Financial Supervisory Authority Annual Report for 2010 – English Abstract

Published by:
Fjarmalaeftirlitid
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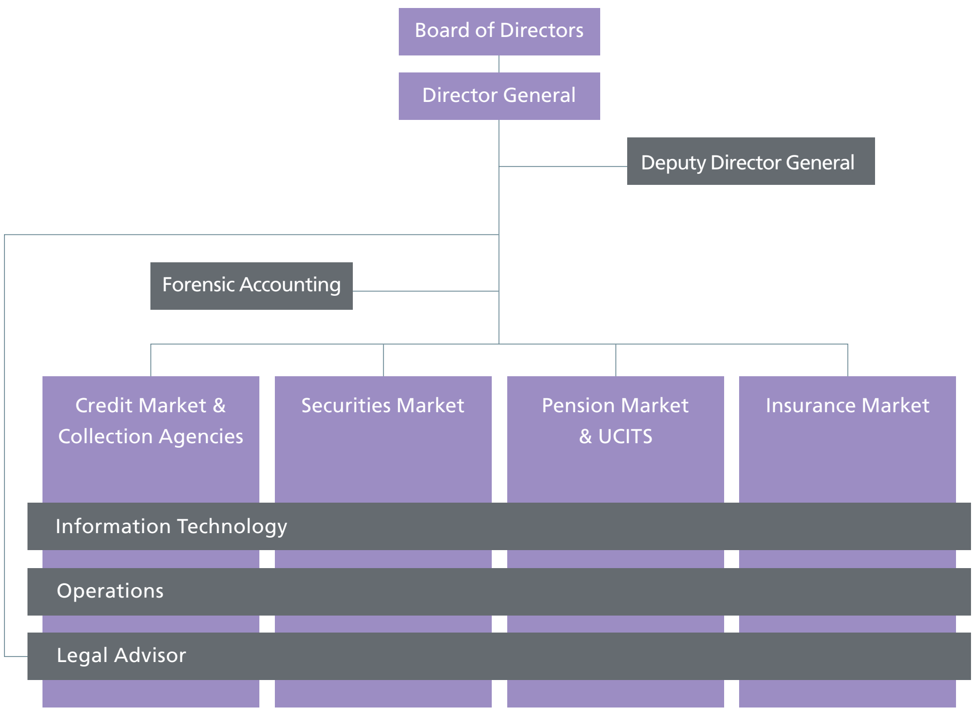
Financial Supervisory Authority, Annual Report for 2010

The Financial Supervisory Authority's 2010 Annual Report discusses the rebuilding of the Icelandic financial system and the organisation and operation of the Authority, in addition to discussing the prospects of the future; the discussion in the Report is concerned primarily with the period from 1 July 2009 to 30 June 2010. In his introduction to the Report Mr. Gunnar T. Andersen, Director General, provides an account of the recent growth of the Financial Supervisory Authority (FME), both in size and strength. The number of staff has doubled since the beginning of 2008 and now comprises just short of one hundred employees. The staff engaged in investigative work relating to the collapse of the banks has been substantially reinforced. In addition, the Authority now includes a separate IT division, a Forensic Accounting division and an Office of Senior Legal Advisor.

The Director General also provides an account of the extensive internal strategic planning that has been ongoing in the FME since the collapse of the Icelandic banks in response to the criticism of the Authority contained in the Report of the Special Investigation Commission of the Althing. A review of the Authority's internal structure led to the creation of a new organisational chart. The work of the FME's Credit Market division has been reorganised and the division, which is primarily responsible for supervision of the commercial banks, has been substantially strengthened. The Board of Directors of the Authority also undertook a detailed review of the Authority's overall strategy, which has now been published. The strategy covers the situation of the Icelandic financial market and the points of focus in the Authority's supervisory work in the near term.

