

ANNUAL REPORT  
OF THE FINANCIAL  
SUPERVISORY  
AUTHORITY  
**2013**



## **Annual Report – Financial Supervisory Authority 2013**

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## Contents

	From the Director General	7
<b>1</b>	<b>The Financial Supervisory Authority's tasks</b>	<b>10</b>
	1.1 On-site Inspections and Securities	10
	1.2 Off-site Supervision	10
	1.3 Oversight	11
	1.4 Additional tasks	12
	1.5 FME's Development Programme	12
	1.6 Operations and finance	14
<b>2</b>	<b>Financial market health</b>	<b>18</b>
	2.1 Credit market	18
	2.2 Securities market	20
	2.3 Pensions market and funds	23
	2.4 Insurance market	26
<b>3</b>	<b>Events of the past year</b>	<b>30</b>
	3.1 Highlights from July 2012 – April 2013	30
<b>4</b>	<b>Entities regulated by FME</b>	<b>36</b>
	4.1 Number of regulated entities	36
	4.2 Activities by foreign parties in Iceland	38



## Contents of the Annual Report

The substantial discussion in the Annual Report of the Financial Supervisory Authority (FME) for 2013 covers primarily the period from 1 July 2012 until 30 April 2013. For the first time, the Annual Report is published in the spring rather than in October or November. The report describes FME's main tasks, including extensive development projects. It also discusses the situation and developments on the credit market, securities market, pensions and funds market, and insurance market in 2012.

The Annual Report provides a table showing the number of regulated entities as of year-end 2012. It is available in Icelandic and English on FME's website, [www.fme.is](http://www.fme.is). A variety of information is also available there concerning the Icelandic financial market and the arrangements for official supervision of financial activities.

### FME's Board of Directors and management

A three-person Board of Directors is ultimately responsible for FME's administration. Its role is to specify the priorities in FME's work and to follow its activities and operations. All major decisions are to be referred to the Board for approval or rejection. The Board engages the Director General, who is responsible for FME's day-to-day administration. As of May 2013 the Board of Directors was comprised of Aðalsteinn Leifsson, assistant professor and Chairman of the Board, Margrét Einarsdóttir, assistant professor and Vice-chairman since 22 April 2013 (was previously an alternate director from 1 July 2012 to 21 April 2013) and Arnór Sighvatsson, Deputy Governor of the Central Bank, appointed by the Central Bank of Iceland. Alternates are Halldór S. Magnússon, former managing director, Ástríður Jóhannesdóttir, attorney, appointed from 22 April 2013, and Harpa Jónsdóttir, assistant managing director at the Central Bank of Iceland.

During the period from 1 July 2012 to 30 April 2013, in addition to the above-mentioned, the following persons have served on the Board of Directors of FME: Valgerður Rún Benediktsdóttir, acting office director, as Vice-chairman of the Board of Directors, appointed provisionally from 1 July to 1 November 2012.

### Director General

Unnur Gunnarsdóttir

### Heads of divisions

#### Chief legal officer

Anna Mjöll Karlsdóttir

#### Off-site Supervision

Halldóra Elín Ólafsdóttir

#### On-site Inspections and securities

Sigurveig Guðmundsdóttir

#### Acting managing director of Oversight

Lilja Rut Kristófersdóttir

#### Operations and Finance

Ingibjörg Sigrún Stefánsdóttir

#### IT division

Jón Andri Sigurðarson

#### Human Resources

Jakobína Hólmfríður Árnadóttir



## From the Director General



The difficult situation which prevails on European financial markets has led to increased reliance on regulators to foster stability and market confidence. This has progressed to the point where regulators are expected to foresee the most unexpected circumstances which may arise in the financial system, and to prevent them. A word of caution is in order with regard to overestimating supervision. As its name indicates, financial supervision to a large extent involves assessing post factum how successful business decisions were and whether they accord with laws and other rules of the game. It must be reiterated that the decisive factor is for responsible decisions to be taken by those persons at the helm of their companies, based on a suitable risk assessment and on accurate information. In a perfect world, supervision would be unnecessary. In our imperfect world, however, it serves as a security valve, for instance, if undertakings fail to satisfy the conditions for their licence or if sanctions need to be applied against statutory violations. FME's role is also to provide guidance, and to this end it issues a large number of instructions on market practice in the form of Rules, Guidelines and Interpretations.

What characterises the market now, almost five years after the collapse of the majority of the financial system? Are we headed in the right direction? In this annual report we discuss the health of the Icelandic financial system. The operations of the commercial banks were successful during the past year, with a combined after-tax profit of almost ISK 66 billion, compared to ISK 30 billion in 2011. Their capital ratios are also high by international comparison, at around 25% at year-end 2012. Their liquidity position is good, with around 17% of their total assets designated as liquid funds. Certain aspects, however, cause uncertainty. Among them are doubts as to the quality of loan portfolios, uneasiness in foreign markets and uncertainty concerning the removal of capital controls. Nor have we reached the end of the story concerning FX-linked loans, although the uncertainty regarding them has been reduced with three Supreme Court judgements pronounced in mid-2012. Furthermore, it is a cause for concern that fourteen Winding-up Boards are still at work on behalf of creditors of insolvent financial undertakings. These estates in winding-up hold stakes in actively operating financial undertakings, in which the Icelandic state also has a holding. The sales processes of these financial undertakings are approaching. Concluding this process in an economically favourable and efficient manner is an important aspect of regaining financial health.

Bond market turnover declined last year, while equity market turnover increased with the advent of new investment options, as the number of listed companies rose somewhat during the year. According to estimates, the net assets of Icelandic pension funds and personal pension savings held by custodians

grew substantially over the past year, by 12%, bringing their total assets to over ISK 2,500 billion at year-end 2012, compared to ISK 2,230 as of year-end 2011. Given the limits on pension funds' foreign investments, it is evident that the funds' need for investment has to be channelled into the domestic securities and real estate market.

Pension funds need to invest around ISK 130 billion annually, a considerably sum relative to the size of the Icelandic economy. It is important that investment opportunities are sufficient to prevent imbalances from developing in the market which could cause bubbles to form.

At year-end 2012, the total assets of all insurance companies in Iceland amounted to ISK 155 billion, increasing by over ISK 9 billion from the previous year. The operations of non-life insurance companies performed well last year as in the previous years. Operations of life assurance companies were stable as they have been in recent years. In contrast to non-life insurance companies, however, their profits decreased slightly year-over-year.

FME supervises the situation, operations and business practices of 113 undertakings licenced to operate in the financial market, as well as 233 other parties, including UCITS and investment funds and issuers of listed securities. This is sometimes referred to as microprudential supervision. In addition, the prevailing view is that FME should, in its work, endeavour to promote financial stability, and a draft bill of legislation proposes to establish a special Financial Stability Council, with the participation of FME, the Central Bank of Iceland, the Minister of Finance and the Minister responsible for financial market affairs, if the bill becomes law.

Recently, an ever-growing regulatory framework and demands from regulators for reporting and other time-consuming information disclosure has been criticised in words and writings. These criticisms are justified to some extent. For this reason, work is currently underway at FME to systematically review the documentation required of regulated entities by the Authority with the aim of reducing it as much as possible, while ensuring the quality of the information which is gathered and achieving the objective of having data delivered "from system to system" as this is referred to in-house. These improvements, which are part of FME's development programme, described in more detail in this Annual Report, are also important in connection with our participation as observer in three European regulatory bodies, the European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA) and European Securities and Markets Authority (ESMA).

The present report describes the financial market situation at year-end 2012. It also contains a description of FME's tasks, its operations and financials. Furthermore, as previously mentioned, it discusses FME's development programme, which is both extensive and ambitious in scope. The report also reviews significant events of the past year and provides a summary of the number of entities regulated by FME and the activities of foreign parties in Iceland.

It is our hope that the report demonstrates clearly that within FME work proceeds on many fronts and with concerted efforts to ensure the Authority supports and reinforces the Icelandic financial market while at the same time providing healthy and necessary discipline.

This is FME's first Annual Report issued in the spring; only six months have passed since the last report was published. From now on, FME plans to publish its Annual Report early in the summer.

### Investigations by FME of issues connected with the banking collapse have concluded

FME's Investigations into the events preceding the banking collapse in the autumn of 2008, which began immediately following the failure of the three large commercial banks, concluded in February this year. FME investigated a total of 205 cases. Complaints concerning 66 of these cases were lodged with the economic crime division of the National Commissioner of Police or the Office of the Special Prosecutor (OSP). Furthermore, 37 cases of alleged violations of the General Penal Code were referred to the OSP, making a total of 103 cases referred for further action.

	No. of cases
Complaints lodged with the OSP	66
Cases referred to the OSP	37
Administrative fines	4
Cases closed without further action	98
Total no. of cases	205

In a few instances, a single complaint concerned violations of a number of different statutory provisions of the Act on Securities Transactions and Act on Financial Undertakings. Furthermore, many complaints included alleged breach of fiduciary duty. The number of alleged offences was thus higher than the number of cases which have been referred onwards or complaints lodged.

Investigations revealed alleged violations in numerous categories of economic crime. Most prominent among them was market abuse, violations concerning large exposures, insider misconduct and breach of fiduciary duty. The most extensive cases involved alleged market abuse and breach of fiduciary duty. FME pointed out, upon the conclusion of investigations, that violations concerning large exposures could also be very extensive, involve very significant amounts and thereby contribute to undermining the financial stability of the banking system. The summary below shows examples of the types of offences, but is not exhaustive.

	Alleged offences by type
Market abuse	18
Insider trading	22
Breach of fiduciary duty	47
Large exposures	6
Act on Mandatory Guarantee of Pension Rights	6
Other violations of the Act on Financial Undertakings	9
Other violations of the Act on Securities Transactions	3
Act on UCITS and Investment Funds etc.	3
Act on Insurance Companies	2

As many as 15 experts within FME worked concurrently on investigations, with qualifications in business administration, law, engineering and economics. The investigation was split between two teams, showing special regard for employees' eligibility.

The investigating teams placed strong emphasis on working professionally and with integrity. They aimed at gathering sufficient data to shed as clear a light as possible on the series of events being investigated and based their decision concerning the outcome of the case on the relevant data.

## 1. FME's tasks

For over a year now, FME has operated under a new project- and process-oriented structure, enabling it to work on a cross-market basis, in contrast to its former organisation which was based on the sectoral division of the financial market. The objective of the changes was to increase the efficacy and co-ordination of activities, while adding flexibility and better utilisation of human resources.

FME's three supervisory divisions are On-site Inspections and Securities, Off-site Supervision and Oversight. In addition to the three supervisory divisions, it has three support divisions: Human Resources, Operations and Finance, and IT, as well as the offices of the Chief Legal Officer and the Director General.

### 1.1 On-site Inspections and Securities

On-site Inspections and Securities is responsible for on-site supervision, securities market regulation and preliminary investigation of economic crime. The division handles on-site inspections of the establishments of regulated entities which cover all aspects of their activities. Securities market regulation supervises trading and other activities in the securities market. This includes, for instance, monitoring investor protection, issuers' disclosure requirements, takeover obligations, market abuse, insider misconduct, treatment of inside information, reviewing and approving issuers' prospectuses etc. Following the banking collapse of 2008, listed companies declined sharply in number, but this trend has recently been reversed. A good number of new listings is expected in coming quarters.

Investigation of cases in connection with the financial market collapse was carried out under the auspices of On-site Inspections and Securities. It concluded at the beginning of 2013, by which time a total of 205 cases had been investigated. Increased consciousness in the market and of the general public has resulted in an increase in the number of notifications to FME. In accordance with FME's statutory role, a unit within the Authority, operating under this division, will continue to handle investigations of this sort.

Some of those employees who worked on investigations were transferred to other tasks within the division, joining forces with the strong group of on-site inspections. On-site Inspections and Securities now has employees with experience of evaluations, investigations, banking operations and regulatory work. Regulated entities are subject to different Acts and rules, requiring a broad knowledge in the group of their activities. On-site Supervision is intended to examine whether regulated entities operate in accordance with Acts and rules and follow sound and proper business practices, as well as verifying the veracity of the information received by FME from them through their regular reporting. Substantial expertise and experience in investigating economic crime has been accumulated by FME in connection with the investigations, making the Authority well prepared to deal with demanding tasks in this area in the future.

