activities.

The FME issued four new operating licences to financial undertakings during the period from November 2005 to October 1st 2006; two licences to credit undertakings and two to securities companies. One of these was an operating securities company which was granted with a further licence to operate as a credit undertaking.

During the period, the FME received a request for the approval of the merger of two savings banks. This is the first time that such a merger is carried out solely on the basis of business decisions instead of being the result of necessary financial organization within one of the savings banks concerned. The FME's role in mergers of this nature is not only to observe that all formal conditions are met and sound and solid business practices are upheld, but also to ensure that the savings banks' reserves are not depleted.

Pursuant to Articles 21 and 22 of Act 161/2002, all commercial banks, savings banks and credit undertakings submit six-monthly reports to the FME on their participation in business activities. The FME has declared that such business participation has come under special review and that Guidelines no. 1/2004 are likely to be revised on the basis of its outcome. Due to projects in other areas, there has been a slight delay in the completion of this review which is, however, expected to end in the spring of 2007.

During the period, two cases were examined of suspected activity for which a licence had not been obtained pursuant to Article 3 of Act 161/2002. One of these cases was referred to the National Commissioner of the Icelandic Police but the other one is still being handled by the FME.

The National Commissioner of the Icelandic Police was also notified of one case of a suspected qualifying holding in a financial undertaking, contrary to the provisions of Act 161/2002.

In July 2006 the FME introduced changes to its Guidelines no. 1/2003 on the material content of codes of practice for the boards of financial undertakings, set on the basis of Article 54, paragraph 2, of Act 161/2002 on Financial Undertakings. Principal changes include the requirement that external auditors examine all exposures towards connected parties and that they present a fully justified opinion that the arm's length principle has been observed. The FME requests that such surveys by external auditors be submitted to the Authority on a yearly basis for undertakings with a balance sheet total exceeding ISK 100 million and every two years in the case of other financial undertakings. The Guidelines give scope for extending this external survey requirement to other financial undertakings should it turn out to be necessary.

The second joint contingency exercise of the Central Bank of Iceland and the Financial Supervisory Authority of Iceland was held on January 13th 2006. The exercise tested channels of communication inside each institution as well as between them in the event of severe shock on the financial market. The procedure checklist for the exercise covered a range of critical points in relation to activities on the credit market, the insurance market, the securities market and in pension funds. Generally speaking, the exercise went well and issues arising at various stages were for the most part easily resolved by staff from both sides. There were relatively few flaws in the process, which went smoothly, and e-mail communication between participants was faultless. The FME has used the outcome of this exercise to further develop and improve its contingency strategy.

A memorandum of understanding between the Prime Minister's Office, the Ministry of Finance, the Ministry of Commerce, the Financial Supervisory Authority and the Central Bank of Iceland on collaboration concerning financial stability and contingency plans for meeting potential shocks to the financial system was signed in February 2006. This agreement is based on work carried out in 2004 and 2005.

1.5 Securities Market Unit

Emphases for the period:

- *Interpretations and guidelines on the implementation of a securities market legislation.*
- *Implementation of the transparency policy for the FME's operations in the securities market.*
- *Implementation of directives on takeovers, market fraud and prospectuses.*
- *Preparations for the MiFID directive and strengthening of Nordic co-operation on supervision*

As legislation for the securities market grows in scope and complexity, the FME has felt an increasing need for legal interpretation and guidelines on implementation. Parallel to defining new strategy objectives which emphasise the FME's importance in the financial market, the FME has determined to focus more than before on interpretation and guidance on issues that may arise from the implementation of laws and regulations in the securities market. Five such interpretations have already been published on the FME website. An increase in this area is anticipated in coming months.

The FME has worked on the formulation and implementation of a transparency policy for supervision in the securities market which was published last year. The results of 11 examinations have been reported since this policy entered into effect. The aim of the FME's transparency policy is to establish faith in supervisory procedures, to strengthen market precaution and support increased knowledge by publishing exemplary cases. The transparency policy supports the FME's function of efficacy and guidance.

The introduction of new EU directives for the financial market demanded much legal work during the period. Three new directives came into effect, i.e. on market fraud, prospectuses and takeovers. A range of issues have arisen on account of these directives and the FME's international contacts have proved useful in resolving some of them. Teams of experts work under the auspices of CESR (Committee of European Securities Regulators) on the formulation and interpretation of the above directives and anticipatory mapping of issues that may arise. It is clear that projects concerning the implementation and development of a new legislation will continue be an important feature of the FME's operations.

The introductory process for the EU directives on the securities market will be completed next year by the entry into effect of the MiFID and Transparency Directives. Preparatory work on the MiFID Directive has been extensive and the FME has participated actively in establishing a Nordic collaboration project on the development and construction of the notification and surveillance system prescribed in Article 25 of the Directive. This collaboration, which is a milestone in Nordic co-operation, has been particularly beneficial for the FME and is a clear indicator of more work of this nature in the future. The system will be put into use in November 2007. Section 3.4 of this Report contains details of the standardisation of supervisory procedures in the securities market relating to the introduction of the new surveillance system.

During the period, the FME granted a licence to the Icelandic Stock Exchange to operate an equity market in accordance with Article 34(a) of Act 34/1998 on the Activities of Stock Exchanges and Regulated OTC Markets.

The following is a list of instances that were subjected to formal examination during the period:

Administrative fines. Alleged infringement of Articles 63 and 64 of Act 33/2003 concerning the obligation to notify of insider transactions were examined in a total of 22 instances. Fifteen cases resulted in the imposition of administrative fines.

Flagging. Six cases concerning flagging obligations as defined by Article 32 of the Securities Transactions Act were examined during the period. Three were reported to the National Commissioner of the Icelandic Police, but three were closed without comment.

Duty of disclosure. During the period, one case concerning the duty of the issuers of securities to notify of insider transactions, pursuant to Article 59 of the Securities Transactions Act, was examined. This case was concluded with remarks.

Market abuse. Three instances of possible market abuse were examined during the period. Two of the cases were closed following the FME's examination without any action being taken. One case is still under review.

Insider fraud. Eight cases of possible insider fraud were examined. Six of them were concluded upon the FME's examination. Two are still under review. Two cases were particularly examined with a view to possible infringements against the ban on disclosing insider information.

Offers. The FME validated five prospectuses during the period. The implementation of the Prospectus Directive has resulted in an increased workload and responsibility for the FME.

Takeover. Two cases concerning takeover obligations were examined, but following extensive examination the FME concluded that further action was not necessary. In one instance the FME remarked on a takeover bid which was submitted after the prescribed deadline had expired.

In addition to warnings against the activities of undertakings offering unlicensed financial services in Iceland, the FME now publishes on its website warnings received from international collaborators through CESR POL. A total of 56 warnings have been published during the period.

1.6 Pension Funds and UCITS Unit

Emphases for the period:

- *On-site inspections and monitoring of financial management*
- *Amendments to articles of association*
- *Supervision of commitments*
- *Database and risk classification systems*

Five on-site inspections of pension funds were completed during the period, either fully or in part. The inspections covered the main features of the funds' operations, such as investment, pension rights accounts, actuarial surveys, investment policies, annual financial statements and internal control. Remarks, comments and requests for corrective action as a result of these inspections are, as in previous years, of a varied nature but deal for the most part with internal control, investment policies, annual financial statements, the breakdown of investment according to the Pension Funds Act, actuarial surveys, pension rights accounts and report submissions.

Three examinations of pension fund investment were conducted during the period. The objective of these investigations was to ascertain whether the categorization of pension fund investment was in line with those provisions of the Pension Funds Act that stipulate investment limits. Another important investigative objective is to monitor that pension fund investment falls within the framework set by law. In addition to the above, a review is also made of investment policies, annual financial statements and internal control.

Around 20 pension funds amended their articles of association during the period. As provided for in the Pension Funds Act, the approval of such amendments by the Ministry of Finance is conditional upon the FME's opinion. Some of these amendments concern the transfers of pension funds from unit based schemes to age dependent schemes while others can partly be traced to the mergers of pension funds.

On one occasion the FME delivered its opinion on rules concerning supplementary pension coverage, changes to those rules and their validation, to the Ministry of Finance in accordance with its advisory function as stipulated by the Pension Funds Act.

There was an emphasis on the examination of pension fund commitments during the period. Improvements were made to the layout of the actuarial survey forms which the funds must submit to the FME. It has also been emphasised that requests for the FME's validation of amendments to articles of association which are made to the Ministry should at all times be accompanied by standardized actuarial information on the effect of the amendments on the financial position of the funds. Finally, the on-site inspections of the pension funds have included comprehensive surveys of pension rights accounts and actuarial surveys.

In recent months the FME has been developing a pension fund database which stores historical data on pension fund investment. Phase two of this project will focus on augmenting the database by adding to it information on pension fund commitments.

2006 saw the first stages of a project concerning the structuring of quality and risk classification systems for the pension funds. The system is made up of a stress test and a quality classification system. The stress test measures the impact of specific changes in the operating environment of the funds on assets and financial position. The quality classification system seeks to assess the funds' quality on the basis of a range of operational and financial information. To begin with, the system will be used within the FME to prioritise supervision of funds and to gain a better overview of pension fund risk and the necessary extent of risk management. The system, which is expected to become a useful interactive supervision tool for both the pension funds and the FME, will be further developed in coming months.

Surveys of the investment policies of non-guaranteed pension funds were continued during the period. The purpose of the surveys is to examine whether the investment policies of the pension funds meet the minimum requirements of current laws and regulations. At the same time, efforts are also made to establish the extent to which the investment policies may be regarded as satisfactory with a view to the nature of the funds. During the period, around 17 such surveys were conducted. Remarks, comments and requests for corrective action are for the most part based on observations that the policies fail to meet the statutory minimum requirements.

As in previous years, there has been an emphasis on examining the investments of UCITS and investment funds and whether they are in compliance with Act 30/2003 on UCITS and Investment Funds. A considerable amount of work was also spent on reorganizing and improving the regular submission of reports for the funds. The FME also stressed the importance of complying with the provisions of Act 30/2003 in all advertising and promotional activities on behalf of UCITS and investment funds.

In March 2006 the FME published Guidelines no. 2/2006 on the use of financial derivatives by UCITS. The Guidelines fix certain basic conditions that must be met for the use of financial derivatives and seek to regulate common risk management processes for UCITS. The Guidelines are, however, not intended as a comprehensive guide to the use of financial derivatives. The Guidelines also require the management companies of UCITS to introduce specific risk management systems that have been approved by the FME.

1.7 Insurance Markets Unit

Emphases for the period:

- *Risk management, internal control and stress testing*
- *Duty to disclose information pursuant to current legislation on insurance contracts and insurance mediation*
- *Examination of technical provisions for life insurance*
- *Examination of the policy conditions of mandatory professional liability insurance*
- *Examination of the articles of association of insurance companies*

Special examinations were conducted into the activities of four non-life insurance companies, three life insurance companies and two insurance intermediaries. Their operations were found to be in compliance with current regulations. Comments were made as necessary, such as concerning notification duties and the submission of data.

The FME issued Guidelines no. 1/2006 on stress tests for insurance companies and information on risk management (including stress testing). The FME has already implemented a standardized stress test in order to assess the degree to which the insurance companies are prepared to withstand certain setbacks. Insurance companies are classified into four risk categories depending on the results of the test. For companies that are placed in either of the top two categories, the most prominent risk factors will be specially monitored by the FME.

The Guidelines also state that insurance companies shall regularly fill in and submit a form which reports on their monitoring and management of different types of risk. It is recommended that all measures taken by the companies in this respect are according to the estimated extent of risk factors as measured, for instance, by stress testing.

Two insurance companies have been subjected to special supervision due to the minimum solvency requirement pursuant to Article 90 of the Act on Insurance Activities.

The FME improved two of its forms which insurance companies must submit on a regular basis, pursuant to Article 47 of the Act on Insurance Activities. Now the FME asks for more detailed breakdown of insurance company assets. The main purpose of this is to monitor assets intended to meet technical provisions. As it is to be expected that the investment profit of insurance companies will become increasingly affected by market fluctuations, it is imperative for the FME to emphasise monitoring of the asset side of the balance sheet.

The FME now requires more detailed and standardized information than before on the reinsurance cover of insurance companies. The purpose is to improve overview and understanding of this type of cover, which is a key feature of the companies' risk management.

The FME issued Guidelines no. 3/2006 on prudential filters on the effects of changes to the assets and liabilities items of insurance companies in relation to the implementation of the international accounting standards (IFRS). This was done in order to harmonize solvency requirements between companies using IFRS and those which have chosen not to do so.

The FME has collaborated with supervisory authorities within the EEA on providing advice to the EU concerning the development of the Solvency II Directive, which will include new risk-based solvency rules and new methods for the supervision of insurance companies. During the period, the FME began introducing the proposed rules to insurance companies and requested their participation in two quantitative impact studies (QIS) in order to establish the impact of change. Despite a tight timeframe in which to conduct the studies and the need to apply new methods, participation in the QIS has been good here in Iceland. These studies are an important stage in preparing insurance companies for Solvency II. It is also crucial to present QIS results from Iceland since the rules are still being developed and different market conditions in individual member states need to be considered.

A number of insurance intermediaries experienced operational difficulties in the period 2000-2003 with instances of bankruptcy and loss of operating licences. The period 2004-2006 appears to have seen a reversal of this trend as far as insurance intermediaries are concerned.

Act 32/2005 on Insurance Mediation incorporates into Icelandic law the provisions of the Insurance Mediation Directive no. 92/2002.

The FME has received a number of notifications from supervisory authorities within the European Economic Area regarding insurance brokers and insurance agents seeking licences to offer services without being established in Iceland.

Examinations were continued on the technical basis for life insurance, pursuant to Article 55, paragraph 2, of the Act on Insurance Activities. Almost all the necessary data and information has now been collected. The purpose of this examination is to establish whether the premiums are fair on the insured and in keeping with risk and cost, cf. the above provision.

A survey was conducted on the policy conditions of mandatory professional liability insurance and comments made as necessary. The survey revealed that this type of insurance provides different cover, for instance depending on the actual professions concerned. Professional liability insurance for insurance brokers appears to stand out with considerably higher coverage than other comparable insurance types.

An examination was made of the articles of association of insurance companies. Comments were forwarded and amendments made to the articles of association in line with current legislation on insurance activities and limited-liability companies.

1.8 Supervision of Measures against Money Laundering and Terrorist Financing

Emphases for the period:

- *New legislation and increased emphasis on supervision*
- *Development of supervision and issuing of guidelines*
- *Collaboration agreement with the Ministry of Foreign Affairs and the police*
- *FATF audit*

During the latter half of 2005 and in 2006 the FME placed increased emphasis on supervising measures against money laundering and terrorist financing. A new employee was hired early in 2006 to take care of this policy area.

A new legislation introducing new supervisory emphases entered into effect in June 2006. FME Guidelines intended to clarify and reiterate the duties and responsibilities of financial undertakings in this respect are being prepared. The FME has also held introductory seminars with those employees of parties subject to supervision who are responsible for measures against money laundering.

Preparations have been made for a collaboration agreement with the Ministry of Foreign Affairs on account of Iceland's international commitments and the FME's legal obligation to notify all parties under its supervision of any persons or legal entities who are suspected of associations with international terrorist activities or money laundering.

Preparations are also being made for a collaboration agreement with the Icelandic police on cooperation, information exchange and education on the supervision of measures against money laundering and terrorist financing. Notifications of suspicious transactions are forwarded to the police authorities, who are in charge of investigations, whereas the FME's role is to ensure that parties subject to supervision adopt adequate procedures and rules and that they comply with laws and regulations in this respect.

The FME has also worked on developing the supervision of measures against money laundering and terrorist financing.
In 2006 this kind of supervision became a specifically defined feature of the overall supervision of individual parties subject to supervision. Special money laundering examinations will be

made and self-assessment questionnaires to assess the level of measures against money laundering and terrorist financing will be sent out to parties subject to supervision once every year.

During the period January 1st to October 1st 2006, a total of 12 examinations of measures against money laundering and terrorist financing were conducted. These examinations formed part of the overall supervision of these parties. A few comments and recommendations were made concerning internal processes, rules and surveillance.

FATF (Financial Action Task Force on Money Laundering) is an international task force working against money laundering and terrorist financing. FATF has issued 40 recommendations on measures against money laundering as well as 9 specific recommendations on terrorist financing, which have all been adopted by the member states. Audits on the protection against money laundering and terrorist financing are conducted on a regular basis in the member states. In 2006 a protection audit was carried out in Iceland with the joint participation of the FME, the Ministry of Commerce (which is responsible for this policy area in Iceland), the Ministry of Justice, the National Commissioner of the Icelandic Police, the Central Bank of Iceland and the Bankers' and Securities Dealers' Association of Iceland. A report on the audit was approved by a meeting of FATF states in October 2006. The results of the audit are generally positive, while at the same time drawing attention to areas that need to be improved as far as legislation and implementation are concerned.

1.9 Qualifying Holdings in Financial Undertakings and Insurance Companies

1.9.1 General

Considerable fluctuations took place in the ownership of financial undertakings and insurance companies last year and the FME received 22 applications for the approval of the acquisition of qualifying holdings in a total of 13 companies. The following presents major areas of emphasis in the FME's processing of these applications during the period:

- Examination on whether the qualifying holding is likely to lead to a conflict of interests in the financial market or likely to impede supervision of the party concerned, for instance on account of connected parties or collaboration.
- Relationships between parties have been examined with a view to establishing whether the qualifying holding has resulted from collaboration or business transactions.
- The FME began publishing the outcome of its handling of applications for the acquisition of qualifying holdings on the FME website.

The processing of many of these applications has been rather time-consuming due to complex ownership links, the investment activities of owners and the size of the holding for which the application is made, but all of these factors require the submission of a considerable amount of information. The FME has, however, not rejected any application made during the period although in most cases the approval has been based on certain conditions.

Contracts for the purchase of qualifying holdings are generally made without seeking the advance approval of the FME, but with reservations concerning such approval. It is right to point out that the law requires the approval to be sought in advance, but explanatory notes to the Act state that contracts for the purchase of qualifying holdings may be drawn up so that they are conditional upon the FME's approval and that the provision will not impede the securing of options to buy such holdings without having obtained the approval of the FME.

The procedure described above has, however, created supervisory problems for the FME. There have been instances where representatives of certain parties have taken their seats on the boards of directors of financial undertakings/insurance companies and where changes have actually been made to the operations of the companies concerned before the acquisition of the qualifying holding had been officially approved. The FME is of the opinion that this procedure is not in line with the general purpose of the legislation and that necessary changes need to be made in order to prevent this kind of situation from arising.

In some cases the ownership of financial undertakings and insurance companies has been in the hands of a single party, thus giving rise to a concern that a financial conglomerate has been formed pursuant to Act 161/2002 on Financial Undertakings and Act 60/1994 on Insurance Activity. Two such instances were examined during the period, but neither examination produced the result that a conglomerate had been formed. The FME is currently preparing rules on supplementary supervision of financial conglomerates which are intended as a full implementation of EU Directive 2002/87/EC.

The FME examined whether a qualifying holding had been formed in Straumur-Burðarás Investment Bank following the purchase by FL Group of a 24.026% share in the company in June 2006. The FME decided that the buyers and sellers of the share capital in question had formed an alliance for the handling of a qualifying holding in Straumur-Burðarás Investment Bank on the basis of Article 40 of Act 161/2002 on Financial Undertakings. As the above parties had not obtained the FME's approval for the qualifying holding, the FME decided that their joint voting right within the company should be limited to 9.99%, cf. Article 45 of the Act cited above.

Over the last two years investors have shown a growing interest in dealing in the guarantee capital shares of savings banks and there are instances of such capital changing hands at multiple premium prices. The legislation on the ownership of guarantee capital in savings banks is somewhat different from the legislation on ownership of share capital in other financial undertakings, for instance concerning the obligatory approval of the board of directors for the selling or endorsement of such capital. The principal purpose of provisions on the handling of holdings in savings banks is to secure distributed ownership. It has become common practice for parties to form holding companies around their shares in financial undertakings and this also applies to the owners of guarantee capital in savings banks. With a view to the obligations of the boards of directors of savings bank concerning the sale or endorsement of guarantee capital holdings, the FME saw fit to issue an interpretation of the provisions of Article 64 and Article 70, paragraph 2, of Act 161/2002 on Financial Undertakings. The interpretation refers to the understanding of the concept "sale or other assignment of a guarantee capital holding" in the case of the sale of companies that are the owners of guarantee capital and the rules that apply to board approval in this respect. The interpretation also refers to the obligations of parties who sell an indirect guarantee capital holding through the selling of shares in a company that is a formal owner of guarantee capital.

The FME's conclusion is that Article 64 of the above Act (cf. also Article 70), which states that guarantee capital holdings in a savings bank may not be sold or otherwise assigned without the approval of the board of the savings bank, not only covers the direct sale or endorsement of guarantee capital but also when a holding exceeding 20% in a company that is the owner of guarantee capital changes hands. The conclusion as well as the rationale behind it is published in full on the FME website.

1.9.2 Examination of a Qualifying Holding in Sparisjóður Hafnarfjarðar

Following an extensive examination in the early spring of 2006, the FME came to the conclusion that a qualifying holding had been formed in the savings bank Sparisjóður Hafnarfjarðar contrary to law. The FME then determined that certain specified owners of guarantee capital should have a combined voting right not exceeding 5% in the savings bank. Pursuant to Article 18 of Act 87/1998, which was then applicable, some of the owners referred the FME's decision to the complaints committee, which subsequently invalidated the decision. The FME's Board of Directors has decided to take court action in order to have the committee's ruling annulled.

