

Annual Report 2001

The Period July 1st 2000 to June 30th 2001

Finme
ACE

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Introduction

This is the second Annual Report of the Financial Supervisory Authority in Iceland (FME). The report gives an account of the FME's operations from July 1, 2000 to June 30, 2001 and discusses developments and the outlook on the financial market, while more detailed reports compiled from the annual accounts and other information supplied by financial institutions can be found on the FME website. The Annual Report also contains a section on the FME's supervisory emphasis for the coming months. Furthermore a list of parties subject to supervision as of June 30, 2001 is published in the report. A range of material on the FME and the Icelandic financial market can be found on the FME website. The URL is: www.fme.is.

Board of directors:

- Mr. Stefán Svavarsson, certified public accountant, associate professor, chairman.
- Mr. Lárus Finnbogason, certified public accountant, vice-chairman.
- Mr. Finnur Ingólfsson, governor of the Central Bank of Iceland.

Alternates:

- Mr. Benedikt Árnason, head of department, Ministry of Industry and Commerce.
- Ms. Thuridur I. Jónsdóttir, district court attorney.
- Mr. Ingimundur Fridriksson, assistant governor, Central Bank of Iceland.

Director General: Mr. Páll Gunnar Pálsson

Deputy Director General: Mr. Ragnar Hafliðason



Ragnar Hafliðason, Páll Gunnar Pálsson, Thuridur I. Jónsdóttir, Lárus Finnbogason, Stefán Svavarsson, Finnur Ingólfsson, Ingimundur Fridriksson, Benedikt Árnason.

1. The operations of FME from July 1, 2000 to June 30, 2001

Supervision as implemented by the Financial Supervisory Authority (FME) consists, in particular, of regular information gathering concerning financial aspects as well as specific on-site investigations of financial enterprises. Handling written inquiries and communications from financial enterprises and their customers is, furthermore, a growing aspect of the Authority's activities. Formal guidelines, based on the Act on Official Supervision of Financial Operations, are a new aspect of the activities of the FME. This section is intended to provide general information on the activity of the Authority during this period, without specifically discussing individual cases. It deals with the FME's tasks in various areas of the financial market, as well as looking especially at risk management and internal controls, reports on an assessment by the International Monetary Fund (IMF) of the Icelandic Financial Market and the operation of the FME among other things.

1.1 Supervision of various areas of the financial market

1.1.1 Credit market

In recent months, the FME has monitored developments in capital adequacy ratios and credit institutions' objectives for equity and loans. A persistent increase in loans continuing into the present year, and decreasing capital adequacy ratios as a result, has given cause for concern and the FME has sought to reverse this trend. The FME has thus requested that credit institutions inform it regularly about their objectives concerning developments in capital adequacy ratio, lending, profit and dividends, and the outlook concerning loan-loss provisions. The FME has followed this up by holding regular meetings with major credit institutions in connection with publication of their financial statements.

The FME is of the opinion that the largest credit institutions in Iceland, with effective risk management and internal controls, should at all times aim at maintaining their capital adequacy ratio at a minimum of 10%. A number of credit institutions lack this capacity. Furthermore, the FME has warned against the widespread use of subordinated loans to fulfil minimum capital adequacy requirements. The FME has emphasised that the risk levels of some credit institutions call for their capital adequacy ratios to be substantially higher than the minimum.

The FME has examined the lending practices of a number of credit institutions. These examinations have focused on supervision of loans, risk spreading, collateral, defaults and loan-loss risk. Special attention was paid to the appraising of loan-loss provisions. In several instances the FME's examinations of loan portfolios have resulted in increased provisions to loan-loss accounts.

Growing activities of Icelandic credit institutions abroad call for changes in emphasis in surveillance. The FME has increased its overview of these

activities through increased information disclosure by the credit institutions in question, in addition to closer cooperation with supervisory authorities abroad. Negotiations on a co-operation agreement with supervisory authorities outside the European Economic Area (EEA) are in process.

Part of the FME's activities involve formulating rules on capital adequacy, as the Authority follows the work of the Basel Committee on Banking Supervision (BCBS). The FME has submitted comments on proposals by the Committee for new rules on capital adequacy. The comments are available on the FME's website. The FME emphasises that new rules on capital adequacy must be suitable for both large and small financial companies and supports the ideas of the Basel Committee to allow use of internal rating systems in calculating the banks' risk-weighted base. This provides motivation for financial companies to develop and improve their risk management.

The FME has been working on systematic risk assessment of commercial and savings banks. The FME bases its evaluation on a simplified risk assessment system, which it plans to develop further. This work will be useful in adapting the new rules on capital adequacy.

