securities market

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The Icelandic Financial Market

Annual Report 2007

FJÁRMÁLAEFTIRLITIÐ

THE FINANCIAL SUPERVISORY AUTHORITY, ICELAND

CONTENTS

INTRODUCTION

The Annual Report of the Financial Supervisory Authority (FME) for the year 2007 contains an overview of the implementation and organization of financial supervision as well as trends and outlook in the financial market. The report covers the period from 1 July 2006 to 30 June 2007 although reference may be made to the month of publication, i.e. November 2007, if necessary. Included in the report is a list of all parties subject to supervision as of 30 June 2007 with reference to changes to their operating licences during the period. Also included is an overview of amendments to laws and regulations for the financial market and a detailed listing of FME Guidelines and legal interpretations. Highlights from the FME's annual financial statements for the year 2006 are appended to the report. The Annual Report of the FME can be downloaded from the FME website, www.fme.is. The FME website contains a range of interesting and useful material on the financial market in Iceland and the organisation of official supervision of financial activities.

FME Board of Directors:

Lárus Finnbogason, Certified Public Accountant, Chairman
Sigríður Thorlacius, attorney, Vice-chairman
Ingimundur Friðriksson, Governor of the Central Bank of Iceland

Alternates:

Kjartan Gunnarsson, Office Manager, Ministry of Commerce
Þuríður Jónsdóttir, District Court Attorney
Sigríður Logadóttir, Chief Attorney, Central Bank of Iceland

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

1 FME ACTIVITIES

1.1 Emphasis in an International Environment

Challenges and Prospects

The main purpose of rules in the financial market is to ensure stability and safety in the management of financial services companies, to safeguard the equality of their customers and investors, and in general to enhance healthy business practices.

The role of the Icelandic Supervisory Authority (FME) is to work towards these goals and to ensure that Icelandic financial markets are known for integrity and reliability. This is achieved by monitoring the financial position and risk of the financial undertakings in the market, verifying the eligibility and credibility of owners, and by participation in specific communication of the financial markets' supervisory bodies, as well as monitoring the implementation of rules. Thus, the FME is an important component of the market's infrastructure.

The Icelandic financial market has in the recent period been characterized by brisk growth, particularly increased overseas activities. This development has, and will, increasingly characterize FME's assignments and work procedures. In the coming year, the FME will put emphasis on the following issues:

Overseas operations

The FME will increasingly monitor the branches of Icelandic undertakings, or do so in cooperation with foreign supervisory bodies, especially where operations of Icelandic undertakings are considerable. Strategies devised at the beginning of 2007 regarding the FME's activities abroad will be fully implemented in 2008.

Integration Risk

The FME will emphasize, possibly in cooperation with its foreign sister institutions, on monitoring the internal processes of financial undertakings to ensure that the capacity of support systems, such as evaluation processes and lending approval, risk management, internal review and observation of regulations, are proportionate to their growth and that oversight and monitoring on a consolidated basis is adequate. Considerable growth over a short period of time which extends to many undertakings in several countries carries an integration risk. This risk increases with the changes that have taken place in the regulatory environment in the last year with new regulations, such as Basel II and MiFID.

Analysis and Self-Evaluation

Financial reports delivered by supervised entities will be analyzed with the purpose of identifying deviations or undesirable developments from the FME's predetermined premises. To make such analysis more focused and efficient for both the FME and supervised entities, the FME constantly reviews its report forms with regard to need, frequency, content, and instructions. Parties subject to supervision will in certain areas perform self-evaluation in the implementation of certain components.

Thematic Inspections and Reactions

On-site inspections will increasingly be based on thematic inspections where specific risk components will be reviewed rather than performing an overall inspection. The FME will furthermore emphasize "reactive" inspections if the occasion arises, for example due to considerable analytical deviations or events in Icelandic or international markets. The FME will especially emphasize follow-ups to ensure that problems discovered in previous inspections have been corrected.

Eligibility of Undertakings, Owners and CEOs

The FME will continue to resolutely emphasize regulations regarding the eligibility of undertakings, owners, and CEOs. This is done through applications for operating licenses, applications for qualifying holdings in financial undertakings and ongoing assessment of owners' behaviour, eligibility assessment for CEOs, and general supervision of CEO competence.

Concentrated Ownership

The FME will continue to put emphasize on the prevention of the damaging effect of concentrated ownership in financial undertakings. There are strong eligibility requirements for owners of qualifying holdings. Good corporate governance will be especially considered, such as in cases of conflicts of interest and rules regarding board approval of business transactions. Transactions between connected parties must be appropriately handled and be based on the arm's length principle in a verifiable way. Rules on large exposures must be followed, especially considering connecting related parties as one exposure and, when in doubt, select the more conservative alternative when determining concentration risk.

1.2 Strategy and Organization

1.2.1. Strategy

In the last year, the FME emphasized on implementing the Balanced Scorecard concept, which is based on 15 main strategy objectives as defined in a strategy chart in which the results of the FME's work, is accessed by spesific key measurements. A special steering group is in charge of adopting the concept, and the FME will publish the results of the measurements for 2007 in early 2008.

Project Management

The FME handles numerous projects concerning supervision, strategy, and information technology. In order to further support professional work practices and goal setting, FME's employees took part in a project management course in 2006 and subsequently adopted a new work strategy in which extensive projects, their goals, products, and costs are defined at the outset and the projects then managed according to a predetermined process. This approach has worked well, and the FME intends to further utilize project management methodology in its's day-to-day work.

FME's strategy concerning overseas operations

The rapid growth of Icelandic financial undertakings in international markets has transformed the Icelandic financial market in a short period of time. At the end of October 2007, Icelandic financial undertakings have announced 56 overseas operating units in 21 countries to the FME. This increased activity abroad has a significant effect on FME's operations, which has devised a specific strategy on international operations. The strategy applies to the supervision of branches, subsidiaries, and representative offices of financial services undertakings. The increased activities of Icelandic undertakings outside of EEA call for the FME to establish Memorandums of Understanding (MoU) with supervisory authorities in other countries. During the last calendar year, the FME signed MoU's with supervisory authorities in the Isle of Man, China, and Dubai. The FME operates in an international environment and employs well educated people with experience and education from abroad. The FME's international strategy is intended to effectively utilize that knowledge and experience and to increase supervision of Icelandic undertakings abroad as required by international obligations.

1.2.2 Information Activities

Distribution of information and corporate communication is an important part of the FME's operations. During the past year, the FME hosted about 40 meetings with 85 guests, including a number of foreign experts, representatives of credit rating agencies, financial undertakings and international institutions, as well as Icelandic guests. In these meetings the FME has introduced it's operations and the Icelandic financial market. Participants in these meetings have without exception reported that they are pleased with the information received from the FME. The FME has also increased information dissemination to the media and other stakeholders in accordance with its policy on increased transparency.

Table 1

Key measurements

V 1.	**Solid financial services market**
V 1.1.	Average score of the FME´s risk assessment
V 2.	**Influencing the development of the market**
V 2.1.	Opinion of market players on the FME´s role in influencing the development of the market
V 2.2.	Number of public guidelines
V 3.	**Good business practices applied on the market**
V 3.1.	Number of incidents and deviation from a defined norm
V 4.	**Credible supervision**
V 4.1.	Opinion of market players on the FME´s role regarding credible supervision of the market
I 1.	**Focused selection of tasks and clear task responsibility**
I 1.1.	Deviation from the FME´s work plan
I 1.2.	Proportion of specific projects in the FME's work plan
I 2.	**Top quality operations**
I 2.1.	Number of projects analyzed regarding quality and process
I 2.2.	Number of approved/revised key processes
I 3.	**Efficient handling of tasks**
I 3.1.	Average process time of projects
I 3.2.	Proportion of projects older than 1 year
I 4.	**Increase in use of electronic processing**
I 4.1.	Proportion of electronic processes
I 5.	**Efficient flow of information**
I 5.1.	Number of information events
S 1.	**Good know-how of staff**
S 1.1.	Proportion of employees with more than 3 years' work experience
S 1.2.	Number of employees who undertake re-educational seminars/courses
	Exemplary information systems
S 2.1.	Status of information system (cf. FME Guidelines no. 1/2005)
S 3.	**Desirable workplace**
S 3.1.	Opinion of employees (workplace study)
S 3.2.	Number of job applications
F 1.	**Financial balance in operations**
F 1.1.	Deviation from budget
F 2.	**Efficient operations**
F 2.1.	Weighted assets of the financial market pr. FME employee
F 3.	**Income secured for new tasks**
F 3.1.	Proportion of new tasks analyzed for cost, which result in budgetary increase

Meetings and seminars for supervised entities

In the past year the FME held a few introductory meetings for parties subject to supervision. The Securities Unit organized meetings regarding the adoption of a reporting system for the securities market and on the implementation of EU's MiFID directive. The insurance division held a series of meetings on QIS 3 on the calculation of solvency claims due to insurance risk and

insurance debt. The insurance division also held introductory meetings on the regulatory environment in the insurance market and the obligations of insurance companies. These meetings were held at the companies headquarters. An introductory meeting on reporting obligations according to Act 32/2005 on Insurance Intermediation was held with insurance companies and insurance brokers at the agency in November 2006.
At the end of 2006 and beginning of 2007 the FME held five introductory meetings for parties subject to supervision regarding the electronic submission of reports. Beginning in January 2006, the FME began receiving reports from parties subject to supervision into an electronic reporting database system.

Liu Mingkang, formaður kínverska bankaeftirlitsins ávarpar fundargesti

Conference about the Expansion of Financial Undertakings to China

At the beginning of June the FME held a breakfast conference on the expansion of Icelandic financial undertakings to China. The occasion was the visit of the chairman and delegation of the China Banking Regulatory Commission (CBRC) and the signing of an MoU between the two authorites due to the operations of Icelandic financial undertakings in China. FME's chairman, Lárus Finnbogason, FME's director Jónas Fr. Jónsson, CBRC's chairman Liu Mingkang, and Glitnir's CEO Lárus Welding spoke at the conference. About 50 people attended the conference.

Report on Financial Reporting in Foreign Currency

Last year February 2007 the FME issued a report on financial reporting in foreign currency. The report was issued as a professional input in the discussion regarding this issue, but the investment bank Straumur-Burðarás had shortly before received approval to change its reporting currency. Other banks had previously declared similar plans and the FME deemed it appropriate to review the effects of such a change.

FME in the Spotlight

In the past year considerable discussion about the importance of the FME for the Icelandic financial markets took place. Representatives of parties subject to supervision pointed out the importance for the FME to grow in proportion to the growth and expansion of financial undertakings. This view also became apparent in a speech by the chairman of the Icelandic Financial Services Association (IFSA) at the association's annual meeting in April 2007, in which he proposed that the FME should be greatly strengthened to enable it to handle larger and more international projects. The same opinion was espoused by the chairman of the Icelandic Pension Funds Association, who said the pension funds operated under strict supervision and it was important for the FME to be able to continue its supervisory activities in an efficient manner.

The Policy Statement of Government of Iceland stipulates that emphasis will be placed on strengthening the FME to enable the Icelandic financial market to enjoy complete confidence. Icelandic editorial writers have also discussed the important role of the FME and emphasized that the institution be able to shoulder the increased responsibilities that accompany the globalization of Icelandic financial undertakings.

1.2.3 IT Strategy

The FME has devised an ambitious IT strategy whose main objectives are to increase efficiency and simplify processes. Its key features are:

- 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 must be able to fulfil all international commitments concerning information communication, such as TRS (Transaction Reporting System) and OAM (Officially Appointed Mechanism).

Electronic Report Submission

In early 2007 the FME adopted an electronic report submission system which accepts annual reports from parties subject to supervision. The agency annually receives approximately 4000 reports. The purpose of the system is to improve the agency's overview of report submissions, increase safety of data transfers, facilitate analysis of data and eliminate paper report submissions.

The electronic report submission system also facilitates reporting for parties subject to supervision and provides them with better oversight of the reports sent to the agency. The FME estimates to save approximately 1100 working hours annually by not having to classify, record, and scan reports previously submitted to the agency on paper. The FME is currently working on developing the system, including checking reports for errors and downloading reports directly from the databases of parties subject to supervision. A system that makes it possible to automatically submit insider lists has also been developed. This system was developed in cooperation with parties subject to supervision.

Automatic Analytical System – Early Warning System

The FME is developing an automatic analysis system, so-called early warning system, which determines deviations and warning signals and makes automatic analysis of data possible and provides an overview of the operations of the various parties subject to supervision.

New Website and Intranet

In 2007 the FME adopted a new web content management system and following that, a new web page. Visits to the home page have increased considerably; foreign visitors use it to find information about Icelandic financial markets. The website was changed somewhat to make information more accessible. Certain information is also automatically uploaded to the website. Insider lists which parties subject to supervision submit to the electronic report submission system are now automatically uploaded to the FME webpage. Prospectuses for about market securities, which the FME is obliged to publish officially, will also automatically be published on the FME webpage. Both save work and time that FME staff can use for other important projects.

Preparations are under way in developing a new intranet for the FME and it is expected to be operational in the year 2008. The objective of using an intranet is to improve knowledge management and flow of information, increase efficiency and quality of methods of work and to support the FME's business culture.

Reporting System and MiFID

Considerable preparation work was done for the implementation of the Transaction Reporting System (TRS) stipulated by MiFID at the beginning of November 2007. The FME has in collaboration with Nordic and Lithuanian supervisory authorities developed a common system for the collection of information on financial transactions. The TRS system is the largest information technology project in which the FME has been involved. The chief gain from this project is cost-efficiency, and parties subject to supervision in the countries concerned will enjoy the benefits of a harmonized interface for the Nordic and Lithuanian markets, but many Icelandic and Nordic financial undertakings operate in these markets.

Supervision of IT

Supervision of IT developments with parties subject to supervision will continue to be an important feature of the FME's activities. In recent years, some of the largest undertakings have emphasized this component. In 2005 the FME issued Guidelines no. 1/2005 on the management of IT systems of parties subject to supervision. Supervisory procedures based on the guidelines have been outlined. IT supervision will take place concurrently with other types of supervision and will be incorporated into regular surveillance activities. Parties subject to supervision will increasingly carry out electronic self-evaluation on IT status.

The FME emphasizes that parties who have applied for operating licenses fulfil the requirements of the Guidelines and has done considerable work collaborating with operating license applicants and assisting them in fulfilling the Guidelines requirements. It is important that parties subject to supervision construct their IT systems from the outset in accordance with the FME's Guidelines.

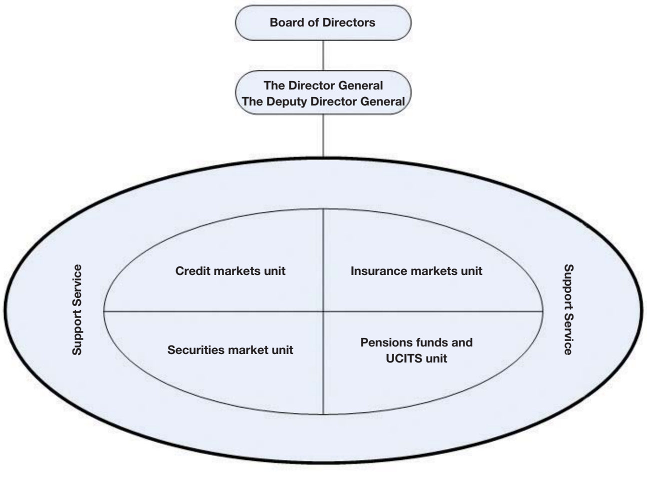
1.2.4. Organization and Human Resources

Organization

The activities of the FME are divided into four operational units and a supporting service under the control of the Director General. The Director General determines which tasks fall under each unit or supporting service. The Director General may appoint one or more individuals to oversee projects in certain units and delegate to them responsibilities over certain tasks.

Human resourses

The FME is a knowledge-based institution which emphasizes that employees are satisfied in their jobs and are able to utilize their knowledge and experience in day-to-day activities as well as for professional advancement. A survey among public employees done by the Institute of Political Science and Politics at the University of Iceland and the consulting firm ParX in November 2006 for the Ministry of Finance showed a high level of job satisfaction among FME employees, higher than among other employees in the public and private sectors.



The FME's employees on the top of Hvannadalshjúkur, Iceland's highest point, in the spring 2007.

The FME has devised a special continuing education policy and pays for the job-related continuing education of its employees, including seminars, introductory meetings and other more extensive educational opportunities. 70% of the FME's employees made use of these educational offers in 2006-2007.

At mid-year 2007 the FME had a staff of 54 (45 full-time employees), including temporary and summer employees. The division is as follows:

- 18 Economists and Business Specialists
- 18 Attorneys
- 2 Actuaries
- 4 IT Specialists
- 4 Other Specialists
- 4 Office Staff
- 9 Temporary and Summer Positions

1.3 Various Statistics on FME Activities

Case/Hours Processing

A total of 1179 new cases were registered with the FME during the reporting period. "Case" refers to any kind of affair brought to the agency, analytical projects of various sort that are created during the supervisory process as well as projects regarding agency operations. The cases are miscellaneous in scope, subject matter and required processing time. The following table includes the total number of new cases and various information regarding the number of FME projects from its case record. For comparison, figures for the preceding 12 months are also included.

Table 2

Some statistics on FME case processing	Period	
	1.07.2005-30.6.2006	1.07.2006-30.6.2007
Cases opened during the period	1123	1179
On-site inspections	45	36
Operating licenses (*new or supplemented*)	8	5
Validations of securities funds and investment funds	29	22
Comments on the articles of association of pension funds	21	17
Authorizations for qualifying holdings	14	12
Registration of notices regarding cross-border services from foreign parties within EEA	1236	421
Notices regarding overseas operations of Icelandic parties subject to supervision	43	44
Eligibility assessment for CEOs of parties subject to supervision	21	23
Regulations, guidelines, interpretations, and translations	3	8
Remarks, recommendations, requests for corrective action	358	453
Daily fines	18	26
Administrative fines (*only in a limited area of the securities market*)	15	8
Financial penalties	1	0
Referral to the National Commissioner of the Icelandic Police, cf. Act 87/1998, Article 12	5	0

The FME case record is linked to its hourly registry and provides information on the division of disposable time between project categories. That information is used to determine proportional division of the FME's operational costs between parties subject to supervision. The following table shows the division of disposable hours for the years 2005 and 2006.

Table 3

Proportional division of disposable hours between groups of parties subject to FME supervision	2005 %	2006 %
Credit undertakings	50	50
Insurance companies and insurance brokers	18	18
Pension funds	18	16
Management companies of UCITS	3	5
Securities undertakings and securities brokerages	1	1
Issuers of equity and bonds	9	9
Others	1	1
	100	100

FME Operations in 2006 and Estimates for 2007

The FME's expenses for the year 2006, including the purchase of assets, amounted to a total of ISK 390.6 million. Income for the year, including interest income, came to ISK 449.7 million. Income from supervision fees was ISK 435.1 million. This gives an operating surplus of ISK 59.1 million. The FME's equity at the end of 2006 was ISK 49.0 million. Not included in the preceding figures are costs and revenues related to rulings committees which are hosted by the FME.

The FME's 2006 operating budget anticipated an ISK 16.6 million income surplus to balance out an anticipated negative capital position at the beginning of 2006. Final income surplus for the year 2006 came out at ISK 59.1 million. The explanation for this increase is mainly that supervision fees for 2006 were ISK 11.2 million higher than anticipated, salary expenses were ISK 28.3 million lower and interest income and other income in excess of ISK 11.6 million. Other agency costs were ISK 8.4 million higher than anticipated. The most significant deviation is related to personnel costs, delays in the hiring of employees and changes in the makeup of the agency's staff following a significant personnel turnover. Increased supervision fees in excess of anticipation are due to licenses for parties subject to supervision that were not foreseen at the time of the preparation of the FME's operating budget.

The FME's 2007 operating budget anticipates that costs without rulings committees will come to ISK 607.6 million. Income, including interest income, is expected to be ISK 609.3; thereof income from supervision fees ISK 601.9 million.

Income surplus for 2007 is expected to be ISK 1.7 million. Given the agency's ISK 49 million equity at the beginning of 2007, equity at the end of 2007 is expected to be ISK 50.7. According to Act 99/1999 on the Payment of Cost for Public Supervision of Financial Activities, the FME presumes a special reserve fund, which at the end of 2007 is expected to be ISK 30 million. Equity less this reserve fund is anticipated to be ISK 20.7 million at the end of 2007, which will be subtracted from levied supervision fees for 2008.

Key statistical information from the FME's annual accounts for 2006 is detailed in Chapter 6 of this report. The annual accounts are published in their entirety on the FME website. The FME's operating budgets and supporting documents are enclosures with the Secretary of Trade's annual bill amending Act 99/1999 on the Payment of Cost for Public Supervision of Financial Activities.

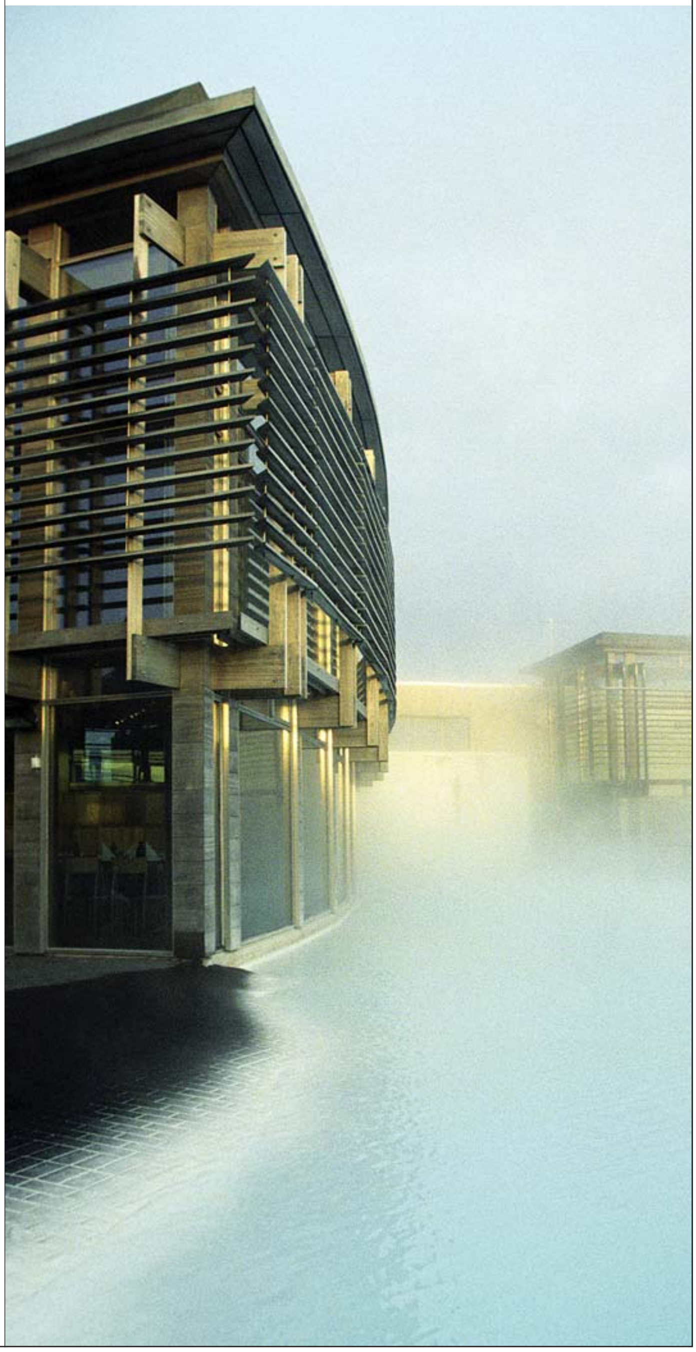


Photo: NordicPhotos

2 FINANCIAL MARKETS

2.1 Implementation and Organisation of Supervision

2.1.1 On-site Inspections

On-site inspections are conducted through visits to the business premises of parties subject to supervision for the purpose of examining various aspects of their activities. On-site inspections are either planned in advance as part of the FME's project schedule or arranged when special incidents or conditions call for specific action by the FME. Each on-site inspection is concluded by drafting a report on the outcome with remarks, comments or requests for corrective action as needed in each particular case. The FME monitors compliance with the findings presented in the report.

The Credit Market

One of the major projects scheduled for 2007 was to conduct a survey of the credit risk of the largest financial undertakings. This was done through on-site inspections at the six largest undertakings in September. The overall objective was to gain a solid overview of the credit risk of banks and the largest savings banks. This was partly achieved by assessing risk management and internal control in these areas. The inspections focused on the on-site collection of various data concerning credit activities and assessing whether the loan framework and internal control systems were sufficient. A summary of the results of this survey will be published as soon as they become available.