The Financial Undertakings Act states that parties proposing to acquire a qualifying holding in a financial undertaking must apply for the FME's approval in advance. The Act contains specific provisions concerning the formation of qualifying holdings in savings banks. Qualifying holdings can only be formed on two clearly separate occasions for which the approval of the FME must be sought. In the savings banks there are, in addition, possible conflicts of interest between the owners of guarantee capital and the private holdings of the institution itself. Since guarantee capital holdings do not equal shareholders' equity in a savings bank, the legislature has prescribed limitations to dealings in such holdings on an open market. In most savings banks, the guarantee capital forms only a small part of total equity. The lion's share of the equity is in most cases owned by the savings banks themselves and the holders of guarantee capital have no claim on such assets.

Most of the parties examined by the FME denied having conspired to form a qualifying holding in Sparisjóður Hafnarfjarðar. Acting on this information, the FME obtained a court order to examine movements on a trust account in the name of a certain law office. All the parties that the FME believed had joined forces to form a qualifying holding were in one way or another traceable to the above-mentioned trust account. It appears that payments of nearly ISK two billion have been made in connection with this case.

The reason for the FME's decision to take court action in an attempt to have the rulings of the complaints committee annulled is that the FME disagrees with the ruling and believes it to be lacking in justification. This case will put to the test a range of important issues for the Icelandic financial market concerning the effectiveness of legal provisions and the power of the Financial Supervisory Authority to implement laws on financial undertakings. This means in particular:

- Burden of proof that a qualifying holding was formed when the parties concerned refuse to cooperate while various other documentation and circumstances indicate that collaboration took place. This can be a crucial factor for foreigners assessing the transparency of ownership links in the Icelandic market.
- Specific provisions concerning distributed ownership and the handling of guarantee capital holdings in savings banks.
- Communication and cooperation between the FME and the National Commissioner of the Icelandic Police – two authorities, each with a different role and resources - on the administration of justice in the financial market. Each carries out examinations into different areas although the one and the same party may be the subject of these investigations. This is in line with the interpretation of the competition appeals committee in the unlawful price fixing case of the big oil companies (3/2004).

1.10 Assessment of Eligibility

1.10.1 Assessment

On 15th November 2005 the FME introduced a special assessment of eligibility for CEOs and board members in financial undertakings and pension funds, but such assessments had been conducted for some time in the insurance sector. This assessment has met with a positive response and proved a valuable opportunity for new CEOs to become familiar with the regulatory framework applying to their companies. Eligibility assessments are conducted when applications are made for new operating licences and as required when changes are made to current operating licences and when new individuals are employed.

The special legislation that applies to the eligibility of CEOs and board members in the above-mentioned undertakings makes stricter requirements than corporation law does on the managing directors and board members of limited liability companies. These are requirements concerning the trustworthiness of the individuals in charge as well as requirements concerning professional competence, i.e. that education, work experience and occupational history is such that there is no doubt the individual can fulfil his/her duties in a satisfactory manner. The mandatory eligibility requirements for executives and board members are part of the conditions for the granting of operating licences and failure to meet them may result in refusal or the revocation of licences. Owing to the nature of operations in the areas of finance, pension savings and insurance, it has been considered normal to make such requirements since in most cases the individuals are responsible for money belonging to the general public.

The eligibility assessment is conducted by calling the CEO to a meeting at the premises of the FME within a given time from having taken up the position or before a new operating licence is granted. At the meeting, the provisions of the laws and regulations necessary for the CEO's work are discussed. Prior to the meeting, the CEO is informed of the material to be covered and given about two weeks to prepare. CEOs are also requested to provide confirmation to the effect that they have not been sentenced for violation of any of the laws pertaining to the operations of the parties subject to supervision, that they are legally competent to manage their own finances and have not been declared bankrupt within the previous five years, as well as written answers to a questionnaire that may be retrieved from the FME website. After the meeting, the FME evaluates whether the individual has shown evidence of sufficient knowledge of the laws and regulations on the agenda and whether (s)he is on other respects qualified with reference to the eligibility clauses of the legislation.

If the FME does not consider that the individual has shown sufficient knowledge of laws and regulations, (s)he is given the opportunity to repeat the assessment. Generally, each individual can only make two attempts at passing the eligibility assessment unless in exceptional circumstances.

A total of eight eligibility assessments were conducted during the period from November 15th 2005 to October 1st 2006. Six individuals passed the assessment, but the two who failed were called in again for a second attempt.

Board members are not required to prove the same level of knowledge of laws and regulations as CEOs, but they must submit written answers to a questionnaire that can be retrieved from the FME website together with confirmations that they have not been sentenced for violation of any of the laws pertaining to the operations of the party subject to supervision, that they are legally competent to manage their own finances and that they have not been declared bankrupt within the past five years. This information must be available to the FME within four weeks of the board member taking a seat on the board of directors or accompany the application for operating licence. The FME does not disclose information on the performance of board members in eligibility assessments unless there is reason to do so.

The FME bases the assessment on Article 8 of Act 87/1998 on Official Supervision of Financial Operations as well as the requirements made by current laws on the operations of the parties concerned. Further information on the eligibility assessments may be obtained from the FME website.

1.10.2 Special Assessment of CEO and Board Member Eligibility

Supervision of the eligibility of CEOs and board members of parties subject to supervision is ongoing and may result in specific reviews by the FME. Between November 2005 and October 2006, the FME made special examinations of the eligibility of two CEOs and seven board members of parties subject to supervision. Some of these examinations were called off when the individuals concerned decided to resign or the FME saw no reason to proceed. Part of the examinations had not been completed on October 1st 2006.

It should be pointed out that the FME has been given direct authority to unilaterally dismiss CEOs and board members of parties subject to supervision if they fail to meet the statutory eligibility conditions, cf. Article 10, paragraph 4, of Act 87/1998 and Article 4 of Act 67/2006.

1.11 International Co-operation

Emphases for the period:

- *General*
- *Nordic cooperation*
- *CEBS*
- *CEIOPS*
- *CESR*

The ongoing increase in the overseas activities of Icelandic financial undertakings has brought the FME into closer contact and collaboration with parallel institutions in countries inside and outside the EEA where Icelandic businesses have their establishments or offices.

The FME has enjoyed fruitful collaboration with its sister authorities in the Nordic countries. The Nordic directors general meet once a year to discuss matters concerning the harmonization of financial supervision between their countries. This year's meeting was held in Iceland at the end of August 2006. Furthermore, there are annual meetings of specialists focusing on supervision in the credit, insurance and securities markets as well as information technology.

The FME is an active member of joint committees of European financial supervisory authorities, i.e. CEBS (Committee of European Banking Supervisors), CESR (Committee of European Securities Regulators) and CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors). These committees have the function of harmonizing supervision in the financial market and thus supporting an effective internal market within the EEA. The committees also serve as advisory bodies to the European Commission on the formulation of a unified legislation for the financial market. The FME's participation in these European committees is of crucial importance in ensuring that regulatory implementation is comparable to practices within the EEA and is, in that way, conducive to strengthening the competitiveness of Icelandic financial undertakings in foreign markets.

In the credit market, the FME has participated in the work of three CEBS sub-committees: Groupe de Contact, which is a group of experts working on the coordination of supervisory procedures; the Expert Group on Capital Requirement and the Expert Group on Financial Information. The main focus of these committees has, in recent years, been been harmonizing the implementation of the Basel II (CAD 3) capital adequacy rules, for instance through the drafting of proposals for basic principles/guidelines and standardized report forms.

The FME has participated in a CEIOPS expert group on Solvency II, which deals with new methods in the supervision of insurance companies and solvency rules. The group has acted as an advisory body to the European Commission on the Pillar I section, which handles the calculation of solvency, solvency requirements, minimum solvency margins and technical provisions as well as rules on assets to match technical provisions. The European Commission will issue in the middle of next year a draft directive to replace other directives concerning insurance activities. In the new solvency rules the calculation of solvency requirements is expected to incorporate all risk factors that may affect the operations of insurance companies. Calculation methods were tested in two quantitative impact studies in which the insurance companies participated during the period.

The FME has participated in a CEIOPS expert group focusing on insurance mediation. A protocol on the cooperation of supervisory authorities within the EEA on the supervision of insurance mediation was signed in 2005. The expert group is currently working on specific areas in the supervision of insurance mediation, such as disclosure of information and notifications of services.

In 2006, the FME worked closely with supervisory authorities in the other Nordic countries on the design and development of a transaction reporting system which is required in the MiFID directive. A meeting of Nordic securities supervisors was held by the FME in Reykjavík in May 2006. TRS was the main topic on the agenda. A consensus has been reached on a common Nordic TRS system. Development of the system will continue during 2007. The system is expected to be in operation by November 2007. This project will be an important step towards increased Nordic cooperation on supervision in the securities market. The FME has also participated in the implementation of the MiFID, Transparency Directive, as well as the enforcement of the MAD and Prospectus directives of the EU. The FME participated in meetings held by the European Commission on the transposition of the EU takeover directive. The FME also participates in CESR-POL, which focuses on increased European cooperation in the investigation and enforcement of the securities legislation.

The FME has participated in a CESR expert group on UCITS and their management companies. The group has, for instance, worked on the preparation of guidelines to simplify the notification procedures of UCITS between countries within the EEA. These rules were issued by the CESR in June 2006 and have been adopted by the FME.

1.12 FME Operations in 2005 and Estimates for 2006

For the year 2005 the FME's expenses, including the purchase of assets, amounted to a total of ISK 324.6 million. Income for the year, including interest income, came to ISK 305.6 million, of which income from supervision fees was ISK 299.9 million. This gives an operating deficit of ISK 19 million for the year 2005. Not included in the above figures are expenses and income arising from the rulings committees which are hosted by the FME. A deficit had been anticipated for 2005 to balance out the positive capital position at the beginning of the year. The deficit was, however, greater than had been expected, primarily as a result of increased salary costs. Due to amendments to the Securities Transactions Act it was necessary to hire two new employees, but this had not been included in the operating budget plan for the year. The FME's equity at the beginning of 2005 was ISK 8.9 million. This was taken into account for the calculation of supervision fees to be levied in 2006, which were approved by Althingi. The income for 2005 was allocated back into the FME's operations during the year. The operating deficit created a negative equity of ISK 10.1 million at the end of 2005, which corresponds to 3.3% of the Authority's net income.

Key statistical information from the FME's annual accounts for 2005 is detailed in Chapter 5 of this Report, but the annual accounts are published in their entirety on the FME website.

According to the FME's operating plan for 2006, operating costs for the year are expected to total ISK 410.5 million. Income, including interest income, is expected to be ISK 438.4 million, of which income from supervision fees should be ISK 435.4 million. Income in excess of expenses is thus expected to reach ISK 27.9 million. Given the negative equity of ISK 10.1 million at the beginning of 2006, the Authority's equity is expected to be positive by ISK 17.7 million at year-end 2006. This will be taken into account when determining the supervision fees for 2007. The largest factor contributing to the FME's positive equity at year-end 2006 is income from supervision fees during the year in excess of anticipation due the enlargement of the assessment base for two credit institutions.

2 THE FINANCIAL MARKET – TRENDS AND OUTLOOK

2.1 The Credit Market

2.1.1 Performance

The operations of credit undertakings have been on an upswing in recent years, spurred by considerable trading gains on stock holdings, a substantial credit growth and decreasing loan losses.

Profitability in 2005 strengthened considerably from the previous year and this trend continued to be in evidence during the first half of 2006 with positive signs of improving core performance which, however, can partly be attributed to inflation gains.

Average return on equity (ROE) of the commercial banks and the six largest savings banks before tax was 42.3% during the first half of 2006, compared with 36.6% in 2005 and 28.6 in 2004. A major portion of this strong performance can, as already stated, be attributed to trading gains on equities and other financial gains. If all performance items other than interest and fee income are excluded, the ROE before tax amounted to 19% in the first half of 2006, compared with just over 11% in 2005 and barely 5% in 2004. This shows that profit from core operations, i.e. not including trading gains and irregular income, is steadily improving.

Figure 1 ROE of Commercial Banks and Largest Savings Banks Based on Different Weightings of "Other Operating Income"

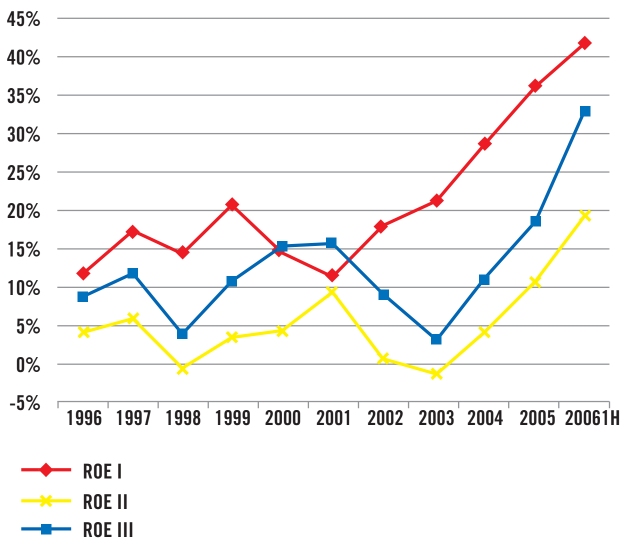


Figure 1 Return on equity (ROE) on an annual basis for commercial banks and major savings banks. ROE I is based on profit as shown in annual financial statements, ROE II is based on profit less operating income other than commission and ROE III is based on profit less trading rate gains. In calculating ROE II and III, lower interest cost has not been assumed in correspondence with lower income so that ROE II and III are underestimated to some extent. In all cases, the figures are based on profit before taxes.

The operating expenses of banks and savings banks in proportion to total assets have dropped in recent years. This ratio was around 2.5% in 2004 but dropped to 1.8% in 2005 and remained similar in the first half of 2006.

Net interest income as a proportion of total assets has been falling in recent years but during the first half of 2006 this trend reversed. In 2004 this ratio was 2.3%, dropped to 1.9% in 2005 and then rose to 2.1% in 2006. This is primarily the result of increased inflation and long exposure of the banks to inflation.

Figure 2 Main Operating Items of Commercial Banks and Savings Banks as a Ratio of Average Total Assets

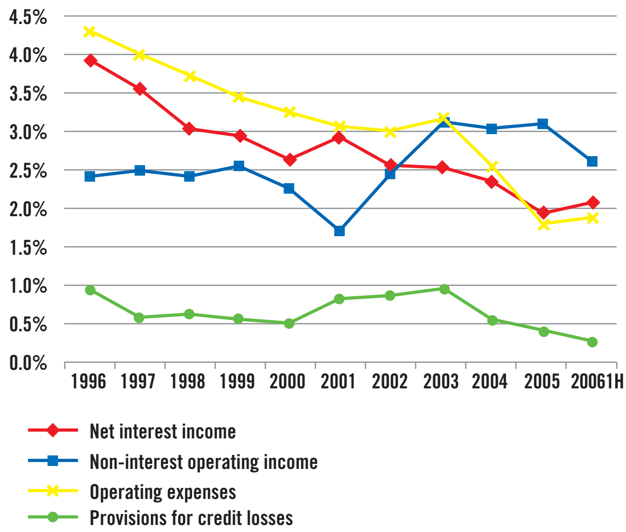


Figure 2 The development of major operating items of commercial banks and major savings banks as a ratio of their average balance sheet position. Figures for the first half of 2006 are extrapolated to an annual basis.

2.1.2 Credit Development

2.1.2.1 Credit Growth

There has been substantial increase in lending at deposit institutions in recent years. The twelve-month increase in outstanding loans at commercial banks and savings banks was 64% from June 2005 to June 2006, for the parent companies, or rising from ISK 1,753 billion to ISK 2,883 billion. The comparable change in 2005 amounted to +67.6% and in 2004 it amounted to +43%. Thereof the increase in outstanding loans to domestic parties amounted to 54%, 51% and 40% respectively. The same figures for the increase in lending to foreign parties are 106%, 163% and 68% respectively. At the end of June 2006 the total amount of domestic loans stood at ISK 2,147 billion and loans to foreign parties amounted to ISK 736 billion. In this respect it is interesting to observe the fact that foreign currency denominated loans amounted to ISK 1,628 billion at the same point in time, but the vast gap between this amount and ISK 736 billion reflects mainly increasing activities of Icelandic businesses abroad.

Figure 3 Outstanding Loans of Commercial Banks and Savings Banks (Parent Companies)

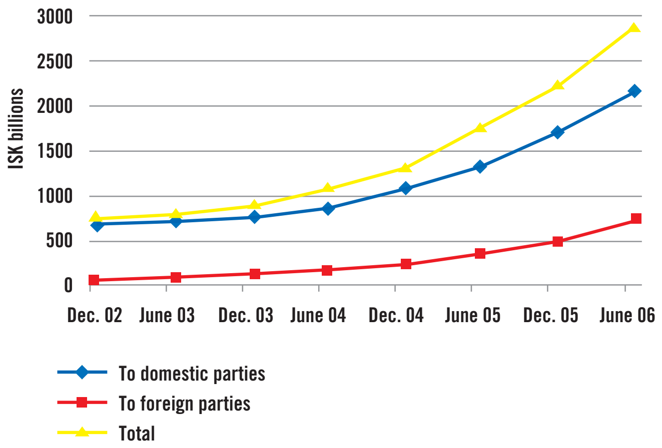


Figure 3 Developments in lending to domestic and foreign parties as well as in total lending

In a wider context, when interpreting credit growth at deposit institutions directed to domestic parties between 2004 and 2006, one must take into account the transfer of housing mortgages from the Housing Financing Fund to commercial banks and savings banks. It is also worth mentioning that the proportion of loans to foreign parties of total loans, based on parent company accounts, rose from 20% to just over 25% between the end of June 2005 and the end of June 2006. At year-end 2002 such loans only amounted to 6.2% of total lending by deposit institutions. The above figures point clearly to increased globalization.

Figure 4 Breakdown of Outstanding Loans of Commercial Banks and Savings Banks (Parent Companies)

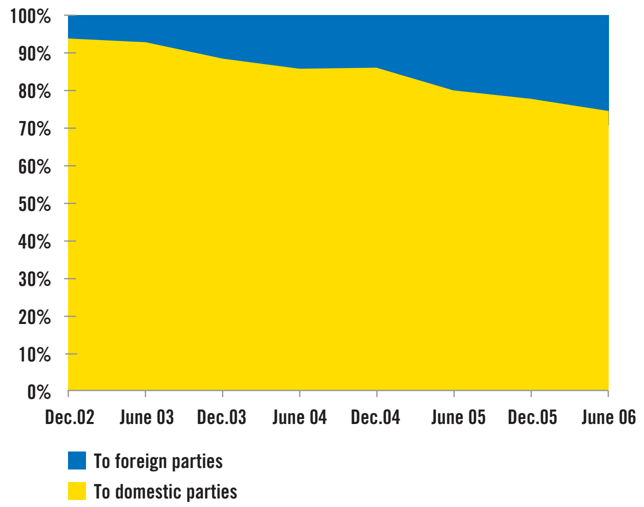


Figure 4 Trends in proportional division of lending between domestic and foreign parties

2.1.2.2 Defaults

Experience has shown that a rapid growth in lending can often be a precursor to systemic difficulties in the financial sectors of countries. Now that the boom which the Icelandic economy has been enjoying in recent years is forecast to be ending, it is imperative for the banks to maintain their strong capital position in order to meet a possible increase in defaults.

Defaults have been falling steadily in recent years. The default percentage has been decreasing, even if calculated with a time lag of two years, i.e. defaults as a percentage of total loans outstanding two years earlier, in order to exclude the impact of major lending growth. Since decreasing defaults can largely be attributed to the current upswing in the domestic economy, they can be expected to increase again once the boom is over. Deposit institutions are, however, in better shape to cope with such a downturn than before due to better diversification of their loan portfolios, both geographically and across industrial sectors, so domestic defaults should have less impact than before on their performance. This diversification is largely on account of takeovers by the banks of foreign financial undertakings in recent years and the increased weight of loans to Icelandic businesses operating abroad. However, the strong growth in overseas lending has created a different kind of problem: increased external funding risks which lead to worsening refinancing rates on the banks' foreign debt. This issue is covered later in this part.