The FME has been formulating rules and formal guidelines on credit market activities. In this connection, it has presented formal guidelines regarding deductions from equity due to banks' trading book holdings in companies involved in financial activities. These guidelines are intended to harmonise legal interpretations in this area. In addition, changes in loan-loss rules and capital adequacy rules are in process.

1.1.2 Securities market

During the period the FME has been organising its surveillance of the securities market to take into consideration extensive changes made to legislation on securities dealings at the end of last year.

The changes involve detailed provisions on insider trading and surveillance in this area. The onus to investigate before dealing is placed with the primary insider; the requirement is made that information on insiders be sent to the FME, which is expected to publish a list of primary insiders. In addition, the FME is to collect and approve rules of issuers on the handling of confidential information and insider trading. The FME has published formal guidelines on the substance of such rules and issued insider list forms to be filled in, together with instructions on how they should be completed.

The same Act now makes clearer provisions than before on public offers of securities. This is provided for in detail in a new Regulation on Securities Offers, No. 477/2001. Clearer provisions strengthen the FME's supervision, in addition to entrusting it with the role of overseeing scrutiny of public prospectuses other than those involving stock exchange listing. The FME's possibilities of monitoring and taking action on public offers have been expanded. During the period the FME received one prospectus for scrutiny. Several cases concerning securities offers have also been examined.

Supervision of the organisation and practices of undertakings in securities services have been and will continue to be among the principal tasks of the FME on the securities market. The FME issued formal guidelines on the substance of rules of financial companies concerning i.a. separation of interests (Chinese walls), trading on own account, employee trading and participation of management and employees in other businesses. The guidelines were issued in July 2001 and the FME will very shortly approve the rules of financial companies which comply with the requirements. These guidelines encourage improved practices on the securities market and involve more stringent requirements which must be followed up in the actual supervision.

The FME examined several cases where there were indications of a violation of provisions on insider trading. One case was referred to the National Commissioner of the Icelandic Police. Indications of market abuse were also investigated, in addition to which inquiries by customers and complaints connected with advice and services in the securities market have been increasing steadily in number.

The FME has substantially increased its supervision of practices in the securities market with the hiring of additional staff and establishment of systematic market surveillance by the Authority. Market surveillance improves the FME's overview of the securities market and enables it to intervene in cases at an earlier stage.

1.1.3 Insurance market

Considerable changes have taken place in the insurance market during this period and the FME's tasks have been affected accordingly.

In the autumn of 2000 a foreign insurer ceased to offer motor vehicle insurance in Iceland. The FME investigated the case especially in order to ensure the legal status of the parties, as the insurance was handled by a domestic insurance broker. The authorisation of the insurer in question to offer motor vehicle insurance was cancelled and appropriate measures taken.

Questions concerning several fishing boat insurance companies have been under investigation by the FME. During the past year the FME authorised the transfer of the insurance portfolio of one company and in October of this year the FME authorised the transfer of insurance portfolios of two more fishing boat insurance companies. The non-life insurance company Sjóvá-Almennar tryggingar hf. has taken over the insurance portfolios of all these companies. Furthermore, the case of a state owned marine insurance company Samábyrgðin hf. has been under examination by the FME, as the company was transformed into a limited-liability company in mid-2000 and the state-owned shares sold. Following this, Sjóvá-Almennar tryggingar hf. purchased the company and a merger of the two companies has been authorised by the FME.

Premiums for compulsory motor vehicle insurance have once more been the subject of public discussion. In July 2000 the FME published the conclusions of an examination of premium increases for motor vehicle insurance the preceding spring. The insurance companies had demonstrated increased claim costs and instability in the sector. Under the circumstances, there was no basis for the FME to take action. It did, however, consider that it was imperative that each insurance company should review the basis for premiums as soon as possible in the light of further experience. The FME has emphasised market discipline and to this end has sought to ensure increased transparency. A committee appointed in the year 2000, entrusted with

reviewing the Regulation on Annual Accounts of Insurance Companies, will complete its duties shortly.

During the period the FME has examined the operations of three life insurance companies. The investigation focused on the companies' working procedures, risk management and internal controls. Comparable examinations were also carried out of the activities of several insurance brokers. In many instances there was cause to improve the information disclosure and general practices of these parties. The FME has communicated its comments and recommendations to this end, in part in a circular sent to insurance brokers.

In two instances in the field of insurance supervision the FME informed the National Commissioner of the Icelandic Police of its findings; one case involved a non-life insurance company and the other an insurance broker. In several instances, insurance brokers handed in their licences following an examination by the FME. One insurance broker's licence was revoked.