Examination of the internal control systems and risk management of one of the commercial banks was completed during the period. For the credit market in general, a total of 12 other on-site inspections were carried out during the period. An integral part of these inspections are regular benchmark meetings held with the CEOs of the financial undertakings concerned to discuss their operational objectives, various operational risks and risk distribution, overseas activities and a range of matters which are specific to each particular undertaking.

On-site inspections regarding the implementation of rules against money laundering and terrorist financing were conducted at the premises of three Icelandic financial undertakings and one branch office of a foreign financial undertaking.

Supervisory visits were made to two overseas branches of Icelandic banks, but these visits are the first on-site inspections to be conducted abroad. These inspections included the innovative supervisory feature of examining the extent to which the banks were prepared to face external crises such as pandemics and natural disasters.

The Securities Market

In its supervisory capacity the FME conducted one examination of the securities trading procedures of one commercial bank with a focus on Chinese walls, compliance and securities trading practices – in particular asset management, private banking services, brokerage and own-account investment. This comprehensive survey was conducted through on-site inspection and data collection. In line with the FME‘s transparency policy, the results of this survey will be published on the Authority‘s website.

An examination of the practices of a securities undertaking was also made during the period. The focal areas were various operational aspects, such as Chinese walls and compliance. Following the examination a report was drafted containing the FME‘s comments and request for corrective action which was to be completed within a given timeframe. In line with the FME‘s transparency policy, the results of the examination were published on the Authority‘s website. The findings indicated insufficient compliance and serious comments were also made concerning the failure to observe laws and regulations concerning Chinese walls.

The Pension Market

Two on-site inspections were completed during the period as were reports on two previous inspections. There was an emphasis on following up on remarks on corrective action and comments that had been made in earlier reports. Inspections of pension fund activity focus on all major operational areas including investment, pension rights accounts, actuarial surveys, investment policies, annual financial statements and internal control. During the period there was also an emphasis on monitoring compliance with the legislation on measures against money laundering and terrorist financing, which will become a standard supervisory feature in the future. The majority of remarks and comments following on-site inspections of Icelandic pension funds concerned investment and investment classification pursuant to the Pension Act, investment policies, annual financial statements, internal control and internal rules.

UCITS and Investment Funds

The core function of the management company of an undertaking for collective investment in transferable securities and investment funds is to establish and operate funds of this kind. The management companies are financial undertakings licensed by the FME. During the period, two on-site inspections were made at the premises of management companies with a special emphasis on the autonomy and independence of the companies and clear separation of principal activities.

Insurance Companies and Insurance Mediation

In the insurance sector specific surveys were conducted into the activities of two non-life insurance companies and three insurance intermediaries through on-site inspections and follow-up measures. The visits to the insurance companies focused on examining financial position, accounting records, reinsurance cover, claims history and the handling of claims. During the period the novelty of holding strategy meetings with the CEOs of the three largest insurance companies was introduced. In total, three such meetings were held and the agenda included discussions of the operational emphases of the companies as well as the emphases of the FME. Three introductory meetings were also held with the insurance companies to discuss the supervisory function of the FME and the obligations of parties subject to supervision, the FME's international co-operation and procedures for the notification of services between countries and the use of data gathered for the purpose of financial supervision.

Visits to insurance intermediaries focused on all major operational areas, such as financial position, operations and compliance with the reporting requirements of the Insurance Mediation Act 32/2005, etc.

Supervision of Measures against Money Laundering and Terrorist Financing

Money laundering is an international problem which has, in the wake of increased economic globalisation and the free flow of capital across borders, become a significant part of international crime, such as terrorism and drug trafficking. The FME places great emphasis on the efficient monitoring of measures against money laundering and terrorist financing.

The year 2006 saw the introduction of new procedures for the surveillance of money laundering and terrorist financing which have given good results. These new procedures were, for instance, applied during the period to overall surveys of the activities of three financial undertakings. Similarly, the examination of measures against money laundering is conducted as a part of other inspections of the activities of parties subject to supervision.

Following a new legislation on money laundering in June 2006, the FME has been preparing guidelines on measures against money laundering and terrorist financing in order to clarify certain legal issues. These guidelines are likely to form a future basis for corrective action requested by the FME by reference to current laws and regulations. The guidelines are published as a draft on the FME website under the title of Discussion Paper 5/2007. They have also been posted for comment to parties subject to supervision and other professional bodies. Some comments have already been made to the guidelines which are likely to be finalized before year-end 2007.

During the period, the Financial Supervisory Authority and the Prosecutor of Economic Crime signed an inter-institutional agreement concerning the collaboration of these two authorities on measures against money laundering and terrorist financing. The aim of the agreement is to facilitate the exchange of information and enhance reporting and education on these matters. There is a special emphasis on the exchange of information gained from international collaboration as well as information on notifications of suspected money laundering.

2.1.2 Off-site Inspection

Off-site inspections conducted by the Financial Supervisory Authority without visiting the premises of a financial undertaking fall within the sphere of financial supervision. This involves, for instance, the examination and analysis of data submitted on a regular basis or as part of a special survey. Every year, the FME thus collects around for thousand reports on a range of topics from parties subject to supervision. The frequency of regular report submissions varies between areas of examination.

Electronic Data Processing

The FME is currently developing an electronic early warning system to provide a regular and automatic analysis of data collected by the Authority and issue advance warnings as to dangers or threats to the operations of parties subject to supervision. Specific indicators have been defined for each market, i.e. ratios which are largely comparable between undertakings engaged in similar activities. The indicators are further sub-divided into statutory and non-statutory ratios. Yellow and red alerts have been identified for all indicators with red alerts referring to statutory ratios as applicable. Red alerts generally signify a threat to the ongoing activities of parties subject to supervision, whereas yellow alerts either call for a closer examination of specific operational aspects or closer monitoring of the general activities of the party concerned. The early warning system has a dual function. On the one hand, it cuts down the FME's reaction time in the event of foreseeable operational difficulties of parties subject to supervision and, on the other hand, enables the FME to organize its supervisory scope to focus more precisely on risk factors and parties subject to supervision where irregularities have occurred or where there appears to be greater risk. The results for a few indicators will be tested towards the end of this year, but the launch of a pilot version of the system is planned for 2008.

The Credit Market

Financial supervision through the collection and processing of data submitted by financial undertakings is primarily concerned with performance and financial position, such as portrayed in annual financial statements, audit reports and capital adequacy reports. This type of supervision also focuses on the analysis of claims and liabilities by geographical areas, the analysis of loans by class and the breakdown of large exposures.

The so-called COREP report (Common Reporting) is one of the innovations introduced during the period. This type of report is based on FME Rules no. 215/2007 on the Capital Requirement and Risk Weighted Assets of Financial Undertakings. The reporting framework was developed by the Committee of European Banking Supervisors (CEBS) for the purpose of harmonizing reports on the capital requirements of financial undertakings within the European Economic Area. The FME is currently preparing the publication of standards for ICAAP (Internal Capital Adequacy Assessment Process) reports to provide information on internal processes for assessing capital requirement. The ICAAP process expects that financial undertakings:

- adequately define, assess, monitor and collect data on their own risk,
- have sufficient own funds corresponding to each undertaking's risk assessment,
- employ and develop sound risk assessment systems.

Furthermore, a special form for reporting on the financing requirements of financial undertakings was introduced.

Work has been carried out on developing a risk assessment system for financial undertakings by which the undertakings are divided into risk categories according to the following criteria:

a) The force of impact on the credibility of a financial market, public interest or the interest of clients or the supervisory objectives of the Financial Supervisory Authority should an undertaking experience an operational crisis.

b) The chances for an undertaking to seriously upset supervisory objectives on its specific risk level with reference to:
   1. the operational policy of the undertaking,
   2. trading risk (e.g. loan, market, liquidity and operational risk) entailed in the undertaking's activities,
   3. financial structuring,
   4. types of clients and services,
   5. internal systems, internal control and rule compliance,
   6. the undertaking´s organization and internal governance.

Financial undertakings are graded by their risk levels. This grading is primarily based on equity position, asset quality, liquidity risk, market risk and management.

Results provided by the risk assessment system are, for instance, used for the prioritization of supervision projects. The grades awarded to the largest financial undertakings are used as criteria by which to measure the security of the financial market which, in turn, is one of the yardsticks for measuring the results of the FME's activities.

Stress testing is an important feature of the FME's activities. The purpose of these tests is to assess the extent to which the parties concerned are prepared to face crises arising from individual risk factors in their operations. An example of regular stress tests carried out by the FME are those of market risk in relation to equity securities and bonds, loan risk and the impact of a weakening of the Icelandic króna on the financial position of financial undertakings. In addition to the above, the FME conducts further stress tests that cover, for instance, fixed interest rate risk on loan book items, increased stress on account of lost loans and liquidity risk. The results of the stress tests are one of the foundations for the FME's assessment of the risk position and financial strength of parties subject to supervision. The introduction of Pillar 2 of the Basel II Framework means an increased emphasis on stress testing by the FME as a means for assessing the risk level of individual financial undertakings as well as for the undertakings themselves to assess their own capital requirements.

The Securities Market

During the period the FME continued developing an electronic system for processing and administering all data concerning issuers on insider lists. The issuers of listed equity securities and bonds submit insider lists in an electronic format through this system, which was formally taken into use towards the end of 2006. As well as saving a great deal of time and effort for issuers, the system simplifies administrative tasks such as the automatic publication on the FME website of lists over the primary insiders of issuers whose shares are listed on a regulated securities market in Iceland.

During the period the FME examined a few cases of instances of potential insider trading and market abuse. Recent amendments to the securities market legislation have helped to reinforce supervision and restraint in this area of the financial sector. The electronic transaction report system TRS is expected to add more power and efficiency to the FME's market surveillance and provide the Authority with added opportunity to intervene more swiftly than before in the event of securities market violations. This does, however, require that the FME keep up an efficient system for processing and analysing the data submitted through TRS.

Pension Funds

The quality and risk classification system for the pension funds was developed further during the period with a view to providing direct access to the FME's databases. The system consists of a stress test and quality classification system and is primarily intended for prioritising supervision of these funds while at the same time giving a better overview of pension fund risk and the necessary extent of risk management. During the period this system was put to use during on-site inspections of individual pension funds.

The quality classification system is based on information stored in the FME's database in addition to other information on the activities of the pension funds, such as report submissions to the FME, internal control systems, the position of investments as permitted by the Pension Act, remarks and comments directed to the funds, long-term investment return and financial position. Similar to the stress test for the pension funds, the system is designed to support and systematically arrange the order of priority for supervising the funds. As the stress tests, however, only allow for financial risk factors, the quality classification system is seen as a valuable enhancement with its coverage of factors relating to the operations of the pension funds. The quality classification system can also be applied to all operating pension funds whereas the stress tests, by nature, cannot be applied to the operations of guaranteed pension funds.

During the period, the FME conducted four examinations of pension fund investment in order to determine whether the investments of the pension funds concerned fell within the framework provided for in the Pension Act and whether they were classified as prescribed by law. Surveys of the pension funds' investment policies, annual financial statements and internal control were also included in these examinations.

A survey of the investment policies of pension funds without employer guarantees was continued during the period. The purpose of the survey is primarily to examine whether the investment policies meet the minimum requirements of the Pension Act as well as current rules and regulations. Nearly all of the above funds have had their investment policies surveyed by the FME. Necessary remarks and comments on the results of the survey have also been sent out to individual pension funds.

UCITS and Investment Funds

UCITS and investment funds must submit quarterly reports on their investments. On an annual basis the number of such reports is close to four hundred. The FME's electronic reporting system is designed to improve the efficiency of supervision of UCITS and investment funds, give a better overview of their investment activities and provide the management companies with an easy and secure way to communicate information.

The Insurance Market

Over the coming months the FME has planned a comprehensive review of report submissions by insurance companies. Anticipated information requirements on account of Solvency II will be given special consideration in this work as well as the increased emphasis on consolidated supervision and supervision on investment risk and risk management.

Among innovations in financial supervision during the period was increased reporting on assets to cover technical provisions. Reports are submitted quarterly and cover all classes of insurance company investment. This change has the effect of increasing supervision of the asset sides of balance sheets, but insurance companies have in recent years come to rely increasingly on investment revenue.

Reporting on reinsurance cover was increased so that in addition to statistical information, the insurance companies are now required to submit explanatory reports on procedures and emphases in this important branch of insurance.

The FME developed a new form for reporting on the cross border activities of Icelandic insurance companies, which have grown considerably in recent years. A summary of this information is sent to other supervisory authorities within the EEA, who in return forward information on similar activities of foreign companies in Iceland.

During the period the FME examined the policy terms of private property insurance, home insurance, business liability insurance and mandatory motor vehicle insurance as provided for by Article 55, paragraph 1, of the Insurance Activity Act. No serious comments were found to be necessary.

During the period the FME concluded its survey on technical provisions for life insurance according to Article 55, paragraph 2, of the Insurance Activity Act. The results of the survey were published on the FME's website. No comments were made regarding actual amounts or the calculation of premiums. The results, however, gave cause for a number of remarks concerning information disclosure and procedures for changing the amount of premiums. The FME intends to follow through on this survey by issuing guidelines on reports to be submitted by the actuaries of life insurance companies.

The FME has cooperated with representatives from other supervisory authorities within the EEA in a committee organised by CEIOPS to provide expert advice on the Solvency II Directive. On 10 July this year the European Commission published a draft directive on new risk-focused solvency margins and new supervisory methods for insurance companies and insurance consolidations. The directive serves as a general framework for certain provisions, but more detailed rules and implementing measures need to be developed further by the European Commission and CEIOPS. The FME will continue to work within CEIOPS by giving advice and assistance in carrying out the implementing measures.

The third round of quantitative impact studies for Solvency II (QIS3) was conducted during the period to test the impact of new solvency rules. The FME held a series of meetings to provide information and guidelines on certain aspects of the study. Meetings were also held with some of the participating companies during the last days before the project deadline in order to clarify company-specific issues. QIS3 was favourably received with five non-life insurance companies and a further two life insurance companies participating in the study.

Preparations have already begun for QIS4. One of the innovations of that study will be the testing of new methods for calculating the best estimate of outstanding claims by simple approach, which is particularly suitable for smaller companies and companies that are new on the market. The FME is currently collaborating with actuaries from Icelandic insurance companies to examine whether and how such approaches can be implemented in Iceland.

Two insurance companies have been under a special surveillance with regard to Article 90 of the Insurance Activity Act on account of their failure to fulfil minimum solvency requirements.

2.1.3 Qualifying Holdings

During the period the FME received 18 applications for possessing qualifying holdings in a total of seven financial undertakings. Six applications were approved, one was rejected, but in seven instances ownership changes took place before the FME has passed its decision. Four applications were still to be processed by 1 November 2007. During the same period, the FME received seven applications for the acquisition of qualifying holdings in insurance companies.

Nearly all approvals for qualifying holdings issued by the FME have been subject to certain conditions which are primarily intended to reduce the risk of conflicting interests arising from large holdings in financial undertakings and insurance companies. Examples of such conditions include financial ratios from the operations of owners, conditions on board membership, owners' business transactions with the undertaking or company in question, ownership of other financial undertakings or insurance companies and reporting to the FME.

A Qualifying Holding in Glitnir Bank

Last April saw voluminous trading taking place in the share capital of Glitnir Bank. This involved the sale by Milestone ehf, Mr Einar Sveinsson (at that time Chairman of the Board of Directors of Glitnir Bank) and connected parties of a approximately 20% stake in the bank to five parties. The Financial Supervisory Authority saw reason to examine these transactions with regard to connections between parties and legal provisions on qualifying holdings. The FME came to the conclusion that three of the buyers, i.e. Jötunn Holding ehf, Elliðatindar ehf and Sund Holding, together with the largest shareholder FL Group hf, were jointly in possession of a qualifying holding exceeding the approved limit. At a general meeting of the shareholders of Glitnir bank, which was held on 30 April 2007, the combined voting right of these parties was limited to 32.99%. In the wake of this decision, two of the buyers sold their shares in the bank and FL Group hf, together with Jötunn Holding ehf, applied for permission to hold altogether a 39.9% stake in the bank. The application is currently being processed by the FME.

Rejection of an Application to Possess a Qualifying Holding

One application to possess a qualifying holding in a financial undertaking was rejected during the period. The reasons for this rejection were repeated infringements by the party concerned of provisions falling within the scope of the FME's supervisory activities. The party concerned was requested to sell exceeding 9,99% in the undertaking within a specified timeframe with reference to Article 45 of Act 161/2002. The voting rights of this party were similarly limited until the sale had been completed.

Supreme Court Ruling in the Case of SPH Savings Bank

During 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. Following this, the combined voting right of certain specified owners of guarantee capital in the savings bank was limited to 5%. The majority of the owners referred the FME's decision to the complaints committee, which subsequently invalidated the decision. On 30 October 2006 the Board of Directors of the FME decided to take court action in order to have the committee's ruling invalidated. Reykjavik District Court ordered on 23 April 2007 that the case should be dismissed. The dismissal is based on the observation that on 8 December 2007 the Financial Supervisory Authority had granted its approval for the merger of the savings banks Sparisjóður Hafnarfjarðar and Sparisjóður vélstjóra. The invalidation of the decision of the complaints committee would thus concern assets in a fund that no longer existed and its ruling would, therefore, in no respect change the legal position of the litigants. This order was confirmed by a Supreme Court ruling in April 2007.

The FME regrets that no substantive ruling was achieved in this case and that the opposing side were able to delay proceedings with reference to technicalities, which amounted to a total of six in the end. Five of these were dismissed but the sixth one was sustained. Request were made for the case to be given rapid procedure before district court in October 2006, but five months later the case was dismissed without the possibility of bringing all the facts into the daylight.

2.1.4 Assessment of Eligibility

Towards the end of 2005 the FME introduced a special assessment of eligibility for CEOs and board members in financial undertakings and pension funds, but such assessments have been conducted for some time in the insurance sector. The eligibility assessment for CEOs focuses on their knowledge of the legal framework within which their undertakings operate as well as assessing whether these individuals meet all regulatory requirements. If the FME considers that a CEO has not shown adequate knowledge of laws and regulations, the individual is given the opportunity to repeat the assessment. Generally, however, individuals are only allowed two attempts at passing the eligibility assessment. Around 20% of all candidates need to repeat the assessment. The eligibility assessments have met with favourable response and most of the CEOs who participated have said they were pleased with it. The eligibility assessment has also attracted some attention from abroad and has been mentioned as an example of good supervisory procedures, for instance in credit agency reports.

The table below shows the number of eligibility assessments conducted between November 2005 and 30 June 2007.

Market	Total
Financial undertakings	18
Insurance companies	13
Insurance mediators	10
Pension funds	3
Altogether	44

During the period the FME saw reason to examine in closer detail the eligibility of one CEO in accordance with provisions on the continuous surveillance of the activities of parties subject to supervision and the eligibility of their management. By 1 November 2007 the examination was still in process.

2.1.5 Operating Licences

Chapter IV of Act 161/2002 on Financial Undertakings lists the kind of activities in which financial undertakings may engage. The Chapter specifies the regulatory framework for these undertakings but does not automatically allow for the right to purse all the activities listed. The law expects each operating licence to cover only those activities that are an unequivocal part of the operations of the undertaking. Applications for operating licences should only be made for the kind of activities that are intended by the undertakings concerned. Should the undertakings, at a later date, decide to offer new kinds of services as permitted by law, they need to apply for a supplementary licence. Licences are renewed when permission to offer new services has been granted. This does not, however, apply to undertakings licensed prior to the entry into effect of the legislation. Instead, these undertakings need to notify the Financial Supervisory Authority of any changes or addition to their services.

Two new financial undertakings were issued with operating licences during the period – a credit undertaking and a management company of a UCITS. In addition, the FME authorized a licensed securities brokerage to operate as a securities company and the licence of one securities company was renewed to accommodate increased services.

Article 27 of Act 60/1994 on Insurance Activity states that an insurance company which has obtained an operating licence in Iceland and subsequently proposes to take up another class or subclass of insurance, or intends a substantial change in its activities, must apply for authorization of the new activity to the Financial Supervisory Authority. One supplementary operating licence was issued to an insurance company for a specific class of insurance. The company's application was part of its plans to offer services abroad within the European Economic Area.

2.1.6 Financial Conglomerates

During the period the FME has been working on the drafting of rules on supplementary supervision of financial conglomerates to support the implementation of the Financial Conglomerates Directive 2002/78/EC. Financial conglomerates are consolidations where at least one of the parties operates in the insurance sector and at least one in the financial sector (financial undertaking). The parent company of the consolidation can either be a party directly subject to supervision or not. Clear definitions have also been made as to when a consolidation may be considered to be a conglomerate. It should be pointed out here that the term consolidation has a broader meaning than general in this context and covers, for instance, participation in companies in the insurance and financial sectors. The principal aims of conglomerate supervision are to:

- Prevent the repeated use of the same resources, either own funds or other financial resources, in order to meet varying capital and solvency requirements within a financial conglomerate.
- Impose requirement for minimum capital / solvency of a financial conglomerate.
- Impose requirements on internal control in order to monitor, measure and manage business within the financial conglomerate on the one hand and concentration of risk on the other.
- Ensure supervision of the financial conglomerate as a whole as well as cooperation with other supervisory bodies.
- Ensure harmonised supervision of financial conglomerates with headquarters or central administration in a country outside the European Economic Area, but nevertheless operating within the EEA.

The FME published draft rules on the supplementary supervision of financial conglomerates as Discussion Paper on 4 September 2007. The rules are expected to be published before the end of the year.

Parallel to this work is an examination of whether specific Icelandic undertakings may be classified as a conglomerate. The results of this examination are not available as of yet.

2.1.7 Act 55/2007 Amending Provisions Concerning Penalties for Financial Market Violations

On 2 April 2007 a new legislation on penalties for economic crime entered into effect. This legislation, which gives the Financial Supervisory Authority added administrative powers, was based on the proposals of a committee appointed by the Prime Minister of Iceland to review and revise the legislation on penalties for economic crime. By this legislation the FME has been granted increased authority to impose administrative fines on undertakings or individuals for infringements of laws that come under its jurisdiction and has the power to determine whether administrative fines should be imposed or cases referred to the police with regard to the severity of the infringement. Before the entry into effect of the amendments the FME could only issue comments or refer cases to the police. The purpose of the legislation is to provide the FME with practical tools, increase efficiency in the fight against economic crime and strengthen the credibility of the market. The Act also serves to define more clearly the nature of collaboration and division of tasks between the FME and the police and the Directorate of Public Prosecutions, for instance by stating that financial market violations can only be prosecuted if charges have been brought to the police by the FME. The Act also contains provisions on the right of individuals not to incriminate themselves while investigating infringements that may lead to administrative fines or criminal liability. Finally, the FME is provided with the authority to conclude cases with a settlement.

The Act serves to amend the following legislation:

Act 33/2003 on Securities Transactions
Act 161/2002 on Financial Undertakings
Act 34/1998 on Stock Exchanges and Regulated OTC Markets
Act 131/1997 on Electronic Registration of Title to Securities
Act 30/2003 on UCITS and Investment Funds
Act 60/1994 on Insurance Activity
Act 32/2005 on Insurance Mediation

As a result of these recent legal amendments, the power of the FME to enforce financial market legislation is now comparable with practices in the best developed financial markets in Europe. The legislation enables the FME to become more active in its supervisory function, enhances the credibility of the financial market in Iceland, and supports efficient surveillance mechanisms that facilitate quick and effective intervention in the event of criminal activity.

During the period the FME worked on preparations for the new authorisations and the development of procedural rules. More work is anticipated in the future on the determination of administrative fines and out-of-court settlements. A number of cases which might test these new authorisations are currently being examined. Some increase in administrative fines is to be expected in coming months.

2.2 The Credit Market

At the end of June 2007 the total assets of commercial banks and largest savings banks amounted to ISK 10,643 billion on a consolidated basis and ISK 7,246 billion on parent company basis. This corresponds to nine-fold and six-fold gross national product respectively.