The Director General discusses the uncertainty that characterised the market following the fall of the three large Icelandic banks and notes that further financial undertakings collapsed in 2010. The FME appointed a provisional board of directors for VBS Investment Bank in March 2010, and for the Keflavik Savings Bank and Byr Savings Bank shortly thereafter, i.e. in April, and their operations were taken



Director General:
Gunnar T. Andersen
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Ragnar Haflidason

Heads of Divisions:
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Runar Gudmundsson
Securities Market
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Chief Legal Counsel
Unnur Gunnarsdottir

over by new financial undertakings. Also, the FME granted a request this year from Avant hf. for the appointment of a provisional board of directors. The board of directors of Askar Capital subsequently submitted a petition to the District Court to appoint a winding-up board for the company.

Two of the three large commercial banks were taken over by creditors in the second half of 2009. The Director General expressed the hope that the Icelandic financial system had finally been brought under control, but noted that there was still unrest following the crisis, and that some weaknesses remained which were still being addressed. All three of the commercial banks, for example, are still struggling to restructure their loan portfolios. The portfolios represent the greatest risk factor in the banks' operations, and it is crucial for the restructuring to be successful.

The Director General discusses in brief terms the reforms of legislation on financial undertakings, under which the Authority has been given added powers, including the power to assess the operations or behaviour of regulated parties and impose restrictions on the operations of financial undertakings. He also mentions that foreign governments and supervisory bodies have been working on reviewing legislation and rules on the supervision of financial undertakings as well as the requirements imposed on financial undertakings with regard to capital and liquidity. In his opinion these requirements may be expected to become even stiffer.

The Director General notes that in early 2010 the Authority set up a three-member advisory committee on the eligibility and qualifications of board members of financial undertakings. According to the Director General there are plans to increase the number of regulated entities whose directors will be assessed for eligibility and qualifications in the future; the purpose of the advisory committee is to ensure that directors possess the required knowledge and experience and to verify their independence.

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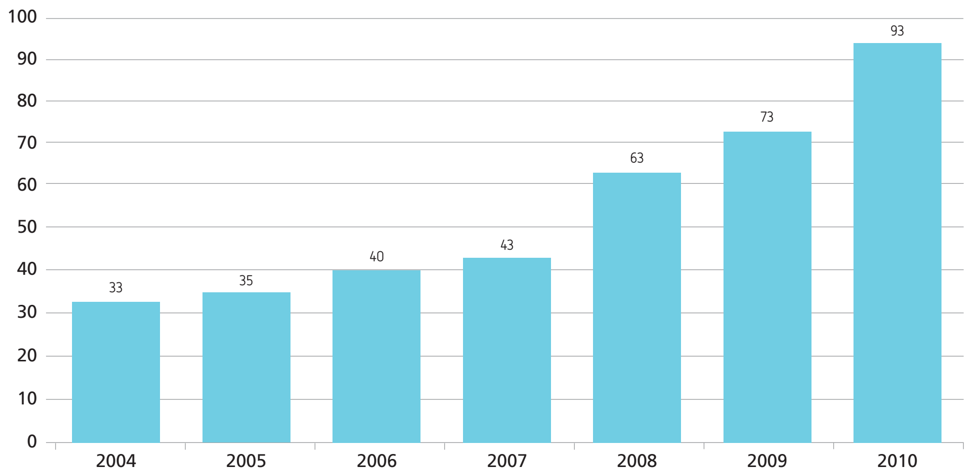
Mr. Andersen discusses the currency-linked loans that were judged to be illegal by the Supreme Court in 2010. An extensive assessment was conducted of the scope and nature of these loans in the FME, and disputes ensued regarding their interest terms following the Supreme Court's findings. The judgment of the Supreme Court with regard to interest terms was effectively that the interest posted by the Central Bank of Iceland should be used as a basis; this was in fact the reference rate that had been recommended by the Financial Supervisory Authority and the Central Bank pending the judgment of the Supreme Court.

The Director General's introduction is followed by a detailed chapter on the ongoing refinancing of the commercial banks. The Report then goes on to discuss investigations conducted by the Authority and the organisation of its investigative team. The response of the Financial Supervisory Authority to the Report of the Special Investigation Commission of the Althing is also discussed, as the Authority has made a point of drawing the appropriate lessons from the comments made in the Report, as mentioned earlier. The Report goes on to discuss the changes that have been made in the legislative framework of financial undertakings and insurance activities.

