

**The annual meeting of the Icelandic Financial Supervisory Authority (FME)
The address of Mr. Jónas Fr. Jónsson, Director General of FME**

Mr. Chairman, ladies and gentlemen.

Growth, changes and internationalisation are the words that best describe the Icelandic financial market as of late.

The Icelandic banks have grown fivefold since the end of 2002, net assets of the pension funds has doubled, transactions of shares at the Stock Exchange have almost quartupled and the assets of the insurance companies has grown by 68%. The contribution of financial services to the GDP has now passed the contribution of the fishery sector.

In less than two years the Icelandic banks have transformed into international companies with headquarters in Iceland. Subsidiaries, branches and agencies have been established in 13 countries. Around 60% of the banks' income originate from abroad and around 40% of their staff are located outside Iceland. It can be mentioned, as an example of this rapid development, that the number of subsidiaries and branches has more than doubled in three years and the same can be said about income from foreign activities.

But growth, changes and internationalisation are also demanding. This became apparent during this years discussion about the Icelandic banks, and it can be claimed that the Icelandic financial system was for the first time faced with so-called reputational risk.

In these discussion, foreign parties addressed, especially, refinancing issues, market risk, financial results, asset quality and ownership issues.

Credit Markets

The Commercial banks and the largest savings banks reported very strong results in 2005 and the results for this year are set to be yet stronger. A significant part of this strong performance can be attributed to trading gains on equities and other financial gains. Still, the core earnings at the commercial banks have also improved.

The capital ratios of the largest financial companies have been strengthening significantly in the past few years and the average amounted to 13,3% last June. All of these companies have passed the quarterly stress test conducted by the FME , but the test is very strict, involving substantial simultaneous shocks. Incidentally, the test has attracted the attention of foreign interested parties who have expressed their appreciation of its existence in the system.

Fast credit growth at the deposit money banks (parent companies) has characterised their operations lately but the balance of outstanding loans at the banks increased by 64% between June 2005 and June 2006. The credit growth has contracted in the past few months as implied by a 47% rise in the balance of outstanding loans in the 12 month period ending 30 September 2006. The increase can be attributed to the general

economic upswing, increased lending to foreign parties or Icelandic companies operating overseas, and to mortgage lending.

At this juncture, however, it is appropriate to advise the banks to carry on prudently since experience shows that strong credit growth may lead to lower credit quality and a corresponding rise in the ratio of non-performing loans once the economic situation weakens. Yet, the ratios of non-performing loans remain at historical lows and the loan books of the commercial banks are more diversified than ever before, both geographically and industry sector wise.

The large proportion of wholesale funding from overseas in the capitalisation of the banks has been known for a long time. As a result of their fast growth these figures had increased substantially and a great deal of capital was needed to refinance maturing debt in the year 2007, or about €9bn.¹ One year ago the Financial Supervisory Authority stated that this was one of the largest risk factors embedded in the banks' operations. The development this year seems to have confirmed this view. The banks have done a good job of managing this risk in light of the circumstances in the markets and have completed the refinancing of all debt maturing in the year 2007. The rates have worsened but time to maturity has lengthened and there is greater geographic diversification on the funding side than before.

The Icelandic banks were criticised by foreign analysts this year for alleged risk seeking practices, most notably for their substantial equity investments. The risks arising from the equity holdings have several facets and these risks are certainly something the banks need to pay close attention to.

- Firstly, the banks' own holdings due to proprietary trading, strategic investments or arising from private equity projects
- Secondly, loans collateralised on stocks or investment in stocks to hedge forward contracts the banks have written

With regard to the first point above it should be noted that the ratio of stocks at own risk of the banks as proportion of CAD equity has contracted by about 25% in the past two years. Also, investments have been increasing in foreign equities which spreads the risk. With regard to participation in non-financial companies it was stated at the last annual meeting that this was being examined. This, however, has not yet been completed due to other tasks at hand but the goal is to have completed this in the spring.

With regard to the second point above it is important that the cover provided by the collateral is sufficient. Furthermore, the commercial banks have taken a step towards making their stock holdings in respect of forward contracts more transparent by setting up separate vehicle to house such holdings.

In the beginning of next year a new capital adequacy regulation for financial companies will become effective in accordance with the Basel II rules and corresponding directives of the EU. According to these rules the financial companies themselves will have more authority to exercise their own assessment of individual risks for capital adequacy purposes. Correspondingly, the requirement for risk

¹ This figure does not include the refunding requirements of subsidiaries which fund their operations independently.

management and internal supervision will be raised. The new regulation should promote better risk management and thus reinforce the financial system. But the changes regarding the financial companies is not limited to the commercial banks. Today 24 savings banks operate in Iceland and they, many of which being small, must feel the strain of competing with the large commercial banks. The savings stocks of some of them are now trading on the grey market at a substantial premium and in some savings banks corporate savings stock holders have become very prominent and even hold collectively the majority of savings stocks.