Figure 1 Total Assets of Commercial Banks and as Ratio of GDP

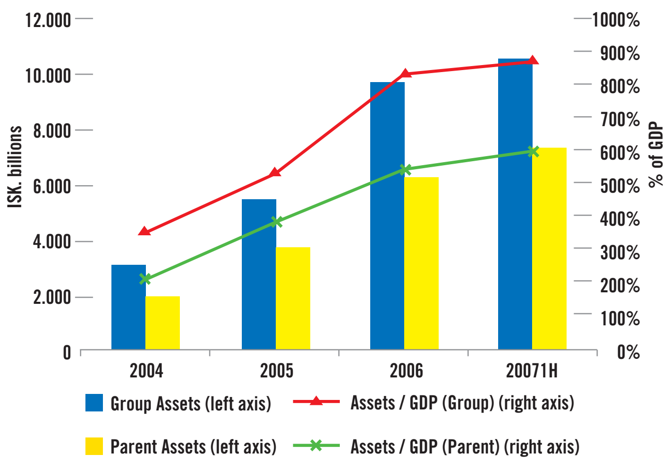


Figure 1. Developments in total assets of commercial banks, both actual amounts and as a ratio of gross domestic product (GDP).

This increase is the result both of organic growth (credit growth and investment in securities) and external growth through takeovers.

Performance

The performance of Icelandic credit institutions was good during the first half of 2007. The banks have been increasing their core income and net interest income has increased by 18% since 2006.

Profitability in 2006 was similar to that of the previous year and this development carried on into 2007. The average return on equity (ROE) of five commercial banks and five of the largest savings banks before tax was 36.1% during the first half of 2007, compared with 37.6% the previous year and 36.6% in 2005. If all performance items other than interest, fee and commission income are excluded, the profit before tax amounted to 12.9% in the first half of 2007, compared with just over 12.2% in 2006 and around 11.3% in 2005. This shows that profit from core operations (i.e. interest, fee and commission income) has been relatively stable in recent years.

Figure 2 Profit before Tax of Commercial Banks and Largest Savings Banks as Ratio of Average Total Equity

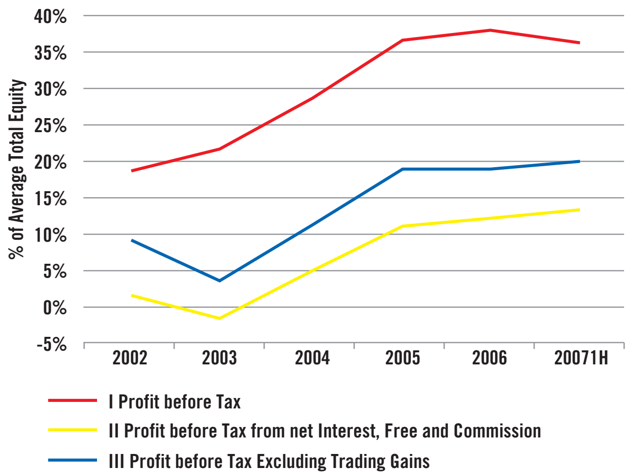


Figure 2. Profit as a ratio of average total equity on an annual basis for commercial banks and the five largest savings banks. Profit I is profit as shown in annual financial statements, Profit II is profit before tax of net interest and fee income, and Profit III is profit before tax less profit from trading assets and other assets at fair value. The calculation of Profits II and III has not taken into account the impact of lower interest cost on account of reduced income so Profits II and III are thus underestimated to some extent. All calculations are based on profit before taxes.

In recent years, the operating expenses of banks and savings banks have been dropping in proportion to total assets. This ratio was around 2.5% in 2004, and in 2005 and 2006 around 1.8%. The first half of 2007, however, saw a steady rise in this ratio, which has reached a current level of around 2%.

Figure 3 Main Operating Items of Commercial Banks and Savings Banks as Ratio of Average Total Assets

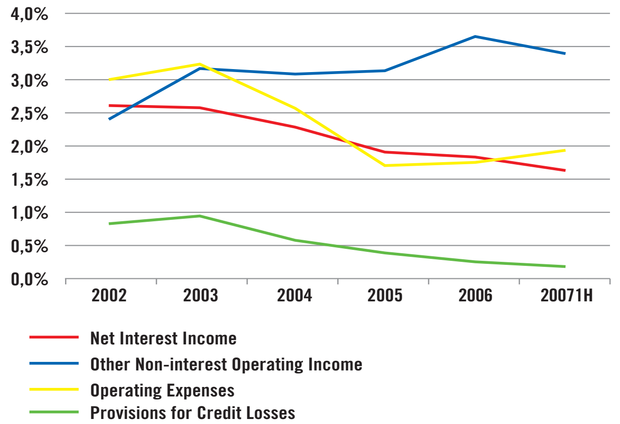


Figure 3. Development of major operating items of commercial banks and the largest savings banks as a ratio of their average balance sheet positions. Figures for H1 2007 are extrapolated to an annual basis.

In recent years, there has been a steady drop in net interest income as a proportion of total assets and this item now stands at 1.7% compared with 2.3% in 2004. Provisions for lost loans as a proportion of balance sheet average has similarly been falling and is currently less than 0.2% compared with 0.6-0.9% in the years 2003 and 2004.

Figure 4 Proportion of Foreign Income of 3 Largest Commercial Banks

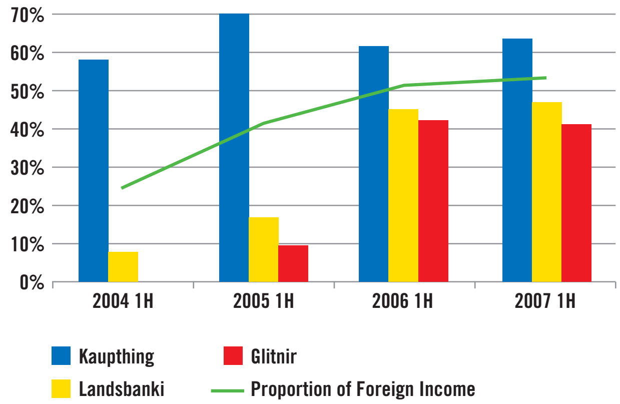


Figure 4. Proportion of foreign income for the three largest commercial banks.

The commercial banks have slightly increased their foreign income as a proportion of overall income since last year and the ratio now stands at 54%, compared with 51% in 2006. Broken down by banks, the division is as follows: Kaupthing Bank 63%, Landsbanki 47% and Glitnir Bank 41%. There are all indications that this ratio will keep growing in the future.

Credit Development

Lending by deposit institutions kept growing although this increase is less substantial than in previous periods. Credit growth based on parent company accounts was thus 18.6% during the period from June 2006 to June 2007 (from ISK 2,909 billion to ISK 3,449 billion) compared with 64.4% in the preceding twelve-month period.

A sizeable proportion of the credit growth stems from increased lending to foreign customers, but the weight of such loans has more than tripled since June 2003, or from 7% of total lending by deposit institutions (based on parent company accounts) to 23% in June 2007.

Figure 5 **Breakdown of Outstanding Loans of Deposit Institutions (Parent Companies)**

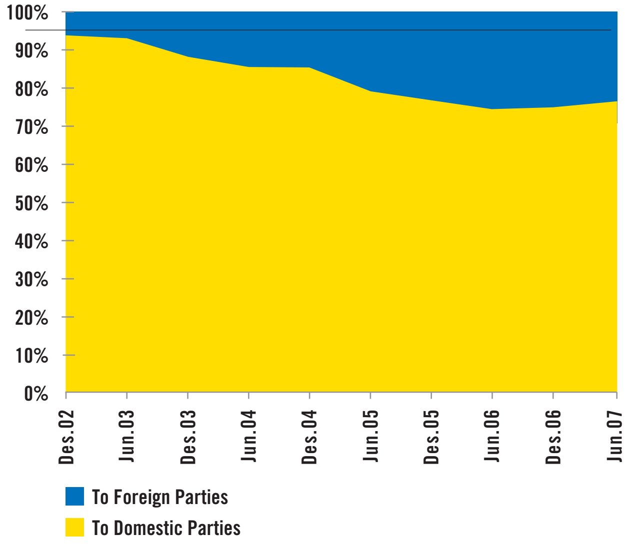


Figure 5. Trends in proportional division of lending between domestic and foreign parties.

Defaults

Defaults have been decreasing steadily in recent years, even when calculated with a two year time lag, i.e. defaults as a percentage of total loans outstanding two years earlier, in order to exclude the impact of credit growth.

Figure 6 **Defaults to Deposit Institutions**

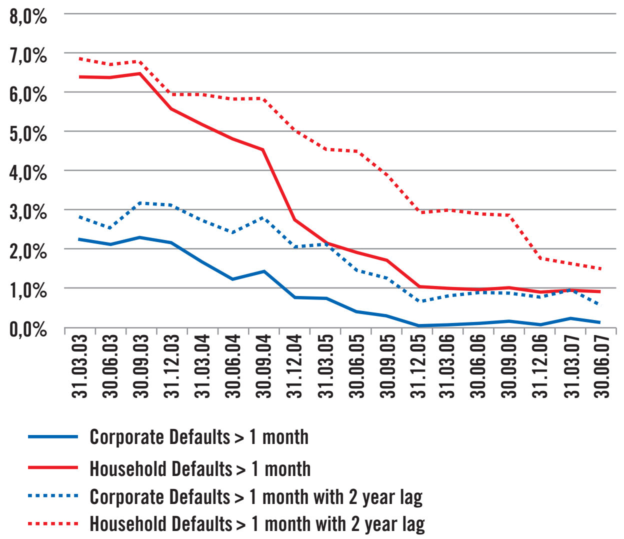


Figure 6. Defaults (>30 days) as a ratio of total lending by deposit institutions (parent companies only) at the end of each quarter.

The ratio of corporate defaults at mid-year 2007 was 0.5% and 0.8% for households. The corporate ratio is the same as in the previous year when the ratio for households was 0.9%. Economic forecasts had warned against increased defaults as a result of reduced domestic economic activity in 2007. This did not materialize, however. Deposit institutions vary in their sensitivity to fluctuations in the domestic economy, but the loan portfolios of the largest deposit institutions are well diversified as regards country risk. Smaller deposit institutions are not so well placed and need to keep a close watch on developments over the coming months.

Mortgage Loans on Residential Real Estate

Since the banks and savings banks entered the mortgage lending market the extent of such type of credit has grown rapidly. From mid-year 2006 to mid-year 2007 the ratio of mortgage housing loans increased by 15% with the commercial banks, or from ISK 289 billion to ISK 330 billion, and by 18% with the largest savings banks, or from ISK 92 billion to ISK 108 billion. Substantial changes in the capital bases of savings banks, for instance as a result of mergers, have the effect of lowering the proportion of this type of credit as a ratio of the capital base when compared with figures from the same time in 2006.

Mortgage loans on residential real estate

	Commercial banks		Largest savings banks	
	1H2006	1H2007	1H2006	1H2007
Ratio of capital base	36.4%	37.1%	306.9%	296.7%
Ratio of loans to customers	10,9%	9.8%	31,4%	35,9%

Nearly a half of all mortgage housing loans at commercial banks and largest savings banks have a loan-to-value (LTV) ratio of 70% or lower, which is a considerable change from the previous year when this LTV ratio applied to nearly a third of all such loans. The LTV ratios seem to have reached a more even distribution than was the case last year as shown in Figure 7.

Figure 7 **Loan to Value (LTV) Ratios of Mortgage loans**

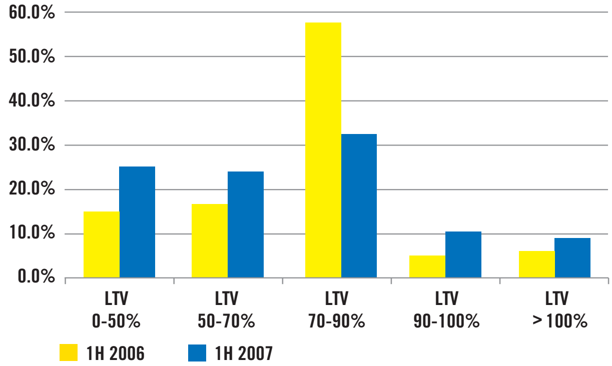


Figure 7. Loan-to-value ratios (loans divided by the value of the mortgaged property) of mortgage loans on residential real estate.

Loans with Securities Pledged as Collateral

Loans with securities pledged as collateral as a ratio of capital base, i.e. the total amount of direct loans and forward contracts, grew considerably from the previous year as far as the commercial banks are concerned, or from 77.8% to 125.9%. There has also been an increase in this ratio at the savings banks, or from 33% to 42.1%. There has been an increase in loans with securities pledged as collateral both at commercial banks and savings bank, with the savings banks assuming the lead in this area with a 90% increase as compared with 43.4% at the commercial banks. The market value of shares thus pledged as collateral and which are listed on the OMX equalled 26.1% of the total market value of the companies listed on OMX Iceland at mid-year 2007, compared with 28.7% in 2006. Total asset cover of direct loans with securities pledged as collateral, excluding forward contracts, has grown both with commercial banks and savings banks from 188% at mid-year 2006 to 268% at mid-year 2007, which constitutes a drop from 53% to 37% in the loan-to-value ratio.

Loans with securities pledged as collateral and forward contracts on securities

	Commercial banks		Largest savings banks	
	1H 2006	1H 2007	1H 2006	1H 2007
Ratio of capital base	77,8%	125,9%	33,0%	42,1%
Ratio of loans to customers	21,9%	18,4%	4,1%	5,0%

The proportion of these loans in terms of overall lending to customers has remained more or less the same between years, dropping from 21.9% to 18.4% at the commercial banks and increasing from 4,1% to 5% at the largest savings banks.
In assessing the extent of lending with securities pledged as collateral the FME has compiled information on both such direct loans and forward contracts between banks and their customers. The total notional amount of forward contracts as a ratio of all loans with securities pledged as collateral at mid-year 2007 equalled around one-third at the three largest commercial banks, which is more or less the same as the year before. As for the savings banks, however, the ratio of forward contracts dropped from 13.3% at mid-year 2006 to 4.2% at mid-year 2007.

Loans with securities pledged as collateral - proportional division

	Commercial banks		Largest savings banks	
	1H 2006	1H 2007	1H 2006	1H 2007
Loans with securities pledged as collateral	68,2%	67,7%	86,7%	95,8%
Forward contracts on securities	31,8%	32,3%	13,3%	4,2%

Large Exposures

In order to minimize the impact of losses incurred by individual customers or groups of connected clients of financial undertakings, the sum total of claims on these parties may never exceed 25% of the capital base of an undertaking. The FME specifically monitors all large exposures, i.e. total exposures of a financial undertaking to a single issuer or connected parties amounting to more than 10% of its capital base.

Figure 8 | Large Exposures of 3 largest Commercial Banks (Consolidated Accounts)

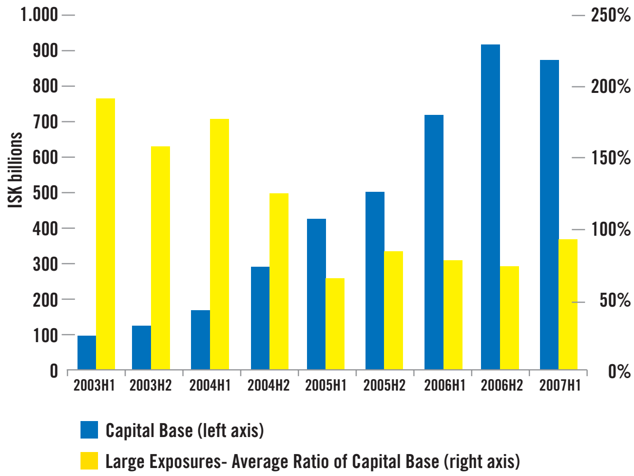


Figure 8. Development of capital base in ISK billion and large exposures as a ratio of the capital base of the three largest commercial banks on a consolidated basis.

As shown in the above figure, the weight of large exposures of Icelandic financial undertakings has been decreasing over the years. At the same time, a growing number of financial undertakings have been adopting their own procedures to restrict further maximum exposure levels. The FME supports this favourable development which is important when foreign parties and agencies are evaluating and rating the Icelandic financial market. The FME believes large exposures should always be treated with utmost caution and if there is ever any doubt about connections between parties, they should be considered to be connected until proven otherwise.

Loans to Connected Parties

In December 2006 the FME issued amendments to its Guidelines on the content of rules of procedure for the boards of directors of financial undertakings. The principal change involves the FME's requirement that financial undertakings solicit an external auditor to review credit facilities to connected parties and compare them with comparable business transactions with other customers and to submit a well-founded report, e.g. concerning terms, renegotiations and balances of the parties in question (arm's length principles). The FME requests that reports prepared by external auditors on the basis of such reviews should be sent to the FME on an annual basis for financial undertakings with total assets exceeding ISK 50 billion (on a consolidated basis) and every other year in the case of other financial undertakings. The purpose of this is to promote increased credibility and faith in the operations of financial undertakings by confirming beyond doubt that sound and prudent business practices are observed in their transactions with connected parties.

Financial undertakings must identify all clients that may be classified as connected parties and include them in their rules of procedure. The FME believes that board members (full members and alternates), management and key personnel who may be considered as having insider status shall be treated as connected parties and also close family members of such parties. By the same token, corresponding parties in subsidiaries and connected undertakings and all shareholders who own 5% or more of the shares of a financial undertaking shall be treated as connected parties. Businesses, in which the above parties hold shares of 10% or more, are employed by or serve as chairmen of the boards of directors shall also be treated as connected parties.

The FME has called for information from financial undertakings concerning their credit facilities to connected parties. At mid-year 2007 total loans to connected parties of commercial banks and the largest savings banks amounted to 7.2% of their overall lending to customers, compared with 6.5% at the same time the year before. Total lending to connected parties as a ratio of the sum total of the capital bases of these undertakings came to 43% at mid-year 2007 compared with 38.6% at the same time in the previous year. It is a matter of interest that the ratio has increased with the commercial banks and decreased with the savings banks.

Loans to connected clients as a proportion of total lending to customers

	30.06.2006	30.06.2007
Commercial banks	7,5%	6,8%
Largest savings banks	1,5%	2,4%

Loans to connected clients as a ratio of capital base

	30.06.2006	30.06.2007
Commercial banks	43,8%	39,3%
Largest savings banks	14,9%	20,1%

Securities Holdings

Holdings of market securities by commercial banks and savings banks started to grow in 2007 after some contraction during the previous year.

Marketable bonds held at own risk amounted to 35.5% of the capital base at the end of June 2007, compared with 25.9% at year-end 2006. Corresponding figures for marketable shares held at own risk were 36.3% at the end of June 2007 and 29.9% at year-end 2006.

This increase may to some extent be explained by changes to the capital base, which has been shrinking since year-end 2006, simultaneously with an increase in the balance of marketable securities by 22%.

Figure 9 Marketable Bonds and Shares Held at Own Risk by Commercial Banks and Largest savings Banks

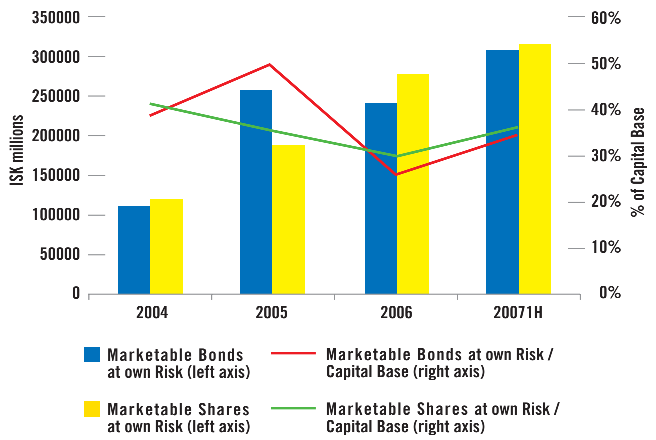


Figure 9. Development of marketable securities holdings by commercial banks and largest savings banks (consolidated accounts) in absolute terms and as a ratio of capital base. Marketable securities holdings are assessed as position risk as calculated in the risk-weighted base in capital adequacy reports.

Financing

In 2006 foreign analysts criticized the commercial banks for their financing methods. This put some strain on the banks' refinancing needs, but they responded by improving the flow of information to the market, diversifying their financing across markets and improving their liquidity, among other things.

Figure 10 Borrowings of Commercial Banks by Location

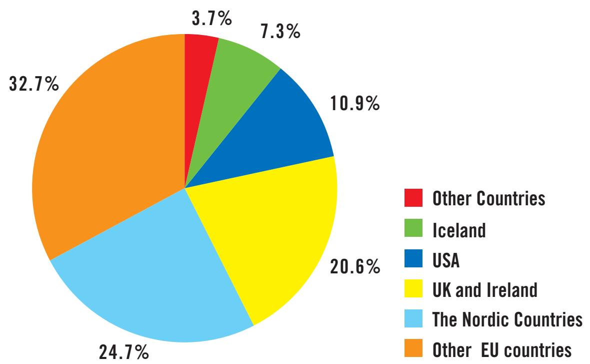


Figure 10. Distribution of borrowings of the banks by countries.

Towards mid-year 2007 the international market experienced some uncertainty and liquidity constraints which could be traced back to the poor performance of substandard loans on the US residential real estate market. The impact of this has not been significant for the Icelandic banks, partly thanks to the measures taken in 2006 as mentioned before.

Part of the criticism levied against Icelandic banks last year was the relatively low ratio of deposits in their overall financing. The deposit-to-loan ratio was low compared with that of similar banks in other countries. This trend is now slowly reversing as a result of increased emphasis on encouraging deposits. As shown in Figure 11 the deposit-to-loan ratio has increased from around 31% in 2005 to 52% at mid-year 2007.

The development in deposits at deposit institutions (both parent companies and branches) between December 2005 and the end of August 2007 provides for an interesting study, cf. the following table. Deposits have nearly tripled during this period, or by 73% from foreign depositors and 27% from domestic depositors. A closer analysis of the deposit increase at six-monthly intervals reveals an average increase of 33%. Deposits by foreign depositors have grown rapidly to the extent that they now own a higher proportion of total deposits than do Icelanders, a situation that has never occurred before. Increased deposits will clearly add variety to the range of resources available to the banks although such financing is by no means risk-free.

Breakdown of Deposits

ISK billion	Des. 05	Jun. 06	Des. 06	Jun. 07	Aug. 07
Total deposits	709	899	1.151	1.952	2.126
Domestic depositors, total	657	742	787	981	1.046
Proportion (%) of total deposits	93%	83%	68%	50%	49%
Foreign depositors, total	52	157	364	971	1.080
Proportion (%) of total deposits	7%	17%	32%	50%	51%

Figure 11 | 3 Largest Commercial Banks, Deposits as a Ratio of Loans to Customers (ISK billions)

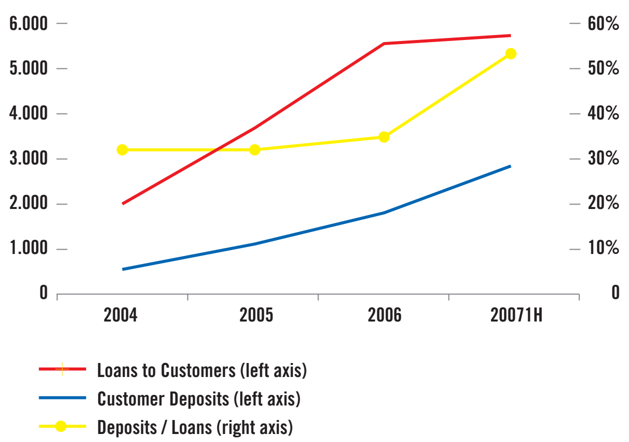


Figure 11. Development of loans to customers and deposits by commercial bank clients and ratio of deposits-to-loans.

Liquidity

The liquidity position of the three largest commercial banks as calculated by the Liquidity Ratio Rules of the Central Bank of Iceland kept improving considerably throughout 2006 and towards the end of 2007. By the end of September 2007 the three-month liquidity position of the banks stood at ISK 1,214 billion, compared with just under ISK 600 billion at the end of March 2006, cf. also Figure 12. As the picture shows, the liquidity position peaked at the end of June when it reached ISK 1,675 billion. Internal criteria determined by the banks state that they should at all times have sufficient liquid funds to meet their obligation for the following twelve months. In an attempt to curb criticism concerning the uncertainty in the refinancing of foreign loans, the banks took measures to improve their liquidity in 2006. As a result of these measures, the banks were well equipped to meet the unrest in the credit market during 2007.

Figure 12 | Liquidity Position of 3 Commercial Banks in ISK billions- Liquid Assets over Current Liabilities (3 month)

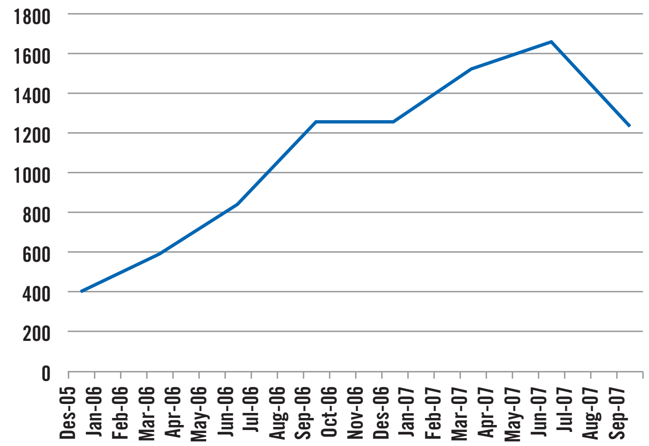


Figure 12. Liquidity position of three commercial banks.