### 1.2 Off-site Supervision

Off-site supervision is FME's largest division; this division's activities focus on regular monitoring of regulated entities. The division is comprised of financial supervision, legal supervision and special legal issues.

Financial supervision is responsible for supervising financial undertakings, pension funds, UCITS and insurance companies. The group's role is to maintain an overview of the risks and situation of each individual regulated entity. Employees' tasks include, for instance, reviewing reports, special examinations and assessment of the eligibility of Directors and CEOs. Special responsible persons are appointed for all regulated entities, who serve as the main intermediaries between them and FME. Employees of the group are also involved in irregular examinations, such as credit evaluations, and take part in on-site checks. Legal supervision is responsible for handling licence applications, notifications of qualifying holdings,

requests for approval of mergers and takeovers of specific operating units, requests for approval of rule changes, confirmation of outsourcing contracts etc.

The special legal issues group was established to respond to the major demands made of FME with regard to transposition of EU Directives and Regulations. There has also been a very substantial increase in legal provisions obliging FME to issue rules on a large number of issues. The group also looks after tasks in connection with consumer protection on the financial market.

FME takes an active part in discussion of consumer protection in European fora. This discussion has focused on promoting transparency, simplicity and fairness towards consumers in the financial market. More detailed rules in this area can be expected in the near future. European co-operation often results in amendments to legislation or adoption of rules in connection with the transposition of Directives.

### 1.3 Oversight

The role of the Oversight division is to assess risk in individual sectors of the financial system and the market as a whole; monitor the development of risk; make proposals for emphases in supervision based on a risk assessment; and evaluate the need for possible intervention by FME. Oversight also directs a development project for the implementation of Risk-based Supervision (RBS) and improved data delivery. Oversight leads the Supervisory Review and Evaluation Process (SREP) for commercial banks and savings banks, the objective of which is to determine how much capital financial undertakings need to hold to cover their risks. Preparation is also underway in Oversight for the introduction of the EU Solvency II Directive, which will transform the operating environment of insurance companies. The introduction of Solvency II involves changes in arrangements for supervision and information on these changes must be communicated to insurance companies. Oversight handles the publication of statistical material and is responsible for implementation of FME's *ðlagaáætlun*.

#### Transposition of Directives

FME acts as both a supervisory and regulatory body. Due to Iceland's membership of the European Economic Area (EEA), it must transpose into Icelandic law the substance of Directives, Regulations and technical standards which apply to the financial market and have been adopted by the EU. This requirement is independent of the number of regulated entities or size of the financial market. By law, FME is assigned an extensive role in setting rules of this sort, in addition to which its participation is sought in adapting legislation on financial services. Following the economic difficulties, EU legislation has become ever more voluminous and complex, resulting in more work for FME's employees, firstly, in transposing it and, secondly, in informing and providing guidance for the market.

FME is currently working on preparations for the introduction of the EU Solvency II Directive<sup>1</sup> which will transform the working environment of insurance companies. FME is also preparing the introduction of the CRD IV Directive<sup>2</sup> and the CRR Regulation<sup>3</sup>, both of which require extensive changes to legislation on and supervision of financial undertakings. The transposition of the Directive on Alternative Investment Fund Managers (AIFMD)<sup>4</sup> will also mean additional tasks. Furthermore, major changes are forthcoming in the securities market with the introduction of EU Regulations on short-selling and changes to the basic securities market framework regarding derivative transactions. New laws on payment services and on the handling and issuance of electronic money will require the adoption of specific rules in these areas. This work is not expected to be completed until 2014.

1 DIRECTIVE 2009/138/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)

2 DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.

3 REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on prudential requirements for credit institutions and investment firms.

4 DIRECTIVE 2011/61/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

## 1.4 Additional tasks

FME's tasks have increased in number considerably since the economic collapse. Its additional duties include supervision of collection agencies, payment institutions and institutional investor funds, provisional supervision of winding-up boards, increased supervision of the Housing Financing Fund and, until year-end 2012, investigations of failed financial undertakings. In addition, at year-end 2011, review and approval of prospectuses was transferred to FME from NASDAQ OMX Iceland. Amendments to Act No. 161/2002, on Financial Undertakings, have also meant new tasks for FME in the form of supervisory authorisations, and the Authority has been assigned a wider role in assessing systemic risk and financial stability. In accordance with FME's strategy, increased emphasis has been placed on information dissemination and participation in public debate on financial market issues. To this end, FME began publication of an electronic journal, *Fjármál* (Financial Affairs), has increased the number of its press conferences and published announcements and information materials for the general public on financial market characteristics and developments.

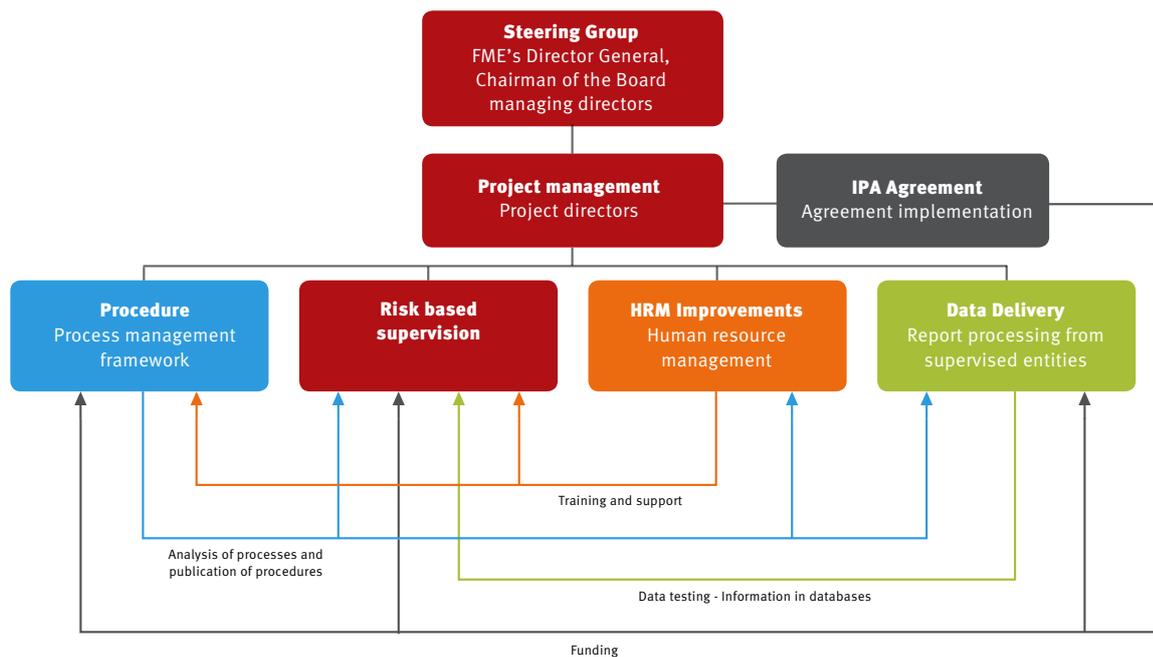
## 1.5 FME's Development Programme

The principal emphases in FME's internal activities are based on an action plan, approved by its Board of Directors in the latter half of 2011. The four development projects are to be carried out over the next three years. The projects are partially funded by grants from EU Instruments for Pre-accession Assistance (IPA), which were approved in March 2013. These are large-scale projects which will have a major impact on FME's activities. In preparing these projects, FME's employees have benefited from the technical assistance available to EU applicant countries, known as TAIEX<sup>5</sup> or Technical Assistance Information Exchange office. Employees have, for instance, gone on study visits to foreign financial regulators to boost their knowledge in the fields of risk-based supervision and human resource management. Applications for further assistance are planned for coming quarters.

At the beginning of 2012 a working group was established which is responsible for implementing the development projects together with project managers. Major emphasis has been placed on moving these projects forward, as they share the common objective of optimally utilising FME's funding and manpower. They are to be concluded for the most part by year-end 2015.

The principal purpose of the programme is to improve FME's work by introducing a project- and process-oriented structure, building up risk-based supervision, human resource training and development and reorganising data delivery from regulated entities to FME. The projects are discussed in more detail below.

<sup>5</sup> TAIEX is assistance in the form of knowledge transfer and advice, where experts from the administration of EU Member States provide member and applicant countries with assistance in preparing themselves for the obligations which EU membership involves. The assistance is made available during the accession process.



### Harmonised procedures

The project involves formulating, introducing and fixing in place documented procedures for all FME's activities. It is intended to enable the Authority to carry out its supervisory role and other statutory duties in a professional, active and successful manner. The objective is to harmonise procedures in carrying out supervision and to ensure consistency and traceability in FME's activities. Part of the project also involves FME's plans to fulfil the conditions of the Basel Core Principles for Effective Banking Supervision.

### Risk-based supervision

The purpose of the project is to formulate, introduce and fix in place risk-based supervision of regulated entities and regular risk assessment in the Icelandic financial system. It is intended to encourage prioritisation in supervising regulated entities and organising this in accordance with their assessed risk and importance for financial stability and for consumers. Doing so should mean better utilisation of the manpower and funding available in each instance.

### Improvements in human resource management

The objective of improvements in human resource management is to provide effective support for FME's activities by ensuring that all employees know their role, possess adequate expertise for their tasks and are well trained in the methodology to be applied in task-, process-, improvement- and risk-based supervision. The benefit gained is increased professionalism in working practices, efficiency and employee satisfaction.

### Data delivery

The purpose of this project is to analyse the data delivery process, improve data quality and consistency in utilisation of the data gathered. Furthermore, it aims at increasing the efficacy of supervision through better analyses based on more accurate data. The objective is to make the process more streamlined and efficient and to move from reporting to electronic data delivery. This results in increased efficiency and savings for both regulated entities and FME.

## 1.6 Operations and Finance

Regulated entities and other fee-paying entities, as defined by Act No. 99/1999, on Payment of Cost due to Official Supervision of Financial Activities, are to bear the cost of FME's operations. In its budget each year the Authority is to assess the relative costs for various categories of regulated entities during the preceding three-year period. This assessment, which is based each year on FME's employee time sheet records, also provides general information on its activities. The following table shows a breakdown of FME's working hours devoted to each main category of regulated entity in 2011 and 2012.:

<b>Relative distribution of FME working hours among categories of regulated entities *)</b>	<b>2011 %</b>	<b>2012 %</b>
Credit institutions	52.7	56.7
Insurance companies and insurance intermediaries	13.5	8.1
Pension funds	13.9	18.8
Fund management companies	8.9	8.5
Securities dealers and securities brokers	3.1	3.6
Equity and bond issuers	5.4	2.6
Other parties	2.5	1.7
Total	100	100

\*) Work on investigations of failed financial undertakings is not included in any of these categories.

FME's time sheet records also enable analysis of activities by type of task or subject. Such analysis of working hours in 2011 and 2012 is as follows:

<b>Relative distribution of FME working hours among its principal tasks</b>	<b>2011 %</b>	<b>2012 %</b>
Supervision	66,9	64,8
Off-site	17,5	22,2
On-site	3,2	8,1
Other supervisory activities	46,2	34,5
Regulatory framework	2,7	4,1
Administration and general operations	27,4	29,3
Foreign co-operation/relations	3,0	1,8
Total	100,0	100,0

Off-site supervision refers to examinations, monitoring and market vigilance of various types, based for the most part on regular information gathering by or reporting to FME. It also includes various specific inspections of the activities, business practices and operating rules of regulated entities. On site supervision refers to supervision tasks which commence with special on-site visits. The heading "Other supervisory activities" includes work in connection with granting of licenses, assessment of eligibility, sanctions, information dissemination, queries etc. This also includes most of the investigative work in connection with the banking collapse. General operations refers to work on FME's document management and archiving, IT, human resources, education matters and other aspects of regular operations and office administration.