Figure 5 | Household and Corporate Defaults as a Ratio of Total Lending -Commercial Banks and Largest Savings Banks (Parent Companies Only)

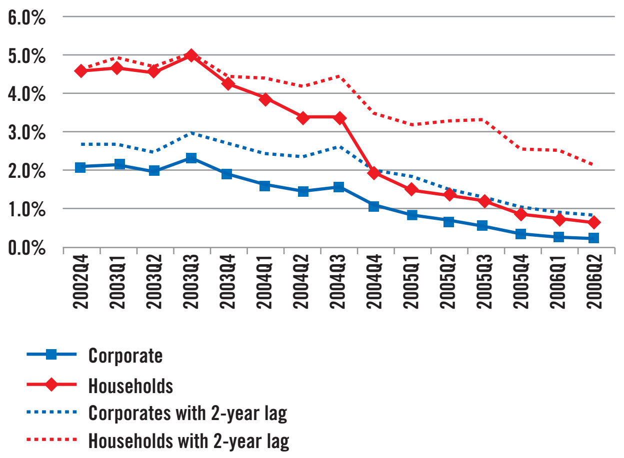


Figure 5 Defaults (>30 days) as a ratio of total lending by deposit institutions (parent companies only) at the end of each quarter

2.1.2.3 Mortgage Housing Loans [1]

Although mortgage lending has been rapidly increasing at commercial banks and savings banks over the past two years, these loans have fallen as a proportion of equity base in Q2 2006.[2] The average ratio thus fell from 45% to just over 36% between the end of the first and second quarter in the case of the commercial banks and from 382% to 307% in the case of the savings banks. This falling weight is largely attributable to an expanding equity base. Mortgage housing loans, however, remained relatively unchanged as a proportion of total lending to customers in the first half.[3]

Mortgage loans on residential property

	Commercial banks		Largest savings banks	
	1Q 2006	2Q 2006	1Q 2006	2Q 2006
Ratio of CAD	45.0%	36.4%	382.3%	306.9%
Ratio of loans to customers	10.9%	10.9%	31.3%	31.4%

Nearly one-third of mortgage housing loans at commercial banks and major savings banks have a loan to value ratio (LTV ratio) of 70% or lower, whereas in most cases (or 57%) LTV ratios range from 70%-90%.[4] From the beginning to mid-year 2006 some loans appear to have moved to the LTV ratio range above 90%. This may be attributable to relatively high inflation and coinciding stagnation in the housing market. This can happen because inflation leads to a rise in the principal of these price-indexed mortgage loans so that as a percentage of property value they tend to rise if temporary stagnation or price decreases take place in the housing market at the same time.

1 Mortgage housing loans sold by banks and savings banks to the Housing Financing Fund are excluded from this summary.
2 In the coverage of mortgage lending, the positon of the savings banks is calculated on a consolidated basis.
3 Claims on credit institutions are excluded from total lending here.
4. Reference to major savings banks means the six largest savings banks.

Figure 6 | Mortgage Loans of Commercial Banks and Largest Savings Banks - Breakdown according to LTV Ratios

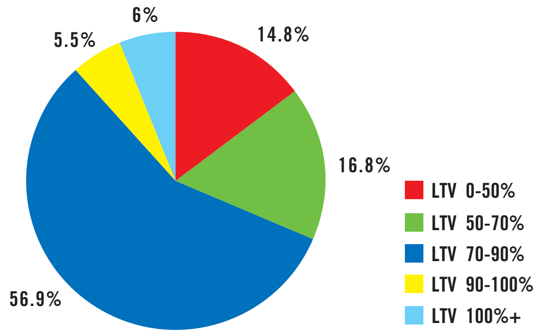


Figure 6 Housing mortgage loans by commercial banks and major savings banks, classified according to LTV ratios

If outstanding mortgage housing loans are analysed in terms of the equity base and classified according the LTV ratios, there appears to be considerable difference between the commercial banks and the major savings banks.

Mortgage loans on residential property

	Commercial banks		Largest savings banks	
2Q 2006	ISK thousand	Ratio of CAD	ISK thousand	Ratio of CAD
Loan to value 0-50%	62,355,791	8.3%	11,352,552	22.8%
Loan to value 50-70%	72,995,192	9.7%	14,223,914	30.8%
Loan to value 70-90%	85,561,774	11.5%	51,780,293	236.4%
Loan to value 90-100%	25,789,540	3.6%	2,308,568	6.0%
Loan to value >100%	24,484,088	3.4%	3,884,038	10.9%

At mid-year 2006, the proportion of loans with an LTV ratio of 90% or higher amounted to 17% of the equity base of the largest savings banks wile the comparable figure for the commercial banks was 7%. Loans with LTV ratios of 70-90% amounted to an average 23% of the equity base of major savings banks, but only 11.5% in the case of the commercial banks.

Ratio of total mortgage loans on residential property

	Commercial banks		Largest savings banks	
	1Q 2006	2Q 2006	1Q 2006	2Q 2006
Loan to value 0-50%	23.9%	24.0%	5.6%	5.6%
Loan to value 50-70%	26.7%	26.0%	8.4%	7.7%
Loan to value 70-90%	38.4%	33.0%	80.5%	80.7%
Loan to value 90-100%	5.1%	9.1%	2.3%	2.0%
Loan to value >100%	5.9%	7.9%	3.2%	4.0%

If mortgage housing loans are classified by LTV ratios it becomes evident that there is a higher concentration at the savings banks than the commercial banks in respect of LTV ratios. Mortgage housing loans in the LTV range 70-90% thus make up nearly 81% of housing loans at major savings banks, compared with 33% at the commercial banks.

2.1.2.4 Loans to investors collateralized on shares

In assessing the extent of loans to investors collateralized on stocks, the FME has compiled both direct loans and forward contracts on stocks (which can be regarded as synthetic loans) between banks and their customers. The total notional amount of forward contracts equals around one-third of the total amount in the case of commercial banks and around 13% in the case of major savings banks.

Proportionate division of loans to investors collateralized on shares and forward contracts on equity				
	Commercial banks		Largest savings banks	
	1Q 2006	2Q 2006	1Q 2006	2Q 2006
Loans with equity and other securities pledged as collateral	70.5%	68.2%	93.4%	86.7%
Forward contracts on equity and other securities	29.5%	31.8%	6.6%	13.3%

Loans (direct and synthetic) to investors collateralized on stocks as a ratio of equity base decreased considerably in the case of commercial banks between the end of the first quarter and until mid-year 2006. Two factors explain this: the volume of these loans has decreased and there has been substantial growth in the equity base. In the case of the savings banks, this ratio increased from 26% to 33% during the same period.

Proportionate division of loans to investors collateralized on shares and forward contracts on equity				
	Commercial banks		Largest savings banks	
	1Q 2006	2Q 2006	1Q 2006	2Q 2006
Ratio of CAD	110.9%	77.8%	26.2%	33.0%
Ratio of loans to customers	25.1%	21.9%	3.0%	4.1%

The weight of these loans in terms of overall lending to customers decreased between quarters in the first half of 2006 for the commercial banks but increased in the case of the savings banks.[5]

2.1.3 Large Exposures

If the exposure of a financial undertaking to a single issuer and connected parties exceeds 10% of its equity base, the total exposure is defined as a large exposure.[6] Exposures of this kind may never exceed 25% of the equity base of a financial undertaking.

As depicted in Figure 7, large exposures have been decreasing in recent years in terms of the equity base of commercial banks. On average, large exposures amounted to 78% of the equity base of commercial banks at the end of the second quarter of 2006, compared with 190% at the same time in 2003.[7] During the same period, the equity base grew from around ISK 95 billion to over 730 billion on a consolidated basis. From this it may be inferred that the reduced weight of large exposures is largely attributable to substantial share capital growth combined with increased diversification of credit risk in the wake of the commercial banks' acquisitions of foreign financial undertakings.

Figure 7 Large Exposures of the Commercial Banks (Consolidated Accounts)

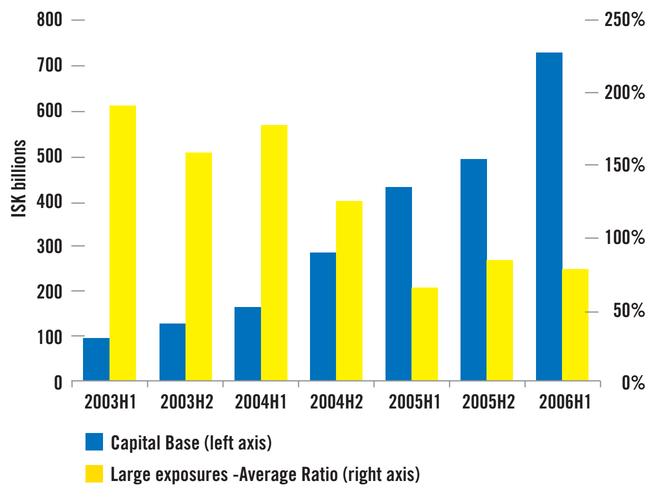


Figure 7 Development of large exposures of commercial banks relative to the equity base

It should be pointed out that the standard deviation of the average ratio for large exposures of commercial banks has decreased considerably since 2003, which reflects increased convergence in this respect among the commercial banks. Thus, the deviation was 112% at the end of the second quarter of 2003, compared with 43% in the same quarter of 2006. Consequently, the average gives a better idea now about the position of individual commercial banks than it did three years ago.

Figure 8 The Number of Large Exposures of Commercial Banks

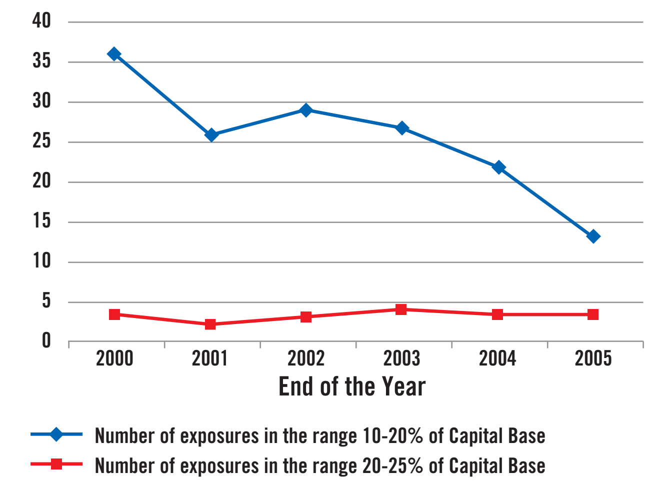


Figure 8 Development in the number of large exposures of commercial banks in recent years

In addition to the reduction in the weight of large exposures, their numbers have also diminished. The number of large exposures ranging from 10-20% of equity base was 39 at year-end 2000, but had dropped to 16 at the end of 2005.

5. Claims on credit institutions are not inclued in overall lending.
6. The definition encompasses all types of exposures – loans, shares, derivatives or other position risk.
7. Figures are calculated on a consolidated basis.

2.1.4 Securities Holdings

In absolute terms, holdings of market securities at commercial banks and savings banks have increased considerably in recent years. However, these assets have fallen as proportion of equity base.

Market bonds held at own risk amounted to nearly 35% of the equity base at the end of June 2006, compared with about 80% at year-end 2000. Corresponding figures for stocks held at own risk were 27.5% at the end of June 2006 and 55% at year-end 2000.

Figure 9 Marketable Bonds and Stocks Held at Own Risk by Commercial Banks and the Largest Savings Banks

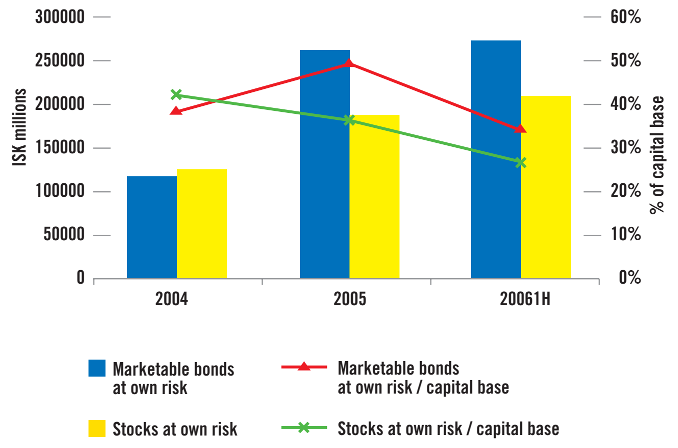


Figure 9 Development of market securities holdings by commercial banks and major savings banks (consolidated accounts) in absolute terms and as a ratio of CAD Equity

It is worth mentioning that the market risk of banks and savings banks in this respect is increasingly on account of investment in foreign shares. Similarly, there has been an increase in the weight of shares in Icelandic companies with major operations abroad. Despite improved diversification, there is still considerable risk associated with securities holdings.

2.1.5 Financing

In recent years there has been a substantial increase in the total assets of deposit institutions, which is largely the result of the rapidly increasing activities of the three major commercial banks abroad. At year-end 2000, total assets of commercial banks and major savings banks amounted to ISK 900 billion based on consolidated accounts and ISK 670 billion based on parent company accounts. Consolidated balance sheet total as a percentage of GDP was 138% and 103% based on parent company accounts. Comparable figures for the end of June 2006 were ISK 7,470 and ISK 5,240 billion respectively, or 642% and 451% as a percentage of GDP. This increase is the result of internal growth (increased lending and securities investment) and sizeable takeovers, primarily the acquisitions of FIH in Denmark, BN Banken in Norway and Singer & Friedlander in the UK.

Figure 10 Total Assets of Deposit Institutions

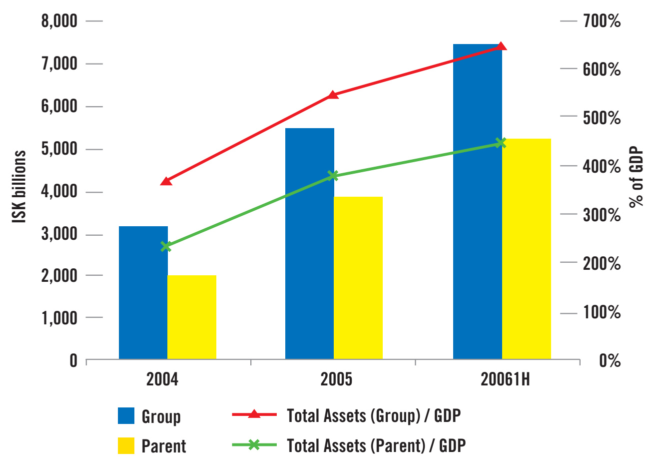


Figure 10 Developments in the activities of deposit institutions, both in absolute terms and as a percentage of GDP

The multiplication of total assets shown above has to a great extent been financed by means of foreign borrowing and new equity issues. There has been a steady fall in the share of deposits as a proportion of total assets and at year-end 2005 this ratio was a mere 21% on a consolidated basis for the commercial banks and major savings banks, compared with 35% at the same time in the year 2000. Comparable ratios for the largest savings banks alone are 44 and 49% respectively. The dwindling deposit ratios of the commercial banks reflect, above all, the high proportion of foreign borrowing in total assets, which in turn makes these institutions highly dependent on international capital markets and thus exposed to fluctuations in market sentiment and economic outlook internationally.

Gross liabilities owed by commercial banks to foreign parties amounted to ISK 400 billion at year-end 2001 (parent company statements) and net liabilities, i.e. less liabilities owed by foreign parties, stood at ISK 340 billion. Comparable figures for the end of June 2006 are ISK 5,280 billion and ISK 2,900 billion, respectively. Gross foreign liabilities have thus multiplied thirteen fold from 2001 and the period has seen an eightfold increase in net foreign liabilities.

In its annual report for 2005, the FME pointed out that despite longer average maturities for the banks' foreign debt and better diversification across credit markets, this increase in foreign borrowing inevitably entails substantial refinancing risk, which would be a major risk factor in their operations. These concerns proved not to be unfounded since the credit terms of the Icelandic commercial banks deteriorated significantly over a short period of time in the first half of 2006 as indeed did their access to the European bond market. This development went hand in hand with a change in the credit rating outlook for the Icelandic State from steady to negative by the international rating agency Fitch, as well as with critical views expressed by influential international investment banks on potential risks associated with certain activities of Icelandic banks. Despite adverse conditions, the banks have been able to refinance nearly all their foreign loans which will fall due next year, albeit at less favourable terms than before.

As previously stated, the banks' growth, primarily external growth, has partly been financed through increases in equity. At year-end 2000 the book value of the equity of commercial banks and major savings banks (excluding minority shares in the equity of subsidiaries) amounted to just under ISK 56 billion, but had increased to ISK 550 billion by the end of June 2006. This means that the banks' equity as a proportion of GDP was 8.6% in the year 2000 and 47.3% at the end of June 2006.

Figure 11 Gross and Net Foreign Liabilities of Commercial Banks

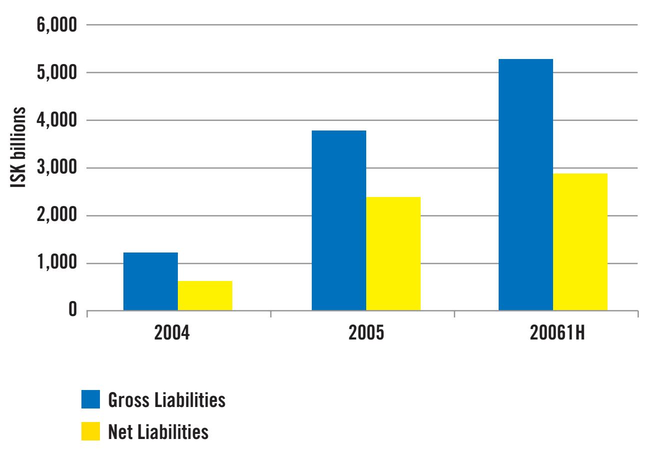


Figure 11 Development of gross and net liabilities of commercial banks and Sparisjóðabankinn - Icebank (parent company statements) owed to foreign parties

2.1.6 Capital Adequacy

The capital base of the commercial banks and the major savings banks has been strengthening since year-end 2000. At the end of June 2006, the CAD ratio was 13.3% compared with about 10% at year-end 2000. The Tier 1 ratio was 10% at mid-year 2006, compared with 8.1% at year-end 2000.

All the commercial banks and major savings banks pass the FME's stress test as of June 30th 2006, which consists of:

- 35% reduction in the book value of Icelandic shares at own risk
- 25% reduction in the book value of foreign shares at own risk
- 7% reduction in the value of marketable bonds at own risk
- 20% devaluation of the Icelandic króna
- 20% reduction in the value of frozen-interest loans and appropriated assets

Some modifications were made to the stress test last year. The stress factor for domestic shares was raised from 25% to 30% and a 20% devaluation of the króna was incorporated into the test. In addition, the FME conducts further stress tests as required. The stress test will be reviewed and subsequently developed in line with the implementation of the provisions of the Basel II Directive.

The primary reason for raising the stress test criteria was a much greater increase in domestic share prices in 2004 and 2005 than in the prices of foreign shares held by the banks. The effects of changes in the exchange rate were incorporated into the test as a result of the unusually strong position of the króna at the beginning of 2006. A simple average of the impact of the stress test on the three largest banks as of June 30th 2006 shows a 2.2 percentage point drop in the CAD ratio. Comparable figures for year-end 2004 and 2005 were 1.7 and 1.6 percentage points according to the criteria applied in the test at that time.

The capital position of commercial banks and savings banks appears fully adequate as of the end of June 2006.

Figure 12 Shareholder Funds at Book Value of Deposit Institutions

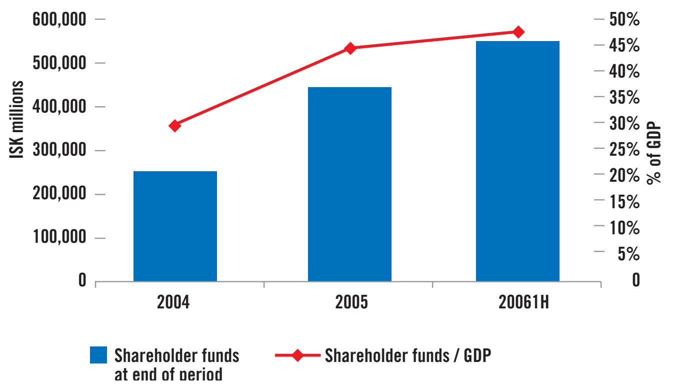


Figure 12 Developments in the book value of equity, both in absolute terms and as a proportion of GDP

Figure 13 CAD Ratio of Commercial Banks and Largest Savings Banks

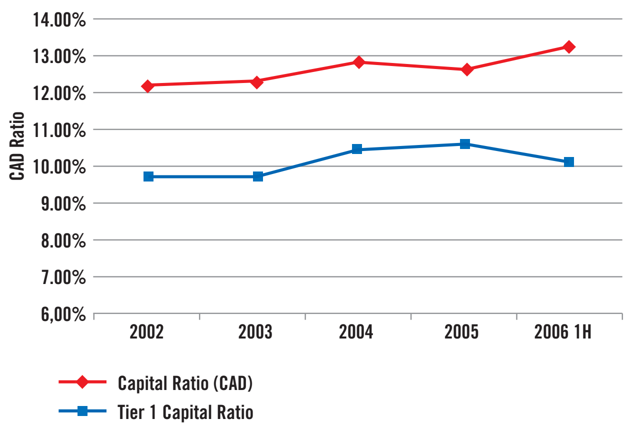


Figure 13 Developments in CAD ratios

Figure 14 Ratio of Foreign Income at Commercial Banks

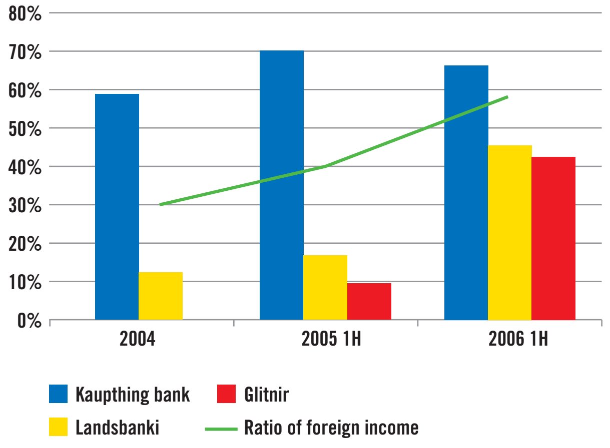


Figure 14 Proportion of the banks' foreign revenue

2.1.7 Summary and Outlook

The revenue bases of the largest commercial banks have grown considerably in recent years in the wake of their acquisitions of foreign financial undertakings as well as increased lending to domestic businesses operating abroad. During the first half of 2006, net operating income from the overseas activities of Icelandic banks amounted to 58% of their total revenue, compared with 25% in 2003. In the case of the largest commercial bank, the proportion of income from overseas activities was 66% during the first half of 2006, compared with just under 50% in 2003. The banks are thus not as dependent on fluctuations in the domestic economic environment as before.