Capital Adequacy

The capital adequacy ratio (CAD ratio) of commercial banks and largest savings banks has been growing in strength in recent years. At the end of June 2007 the CAD ratio was 13.9% compared with 13.3% at mid-year 2006 and 16.2% at year-end 2006. The drop in the CAD ratio this year can largely be explained by the overseas investment of the banks in foreign financial undertakings during H1, which has caused the risk weighted base to increase by 10% while the equity base has simultaneously decreased by 6%, among other due to dividend payments. The Tier 1 ratio measured at 10.4% at mid-year 2007 compared with 10% at the same time in 2006 and 12.2% at year-end 2006.

Figure 13 | Capital Adequacy Ratio of Commercial Banks and Largest Savings Banks with and without Subordinated Loan Capital

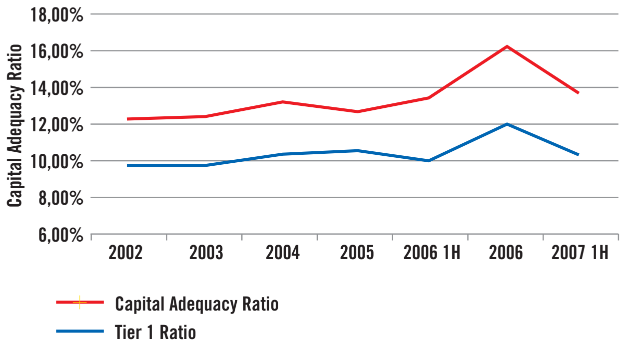


Figure 13. Development of CAD ratios.

All the commercial banks and the largest savings banks pass the formal stress test of the FME which anticipates that the following crises occur simultaneously:

35% drop in the book value of Icelandic shares held at own risk
25% drop in the book value of foreign shares held at own risk
7% drop in the value of marketable bonds held at own risk
20% devaluation of the Icelandic króna
20% drop in the value of non-performing loans and appropriated assets

The capital position of commercial banks and savings banks appears to be fully adequate as of the end of June 2007 and even somewhat better than last year.

Implementation of the Basel II Framework

New rules on the capital requirement of financial undertakings (the Basel II Framework) were implemented at the beginning of 2007 following amendments to the capital requirement provisions of Act 161/2002 which entered into effect at the end of 2006. Pursuant to this Act, the FME adopted new rules on the capital requirement and risk-weighted assets of financial undertakings as well as new rules on large exposures of financial undertakings. The calculation of the capital requirement and risk-weighted assets according to the new rules may be deferred until 1 January 2008. Until that date, financial undertakings are permitted to apply the provisions that were effective at year-end 2006. Around two-thirds of Icelandic financial undertakings have opted to avail themselves of this deferral clause; the majority being smaller financial undertakings holding less than 5% of the total assets of financial undertakings.

In April 2007 the FME published guidelines on standards to promote convergence in supervisory procedures and guidelines on standards for stress tests for financial undertakings, standards for managing the concentration risk of financial undertakings and standards for managing interest rate risk in the banking book. At the end of year 2007 the FME will publish a description of SREP (Supervisory Review and Evaluation Process) and ICAAP (Internal Capital Adequacy Assessment Process) which both come under the scope of Pillar 2 of the Basel II Framework.

Two commercial banks have applied for permission to use the internal ratings based approach "Foundation-IRB" and these applications are currently being processed by the FME.

The FME is currently preparing the implementation of Pillar 3 of the Basel II Framework which is primarily concerned with market discipline and public disclosure of financial undertakings. The FME plans to publish a more detailed description of its market discipline requirements during the first quarter of 2008.

Preparation for Basel II started

2003	Preparation for Basel II started.
Dec. 2006	The act on Financial Undertakings amended with respect to Directives 2006/48/EC and 2006/49/EC, reflecting Basel II provisions in the EU.
March 2007	The FME implements detailed rules on most Pillar I issues, e.g. own funds, standardized approach and the internal ratings based approach (Rules No 215/2007) and large exposures (Rules No 216/2007). The FME publishes information on supervisory disclosure and information concerning Basel II.
April 2007	The FME publishes guidelines built on the EU´s Directives, such as on the Supervisory Review Process (Pillar II) and on concentration risk.
April 2007	Banks report under the common European reporting scheme (COREP) for the fist time in Q1/2007. Parallel running of Basel I and Basel II (COREP) reporting schemes will be conducted throughout 2007.
April 2007	Two Banks have applied to the FME for use of Internal Ratings Based Approaches (IRB). The roll-out includes operations in 7 countries.
Nov/Dec 2007	The FME publishes minimum requirements concerning the internal capital adequacy assessments of financial undertakings (ICAAP) and procedures for reviewing the risk assessment of financial undertakings (SREP).
Dec. 2007	The FME collects the first ICAAP reports under Pillar II at year-end.
Spring 2008	The FME publishes minimum requirements on the duty of financial undertakings to provide information to the market (Pillar III – market discipline)

Action Group and Nordic Contingency Exercise

The FME operates an action group which has been given the task of preparing a contingency plan to combat issues that might arise on the market. Information on major risks in the operations of parties subject to supervision as well as key personnel to contact in case of emergency is already available. The action group has set up special working facilities at the FME's premises which can be swiftly mobilized in the event of a financial crisis or other issues that need to be dealt with quickly and efficiently.

A joint contingency exercise of Nordic and Baltic supervisory authorities was held on September 20 to 25, 2007. Representatives of the FME, the Central Bank of Iceland and the Ministry of Finance participated in the exercise.

The contingency exercise was a clear expression of the willingness of all the authorities concerned to measure the collaboration and coordination procedures of their institutions. The organization and preparation of the exercise took more than a year and tested the cooperation between various bodies and possible joint measures. Particular emphasis was placed on the coordination of decision-making processes between authorities in the participating countries.

Mergers of Savings Banks

Mergers of savings banks were rather prominent during the period and this trend is likely to continue. The merger of savings banks is governed by Act 161/2002 on Financial Undertakings as well as the provisions of Act 2/1995 on Public Limited Companies and contracts between the parties concerned. In Article 106 of the Financial Undertakings Act it is stated that mergers of financial undertakings shall be subject to approval by the Financial Supervisory Authority. The FME examines in particular whether decisions on mergers are in conformity with law and whether the operations of the undertakings are financially sound and secure.

The FME approved the merger of Sparisjóður Vélstjóra and Sparisjóður Hafnafjarðar under the new name of BYR Savings Bank at the beginning of this year. The FME also approved the merger of Sparisjóður Ólafsvíkur with Sparisjóður Keflavíkur and the merger of Sparisjóður Hornafjarðar og nágrennis with Sparsjóður Vestmannaeyja. The number of Icelandic savings banks has thus decreased by a total of three in the last twelve months, or from 24 to 21. The following mergers, which mean an even further reduction in the number of savings banks, have been planned:
Sparisjóður Kópavogs and BYR Savings Bank,
Sparisjóður Norðlendinga and BYR Savings Bank,
Sparisjóður Skagafjarðar and Sparisjóður Siglufjarðar,
Sparisjóður Vestfirðinga, Sparisjóður Húnaþings og Stranda and Sparisjóðurinn í Keflavík,
Sparisjóður Ólafsfjarðar and Sparisjóður Siglufjarðar.

2.3 The Securities Market

Operational Overview
Financial Market Directives

The work of FME's securities market unit has largely focused on the introduction of a range of EC directives. This work was concluded by the implementation of the MiFID Directive on Markets in Financial Instruments and the Transparency Directive through a legislation which entered into effect on 1 November 2007. Preparations for the MiFID Directive have been extensive and also the preparation and development of an electronic transaction reporting system. The reporting system receives and stores information on transactions by financial undertakings and exchanges information thus stored with supervisory authorities abroad. The FME was an active participant in a Nordic project on the collaborative design and development of a reporting and surveillance system.

Compared with the present legislation, the MiFID Directive extends the range of financial operations subject to authorisation to cover such activities as advisory services for other types of investment than securities and multilateral trading facilities (MTFs). This will vastly increase the number of applications from companies requiring licences to operate as financial undertakings. More detailed and precise rules on the business practices of financial undertakings and investor protection similarly call for more wide-ranging and complex supervision by the FME of compliance with these rules and their implementation.

The above-mentioned implementation is the final phase in a legislative process instigated by various EC Directives for the financial market. In all, the period saw the implementation of five such Directives, viz. the MiFID Directive, the Transparency Directive, the Prospectus Directive, the Market Abuse Directive (MAD) and the Takeover Directive as well as numerous Commission directives and regulations. A range of queries and issues have been raised as a result of this process and the FME has made every effort to provide satisfactory solutions, often through fruitful collaboration with authorities and institutions abroad. The Committee of European Securities Regulators (CESR) operates groups of experts who work on the formulation and interpretation of the above directives as well as surveying issues that may arise.

The increased overseas expansion of Icelandic financial undertakings has put greater emphasis on supervision across borders, particularly as regards possible insider fraud and market abuse. The FME has detected a corresponding increase in the number of inquiries on the activities of Icelandic undertakings from supervisory authorities abroad. The implementation of MiFID and the introduction of the transaction reporting system call for improved co-operation between supervisory authorities within the EEA.

The Iceland Stock Exchange – OMX Group

At year-end 2006 the Iceland Stock Exchange joined OMX Group, which owns and operates the largest securities market in N-Europe. Following the merger, OMX became the parent company of the group and Icelandic companies on the Stock Exchange list were added to First North at the beginning of April 2007. The merger of the Iceland Stock Exchange with OMX provides Icelandic investors with a greater variety of opportunities and the creation of an integrated Nordic market will boost transactions between the Nordic countries. This merger also helps improve the marketability of Icelandic securities. Increased investment opportunities and rapid technological changes which help open up new markets worldwide, however, also increase the danger of market abuse. The FME and OMX Iceland cooperate closely on supervisory matters with particular view to the division of duties and the harmonisation of procedures in order to support powerful market surveillance. A sizeable proportion of cases examined by the FME arise from comments forwarded by the Iceland Stock Exchange.

Guidelines and Interpretations for the Securities Market

As legislation for the financial market has grown in scope and complexity, the FME has felt a growing need for interpretations and guidelines on its implementation. The FME is conscious of its influential function in the financial market and is determined to enhance its publication of interpretations and guidelines on issues arising from the implementation of laws and regulations in the securities market. All FME interpretations are published on the Authority's website. Similarly, warnings from foreign authorities issued through CESR are also published on the website.

The FME collaborates closely with supervisory authorities in other EEA countries through its participation in CESR. The results of various European projects are published on the website of CESR as interpretations, recommendations and other useful information. The overall objective is the harmonisation of interpretation and implementation of rules pertaining to securities market law within the EEA in order to achieve a homogenous internal market.

Case Overview

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

- Administrative fines. Five instances concerning flagging obligations as defined by Article 32 of the Securities Transactions Act were examined during the period. Alleged infringements of Articles 62, 63 and 64 of Act 33/2003 concerning the obligation to investigate and the obligation to notify transactions of primary insiders and issuers were examined in a total of 34 cases. In eight cases the FME's examination resulted in the imposition of administrative fines and 18 further cases are still under examination.
- Market abuse. Five instances of possible market abuse were examined during the period. Three cases were closed following the FME's examination without any action being taken but two cases are still under review.
- Insider fraud. Six cases of possible insider fraud were examined during the period. Four were closed upon examination but two cases are still under review.
- 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.
- Takeovers. Six cases concerning takeover obligations were examined, but following extensive examination the FME concluded that further action was not required.

Trend in the Securities Market

Financial market developments in 2006 were favourable for investors, both on the equity and the bond markets. Negative international reports on the Icelandic financial market at the beginning of 2006 caused a sharp downfall in share prices as foreign analysts criticised the Icelandic market for over-rapid growth and tight ownership. Share prices began to rise again around mid-year 2006 when adverse predictions were proved to be unfounded, listed companies showed good results and the year as a whole turned out to be most promising. The Icelandic market index rose by 15.8% compared with 64.7% in the previous twelve-month period. There was a record turnover in trading on the Stock Exchange in 2006 amounting to ISK 4,484 billion, which corresponds to a 77% increase in turnover between years.

When the Iceland Stock Exchange became part of the OMX Group its name was changed to OMX Nordic Exchange Iceland hf. (Kauphöll). As a result of this change, the Icelandic market index is now known as the OMX Iceland 15 index or OMXI15.

The OMXI15 index rose steadily from 6,410 points at the beginning of 2007 to a peak of 9,016 points on 18 July. Since then the index has dropped considerably with the lowest point occurring at 7,223 points on 9 November. The Icelandic equity market experienced considerable fluctuations during Q3/2007 and well into Q4. These fluctuations occurred simultaneously with changes in international markets as a result of the US housing loan crisis and liquidity problems of British banks, which caused quite a stir in global markets. This correlation shows clearly that the Icelandic market is no longer an isolated one. Icelandic businesses are now operating in a global context and a sizeable proportion of their revenue is in foreign currencies. As a result of this exodus, many Icelandic businesses have opted to register their equity in foreign currencies, primarily Euro, and more have declared their willingness to follow this example. The OMXI15 dropped by 3.87% in Q3/2007 which was a significant turnaround from Q1 and Q2 when the index rose by 16.9% and 10.8% respectively. At the end of October the OMXI15 stood at 8,115 points and had risen by 26.6% from the beginning of the year or by 30% over the preceding twelve-month period.

Figure 14 The OMEXI-Main index and the OMEXI 15-index

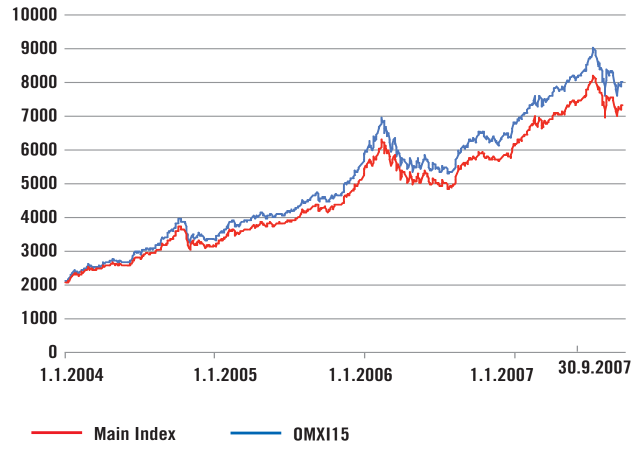


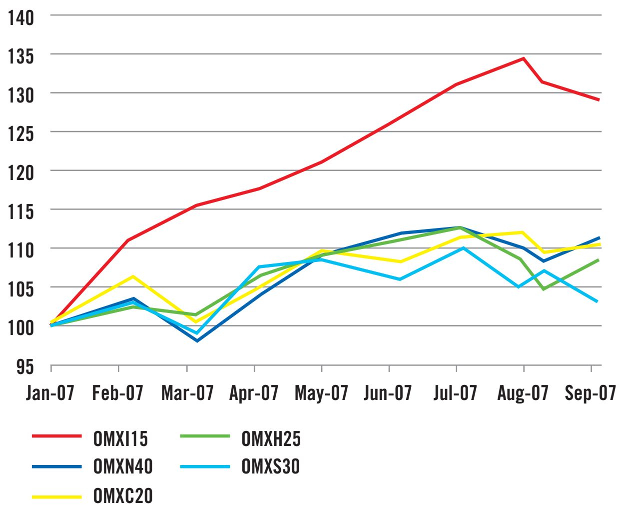
Figure 14 The OMX Iceland 15 Index.

The Icelandic equity market has seen a considerable increase in turnover in recent years. Total equity trading on the Iceland Stock Exchange in 2002, for instance, amounted to ISK 321 billion, but last July it reached just under ISK 528 billion, which is a record turnover for one month. During the first 9 months of 2007 the overall turnover in the equity market reached ISK 2,485 billion. As before, trading is greatest in equities and bonds issued by the four commercial banks, or around 73% of total turnover at the end of Q3/2007.

Total equity trading in 2006 amounted to ISK 2,192 billion, compared with ISK 1,202 billion in 2005, which corresponds to an increase of 82% between years. Total equity trading during the first six months of 2007 came to ISK 2,485 billion compared with ISK 1,080 for the same period in 2006, which constitutes a staggering increase of 130%.

The yield in Nordic equity markets varied between countries during the first nine months of the year, but despite the turn-around in Q3 the Icelandic market index showed the biggest rise by far.

Figure 15 | **Monthly changes in Nordic indices**



Mynd 15. Development of Nordic indexes. (Initial criteria for the beginning of 2007 adjusted to 100)

Number of Listed Companies on OMX Iceland and their Market Capitalisation

The number of companies listed on OMX Iceland increased from 26 to 27 during 2006. Five new entrants to the list were Eimskip (formerly Avion Group), Exista, Teymi, OMX AB and Icelandair Group Holding. Two companies, Hampidjan Group and HB Grandi, moved from the ICEX Main List to the ISEC market and four companies, Jarðboranir (Iceland Drilling Company), Kögun, Fiskmarkaður Íslands (FMI Ltd) and Fiskeldi Eyjafjarðar, were delisted.

During the first ten months of 2007, three new companies have been listed on OMX Iceland, viz. Føroya Banki P/F, Eik Banki P/F and SPRON hf. Investors have welcomed these new options and the equity offers of the two Faeroese banks aroused particular interest. Actavis hf was delisted at the end of August and requests have been made for the delisting of Vinnslustöðin hf and Mosaic Fashion hf. The companies that make up the market index OMXI15 have thus been reduced from 14 to 12 by the delisting of Actavis hf and Mosaic Fashion hf. In keeping with the rules of OMX Iceland, new companies will not be added to the index for the period January-December 2007 to replace the two delisted companies.

Following the listing of Føroya Banki P/F and Eik Banki P/F a special Faeroese share index accommodating the two banks and P/F Altantic Petroleum, OMXIFO, was created.

The First North Iceland market was launched at mid-year 2007. Century Aluminium Company, the parent company of Norðurál, was the first company to be listed on First North Iceland.

The ISEC market, which is intended for small and medium sized companies, was established in July 2006. Two companies that were previously on the Main List, Hampidjan Group and HB Grandi, moved between lists and at the beginning of 2007 the ISEC market became part of OMX First North. Trading on ISEC amounted to ISK 4.2 billion in 2006.

Looking on towards the end of 2007, no company has so far made known its intentions of applying for an OMX listing. However, a small number of companies have shown an interest in entering the market and are likely to be listed in coming months. There are indications of an increase in the number of OMX listed companies and that trend is likely to reduce the weight of financial undertakings on the stock exchange and provide investors with a wider range of options. Only one company, Tryggingamiðstöðin hf, has notified of a delisting before year-end, which brings the total of delisted companies to four during the year. The main reasons for delisting are mergers with other listed companies or that conditions on distributed ownership can no longer be met.

The market value of ICEX listed companies was ISK 2,596 billion at year-end 2006. By the end of September 2007 their value had increased by 22% to ISK 3,172 billion. The share of financial undertakings in the market value is around 67%. Increased market value of listed companies can partly be traced to the successful exodus of Icelandic businesses into overseas markets. Most of the companies of the OMX15 index have been involved in either buying or taking over businesses abroad.

Number:	2001	2002	2003	2004	2005	2006	30.09 2007
ICEX listed companies	71	64	48	34	26	27	29

Figure 16	Marked value of listed securities on the Icelandic Stock Exchange, ISK millions

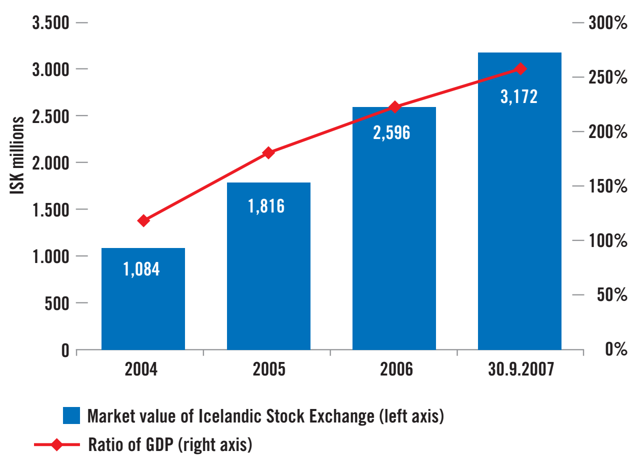


Figure 16. Market value of listed equity certificates.

The Bond Market

Yields on the bonds market were promising and the turnover increase for 2006 reached 72% compared with a decrease of 11.6% between 2004 and 2005. The last quarter of 2006 saw a record-breaking turnover in the bonds market, or ISK 679 billion, which is the biggest quarterly turnover since systematic measuring began. Overall trading in debt securities amounted to ISK 2,274 billion in 2006 compared with ISK 1,322 billion in 2005.

Total turnover in the bonds market for the first six months of 2007 was ISK 875 billion and compared with a turnover of ISK 1,076 billion during the same six-month period in 2006 this constitutes a 23% decrease. The greatest ever single-day bond and money market turnover of ISK 28.7 billion occurred on 19 September 2007. The total turnover of bonds and bills of trade reached ISK 270 billion in October 2006, which is the highest monthly turnover to be measured on the bonds market. Unlike equity certificates, there is a negligible increase between years in the turnover of bonds and for the first nine months of 2007 the turnover remains more or less unchanged at ISK 1,590 billion.

The market value of bonds and bills of trade has risen by 7% since the beginning of 2007 and stood at ISK 1,388 billion at the end of September.

Figure 17	Marked value of listed bonds on the Icelandic Stock Exchange, ISK millions

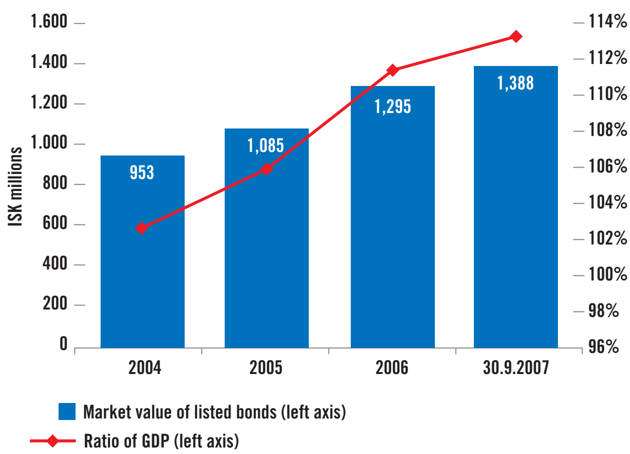


Figure 17. Market value of listed bonds.

2.4 The Pension Savings Market and UCITS

2.4.1 Pension Funds

Net assets of Icelandic pension funds at year-end 2006 amounted to ISK 1,498.8 billion, compared with ISK 1,219.5 billion at the same time in 2005. The increase between years is thus 22.9% which corresponds to an increase of 14.9% in real terms as measured by the consumer-price index. Pension fund assets as a proportion of GDP at year-end 2006 were 129% but were 120 % at year-end 2005. Figure 18 shows the developments of net pension fund assets as a ratio of GDP for the years 1997 to 2006.

Figure 18	Net Assets of Pension Funds

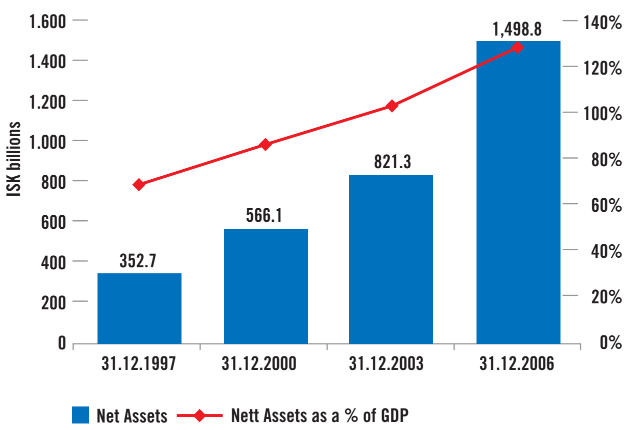


Figure 18. Developments in net pension fund assets.

Return on Investment

Net real return on Icelandic pension fund investments remained adequate in 2006, or 10.2%, compared with 13.2% in 2005, which was a record year for the funds. The net real return of a pension fund is the return on its assets adjusted to the consumer-price index after deducting cost form investment income.