Organisation and operation

The organisation and operation of the Financial Supervisory Authority are discussed in a separate chapter of the Annual Report. A new organisational chart was introduced in 2009 and subsequently revised in line with several changes that were made in the roles of individual divisions and in the procedures employed by the FME in its supervisory work. As mentioned earlier, the FME's staff has grown substantially. The largest group consists of experts in business administration and economists, followed by legal experts. Following the financial collapse, recruiting staff with more extensive and varied experience has been easier than in the years preceding the collapse.

Number of staff 2004-2010



Looking at the proportional allocation of the total available time of the FME among the categories of regulated entities shows that the Authority spends by far the greatest proportion of its time on its supervision of credit institutions, with approximately 57% of the total time at the disposal of the Authority devoted to this activity in 2009. Supervisory activities accounted for almost 68% of the Authority's total available time.

Division of total available time in the FME by regulated entities		
	2008 %	**2009 %**
Credit institutions	65.2	57.3
Insurance companies and brokerages	9.7	11.3
Pension funds	9.1	15.2
UCITS management companies	5.8	6.7
Securities companies and brokerages	1.0	0.9
Issuers of shares and bonds	7.2	6.6
Other	2.0	2.0
	100	**100**

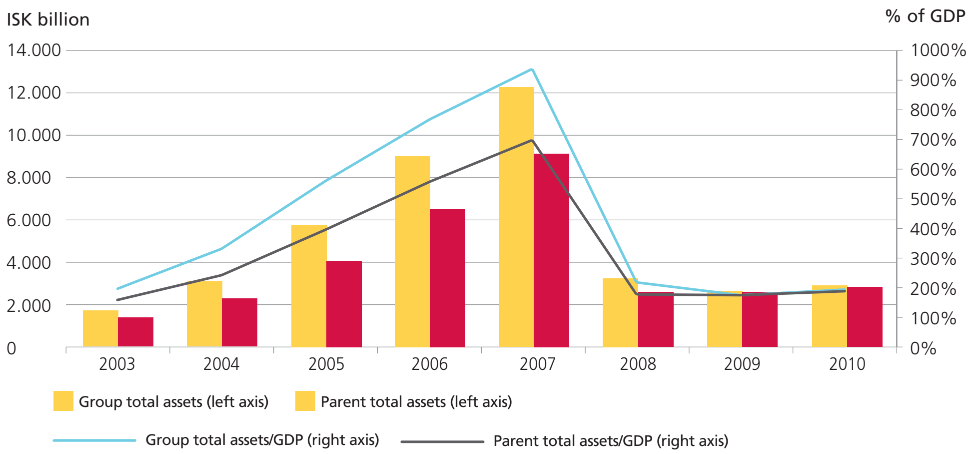
Division of total available time in the FME by core functions		
	2008 %	**2009 %**
Supervisory tasks	59.0	67,7
Off-site supervision	20,6	25,3
On-site supervision	9,1	2,6
Other supervisory matters	29,3	39,9
Drafting of rules	6.8	4.0
General operation	24.9	23.4
International co-operation/relations	9.2	4.8
	100	**100**

The Authority's budget for 2010 projects expenses, net of the cost of appeals committees, at a total of ISK 1,195 million. Total income, including interest income, is estimated at ISK 1,160 million.

Financial markets

The longest chapter of the 2010 Annual Report is concerned with financial markets. The chapter covers the credit market, securities market, pension market and the UCITS and insurance markets. The discussion of the credit market reveals that the total assets of the commercial banks, which account for nearly 90% of the credit institutions' total assets, have not shown significant fluctuations since October 2008, amounting to approximately ISK 3,000 billion, or close to double the gross domestic product. This is a similar proportion of GDP as at the end of 2003, when the privatisation of the banks had just been completed.