The FME has instructed insurance companies to adopt internal rules on securities trading by the company itself, its management and employees, as recent amendments to the Act on Insurance Activities require them to adopt such rules. This work is expected to conclude later this year.

The FME has been working on drafting two sets of formal guidelines. This spring the FME published on its website a consultative document on draft guidelines on insurance companies' bonus rules for compulsory motor vehicle insurance. The FME has also published a consultative document on draft guidelines for provisions on insurance companies' claims settlements.

1.1.4 Pension savings market

Until late in the year 2000, a substantial part of supervision of pension funds was connected with the issuing of licenses. Under the Act on Mandatory Insurance of Pension Rights and the Operation of Pension Funds, which entered into force July 1, 1998, all pension funds were required to apply for a license from the Ministry of Finance or, in the case of pension funds operating under special legislation, have their articles of association approved. The FME issued comments in this regard. The pension funds' adaptation to the Act proved to be a time-consuming process and the work was not completed until this year.

The largest project undertaken during the period was an extensive examination of pension funds investments, which involved requesting detailed data from some 30 funds. The objective was to examine if the investments of individual pension funds were in compliance with the provisions of Chapter VII of the Act, which deals with limits on pension funds' investments.

A number of funds turned out to have exceeded the limits provided for by law. This involved primarily investments in unlisted securities. If pension funds exceeded the investment limits upon the entry into force of the Act, they are not required to sell securities in order to comply with its requirements. The FME has insisted on corrections by several pension funds.

Activities concerning supplementary benefits and personal pension savings continue to expand and diversify. Depository parties of these supplementary pension savings, i.e. commercial and savings banks, securities firms, life insurance companies and pension funds, are required to seek the approval of the Ministry of Finance for their rules applying to this activity. The FME gives comments to the Ministry on the granting of these approvals. The depository parties also seek the FME's comments on the contract forms for supplementary pension savings and its confirmation that these agreements are in accordance with applicable Acts and Regulations. Due to the large number of parties offering this type of savings, this work has proven to be time-consuming and a variety of comments have been submitted.

In accordance with recent amendments to the Act on Pension Funds, funds must now adopt internal rules on securities trading by the fund itself, its management and employees, which are to be approved by the FME. The FME has been in consultation with the pension funds and their association on drafting these rules and it is hoped that they will be approved shortly.

In its supervision, the FME has emphasised the role and responsibility of the boards of pension funds. The role of the board is all the more important in consideration of the facts that pension fund activities are based on compulsory membership; the transfer of collective pension rights is prohibited and the possibilities for fund members to directly influence the management of their pension fund are limited.

1.2 Supervision of internal controls, risk management and information technology (IT)

In recent months large fluctuations in financial markets and credit expansion have put pressure on risk management and the internal controls of financial companies. During this period the FME has continued its examination of the situation of internal controls and risk management of parties subject to supervision. The FME places great emphasis on their responsibility for their own activities and internal control measures of the same.

Examinations by the FME have focused in particular on the organisational structure of the companies, the objectives set for their activities, the existence and enforcement of rules on risk management, internal controls and the efficacy of internal auditing. For example, internal controls regarding credit-giving procedures have been examined, together with the supervision of market risk in activities of financial companies and risk management in this context. The FME has stressed to the companies' boards their duties in this respect.

Previously the FME has expressed its opinion that risk management and internal controls for well-established activities of financial companies have generally been in a better state than where new or rapidly expanding financial services are involved. Improved risk management by many companies would thus irrefutably have reduced the effects of unfavourable development on the securities and foreign exchange markets.

Risk management and internal controls are at various stages of development in individual areas of the financial market. The FME has been working on drafting formal guidelines concerning internal controls and risk management in financial companies, for the purpose of establishing a firmer approach to these matters. The guidelines will be based on the basic principles of the Basel Committee on Banking Supervision while intended to apply to all financial companies.

Work is presently in progress at the FME on formulating policy for supervision of information technology (IT) of parties subject to supervision. Its main emphases will be on the operational security of computer systems and data secrecy. It is important to ensure the security of such activities, as well as see to safeguard data secrecy wherever possible. The responsibility and supervision of

directors of the financial companies concerned must be ensured.

Formal guidelines are in preparation in connection with the outsourcing of computer services and computer equipment, as well as services provided on the Internet. Furthermore, in co-operation among Nordic financial supervisory authorities, reference guidelines for minimum supervision are being developed which will form the basis for supervision of Internet banking in this region. The FME will base its supervision on this foundation.