### **Operations in 2012 and estimates for 2013 operations**

FME's endorsed annual financial statements for 2012 were not available when the Annual Report was finalised. The draft annual financial statements available, however, show that expenses including assets purchased in 2012 totalled ISK 1,745.5 million, while revenues, including financial income, amounted to a total of ISK 1,966.2 million. Of this, revenues from supervision fees were ISK 1,879.8 million. Revenues also include a special ISK 68 million contribution from the state in connection with FME's measures following the banking collapse, on the basis of the emergency legislation. According to the above, FME's operations had a surplus of ISK 288.7 million in 2012. The revenue surplus is due both to operating expenses which were below budget and higher independent revenues and revenues from supervision fees. The above-mentioned special state contribution has also had an effect. At year-end 2012, equity therefore amounted to ISK 622.9 million, compared to ISK 334.2 at the beginning of the year. Equity at year-end reduces supervisory fees the following year, in accordance with Act No. 99/1999, on Payment of Cost due to Official Supervision of Financial Activities. FME may, however, create a reserve within certain limits prescribed by the Act. The reserve authorised under this provision amounted to ISK 38.3 million of equity at year-end 2012. FME's annual financial statements for 2012 will be published on the Authority's website as soon as they are endorsed. Annual financial statements from previous years are also available on the website.

FME's budget for 2013 was approved by the Icelandic parliament Althingi in December 2012, with the adoption of the Bill presented by the Minister of Industries and Innovation amending the Act on the Levying of a Supervision Fee, i.e. Act No. 132/2012. The budget is accessible on the Althingi website as an accompanying document to the said Bill.

### **International co-operation**

FME's participation in international collaboration is an important part of its activities. It involves participation on committees of those institutions and organisations of which FME is a member. Such participation offers opportunities to follow the preparations for innovations to regulations and supervisory methods, especially in EU fora. The knowledge and connections acquired through such participation facilitate the work on introducing the rules in Iceland and harmonising supervisory methods. Participation in foreign collaboration also creates opportunities to communicate information on Iceland's experience of financial market supervision.

FME is an observer in the EU supervisory institutions ESMA – the European Securities and Markets Authority, EBA – the European Banking Authority and EIOPA – the European Insurance and Occupational Pensions Authority. It is also a member of an EFTA working group on financial services.

In addition, FME has regular exchanges with regulators in the Nordic countries on various issues concerning developments in financial activities and harmonisation of supervision. Following the financial market difficulties of recent years, collaboration between financial regulators and central banks in Europe, and between Nordic and Baltic countries especially, has been increased with the aim of promoting financial stability.

### **Improvements to the regulatory framework and supervision of financial activities**

In March 2012, the Minister of Economic Affairs published a report entitled *The Future Structure of the Financial System*, and concurrently a three-person expert committee (G3) was appointed comprised of former government Minister Jón Sigurðsson, Gavin Bingham and Kaarlo Jännäri. The G3 was entrusted with the task of reviewing the regulatory framework and arrangements for financial supervision in Iceland and internationally, together with developments in this area, with a view to how the flaws in both the regulatory framework and supervision of financial activities, which had been revealed in the financial crisis, could best be rectified. The conclusions of the expert committee were set out in a report to the Minister of Industries and Innovation, *The Framework for Financial Stability in Iceland*, which was published in October 2012. The report makes a variety of proposals for improvements to legislation to promote stability and cost-efficiency in the financial system, and to make it simpler and more effective. To follow up on the report, the Minister of Finance and Economic Affairs appointed a committee to discuss specifically the group's proposals concerning financial stability. This committee worked on a bill of legislation to establish a Financial Stability Council. The committee's proposals would also oblige FME to encourage financial stability through its work, and to increase its collaboration with the Central Bank of Iceland in this regard. The Minister of Industries and Innovation has also appointed two committees to follow up on the proposals of the G3. The first committee is to draft a bill of legislation on the winding-up and liquidation proceedings of financial undertakings, capital requirements of financial undertakings, interbank transactions and the interrelationship between a deposit insurance scheme and ideas for a special winding-up fund. The second has been entrusted with drafting a bill on granting of housing mortgages.

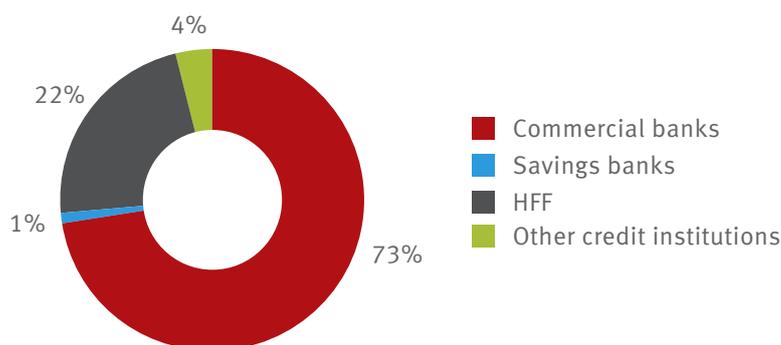


## 2 Financial market health

### 2.1 Credit market

At year-end 2012, 4 commercial banks, 9 savings banks and 6 credit institutions were operating in Iceland, in addition to the state-owned Housing Financing Fund (HFF), or a total of 20 credit institutions. During the year, the number of credit institutions decreased by 4, cf. the summary table in the final section of this Annual Report.

**Chart:** Relative distribution of credit institutions' assets



The commercial banks have operated under the shelter of capital controls since the autumn of 2008. The banks' operations were quite successful last year, and their combined after-tax profit amounted to almost ISK 66 billion, compared to ISK 30 billion the previous year. By international comparison their capital ratios are high, at around 25% on average at year-end 2012, and their Tier 1 ratio 22.2%. Their combined equity base amounts to ISK 553 billion and total assets to ISK 2,878 billion, with little change from the previous year. The size of the banking system is currently equivalent to around 170% of GDP. The banks' liquidity position is good, with around 17% of their total assets designated as liquid funds.

Despite their strong equity and liquidity, there are certain aspects which give rise to uncertainty and could have a negative impact on the banks' performance in coming quarters. Chief among them are uncertainty concerning the quality of loan portfolios; legal uncertainty concerning loans linked to foreign currencies, which admittedly is decreasing, as pointed out below; long-term funding in foreign currencies; unrest on foreign markets; and the uncertainty arising from the proposed removal of capital controls. In this connection, the proposed compositions of the three failed banks and their potential impact on financial stability is a major risk factor.

In mid-2012, three judgements were pronounced by the Supreme Court confirming the legality of loan contracts. In FME's estimation, these judgements are of considerable significance as precedents and result in reducing uncertainty concerning the impact on the banks' equity position. The response to the uncertainty which remains is to increase the banks' capital requirements.

The economic recovery slowed somewhat last year. GDP growth was 1.6%, compared to 2.9% the previous year. The rise in purchasing power, real housing price increases and growth of private consumption have all slowed. Unemployment has fallen, but more slowly than forecast. All of these factors affect the commercial banks' operating environment.

The debt situation of both corporates and households has improved. This is reflected in decreasing default rates,<sup>6</sup> which have not been lower since the new banks were established in the autumn of 2008. Defaults averaged around 8% according to annual results for 2012, compared to 13% the preceding year. Despite the decrease this is still high by international comparison. Much work remains to be done

<sup>6</sup> The measure of defaults here is facility-based.

<sup>7</sup> Definition of core operations: Net interest, fee and commission income, salaries and salary-related expenses, administration cost and write-offs of PPE and intangible assets.

on restructuring corporate and household debt, and uncertainty prevails concerning the durability of the restructuring already concluded.

Commercial banks' ROE averaged 13.9% in 2012 and return on total assets was 2.3%, which is a slight increase over the previous year. Profitability of core operations<sup>7</sup> has fallen to an average of 10.7% on equity and 1.8% on total assets, according to 2012 results, compared to 11.6% and 1.8% respectively the previous year.

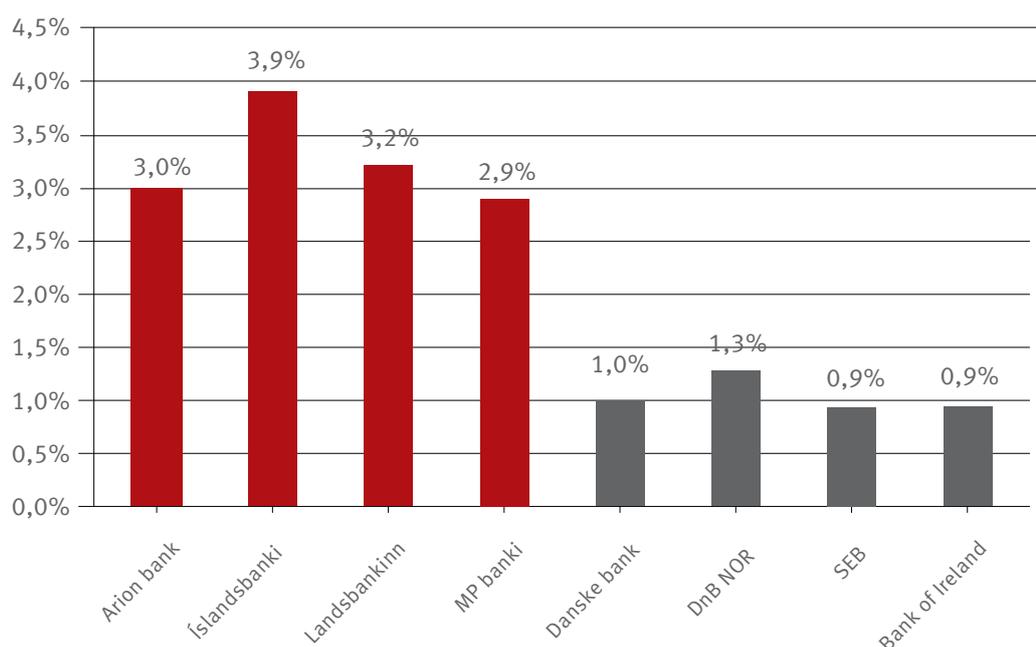
In 2012 the banks' interest margin averaged 3.5%. The interest margin has varied from one bank to the next, cf. the chart, as a result of varying methods of capitalising discounts on loan portfolios acquired from the old banks and, on the other hand, of the different composition of their assets and liabilities. Once capitalising of discounts concludes, the difference between the banks can be expected to be considerably less and their interest margin to be 3% on average. The banks' interest margin is considered high by foreign comparison<sup>8</sup> cf. the chart. One of the factors contributing to their high interest margin compared to that of foreign banks is the lack of economies of scale achievable in such a small market as that of Iceland. It may also make a difference that the interest margin of the Icelandic banks includes certain services which are separately designated as commission income by foreign entities. In addition, the banks' competitive position is very different from that of foreign banks.

The Icelandic banks' cost ratios are also high by international comparison<sup>8</sup> cf. the chart. The cost of core operations as a ratio of assets grew YoY. The principal explanations for the increased operating cost are restructuring of loans, increased salary expenses exceeding contractual wage increases, a variety of expenses in connection with mergers with other financial undertakings and various public levies. It is evident that unavoidable cost-cutting measures lie ahead for the banks.

HFF's situation is definitely worrisome, as the Fund's equity ratio has been dropping in recent quarters and its prepayment risk is considerable, especially in the current interest rate environment. The Fund's difficulties are substantial and finding a long-term solution is important.