Figure 1 | Commercial banks' total assets
- Amounts in ISK billion and as a proportion of GDP

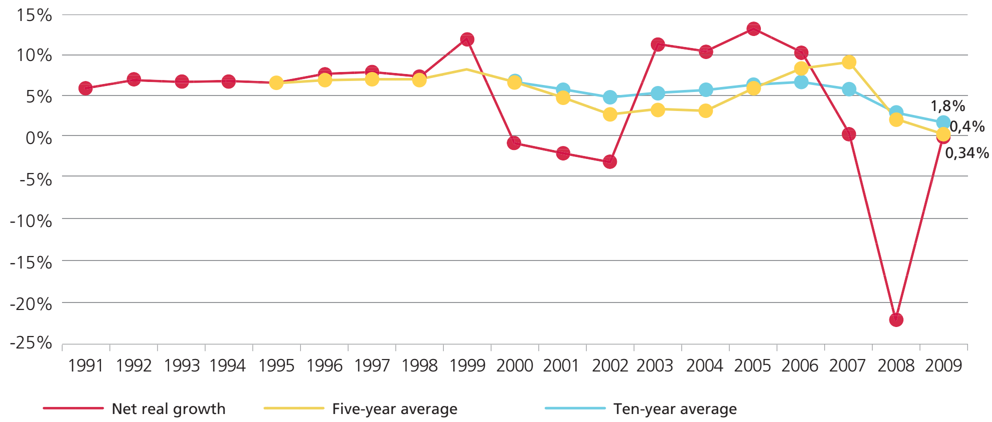


The discussion of individual markets also reveals that the financial results of the three large commercial banks were positive in 2009 as well as in 2010, but it should be borne in mind that there is still significant uncertainty as regards the quality of their loan portfolios. Looking at the equity ratios of the largest financial undertakings on 30 June 2010 reveals that it has never been greater.

Figure 2 | Market value of securities

Market trading in equities was slow following the collapse in the autumn of 2008. The volume of trading in the bond market, on the other hand, was significant even though bond issues were limited. Listed bonds and bills account for 87% of the market value of the financial instruments listed in the stock exchange. The corresponding ratio at year-end 2007 was less than 37%. The Icelandic market today is characterised by heavy trading in state-backed bonds. The real and nominal yield of these securities has fallen significantly from mid-year last year, one of the reasons being the growing demand for low-risk financial instruments.

Figure 3 | Pension funds' net real growth in 1991-2009

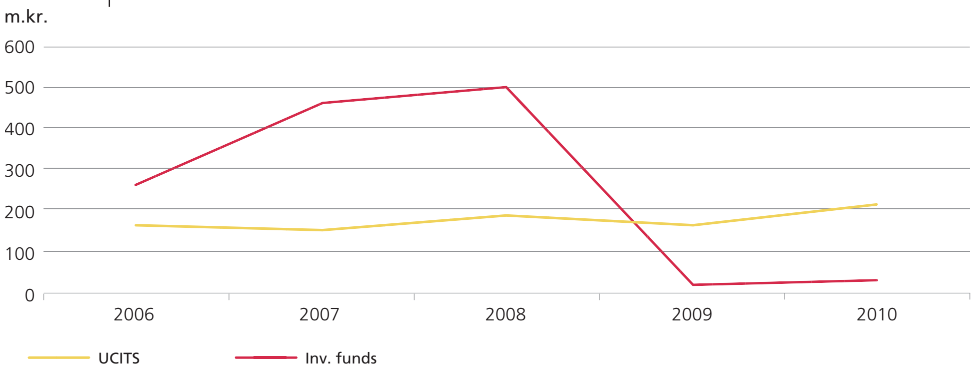


The Report reveals that the increase in the net assets of the pension funds from 2008 to year-end 2009 was 11.1%, which corresponds to a real increase of 2.2% over the consumer price index. The net real growth of the pension funds increased between years, amounting to 0.34% in 2009, as compared to a negative real growth of 22% in 2008. The actuarial position of the pension fund, net of liabilities, deteriorated in 2009 for the third consecutive year.

At year-end 2009, the asset structure of the pension funds' defined benefits sections was similar to the position in the year before. The proportion of variable income securities in their asset portfolios was reduced, however, at the expense of fixed-income securities in their defined contributions sections. The proportion was substantially reduced for the second consecutive year, this time from 51% to 41%.