The pension funds are long-term investors and therefore it is important to consider this factor when assessing their performance. As depicted in Figure 19, which shows the development of net real returns of Icelandic pension funds from 1991, the five-year and ten-year averages are clearly above the 3.5% returns imputed by actuarial surveys of the funds.

Figure 19 Net Real Return of Pension Funds

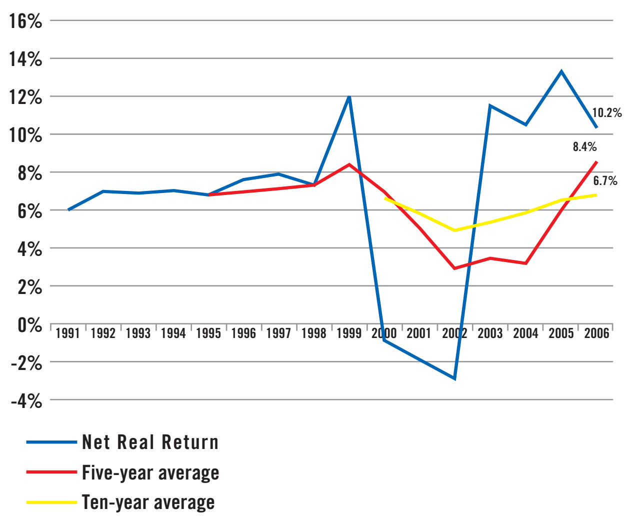


Figure 19. Net real return on pension fund investment.

All pension fund divisions showed a positive real return on investment in 2006, with the highest return of a mutual insurance division being 13.3% and the lowest 0.2%. The same figures for private pension schemes in 2006 were 14.1% and 0.9% respectively, but in that year the highest five-year average for mutual insurance funds was 11% and the lowest five-year average 3.5%.
The pension funds have been successful in achieving a positive return on their assets for the past four years. The return on investment is, however, relatively high when viewed in a historical context and that should be taken into consideration when it comes to the increment of pension rights. 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.

Financial Position

In 2006 the actuarial position of pension funds without employer guarantee kept improving for the second year running. At year-end 2006 a total of 35 such divisions were operated by 28 pension funds. As shown in Figure 20 the position in 25 divisions was positive by up to 23.9% as compared with 22 divisions at year-end 2005. A total of 10 divisions showed a deficit ranging from 0.1% to 10% and no division had a deficit higher than 10%. Pursuant to the Pension 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 exceeds 5% for five consecutive years.

Figure 20 Actuarial Position of Pension Funds not Guaranteed by Other Party

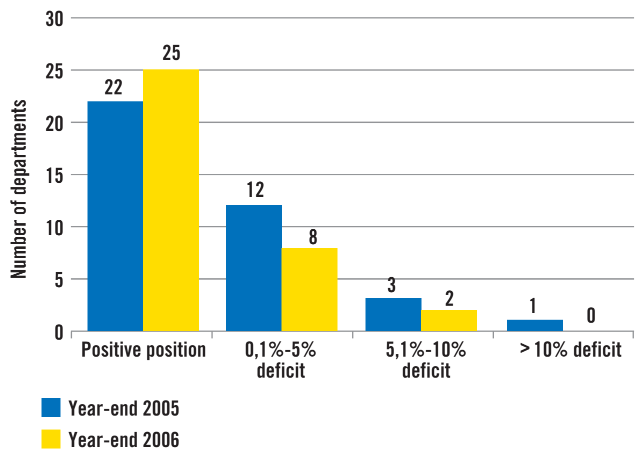


Figure 20. Actuarial position of non-guaranteed pension funds at year-end 2005 and 2006.

Investment

The ratio of variable-yield securities continued to grow at the expense of fixed-income securities in 2006. The ratio of variable-yield securities in mutual insurance divisions was 52% at year-end 2006 compared with 48% at the same time in 2005 as shown in Figure 21. In private pension schemes this ratio increased from 65% to 69% in 2006. The higher ratio of variable yield securities in the private pension schemes is a direct reflection of more risk-seeking investment strategies in this sector.

Figure 21 Pension Funds' Assets Composition at Year-end 2005 and 2006

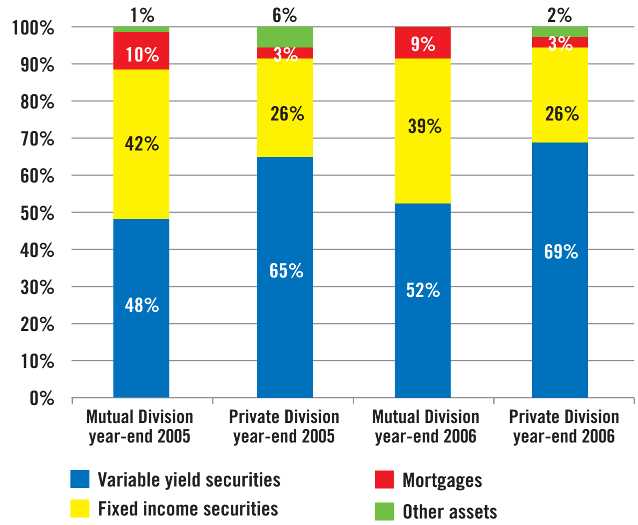


Figure 21. Asset composition of mutual insurance divisions and private pension schemes at year-end 2005 and 2006.

Equities and units and shares in other collective investment undertakings than UCITS, cf. Act 30/2003 on UCITS, as a ratio of net pension fund assets, was 40% at year end 2006 compared with 35% at year-end 2005, as shown in Figure 22. This ratio has been growing steadily since the entry into effect of the Pension Act. Pursuant to the Pension Act, pension funds may at present hold equity amounting to a maximum of 60% of net assets as opposed to 50% which was the permissible limit in 2006. There is thus considerable leeway for the pension funds to increase their investment in this type of securities.

The ratio of unit share certificates in UCITS operating in accordance with Act 30/2003 of the net assets of mutual insurance divisions was 28% at year-end 2006 as shown in Figure 22 and has also been growing in recent years. Pursuant to the Pension Act, a pension fund may not invest in more than 25% of all issued unit share certificates in a single UCITS. The classification of unit share certificates takes into account the underlying assets of the UCITS but there are no legal limits to maximum ownership as a ratio of net pension fund assets. Part of the equity certificates held by the pension funds are thus unit certificates in UCITS and shown as such in the following figure.

Figure 22 Unit Shares in Collective Investment Undertakings (Act. No. 30/2003) and Equities as a Ratio of Net Assets

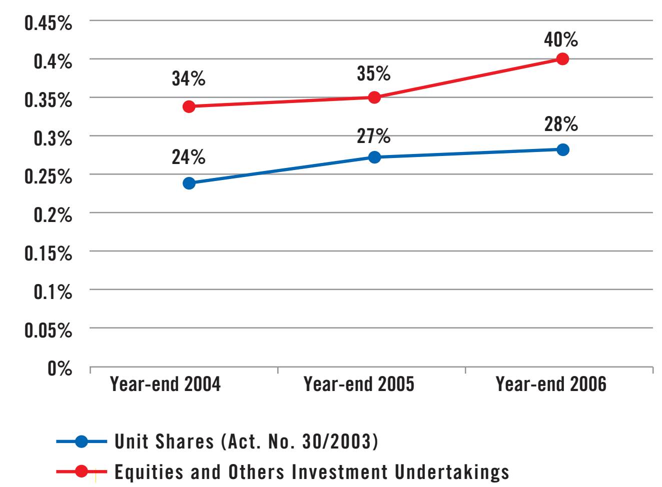


Figure 22. Unit certificates in UCITS (Act 30/2003) and equity certificates as a ratio of net pension fund assets at year-end 2004, 2005 and 2006. Equity certificates are included in ratios for unit certificates.

Assets denominated in foreign currencies as a ratio of net pension fund assets were 27% at year-end 2006 compared with 25% at year-end 2005. The ratio has been growing since the entry into effect of the Pension Act as shown in Figure 23, which depicts the development since 2000. The ratio of foreign currency assets is somewhat higher in private pension schemes than in mutual insurance divisions, or 29% at year-end 2006 as shown in the figure below. Assets denominated in a foreign currency may never, pursuant to the Pension Act, exceed 50% of net assets. The pension funds still have considerable leeway for investment in foreign securities.

Figure 23 Exchange-rate-linked Assets as Ratio of Net Assets

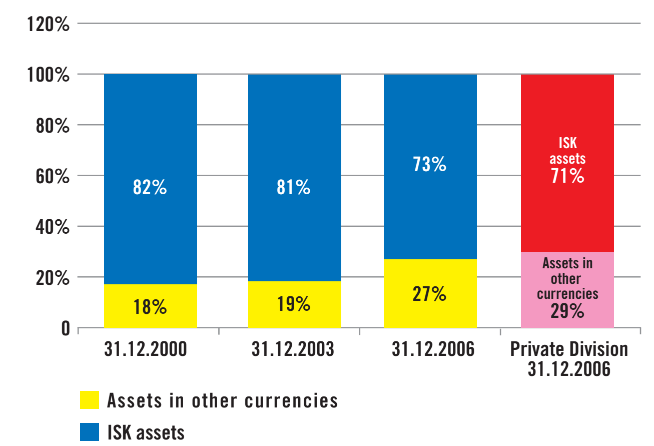


Figure 23. Assets denominated in a foreign currency as a ratio of net pension fund assets.

Pension Funds and Pension Rights

The number of pension funds kept decreasing during the period. As of 1 July 2007 there were 40 pension funds in operation, compared with 42 funds on the same date the year before. Of the 40 pension funds, 32 were still fully operational while 8 funds no longer received premiums. Since the entry into effect of the Pension Act, the number of pension funds has dropped by an average of 3 funds per year. At year-end 2006, the 10 largest pension funds held 80% of the aggregate net assets of all Icelandic pension funds.

The past two years have seen an increasing trend towards the mergers of large pension funds and further mergers, especially of smaller funds, are also to be expected. Pension fund mergers are generally a positive sign, since fewer and larger funds are more likely to achieve an improved rationalisation and lower operating cost, better risk distribution as regards both assets and liabilities and higher levels of know-how and professionalism. By the same token, the operations of large funds are inherently more complex and call for stricter internal control systems and risk management although the economies of scale pave the way for a stronger internal framework.

The assets of age-related pension schemes have been gradually increasing since the entry into effect of the Pension Act at the expense of unit based pension schemes. This trend accelerated dramatically in 2005 when six funds changed their benefits accumulation systems from unit pension schemes to age-related pension schemes. During 2006, five more funds followed suit by taking up age-related schemes instead of their previous unit systems. Figure 24 shows the development for the years 2004, 2005 and 2006.

Figure 24 | Types of Pension Rights Accumulation Schemes at Year-end 2004, 2005 and 2006

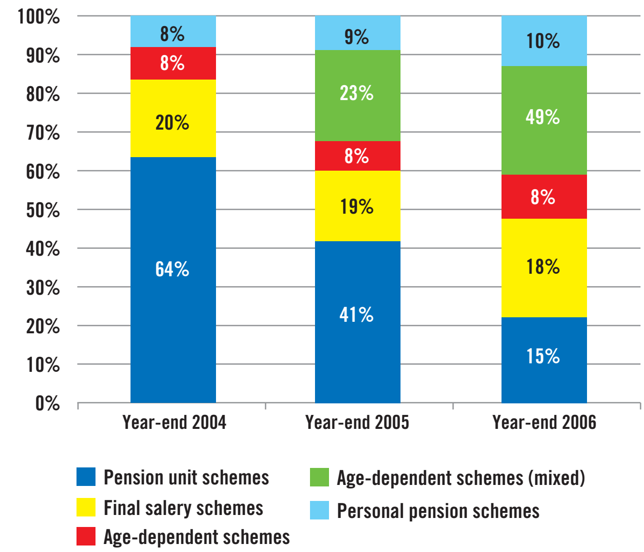


Figure 24. Pension fund rights accumulation schemes as a proportion of net assets.

Benefits earned by membership in the above-mentioned funds are, however, not purely age-related. A specific number of fund members may continue to pay a percentage of their pension fund premiums towards a unit pension scheme on the basis of premiums paid prior to the change. These are fund members who would suffer a considerable curtailment of rights if they were moved into the age-related system during the latter part of their working lives after having paid premiums into the unit pension scheme during their earlier years. The accumulation of all pension fund rights will though, with time, become purely age-related.

Supplementary Pension Cover and Private Pension Savings

Pension funds, banks, savings banks, securities undertakings and life insurance companies may accept contributions under a contract for supplementary insurance benefits over and above the statutory minimum pension cover pursuant to the Pension Act.

Accumulated supplementary pension savings with pension funds and other pension savings depositories amounted to ISK 197.5 billion at year-end 2006, compared with ISK 146.2 billion at year-end 2005, which constitutes an increase of 35% between these years. During the period 1999-2006 there was an average per-annum growth in supplementary pension savings of around 30% - ranging from 21% to a peak of 41%. Figure 25 shows the proportional division of private pension savings between depositories at year-end 2000 and 2006. As indicated in the figure, by far the largest share of private pension savings is in the custody of pension funds which were operating solely as personal pension savings schemes prior to the entry into effect of the Pension Act. This share, however, is gradually decreasing.

Figure 25 | Depositaries Relative Share of Private Pension Savings at Year-end 2000 and 2006

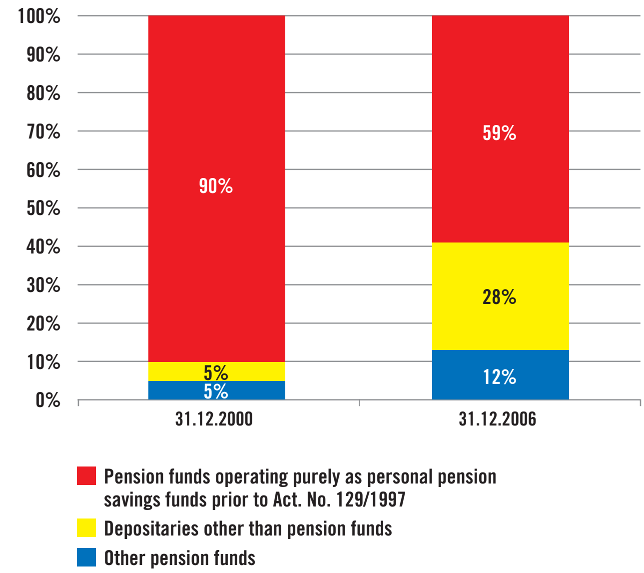


Figure 25. Proportional division of accumulated private pension savings between depositories.

Figure 26 shows the development of accumulated supplementary pension savings over the years 2004, 2005 and 2006 with depositories other than pension funds previously operating solely as personal pension savings schemes. Accumulated supplementary pension savings with other pension funds amounted to ISK 24.5 billion at year-end 2006 whereas such savings with depositories other than pension funds, i.e. banks, securities undertakings, savings banks and life insurance companies, totalled ISK 55.7 billion and was divided as shown in the figure.

Figure 26 | Private Pension Savings on Deposits with Parties other than Pension Funds Operating Purely as Personal Pension Savings Funds prior to Act. No. 129/1997

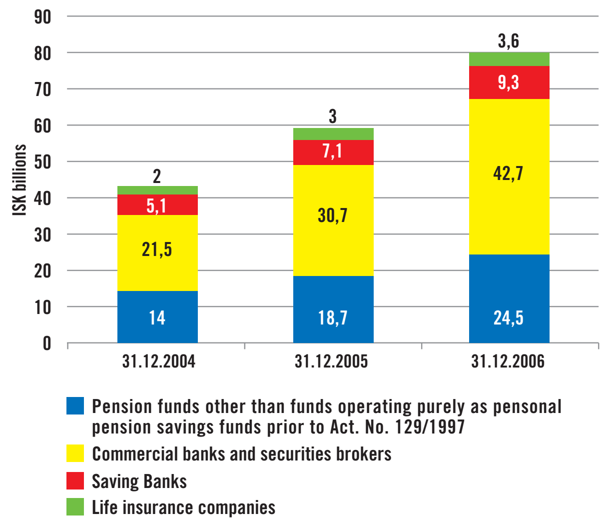


Figure 26. Accumulated supplementary pension savings (excluding pension funds operating purely as personal pension savings funds prior to the entry into effect of Act 129/1997).

Pension funds may, pursuant to the Pension Act, determine their statutory minimum insurance cover in such a way that a contribution (currently 12% of wages earned) be devoted in part to acquiring pension rights in individual pension accounts. Such individual pension savings can either be part of the minimum pension cover or a supplementary pension cover. This means that personal pension savings are not solely derived from direct contributions towards supplementary pension coverage although this applies to the largest proportion of such savings as shown in Figure 27 below.

Figure 27 **Types of Personal Pensions Savings at Year-end 2006**

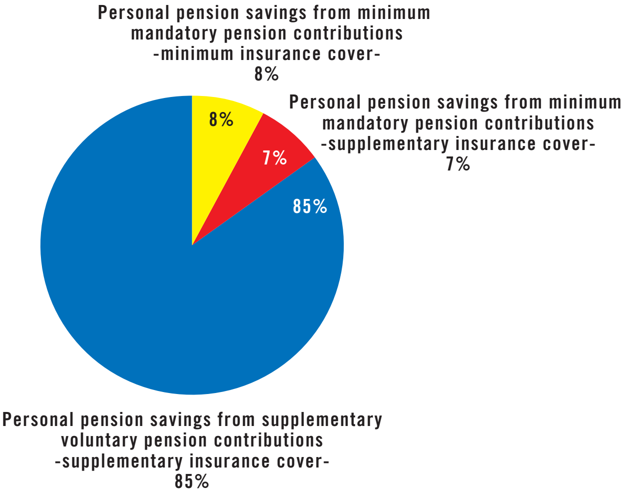


Figure 27. Types of personal pension savings at year-end 2006.

The figure shows that around 85% of accumulated personal pension savings, amounting to a total of 197.5 billion, derive from contributions towards supplementary pension coverage. Around 15% of such savings, however, derive from premiums paid for minimum pension insurance, which may be subdivided into 7% in personal pension accounts as part of supplementary pension insurance and around 8% in personal pension accounts as part of the minimum pension insurance.

Personal pension savings in the custody of the pension funds amounted to ISK 141.9 billion at year-end 2006 or 9.5% of net pension fund assets. This ratio has been increasing since the entry into effect of the Pension Act and was, for instance, 8.6% at year-end 2005.

Adding the total personal pension savings with depositories other than pension funds amounting to ISK 55.7 billion at year-end 2006 to the net assets of pension funds amounting to ISK 1,298.8 billion at the same point in time brings the overall assets of the entire pension system to ISK 1,554.5 billion, or 133.7% of GDP. For comparison, this amount stood at ISK 1,260 billion at year-end 2005, or 124.5% of GDP.

Investment Authorizations of Pension Funds

The Pension Act contains detailed provisions concerning the investment authorizations of pension funds. The pension funds must formulate their investment policies and invest their funds with regard to the most favourable terms available at each time considering risk as well as return on investments. The types of investments permissible to the funds are listed in the Pension Act and include all major classes of negotiable securities, deposits and derivatives for hedging. The Act also sets limits concerning individual types of investments, individual issuers of securities, foreign securities and unlisted securities, which are generally based on a proportion of the net assets of the pension funds.

The investment authorizations of the Pension Act require the funds to exercise caution in their investment decisions and to ensure that there is always a clear legal permission according to the law for the investments of the funds. The legislation was formulated with regard to the interests that the funds are expected to safeguard, i.e. mandatory pension savings for minimum maintenance upon retirement. It must be unequivocal that decisions on pension fund investment and investment authorizations are at all times made with the best interests of the fund members at heart.

Rapid developments and growth in the financial market have resulted in increased competition and a greater variety of investment opportunities for the pension funds. This has, for instance, called for interpretations by the FME as to whether investments which pension funds have already made or intend to make are in accordance with the authorizations contained in the Pension Act. An example of such findings is the interpretation published on the FME's website during the period that pension funds may not engage in securities lending, but OMX recently had plans to launch a formal market for such loans. The FME also stressed to the pension funds the limited authorizations permitted by law to engage in derivatives trading which has become a popular investment option of late.

A comprehensive legislation needs to be allowed to develop naturally in the light of experience gained and changed circumstances. From the entry into effect of the Pension Act, the investment authorizations of pension funds have been extended three times through amendments to the law. The last instance of this was in 2006 when the limits for investment in equity was raised from 50% to 60% of net assets and the maximum loan-to-value ratio of mortgage bonds was increased from 65% to 75%. Further changes to the legislation are only to be expected. Recent public discussions have, for example, called for even greater extensions of the investment authorizations of pension funds. Certain provisions also need to be clarified in more detail, such as provisions on derivatives trading, which can be risky and should not be left for individual evaluation.

Extended investment authorizations demand increased responsibility. This means stricter requirements on sound internal organisation, primarily as regards internal control and risk management as well as professionalism and general know-how. The creation of larger and more powerful pension funds through mergers and rapid asset growth will enable more funds to meet such requirements in the future.

2.4.2 UCITS

At the end of October 2007 there were a total of seven management companies of undertakings for collective investment in transferable securities being supervised by the FME, including four which had been granted licences to engage in asset management.

Consistent with recent developments there was an increase in the number of UCITS operating during the period. At the end of June 2007 there were 25 UCITS compared with 15 at the same time in 2006 and 10 in 2005. There was also a similar increase in the number of investment funds and by the end of June 2007 a total of 37 investment funds had been validated by the FME, compared with 24 at the same time in 2006 and 13 in 2005 as shown in the following table.

Number:	30.6.2005	30.6.2006	30.6.2007
UCITS	10	15	25
There of divisionalized	4	4	4
Divisions	28	25	16
Investment Funds	13	24	37
There of divisionalized	3	4	5
Divisions	5	17	20

Judging by the number of recent validation applications for new funds, the increase appears to have slowed down. Looking further ahead, however, it is likely that growing numbers of financial undertakings will go hand in hand with a growing number of management companies of UCITS which, in turn, will result in an overall increase in the number of Icelandic UCITS and investment funds.

Between 1 July 2006 and 30 June 2007 the FME processed a total of 14 applications submitted by validated UCITS and divisions for official certification of their status as UCITS on account of the marketing of these funds in other states within the European Economic Area. This is particularly noteworthy as no such applications have been processed before and may be interpreted as an indication of increased marketing of Icelandic UCITS abroad on the basis of common European rules on the marketing of UCITS. For comparison, the FME has received over 30 notifications from foreign UCITS with around 240 sub-funds declaring their intentions to market their funds in Iceland. A list of foreign UCITS can be downloaded from the FME's website.

The assets of UCITS and investment funds, cf. Act 30/2003 governing the operations of such funds, amounted to ISK 452 billion at year-end 2006, compared with ISK 363 billion at year-end 2005. The assets of UCITS totalled ISK 170 billion and the assets of investment funds came to ISK 282 billion at year-end 2006. Figure 28 shows the development of the assets of UCITS and investments funds from 2002 to 2006. During the last three years, the assets of the funds have increased by 130%.

Figure 28 Assets of Undertakings for Collective Investment (UCITS) and Investment Funds

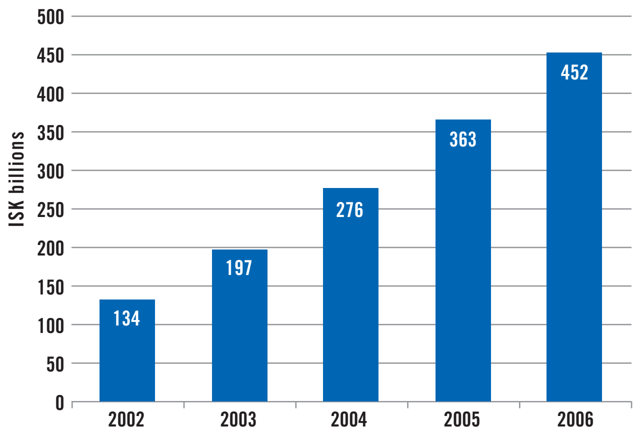


Figure 28. Developments in the assets of UCITS and pension funds.

The largest proportion of the assets of UCITS and investment funds is made up of fixed-income securities, or 78% in the case of UCITS and 71% in the case of investment funds. Other assets are mainly equity certificates, unit share certificates and bank balances.