1.3 IMF assessment of the Icelandic financial system

At the end of the year 2000 the International Monetary Fund (IMF) carried out an evaluation of the Icelandic financial system entitled Iceland – Financial Sector Stability Assessment. The evaluation is part of a special initiative by the Fund intended to strengthen the overview of financial sector vulnerabilities in individual countries and thus encourage stability. It included an examination of Acts and rules on activities on financial markets and the supervisory framework, having regard to the core principles which have been adopted in international co-operation of supervisory authorities in banking, securities and insurance. The discussion also covered legislation on and supervision of pension funds.

The IMF's principal conclusions were that the financial regulatory framework in Iceland is effectively equipped to fulfil its task. Nonetheless, the Fund also maintained that there were weaknesses in the Icelandic financial sector that could jeopardise its stability. The Fund commented upon and underscored a number of areas for improvement that would increase stability, both with respect to legislation and public supervision.

The most significant criticisms advanced by the IMF concerned the capital adequacy of Icelandic credit institutions, which was considered generally too low in consideration of financial conditions in Iceland. The Fund emphasised the need to increase the authorisation of the FME to enforce increased capital adequacy ratios (CARs) and to demand a higher CAR for individual credit institutions when their operations involve special risk. Furthermore, the IMF was of the opinion that the CARs as indicated may be unreliable due to weaknesses in legislation or rules, not least with regard to provisions and asset classification. The

IMF underscored especially that provisioning arrangements by credit institutions and asset classification were not in accordance with best practice.

Concerning the weaknesses in provisioning arrangements and asset classification, the FME agrees on the need to strengthen current rules. Classification of loan assets and the connection between this classification and assessment of general provisioning should be strengthened. Furthermore a clearer definition of default loans is needed as well as more detailed rules regarding loan loss provisioning. Icelandic rules in this area are, in principle, in accord with rules in other Nordic countries. The FME has prepared amendments to these rules due to the above, which are expected to enter into force later this year.

The IMF was, furthermore, of the opinion that the number of specialists employed by the FME should be increased, thereby further strengthening public supervision of financial activity. The FME has now published on its website its own evaluation of staffing requirements in the near future.

The FME is of the opinion that the IMF comments and recommendations give useful indications. In most respects they accord with the assessment of the FME, although emphases may differ in some instances. A number of the recommendations call for changes in legislation, many of which are presently under discussion by a committee under the auspices of the Ministry of Commerce that is working on drafting new legislation on financial enterprises. Several IMF recommendations concern internal FME activities directly, most of them in accordance with its prior policy and work programmes.

The Annual Report is available on the IMF website: <http://www.imf.org>.

1.4 International co-operation

During the period the FME has hosted several meetings connected with international co-operation. In the Nordic sphere, the FME held the annual meeting of directors of Nordic financial supervisory bodies last August. It also arranged two co-operation meetings of banking supervisory experts, one meeting of experts in securities supervision and two meetings concerning insurance supervision. Furthermore, the FME held the annual co-operation meeting of Nordic financial supervisory bodies on operational issues. The

FME also hosted the co-operation meeting of European banking supervisory bodies, Groupe de Contact, which operates in connection with the EU Commission. The FME also co-hosted a conference of European insurance supervisory bodies held in Oslo.

The FME is involved in extensive international co-operation and attends meetings in this regard. There are two main reasons for participating in this co-operation. On the one hand, the FME seeks to bring back to the Icelandic financial market knowledge and experience gained in supervision of larger and more developed markets. On the other hand, the FME has considered it to be part of its role to strengthen the competitiveness of the Icelandic financial market. Its participation in international co-operation is a major aspect of such efforts, since close co-operation and co-ordination with similar bodies abroad improves the probability of developing in Iceland comparable attitudes towards the soundness and credibility of the Icelandic market and its supervision.

In addition to its co-operation with Nordic financial supervisory bodies, the FME is a member of the Conference of European Insurance Supervisors, European banking co-operation (in Groupe de Contact) and the Committee of European Securities Regulators (CESR, previously FESCO) which was established in September 2001. The FME is also a full member of the International Association of Insurance Supervisors (IAIS).

1.5 The FME's internal operation

Scope of operations and supervision fee

The income of the FME is provided by a supervision fee levied on parties subject to supervision. The levying and collection of the supervision fee is provided for in Act no. 99/1999, on Payment of Cost Due to Official Supervision of Financial Activities, as subsequently amended. The supervision fee is calculated in most instances as a specific percentage of the total assets, income or premiums of the party in question, depending upon the nature of its activities. In all cases, however, there is a specific minimum fee levied.