Furthermore, a merger between two large savings banks is now underway but this merger is entirely based on commercial principles but not financial restructuring of one of them following financial difficulties as in the past. I would not be surprised if the number of mergers would rise in the near future and thus the number of savings banks shrink. During such merger process it needs to be kept in mind that the legal status of savings banks is different from other financial companies, i.e. part of their net assets does not belong to savings bank stock holders and a qualified holding can only be formed in exceptional cases. On the other hand it is possible that it is now timely to revise the law governing savings banks in light of the development in the financial markets in recent years.

Securities Market

The legislation relating to the securities markets has been developing rapidly. In July 2005 the EU Directives on Prospectuses, Market Manipulation and Takeovers were transposed into domestic law. In 2006 the Transparency Directive and the MiFID (Markets in Financial Instruments Directive) will be implemented.

These changes will impose further responsibility upon the FME, e.g. with regard to communication and information sharing with foreign supervisors. According to MiFID competent authorities in Europe must share information on transactions in securities with the competent authority of the most relevant market. The FME is developing an electronic transaction reporting and surveillance system in cooperation with the competent authorities in the other Nordic countries and Lithuania. This system will be connected to a European system, hosted by CESR. Further information on this system can be found on the FME's homepage.

In light of added complexity and expansion of the legislation, the FME has sensed a need for interpretation and guidance on the practical application of the legislation. In order to respond to this need the FME has published 5 interpretations on specific provisions of the Securities Act on its homepage, and aims to publish further guidance in the future as the need rises. Through this practice the FME can address misinterpretation of the legislation and steer the market in the right direction. In addition, no one has to be in any doubt on the FME's position regarding the provisions in question. It should be noted that interpretations have also been issued with regard to other legislation under supervision by the FME.

Last year, I explained the FME's transparency policy based on a new provision in the Securities Act. In accordance with the transparency policy the FME has during last year published its findings in several cases, in addition to publishing the results of on site investigations of two securities issuers. The goal of the policy is to enhance the

credibility of the supervision, strengthen the deterring effect and add to the knowledge of market participants by issuing precedents.

It is my assessment that the execution of the transparency policy has been successful and that there is a reason to explore further expansion of the policy with regard to other legislation under supervision.

Pension funds and UCITS

The year 2005 was favourable for pension funds overall. Net assets of pension funds increased by 23% and net real return on assets was 12,3%. More important, pension funds' average real return over the past ten years (6,3%) has been considerable higher than the net real return used in actuarial assessments of pension funds (3,5%). In the beginning of this year the investment limits of pension funds were expanded by amendments to the law.

The actuarial status of pension funds not guaranteed by an employer continued to improve and only four pension funds have deficits greater than 5%. In spite of this pension funds should be encouraged to proceed with caution in increasing benefits because of improved actuarial status, as net real return in the last three years has been very high in historical context.

Three mergers of pension funds occurred in the year. Furthermore, amendments to Articles of Association of pension funds caused by two mergers are currently under reference at the FME. Taking this into account, the pension funds will be 40 and the 10 largest funds will have 80% of total net assets of pension funds.

Considering the trend during recent years further mergers can be expected. Mergers cause rationalization in management and improved diversification of assets. On the other hand mergers result in more systematic concentration of risks and consequently stricter requirements on risk management.

Total assets of undertakings for collective investments (UCITS) and investment funds accepting funds from members of the public for investment have nearly tripled in the last three years as well as the number of divisions of the funds have increased. Total assets of the funds now amount to approximately 30% of total net assets of pension funds. Additionally a proportion of savings of the members of the public in this form is presumably in some of the 35 foreign UCITS that have notified the FME of marketing of unit shares in Iceland².

In the supervision of pension funds, the FME places emphasises on monitoring that investments are in accordance with provisions in law and that actuarial assessments and bookkeeping of pension rights accounts are in solid condition. In supervision of UCITS and investment funds and their management companies the FSA also monitors investments as well the marketing of the funds.

Supervision of the activities of these parties is an important part of the supervisory activities of the FME as they have in their custody (hold in their care) a large share of the savings of the population as well as being influential investors.

² These funds have notified marketing of more than 300 divisions.