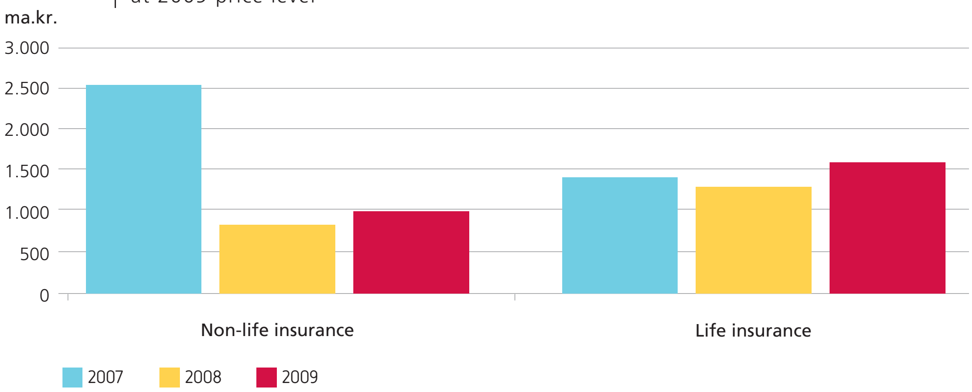
The assets of UCITS and investment funds increased by 32% between 2009 and 2010. It appears that the huge decline of the preceding year, which amounted to 72% between 2008 and 2009, is to some extent being reversed. In 2006 – 2008 assets belonging to investment funds by far exceeded the assets of UCITS, with the difference largely explained by the money market funds, whose assets at mid-year 2008 amounted to approximately ISK 400 billion. Following the collapse of the banks, UCITS unit holders appear to have channelled their investments into UCITS rather than investment funds.