Although the greater diversification of credit risk generated by the banks' expansion overseas must be considered a positive sign, the expansion has also resulted in considerable increases in refinancing risk in respect of foreign debt. The strain on foreign financing experienced by the banks during the first half of 2006 is primarily the result of this increase in refinancing risk. The increased strain may also be explained by deteriorating prospects for the domestic economy and critique published by influential international investment banks on certain aspects of the banks' operations, such as cross-shareholdings, lending collateralized on shares and connected lending. As the FME has pointed out to investors, the banks are not in violation of any regulations in their operations in this respect. On the other hand, it was only to be expected that the extraordinary growth of the Icelandic banks, their record rates of return and their substantial overseas acquisitions would raise questions and even suspicion among those who are not familiar with how this could be accomplished in such a short period of time. The banks responded to this criticism by providing investors with improved information on their activities. Instances of cross-ownership were reduced through the sale and extraordinary dividend payments in shares held by Kaupthing Bank in Exista. These efforts have been favourably received by interested parties abroad and, since the banks' refinancing for 2007 is now almost complete, should serve to calm the waves of criticism levied by foreign analysts.

Less favourable terms on foreign loans coupled with an anticipated slowdown in the Icelandic economy in the near future might result in a somewhat reduced performance by the banks over the next 12-18 months, but Icelandic banks have been performing extremely well in recent years. Under such conditions it can be assumed that the banks will need to exercise extra caution in their investments in the near future, in foreign as well as in domestic markets.

Finally, the growth of the commercial banks and increased operational complexity calls for stricter risk management than before. The implementation of the Basel II Directive also means that the banks will have to spend considerable time and effort on ensuring that all the provisions of Basel II concerning internal control are met - which, of course, applies to all financial undertakings across Europe as well.

2.2 The Securities Market

2.2.1 Trends in the Securities Market

Financial market developments in 2005 were favourable for investors, both on the equity and bond markets. The ICEX-15 index rose by 64.7% during the year, which is substantially more than in comparable markets abroad. Returns on the bond market were also good despite a drop in turnover by 11.6% from the previous year. The trend this year to date is not quite the same, however. Considerable fluctuations in the equity market brought the ICEX-15 index to a peak of 6,925 points on February 15th this year and then down to 5,259 points on July 27th. By the end of September the index stood at 6,286 points and had risen by 13.58% from the beginning of the year, or 37.19% over the preceding twelve-month period. This trend is roughly parallel to developments in other markets, although price fluctuations have been somewhat greater in Iceland. Public equity offers in the autumn months received greater attention than similar offers made earlier in the year and turnover increased during the first nine months, both in the equity and the bond markets. As before, trading is greatest in equities and bonds issued by the four commercial banks, or around 79% of total turnover as of the end of the third quarter.

Total equity trading in 2005 amounted to ISK 1,202 billion, compared with ISK 721 billion in the previous year, which corresponds to an increase of 67% between years. Total equity trading during the first half of 2006 was around ISK 1,080 billion, compared with ISK 403 billion during the same period in 2005.

Total bond market trading amounted to around ISK 1,322 billion in 2005, but reached ISK 1,496 billion in 2004. Bond market turnover increased considerably between 2005 and 2006, or from ISK 573 billion to ISK 1,076 billion.

Figure 15 ICEX Main List and ICEX-15 Indices

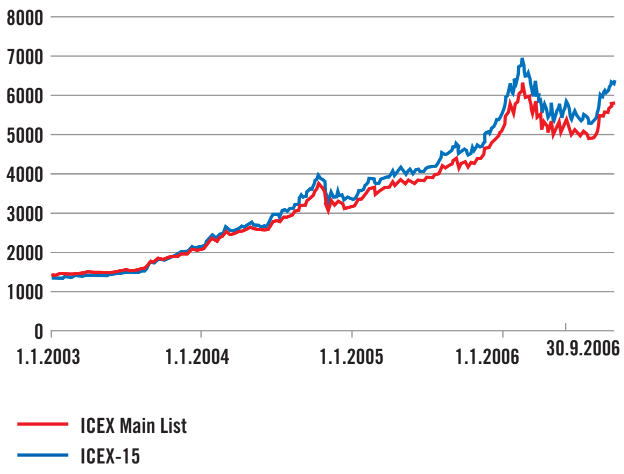


Figure 15 Aggregate index - ICEX 15

2.2.2. Number of Listed Companies on ICEX and their Market Capitalization

The number of companies listed on ICEX continued to drop in 2005, or from 34 at the beginning of the year to 26 at year-end. Two new companies have been listed on the Iceland Stock Exchange so far in 2006, Avion Group in January and Exista in September, and both have been received favourably by investors. Four companies were delisted during the first nine months of this year, viz. Iceland Drilling Company Ltd, Kögun hf, Fiskmarkaður Íslands hf and Fiskey Ltd. Hampiðjan Group moved from ICEX to a new market, iSEC (similar to the UK-based AIM market), which was established last July and is intended to serve as a growth market for small and medium-sized enterprises. Towards the end of this year, at least one new company is expected to be listed and HB Grandi has announced its move from ICEX to iSEC. Dagsbrun Communications has announced a partitioning of the company and the listing of one section on ICEX in November.

The market value of ICEX listed companies was ISK 1,816 billion at year-end 2005. By the end of September their value had increased by 36% to ISK 2,476 billion. There have been fewer mergers of listed companies and the increase in value can partly be traced to new listings and continuing expansion overseas.

In September 2006 an announcement was made of the signing of a memorandum of understanding between OMX and Eignarhaldsfélagið Verðbréfaþing hf concerning OMX's purchase acquisition of the holding company. A formal agreement was subsequently signed in October and OMX intends to apply for an ICEX listing as soon as the acquisition has been finalized. The merger is expected to lead to greater saleability in the Icelandic market and a pooling-of-interests impact on balance sheet items. OMX will be the parent company of the group, but the Iceland Stock Exchange and the Icelandic Securities Depository will continue to be subject to Icelandic law and surveillance.

Figure 16 Number of Listed Companies on ICEX at End of Period

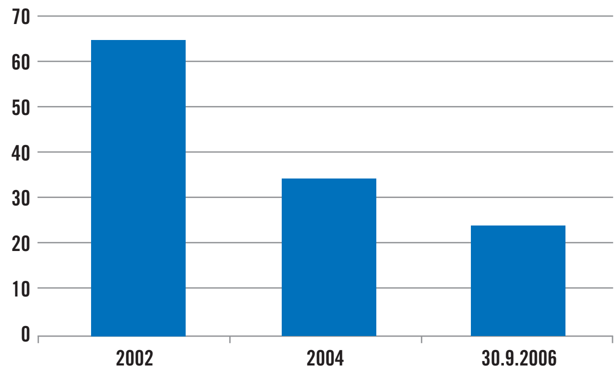


Figure 16 Number of ICEX listed companies

2.2.3 The Bond Market

Trading on the bond market has been flourishing and reached all-time record levels in September. The greatest ever single-day bond and money market turnover of ISK 28.7 billion occurred on September 19th. Total turnover of bonds and bills of trade during the month of September amounted to ISK 229 billion, which is the highest monthly turnover to be measured. The market value of bonds and bills of trade at the end of September was ISK 1,236 billion, which corresponds to a 14% increase since the beginning of the year. Total turnover and the number of transactions have taken a sharp upward swing, which may in part be traced to rising interest rate ceilings and increased inflation.

Figure 17 Market Value of Listed Bonds- Isk.bn.

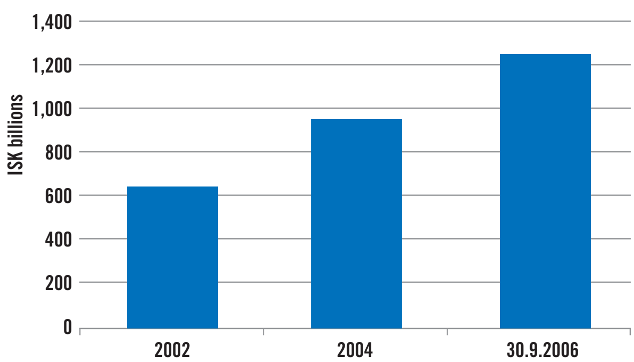


Figure 17 Market value of listed bonds

Figure 18 Market Value of Listed Equities -Isk. bn.

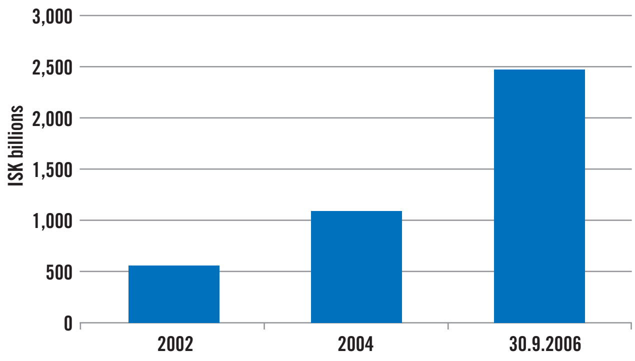


Figure 18 Market value of listed equities

2.3 The Pension Savings Market and UCITS

Pension Funds

2.3.1 Performance

Net assets of Icelandic pension funds amounted to ISK 1,219.5 billion at year-end 2005, compared with ISK 986.7 billion at the same time in 2004. The increase between years is thus 23.6%, which corresponds to an 18.7% increase in real terms as measured by the consumer-price index. Pension fund assets as a proportion of GDP at year-end 2005 were 120% but were 112% at year-end 2004. Figure 19 shows the developments of net pension fund assets as a ratio of GDP for the years 2003, 2004 and 2005.

Figure 19 Pension Funds' Net Assets at Year-end 2003, 2004 and 2005

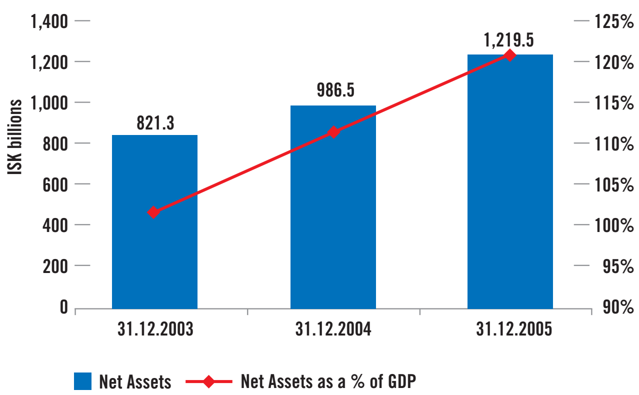


Figure 19 Developments in net pension fund assets for the years 2003, 2004 and 2005

2005 was a record year for the pension funds, which showed net real return of 12.3% compared with 10.4% in the previous year. The net real return of a pension fund is the return on its assets adjusted to the consumer-price index after deducting cost from investment income. All pension fund divisions showed positive net real return during 2005; that of mutual divisions being 13.5% and 8% for private pension schemes. Figure 20 shows the net real return of pension funds for the years 2003, 2004 and 2005. For comparison, average net real return for the previous five and ten years is included.

In assessing the net real return of pension funds, it is important to look to long-term returns. The funds are long-term investors and actuarial surveys of the funds anticipate long-term returns of around 3.5%. As shown in Figure 20, both the five- and ten-year averages are clearly above the 3.5% imputed interest rates of the actuarial surveys.

Figure 20 Pension Funds' Net Real Return in 2003, 2004 and 2005 Compared to Five-year Average and Ten-year Average

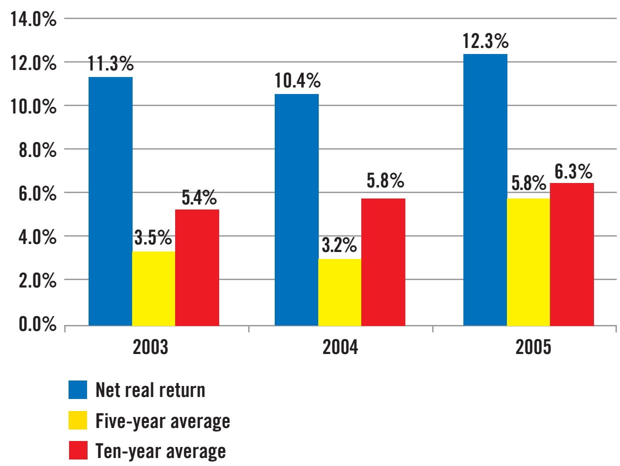


Figure 20 Net real return of pension funds in 2003, 2004 and 2005 compared with average returns for the previous five and ten years

As stated above, net real return on pension fund investments was 12.3% in 2005. The highest net real return of a mutual insurance division was 17.7% and the lowest 0.2%. The division showing the highest return was thus 5.4% above the average for all pension funds while the lowest one was 17.5% below that average. Figure 21 shows the highest and lowest net real return of mutual insurance divisions as well as the highest and lowest five-year average returns for the years 2004 and 2005. An important explanation for different net real return amongst pension funds within periods is different composition of assets. The funds' investment policies vary on account of different estimates for future flow of premiums as well as different rights systems and pension burden.

Figure 21 | Highest and Lowest Net Real Return of a Division and Highest and Lowest Five-year Average of a Division in 2004 and 2005

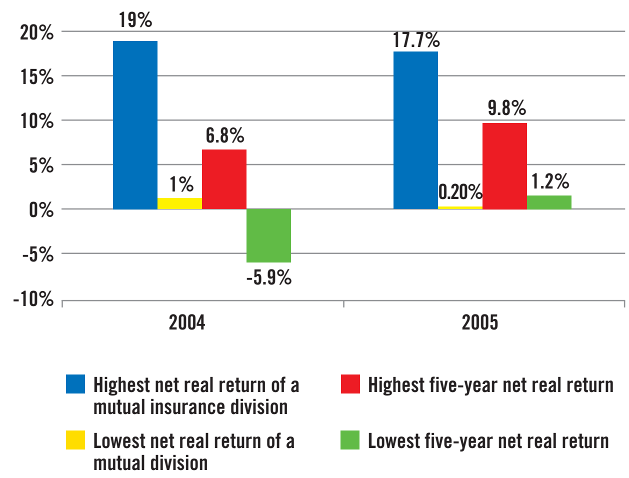


Figure 21 Highest and lowest five-year average returns of a division for 2004 and 2005

Improved performance in 2005 brought recovery to the actuarial position of pension funds without employer guarantees. At year-end 2005, a total of 38 such divisions were operated by 33 pension funds. As shown in Figure 22, the position in 22 divisions was positive by up to 10.9% as compared with 13 divisions in 2004. Fifteen divisions showed a deficit ranging from 0.1% to 10% while only one had a deficit higher than 10%. Pursuant to the Pension Funds Act, pension funds must amend their statutes in order to achieve a balance between their assets and obligations if the difference is greater than 10% or 5% for five consecutive years. Consequently, one pension fund division needs to take necessary action in order to reach the assets-obligations equilibrium required by law.

Figure 22 | Actuarial Position of Pension Funds not Guaranteed by Other Party

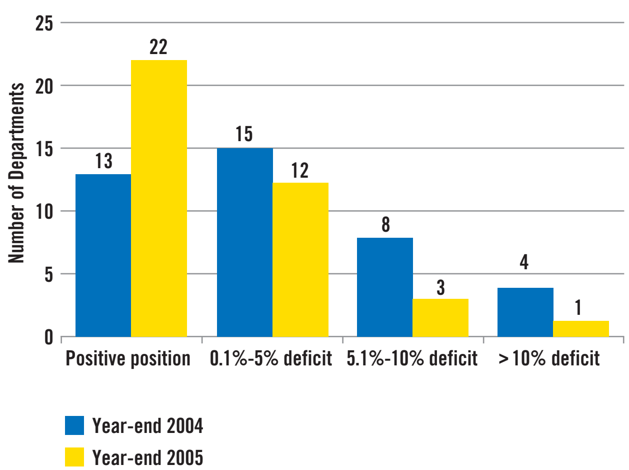


Figure 22 Actuarial position of non-guaranteed pension funds at year-end 2004 and 2005

Employer-guaranteed pension funds showed little change in their actuarial positions. Nearly all divisions carry a hefty deficit, but the guarantees help to bridge the gap between assets and obligations in actuarial statements.

Pension fund returns have reached an all-time high during the previous three years, but it is doubtful that such a trend will continue in years to come. It is, therefore, important to exercise caution in the increment of rights although the financial position has improved. It is also important for the funds to continue developing their risk management procedures so they will be in a position to meet market fluctuations at all times.

2.3.2 Investments

The ratio of variable-yield securities continued to grow at the expense of fixed-income securities in 2005 - a trend which had indeed established itself in preceding years. As shown in Figure 23, this ratio was 48% in mutual insurance divisions at year-end 2005 compared with 43% at the same time in 2004. The figure also shows an increase from 62% to 65% between years for the funds' private pension schemes. The relatively higher ratio of variable-yield securities in the private pension scheme divisions reflects more risk seeking investment strategies, which is only to be expected since supplementary pension savings are of a different nature than the minimum pension coverage offered by mutual insurance divisions.

Figure 23 | Pension Funds' Assets Composition at Year-end 2004 and 2005

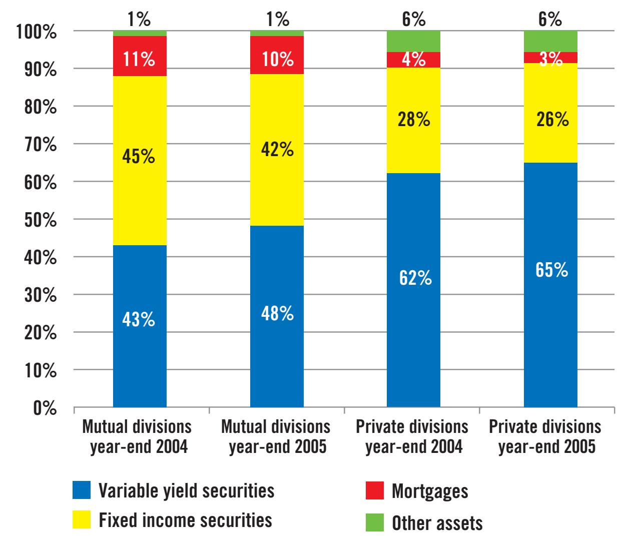


Figure 23 Asset composition of mutual insurance divisions and private pension schemes at year-end 2004 and 2005

Figure 24 shows developments in the ratio of mortgages as a percentage of the net assets of pension funds in 2003, 2004 and 2005. This ratio, which has been decreasing steadily from its peak of 16% in 2001, dropped from 10% at year-end 2004 to 9% at the same time in 2005. The mortgages are largely loans to fund members. In 2006 the pension funds were given increased leeway for the granting of such loans by raising the mortgage limits from 65% to 75% of the market value of the mortgaged property.

Figure 24 Mortgages as a Ratio of Net Assets at Year-end 2003, 2004 and 2005

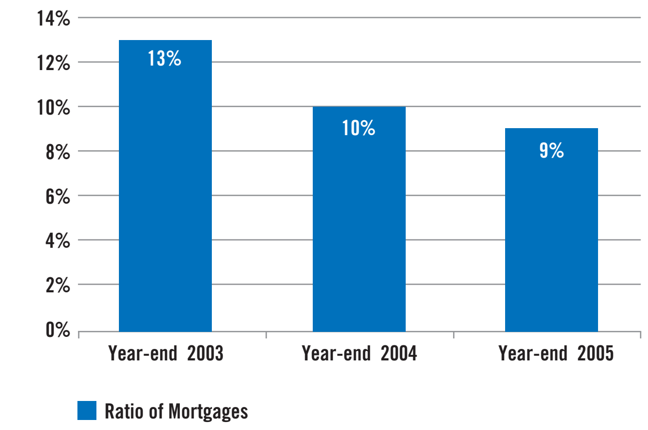


Figure 24 Proportion of mortgages in the net assets of pension funds at year-end 2003, 2004 and 2005

Figure 25 shows developments in equity as a ratio of net assets at year-end 2003, 2004 and 2005. The figure includes shares in limited companies and unit share certificates in funds other than UCITS. This ratio dropped slightly between 2004 and 2005, or from 38% to 37%. The ratio has been growing steadily since the entry into effect of the Pension Funds Act in 1998, when it was 15%. Pursuant to the Pension Funds Act, pension funds may hold equity amounting to 60% of net assets, but this ratio was increased from 50% in 2006. The maximum for units and unit share certificates in other funds is 50%. The combined ratio of these two types of investment may not exceed 60%, which leaves considerable scope for investment.