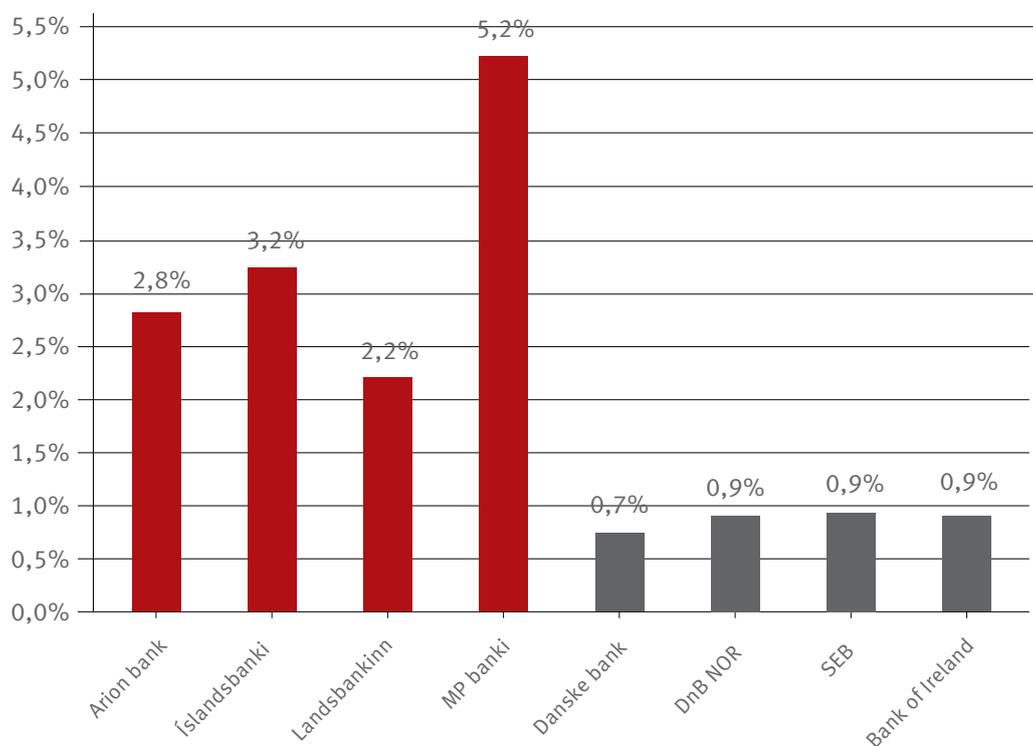
In 2012, the profits of the nine savings banks totalled ISK 363 million, but if extraordinary items are deducted, their profits were negligible. The book value of the savings banks' equity at year-end amounted to ISK 4.4 billion and their total assets to ISK 56.5 billion. The savings banks' situation remains fragile.

**Chart:** Interest margin – comparison with foreign banks<sup>8</sup>



<sup>8</sup> As of year-end 2012 for the Icelandic banks and as of year-end 2011 for the foreign banks.

**Chart:** Cost ratios – comparison with foreign banks<sup>9</sup>



## 2.2 Securities market

### Security market developments

While the equity market continued to expand in 2012, bond market turnover dropped. The advent of new investment options boosted equity market turnover, as the number of listed companies rose somewhat last year. It must be borne in mind that investment options are more limited while capital controls are in effect, causing a risk of asset bubbles forming.

### Equity market trends

Equity turnover rose by 29.3% in 2012 over that of 2011, increasing from ISK 68.4 billion to almost ISK 88.5 billion, and has continued to increase year-to-date in 2013. The increased turnover is due in part to the listing of new companies on the market, as shares of Hagar hf. were admitted to trading at year 2011 and those of Reginn hf., Eimskip hf. and FjarSKIPTI hf. in 2012. Despite the continuing increase over previous years, equity turnover is still rather low in an historical context and low liquidity has more often than not caused sharp fluctuations in equity prices.

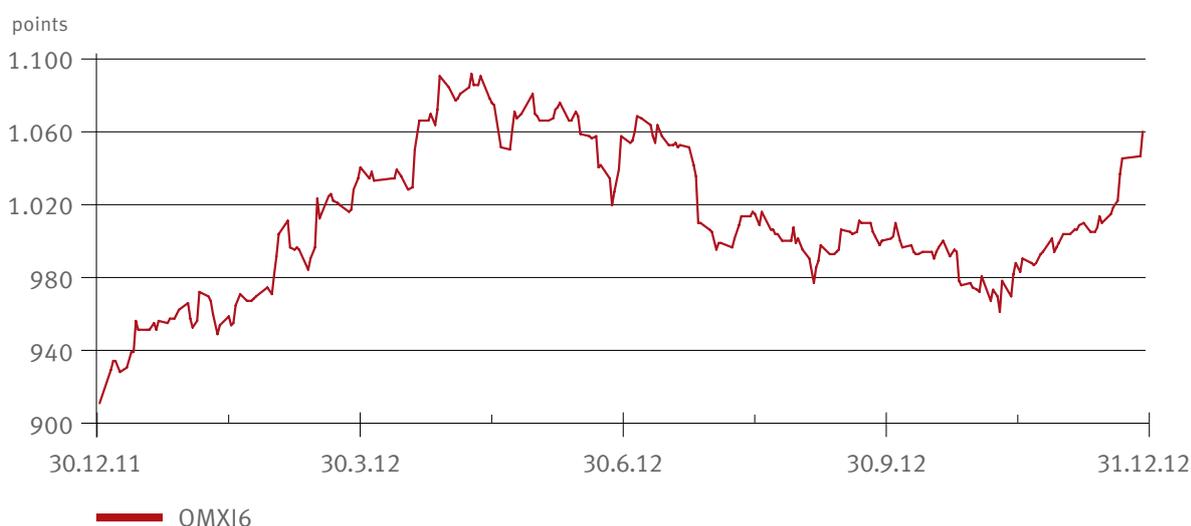
The OMXI6 selected shares index rose steeply during the first half of 2012, reaching a peak for the year at 1092 at the beginning of May, after increasing by 20% since the beginning of the year. This was followed by a decrease of approximately 12%, to a temporary low point of 960 in early November. After that the index began to climb once more and closed at 1059 at year-end. The increase from the beginning of the year to year-end was 16.5%, a turnaround from the previous year when the index fell by 2.6%. The index at the beginning of 2012 was 910. The market capitalisation of companies listed on the exchange as of year-end 2012 was around ISK 396 billion, compared to ISK 278 billion at the beginning of the year.

<sup>9</sup> As of year-end 2012 for the Icelandic banks and as of year-end 2011 for the foreign banks.

At the beginning of 2013 there were 15 companies listed on NASDAQ OMX Iceland, 11 on the main list and 4 on First North. As mentioned, three new companies were listed on the exchange in 2012. All of them met with a positive reception, all three IPOs were oversubscribed and all of these companies' shares rose considerably from their listing price. Investment options are expected to increase in the coming year, as a good number of companies in various sectors have either indicated that they intend to go public or have been reported to be considering listing. Their entry into the market can be expected to comprise a welcome addition for investors, who are faced with limited investment options due to capital controls, enabling them to increase the diversification of risk in their portfolios.

From the increase in leveraged share purchases, it appears that some market actors consider investment in POs to offer a secure return. Although all new listings to date have given a positive return, it should be borne in mind that investment in equities involves considerable risk.

**Chart:** NASDAQ OMXI6 Selected shares index

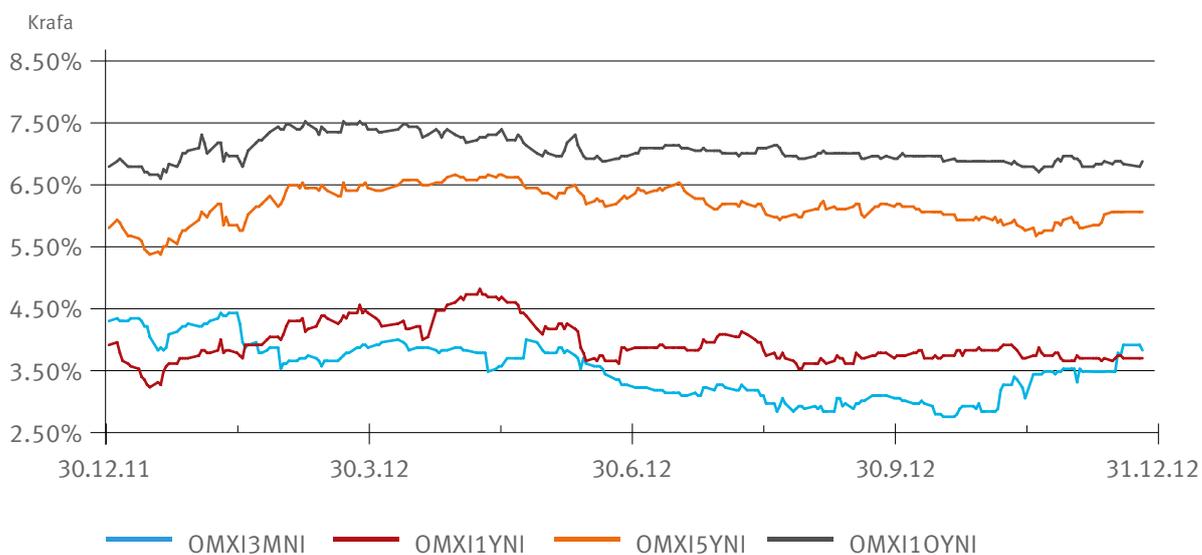


### Bond market trends

Unlike the equity market, where activity has been increasing, turnover on the bond market decreased by 10.7% in 2012. During the first half of the year, average monthly turnover was close to the highest seen since 2008, at almost ISK 242 billion. In the latter half of the year, however, monthly turnover dropped by almost 40% to 146 billion, resulting in a monthly average of just under ISK 194 billion for the year as a whole. As in previous years, turnover was highest in non-indexed Treasury notes, which comprised over 60% of total turnover in listed market bonds. The total market value of bonds listed on NASDAQ OMX Iceland at year-end 2012 was ISK 1,866 billion, following an increase of ISK 39 billion during the year. Of this amount, around 14% of listed bonds by value were issued by private entities while 86% were bonds of public bodies.

In 2012 yields on non-indexed short-term bonds dropped by 22-48 bp, but increased on longer-term bond classes by 6-25 bp. Yields on CPI-indexed 10Y bonds, as measured by the OMXI10YI index, fluctuated over a range of some 50 bp during the year, only to close almost unchanged from the beginning of the year while yields on indexed 5Y bonds according to OMXI5YI rose sharply during the first half of the year, by some 88 bp, then weakened again during the latter half to close at 73 bp higher.

**Chart:** Yields as reflected in NASDAQ OMX non-indexed bond indices Iceland



**Chart:** Yields as reflected in NASDAQ OMX indexed bond indices Iceland



The impact of capital controls and non-residents on market price formation was clearly visible in March 2012, in the tumult on the bond market following an announcement by the Central Bank of Iceland tightening rules on foreign currency. Prices for the Housing Financing Fund bond series HFF140915 fell immediately following the announcement by 13%, as non-residents had purchased the bonds in large quantities, and for a brief period their yields were negative. At year-end 2012, 48% of all Treasury bills and around 24% of Treasury bonds were owned by non-residents; they are most predominant in short-term bond classes, where they hold as much as 85%, while Icelandic pension funds are the leading owners of longer-term bonds.

The entry of financial institutions into the bond market to seek funding which began in Q4 of 2011 continued in 2012. Total turnover in bonds of financial institutions amounted to almost ISK 5.1 billion during this period. Trading in bonds issued by public authorities (the state, HFF and municipalities) still comprises 99% of bond market turnover, however.