2.5 The Insurance Market

2.5.1 Performance of Insurance Companies in 2006

Total profits of the five domestic non-life insurance companies amounted to just over ISK 17.3 billion in 2006 compared with 19 billion in 2005. Around 87% of the insurance companies profits derives from their financial activities and the decrease in profit between years can largely be explained by lower price rises in the securities market in 2006 compared to previous years. Profits from the insurance portfolio have, on the other hand, improved since 2005 as a result of higher insurance premiums. The performance of the four domestic life insurance companies has improved considerably between years. Total profits for 2006 were ISK 1.5 billion, compared with a profit of ISK 900 million in the previous year. Around 86% of the profits derive from life insurance activities, which have shown a steady upward trend between years. This is partly due to an increase in premiums for sickness insurance. The life insurance companies are all owned by non-life insurance companies or other undertakings in the financial market.

Increased Profits from Non-life and Life Insurance Activities[1]

The non-life insurance companies raised their premiums considerably in 2006 which resulted in profits for the year in this sector, as shown in Figure 29. Financial activities have been an important source of income for the insurance companies in recent years as their non-life insurance activities have tended to yield negligible profits or even losses. As already stated, profit from financial activities decreased by over 35% between 2005 and 2006. From this it may easily be deducted that increased equity ownership by insurance companies is likely to create fluctuations in their performance. This requires that the insurance companies maintain an active and efficient risk asset and liability management.

Profits from life insurance activities in 2006 amounted to ISK 1.2 billion, which constitutes an increase of 386%, largely as a result of higher premiums for sickness insurance.

Figure 29 Profits on Insurance Companies´ Main Areas of Activity, 2006 price levels

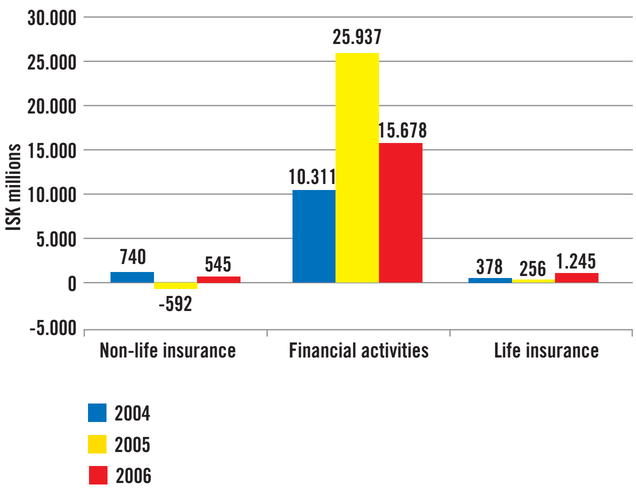


Figure 29. Profit from major insurance activities adjusted to 2006 prices.

The proportion of consolidated companies in the total assets of insurance companies increased from 8% in 2005 to 26% in 2006 as shown in Figure 30. Among the reasons for this is the acquisition by Tryggingamiðstöðin hf of the Norwegian insurance company Nemi Forsikring ASA and the overall trend for insurance companies to establish specific companies around their investments. Equity related securities still remain a sizeable proportion of insurance company assets, or around 36% in 2006. This item has, however, reduced somewhat between years because of lower price rises in the securities market and as mentioned earlier the fact that subsidiaries are in an increased way managing the equity based assets.

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

Figure 30 Share of various Asset items in Insurance Companies' Assets 2004-2006

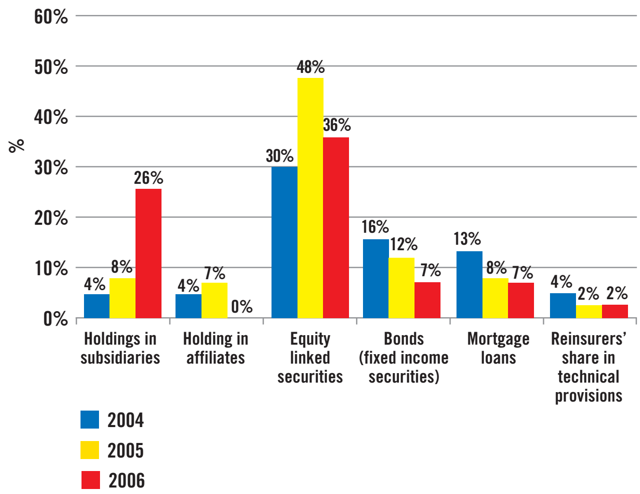


Figure 30. Percentages for some asset items of insurance companies 2004-2006

Decreasing Rates of Return on Financial Activity

Owing to the fact that non-life insurance companies tend to own more equities than life insurance companies, they have been showing more profit from financial activities in recent years. The securities market, however, appeared to be slowing down in 2006 and this is reflected in decreasing profits from financial activities as a ratio of equity, cf. Figure 31. In the case of the non-life insurance companies, the ratio decreased from 47% in 2005 to 27% in 2006. As for the life insurance companies, the ratio has decreased even further, or down to just over 9% in 2006. This, as well as the fact that life insurance activities showed a relatively higher profit in 2006, indicates that life insurance companies are not as reliant upon the outcome of their financial activities as are the non-life insurance companies.

Figure 31 Profits from Financial activities as a Ratio of Equity 2004-2006

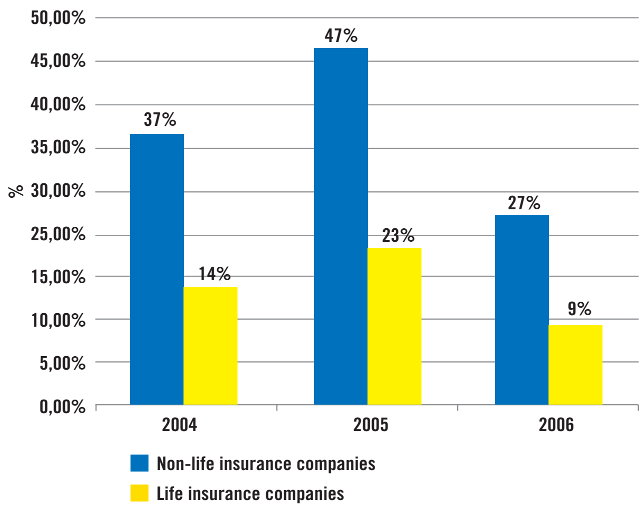


Figure 31. Profits from financial activities as a proportion of equity 2004-2006.

Improving Performance of Non-life Insurance

The major classes of non-life insurance were operated at a profit in 2006 with the exception of accident and sickness insurance. Figure 32 shows the development of premiums and performance for individual classes over the past three years. Motor vehicle insurance premiums were raised, which results in a better performance for that class. It is worth pointing out that property insurance showed good results at the end of the year although the premiums remained more or less the same.

Figure 32 Premiums and Profit / Loss in main non-life Insurance classes 2004-2006, 2006 price levels

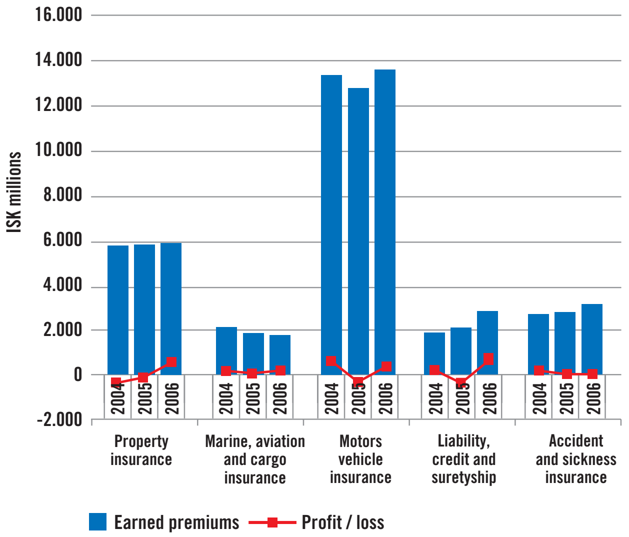


Figure 32. Premiums and performance of major non-life insurance classes 2004-2006 adjusted to 2006 prices.

By far the biggest increase in premiums occurred in liability insurance, credit insurance and suretyship insurance. The extent of marine, aviation and cargo insurance has, on the other hand, been growing less important in recent years.

Motor vehicle insurance may be subdivided into mandatory and optional insurance. Figure 33 shows the development of premiums, claims and performance in these two subclasses. Mandatory motor vehicle insurance has not been operated at a loss in recent years, nor has there been an increase in claims. In the optional insurance class the situation is quite the reverse. Claims have been rising steadily and performance has grown poorer. As a result of this trend, the insurance companies have focused on raising the premiums for optional motor vehicle insurance.

Figure 33 Premiums, claims and Profits / Loss in Compulsory and Other Motor Insurance 2004-2006, 2006 price levels

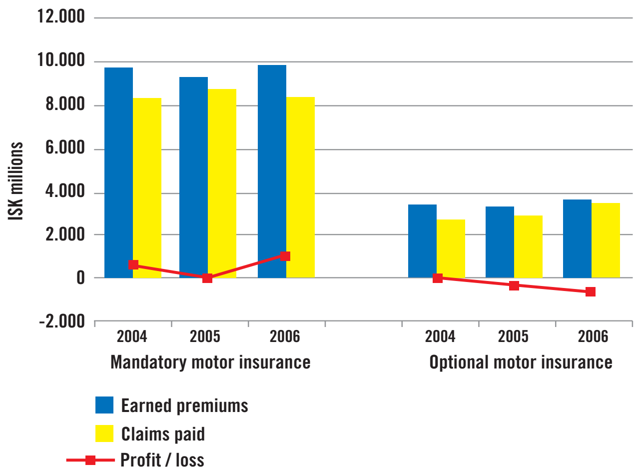


Figure 33. Premiums, claims and profit/loss in mandatory vs. optional motor vehicle insurance 2004-2006 adjusted to 2006 prices.

The overall market share of the three largest insurance companies (Sjóvá-Almennar tryggingar hf, Tryggingamiðstöðin hf and Vátryggingafélag Íslands hf) in motor vehicle insurance has been decreasing in recent years, as shown in Figure 34. Last year the market share was just under 91%.

Figure 34 Market share of Three Largest Insurance Companies in Motors vehicle Insurance 2004-2006

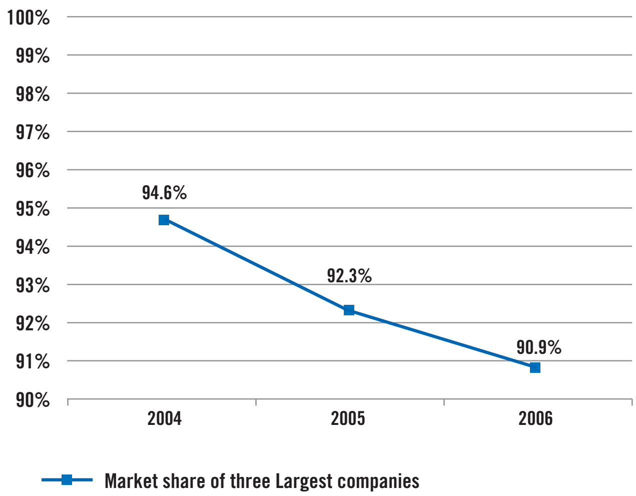


Figure 34. Market share in motor vehicle insurance of the 3 largest insurance companies 2004-2006.

Growth in Mortality Risk Insurance and Health Insurance while Unit Link Insurance Reduces

Icelandic insurance companies began offering unit-link life insurance in 1998 whereby the insured bears the investment risk. This class of insurance became popular and premiums rose to a peak in 2002. This class has, however, been on the wane as have premiums, cf. Figure 35 which shows the division of the written premiums of life insurance companies broken down by insurance classes.

Figure 35 Breakdown of Written Premiums According to life Insurance Class 2004-2006

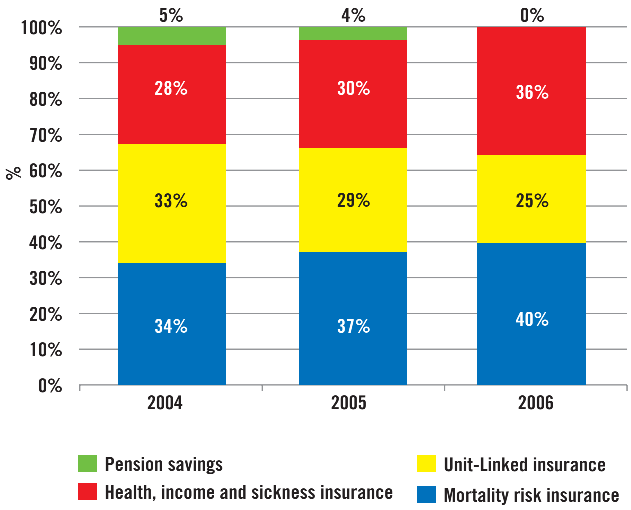


Figure 35. Division of written premiums between life insurance classes 2004-2006.

The life insurance companies have been increasing their activities in mortality risk life insurance and health insurance as can also be seen in Figure 35. Activities concerning supplementary pension savings are no longer measurable.

These figures indicate that the life insurance companies are directing their marketing efforts away from savings and towards focusing on high risk insurance for health and life. The companies are also likely to start specializing in these areas within the next few years.

Increased Activities Abroad

Figure 36 shows the development over the past three years in the premiums and claims of insurance companies licensed to operate in Iceland in other EEA member states. Premiums are received on the basis of cross border services. The largest single contributor in this sector is the European Risk Insurance Company (ERIC) which is solely engaged in liability insurance in the UK.

Figure 36 Icelandic Insurance Companies' Operations in others EEA member states 2004-2006, 2006 price levels

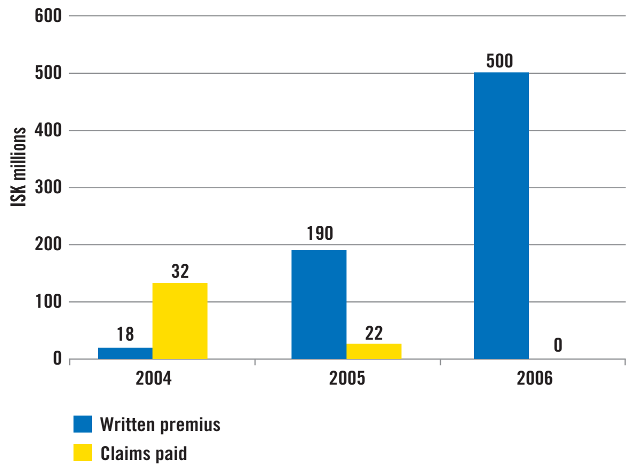


Figure 36. Operations of Icelandic insurance companies in direct insurance in other EEA member states 2004-2006 adjusted to 2006 prices.

As well as doing cross border services, Icelandic insurance companies are increasingly forging closer links with insurance companies abroad. Tryggingamiðstöðin hf has a subsidiary in Norway, Nemi Forsikring ASA, which specializes in business and commercial insurance. This year, Milestone ehf, the owner of Sjóvá-Almennar tryggingar hf, purchased the Swedish financial conglomerate Invik & Co AB - the owner of the insurance group Moderna Försäkringar, which operates both life and non-life insurance companies. During this year, Exista hf, the owner of Vátryggingafélag Íslands hf and Líftryggingafélag Íslands hf, sold its majority holding in the British insurance company IGI Group Ltd. On the other hand, Exista purchased a 20% holding in the Finnish insurance company Sampo.

Assets to Meet Technical Provisions

The largest single assets of insurance companies for meeting technical provisions were securities listed on a regulated market. These amounted to 36% in 2006 as shown in Figure 37. Second in size are deposits with credit institutions amounting to 22%, and then government bonds on the one hand and property, land and building plots on the other, amounting to 17%. According to the Regulation on assets to meet technical provisions no. 646/1995, there are certain limits on the amounts from each asset class which may be used by the insurance companies for this purpose. As shown in the figure, the insurance companies have almost exhausted their authorizations in the asset class of securities listed on a regulated market and unlisted equities. This shows that Icelandic insurance companies are somewhat high risk appetite and tend to invest rather heavily in equities.

With regard to the above mentioned, it should also be pointed out that a number of Icelandic insurance companies took part at mid-year 2007 in a quantitative impact study (QIS3) to assess the potential effects of the Solvency II Directive currently under preparation by the EU, which aims at basing solvency requirements on all the risk factors inherent in the operations of an insurance company. This study included the element of market risk anticipating a solvency requirement (capital requirement) corresponding to 32% of equity, which will probably be burdensome for the Icelandic companies. In the asset class of unsecured loans/claims, the insurance companies appear to have exceeded the limits, but the reason for this is the fact that individual insurance companies are operating on the basis of an exemption granted in accordance with Article 13 of the above-mentioned Regulation.

Figure 37 Ratios of Asset classes covering Technical Provisons 2005-2006

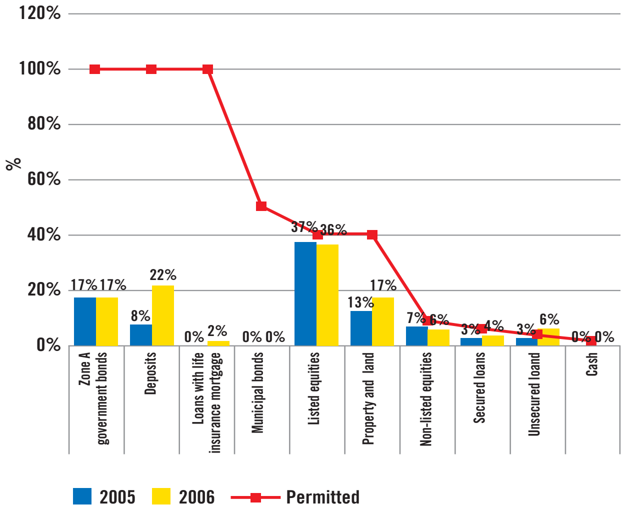


Figure 37. Ratios for assets to meet technical provisions 2005-2006.

As shown in Figure 38, 99% of the technical provisions are in ISK and 1% in GBP. The assets of insurance companies are, however, distributed between more currencies than the technical provisions. The assets are mostly in ISK, or 86%, then 5% in EUR, 4% in GBP, 3% in USD and 2% in NOK. The reason for this is that the Icelandic insurance companies have been expanding their operations overseas by purchasing foreign companies, which inevitably creates assets in currencies other than ISK. It is important that the insurance companies take measures in order to protect themselves against increased foreign exchange risk. Similarly, the companies should pay heed to the fact that they may not invest more than 20% of their technical provisions in a specific currency in assets denominated in another currency, cf. Article 10 of the above Regulation. This provision might pose a future problem for the insurance companies as it is also stricter than similar provisions applying, for instance, to pension funds.

Figure 38 Breakdown of Technical provisions 2006 and Assets Covering it by Currencies

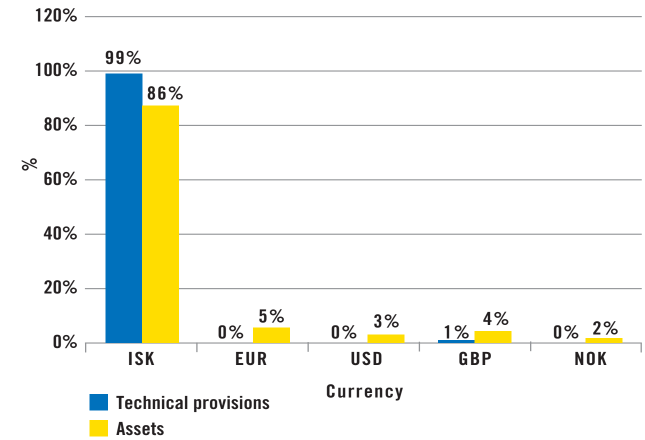


Figure 38. Division of technical provisions and assets to meet technical provisions 2006 by currencies.

2.5.2 Insurance Mediation

The number of Icelandic entities licensed in the area of insurance mediation decreased by one between years, bringing them to a total of six. Of the six licensees, one insurance intermediary does not mediate new insurance but makes use of the licence in order to manage an existing insurance portfolio.

A number of foreign insurance intermediaries and insurance agents with headquarters in other EEA member states are licensed to operate in Iceland. Icelandic insurance intermediaries and insurance agents have as yet not applied for authorization to offer their services abroad within the European Economic Area. Commissions for insurance mediation increased from just under ISK 285 million in 2005 to slightly over ISK 400 million in 2006. The performance of insurance intermediaries has generally improved between years and profits have tripled from ISK 33 million in 2005 to ISK 103 million in 2006.

Mynd: NordicPhotos

3 ICELANDIC IFNANCIAL MARKET IN AN INTERNATIONAL ENVIRONMENT

3.1 Globalization of the Financial System

One of the characteristics of the Icelandic financial market is that the majority of the Icelandic financial undertakings' income and assets comes from abroad. However, the operations of foreign parties in Iceland are almost nonexistent. 54% of the financial undertakings' income comes from foreign operations, 60% of loans are to foreign customers, assets of foreign subsidiaries are 45% of total assets and half of their employees operate in foreign branches. Icelandic financial undertakings now operate in 56 operating units in 21 countries. These numbers will certainly grow.

Internationalization is not only limited to the commercial banks. Insurance companies have acquired shares in foreign insurance companies or begun close collaboration with foreign insurers. The Iceland Stock Exchange and the Icelandic Securities Depository are subsidiaries of OMX A.B. Icelandic investors have also bought qualifying holdings in foreign insurance companies.

This development has been swift; for example in the year 2004, the commercial banks' foreign income amounted to 29% of their operating income. The momentum has increased, and in the last few months the expansion has increasingly been in the establishment of branches.

Internationalization has certain advantages, such as distribution of risk, wider source of income and presumably a stronger balance sheet. There are certain risks as well, such as financing of growth, less oversight and integrated support systems that grow at the same pace as the consolidation. Reputational risk also increases as undertakings grow and expand in more markets.

The consequences of this development have been significant for the FME, since the operations of Icelandic undertakings abroad are contingent on their Icelandic operating licenses and the trust foreign supervisory authorities have in these licenses. In the case of branches, the FME has direct supervisory responsibility but FME is responsible for consolidated supervision in the case of subsidiaries. Communication between the "home" and "host" supervisory authorities are necessary (and often required) as operations of the undertakings grow. Additionally, operations outside of the EEA call for the establishment and maintenance of MoU's with foreign supervisory authorities.

Thus the FME's operations have in a short time become international, which places new demands on organization, work procedures, and staff. It is clear that monitoring operations abroad and communications with foreign parties will clearly demand an increase of FME staff time commensurate with the growth of the Icelandic financial market. It is important that the FME succeeds during this period since the integrity of Icelandic undertakings and the Icelandic financial market is in part evaluated by the FME's strength and quality and its performance in foreign collaboration.

3.2 Foreign Expansion of Activities of Financial Undertakings and Insurance Companies

Foreign Expansion of Activities of Financial Undertakings
The expansion of Icelandic undertakings within the EEA is based on operating licenses issued in Iceland by the FME. European supervisory authorities therefore trust the efficiency and independence of the Icelandic supervisory authority. In cases of expansion to countries outside of the EEA, undertakings must usually apply for a special license with the supervisory authority of the appropriate state. At the beginning of October 2007 Icelandic financial undertakings had 56 operational units in 21 countries.

The table below demonstrates that the expansion has been very rapid and can be expected to increase even more before end-of-year 2007, as well as in 2008. What characterizes this development is the growing number of branches, which places a direct supervisory responsibility on the FME.

Number and Types of Branches

	Year-end 2005	October 4, 2007
Subsidiaries	21	31
Branches	4	21
Representative agencies	1	4
Number of operating units	26	56
Numbers of states where activities are pursued	12	21

Foreign operating units of Icelandic financial undertakings				
	Subsidiaries	Branches	Representatives	Subsidiaries or branches of subsidiaries
UK	X	X		
Ireland	X			
Norway	X	X		X
Sweden	X	X		
Denmark	X	X		
Finland	X	X		
Faroe Islands		X	X	
France	X			
Switzerland				X
Luxemburg	X			
Belgium				X
Netherlands	X	X		X
Germany		X		X
Spain				X
Italy				X
Malta				X
Czechoslovakia	X			
Slovakia				X
Lithuania		X		
Russia				X
U.S.A.	X			X
Canada		X	X	
Singapore				X
China			X	
Isle of Man	X			
Guernsey	X			
Dubai		X		
Qatar		X		

The Dutch bank, NIBC and its subsidiaries are included in the table, but the FME had not approved Kaupthing's acquisition of the bank as of date of the publication of the report.

Foreign Activities of Insurance Companies

The FME monitors the expansion of domestic insurance companies and holding companies in foreign markets. Continuing expansion of Icelandic parties in the insurance market is to be expected

Certain domestic insurance companies offer their services abroad in EEA markets, and that growth is expected to continue. As in the credit division, this will result in new emphases on supervision of these insurance companies. The FME monitors this activity as home supervisor based on EEA regulations. It is important that parties prepare insurance contracts carefully and consider all appropriate regulations, including selection of acts on insurance contracts.