Figure 25 Equities and Units and Shares in Other Collective Investment Undertakings as a Ratio of Net Assets at Year-end 2003, 2004 and 2005

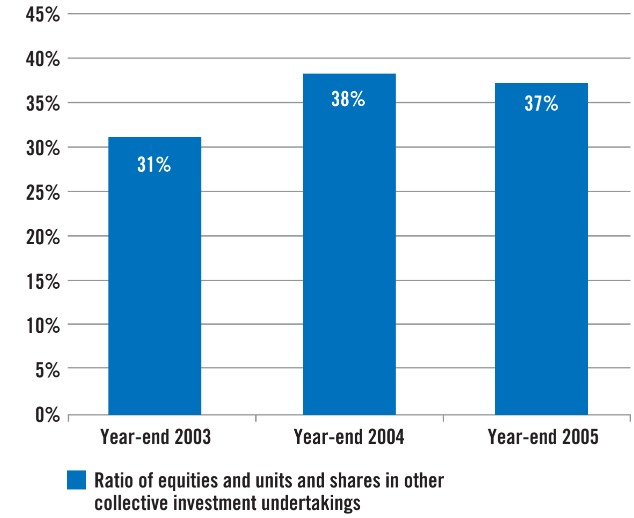


Figure 25 Equity and units and shares in other collective undertakings as a ratio of pension fund assets at year-end 2003, 2004 and 2005

2.3.3 Mergers and Age-related Accumulation of Rights

The number of pension funds kept decreasing during the period. As of July 1st 2006, there were 42 pension funds in operation, compared with 46 funds on the same date the year before. Of the 42 funds, 34 were still fully operational, while eight no longer received premiums, as shown in Figure 26. Since the entry into effect of the Pension Funds Act in 1998, the number of pension funds has dropped by a third, or on average by three funds per year, as shown in Figure 26.

Figure 26 Number of Pension funds at Year-end 1998, 2005 and June 30, 2006

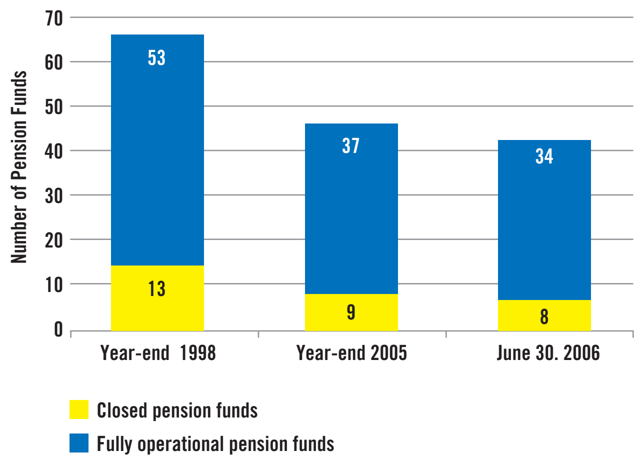


Figure 26 Developments in the number of pension funds as of year-end 1998, year-end 2005 and June 30th 2006

Three pension fund mergers took place during the period and one pension fund was dissolved following the demise of its last member. By mid-October 2006, two further mergers with ensuing statutory amendments had come under the FME's review. Given these mergers, the number of pension funds will be 40 and ten of the largest funds will hold 80% of the aggregate net assets of all pension funds as of year-end 2005.

Pension fund mergers are generally a positive sign and will no doubt become more frequent in the future. An important result of such mergers is fewer and larger funds which are likely to achieve greater distribution of risk on account of assets and obligations as well as improved rationalization of operations. Improved rationalization encourages a more powerful framework for internal control and risk management and professional know-how within the funds. On the other hand, fewer and larger funds also mean increased concentration of risk and even call for heightened surveillance activities, as do the extended investment authorizations granted to the funds.

In 2005, six pension funds changed their benefits accumulation systems from unit pension schemes to age-related pension schemes. This trend has grown steadily in recent years, as indicated in Figures 27(a) and 27(b), which show changes in the proportional division of net assets by type of pension rights accumulation of pension funds. A total of 31% of pension fund assets were tied up in pension funds with age-related schemes, compared with 8% in the previous year.

Figure 27a	Pension Funds at Year-end 2005

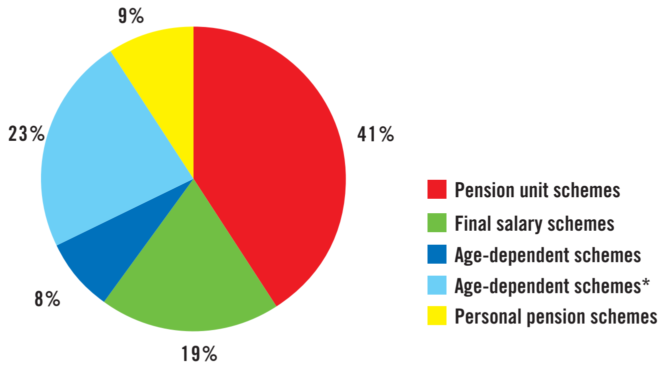


Figure 27(a) Pension fund rights accumulation schemes at year-end 2005 as proportion of net assets

Benefits earned by membership in the six funds mentioned above are, however, not purely age-related although these funds are categorized as age-related schemes* in Figure 27(a). A specific number of fund members may continue payments into a unit pension system for a limited period of time, or until their retirement, but only as a percentage of a premium based on fixed prices and which corresponds to a premium that was earlier paid towards a unit pension scheme. These individuals are fund members who made payments into unit schemes for considerable lengths of time during their earlier working years and who would suffer substantial curtailments of rights if they were to change into an age-related benefit scheme during the latter part of their working lives.

Figure 27b	Pension Funds at Year-end 2004

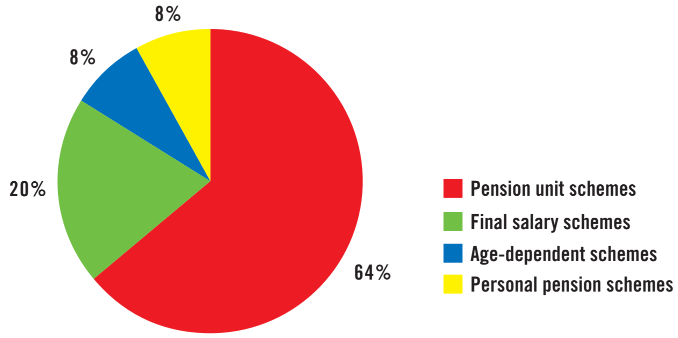


Figure 27(b) Pension fund rights accumulation schemes at year-end 2004 as proportion of net assets

Poor investment returns during the period 2000-2002 and altered assumptions of actuarial examinations for pension funds due to increased life expectancy and rising disability frequency have mainly pressed the funds to introduce age-related benefit schemes.

In an age-related benefit scheme, the accumulation of rights is based on the age of the fund member at the time payment is made and, hence, the length of time for which the premium will remain invested in the fund. The accrued benefits are thus actuarially correct. In a unit pension scheme, however, fund members earn the same rights for the same premium throughout their working lives. The fundamental assumptions in a unit pension scheme are that fund members pay the same percentage of the same wage until they retire and that there will always be sufficient recruitment. With rising wages, higher contributions and less recruitment in the units schemes, these assumptions are likely to become at least partially distorted. Another negative factor for the unit schemes is people's readiness to contribute towards an age-related scheme at a younger age and their tendency to revert to a unit scheme as they approach retirement age.

With a view to these facts, it is only to be expected that pension funds operating unit pension schemes will introduce age-related benefit schemes in the near future. The mergers of pension funds are also likely to continue as to date and in the case of pension funds operating pension unit schemes parallel to the adoption of age-related pension schemes.

2.3.4 Supplementary Pension Cover and Private Pension Savings

Accumulated supplementary pension savings with pension funds and other pension savings depositories increased by 32%

from year-end 2004, or from ISK 110.5 billion to ISK 146.2 billion at the end of 2005. There has been an average per-annum growth in supplementary pension savings of around 30% since 1999, ranging from 21% that year to a peak of 41% in 2003. Figures 28(a) and 28(b) show the proportional division of savings between depositories.

Figure 28a | Depositaries' Relative Share of Private Pension Savings at Year-end 2000

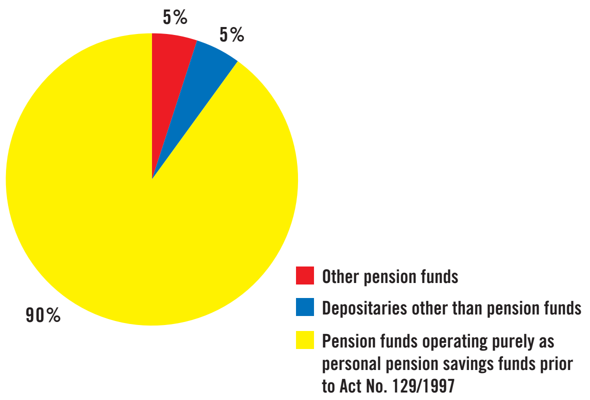


Figure 28(a) Proportional division of accumulated supplementary pension savings between depositories at year-end 2000

Figure 28b | Depositaries' Relative Share of Private Pension Savings at Year-end 2005

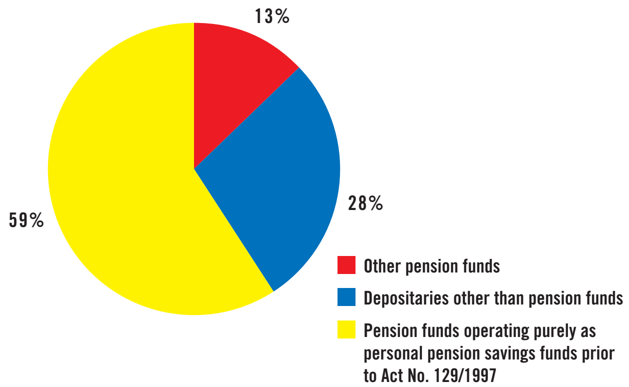


Figure 28(b) Proportional division of accumulated supplementary pension savings between depositories at year-end 2005

When considering the developments of supplementary pension savings, it should be borne in mind that a large proportion of these savings is in the custody of pension funds which were operating solely as private pension schemes prior to the entry into effect of Act 129/1997 in the year 1998, or ISK 86.7 billion, cf. Figure 28(b). Figure 29 shows accumulated supplementary pension savings with depositories other than those funds, which amounted to ISK 59.5 billion at year-end 2005, compared with ISK 42.5 billion at year-end 2004.

Figure 29 | Private Pension Savings on Deposit with Parties Other than Pension Funds Operating purely as Personal Pension Savings Funds prior to Act No. 129/1997

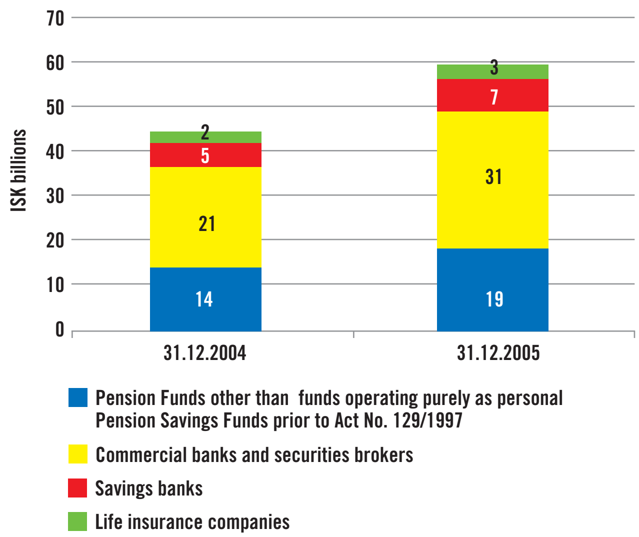


Figure 29 Accumulated private pension savings with depositories other than pension funds operating as private pension schemes prior to the entry into effect of Act 129/1997

Accumulated supplementary pension savings with depositories other than pension funds amounted to ISK 40.8 billion at the end of 2005. Adding this amount to the net assets of pension funds brings the total assets of the entire pension system to ISK 1,260.3 billion at year-end 2005, or 124.5% of GDP. For comparison, this amount stood at ISK 1,015.1 billion, or 87.5% of GDP, at the end of 2004.

UCITS and Investment Funds

The FME supervises the activities of management companies of undertakings for collective investment in transferable securities and investment funds.

The difference between UCITS and investment funds lies primarily in their different investment authorizations. A UCITS is a fund that is licensed to operate within the EEA and is established and operated by a management company which issues unit certificates that are redeemable from the fund's assets upon the owners' request. An investment fund carries an operating licence but is not allowed to market itself within the EEA, i.e. can only operate on the domestic market. An investment fund issues unit certificates or equity and has greater leeway for investment than UCITS. This means that an investment fund may invest to a higher degree in unlisted securities and is not subject to equally strict risk distribution requirements.

UCITS and investment funds have the sole objective of receiving money from the public for collective investment in financial instruments and other assets based on a distribution of risk in line with a previously advertised investment strategy. The FME certifies UCITS and investment funds, or individual divisions, which issue unit certificates and grants operating licences to investment funds which issue equity, pursuant to Act 30/2003.

The FME supervises the investment activities of UCITS and investment funds. Act 30/2003 contains provisions concerning the investment authorizations of these funds. Investments must be within the limits set by law as well as the funds' investment policies that have been approved by the FME. Supervision consists of regular report submissions by the management companies and surveillance visits to the management companies by FME representatives.

The FME monitors the advertising and promotional activities of UCITS and investment funds and emphasises that their management companies comply with laws and regulations in this respect. The FME also supervises the marketing of foreign funds in Iceland and reviews the notifications of foreign funds intending to offer their services in the Icelandic market.

There was an increase in the number of UCITS operating during the period. One management company received approval to operate 5 UCITS, so by July 1st 2006 there was a total of 15 such funds, compared with ten in the previous period.

On the other hand, there was a decrease in the number of UCITS divisions. Of the 15 UCITS operating on July 1st 2006, four were split into a total of 25 divisions. During the preceding period, there were also four sectionalized UCITS, whereas the total number of divisions was 28.

There was also an increase in the number of investment funds during the period. A total of 24 investment funds were operating on July 1st 2006, compared with 13 in the preceding period. This is because one management company was licensed to operate ten new investment funds and another management company, which had not previously operated an investment fund, received certification.

Investment fund divisions also increased during the period. Of the 24 investment funds operating during the period, four were split into a total of 17 divisions. In the preceding period, three of the funds were operating in five divisions. The reason for this increase is that all the divisionalized investment funds received authorization to augment the number of their divisions.

Number:	2006	2005
UCITS	15	10
Thereof divisionalized	4	4
Divisions	25	28
Investment funds	24	13
Thereof divisionalized	4	3
Divisions	17	5

As shown in Figure 30, the assets of UCITS and investment funds have grown substantially in recent years. Assets thus increased from ISK 134 billion at year-end 2002 to ISK 363 billion at year-end 2005, both as a result of new capital and excellent returns during the period.

Figure 31 shows the proportional division of UCITS assets at year-end 2005. The largest share, or 75.6%, is fixed-income financial instruments while equity holdings make up a total of 11.2%. Figure 32 shows, on the other hand, the proportional division of investment funds assets at year-end 2005. The proportion of fixed-income financial instruments is somewhat lower than with the UCITS, or 68.4%, whereas share ownership is higher, or 15.4%. This is largely to be explained by the fact that investment funds are generally more risk seeking than UCITS.

Figure 30 **Assets of Undertakings for Collective Investments and Investment Funds**

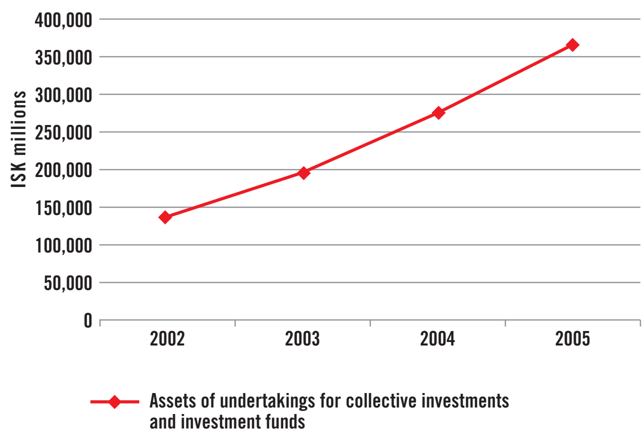


Figure 30 Developments in the assets of UCITS and investment funds, ISK million

Figure 31 **Composition of Assets of Undertakings for Collective Investment at Year-end 2005**

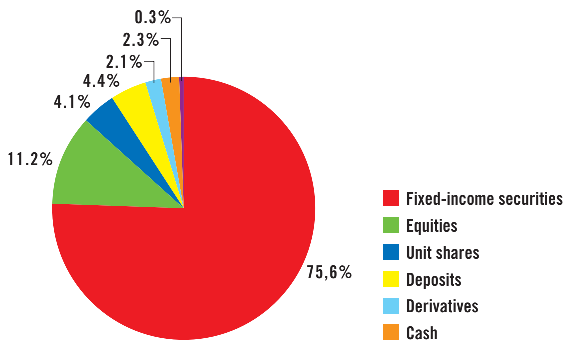


Figure 31 Proportional division of UCITS assets at year-end 2005

Figure 32 Composition of Assets of Investment Funds at Year-end 2005

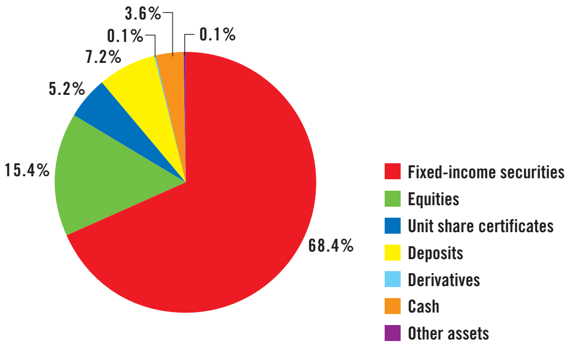


Figure 32 Proportional division of investment funds assets at year-end 2005

Figure 33 Profits on Insurance Companies' Main Areas of Activity, 2005 price levels

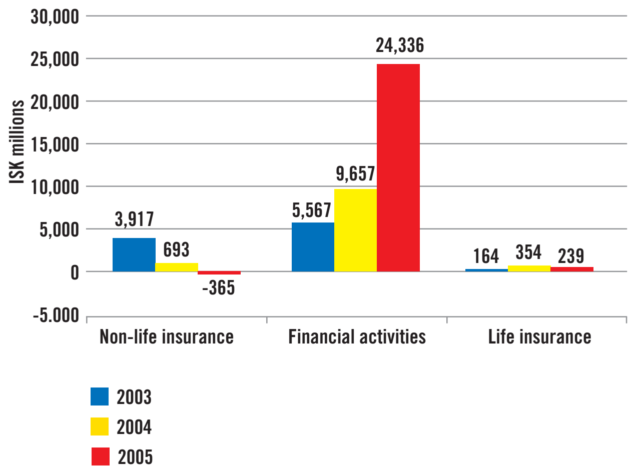


Figure 33 Profit from major insurance activities adjusted to 2005 prices

2.4 The Insurance Market

2.4.1 Record Profit from Investment and Increased Weight of Equities[8]

In 2005, two insurance companies - Tryggingamiðstöðin hf and Vátryggingafélag Íslands hf - began implementing international financial reporting standards (IFRS). These standards also affect the financial statements of affiliated insurance companies, i.e. Líftryggingamiðstöðin hf, Trygging hf and Líftryggingafélag Íslands hf. KB Life Insurance is a subsidiary of Kaupthing Bank and IFRS has thus an indirect impact on its financial statements. The insurance company Sjóvá-Almennar tryggingar hf. will also implement the standard this year for the consolidated accounts of the company and Sjóvá-Almennar life insurance. The two last-named companies have, in fact, already begun preparations for the implementation of the standards, as the settlement of its market securities has been at market value since 2003.

The introduction of IFRS and favourable market conditions contributed towards making 2005 a record year of profit for Icelandic insurance companies.

Financial activities have turned out to be an important source of income for insurance companies, since non-life insurance activities - i.e. the insurance portfolio itself - have more often than not returned negligible profit or even been run at a loss. Figure 33 shows how profit from financial activities increased by 152% in 2005 while profit from life insurance activities shrank by 32%. Non-life insurance was, on the other hand, operated at a loss for the first time since 2000.

The insurance companies' profit from equities and equity-related securities in 2005 has meant that this item has grown as a proportion of assets from 30% to 48%. At the same time, increased insurance company investment in qualifying holdings has resulted in increments in shares in consolidated and associated companies, as shown in Figure 34. The proportion of other asset items has, however, dropped over the past three years.