Insurance market

During this year the insurance companies and the insurance brokers have been adjusting to the new Insurance Contract Law (no. 30/2004) and Law on Insurance Mediation (no. 32/2005), as the mentioned legislation contains now provisions which affect the their working procedure.

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. A survey was conducted on the terms of mandatory professional liability insurance and comments made as necessary.

The insurance companies had record profits in 2005 and the mid-term accounts for 2006 point to continuing profits. However, we have to bear in mind that the profits are mostly from investment activities but the insurance activity, i.e. the management of the insurance portfolio made losses in 2005.

Assets related to equities have increased and make up approximately half of the total assets. This development increases the likelihood of fluctuations in profits and emphasizes the importance of risk management.

In the beginning of 2006 the FME issued *Guidelines on stress tests for insurance companies and information on risk management*. The stress test gives important information on the financial standings and whether a more thorough inspection of asset allocation and risk management is needed.

The FME has collaborated with supervisory authorities within the EEA on providing advice to the EU concerning the development of the Solvency II Directive. In relation to that work some of the insurance companies have participated in two quantitative impact studies (QIS) in order to establish the impact of change. The results of that work have contributed to the total EEA results.

The foreign activities of the insurance companies have increased significantly during a short period and foreign written premiums were 12 times higher in 2005 than the previous year. The increase in foreign activity is both due to provision of services and acquisition of foreign subsidiaries.

Anti Money Laundering and Terrorist Financing Supervision

Since the last annual meeting, the FME has put increased emphasis on anti money laundering and terrorist financing supervision³. In this respect, its role is to supervise compliance with rules, procedures and that application of financial undertakings are adequate. Special working practices have been developed in AML/CFT supervision, information meetings have been held with money laundering reporting officers of supervised entities and a person has been hired, who will be dedicated to the issue. FME has done 12 inspections on measures against money laundering of supervised entities, which led only to minor comments.

³ Reference to money laundering does also include terrorism financing.

In the first half of the year, regular assessment was done on Iceland's implementation of Financial Action Task Force (FATF) Forty Recommendations against money laundering and Nine Special Recommendations on terrorist financing. FATF is an inter-governmental body of thirty-one countries and two regional organisations whose purpose is to combat money laundering and terrorism financing.

The conclusions of the FATF assessment team are in general positive, but there are also some recommendations on what could be improved in the legal framework and implementation in this field. In short it can be said that the outcome of Iceland is similar as that of other Nordic countries.

Changes at the FME

The transformation of the Icelandic financial markets has, naturally, had an impact on the operations of the FME, being an important part of the market infrastructure.

In the beginning of the year, the FME adopted a new strategy with 15 goals, which should contribute to the fulfilment of its mission of promoting a stable financial services market with sound foundations and credible and lawful operation. For each goal there have been defined certain result-based targets, which will be measured for the year 2007 and the results published in the beginning of 2008.

The organizational structure of the FME was changed with the aim to delegate power and increase the responsiveness of the organisation. The activities of the FME is divided between four operational units and the Director General may appoint one or more individuals as heads of units and delegate to them responsibility over certain tasks.

Recruiting procedures have been changed in order to ensure the recruitment of staff of highest quality that will be fully operational after 3-6 months of training. It is the ambition of the FME to have sufficient number of staff and to be able to recruit and maintain outstanding people.

Some issues of focus in near future

I would like to turn to some issues, which will be receiving attention from the FME in near future

International relations and disclosure of information

In brief, one can say that FME's international relations mainly concern 4 issues:

- Co-operation with supervisory authorities in countries where Icelandic firms operate, particularly due to the operations of their subsidiaries
- Direct supervision on operations of branches and services provided from Iceland
- Co-operation between supervisory authorities in Europe and in the Nordic countries
- Information on the Icelandic financial market

The increased foreign activities have resulted in increased relations with foreign supervisory authorities. Recently, the numbers of branches and representative offices abroad have increased and it seems that the development is more in the direction of

establishing foreign branches rather than subsidiaries. This means that the FME will be directly responsible for the supervision of such foreign activities. The extent of the foreign activities requires re-evaluation of FME's working methods and the FME has been working on internal policy concerning the increased foreign activities. This will include policy on relations with foreign supervisory authorities, the need for co-operation agreements, reports on foreign activities and the conduct of supervision.

Co-operation on Europe-level, in general, has been increasing and becomes more and more important with increasing cross-border activities. In this field, co-operation includes coordination of legislation and the conduct of supervision within the European Economic Area, e.g. regarding the exchange of information between supervisory authorities. The EU Council of Ministers has indicated that this co-operation is considered to be one of the key elements in achieving the benefits of the Internal Market in financial services.