One domestic insurance company owns a foreign insurance company in Norway as a subsidiary. Because of this the FME and the Norwegian Financial Supervisory Authority cooperate closely in the supervision of these insurance companies. The FME has the position of so-called “lead supervisor” in the authorities’ cooperation. As such the FME has an increased responsibility for the insurance companies and the companies as a whole, including the necessary oversight of their operations.

Acquisition of Icelandic companies in financial services of foreign undertakings from 01.07.2007 to 01.10.2007

Icelandic company	Foreign Company	Countries	Balance sheet in appr. currency (millions) 31.12. 2006	Type of activity
Tryggingamiðstöðin hf.	Nemi forsikring ASA	Norway	1.186 m.NOK	Insurance company
Milestone hf.	Invik & Co AB	Sweden (headquarters), Luxemburg, Netherlands, Norway	14.489 m.SEK	Financial corporation, main activity insurance (Moderna Försäkringar) and banking in Luxemburg (Banque Invik)
Exista hf.	Sampo Group Oyj (19,98%)	Finland (headquarters), Sweden, Estonia, Latvia, Lithuania	47.260 m. EUR	Insurance corporation
Straumur-Burðarás Fjárfestingabanki hf.	eQ	Finland	627 m.EUR	Investment banking
Straumur-Burðarás Fjárfestingabanki hf.	Wood and Company (50%)	Czechoslovakia Slovenia Malta Switzerland Luxemburg	51,2 m.EUR	Investment banking
Glitnir banki hf.	FIM Group Oy (Glitnir Corporation)	Finland Sweden Russia	142,4 m.EUR	Investment banking
Glitnir banki hf.	Leimdörfer AB (90%)	Sweden Finland Norway	81,3 m.SEK	Real estate
Glitnir banki hf.	BSA AS	Norway	32,9 m.NOK	Real estate
Landsbanki Íslands hf.	Bridgewell (Landsbanki Securities Ltd)	Britain	48,9 m.GBP	Securities company
Landsbanki Íslands hf.	Cheshire Guernsey Limited	Guernsey	124,6 m.GBP	Commercial banking
Kaupþing banki hf.	NIBC	Netherlands U.S.A. Britain Belgium Germany Singapore	32.636 m.EUR	Commercial banking

3.3 Activities of Foreign Parties in Iceland

The following summary shows the number of parties that at the end of October 2007 are authorized to provide services in Iceland based on EEA regulations:

Foreign banks with an operating unit, i.e. branch	1*)
Foreign banks without an operating unit	147
Securities Funds (UCITS)	30
Insurance companies with an operating unit	2*)
Insurance companies without an operating unit	316
Insurance brokers and insurance representatives	3.712

*) *One foreign financial undertaking operates a branch in Iceland, the Swedish bank Forex Bank AB. The German insurance companies Allianz Lebensversicherungs AG and Allianz Versicherungs AG also operate a branch in Iceland.*

3.4 Supervisory Activities in an International Environment

The growing globalization of Icelandic financial undertakings, as well as the increased cooperation between European supervisory authorities, has called for a considerable increase in foreign communications by the FME.

Demand from various foreign parties, such as international organizations, credit rating agencies and research analysts. for information about the Icelandic financial market grows continually. The FME's goal is to respond to this demand by increased information dissemination in English.

During the former half of 2007, the FME set a special strategy regarding the supervision of the overseas operations of Icelandic financial undertakings and performed a workload analysis in connection with this part of the supervisory activity. The key points of this strategy are as follows:

- Supervision of branches: On-site inspections at larger branches every two years. Smaller branches as needed but never less than every four years.
- Supervision of subsidiaries: Participation in on-site inspections of host authorities if subsidiaries constitute at least 10% of the consolidated total assets. Such subsidiaries will also be visited every two years to get a good oversight of activities.
- Information provisions: Annual reports in cases of branches and subsidiaries on the FME's (electronic) form, as well as balance sheets and P & L accounts of all branches and subsidiaries constituting at least 10% of the consolidated total assets.
- Communication with foreign supervisory authorities: General review on a regular basis where activities of Icelandic companies are extensive.
- Memorandum of Understanding (MoU): Follow "expansion" to states outside of the EEA with MoU's.
- Expenses: Collect a special fee pursuant to Article 7 of Act 99/1999 on the Payment of Costs for Public Supervision of Financial Activities.

Collaboration with other Supervisory Authorities

The FME has considerable communications and collaborations with foreign other supervisory authorities where Icelandic undertakings operate. Such interactions take place, among other things, during the acquisition of Icelandic financial undertakings of foreign financial undertakings, the establishment of branches abroad as well as in connection with ongoing supervision of financial undertakings on a consolidated basis, such as financial supervision, CEO and owner eligibility assessments, etc.

The FME communicates on a regular basis with its sister supervisory authorities in the Nordic countries. The authority directors meet annually to discuss various issues pertaining to the development of financial activities in the Nordic countries and integration of supervision where appropriate. Expert groups with representatives from the countries also meet to discuss various technical issues regarding supervision and adoption of EU directives.

Memorandum of Understanding (MoU)

The FME has during the period increased interactions with supervisory authorities outside of the EEA in connection with the activities of Icelandic financial undertakings in those countries. A special component of these communications is the establishment of MoUs with foreign supervisory authorities, which is necessary in cases of states outside of the EEA. During the period the FME signed MoUs with the following parties:

- Isle of Man Financial Supervisory Commission
- China Banking Regulatory Commission
- Dubai Financial Services Authority

The FME is also in the process of preparing MoUs with supervisory authorities in Canada, U.S.A., Qatar, Guernsey, Hong Kong, and the Faroe Islands.

European Joint Committees and International Cooperation

The FME participates in joint committees of European financial supervisory authorities. These committees are CEBS, CEIOPS, and CESR. The committees are a part of the EU's so-called Lamfalussy process whose purpose is to increase homogeneity and uniformity in the securities markets, improve the competitiveness of financial undertakings and finance markets, and support increased economic growth and employment. The process is divided into four levels, and the aforementioned committees pertain to Level 3 of the process. The committees' main role is to support the uniformity of supervision within the union and thus support the efficiency of the inner market and to consult with management regarding the formulation of uniform legislation in the financial markets. The following figure describes the Lamfalussy process and the role of parties at each stage in the process.

Level 1

Directives and regulations to establish core values adopted by the European Parliament.

Level 2

The European Commission (sector-specific committees) adopts directives or regulations providing further technical details to the legislation in LEVEL 1. Binding to EEA law. Emphasis on speeding up the process.

Level 3

National regulators committed to collaborate on the implementation and interpretation of new regulations. Special committees established for this purpose and also to provide advice to the Commission concerning legislation at LEVEL 2.

Level 4

Harmonisation and compliance with new rules and laws. The FME actively participates in the work of the aforementioned committees. Such participation is necessary to ensure that the adoption of regulations and implementation of supervision is commensurable with the European Economic Area.

The FME participates in the work of three expert committees within CEBS (Committee of European Banking Supervisors). They are expert committee on integration of supervision implementation (Group de Contact), expert committee on WACC (Expert Group on Capital Requirement), and expert committee on financial information (Expert Group on Financial Information). The work of these committees has in the past year mainly been concerned with the uniform adoption of the Basel II equity regulations.

The FME is partner to and participates in the work of CESR (Committee of European Securities Regulators). CESR plays an important role in the interpretation and uniformity of rules pertaining to the securities division, and the FME emphasizes participation in expert committees in that area.

The FME has during the period participated in coordination efforts due to the MiFID directive, the prospectus directive, the takeover directive, and the transparency directive. The FME has also continued participating in the CESR Review Panel, CESR-Tech, and CESR-Pol. The FME has also appointed a representative to CESR-Pol's subcommittee, Surveillance & Intelligence Group.

Task force on Money Laundering and Terrorist Financing

Iceland is a member of FATF (Financial Action Task Force on Money Laundering), which is an international task force working against money laundering and terrorist financing. FATF carried out an assessment in Iceland in 2006 and this will be followed up in 2008 with a review of corrective actions. The FME regularly attends FATF meetings, which are held three times a year.

3.5 Complicated Risk Management – Increased Levels of Complexity

The Icelandic financial market has undergone revolutionary changes in a short period of time. The geographical growth of the financial undertakings has resulted in an broader income base while, at the same time, operational and risk distribution has significantly increased. This growth is accompanied by numerous challenges pertaining to the integration of operational units and information systems and minimization of integration risk which follows increased growth. The expansion also entails increased levels of complexity, which are a part of more extensive and diffuse operations and an increased supply of the undertakings' complex financial products. The financial undertakings' operations in various countries also result in increased requirements for good management control systems and risk management on a consolidated basis and overview of collaterals and large exposures.

In light of the growing foreign activities of financial undertakings, the FME has emphasized on monitoring the development of risk management. The adoption of new equity rules, Basel II, has led to increased demands for risk management of financial undertakings. Considereing this, it will also be necessary to strengthen the internal auditing divisions' activities of financial undertakings.

The internationalization of Icelandic financial undertakings has made them more resistant to fluctuations in the Icelandic economy but has also made them more sensitive to volatility in international markets. They are also now being observed by foreign financial supervisory authorities, credit analysts, and credit rating companies.

3.6 Reputational Risk

Reputational risk is the risk of a significantly negative attitude toward a party involved in a financial activity, related to something the party either did or did not do. It does not matter whether the attitude is legitimate or not, as long as it affects the general trust and goodwill of the financial undertaking.

In 2006 Icelandic financial undertakings realized that their expansion in foreign markets was attracting the interest and attention of foreign parties, which increasingly became interested in the Icelandic economy and financial system. Suddenly the discussion turned against the Icelandic financial undertakings and, in fact, to a great extent against the Icelandic financial and economic system. The Icelandic financial system was considered to be characterized by concentrated ownership and lack of transparency; additionally, cross-ownership in the Icelandic business environment was criticized.

The financial undertakings, the FME, and other government agencies reacted to this criticism and increased transparency by more proactive information dissemination, and cross-ownership was reduced. The FME held about 60 meetings in 2006 with foreign credit rating agencies, analytical parties and media, and the interest seems no less in 2007.

Reputational Risk of Icelandic Financial Undertakings

The globalization of Icelandic financial undertakings has resulted in the increased interest of foreign supervisory parties, analysts, business media, and credit rating agencies. This places additional transparency and information demands on financial undertakings.

One way to increase transparency in the financial market is increasing uniformity in the regulatory process and implementation of supervision. The EU has in the past few years emphasized increased uniformity in these areas. Such conformity increases homogeneity in the regulatory environment and contributes to increased safety in the European financial market. It is the role of joint committees of European financial supervisory authorities to shape and coordinate regulatory processes in the European financial market. Examples of such regulatory processes are the Basel II standard on equity and risk basis of financial undertakings, Solvency II regulations in the insurance market, and the MiFID directive in the securities market.

Because of the small size of the Icelandic economic system, it is to be assumed that ownership is more concentrated and business relations greater than in larger countries. A certain risk pertaining to the reputational risk of Icelandic financial undertakings is inherent in this situation. To minimize the effects of the reputational risk of concentrated ownership, the Icelandic undertakings must be in the forefront when it comes to good corporate governance, detailed and efficient information dissemination and effective monitoring and follow-up of internal rules.

The Authority and Role of the FME

In the last two years the FME has greatly emphasized the supervision of concentrated ownership in Icelandic financial undertakings, since their and the Icelandic financial market's reputation on the whole is sensitive when it comes to this issue. The FME's key issues in this area are:

- Evaluation and supervision of qualifying holdings in financial undertakings, i.e. 10% or more, and eligibility of parties to have qualifying holdings in a financial undertaking.
- Transactions of related parties should be based on the arm's length principle.
- Supervision of large risk liabilities; pursuant to regulations no one or related parties have greater exposures than 25% of equity with a credit undertaking.
- Eligibility assessment of CEOs and board members of financial undertakings.

The FME's 2006 guidelines on the content of operating procedures for executive boards of financial undertakings stipulate that financial undertakings submit to an external auditor details on connected lending and compare with comparable transactions of other customers. In dealing with such issues, according to the guidelines, an outside accountant must also submit a substantiated opinion stating that the arm's length principle has been observed. The guidelines also stipulate that board members must depart a meeting in which issues having to do with them are being discussed.

Joint Interest

Reputation is the most valuable asset of a financial undertaking. It is in joint interest of the FME and financial undertakings that they enjoy trust and credibility in international markets. The expansion of Icelandic financial undertakings began for real in mid-year 2004. The Icelandic undertakings have certainly had to tolerate difficulties and criticism during this period. A key issue in overcoming these obstacles is for the undertakings to build trust by continuing to emphasize transparency and sound business practices. The expansion of Icelandic financial undertakings is based on the operating licenses issued to them by the FME. Those licenses are their key to foreign markets. Thus it is imperative that the FME remains independent, holds sufficient and efficient authority, and has financial latitude to perform its supervisory activities in an international environment. That is the common interest of all parties in the Icelandic financial system.

Mynd: NordicPhotos

4 PARTIES SUBEJCT TO SUPERVISION

4.1 Number of Parties Subject to Supervision

As of 30 June 2007, the number of parties subject to supervision was as follows:

	Number 30.06.2007	Operate in accordance with:
Commercial banks	4	Act 161/2002 on Financial Undertakings
Savings banks	21	Act 161/2002 on Financial Undertakings
Credit undertakings	12	Act 161/2002 on Financial Undertakings
Deposit departments of co-operative societies	1	Act 22/1991 on Co-operative Societies
Securities companies	9	Act 161/2002 on Financial Undertakings
Securities brokerages	2	Act 161/2002 on Financial Undertakings
Management companies of UCITS	7	Act 161/2002 on Financial Undertakings
*UCITS (Total number 25, including 4 departmentalized)**		Act 30/2003 on UCITS and Investment Funds
*Investment funds (Total number 37, including 5 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	40	Act 129/199 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	6	Act 32/2005 on Insurance Mediation
Other parties subject to supervision	3	Various Acts
Total	119*)	

**) 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 the funds operate in more than one division.*

4.2 Changes in the Operating Licenses, Names and Number of Parties Subject to Supervision from 1 July 2006 to 30 June 2007.

Financial undertakings

On 30 November 2006 the name of Sparisjóðabanki Íslands hf. was changed to Icebank hf.

On 8 December 2006 the FME approved the merger between Sparisjóður vélstjóra and Sparisjóður Hafnarfjarðar.

On 21 June 2006 the FME was informed that the co-operative society Kaupfélag Austur-Skaftfellinga would cease the operation of deposit departments.

On 30 December 2006, Act 150/2006 on the incorporation of Municipality Credit Iceland as a Statutory Limited Liability Company went into effect. Lánasjóður sveitarfélaga ohf. received a license to operate as a credit undertaking on 14 September 2007.

On 18 January 2007 the FME approved the merger between Sparisjóður Vestmannaeyja and Sparisjóður Hornafjarðar. The name Sparisjóður Hornafjarðar was discontinued, and the name of the merged savings bank is Sparisjóður Vestmannaeyja.

On 26 January 2007 the FME approved the merger between Sparisjóðurinn í Keflavík and Sparisjóður Ólafsvíkur. The name Sparisjóður Ólafsvíkur was discontinued and the name of the merged savings bank is Sparisjóðurinn í Keflavík.

On 30 January 2007 the FME granted SPRON Verðbréf hf. a supplemented operating license as a securities company.

On 6 March 2007 the FME issued a license to H.F. Verðbréf hf. to operate as a securities company based on Act 161/2002 on Financial Undertakings.

On 13 March 2007 the name of the merged savings banks Sparisjóður vélstjóra and Sparisjóður Hafnarfjarðar was changed to Byr sparisjóður.

On 27 December 2006 the name of Sjóvá-Fjármögnun hf. was changed to Askar Capital hf. On 11 March 2007 the name Askar Capital hf. was changed to Avant.

On 20 April 2007 the FME issued a license to Saga Capital Fjárfestingarbanki hf. to operate as a credit undertaking (investment bank) on the basis of Act 161/2002 on Financial Undertakings

Management Companies of UCITS

On 14 June 2007 the FME issued a license to Rekstrarfélag MP Fjárfestingarbanki hf to operate UCITS and other joint investment funds, property management, investment management, investment consulting, and custody and management of financial transactions in joint investments.

Validations of UCITS and Investment Funds.

During the time period, the following UCITS and investment funds received the FME´s validation in accordance with Act 30/2003 on UCITS and Investment Funds. The funds are specified under their business name along with the date of validation.

Rekstrarfélag verðbréfasjóða ÍV hf.		**Validation**
Alþjóðlegur Hávaxtasjóður ÍV	Investment fund	19.12.2006
Landsvaki hf.		
Landsbanki Diversified Yield Fund	Investment fund	27.9.2006
Landsbanki Nordic 40	UCITS	27.12.2006
Safnbréf blönduð	Investment fund	15.2.2007
Safnbréf framsækin	“	15.2.2007
Safnbréf varfærin	“	15.2.2007
Peningabréf Landsvaka CAD	“	17.4.2007
Peningabréf Landsvaka DKK	“	17.4.2007
Rekstrarfélag Kaupþings banka hf.		
Kaupthing Liquidity Fund EUR	Investment fund	25.8.2006
Kaupthing Liquidity Fund USD	“	18.9.2006
Kaupthing Liquidity Fund GBP	“	22.11.2006
Kaupthing Nordic Equities	UCITS	5.3.2007
Kaupthing Scandinavian Fund	“	5.3.2007
Kaupthing Global Opportunities	Investment fund	7.6.2007
Kaupthing Emerging Leaders Fund	UCITS	7.6.2007
Kaupþing Erlend hlutabréf EUR-deild	Investment fund	8.6.2007
Glitnir sjóðir hf.		
Fjárfestingarsjóðir Glitnis		
Peningamarkaðsbréf EUR	Investment fund	9.5.2007
Peningamarkaðsbréf NOK	“	9.5.2007
Peningamarkaðsbréf USD	“	9.5.2007
Rekstrarfélag SPRON hf.		
Peningamarkaðssjóður SPRON hf.	Investment fund	1.9.2006
Stýrður hlutabréfasjóður	“	18.9.2006
BRIK – sjóðurinn	UCITS	18.12.2006
Rekstrarfélag MP Fjárfestingarbanka hf.		
Verðbréfasjóður MP Fjárfestingarbanka		
MP Eastern European Fund	UCITS	22.8.2007
MP Baltic growth Fund	“	22.8.2007
Fjárfestingarsjóður MP Fjárfestingarbanka		
Fyrirtækjaskuldabréfasjóður MP	Investment fund	19.10.2007
Peningamarkaðssjóður MP	“	19.10.2007

Name changes of UCITS and investment funds

Markaðsbréf Landsbankans 1	now named	Markaðsbréf Landsbankans – stutt
Markaðsbréf Landsbankans 2	now named	Markaðsbréf Landsbankans - meðallöng
Ís 15	now named	Kaupþing ÍS 15
Úrvalsvísitölusjóður	now named	Kaupþing Úrvalsvísitölusjóður
Einingabréf 9	now named	Kaupþing Heildarvísitölusjóður
Peningamarkaðssjóður	now named	Kaupþing Peningamarkaðssjóður
Skamtímasjóður	now named	Kaupþing Skamtímasjóður
Hávaxtasjóður	now named	Kaupþing Hávaxtasjóður
Ríkisverðbréfasjóður-millilangur	now named	Kaupþing Ríkisverðbréfasjóður-millilangur
Ríkisverðbréfasjóður-langur	now named	Kaupþing Ríkisverðbréfasjóður-langur
KB Skuldabréf Stutt	now named	Kaupþing Skuldabréf-Stutt
KB Skuldabréf Millilöng	now named	Kaupþing Skuldabréf-Millilöng
KB Skuldabréf Löng	now named	Kaupþing Skuldabréf-Löng
Eignarstýringarsjóður	now named	Kaupþing Eignarstýringarsjóður
Alþjóða sjóðurinn	now named	Alþjóða virðissjóðurinn

Mergers and Dissolutions of UCITS and Investment Funds

On 15 September 2006 two fund divisions of Verðbréfasjóður Sparisjóðanna, Lyf- og líftæknisjóðurinn and Hátæknisjóðurinn, were dissolved. That same day, the fund divisions Fjármálasjóðurinn and Alþjóða sjóðurinn were merged under the name Alþjóða virðissjóðurinn. Rekstrarfélag Sparisjóðanna hf. is the fund's management company.

On 29 March 2007 the UCITS of Landsvaki, Markaðsbréf Landsbankans 3 and Markaðsbréf Landsbankans 4 were merged. The fund is now named Markaðsbréf Landsbankans – löng.

On 29 March 2007 the investment funds of Landsvaki, Safnbréf hlutabréf/skuldabréf merged with the fund Safnbréf varfærin.

On 29 March 2007 the investment funds of Landsvaki, Safnbréf innlend/erlend merged with the fund Safnbréf blönduð.

On 31 May 2007 the UCITS Markbréf was dissolved. Rekstrarfélag Kaupþings banka hf. was the fund´s management company.

Pension Funds

Lífeyrissjóður Austurlands and Lífeyrissjóður Norðurlands merged on 1 January 2007. The name of the merged funds was changed to Stapi lífeyrissjóður.

Lífeyrissjóðurinn Lífiðn and Samvinnulífeyrissjóðurinn merged on 1 January 2007. The name of the merged funds was changed to Stafir lífeyrissjóður.

Lífeyrissjóður Vesturlands and Lífeyrissjóður Suðurlands merged on 29 December 2006. The name of the merged funds was changed to Festa lífeyrissjóður.

Eftirlaunasjóður starfsmanna Íslandsbanka hf. changed its name to Eftirlaunasjóður starfsmanna Glitnis hf. with amendments that took effect on 25 March 2007.

Insurance Market

Insurance Companies

On 30 May 2007 the name of Vörður Íslandstryggingar hf. was changed to Vörður tryggingar hf.

Insurance Intermediaries

On 16 January 2007 Tryggingamiðlun Reykjavíkur hf. turned in its license to operate as an insurance broker.

Other Parties Subject to Supervision

A change in Act 61/1997 on the New Business Venture Fund (Act 53/2007), discontinued the FME´s supervisory oversight of the New Business Venture Fund as of 17 March 2007.

4.3 List of Parties Subject to Supervision as of 30 June 2007

COMMERCIAL BANKS	Headquarters
Glitnir banki hf.	Reykjavík
Icebank hf.	Reykjavík
Kaupþing banki hf.	Reykjavík
Landsbanki Íslands hf.	Reykjavík
Straumur – Burðarás Fjárfestingarbanki hf.	Reykjavík
(An investment bank prior to commercial bank operating licence 28.08.2007.)	