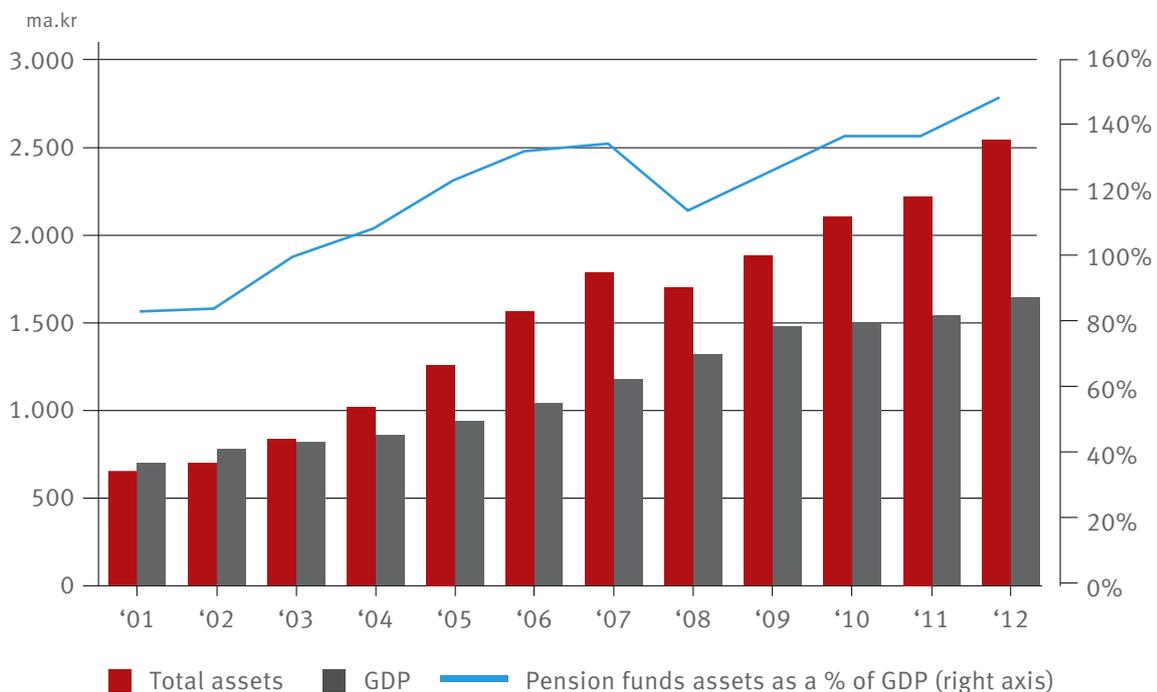
## 2.3 Pension funds and UCITS

### The pensions market

At year-end 2012, there were 32 pension funds operating a total of 82 mutual and private pension fund divisions. Of these 32, one fund no longer accepts contributions, reducing the number of fully operative funds to 31. Twelve funds enjoy an employer guarantee, while 20 have no guarantees. At year-end there were 8 custodians of private pension schemes other than pension funds, operating 35 divisions.

According to estimates, the net assets of Icelandic pension funds and personal pension savings held by custodians grew substantially over the past year, by almost 12%, bringing their total assets to over ISK 2,500 billion at year-end 2012, compared to ISK 2,230 as of year-end 2011. The increase in mutual insurance divisions was close to 14% due to a net inflow, while the proportional increase in private pension divisions was slightly less, at around 10%, due to increased disbursements based on special legislation authorising withdrawals on a temporary basis. Good returns in the past year also played a major role in this substantial asset increase: according to provisional figures, pension funds' weighted average net return is likely to be 7-8%. Assets of Icelandic pension funds and private pension custodians are estimated to be equivalent to around 148% of GDP. Iceland is likely to head the OECD list of countries' autonomous pension funds ranked by the size of their assets relative to GDP. It should be borne in mind in making this comparison that in many countries the public has considerable entitlements with insurance companies in the form of various types of pension products and company pension plans; such entitlements are not reflected in this comparison.

**Chart:** Assets of pension funds and private pension custodians / GDP

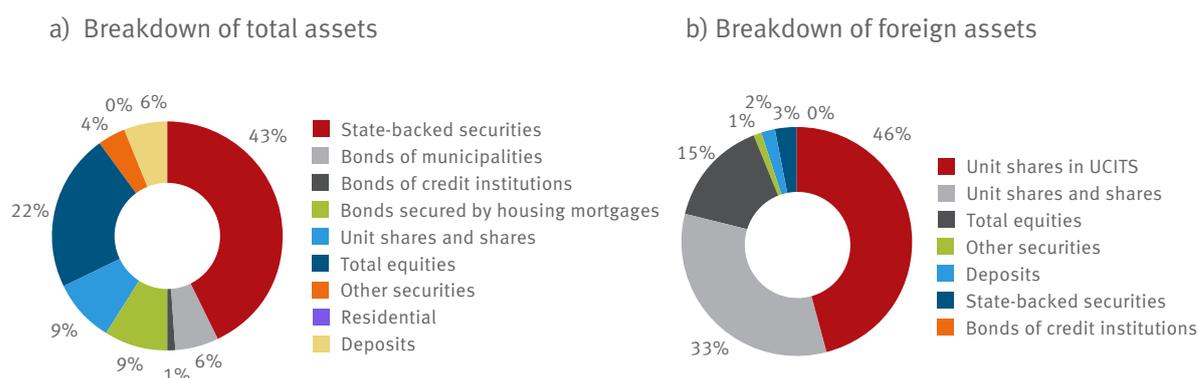


Good returns last year will clearly improve the actuarial status of pension funds' mutual insurance divisions, although their obligations have increased due to the rising age of the population. The conclusions of actuarial assessments for 2012 are not available but at year-end 2011 the actuarial deficit of the pension funds' mutual insurance divisions amounted to some ISK 667 billion. The largest share of this deficit was among funds guaranteed by the state and municipalities, which amounted to almost ISK 545 billion.

Given the limits on pension funds' foreign investments, it is evident that the funds' need for investment has to be channelled into the domestic securities and real estate market.

Their current net investment needs annually are estimated at around ISK 130 billion, or the equivalent of members' contributions plus returns on securities net of pensions paid. This is a considerable amount, given the size of the Icelandic economy, making it important to have sufficient investment opportunities to prevent market imbalances from developing which could result in the formation of bubbles in individual asset classes. Investments by pension funds in the Icelandic Enterprise Investment Fund and in newly listed companies on the domestic equity market appear to have been successful in the past year and have played their part in the funds' improved returns. To encourage a deeper and more efficient equity market it is important for additional investors to become active in the market and to increase the supply of investment options. The domestic securities market situation and restrictions on foreign investment have in part resulted in securities guaranteed by the state (state-backed securities) and municipalities becoming around half of the assets of the pension funds' mutual insurance divisions. By a conservative estimate, around 2/3 of these state-backed securities are HFF bonds. Chart a) shows the breakdown of assets as of year-end 2012, including the "underlying" assets of UCITS governed by Act No. 128/2011.

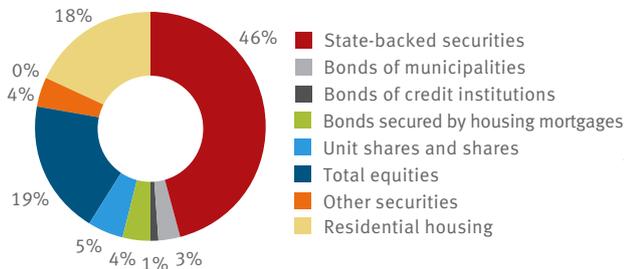
**Chart:** Breakdown of investments of pension funds' mutual insurance divisions at year-end 2012



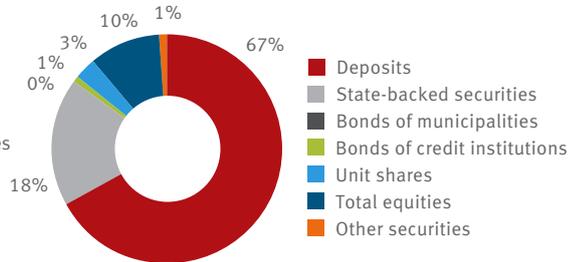
At year-end 2012, foreign assets of mutual insurance divisions amounted to around ISK 530 billion, or approximately 25% of their total assets. The return on these assets was very good this past year due to positive trends on foreign securities markets and, in part, to ISK weakening. A glance at the breakdown of foreign assets in Chart b) shows that the largest asset class is unit shares in UCITS. By far the greatest share of the underlying assets of these funds are in equities, primarily in listed equities. Around 1/3 of their assets are in unit shares of other funds for collective investment, which invest to a considerable extent in venture capital funds. According to the above, therefore, the majority of foreign assets are directly or indirectly in equities. The risk diversification of foreign assets must be considered good despite the high proportion of equities, due to very broad distribution over a large number of issuers by markets, sectors and countries.

**Chart:** Breakdown of investments of private pension savings at year-end 2012

a) Private pension savings of pension funds



b) Custodians other than pension funds



It is estimated that at year-end 2012 private pension savings managed by pension funds amounted to around ISK 236 billion and that private pension savings managed by other custodians totalled around ISK 140 billion. The asset breakdown of private pension savings managed by pension funds, shown in Chart a), differs clearly from that of the pension funds' mutual insurance divisions. Assets of private pension savings naturally need to be more liquid on short notice due to extensive withdrawal authorisations. It is noteworthy, however, how high a proportion of assets in private pension savings with custodians other than pension funds are in the form of deposits, which account for almost 2/3 of all assets. This is likely due to the fact that these parties have less locked-in savings and therefore the demand for asset liquidity is higher. Due to temporary statutory provisions which have been in force in recent years, individuals have been able to withdraw their assets within certain limits. This has resulted in a considerable outflow of private pension savings, especially from custodians other than pension funds. These withdrawals increased substantially in 2011, amounting to ISK 23 billion. Total disbursements in connection with the temporary provisions amounted to ISK 70 billion in 2009-2012. Following the publication of FME's Guidelines on risk management for mutual insurance divisions of pension funds and custodians of private pension savings in January 2013, FME expects the funds to devote concerted efforts to expanding risk management. The economic significance of pension funds increases steadily, making it important to give more concern to their risk management and long-term investment strategy, focusing on the interests of fund members and the economy as a whole.

### Management companies of UCITS, UCITS and investment funds, institutional investor funds

There were ten management companies regulated by FME at the end of 2012, an increase of one company over the previous year. Fund management companies are financial undertakings whose principal activity is to manage UCITS and other funds for collective investment.

The companies operate a total of 56 UCITS funds and fund divisions and 28 investment funds and fund divisions. At year-end 2012, total assets of UCITS and investment funds amounted to ISK 328 billion. Of this, assets of UCITS were just over ISK 255 billion and assets of investment funds just over ISK 71 billion. At year-end 2011, institutional investor funds came under the supervision of FME. Institutional investor funds are funds for collective investment which are only open to institutional investors. At year-end 2012, 47 institutional investor funds were operated by 10 management companies. Their total assets amounted to ISK 288 billion, and net assets to ISK 120 billion.

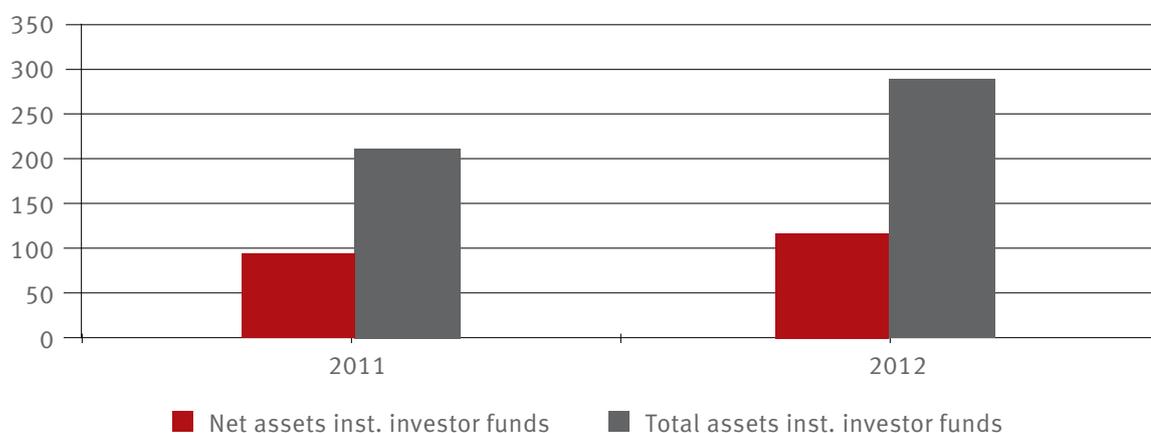
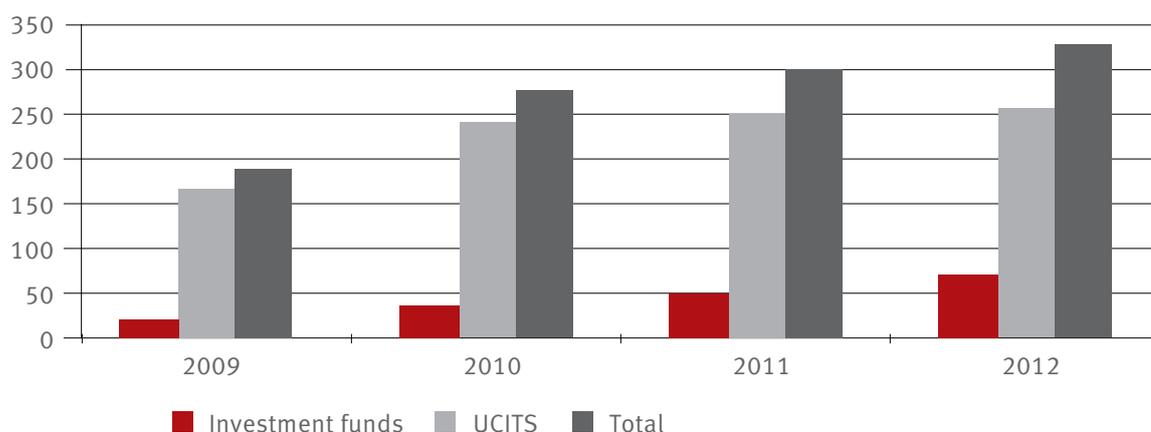
FME approves UCITS and investment funds, i.e. authorises a management company to operate such funds. In the case of institutional investor funds, FME receives notifications of the establishment of such funds.