Figure 34 Share of Various Asset Items in Insurance Companies Assets 2003-2005

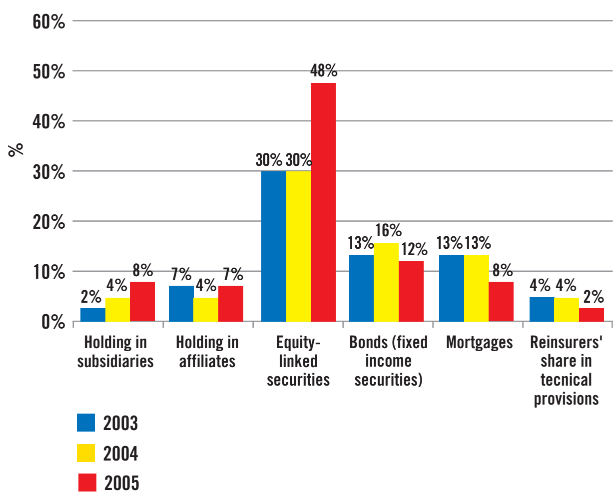


Figure 34 Percentages for major asset items of insurance companies from 2003-2005

8 *The State Natural Catastrophe Fund is not included in figures explaining operations and performance.*

Increased share ownership and the settlement of shares at market value are likely to create considerable fluctuations in the insurance companies' profits from financial activities. This calls for improvements in the FME's overview of the asset sides of their balance sheets. The importance of risk and asset liability management needs to be addressed. Equities are primarily suitable to meet long-term commitments as in the case of pension funds, whereas insurance company obligations are generally for shorter periods of time.

In 2006 the FME introduced standardized stress tests in order to monitor the impact of a number of prespecified shocks on the solvency ratio of insurance companies. The largest single impact in these tests is the assumption of lowering share ownership by 35%. The stress tests provide valuable information on financial position, which cannot be obtained from simple comparisons of solvency and minimum solvency. Stress test results might, in a few instances, give rise to more detailed examinations than normally applied of the asset composition and risk management of insurance companies.

A number of non-life insurance companies have participated in quantitative impact studies in relation to the introduction of the Solvency II Directive developed by the EU. The objective of this directive is that solvency requirements take into account all risk factors in the operations of insurance companies. The QIS2 study, which was conducted at mid-year 2006, focused primarily on testing possible modules for measuring solvency requirements. An important assumption in the study was that the proportion of capital against equity risk would need to amount to 40% of share ownership, i.e. in order to offset such decreases. The result was that this requirement would substantially reduce the solvency ratio of Icelandic insurance companies. This impact has also been felt in other European countries, so it may turn out to be necessary to carry out some modifications to the methods used for measuring equity risk.

2.4.2 Positive Returns - Equity Position Strengthens

Profits from financial activities as a proportion of equity have throughout the years been higher with non-insurance companies than life insurance companies. The primary reason is the fact that a larger proportion of the assets of non-life insurance companies is tied up in equities. Over the past three years, return on equity has, however, generally been very good, as shown in Figure 35.

Figure 35 Profits from Financial Activities as a Ratio of Equity 2003-2005

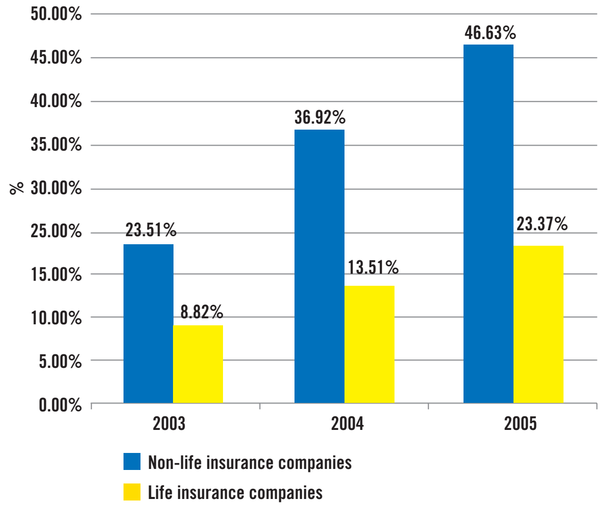


Figure 35 Profits from financial activities as proportion of equity 2003-2005

In 2005, aggregate equity was higher than aggregate technical provisions for the first time since public supervision of insurance activities began in 1974, as equity increased substantially with those companies which introduced IFRS during the year.

The introduction of IFRS also means that equalization provisions are disappearing and now only exist in the company Viðlagatrygging Íslands (State Natural Catastrophe Fund). Other insurance technical provisions remain relatively unchanged, as shown in Figure 36.

Figure 36 Principal Items of Technical Provisions 2003-2005 at 2005 price levels

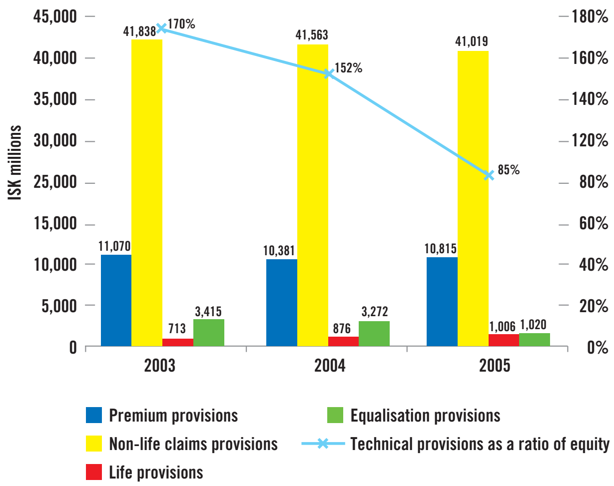


Figure 36 Main insurance technical provisions 2003-2005 adjusted to 2005 prices

2.4.3 All Classes of Non-life Insurance Showing Loss or Negligible Profit

None-life insurance premiums remained relatively unchanged in 2005 and were even reduced for some insurance classes compared with constant price levels. Figure 37 shows developments in premiums and performance of individual insurance classes over the last three-year period. Reductions in premiums for motor vehicle insurance are most striking, but all insurance companies increased these premiums in 2006.

Motor vehicle insurance has in recent years been returning a profit, largely from financial income from technical provisions. During 2005, this insurance class was, however, operated at a loss. Other non-life insurance classes also show losses or negligible profits.

Figure 37 Premiums and Profit /Loss in Main Non-life Insurance classes 2003-2005, 2005 price levels

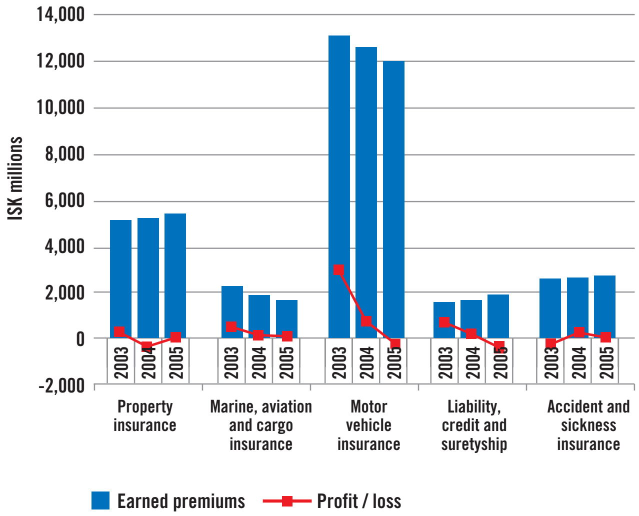


Figure 37 Premiums and performance of major non-life insurance classes 2003-2005, adjusted to 2005 prices

The principal reason for losses in the motor vehicle insurance class is a steady upsurge in claims while premiums have been dropping. This year's premium rises reflect the insurance companies' reactions to the heavy claims burden and general price level increases.

While claims have been escalating, there has been a constant drop in claims provisions in mandatory motor vehicle insurance, which constitute by far the largest part of insurance technical provisions, as shown in Figure 38. This is an indicator of speedier claims settlements and, as a result of this development, the FME now intends to review the criteria set in Rules 903/2004 on the assessment of outstanding claims and report submissions in that respect, which is used as a basis for calculating minimum and maximum levels for claims provisions.

Figure 38 Claims and Claims Provisions in Compulsory Motor Insurance at 2003-2005, 2005 price levels

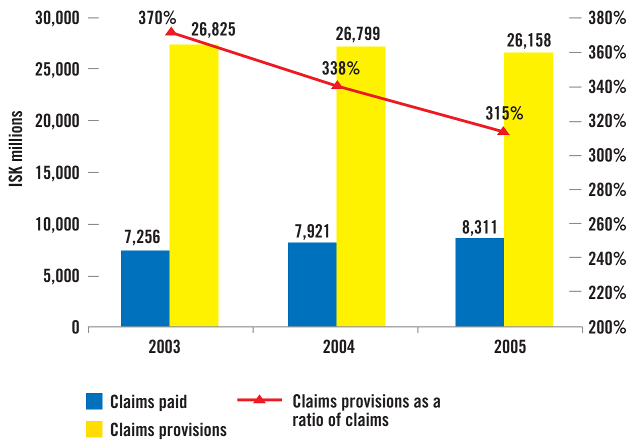


Figure 38 Claims and claims provisions in mandatory motor vehicle insurance 2003-2005, adjusted to 2005 prices

Finally, the dominant position of the three largest insurance companies (Sjóvá-Almennar tryggingar hf, Tryggingamiðstöðin hf and Vátryggingafélag Íslands hf) in the motor vehicle insurance sector appears to be on the wane, as shown in Figure 39. The market share of these three companies, as measured by premiums paid, was 92.3% in 2005, compared with 94.6% in 2005 and 97.5% in 2005.

Figure 39 Market Share of Three Largest Insurance Companies in Motor Vehicle Insurance 2003-2005

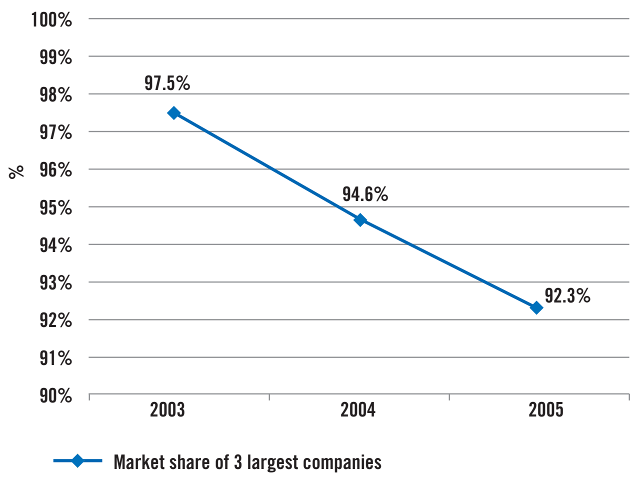


Figure 39 Market share in motor vehicle insurance of the three largest insurance companies 2003-2005

2.4.4 Increased Activities Abroad

Similar to other financial undertakings, insurance companies have in recent years increasingly sought to expand their activities overseas. This trend has been particularly noticeable over the past two years.

In September 2005, Vátryggingafélag Íslands hf purchased a 54% equity in IGI (Intercorporated General Insurance) Group Ltd in the UK and in 2006 Tryggingamiðstöðin acquired all the shares of Nemi forsikring ASA in Norway. Sjóvá-Almennar tryggingar hf cooperate with Royal & Sun Alliance in the UK on the selling of insurance to Icelandic multinational companies.

One insurance company, European Risk Insurance Company hf (ERIC), only offers liability insurance in the UK. This company, which received its operating licence in 2003, is currently in considerable growth and the overall increase in insurance premiums received abroad is primarily the result of extended activities by this company alone. The activities of other insurance companies within the EEA, as authorized by directives on the internal market, have also shown certain signs of an upswing, both in 2006 and 2005. The increase in premiums received abroad can be seen in Figure 40. This trend is expected to continue in years to come.

Figure 40 Icelandic Insurance Companies' Operations in Other EEA Member States at 2003-2005 at 2005 price levels

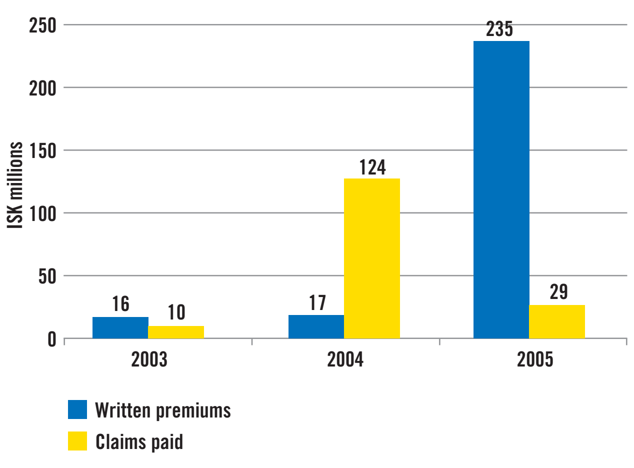


Figure 40 Activities of Icelandic insurance companies within the EEA 2003-2005 adjusted to 2005 prices

2.4.5 Foreign Companies Strong in the Life Insurance Sector

Recently, the FME compiled for the first time statistics on the activities of foreign insurance companies from within the EEA, which are licensed to operate in Iceland in accordance with the provisions of Chapter VII of Act 60/1994 on Insurance Activity and EEA directives. The statistics in Figure 41 show that foreign insurance companies had around one-third of the market share in the life insurance sector in Iceland during the period 2002-2004.

Figure 41 Written Premiums in the Life Insurance Market 2002-2004, 2005 price levels

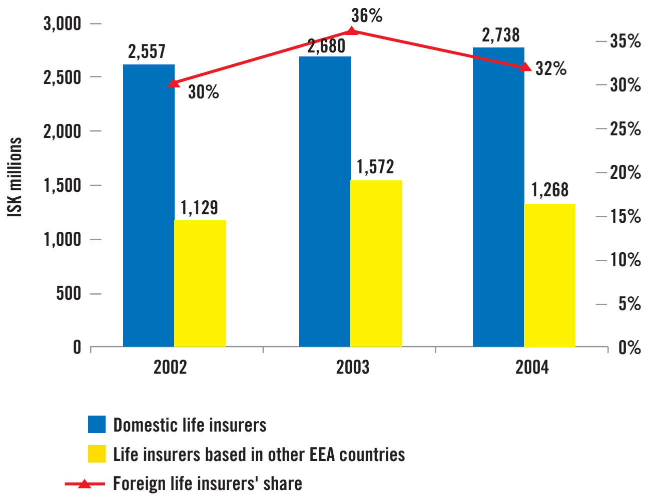


Figure 41 Life insurance premiums 2002-2004 adjusted to 2005 prices

There has been a reduction in the operations of insurance intermediaries in Iceland, partly due to the fact that a number of foreign insurance companies have withdrawn from the market. As a result, a further drop in the market share of foreign life insurance companies is expected. Figure 42 shows the strengthening of insurance mediation activities in 2004 followed by a considerable drop in 2005.

Figure 42 Total Asset and Number of Icelandic Insurance Intermediaries 2003-2005

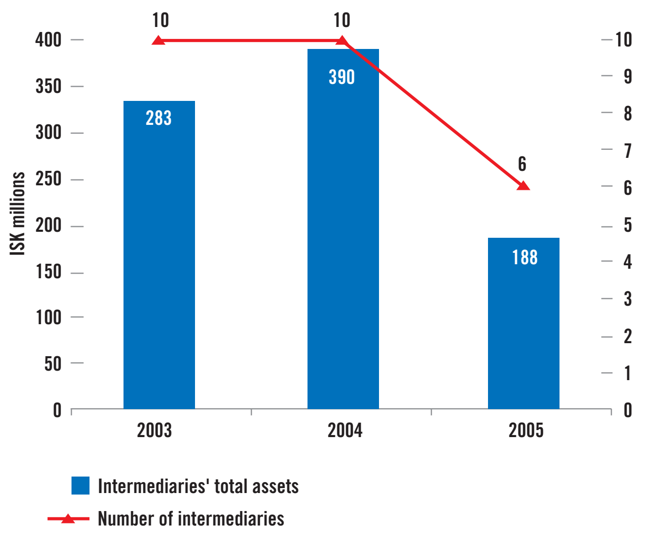


Figure 42 Assets and number of domestic insurance intermediaries 2003-2005

There appears to be an increased emphasis on mortality risk life insurance at the expense of unit-link insurance, as shown in Figure 42. At the same time, there is an apparent growth in health, income and sickness insurance. Pension savings have to date not been a crucial factor in the operations of life insurance companies.

Figure 43 Breakdown of Written Premiums According to Life Insurance Class 2004-2005

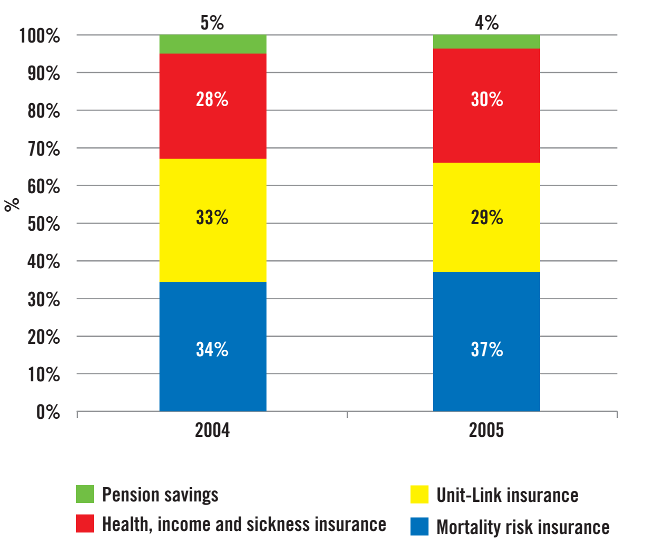


Figure 43 Division of premiums between life insurance classes 2004-2005

3 EMPHASES IN THE FME'S WORK IN COMING MONTHS

3.1 International Activities and Disclosure of Information

The overseas activities of Icelandic financial undertakings have largely been centred on subsidiaries that have either been established or purchased. Judging by the flurry of notifications concerning the establishment of overseas branches recently received by the FME, this trend appears to be changing. Greater numbers of financial undertakings are also opening agencies abroad. The role of an agency is to promote the activities of a financial undertaking in the country where it is operating or establish customer links, but the agency is not authorized to provide financial services, such as receiving deposits, granting loans, finalizing securities transactions, etc.

Overview of the overseas activities of Icelandic financial undertakings

	Year-end 2003	Year-end 2004	Year-end 2005	Oct 1, 2006
Subsidiaries	9	14	20	25
Branches	2	2	4	8
Representatives	0	0	2	4
Foreign states where activities are pursued	8	9	12	13

The purchase of licensed businesses abroad is primarily intended to facilitate the access of Icelandic undertakings to foreign markets, but all such acquisitions are conditional upon the approval of supervisory authorities in the states concerned. The establishment of branches is, on the other hand, a much simpler process, at least within the EEA, where domestic businesses automatically gain the right to establish branches in other member states provided certain formalities have been fulfilled.

The activities of foreign subsidiaries are subject to supervision in the states where they are established, but the FME is responsible for supervision on a consolidated basis. This includes, for instance, financial supervision of the corporate group and risk management surveillance. The activities of foreign branches and agencies are, on the other hand, subject to FME supervision.

The growing number of branches and increased weight of overseas activities among parties subject to supervision will clearly enhance the workload and responsibility of the FME. Already, the proportion of employees working for the three large banks abroad amounts to 40% of overall personnel and income from overseas operations is around 60% of the banks' total revenue.

The FME is currently formulating a strategy on the supervision of the overseas activities of parties subject to its supervision and collaboration with supervisory authorities abroad on account of these activities. This strategy will include directions for supervision in the overseas branches of domestic financial undertakings and requisite report submissions as well as procedures for the consolidated supervision of foreign subsidiaries, as required, in collaboration with supervisory authorities in the states concerned. The FME has signed a few partnership agreements with foreign supervisory authorities and expects to enter into further agreements of this nature in coming months, for instance with supervisory authorities in states outside the European Economic Area on account of financial operations in those countries.

3.2 First-Rate Information System - Supervision of IT Developments

3.2.1 IT and Modernization

The collection and processing of data and subsequent informed decision-making are the cornerstones of all knowledge-based activities. Effective information systems can speed up and improve decision-making processes and thus increase operational efficiency and success. Powerful information systems also help retain knowledge within an institution, irrespective of manpower changes, while at the same time ensuring decision-making consistency and a clear overview of precedence.

The FME takes pride in maintaining an up-to-date information system which supports the Authority in achieving its goals in an efficient manner. The FME has formulated an IT strategy for the next three years, of which the following are the key features:

- All communications with parties subject to supervision shall be electronic.
- There will be a processing system for the primary analysis of data which will also serve as an early warning system.
- Databases and the FME's case management system will be coordinated to facilitate the storage, processing and use of information.
- Information security must be reliable and the FME will apply for ISO 27001 certification.
- Web management systems and the FME webpage should support efficient and effective dissemination of information at different levels, i.e. internal network (within the institution), external network (specific sites for individual parties subject to supervision or partner institutions) and Internet (for the general public).
- Software and hardware meet all requirements at any point in time.
- The FME shall be able to fulfil all international commitments concerning information communication.

The key objective in the FME's strategy is that all communication with parties subject to supervision will be electronic and that the Authority continues to develop the use of information technology for its surveillance activities.

Every year, for purposes of supervising compliance with a range of different rules and analyzing potential operational weaknesses, the FME collects around 3500 reports from parties subject to supervision on various aspects of their operations. The reports, which are submitted either by mail or e-mail, are checked for errors by FME employees who enter the data into specially designed databases. As of the beginning of 2007, reports will only be accepted if sent by e-mail - at least while other and more efficient ways for the electronic submission of information are being developed. No paper-based reports will be accepted.