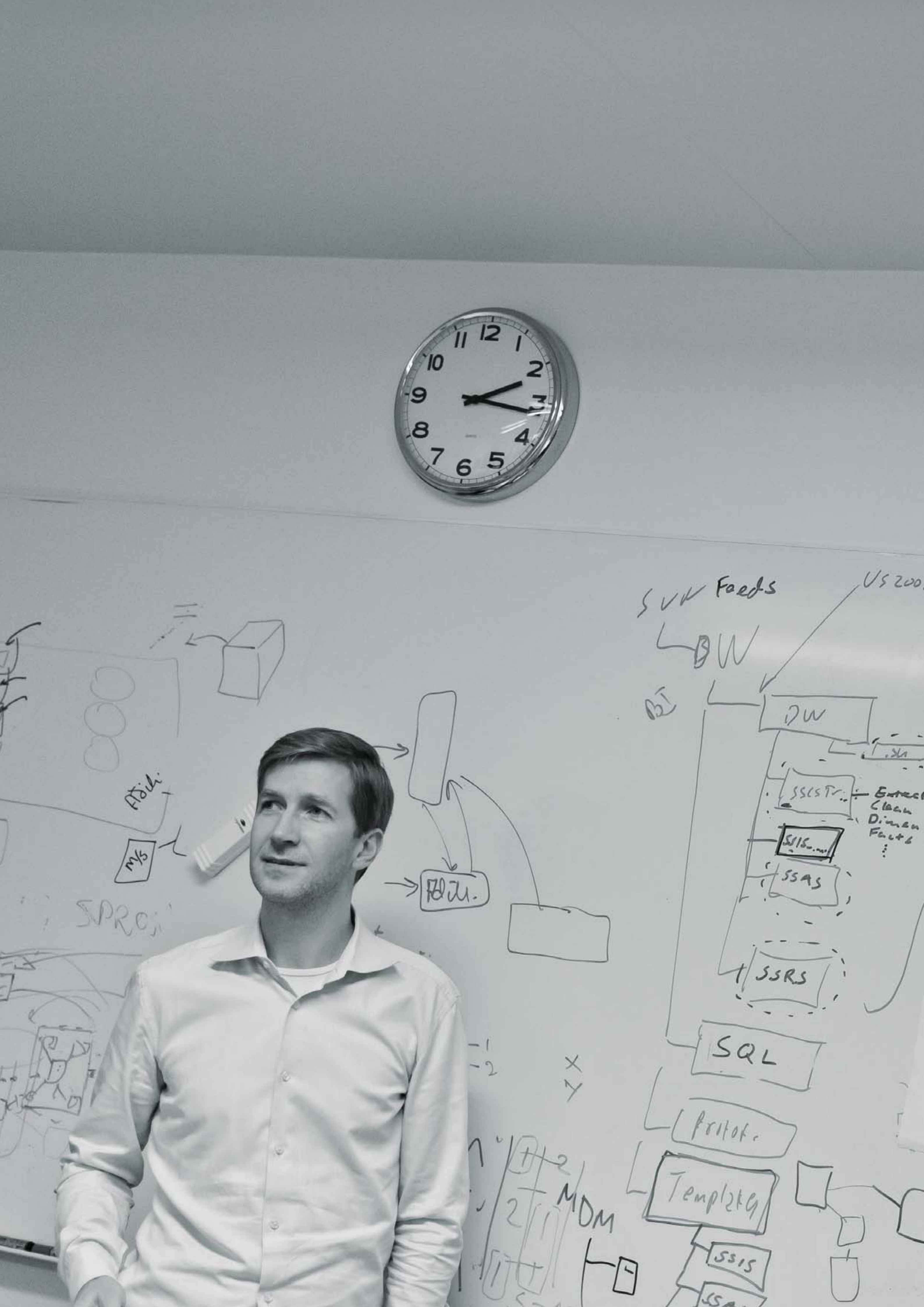
Figure 4 | UCITS and inv. funds' assets



The insurance sector saw a turnaround in non-life insurance activities, with most companies operating at a profit in 2009. All the five life insurance companies in Iceland showed a profit in 2009. Vehicle insurance is the single largest category of insurance in Iceland and has been operated at a profit on the whole in recent years. There were significant increases in premiums and incidents of damage in compulsory motor insurance in spite of indications of significant competition in the market.

Figure 5 | Profit from insurance companies' core operations at 2009 price level




DW
SSAS
SSRS
SQL
MDM
SSIS

Future prospects

Under the heading “Future Prospects,” Chapter 4 of the Report discusses advances in Information Technology, which has been under detailed review in the FME in recent months. Work was continued on developing the IT division in 2010, with staff increased from five to seven. The main focus is on the development of a data warehouse, document control and the internal organisation of the division with a view to increasing efficiency. Also, the FME intends to sharpen its focus on ensuring the quality of data from regulated entities and the electronic submission of documents to the Authority.

The Forensic Accounting division is a new division in the FME, started in April 2010. The purpose of the division is to introduce an interdisciplinary approach to the financial markets as regards supervision, proactive measures and audits. The division will work closely with other supervisory divisions, but at the same time it has been granted independent powers to take action, e.g. to conduct audits on its own initiative.

Among the topics of discussion in this chapter are the advisory committee on the eligibility and qualifications of board members of financial undertakings, which was discussed by the Director General in his introductory remarks. A separate section discusses the focus on risk analysis and risk management among regulated entities. The chapter goes on to discuss a sign-off project which was designed, among other things, to follow up on weaknesses in the risk management of the three banks, Arion Bank, Íslandsbanki hf. and NBI hf. The factors to be examined include board participation in decision-making, risk appetite, handling of large exposures and portfolio restructuring.

As regards the pension and UCITS market, the Pension Market and UCITS division reviewed the supervision that has been in place of the risk management systems of pension fund management companies. Among other things, new recommendations will provide for minimum procedures and criteria to be used by management companies in dealing with market risk.