At last, provisions of information on the Icelandic financial market can be mentioned.

As mentioned before, there was a considerable discussion and media coverage abroad on the Icelandic financial market in the beginning of this year.

The discussion demonstrates how internationalisation can make firms and financial systems as a whole *more vulnerable* towards reputational risk. To my estimation, the banks reacted correctly to this discussion. A lot of effort and work was put into increased transparency and disclosure of information, and at last but not the least, to prove that they were able to both deliver good financial results and to manage to refinance their business in difficult times.

It is not of common knowledge that numerous foreign parties turned to the FME and sought information on the Icelandic financial market and the conduct of supervision. In all 54 meetings were held during the year 2006 with approximately 250 foreign guests from international institutions, rating agencies, analysts, institutional investors and the media. The number of meetings is approximately 10 times larger than before the year 2006. Most of these meetings went well and I am confident that these meetings played a role in changing the discussion regarding the Icelandic banks.

Even though this year is not a typical one, I am convinced that increased requirements on provision of information is here to stay.

Exemplary information systems

The FME has laid down an ambitious information policy, which aims at having exemplary information systems. The FME is conducting typical knowledge activities, which are based on collecting and analysing information. Organised and targeted use of information technology can both accelerated and improved decision making and hence increased efficiency and results of the operation.

The FME aims at having most of its interactions with supervised entities made in electronic format, and believes that it will be simpler and more economical. In the beginning the FME will concentrate on interaction in the form of the 3500 reporting-units it collects every year. The aim of the reporting collection is general surveillance

of various rules and analysis of possible weaknesses in the operation of supervised entities.

We have already taken the first steps in this direction. Four companies (Actavis, Dagsbrun, Kaupthing and Ossur), which have their shares listed at the Stock Exchange, are participating in a pilot-project on electronic submission of insider lists. Given successful results of the project, the goal is to receive insider lists in electronic format, as of 1 December 2007, from all companies having their shares listed at the Stock Exchange and, as of 1 January 2008, from all parties, which have listed bonds at the Stock Exchange.

Tight ownership and corporate governance

At the same time as Icelandic banks have grown and increased the operations abroad their ownership has become more narrow and the share of the largest owners have become larger. Today, the combined stake of the two largest shareholders, in the four banks, is 43%. In addition, large shareholders often are customers of the respective bank or investment partners.

Large ownership stakes and business relationship between owners and financial institutions does not have to be improper, but there are certain risks associated with it. Those risks relate to the operations of the respective entities being fit and proper and to the reputation of the Icelandic financial market.

It is the objective of the FME to prevent that tight ownership has negative consequences on financial institutions and to ensure that certain main rules regarding equality, eligibility and conflict of interests are followed. The importance of this should be emphasized at times when Icelandic financial companies, and the market as such, become increasingly more international.

This is, in my view, a common task, for the FME, financial institutions and their largest shareholders. The financial institutions can be in the forefront in terms of corporate governance and transparent application of internal rules. The owners can demonstrate this when appointing persons to the Board, by ensuring that business relationship is based on arms-length principles and by making demanding requirements of eligibility when participating in individual decisions.

Finally,

Finally, I would like to mention that Mr. Stefán Svavarson will not seek reappointment as the Chairman of the Board of the FME. Mr. Svavarsson has done a very good job for the last 6 years, during a period of transformation of the Icelandic financial market. Both the Board and the staff of the FME has benefited from his experience and knowledge. I would like to use the opportunity to thank Mr. Svavarsson for pleasant cooperation and wish him all the best in his new occupation as the Internal Auditor of the Central Bank. I would ask you all to bid him farewell with applause.

Dear guests,

In my opinion growth, change and internationalisation will continue to be characteristic for the Icelandic financial market in the next few years.

The main aim of the FME is to promote sound financial services market in Iceland. The discussion that has taken place regarding the foundations of the growth and the internationalisation of Icelandic financial institutions, demonstrates that strong FME is a prerequisite for the confidence these institutions need. Such confidence is even more important if the aim is to make Iceland an International Financial Centre.

It is the responsibility of each and everyone working in the financial markets to demonstrate that the foundations of the companies are solid, that the rules are followed and that relatively tight ownership and the small size of the economy does not damage sound business practices. The best way to ensure this is by increasing transparency and to ensure that good corporate governance practices are followed.

In this aspect we might even have to go further than larger countries. The benefits from that will be increased trustworthiness and protection against reputational risks.