Electronic report submissions will save a great deal of work, improve supervisory procedures and increase the operational efficiency of parties subject to supervision. In such a system, data will automatically be checked for errors before it is formally accepted and the data transferred by electronic means to the corresponding database. The FME also plans to install a processing system for primary analysis of data submitted by parties subject to supervision, which will sharpen the focus of supervision and make it more methodical.

Developments are in progress of a system for handling electronic insider lists for publication on the web. Testing has already begun in collaboration with a number of parties that return such lists on a regular basis.

The FME plans that databases for its operations, as well as systems for electronic data submissions and processing, will be ready in 2007 and 2008. Increased use of information technology will lead to substantial operational efficiency in the future although initial costs are undeniably high.

New capital adequacy rules based on Basel II and new rules on annual financial statements call for changes in the reports submitted to the FME by parties subject to supervision. The so-called COREP reports (a new equity report form as required by Basel II) and FINREP reports (a new report form for financial information) are vastly different from comparable earlier forms. Parties subject to supervision will be required to return these reports in XBRL format. Preparations are currently in progress at the FME for the reception of such reports, which will be automatically fed into the FME's database.

The electronic submissions project is also important in light of the internationalization of Icelandic financial undertakings, since various bodies, such as foreign partner institutions to the FME, associations of European supervisory authorities, international organizations like the IMF and FATF and credit-rating agencies, are increasingly requesting a range of statistical information and analyses.

Finally, it is worth mentioning that formal requests for electronic information communication between supervisory authorities have already been made in European directives (see, for instance declaration by the Council of Ministers of May 5th 2006). The MiFID directive also expects supervisory authorities within the EEA to engage in electronic transaction reporting. The FME needs to establish a reporting system for the gathering of information on financial transactions pursuant to Article 25 of the MiFID Directive. Parties subject to supervision are obliged to submit such information to the FME on a daily basis. The FME will forward transactions involving parties subject to supervision by other surveillance authorities within the EEA to the respective authorities through a central information exchange system which will be run by CESR (committee of European securities regulators).

Preparations for a transaction reporting system of the kind stipulated by MiFID are already well under way. The FME co-operates with Nordic and Lithuanian supervisory authorities on developing a common system for the collection of information on financial transactions. A project analysis has been made and a draft systems description has been proposed. The Swedes are leading the project and the system will be developed in Sweden. The proposed system will fit in with the FME's existing IT systems. The chief gain from this project is cost-efficiency, but parties subject to supervision in the countries concerned will also enjoy the benefits of a harmonized interface for the Nordic and Lithuanian markets.

The transaction reporting system will enable the FME to implement an efficient electronic surveillance system for the securities market. The ideology behind the system has already been presented to the parties concerned and a special workgroup has been formed with the participation of the Iceland Stock Exchange, public authorities on securities listing and representatives of the commercial banks. A contract has also been made with an IT consultant.

3.2.2 Supervision of IT

Supervision of IT developments will continue to be an important feature of the FME's activities. In recent years, there has been a special emphasis on this area of supervision with some of the largest undertakings. During the first half of 2005, the FME issued Guidelines no. 1/2005 on the management of the IT systems of parties subject to supervision and supervisory procedures based on these Guidelines are currently being developed. IT supervision will take place concurrently with other types of supervision and will be incorporated into regular surveillance activities.

Questionnaires will also be sent out as required. They will even be constructed in the form of self-assessment whereby immediate feedback is given in line with the answers provided. If the outcome or the answers give rise to concern, they will be followed up by on-site visits.

At the beginning of 2006, a special survey was conducted into online banking fraud. The survey revealed a considerable frequency of such offences, which can chiefly be traced back to slack practices by the users of such banking services - in most cases spyware applications that had installed themselves on the users' computers. Online banking security is of primary importance and the users, as well as the providers, of such services must be constantly on the alert to find ways to avert such unlawful behaviour.

3.3 Supervision based on Risk Assessment and Rating System or Irregularity Checks

The FME gathers substantial amounts of statistical data from parties subject to supervision. Work is currently in progress on entering this information into a database, which will simplify the processing of data and create new possibilities for automatic processing.

Statistical data is intended to provide information on key features in the operations of parties subject to supervision. By shortening the time required for reviewing and processing data, the FME is more likely to be able to intervene in time should serious deviations or threatening situations occur.

With this in mind, the FME is currently developing an early warning system. Deviations and threatening situations will be clearly defined as well as the FME's appropriate reactions based on the seriousness of the deviation or situation.

An early warning system helps improve the effectiveness of the FME's stress tests. The results of the stress test could be available immediately after the required data has been submitted.

Stress testing to assess the position of undertakings in the credit market was introduced two years ago and this year saw the launching of stress tests for the insurance market. A draft stress test for pension funds is now available and it will most likely be implemented during the first half of 2007.

Stress test results provide indications of the financial position of undertakings which are generally not revealed through the more traditional examination of profit and loss and balance sheet items. The stress tests can pinpoint crucial risk factors, so the FME will be able to focus immediately on specific areas instead of relying on finding deviations or danger signs in the overall examinations conducted into the activities of parties subject to supervision.

The stress tests are also intended to serve as a tool for prioritizing supervision. They will be used in conjunction with other methods in order to determine the frequency of on-site visits to parties subject to supervision or surveys of their activities. Furthermore, stress test results indicate factors that need special examination.

Examples of indicators that will be automatically monitored by the FME are traditional financial ratios used by analysts in their examinations of the position of financial undertakings. The FME will also use financial ratios that are calculated from confidential data it collects. This type of processing is also likely to be useful to the parties subject to supervision in their risk management efforts, particularly the smaller ones.

As well as diagnosing deviations and danger signs, the automated processing of data will equip the FME with invaluable tools to analyze and gain an overview of the activities of individual parties subject to supervision as well as the market as a whole. Thus it will, for instance, be possible to provide interested parties with the most recent information more quickly than before, which will in turn reinforce confidence in the market.

In addition to the effective handling of submitted statistical information, the FME emphasises qualitative information from parties subject to supervision, for instance regarding risk management. Risk in the financial market varies from one company to the next and companies may at times take excessive risk deliberately. Information on the quality of risk management is also important to the FME's stance concerning the risk composition of parties subject to supervision.

Work is in progress on developing standardized supervisory measures for the securities market in relation to price sensitive news and specific movements in the market. As part of the transaction reporting system required by Article 25 of the MiFID Directive, the FME intends to implement an electronic surveillance system which will enable the FME to operate efficient and effective market surveillance through analysis of the data collected in the database. The system will be useful, for instance, in monitoring insider trading, market abuse and best execution of orders by financial undertakings.

3.4 Concentrated Ownership and Good Governance

As Icelandic banks have grown and vastly increased their overseas activities, their ownership has become more concentrated and large shares have become prominent. At the same time, large shareholders are also clients of the banks concerned or their investment partners.

Large shares or business relations between owners and financial undertakings are, however, only natural in their own right. By the same token, concentrated ownership and intricate business relations are also rather to be expected in a small economy than in more complex ones. Nevertheless, this entails certain risks and it is the FME's role to ensure that certain principles of equality, conflicts of interests and eligibility are adhered to.

The Risks

The potential risks involved in concentrated ownership and business relations are primarily the following:

- Owners enjoy easier access than non-related parties to loan capital or favourable credit terms.
- Owners enjoy greater understanding than non-related parties concerning guarantees or measures in the event of default.
- Investment projects involving owners are not subject to the same scrutiny as projects involving non-related parties.
- Owners receive information on the operations, trading conditions or future policies of customers (or companies) which may be their competitors (or their subsidiaries/associates) in a specific area.
- Publicity risk, if a foreign rating agency or investors are of the opinion that supervision of these risks is inadequate.

Remedies

The remedies proposed by the legislature in order to avoid the detrimental effects of concentrated ownership and in order to prevent these risks from becoming actual threats are primarily as follows:

- Applications for the acquisition of qualifying holdings in financial undertakings, i.e. 10% or more, must be made to the FME. This is followed by an assessment as to whether the holding may in any way weaken the sound and solid operations of the undertaking. Approvals may be conditional or unconditional.
- The FME ensures that advances to affiliated parties are based on the arm's length principle, i.e. on the same terms as available to comparable non-related parties. The FME intends to encourage improved transparency in this respect, for instance by recommending that external auditors examine such advances.
- The FME monitors eligibility rules, i.e. on the general eligibility of board members and CEOs and also their specific eligibility to handle individual cases.
- Large exposures are monitored. Regulations stipulate that no individual or affiliated parties enjoy credit facilities amounting to 25% of a credit undertaking's equity.
- Specific precautionary rules apply to ownership links between financially related companies. In such cases, the shareholding is deducted from the equity when calculating minimum equity.

The essence of these remedies is credibility and good corporate governance. The undertakings can thus make their own contribution by assuming the lead concerning good governance and compliance with internal rules. With a view to the developments that have been described here above and increased internationalization and operational complexity, it is important to present transparent evidence that these principles are honoured in the financial market in Iceland.

4 PARTIES SUBJECT TO SUPERVISION

4.1 Number of Parties Subject to Supervision

As of June 30th 2006, the number of parties subject to supervision was as follows:

	Number 30.06.2006	Operate in accordance with:
Commercial banks	4	Act 161/2002 on Financial Undertakings
Savings banks	24	Act 161/2002 on Financial Undertakings
Credit undertakings	11	Act 161/2002 on Financial Undertakings
Deposit departments of co-operative societies	2	Act 22/1991 on Co-operative Societies
Securities companies	8	Act 161/2002 on Financial Undertakings
Securities brokerages	3	Act 161/2002 on Financial Undertakings
Management companies of UCITS	6	Act 161/2002 on Financial Undertakings
*UCITS (Total number 15, including 4 departmentalized)**		Act 30/2003 on UCITS and Investment Funds
*Investment funds (Total number 24, including 4 departmentalized)**		Act 30/2003 on UCITS and Investment Funds
Stock exchanges and other regulated OTC markets	1	Act 34/1998 on Stock Exchanges and Regulated OTC Markets
Central securities depositories	1	Act 131/1997 on Electronic Registration of Title to Securities
Pension funds	43	Act 129/1997 on Mandatory Guarantee of Pension Rights and the Operation of Pension Funds
Insurance companies	12	Act 60/1994 on Insurance Activities
Insurance intermediaries	7	Act 32/2005 on Insurance Mediation
Other parties subject to supervision	4	Various Acts
Total	126 *)	

**) UCITS and investment funds are operated by management companies. The number of those funds is not included in the total number of parties subject to supervision. Several of these funds operate in more than one division.*

4.2 Changes in the Operating Licences, Names and Number of Parties Subject to Supervision from July 1st 2005 to June 30th 2006

The Credit Market

On August 17th 2005 the FME granted a licence to Lánasjóður sveitarfélaga to operate as a credit undertaking in accordance with Act 161/2002 on Financial Undertakings.

On September 15th 2005 the name of Straumur Fjárfestingabanki hf. was changed to Straumur-Burðarás Fjárfestingabanki hf.

On November 1st 2005 Sparisjóður Húnaþings og Stranda took over the deposit department of the co-operative society Kaupfélag Vestur Húnvetninga.

On December 9th 2005 the FME granted a licence to Verðbréfastofan hf. to operate as a credit undertaking, but the company had previously operated as a securities firm. On February 16th 2006 the name of the undertaking was changed to VBS fjárfestingarbanki hf.

Act 68/2005 amending Act 68/1997 on the Agricultural Loan Fund authorizes the Minister of Agriculture to sell off all assets and enter into negotiations concerning the takeover of the fund's liabilities. At the same time, laws on the fund were repealed as of December 31st 2005.

On March 17th 2006 the FME granted a licence to Sjóvá fjármögnun hf. to operate as a credit undertaking in accordance with Act 161/2002 on Financial Undertakings.

On March 28th 2006 the name of Íslandsbanki hf. was changed to Glitnir banki hf.

The Securities Market

Securities Companies

On October 14th 2005 the name of the securities company Verðbréfaþjónusta Sparisjóðsins hf. was changed to Verðbréfaþjónusta Sparisjóðanna hf.

On December 9th 2005 the FME granted a licence to the securities company Verðbréfastofan hf. to operate as a credit undertaking.

On February 10th 2006 the FME granted a licence to SPRON Verðbréf hf. to operate as a securities company in accordance with Act 161/2002 on Financial Undertakings.

On March 28th 2006 the FME granted a licence to A.R.E.V.

hf. to operate as a securities company in accordance with Act 161/2002 on Financial Undertakings. On May 30th 2006 the name of the company was changed to Arev verðbréfafyrirtæki hf.

Management Companies of UCITS

On July 25th 2005 the name of Íslensk verðbréfa-eignastýring hf. was changed to Rekstrarfélag verðbréfasjóða ÍV hf.

On April 10th 2006 the FME granted and extended licence to the Management Company of ÍSB hf. for asset management in accordance with Act 161/2002 on Financial Undertakings. On April 28th 2006 the name of the management company was changed to Glitnir sjóðir hf.

UCITS and Investment Funds

Pursuant to Act 30/2003 on Undertakings for Collective Investment in Transferable Securities (UCITS) and Investment Funds, UCITS shall be established and operated by a management company. Such funds are, therefore, not autonomous legal entities or limited companies as stipulated in previous legislations on UCITS. On the basis of the above legislation, the FME validates UCITS and investment funds (or their departments) which issue unit share certificates and grants operating licences to investment funds issuing shares.

In September 2005 the FME validated ÍSB Sjóður 15 - selection of foreign government bonds in the investment funds of Glitnir - which is operated by Glitnir Funds Ltd.

In June 2006 the FME validated changes to the rules of the securities funds and investment funds of Glitnir on account of a change in the name of their management company. The securities funds and investment funds of Íslandsbanki are now named Glitnir Securities Funds and Glitnir Investment Funds. By the same token, the UCITS departments ÍSB Fund 1 - Bonds, ÍSB Fund 5 - Icelandic Government Bonds, ÍSB Fund 6 - ICEX Main List, ÍSB Fund 7 - Long-term Government Bonds, ÍSB Fund 11 - Long-term Bonds and ÍSB Fund 12 - Global Portfolio shall, following the validation, be known as GLB Fund 1 - Icelandic Bonds, GLB Fund 5 - National Government Bonds, GLB Fund 6 - ICEX Main List, GLB Fund 7 - Housing Bonds, GLB Fund 11 - Long-term Bonds and GLB Fund 12 - Global Portfolio. The UCITS departments ÍSB Fund 9 - Money Market Fund, ÍSB Fund 10 - Selected Domestic Equities and ÍSB Fund 15 - Selected Foreign Government Bonds shall henceforth be known as GLB Fund 9 - Money Market Fund, GLB 10 - Selected Domestic Equities and GLB Fund 15 - Selected Foreign Government Bonds.

In November 2005 the FME validated the department Alþjóðlegur skuldabréfasjóður ÍV (International Bonds, Icelandic Securities) which is operated by the management company of the UCITS of ÍV hf. The department Alþjóðlegur sjóður in the UCITS of ÍV, which was operated by the same management company, was wound up.

In November 2005 the FME validated the UCITS Safnbréf/hlutabréf/skuldabréf, Safnbréf innlend/erlend and Landsbanki Global Opportunity Fund, and in March the UCITS Peningabréf EUR, Peningabréf GBP and Peningabréf USD. These are all UCITS in the investment fund of Landsvaki, which is operated by Landsvaki hf. In September 2006 the FME validated the investment fund Landsbanki Diversified Yield Fund, which is operated by the same management company.

In August 2005 the FME validated the investment fund KB Langtímasjóður (long-term fund) and in October 2005 the investment fund KB Foreign Bonds. In May 2006 the investment funds KB Short-term Bonds, KB Long-term Bonds and KB Intermediate-term Bonds were validated. In June 2006 the investment funds KB Selection 1, KB Selection 2, KB Selection 3, KB Selection 4 and Kaupthing Balanced Fund were validated. The investment fund Kaupthing Liquidity Fund EUR was validated in August 2006 and the investment fund Kaupthing Liquidity Fund USD was validated in September 2006. These funds are operated by the management company of Kaupthing Bank Ltd.

October 2005 saw the validation of Fjárfestingarsjóður Sparisjóðanna, a departmentalized investment fund operated by the management company of Sparisjóðurinn (the Savings Bank) hf. as well as the validation of the UCITS Fyrirtækjasjóður (Corporate Fund) and Peningamarkaðssjóður (Money Market Fund). In June 2006 the department Alþjóða vaxtarsjóðurinn in the Savings Banks UCITS was validated, but this department is operated by the same management company.

In July 2005 the FME validated the UCITS Skuldabréfasjóðurinn-Stuttur, Skuldabréfasjóðurinn-Langur, Úrvals hlutabréfasjóðurinn and Alþjóða hlutabréfasjóðurinn, which are all operated by the management company of SPRON hf. The management company of SPRON hf. took over the UCITS Áskriftasjóður ríkisverðbréfa (subscriptions to government securities) in August 2005, but the fund's assets had previously been managed my the management company of Kaupthing Bank. The FME validated the investment funds SPRON Money Market Fund and Managed Equity Fund, which are operated by the same management company, in September 2006.

Pension Funds

The pension fund Lífeyrissjóður Suðurnesja merged with the pension fund Lífeyrissjóður Suðurlands on August 1st 2005.

The pension fund of the employees of Reykjavíkurapótek ceased operations as of December 31st 2005.

The pension fund Lífeyrissjóður Bolungarvíkur merged with Frjálsi lífeyrissjóðurinn as of January 1st 2006.

The pension fund of medical practitioners and the pension fund Almenni lífeyrissjóðurinn merged on January 1st 2006.

The Insurance Market

Insurance Companies

A small number of insurance companies were issued supplementary operating licences following their requests for authorization to conduct insurance activities abroad.

In 1995 the insurance licence of Bátaábyrgðafélag Vestmannaeyja g.t. was revoked as of January 1st 1995 upon the company's request which was dated January 10th 1995. On October 7th 1994 a company meeting resolved that the company would cease all insurance activities as of January 1st 1995 and would be voluntarily wound up. On July 26th 2006 the company's board of directors notified the FME of the voluntary winding up of the company and requested that its name be deleted from the register of insurance companies. As the company had no outstanding liabilities it has now been removed from the register of insurance companies.

On September 12th 2005 the name of Alþjóþa líftryggingafélagið was changed to KB líftryggingar hf.

On February 16th 2006 Vélbátaábyrgðarfélagið Grótta g.t. turned in its insurance licence together with a notification of the voluntary winding up of the company.

Insurance intermediaries

In September 2005 Sigurður Rúnar Ástvaldsson resigned his licence to operate as an insurance broker.

In January 2006 Hákon Hákonarson resigned his licence to operate as an insurance broker and left his position as the managing director of Tryggingar og ráðgjöf ehf. He was replaced by Guðmundur Þór Magnússon.

In January 2006 Eiríkur Hans Sigurðsson resigned his licence to operate as an insurance broker.

In June 2006 DDF Vátryggingamiðlun ehf. resigned its licence to operate as an insurance intermediary.

Other Parties Subject to Supervision

On November 30th 2005 the FME granted a licence to the Icelandic Stock Exchange to operate the equity market isec in accordance with Article 34 of Act 34/1998 on Activities of Stock Exchanges and Regulated OTC Markets. The operating licence covers the activities of an equity market which handles the systematic trading in securities that are not listed on a regulated market.

4.3 List of Parties Subject to Supervision as of June 30th 2006

COMMERCIAL BANKS

	HEAD OFFICES
Glitnir banki hf.	Reykjavík
Kaupþing banki hf.	Reykjavík
Landsbanki Íslands hf.	Reykjavík
Sparisjóðabanki Íslands hf.	Reykjavík

SAVINGS BANKS

nb.is-sparisjóður hf.	Reykjavík
Sparisjóður Bolungarvíkur	Bolungarvík
Sparisjóður Hafnarfjarðar	Hafnarfjörður
Sparisjóður Hornafjarðar og nágrennis	Höfn
Sparisjóður Húnaþings og Stranda	Hvammstangi
Sparisjóður Höfðhverfinga	Grenivík
Sparisjóður Kaupþings hf.	Reykjavík
Sparisjóður Kópavogs	Kópavogur
Sparisjóður Mýrasýslu	Borgarnes
Sparisjóður Norðfjarðar	Neskaupstaður
Sparisjóður Norðlendinga	Akureyri
Sparisjóður Ólafsfjarðar	Ólafsfjörður
Sparisjóður Ólafsvíkur	Ólafsvík
Sparisjóður Reykjavíkur og nágrennis	Reykjavík
Sparisjóður Siglufjarðar	Siglufjörður
Sparisjóður Skagafjarðar	Sauðárkrókur
Sparisjóður Strandamanna	Hólmavík
Sparisjóður Suður-Þingeyinga	Laugar
Sparisjóður Svarfdæla	Dalvík
Sparisjóður Vestfirðinga	Þingeyri
Sparisjóður Vestmannaeyja	Vestmannaeyjar
Sparisjóður vélstjóra	Reykjavík
Sparisjóður Þórshafnar	Þórshöfn
Sparisjóðurinn í Keflavík	Keflavík

CREDIT UNDERTAKINGS

Byggðastofnun	Reykjavík
Frjálsi Fjárfestingarbankinn hf.	Reykjavík
Greiðslumiðlun hf. - VISA Ísland	Reykjavík
Kreditkort hf. - EUROPAY Ísland	Reykjavík
Lánasjóður sveitarfélaga	Reykjavík
Lýsing hf.	Reykjavík
MP Fjárfestingarbanki hf.	Reykjavík
Sjóvá fjármögnun hf.	Reykjavík
SP-Fjármögnun hf.	Reykjavík
Straumur – Burðarás Fjárfestingarbanki hf.	Reykjavík
VSB-fjárfestingarbanki hf.	