### Assets of UCITS and investment funds

Assets of UCITS and investment funds increased by over ISK 28 billion during 2012, or by 9.5%. UCITS increased by almost ISK 7 billion during the year, or by 2.7%, while investment funds grew by over ISK 21 billion or by 43.1%. The increase in investment funds can be attributed to a large extent to the increase in investments in equities.

The great majority of assets of UCITS and investment funds (around 73%) are invested in bonds issued by or guaranteed by the Icelandic state. The remainder is in equities, deposits and UCITS.

**Chart:** Assets of UCITS, investment funds and institutional investor funds (ISK bn) at the end of each year:



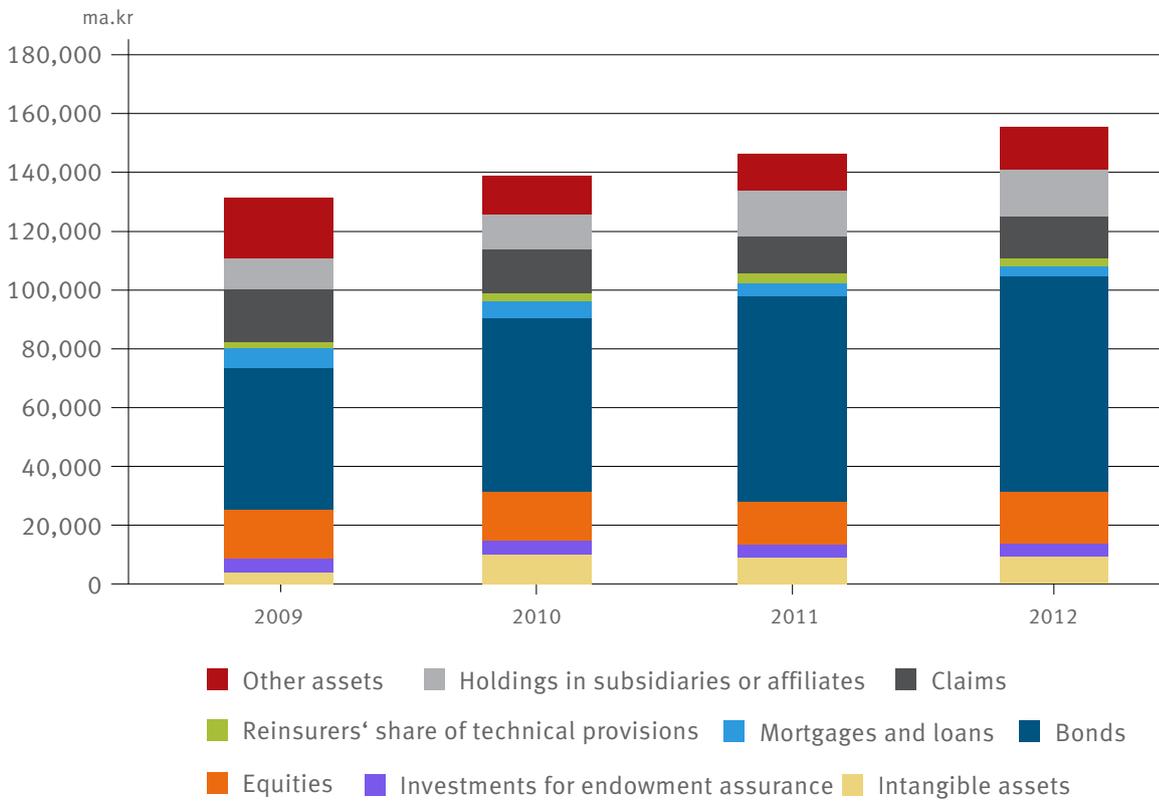
## 2.4 Insurance market

### On the insurance market in general

At year-end 2012, 13 insurance companies were licenced to operate by FME. Of these, five companies operate in the life insurance market and five in the non-life insurance market. One of them, European Risk Insurance Company hf., has no activities in Iceland. Íslensk endurtrygging hf. and Trygging hf. only settle older reinsurance obligations and the last one, Iceland's Natural Catastrophe Insurance, operates in accordance with special legislation.

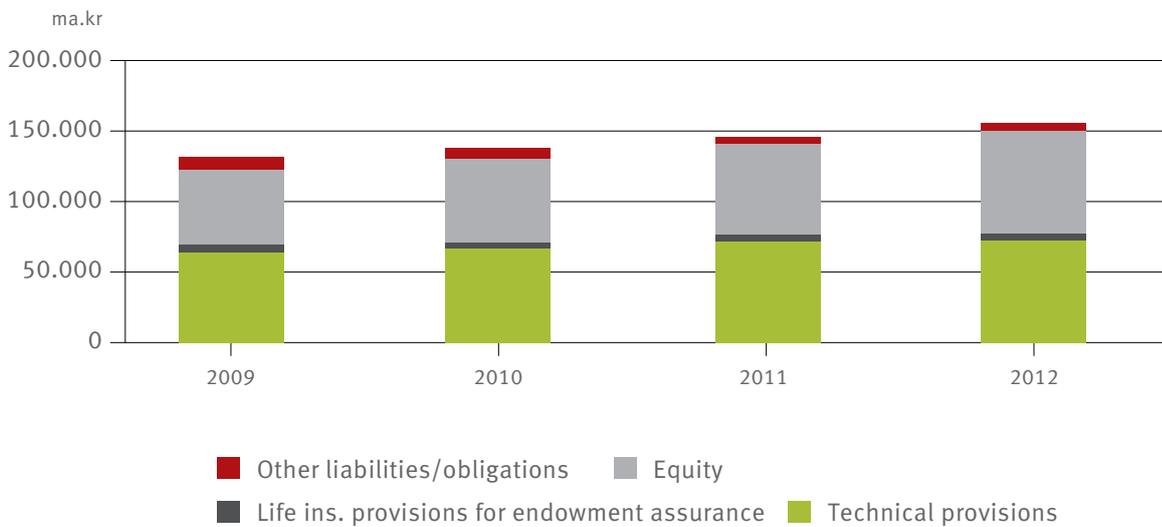
At year-end 2012, the total assets of all insurance companies in Iceland amounted to ISK 155 billion, increasing by over ISK 9 billion from the previous year. The chart below shows the development of assets and asset breakdown of insurance companies in 2009-2012. The companies' bond assets continue to increase and currently comprise half of their assets.

**Chart:** Insurance companies' assets and asset breakdown 2009-2012



The chart shows a breakdown of balance sheet liabilities for the same period. The equity position has improved steadily, while technical provisions have remained almost unchanged, their value decreasing in terms of fixed price levels.

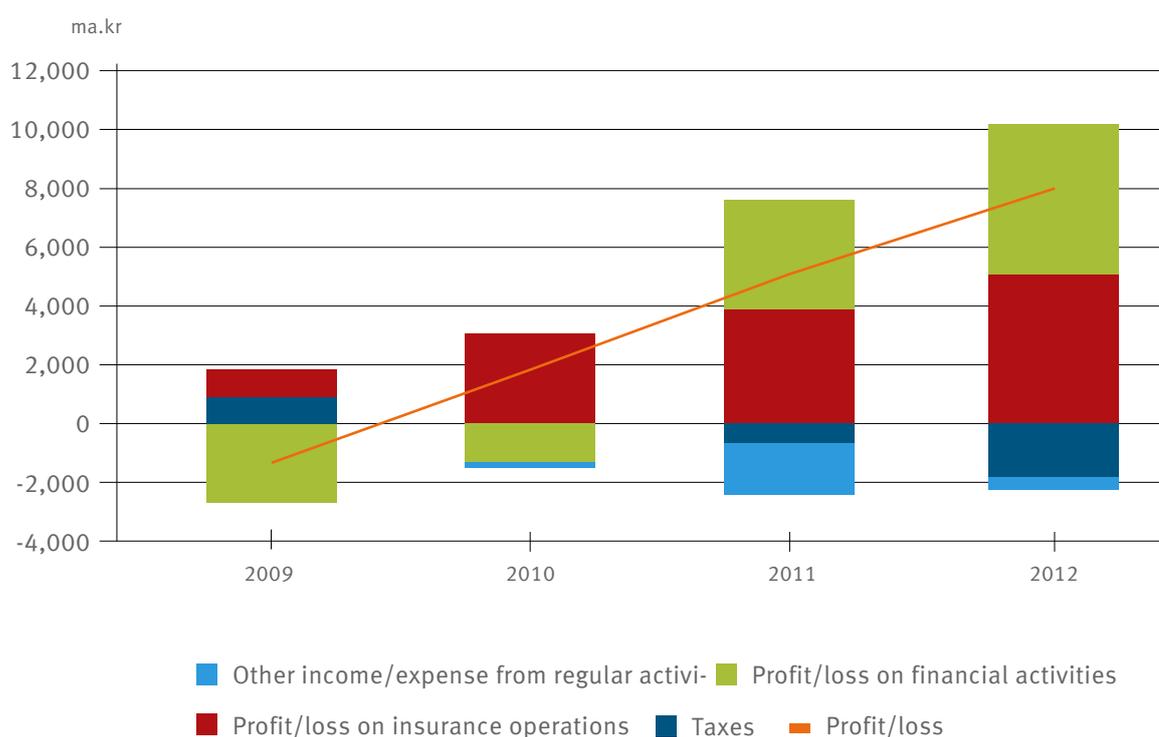
**Chart:** Insurance companies' equity and liabilities 2009-2012



### Operations of non-life insurance companies

The operations of non-life insurance companies performed well last year as in the previous years. The companies' combined profits amounted to around ISK 8 billion, compared to profits of ISK 4.8 billion the previous year. There were no major fluctuations from one year to the next, however, income from premiums increased and claims costs decreased. In addition, profit on financial operations rose by ISK 1.5 billion. The performance of non-life insurance companies is shown in the chart below. It shows that all aspects of operations improved their performance. It also reveals that non-life insurance companies paid considerably higher income taxes than in previous years.