SAVINGS BANKS	
Byr sparisjóður	Reykjavík
nb.is-sparisjóður hf.	Reykjavík
Sparisjóður Bolungarvíkur	Bolungarvík
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 Reykjavíkur og nágrennis hf.	Reykjavík
(changed to LLC. on 19.09.2007)	
Sparisjóður Siglufjarðar	Siglufjörður
Sparisjóður Skagafjarðar	Sauðárkrókur
Sparisjóður Strandamanna	Hólmavík
Sparisjóður Suður-Þingeyinga	Laugar
Sparisjóður Svarfdæla	Dalvík
Sparisjóður Vestfirðinga	Þingeyri
Sparisjóður Vestmannaeyja	Vestmannaeyjar
Sparisjóður Þórshafnar	Þórshöfn
Sparisjóðurinn í Keflavík	Keflavík

CREDIT UNDERTAKINGS	
Askar Capital hf. *(operating license 29.08.2007)*	Reykjavík
Avant hf.	Reykjavík
Borgun hf. *(was Kreditkort hf. until 31.07.2007)*	Reykjavík
Byggðastofnun	Reykjavík
Frjálsi Fjárfestingarbankinn hf.	Reykjavík
Lánasjóður sveitarfélaga ohf.	Reykjavík
(credit undertaking operating license 14.09.2007)	
Lýsing hf.	Reykjavík
MP Fjárfestingarbanki hf.	Reykjavík
Saga Capital Fjárfestingarbanki hf.	Akureyri
SP-Fjármögnun hf.	Reykjavík
Valitor hf. *(was Greiðslumiðlun hf. until 06.09.2007)*	Reykjavík
VSB-fjárfestingarbanki hf.	Reykjavík

DEPOSIT DEPARTMENTS OF CO-OPERATIVE SOCIETIES	
Kaupfélag Skagfirðinga	Skagafjörður

SECURITIES COMPANIES	Headquarters
Arev verðbréfafyrirtæki hf.	Reykjavík
Arion verðbréfavarslan hf.	Reykjavík
Íslensk verðbréf hf.	Akureyri
H.F. Verðbréf hf.	Reykjavík
Jöklar - Verðbréf hf.	Reykjavík
NordVest Verðbréf hf.	Reykjavík
SPRON Verðbréf hf.	Reykjavík
Verðbréfaþjónusta Sparisjóðanna hf.	Reykjavík
Virðing hf.	Reykjavík

SECURITIES BROKERAGES	
A Verðbréf hf. *(operating license 13.09.2007)*	Reykjavík
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	*(department of Verðbréfasjóður ÍV)*
Skuldabréfasjóður ÍV	"
Heimssjóður ÍV	"
Fjárfestingarsjóður ÍV	*(departmentalized investment fund)*
Peningamarkaðssjóður ÍV	*(department of Fjárfestingarsjóður ÍV)*
Hlutabréfasjóður ÍV	"
Alþjóðlegur skuldabréfasjóður ÍV	"
Alþjóðlegur hávaxtasjóður ÍV	"
Landsvaki hf.	**Reykjavík**
Verðbréfasjóðir Landsvaka	*(departmentalized UCITS, cf. list)*
Markaðsbréf stutt	"
Markaðsbréf millilöng	"
Markaðsbréf löng	"
Sparibréf	*(UCITS)*
Skuldabréfasjóður	*(UCITS)*
Vísitölubréf	*(UCITS)*
Landsbanki Global Equity Fund	(UCITS)
Reiðubréf	*(UCITS)*
Landsbanki Nordic 40	*(UCITS)*
Fjárfestingarsjóðir Landsvaka	*(departmentalized investment fund)*
Peningabréf ISK	*(department of Fjárfestingarsjóðir Landsvaka)*
Fyrirtækjabréf	"
Úrvalsbréf	"
Peningabréf EUR	"
Peningabréf GBP	"
Peningabréf USD	"

	Headquarters
Landsbanki Global Opportunity Fund	*(fjárfestingarsjóður)*
Safnbréf blönduð	“
Safnbréf framsækin	“
Safnbréf varfærin	“
Landsbanki Diversified Yield Fund	“
Peningabréf L. CAD	“
Peningabréf L.DKK	“

Rekstrarfélag Kaupþings banka hf. **Reykjavík**

Kaupþing Úrvalsvísitölusjóður	*(UCITS)*
IceQ	“
Kjarabréf	“
Ríkisverðbréfasjóður langur	“
Ríkisverðbréfasjóður millilangur	“
Kaupþing Emerging Leaders Fund	“
Kaupþing Scandinavian Fund	“
Kaupþing Nordic Equities	“
Kaupþing Skammtímasjóður	*(investment fund)*
Kaupþing Hávaxtasjóður	“
Kaupþing IS 15	“
KB erlend hlutabréf	*(departmentalized investment fund)*
EUR-deild	*(department of KB erlend hlutabréf)*
ISK-deild	“
Kaupþing Samval	*(investment fund)*
Ævileið 1	“
Ævileið 2	“
Kaupþing Eignastýringarsjóður	“
Kaupþing Peningamarkaðssjóður	“
Kaupþing Heildarvísitölusjóður	“
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	“
KB verðbréfaval 5	“
Kaupthing Liquidity Fund EUR	“
Kaupthing Global Opportunities Fund	“
Kaupthing Liquidity Fund USD	“
Kaupthing Liquidity Fund GPD	“

Glitnir sjóðir hf. **Reykjavík**

Verðbréfasjóðir Glitnis	(departmentalized UCITS)
GLB Sjóður 1 – skuldabréf	*(department of Verðbréfasjóðir Glitnis)*
GLB Sjóður 5 - íslensk ríkisskuldabréf	“
GLB Sjóður 6 – aðallistinn	“
GLB Sjóður 7 - löng ríkisskuldabréf	“
GLB Sjóður 11 - fyrirtækjabréf	“
GLB Sjóður 12 - heimssafn	“

	Headquarters
Fjárfestingarsjóðir Glitnis	*(departmentalized investment fund)*
GLB Sjóður 9 – peningamarkaðsbréf	*(department of Fjárfestingarsjóðir Glitnis)*
GLB Sjóður 9.1 – peningamarkaðsbréf E	“
GLB Sjóður 9.2 – peningamarkaðsbréf N	“
GLB Sjóður 9.3 – peningamarkaðsbréf U	“
GLB Sjóður 10 – úrval innlendra hlutabréfa	“
GLB Sjóður 15 - úrval erlendra ríkisskuldabréfa	“

Rekstrarfélag Sparisjóðanna hf. **Reykjavík**

Verðbréfasjóðir Sparisjóðanna	*(departmentalized UCITS)*
Úrvalssjóðurinn	*(department of Verðbréfasjóðir Sparisjóðanna)*
Skuldabréfasjóðurinn	“
Alþjóða virðissjóðurinn	“
Alþjóða vaxtasjóðurinn	“
Fjárfestingarsjóður Sparisjóðanna	*(departmentalized investment fund)*
Fyrirtækjasjóðurinn	*(department of Fjárfestingarsjóður Sparisjóðanna)*
Peningamarkaðssjóðurinn	“

Rekstrarfélag SPRON hf. **Reykjavík**

Skuldabréfasjóðurinn-Stuttur	*(UCITS)*
Skuldabréfasjóðurinn-Langur	“
Úrvals hlutabréfasjóðurinn	“
Áskriftarsjóður ríkisverðbréfa	“
Alþjóða hlutabréfasjóðurinn	“
BRIK- hlutabréfasjóðurinn	“
Peningamarkaðssjóður SPRON	*(investment fund)*
Stýrður hlutabréfasjóður	“

Rekstrarfélag MP Fjárfestingarbanka hf.

Verbréfasjóður MP Fjárfestingarbanka	*(departmentalized UCITS)*
MP Baltic Growth Fund	*(department of Verðbréfasjóður MP Fjárfestingarbanka)*
MP Estern European Fund	“
Fjárfestingarsjóður MP Fjárfestingarbanka	*(departmentalized investment fund)*
MP Baltic Growth Fund	*(department of Fjárfestingarsjóður MP Fjárfestingarbanka)*
MP Estern European Fund	“

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

	Headquarters
Eftirlaunasjóður Sláturfélags Suðurlands	Reykjavík
Eftirlaunasjóður starfsmanna Hafnarfjarðarkaupstaðar	Hafnarfjörður
Eftirlaunasjóður starfsmanna Glitnis banka hf.	Reykjavík
Eftirlaunasjóður starfsmanna Olíuverslunar Íslands	Reykjavík
Eftirlaunasjóður starfsmanna Útvegsbanka Íslands	Reykjavík
Festa - lífeyrissjóður	Reykjanesbær
Frjálsi lífeyrissjóðurinn	Reykjavík
Gildi-lífeyrissjóður	Reykjvík
Íslenski lífeyrissjóðurinn	Reykjavík
Lífeyrissjóður Akraneskaupstaðar	Akranes
Lífeyrissjóður bankamanna	Reykjavík
Lífeyrissjóður bænda	Reykjavík
Lífeyrissjóður Hf. Eimskipafélags Íslands	Reykjavík
Lífeyrissjóður Flugvirkjafélags Íslands	Reykjavík
Lífeyrissjóður hjúkrunarfræðinga	Reykjavík
Lífeyrissjóður Mjólkursamsölunnar	Reykjavík
Lífeyrissjóður Neskaupstaðar	Reykjavík
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 Tannlæknafélags Íslands	Reykjavík
Lífeyrissjóður verkfræðinga	Reykjavík
Lífeyrissjóður verslunarmanna	Reykjavík
Lífeyrissjóður Vestfirðinga	Ísafjörður
Lífeyrissjóður Vestmannaeyja	Vestmannaeyjar
Lífeyrissjóðurinn Skjöldur	Reykjavík
Stafir lífeyrissjóður	Reykjavík
Stapi lífeyrissjóður	Akureyir
Sameinaði lífeyrissjóðurinn	Reykjavík
Söfnunarsjóður lífeyrisréttinda	Reykjavík

INSURANCE COMPANIES

European Risk Insurance Company hf.	Reykjavík
Íslensk endurtrygging hf.	Reykjavík
Kaupþing 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 trygging hf.	Reykjavík

INSURANCE INTERMEDIARIES

	Headquarters
Árni Reynisson ehf.	Reykjavík
Fjárfestingarmiðlun Íslands ehf.	Kópavogur
Nýja vátryggingaþjónustan hf.	Reykjavík
Olaf Forberg	Kópavogur
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	- Tryggingar 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
Tryggingarsjóður innstæðueigenda og fjárfesta	Reykjavík
Tryggingasjóður sparisjóða	Reykjavík

5 AMENDMENTS TO ACTS AND REGULATIONS

5.1 General

Act 55/2007

Amendments:

This Act contains amendments to provisions concerning penalties for financial market violations and serves to amend the following Acts: no. 161/2002 on Financial Undertakings, no. 87/1998 on Official Supervision of Financial Operations, no. 33/2003 on Securities Transactions, no. 34/1998 on the Activities of Stock Exchanges and Regulated OTC Markets, no. 131/1997 on Electronic Registration of Title to Securities, and no. 60/1994 on Insurance Activities. The FME is given extended power to impose administrative fines for violations. The Act aims to harmonize penalty provisions in current financial market legislation in order to improve effectiveness and efficiency. Provisions concerning closer co-operation between the police and the FME have also been added to the financial market legislation. As a result of these amendments, the FME may now impose administrative fines for practically all violations of financial market legislation. Furthermore, the Act provides the FME with the statutory power to conclude cases with out-of-court settlements. The amounts for fines range from ISK 25,000 to ISK 25,000,000 for individuals and ISK 50,000 to ISK 50,000,000 in the case of corporate violations.

5.2 The Credit Market

Act 161/2002 on Financial Undertakings

Amendments:

Act 170/2006: This Act implements the Basel II framework for the capital adequacy of financial undertakings. Only the principal features of the framework were incorporated into the actual legislation while at the same time referring all details and technicalities to specific rules adopted by the FME. The objective of these amendments is to base decisions concerning the minimum capital adequacy of financial undertakings on more precise standards than before so that financial undertakings which exercise sound control of their exposures may benefit from so doing in the calculations of capital adequacy ratios.

Act 111/2007: Last June the legislation on financial undertakings was amended in line with the implementation of the MiFID Directive on Markets in Financial Instruments adopted by the European Parliament and the European Commission. Following the amendment the legislation now covers all investor-related activities, including investment advisors. The operations of multilateral trading facilities (MTF) are now subject to official licensing. The amendments also have the effect of increasing the number of financial instrument types governed by the Directive, for instance incorporating raw material and credit risk transfer derivatives. The Act came into effect on 1 November last.

Rules on the Capital Requirement and Risk Weighted Assets of Financial Undertakings no. 215/2007

At the beginning of 2007 the FME adopted new rules on the capital requirement and risk weighted assets of financial undertakings to replace its older rules no. 530/2003. The FME‘s rules are based on new international rules on the equity capital of financial undertakings which entered into effect at the beginning of 2007. The international rules are in turn based on standards issued by the Basel Committee on Banking Supervision, the Basel II Accord. The aim of these amendments is primarily to apply more precise standards to decisions concerning the minimum capital requirements of financial undertakings so that financial undertakings which exercise rigorous risk management procedures may benefit from so doing in the calculation of capital adequacy ratios.

Rules on Large Exposures Incurred by financial Undertakings no. 216/2007

At the beginning of 2007 the FME adopted new rules on large exposures incurred by financial undertakings to replace its older rules no. 531/2003. The new rules implement the provisions of Articles 106 to 119 of Directive 2006/48/EC (formerly 2000/12/EC) which was amended in line with the incorporation of the rules of Basel II into EC directives.

Guidelines no. 4/2006 on the subject of rules adopted pursuant to Article 54, paragraph 2, of Act 161/2002 on financial undertakings

The guidelines are intended to make provision for rules on the activities of the boards of financial undertakings. According to the guidelines, internal codes of practice should ensure equality of treatment and independent and unbiased procedures. The aim of the guidelines is to ensure procedural clarity as well as creating a solid framework for transactions by board members and their access to client information. Principal innovations include the obligation for financial undertakings to submit all exposures towards connected parties to an external auditor for examination and comparison with similar transactions by other clients and to obtain an objectively justified opinion with regard to terms, contract renewals and the status of the party concerned (the arm‘s length principle). The FME requests that all external auditor reports arising from such examinations be submitted to the Authority on an annual basis by financial undertakings where the balance sheet total exceeds ISK 50 billion, but every two years by other financial undertakings.

Guidelines no. 1/2007 on a basic framework of harmonised supervisory procedures for financial undertakings

The guidelines are based on the rules of the Basel II Accord concerning the own funds of financial undertakings, which in turn are based on standards adopted by the Basel Committee.

Guidelines no. 2/2007 on a basic framework for stress testing and the concentration and interest rate risks of financial undertakings

These guidelines are intended to implement Guidelines on the Application of the Supervisory Review Process under Pillar 2 (GL 03) which were adopted by the Committee of European Banking Supervisors (CEBS) in order to harmonize methods for supervising financial undertakings. The CEBS guidelines state that when conducting an internal capital adequacy assessment (ICAAP), financial undertakings must take into account the impact of economic fluctuations as well as sensitivity to external risk, such as country risk, risk specific to the jurisdiction(s) in which they operate and risk arising from the actions of competitors. Stress tests are conducted in order to assess this impact. The FME has conducted stress tests in order to assess the need for intervention on its behalf in the operations of a financial undertaking.

Interpretation of Article 70, paragraph 3, and Article 75, paragraph 1, of Act 161/2002 on Financial Undertakings concerning voting rights in savings banks

On 8 August 2007 the FME published the following interpretation of voting rights in savings banks with regard to the definition of connections between parties:

„In Article 70, paragraph 3, and Article 75, paragraph 1, of Act 161/2002 on Financial Undertakings it is stated that no owner may exercise more than 5% of the total voting rights in a savings bank, whether the control upon which such voting rights are based derives directly or indirectly from a share in the guarantee capital of the savings bank. For the assessment of indirect shares as stated in the above-mentioned provisions the same criteria shall apply as for the same concept as stated in Articles 40 and 40(a) of Act 161/2002 on Financial Undertakings.“

5.3 The Securities Market

Act 108/2007 on Securities Transactions and Act 110/2007 on Stock Exchanges of 13 June 2007 implementing the MiFID Directive no. 2004/39/EC on markets in financial instruments adopted by the European Union on 21 April 2004. The Securities Transactions Act also implements Directive 2004/109/EC of the European Parliament and the Council on the harmonisation of transparency requirements with regard to information about issuers whose securities are admitted for trading on a regulated market and amending Directive 2001/34/EC (the Transparency Directive).

Regulation 169/2007 of 1 March 2007 amending Regulation 243/2006 which was adopted to implement Commission Regulation 809/2004 on the implementation of the Prospectus Directive of the European Parliament and of the Council no. 203/71/EC as regards the information contained in prospectuses and how it is presented, the incorporation of information by reference, the publications of prospectuses and advertising. The present regulation was adopted upon the entry into effect of Commission Regulation 1787/2006 of 4 December 2006 amending Commission Regulation 809/2004 and as authorised by Article 73 of Act 33/2003 on Securities Transactions.

FME Rules no. 987/2006 of 21 November 2006 on the handling of insider information and insider trading.

Stock Exchange Rules for the issuers of securities of 2 April 2007. These rules were adopted pursuant to Act 34/1998 on the Activities of Stock Exchanges and Regulated OTC Markets. The rules contain provisions concerning registration and duty of disclosure for the issuers of equity securities, bonds and unit share certificates. The rules are intended to augment and clarify the provisions contained in laws and regulations on stock exchanges and regulated securities markets on the one hand and securities transactions on the other hand with regard to registration, prospectuses and duty of disclosure.

Interpretation of Article 40, paragraph 2, of Act 33/2003 on Securities Transactions concerning pricing in takeover bids.

On 4 October last the FME published the following interpretation:

“The Financial Supervisory Authority is of the opinion that Article 40, paragraph 2, provides for three different methods for determining prices, but the offer price shall at all times be based on the method yielding the highest value. This is an understanding of the provision stating that the price shall be at least equal to the highest price paid during a

given period but, however, never lower than the latest transaction price during the same period. This understanding is also consistent with the generally accepted view that the purpose of takeover rules is to protect the interests of minority shareholders during a takeover and that they should be given the opportunity to sell their shares at a fair price.

The Financial Supervisory Authority believes that the second sentence of paragraph 2 in Article 40 concerning the transaction price for shares in the company in question the day before the bidding obligation arose or notification was given of the proposed bid should be interpreted as referring to all trading in the shares in question and not only the transaction price paid by the offeror or parties acting in concert with the offeror."

5.4 Pension Funds

Act 129/1997 on the Mandatory Guarantee of Pension Rights and the Operation of Pension Funds.
Amendments:
Act 65/2006: Article 16, paragraph 3, of this Act has been amended to the effect that the recognized cohabitation or consensual union of same sex and opposite sex couples is given equal legal status.

Act 108/2006: This Act amends Article 8, paragraphs 4 and 5, to accommodate implementation of the Hoyvik Agreement. Life insurance companies which are established and licensed to operate in the Faroe Islands are thereby authorized to receive premiums for contracts on supplementary insurance cover.

Act 140/2006: This Act contains an amendment stating that when the standby creditors of pension funds which are guaranteed by the Treasury, municipal authorities or banks settle part of their obligations to the funds in unlisted securities (cf. point 1 of the first paragraph of Article 36) the funds may receive and hold such shares notwithstanding the 10% limit on investment in unlisted securities stated in the first sentence of paragraph 3 in Article 36.

Act 167/2006: The Act fixes the minimum pension premium at 12% of wages instead of the previous 10%. Pension funds which are, or were, guaranteed by the Treasury, municipal authorities or banks are given scope to make the necessary changes to their Statutes in accordance with the provisions of Article 39, paragraph 2.

Act 78/2007 on Occupational Retirement Funds
This Act implements Directive 2003/41/EC of the European Parliament and of the Council on the activities and supervision of institutions for occupational retirement provision. The Act covers funds which are optional and linked to specific occupations. Legal bodies are enabled to offer specific services across borders within the European Economic Area.

Interpretation of Article 48, paragraph 2, of Act 129/1997 on the Mandatory Guarantee of Pension Rights and the Operation of Pension Funds concerning the duty to report the mergers of pension funds to the FME.

On 15 February 2007 the FME published the following interpretation:
"Pursuant to Article 48, paragraph 2, of Act 129/1997 decisions on the winding up of pension funds shall be immediately notified to the Ministry of Finance and the Financial Supervisory Authority, whether by merger or by other means, cf. Article 48, paragraph 1. It is the Authority's understanding that the above should be interpreted in such a way that pension funds are obliged to notify the Authority of the winding up of a pension fund through a merger with another pension fund as soon as such a decision has been made by its board or other competent entity as the case may be. In accordance with the above provision it is also necessary that such notifications contain information on the date of the proposed merger."

Interpretation concerning the increase or reduction of rights cf. Article 39, paragraph 2, of Act 129/1997 on the Mandatory Guarantee of Pension Rights and the Operation of Pension Funds.

On 20 February 2007 the FME published the following interpretation:
"With regard to the provisions of Article 39, paragraph 2, and Article 27, paragraph 2(8) it is necessary that all changes to the rights of pension fund members, including proportional increases or reductions of rights earned, be stated in the Statutes of the pension funds and approved as such by the Ministry of Finance pursuant of Article 28 of the Pension Act."

Interpretation of Article 36 of Act 129/1997 on the Mandatory Guarantee of Pension Rights and the Operation of Pension Funds concerning the right for pension funds to engage in securities lending activities.

On 13 July 2007 the FME published the following interpretation:
"Article 36 of Act 129/1997 contains a clear definition and a comprehensive list of the ways in which a pension fund may invest its assets, cf. also Article 20, paragraph 1, of the same Act. There is no mention of securities lending and pension funds are, consequently, in the opinion of the Financial Supervisory Authority, not permitted to engage in such activity."

5.5 The Insurance Market

Act amending various legislation to accommodate the 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 hand, no. 108/2006

The Act includes, inter alia, amendments to the Insurance Act no. 60/1994. This enables insurers in Iceland and the Faroe Islands to engage in insurance activity on the basis of operating licences granted by their own respective authorities provided all conditions for the establishment of a branch office or providing services without an establishment.

In relation to the implementation of this new legislation, the FME is currently preparing a Memorandum of Understanding with the Faroese insurance commission.

Regulation on examination for insurance intermediaries no. 972/2006.
In collaboration with the special examinations board, the FME conducts examinations for individuals intending to manage the day-to-day activities of insurance brokerages, cf. Article 17 of the Act on Insurance Mediation. Candidates must meet the requirements set out in the regulation. The first part of the examination is oral and focuses on assessing the candidate‘s knowledge of the legal environment of insurance mediation and insurance activities. The second part of the examination is written and intended to evaluate the candidate‘s ability to complete specialised tasks.

The first examination will be held by the FME in November 2007.

Guidelines no. 3/2007 on the professional practices of insurance salesmen of insurance intermediaries, insurance agents and insurance companies

The guidelines are intended to encourage sound and fair trading practices, for instance in the selling of insurance, with reference to Act 32/2005 on Insurance Mediation, Act 60/1994 on Insurance Activities and Act 30/2004 on Insurance Contracts.

The Insurance Mediation Act contains provisions concerning the reporting requirement of insurance intermediaries, insurance agents and insurance salesmen. An insurance salesman, in the understanding of the Guidelines, is an individual employed by or acting on behalf of a specific insurance company, insurance agent or insurance intermediary on the basis of an employment or work contract, cf. Article 3, point 4, of the Insurance Mediation Act. The above-mentioned act contains provisions on obligations and duties, for instance when selling insurance. The Act on Insurance Activity covers various aspects concerning the professional practices of insurance companies, but not those of individuals employed to sell insurance. The FME believes it is important that the same rules apply to the activities of all insurance salesmen, whether they are employed by insurance intermediaries, insurance agents or insurance companies. The Act on Insurance Contracts contains provisions on the duty of disclosure in the sale of insurance. The Guidelines contain provisions concerning the requisite knowledge and responsibility of individual employees as well as their professional conduct and duty of disclosure. Before an insurance contract is signed, the insurance salesman shall, for instance, explain to the prospective client the reasons underlying the advice that is given. The justification for this advice shall take aim of the nature of the recommended insurance contract.

Mynd: NordicPhotos

6 HIGHLIGHTS OF FME´S 2006 ANNUAL FINANCIAL STATEMENTS

The following presents the main outcomes of the FME´s annual financial statements for 2006. The annual financial statements were approved by the FME´s Board of Directors on 29 May 2007 and endorsed by the National Audit Bureau on 30 May 2007.

Profit and Loss Account 2006

Amounts in krónur (ISK)

	2006	2005
Financial income		
Income from supervision fees	435,054,000	299,903,000
Other income	9,545,027	5,511,780
	444,599,027	305,414,780
Financial expenses		
Salaries and related expenses	279,180,727	239,455,520
Complaints committees	5,604,387	4,624,091
Administrative expenses	17,030,236	16,393,805
Travel and personnel related expenses	26,778,625	22,722,068
Expert services purchased	22,531,678	7,587,568
Operation of equipment	6,977,200	6,034,916
Other operating expenses	4,549,912	3,909,044
Housing	25,023,942	24,893,895
Transfers	1,068,500	604,900
	388,745,207	326,225,807
Purchased assets	7,433,995	2,995,713
	396,179,202	329,221,520
Operating profit before net interest income	48,419,828	(23,806,740)
Interest income (interest expense)	10,678,588	4,783,300
Profit for the year/ (Loss)	59.098,416	(19.023,440)

Balance Sheet 31 December 2006

Amounts in krónur (ISK)

	2006	2005
Assets		
Current Assets		
Treasury	550,466	0
Accounts receivables	5,061,145	1,832,521
Other receivables	2,490,938	760,201
Cash and cash equivalents	50,016,597	6,128,009
	58,119,146	8,720,731
Total assets	58,119,146	8,720,731
Equity and Liabilities		
Equity		
Equity at the beginning of the year	(10,145,835)	8,877,605
Profit for the year /(Loss)	59,098,413	(19,023,440)
Equity	48,952,578	(10,145,835)
Current Liabilities		
Treasury	0	14,006,004
Accounts payable	375,200	998,200
Other short-term debt	8,791,368	3,862,362
Liabilities	9,166,568	18,866,566
Equity and Liabilities	58,119,146	8,720,731

FJÁRMÁLAEFTIRLITIÐ
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