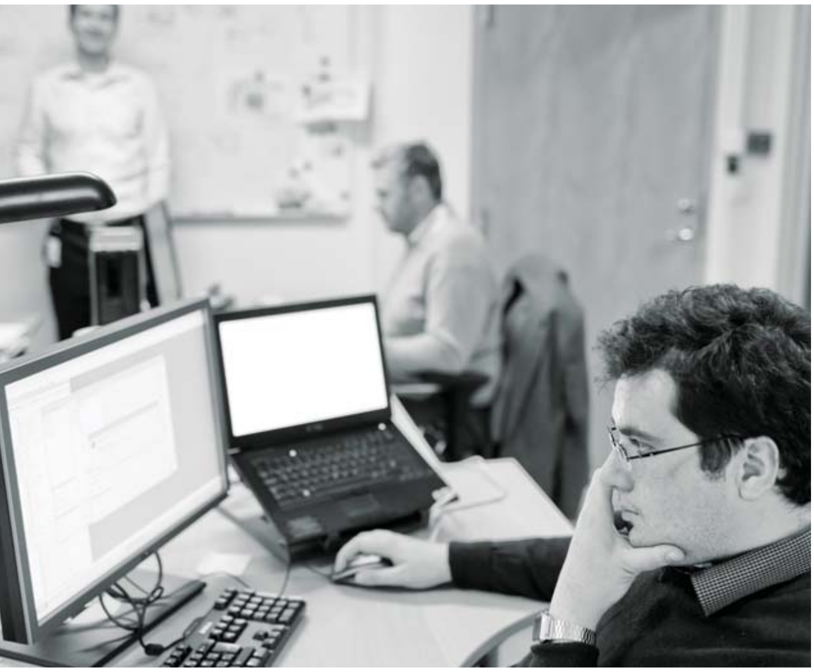
The Pension Markets and UCITS division began preparatory work on the publication of guidelines on pension fund risk management in 2010. Among the principal objectives of the FME’s recommendations is to establish a firm foundation and minimum requirements for pension funds’ risk management.

In the Insurance Markets division, the FME has been working on reviewing its recommendations designed to prepare insurance companies for the increased requirements entailed by the Solvency II directive and sharpen the requirements they will be required to meet. Also, the Insurance division has been working on a review of its risk analysis procedures for insurance companies.

Supervision of internal assessments conducted by financial undertakings of their own compliance with capital requirements

A separate chapter in the Report discusses the work of the Financial Supervisory Authority based on the Basel standards designed to assess the minimum capital requirements of financial undertakings. The implementation of Basel II has begun. The first of the three Basel II pillars was implemented in 2007. The second pillar enables the FME to assess the minimum capital requirements of financial undertakings based on an evaluation of their exposures. Financial undertakings are required to file a report outlining their own assessment of minimum capital requirements to meet potential future setbacks. It is the opinion of the Financial Supervisory Authority that new approaches will improve surveillance.

The Annual Report provides an account of the register of obligations that is new required under new provisions in the Act on Financial Undertakings No. 161/2002, enacted in June 2010. According to the Act, financial undertakings are required to send to the Financial Supervisory Authority an updated register showing obligations in excess of ISK 300 million, itemised by the name and identifier of each borrower. Also, financial undertakings are required to submit to the Financial Supervisory Authority information on all credit extended to related parties that are included in the register.



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New international focus

The final sections of the chapter on future prospects in the FME's Annual Report for 2010 discuss the new points of focus in the Authority's international work, covering the proposals for the reform of the Basel Rules and minimum capital requirements, the new liquidity regulations and proposals to reduce systemic risk and interconnectedness. The discussion also covers other recommendations of the Basel Committee and the interrelation between macro and micro supervision and the decision to aim for closer co-operation between the Financial Supervisory Authority and the Central Bank of Iceland on these matters. Finally, the chapter concludes with a discussion of relations with regulatory bodies outside Iceland and international co-operation.

The final two chapters of the FME's Annual Report for 2010 provide an overview of the number of regulated entities as at 30 June 2010, on the one hand, and some highlights from the annual financial Report of the Financial Supervisory Authority for 2009 with a comparison with the corresponding figures for 2008.

Board of Directors:

Kristin Haraldsdottir, vice chairman, Lilja Olafsdottir, chairman, and Jon T. Sigurgeirsson, board member (sitting from left).
Sigurdur Thordarson and Tryggvi Palsson, alternate board members (standing from left). Kjartan Gunnarsson, an alternate board member, is not in the picture.

Adminstration:

Halldora E. Olafsdottir, Head of Pension Market and UCITS, Gudmundur Jonsson, Head of Credit Market, Gunnar T. Andersen, Director General, Maria Ruriksdottir, Head of Forensic Accounting (sitting from left). Gudrun Jonsdottir, Head of Securities Market, Ragnar Haflidason, Deputy Director General, Jon Andri Sigurdarson, Head of Information Technology, Unnur Gunnarsdottir, Chief Legal Councel and Runar Gudmundsson, Head of Insurance Market (standing from left).