**Chart:** Performance of non-life insurance companies 2009-2012

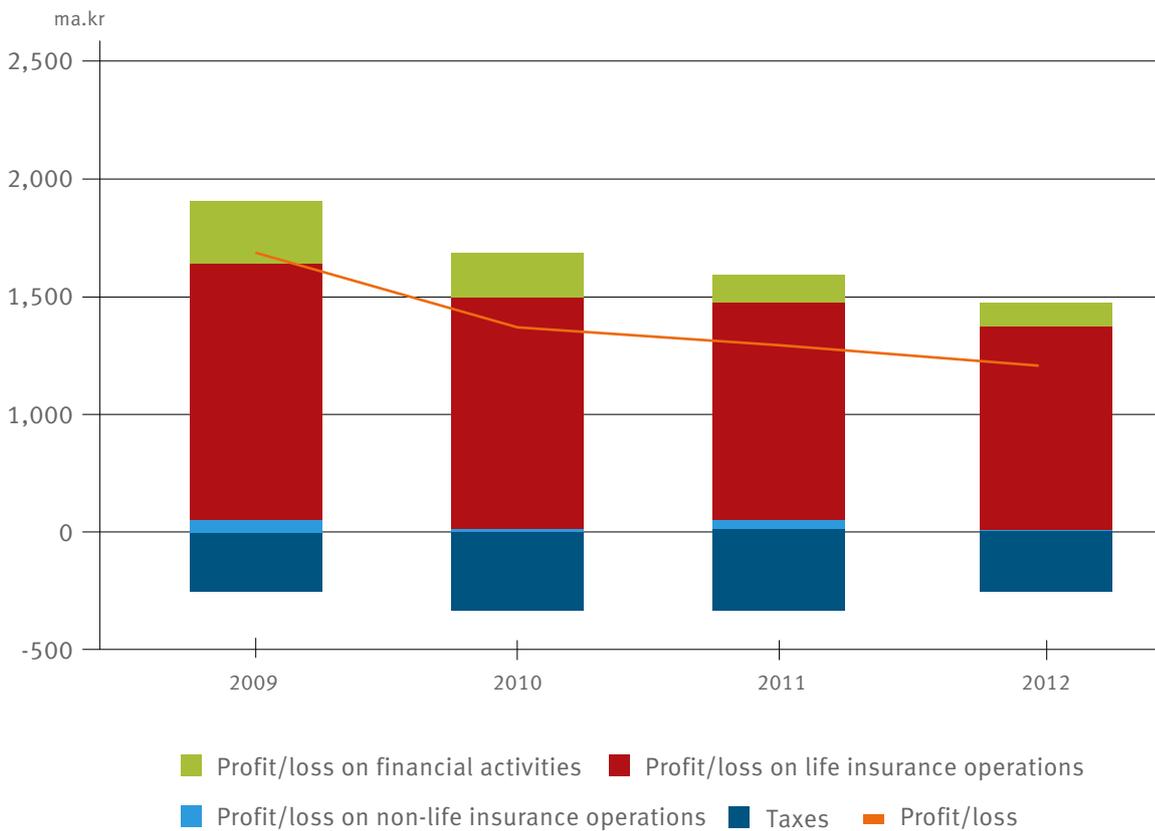


The equity of non-life insurance companies rose by 9.8% YoY, to an aggregate amount of over ISK 43 billion at year-end. At year-end 2012 all the non-life insurance companies satisfied minimum solvency requirements as provided for in Act No. 56/2010, on Insurance Activities.

### Operations of life insurance companies

In recent years operations of life insurance companies have been characterised by stability. In contrast to non-life insurance companies, however, their profits decreased slightly year-over-year. As the chart below shows, the main fluctuations are in profit on financial operations, but the decreasing profit on life insurance operations can also be explained by falling investment income in connection with these activities, i.e. the investment income which can be attributed to technical provisions.

**Chart:** Performance of life insurance companies 2009-2012



The equity of life insurance companies rose by 2.1% YoY, to an aggregate amount of ISK 6.4 billion at year-end. At year-end 2012 all the life insurance companies satisfied statutory requirements for minimum solvency. Total dividends paid by life insurance companies to their owners for 2011 amounted to ISK 1.3 billion last year.

## 3 Events of the past year

### 3.1 Highlights from July 2012 – April 2013

#### **FME discusses the pension funds' situation in 2011**

FME reviewed the situation of pension funds in 2011 at a press conference convened at the beginning of July 2012. It discussed the pension market in general in 2011, focusing especially on the situation of the five largest pension funds. Furthermore, the actuarial position of Icelandic pension funds was examined and their position by international comparison.

#### **Unnur Gunnarsdóttir appointed FME's Director General**

Unnur Gunnarsdóttir, who had served as FME's acting Director General since 1 March 2012, was appointed Director General at the beginning of July 2012. A law graduate of the University of Iceland, Unnur pursued postgraduate legal studies in both the UK and Canada. She was previously FME's Chief Legal Officer.

#### **Rules on pension funds' Audit Departments and independent pension fund supervisors**

At the beginning of July 2012, it was reported on FME's website that the Authority had set rules on pension funds' Audit Departments and independent pension fund supervisors. These were published in the electronic issue of the Official Journal of Iceland (Stjórnartíðindi) as Rules No. 577/2012. They are also accessible on FME's website.

#### **Parties carrying out seizure of assets must apply for a collection license**

Changes to the Collection Act were reported on the FME website on 12 July 2012, which added seizure of assets to the statutory definition of collection and added parties carrying out such asset seizure to the statutory definition of collection parties. Upon the entry into force of the Act, parties carrying out asset seizure in connection with primary and secondary collection measures were obliged to apply to FME for a collection licence. According to the Collection Act, primary collection is warning of impending collection actions and secondary collection is the collection actions which commence after a debtor has received a warning of impending collection and before legal collection commences.

#### **All financial undertakings now publish information on owners' names and proportional holdings**

In a news item on 12 July 2012, FME pointed out that the following provision had been added to the fourth paragraph of Art. 19 of the Act on Financial Undertakings: "A financial undertaking shall specify on its website the names and proportional holdings of all parties owning an interest of 5% or more in the undertaking."

#### **Comment from FME regarding the decision to rescue the insurance company Sjóvá**

On 13 August 2012, FME raised objections to news reporting by the television station Channel 2 and the radio station Bylgjan the preceding days, discussing losses by the Icelandic state in rescuing Sjóvá in 2009. This stated, firstly, that FME had demanded that Sjóvá be rescued and, secondly, that FME had placed strong emphasis on this. This was rejected in the announcement, and the following stated, among other things:

"The truth is that FME provided the authorities, including the Prime Minister, the Minister of Finance and the Ministry of Economic Affairs, with information on the situation, the parties' financial position, the legal status of customers upon bankruptcy etc. It is emphasised, however, that it was a political decision whether the Treasury would be involved in rescuing the company. FME did not demand that Sjóvá be rescued, nor is this its role. FME did not raise objections to the

decision by the Treasury to come to the assistance of Sjóvá, in consideration of the interests of the company's customers, including parties entitled to compensation and the financial market in Iceland.

The statement in Channel 2's news item, that other insurance companies offered to take over Sjóvá's insurance portfolios, is also incorrect. They did not make a formal attempt to test this, and to do so they would of course have needed considerable financial strength."

### **Changes to FME's Board of Directors**

On 8 August 2012, it was announced that changes had been made to the Board of Directors of FME. Valgerður Rún Benediktsdóttir, office director, had been appointed a director, replacing Ingibjörg Þorsteinsdóttir who had been granted a temporary leave of absence as director. Valgerður Rún was appointed temporarily from 1 July to 1 November 2012. In addition, assistant professor Margrét Einarsdóttir had been appointed an alternate director, replacing Sigurður Þórðarson. Margrét's appointment was valid from 1 July 2012 to 30 December 2014.

### **Summary of financial undertakings' annual financial statements for 2011**

On 24 September 2012, FME published a report on the overall results of the annual financial statements for 2011 from financial undertakings, providing summary information on commercial banks, savings banks, credit undertakings (collectively referred to as credit institutions), securities dealers, securities brokers and management companies of UCITS as well as on UCITS and investment funds.

### **Third issue of Fjármál published**

The third issue of FME's electronic journal Fjármál was published on 10 October 2012. The journal included an article by Skúli Magnússon and Hjálmur Nordal on temporary activities of financial undertakings in unrelated operations, as considerable success had been achieved in reducing such activities. Valdimar Þorkelsson wrote an article entitled "What is a prospectus and what questions can it answer?" The third and final article in the issue was the article "Improvements to the organisation and activities of FME and amendments to the regulatory framework of the financial market since the autumn of 2008" by Ragnar Hafliðason.

### **FME Annual General Meeting 2012**

FME's 2012 Annual General Meeting was held on 24 October in Salurinn, the concert hall in Kópavogur. Speakers at the meeting were Aðalsteinn Leifsson, Chairman of the Board of FME, FME Director General Unnur Gunnarsdóttir and Charlotte Sickermann, from the EU Commission.

### **New rules on implementation of the eligibility assessment of CEOs and directors of insurance companies and financial undertakings**

New rules on how the eligibility of CEOs and directors of insurance companies and financial undertakings is to be assessed were issued by FME in October 2012. These rules specify more precisely the views and criteria upon which FME bases assessment of the financial independence of CEOs and directors of the respective financial institutions. The rules were adopted in part in response to a decision by the Data Protection Authority concerning these aspects.

### **Outcome of an examination of the implementation of a private offering of shares in Eimskipafélag Íslands hf. by Straumur Investment Bank hf. and Íslandsbanki hf.**

On 15 November 2012, FME published the results of its examination of the implementation of a private offering of shares of Eimskipafélag Íslands hf. which took place on 23-25 October 2012, on the basis of Act No. 87/1998, on Official Supervision of Financial Activities and Act No. 108/2007, on Securities Transactions. The examination was directed exclusively at how the private offering

was carried out. A public offering of shares in Eimskipafélag Íslands hf. was held from 30 October to 2 November 2012. FME found no examples of transactions having taken place based on inside information.

#### **Examination of whether the Icelandic Securities Depository hf. and the securities clearing environment in Iceland satisfies recommendations for secure securities settlement.**

During the winter of 2011-2012 FME, in collaboration with the Central Bank of Iceland, carried out an examination of arrangements in Iceland for settlement of securities transactions and the settlement system of the Icelandic Securities Depository hf. The examination focused on whether securities clearing in Iceland and the settlement system of the Icelandic Securities Depository satisfied the recommendations of the European Central Bank and the Federation of European Securities Exchanges (CESR) for securities settlement systems.

A summary of the information was published in an attachment to the news announcement concerning the examination on 23 November 2012.

#### **FME issues guidelines on information systems of regulated entities**

On 12 December 2012 FME issued Guidelines No. 1/2012, on IT Systems of Regulated Entities. During the consultation phase, around 84 comments were received from various parties, 41 of which were taken into consideration in part or in full. Following the review of comments, the draft guidelines were emended and submitted to FME's Board of Directors on 28 November last year, where they were adopted as Guidelines on the Operation of IT Systems No. 1/2012. The Guidelines were published on FME's website.

#### **New rules on the treatment of inside information and insider trading, together with Guidelines from FME on implementation of these Rules**

A news announcement on 14 December 2012 drew attention to the fact that earlier that month new rules on the treatment of inside information and insider trading, No. 1050/2012, had been published on the website of the Official Journal of Iceland (Stjórnartíðindi). In tandem with publication of the rules, FME issued Guidelines No. 2/2012, on their implementation. The Guidelines were issued to provide securities market actors with general directions concerning individual provisions of the Rules, to explain in more detail the minimum requirements they make for handling inside information and on insider trading. The Guidelines go over the main provisions of the Act on Securities Transactions, No. 108/2007, concerning this area and discuss in general terms the purpose of the applicable rules.

#### **Fourth issue of Fjármál**

The fourth issue of FME's electronic journal Fjármál was published on 19 December 2012. This issue contained four articles by FME employees. Björn Z. Ásgrímsson discussed Icelandic pension funds in international comparison, as of year-end 2011; Sigurveig Guðmundsdóttir examined FME's notifications on transparency; and Guðmundur Örn Jónsson described the Credit Registry which FME is currently compiling. Finally, Helga Rut Eysteinsdóttir discussed FME's supervision of actions to combat money laundering and terrorist financing.

#### **Course on the breakdown of investments for pension funds and custodians of private pension savings**

On 17 January 2013, FME arranged a course intended for employees of pension funds and other custodians of private pension savings. The course included a review of FME's new structure, electronic reporting and completing a report on the breakdown of investments, investment authorisations, classification of investments, new interpretations by FME concerning Act No.

129/1997 and more. Shortly thereafter a course was held on completing a report on the breakdown of investments of pension funds and other custodians of private pension savings.

### **FME concludes its investigations of cases connected to the banking collapse**

On 14 February 2013, FME held a press conference to mark its conclusion of investigations of cases connected to the banking collapse. At this meeting Director General Unnur Gunnarsdóttir and Sigurveig Guðmundsdóttir, managing director of FME's On-site Inspections and Securities division, discussed among other things the number of cases investigated, in how many cases complaints had been lodged with the Office of the Special Prosecutor, how many cases had been referred to this Office and how many cases had been concluded without further action. They also provided a breakdown of the main offences and described in general terms examples of offences.