DEPOSIT DEPARTMENTS OF CO-OPERATIVE SOCIETIES

Kaupfélag Austur-Skaftfellinga	Höfn
Kaupfélag Skagfirðinga	Skagafjörður

SECURITIES COMPANIES

	HEAD OFFICES
Arev verðbréfafyrirtæki hf.	
Arion verðbréfavarslan hf.	Reykjavík
NordVest Verðbréf hf.	Reykjavík
Íslensk verðbréf hf.	Akureyri
Jöklar - Verðbréf hf.	Reykjavík
SPRON Verðbréf hf.	Reykjavík
Verðbréfaþjónusta Sparisjóðanna hf.	Reykjavík
Virðing hf.	Reykjavík

SECURITIES BROKERAGES

H.F. Verðbréf hf.	Kópavogur
Íslenskir fjárfestar hf.	Reykjavík
Vaxta hf. - verðbréfamiðlun	Kópavogur

MANAGEMENT COMPANIES OF UCITS

UCITS and investment funds operated by them

Rekstrarfélag verðbréfasjóða ÍV hf. **Akureyri**

Verðbréfasjóður ÍV
(Departmentalized UCITS, cf. list)
Ríkisskuldabréfasjóður ÍV
Skuldabréfasjóður ÍV
Heimssjóður ÍV
Fjárfestingasjóður ÍV
(Departmentalized investment fund, cf. list)
Peningamarkaðssjóður ÍV
Hlutabréfasjóður ÍV
Alþjóðlegur skuldabréfasjóður ÍV

Landsvaki hf. **Reykjavík**

Verðbréfasjóðir Landsvaka
(Departmentalized UCITS, cf. list)
Vísitölubréf
Global Equity Fund
Reiðubréf
Sparibréf
Skuldabréfasjóður
Markaðsbréf 1
Markaðsbréf 2
Markaðsbréf 3
Markaðsbréf 4
Fjárfestingasjóðir Landsvaka
(Departmentalized investment fund, cf. list)
Peningabréf
Fyrirtækjabréf
Úrvalsbréf
Peningabréf EUR
Peningabréf GBP

Peningabréf USD
Safnbréf hlutabréf/skuldabréf
Safnbréf innlend/erlend
Landsbanki Global Opportunity Fund
Landsbanki Diversified Yield Fund

Rekstrarfélag Kaupþings banka hf. **Reykjavík**

Úrvalsvísitölusjóður	(UCITS)
IceQ	“
Kjarabréf	“
Markbréf	“
Ríkisverðbréfasjóður langur	“
Ríkisverðbréfasjóður millilangir	“
Skammtímasjóður	(Investment Fund)
Hávaxtasjóður	“
IS 15	“
KB erlend hlutabréf	“
KB Samval	“
Ævileið 1	“
Ævileið 2	“
Eignastýringarsjóður	“
Peningamarkaðssjóður	“
Einingabréf 9	“
KB Langtímasjóður	“
KB erlend skuldabréf	“
KB skuldabréf stutt	“
KB skuldabréf löng	“
KB skuldabréf millilöng	“
KB verðbréfaval 1	“
KB verðbréfaval 2	“
KB verðbréfaval 3	“
KB verðbréfaval 4	“
Kaupthing Balanced Fund	“
Kaupthing Liquidity Fund EUR	“ (FME validation 24.08.2006)

Glitnir sjóðir hf. **Reykjavík**

Verðbréfasjóðir Glitnis hf.
(Departmentalized UCITS, cf. list)
GLB Sjóður 1 – skuldabréf
GLB Sjóður 5 – íslensk ríkisskuldabréf
GLB Sjóður 6 – aðallistinn
GLB Sjóður 7 – löng ríkisskuldabréf
GLB Sjóður 11 – fyrirtækjabréf
GLB Sjóður 12 – heimssafn
Fjárfestingarsjóðir Glitnis hf.
(Departmentalized investment fund, cf. list)
GLB Sjóður 9 – peningamarkaðsbréf
GLB Sjóður 10 – úrval innlendra hlutabréfa
GLB Sjóður 15 – úrval erlendra ríkisskuldabréfa

HEAD OFFICES

Rekstrarfélag Sparisjóðsins hf. **Reykjavík**

Verðbréfasjóðir Sparisjóðanna
(Departmentalized UCITS, cf. list)
Úrvalssjóðurinn
Skuldabréfasjóðurinn
Lyf- og líftæknisjóðurinn
Hátæknisjóðurinn
Fjármálasjóðurinn
Alþjóða sjóðurinn
Alþjóða vaxtarsjóðurinn
Fjárfestingasjóður Sparisjóðanna
(Departmentalized investment fund, cf. list)
Fyrirtækjasjóðurinn
Peningamarkaðssjóðurinn

Rekstrarfélag SPRON hf. **Reykjavík**

Skuldabréfasjóðurinn-Stuttur	(UCITS)
Skuldabréfasjóðurinn-Langur	“
Úrvals hlutabréfasjóðurinn	“
Áskriftarsjóður ríkisverðbréfa	“
Alþjóða hlutabréfasjóðurinn	“
Peningamarkaðssjóður SPRON	(Investment Fund) (FME validation 01.09.2006)
Stýrður hlutabréfasjóður	“ (FME validation 18.09.2006)

STOCK EXCHANGES AND REGULATED OTC MARKETS

Kauphöll Íslands hf. Reykjavík

CENTRAL SECURITIES DEPOSITORIES

Verðbréfaskráning Íslands hf. Reykjavík

PENSION FUNDS

Almenni lífeyrissjóðurinn	Reykjavík
Eftirlaunasjóður F.Í.A.	Reykjavík
Eftirlaunasjóður Reykjanesbæjar	Keflavík
Eftirlaunasjóður Sláturfélags Suðurlands	Reykjavík
Eftirlaunasjóður starfsmanna Hafnarfjarðarkaupstaðar	Hafnarfjörður
Eftirlaunasjóður starfsmanna Íslandsbanka hf.	Reykjavík
Eftirlaunasjóður starfsmanna Olíuverslunar Íslands	Reykjavík
Eftirlaunasjóður starfsmanna Útvegsbanka Íslands	Reykjavík
Frjálsi lífeyrissjóðurinn	Reykjavík
Gildi-lífeyrissjóður	Reykjvík
Íslenski lífeyrissjóðurinn	Reykjavík
Lífeyrissjóður Akraneskaupstaðar	Akranes
Lífeyrissjóður Austurlands	Neskaupstaður
Lífeyrissjóður bankamanna	Reykjavík
Lífeyrissjóður bænda	Reykjavík
Lífeyrissjóður Hf. Eimskipafélags Íslands	Reykjavík
Lífeyrissjóður Flugvirkjafélags Íslands	Reykjavík

	Höfuðstöðvar
Lífeyrissjóður hjúkrunarfræðinga	Reykjavík
Lífeyrissjóður Mjólkursamsölunnar	Reykjavík
Lífeyrissjóður Neskaupstaðar	Reykjavík
Lífeyrissjóður Norðurlands	Akureyri
Lífeyrissjóður Rangæinga	Hella
Lífeyrissjóður starfsmanna Akureyrarbæjar	Akureyri
Lífeyrissjóður starfsmanna Áburðarverksmiðju ríkisins	Reykjavík
Lífeyrissjóður starfsmanna Búnaðarbanka Íslands hf.	Reykjavík
Lífeyrissjóður starfsmanna Húsavíkurkaupstaðar	Reykjavík
Lífeyrissjóður starfsmanna Kópavogsbæjar	Kópavogur
Lífeyrissjóður starfsmanna Reykjavíkurborgar	Reykjavík
Lífeyrissjóður starfsmanna ríkisins	Reykjavík
Lífeyrissjóður starfsmanna sveitarfélaga	Reykjavík
Lífeyrissjóður starfsmanna Vestmannaeyjabæjar	Vestmannaeyjar
Lífeyrissjóður Suðurlands	Selfoss
Lífeyrissjóður Tannlæknafélags Íslands	Reykjavík
Lífeyrissjóður verkfræðinga	Reykjavík
Lífeyrissjóður verslunarmanna	Reykjavík
Lífeyrissjóður Vestfirðinga	Ísafjörður
Lífeyrissjóður Vestmannaeyja	Vestmannaeyjar
Lífeyrissjóður Vesturlands	Akranes
Lífeyrissjóðurinn Lífiðn	Reykjavík
Lífeyrissjóðurinn Skjöldur	Reykjavík
Sameinaði lífeyrissjóðurinn	Reykjavík
Samvinnulífeyrissjóðurinn	Reykjavík
Söfnunarsjóður lífeyrisréttinda	Reykjavík

INSURANCE COMPANIES

European Risk Insurance Company hf.	Reykjavík
Íslensk endurtrygging hf.	Reykjavík
KB líftryggingar hf.	Reykjavík
Líftryggingafélag Íslands hf.	Reykjavík
Líftryggingamiðstöðin hf.	Reykjavík
Sjóvá-Almennar líftryggingar hf.	Reykjavík
Sjóvá-Almennar tryggingar hf.	Reykjavík
Trygging hf.	Reykjavík
Tryggingamiðstöðin hf.	Reykjavík
Vátryggingafélag Íslands hf.	Reykjavík
Viðlagatrygging Íslands	Reykjavík
Vörður Íslandstrygging hf	Reykjavík

INSURANCE INTERMEDIARIES

Árni Reynisson ehf.	Reykjavík
Fjárfestingarmiðlun Íslands ehf.	Kópavogur
Nýja vátryggingaþjónustan hf.	Reykjavík
Olaf Forberg	Kópavogur
Tryggingamiðlun Reykjavíkur ehf. (skilaði starfsleyfi í október 2006)	Reykjavík
Tryggingamiðlun Íslands ehf.	Reykjavík
Tryggingar og ráðgjöf ehf.	Reykjavík

Insurance intermediaries covered by professional liability insurance of insurance intermediaries

Árni Reynisson	- Árni Reynisson ehf.
Guðmundur Þór Magnússon	- Trygging og ráðgjöf ehf.
Karl Jónsson	- Tryggingamiðlun Íslands ehf.
Ómar Einarsson	- Nýja vátryggingaþjónustan hf.
Þorlákur Pétursson	- Fjárfestingarmiðlun Íslands ehf.

OTHER PARTIES SUBJECT TO SUPERVISION

Íbúðalánasjóður	Reykjavík
Nýsköpunarsjóður atvinnulífsins	Reykjavík
Tryggingarsjóður innstæðueigenda og fjárfesta	Reykjavík
Tryggingasjóður sparisjóða	Reykjavík

4.4 Activities of Foreign Financial Undertakings in Iceland

Pursuant to the legal framework established by the Agreement on a European Economic Area, various foreign financial undertakings, i.e. credit undertakings, UCITS, securities companies and intermediaries, insurance companies, insurance brokers and insurance agents may offer their services in Iceland on the basis of an operating licence granted in their home state. The numbers of foreign parties who have given notice that hey intend to offer services in Iceland pursuant to the above are as follows:

Foreign banks	120
UCITS	35
Investment firms	726
Insurance companies with establishments	2
Insurance companies without establishments	236
Insurance intermediaries and insurance agents	3.493

5 AMENDMENTS TO ACTS AND REGULATIONS

5.1 General

Act 87/1998 on Official Supervision of Financial Operations

Amendments:
Act 67/2006: The Act strengthens the power of the FME regarding supervision in accordance with special laws. The FME is among other given power to use the Act's supervisory powers, such as information gathering, for supervision and other projects towards individuals and legal persons as provided for by special laws and in other rules and regulations. This applies even though the parties concerned are not subject to supervision within the meaning of the law. The Act also strengthens the FME's power regarding the supervision of eligibility of board members of parties subject to its supervision. The FME is authorized to dismiss a board member who does not meet the fit and proper requirements. At the same time, provisions concerning the right to refer the FME's decisions to an Appeals Committee were removed. Instead, parties must take court action should they see reason to ask for annulment of such decisions.

Act 64/2006 on Measures against Money Laundering and Terrorist Financing

Amendments:
In June 2006 a new Act No. 64/2006 on Measures against Money Laundering and Terrorist Financing was adopted. The Act lists the parties covered by the legislation and refers to them as persons under obligation to report. Persons under obligation to report are required to establish the identity of their clients and ascertain who stands behind individual transactions. The Act contains detailed provisions concerning customer due diligence measures but also permits measures in respect of customers to be conducted on the basis of risk assessment. Strict requirements are made concerning the gathering of information under conditions where the risk of money laundering and terrorist financing is considered likely. The Act requires persons under obligation to report to establish written internal rules and maintain internal controls designed to prevent their business activities from being used for money laundering and terrorist financing. They shall also have systems in place which enable them to respond promptly to queries from the police or other competent authorities. The FME shall monitor compliance by the parties specified in sub-sections (a) to (e) in Paragraph 1 of Article 2 with the provisions of the Act.

Regulation No. 550/2006 on obligation to report and customer due diligence in measures against money laundering and terrorist financing

Amendments:
Regulation on the obligation to report and customer due diligence in measures against money laundering and terrorist financing entered into effect in June 2006. It is based on the provisions of Article 28 of Act 63/2006 on Measures against Money Laundering and Terrorist Financing.

Act 108/2006: This Act amends various legislations due to an agreement between the Government of Iceland, on the one hand, and the Government of Denmark and the Home Rule Government of the Faroe Islands, on the other, which was signed on August 31st 2005 in Hoyvik in the Faroe Islands. The aim of the agreement is to establish a common economic area in the territories of Iceland and the Faroe Islands. The agreement covers trading of goods and services, free movement of people and right of residence, movement of capital and investments, right of establishment, competition, state monopoly, state aid and government procurement. The agreement prohibits any discrimination based on nationality, place of establishment or country of origin of goods in the area within its scope. This Act has called for amendments to Act 161/2002 on Financial Undertakings, Act 60/1994 on Insurance Activities, Act 34/1998 on the Activities of Stock Exchanges and Regulated OTC Markets and Act 30/2003 on UCITS and Investment Funds.

5.2 The Credit Market

Act 161/2002 on Financial Undertakings

Amendments:
Last June amendments were made to the provisions of the Act on Financial Undertakings concerning qualifying holdings in financial undertakings. In recent years it has become increasingly difficult to prove whether qualifying holdings have been formed in financial undertakings, for instance through collaboration. The amendments are intended to correct this situation by providing clear definitions of what constitutes direct and indirect qualifying holdings and collaboration between parties. The amendments also add a new stage for which permission to own or add a qualifying holding in a financial undertaking is

necessary. Previously, it had been obligatory to seek approval when direct or indirect ownership of equity, initial capital or voting right exceeded 10, 20, 33 or 50% or was large enough for the financial undertaking concerned to be considered a subsidiary. Pursuant to the new Act, it has now become mandatory to seek approval whenever ownership or voting right exceeds 25%.

5.3 The Securities Market

Act 33/2003 on Securities Transactions

Amendments:
Act 94/2006: The Act contains a definition of the term 'professional investor' as well as some minor amendments to specific provisions in Act 33/2003 on Securities Transactions, as amended, pertaining to prospectuses. The bill is part of the introduction procedures for Directive 2003/71/EC of the European Parliament and of the Council of November 4th 2003 on the prospectus to be published when securities are offered to the public or admitted to trading.

Act 67/2006: This Act repeals Article 74, paragraph 3 of Act 33/2003 on Securities Transactions. This amendment entails that FME decisions on administrative fines can now be referred to the courts instead of a complaints committee, which has been dissolved.

Regulation no. 242/2006 on the public offer of securities amounting to ISK 210 million or more and the listing of securities on a regulated securities market. The regulation provides a framework for conducting public offers when the offer price is ISK 210 million or higher.

Regulation no. 243/2006 on the entry into effect of EC Regulation no. 809/2004 on the implementation of Directive 2003/71/EC concerning the information content of prospectuses and the way this information is presented, information incorporated by reference, the publication of prospectuses and advertising. The Regulation contains details relating to the content and publication format of prospectuses as well as rules regarding the advertising of public offers of securities.

Regulation no. 244/2006 on the public offer of securities ranging from ISK 8.4 to 210 million. The regulation provides a framework for conducting public offers when the offer price is at a range from 8.4-210 million ISK.

The FME's Table of Fees for examination of prospectuses in a public offer of securities (1075/2005).

Act 34/1998 on Activities of Stock Exchanges and Regulated OTC Markets

Amendments:
Act 67/2006: This Act amends Article 34, paragraph 3, of Act 34/1998. The amendment provides a more clearly defined authorization on behalf of the FME to gather data during its supervision of qualifying holdings.

Act 108/2006: This Act amends Article 2 of Act 34/1998 to include the Faroe Islands as well as parties within the European Economic Area and the European Free Trade Association. The Act also contains an amendment to Act 131/1997 on Electronic Registration of Title to Securities to the effect that nationals of the Faroe Islands are exempt from the residence clause in subparagraph 2 of paragraph 2, Article 4.

5.4 Pension Funds

Act 129/1997 on the Mandatory Guarantee of Pension Rights and the Operation of Pension Funds

Amendments:
Act 28/2006: This Act amends Act 129/1997 on Mandatory Guarantee of Pension Rights and the Operation of Pension Funds. Amendments were made to Article 20, paragraph 2, on pension fund activities and Article 36, point 3 of paragraph 1, paragraph 4 and paragraph 7, subparagraph 1, on conditions for pension fund investments.

5.5 The Insurance Market

Act 67/2006: This Act amends provisions on financial supervision, including Act 60/1994 on Insurance Activities, and gives the FME added scope to gather information concerning applications for the procurement of qualifying holdings in insurance companies. The Act also covers direct and indirect holdings.

Act 108/2006, as before mentioned.

5.6 FME Guidelines

The FME has issued general guidelines for activities in various sectors of the financial market. The guidelines are based on the provisions of Article 8, paragraph 2, of Act 87/1998 on Official Supervision of Financial Activities.

Pursuant to this provision, the Financial Supervisory Authority is authorised to publish and publicly announce general directive requests regarding the activities of parties subject to supervision, provided the issue concerns a group of such parties.

Guidelines no. 1/2006 on stress tests for insurance companies and information on risk management, including stress testing

These guidelines are intended to reinforce the risk management of insurance companies, strengthen risk management surveillance and establish a standardized format for the FME's risk assessment which will be consistent with stress test results.

Guidelines no. 2/2006 on the use of derivatives in UCITS

The Guidelines stipulate certain basic requirements which must be met in the use of financial derivatives instruments by undertakings for collective investment in transferable securities. The Guidelines set certain principles to regulate the risk management processes employed by UCITS, but they are not intended to provide comprehensive coverage on the use of derivatives. The Guidelines further require the management companies of UCITS to maintain and use risk management systems which have been approved by the FME.

Guidelines no. 3/2006 on prudential filters regarding the implications of the introduction of IFRS on the solvency of insurance undertakings

The purpose of these Guidelines is to harmonize minimum solvency requirements to the effect that the actual accounting methods applied will be immaterial by limiting the impact of change in equity and liabilities items on the solvency of insurance companies.

6 HIGHLIGHTS OF FME'S ANNUAL FINANCIAL STATEMENTS 2005

The following presents the main figures of the FME's annual financial statements for 2005. The annual financial statements were approved by the FME's Board of Directors and endorsed by the National Audit Bureau on May 29th 2006. The annual financial statements are published in full on the FME website: www.fme.is

Profit and Loss Account 2005

	2005	2004
Financial income		
Income from supervision fees	299,903,000	288,322,000
Other income	5,511,780	6,739,399
	305,414,780	295,061,399
Financial expenses		
Salaries and related expenses	239,455,520	203,358,665
Complaints committees	4,624,091	6,352,568
Administrative expenses	16,393,805	12,247,771
Travel and personnel related costs	22,722,068	20,002,527
Expert services purchased	7,587,568	10,786,225
Operation of equipment	6,034,916	6,120,186
Other operating expenses	3,909,044	2,940,401
Housing	24,893,895	25,234,206
Transfers	604,900	541,000
	326,225,807	287,583,549
Purchased assets	2,995,713	6,031,909
	329,221,520	293,615,458
Operating profit before net interest income	(23,806,740)	1,445,941
Interest income (interest expenses)	4,783,300	2,673,284
(Loss) / Profit for the year	(19,023,440)	4,119,225

Balance Sheet 31 December 2005

	2005	2004
Assets		
Current Assets		
Accounts receivable	1,832,521	1,768,996
Other receivables	760,201	1,583,841
Cash and cash equivalents	6,128,009	13,879,935
	8,720,731	17,232,772
Total Assets	8,720,731	17,232,772
Equity and Liabilities		
Equity		
Equity at the beginning of the year	8,877,605	4,758,380
(Loss)/Profit for the year	(19,023,440)	4,119,225
Equity	(10,145,835)	8,877,605
Current Liabilities		
Treasury	14,006,004	294,883
Accounts payable	998,200	1,755,462
Other short-term debt	3,862,362	6,304,822
Liabilities	18,866,566	8,355,167
Equity and Liabilities	8,720,731	17,232,772

FJÁRMÁLAEFTIRLITIÐ
THE FINANCIAL SUPERVISORY AUTHORITY, ICELAND

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