### **Examination of whether life insurance companies satisfy their disclosure requirements under Art. 65 of Act No. 30/2004, on Insurance Contracts.**

In a news announcement at the end of February 2013, FME reported that the Authority had recently carried out an examination of how life insurance companies provided their customers with the information referred to in Art. 65 of Act No. 30/2004, on Insurance Contracts. The provision lists in detail what information is to be disclosed before a life insurance contract is concluded and while the contractual relationship is in force. The information must be provided in writing and in a clear and comprehensible manner. The transparency announcement providing the results of the examination was also published on FME's website.

### **Rules on the implementation of eligibility assessment for pension funds and the Housing Financing Fund (HFF)**

FME first reported in March 2013 that the Authority had adopted two new Rules on the implementation of eligibility assessment, Rules No. 180/2013, on the Implementation of Eligibility Assessment of CEOs and directors of pension funds, and Rules No. 181/2013 on the Implementation of Eligibility Assessment of the CEO and directors of the Housing Financing Fund. Both rules were approved by FME's Board of Directors on 6 February this year and were published in the Official Journal of Iceland on 27 February.

### **New issue of Fjármál published**

A new issue of FME's electronic journal Fjármál was published on 25 March 2013. It included the article "Has Iceland achieved acceptable success in dealing with loans in default?" by Stefán Þór Björnsson. Another article entitled "Consumer Protection on the Financial Market" was written by G. Áslaug Jósepsdóttir and Valdimar Gunnar Hjartarson. In addition, Elvar Guðmundsson discussed the publication of the results of assessment of equity requirements according to SREP and Rúnar Guðmundsson discussed the increase in the number of cases referred to the Insurance Complaints Committee, of which he is chairman. The issue also included a brief interview with Unnur Gunnarsdóttir, Director General of FME.

### **Judgement in the case of the pension fund Stapi v FME**

At the end of March 2013, FME reported on its website that the Reykjavík District Court had pronounced its verdict in the case brought by the pension fund Stapi against FME concerning a supplementary supervision fee for assessment of the eligibility of Stapi's directors. The conclusion of the Court was to invalidate FME's decision on the supplementary supervision fee.

### **FME sends credit institutions recommendations for recalculation of exchange-rate-linked loans**

Around mid-April 2013 FME sent credit institutions, winding-up boards of financial undertakings and their subsidiaries recommendations on the occasion of a second round of recalculations of loans linked to the exchange rates of foreign currencies. FME recommended that credit institutions send those borrowers whose FX loans they considered to be lawful a letter explaining the grounds upon which this conclusion was based. FME also recommended that this letter provide information as to the actions open to customers if they did not wish to accept the lender's decision.

### **Leveraged share purchases are risky**

Following news of investors' growing interest in leveraged share purchasing in the daily Morgunblaðið on 16 April 2013, FME placed a cautionary announcement on its website. By so doing, FME wished to draw the special attention of retail investors to the risk involved in such transactions.

It pointed out that leveraged share purchases, where investors themselves provide only part of the purchase price, were by their nature high risk transactions and conducive to increasing volatility of returns, whether profit or loss. In the end, such investment can cost an investor losses which they cannot afford to lose. FME pointed out that capital controls and the investment environment which currently prevails in Iceland provides no certainty as to a positive return on equities. All investment, including investments in equities, involve risk and investors are always in danger of losing their funds partially or in full.

### **Position of Deputy Director General advertised**

On 19 April 2013, FME invited applications for the position of Deputy Director General of FME, to take part in FME's further development and to direct, together with the Director General, FME's work on financial stability and in formulating its strategy for general financial market supervision. This is a new position in the current organisational structure. The Deputy will serve as acting Director General in the latter's absence.

### **FME seminar on insiders and insider information in public administration**

FME arranged a seminar on insiders and insider information in public administration on 23 April 2013. Lectures were delivered by Inga Dröfn Benediktsdóttir and Harald Björnsson, employees of FME's On-site Supervision and Securities division. The seminar was attended by persons from the Central Bank, HFF, the Ministry of Industries and Innovation, the Ministry of Finance and additional public bodies. It dealt with FME's rules on treatment of inside information and insider trading and the Guidelines on implementation of these Rules and how they affect public servants and public sector activities.

**FME published the following decisions and transparency announcements during the period from 01 July 2012 until 30 April 2013**

- 2 July 2012** Transparency announcement in connection with FME's confirmation of the qualifying holding of Vörður Insurance hf. in Vörður Life Insurance hf.
- 12 July 2012** Conclusion of an examination of procedures of Arion Bank hf. in client classification with regard to investor protection
- 17 August 2012** Transparency announcement in connection with FME's confirmation of the qualifying holding of Vátryggingafélag Íslands hf. in Lífrýggingafélag Íslands hf.
- 1 Oct. 2012** Announcement of reissuing of an operating licence to Jökla-Verðbréf hf.
- 17 Oct. 2012** Conclusions of an on-site inspection in connection with the issuance of covered bonds by Íslandsbanki hf.
- 18 Oct. 2012** Conclusion of an examination of procedures of Straumur Investment Bank hf. in client classification with regard to investor protection
- 25 Oct. 2012** Conclusion of an examination of the status and activities of the commercial banks' Internal Audit divisions
- 6 Nov. 2012** Conclusions of on-site inspection of the loan portfolio of Arion Bank hf.
- 9 Nov. 2012** Conclusion of an examination of procedures of Arion Bank hf. in client classification with regard to investor protection
- 13 Nov. 2012** Conclusion of an examination of the activities of the management company Júpíter rekstrarfélag hf.
- 15 Nov. 2012** Conclusions of an examination of the implementation of a private offering of shares in Eimskipafélag Íslands hf. by Straumur Investment Bank hf. and Íslandsbanki hf.
- 21 Nov. 2012** Transparency announcement concerning an examination of working practices of Drómi hf.
- 26 Nov. 2012** Transparency announcement concerning an examination of working practices of Lýsing hf.
- 29 Nov. 2012** Transparency announcement concerning an examination of working practices of Arion Bank hf. in connection with B.M.Vallá hf.
- 11 Dec. 2012** Conclusion of an examination of certain details in the capital report of Arion Bank hf.
- 11 Dec. 2012** Conclusion of an examination of the investments and investment decisions of the Bank Employees' Pension Fund
- 11 Dec. 2012** FME has assessed Sigurður Kristinn Egilsson as eligible to exercise a qualifying holding in ALM Fjármálaráðgjöf.
- 18 Dec. 2012** Purchase by the managing director of a vehicle owned by the pension fund Sameinaði lífeyrissjóðurinn
- 18 Dec. 2012** Announcement of the unilateral dismissal of a director of a regulated entity
- 7 Jan. 2013** Conclusion of an examination of the activities of the pension Stafir lífeyrissjóður
- 4 Feb 2013** Conclusion of an examination of certain details in the capital report of Íslandsbanki hf.
- 25 Feb 2013** Conclusion of an examination in connection with issuance of covered bonds by Arion Bank hf.
- 27 Feb 2013** Examination as to whether life insurance companies satisfy their disclosure requirements under Art. 65 of Act No. 30/2004, on Insurance Contracts.
- 6 March 2013** Conclusion of an examination of certain details in the capital report of Landsbankinn hf.
- 20 March 2013** Follow-up on an examination of the activities of the pension fund Lífeyrissjóður Rangæinga
- 26 March 2013** Conclusion of an examination of supervision of money laundering and terrorist financing at Landsbankinn hf.
- 8 Apr. 2013** Conclusion of an overall examination of the pension fund Lífeyrissjóður Vestmannaeyja
- 8 Apr. 2013** Measures taken by Júpíter rekstrarfélag hf. following an examination by FME of the company's activities
- 10 Apr. 2013** Follow-up on an examination of procedures of Straumur Investment Bank hf. in client classification with regard to investor protection
- 26 Apr. 2013** Follow-up on an examination by FME of the activities of the Bank Employees' Pension Fund

## 4. Entities regulated by FME

### 4.1 Number of regulated entities

Classes of regulated entities at year-end	Notes	2007	2008	2009
<i>Subject to licence or operating under specific legislation:</i>				
Commercial banks		5	6	4
Savings banks		20	16	14
Credit undertakings		12	12	11
Housing Financing Fund (HFF)		1	1	1
Deposit departments of co-operative societies		1	1	1
Securities dealers		9	9	9
Securities brokers		3	4	3
Fund management companies	1)	7	7	8
Institutional investor funds - legal entities				
Stock exchanges		1	1	1
Securities depositories		1	1	1
Pension funds	2)	37	37	37
Insurance companies		13	13	13
Insurance brokers		7	6	6
Parties with debt collection licenses				4
Payment institution				
Guarantee funds		2	2	2
<i>Total</i>		<i>119</i>	<i>116</i>	<i>115</i>
<i>Other parties subject to supervision:</i>				
UCITS (not legal entities)	3)	38	38	41
Investment funds (not legal entities)	3)	54	54	30
Institutional investor funds (not legal entities)	3)			
Custodians of private pension savings	4)	10	11	24
Issuers of listed equities		31	17	13
Issuers of listed bonds		95	84	64
Agent of foreign payment agency				
Holding companies	5)	2	2	6
Financial undertakings in winding-up proceedings			3	10
<b>Total</b>		<b>333</b>	<b>325</b>	<b>304</b>

1) See further the number of UCITS and investment funds and institutional investment funds further down in the table.

2) Many pension funds have more than one division. Including their divisions would add approximately 50 to the number shown in the table for each year.

3) Funds which are not legal entities but operated by management companies of UCITS. See the number of management companies above in the table. Several UCITS and investment funds have more than one division, and the number of divisions is reflected in the figures in the table.

4) Excluding two foreign custodians of private pension savings the parties included here are also included in the figures for parties above in the table.

5) Holding companies in the financial sector and insurance sector and mixed holding companies, see for more details the definition in Act No. 161/2002 and Act No. 56/2010, as of the end of each year. These are active shareholders who hold more than 50% in the regulated entities. Active shareholders with stakes of 10-50% are not included in the table.

<b>Classes of regulated entities at year-end</b>	<b>Notes</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
<i>Subject to licence or operating under specific legislation:</i>				
Commercial banks		5	5	4
Savings banks		12	10	9
Credit undertakings		8	8	6
Housing Financing Fund (HFF)		1	1	1
Deposit departments of co-operative societies		1	1	1
Securities dealers		12	13	11
Securities brokers		3	2	2
Fund management companies	1)	8	9	10
Institutional investor funds - legal entities			3	4
Stock exchanges		1	1	1
Securities depositories		1	1	1
Pension funds	2)	33	33	32
Insurance companies		13	13	13
Insurance brokers		6	6	11
Parties with debt collection licenses		6	4	4
Payment institutions				1
Guarantee funds		2	2	2
<i>Total</i>		<i>112</i>	<i>112</i>	<i>113</i>
<i>Other parties subject to supervision:</i>				
UCITS (not legal entities)	3)	49	56	56
Investment funds (not legal entities)	3)	21	24	28
Institutional investor funds (not legal entities)	3)		28	43
Custodians of private pension savings	4)	19	18	15
Issuers of listed equities		11	12	15
Issuers of listed bonds		49	47	49
Agent of foreign payment agency				1
Holding companies	5)	6	7	12
Financial undertakings in winding-up proceedings		13	11	14
<b>Total</b>		<b>281</b>	<b>299</b>	<b>346</b>

#### 4.2 Activities of foreign parties in Icelandi

The following summary shows the number of parties/companies authorised to provide services in Iceland based on rules which apply in the European Economic Area:

	30/6/09	30/6/10	30/6/11	31/12/12
Foreign banks without establishments	218	225	222	224
UCITS (no. of divisions in parentheses)	50 (350)	47 (313)	47 (367)	53 (352)
Securities dealers/brokers (Investment firms)	1.878	1.995	2.113	2.020
Insurance companies with establishments	2	2	2	2
Insurance companies without establishments	439	384	405	377
Insurance brokers and insurance agents	4.654	5.025	5.158	4.990





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