Income for the year 2000 amounted to a total of ISK 197 million, of which income from the supervision fee comprised ISK 192.5 million. Total expenses amounted to ISK 183.2 million. The

estimated supervision fee levied for the year 2001 will amount to ISK 198.8 million and operating costs are expected to amount to ISK 211.4 million.

The levying of the supervision fee for 2002 is now in preparation. According to the operating plan prepared by FME, the supervision fee levied in 2002 is expected to amount to some ISK 215.0 million. Operating costs for 2002 are, however, estimated at ISK 264 million, but taking into consideration the surplus from former years and other income of the Authority during that year, income and cost should balance out by year-end 2002. The increased scope of FME's operations in 2002 can be explained first and foremost by plans to increase the number of employees and rental of additional premises.

Number of employees

In mid-2001, the FME had 27 employees, fulfilling a total of just under 26 full-time positions. The majority of personnel are specialists, in particular in law, commerce or computer sciences. From mid-2000 to mid-2001 a total of six employees began work at the FME, while five employees left to take up positions elsewhere. Staff turnover was similar to that of Icelandic undertakings in general during this period. Since the FME began operations at the beginning of 1999, there have been plans to increase the number of employees at the Authority, as there were originally 22 full positions. This increase has, however, not been achieved to the extent necessary to keep pace with developments on the financial market and increased responsibilities of the FME.

The FME has published on its website its own evaluation of staffing requirements for coming months. This account is also an accompanying document to the FME's operating plan for the coming year. The plan assumes that from July 1, 2001 to year-end 2002 the number of positions at the Authority will increase from 26 to 32.

In-house rules and continuing education

Work has continued on building up FME's internal framework. Rules have been issued concerning the dealings of the employees, director and board with parties subject to supervision, rules on the treatment of confidential information and securities dealings of employees and management, etc.

Furthermore, the FME has adopted a special continuing education policy for its employees, containing a specific proportion of salary expenses each year to be spent on this matter and specifying alternatives in this area.

Various figures for the period from July 1, 2000 to June 30, 2001

The FME has sent over 2000 letters during this period and received 2100. Parties subject to supervision have submitted 1200 reports concerning regular data and information gathering.

Special examinations of various sorts totalled around 100 during the period. These examinations are of a very varied nature, and differ considerably in their extent.

Furthermore, the FME has handled some 160 communications from parties subject to supervision, nearly 120 communications from customers of parties subject to supervision and some 160 communications from other parties, both in Iceland and abroad. During the twelve-month period under discussion here, the FME has, in 90 instances, deemed it necessary to raise formal objections or demand improvements of one sort or another by parties subject to supervision. It should also be mentioned that the FME provided 20 opinions on granting licences to parties subject to supervision during the period in question.

In addition to the above, it could be mentioned that increased coverage by the mass media during the past year or two of financial market issues, concurrent with the increased visibility of the FME, has led to increasing demands from the general public for the assistance of the FME. During the period from July 1, 2000 to June 30, 2001, 60 complaints and other consumer issues were handled together with 105 inquiries. During the preceding twelve-month period complaints and consumer matters were 44 in total and inquiries 34.

The above information is provided solely for information purposes and is by no means a definitive measure of FME activities.

2. The Financial Market – Trends and Outlook

2.1 Credit and securities market

Worsening performance

In the past year or so, credit institutions' operating environment has been difficult in many respects. Thus the cumulative profits of commercial and savings banks¹ for the year 2000 amounted to ISK 4.4 billion as compared with ISK 6.7 billion in 1999. Return on equity (ROE) dropped from 18% to less than 10% from one year to the next, cf. Figure 1. The drop in earnings from 1999 to 2000 can be explained principally by trading rate losses, in particular on shares and bonds. Performance in 2000 would have been even worse if it had not been for capital gains realised from sales or adjustment to market value of the holdings of many savings banks in the investment bank Kaupthing hf.

During the first half of 2001 the cumulative earnings of commercial and savings banks amounted to ISK 2.7 billion, which corresponds to approx. 11% ROE. Operations of credit institutions during the first half of 2001 were characterised by continued trading rate losses on financial activities, in particular shares and foreign exchange trading. This was offset by an increase in net interest income due to higher inflation and increases in other income resulting from capital gains realised from the sale of savings banks' shares in Kaupthing hf. Return on equity is expected to be rather low for the next year or so, due to a foreseeable increase in provisions for bad loans as well as uncertainty concerning income from market trading and market securities.

Cost/income ratios still high

The cost/income ratio, i.e. operating costs as a percentage of gross income, was slightly lower during the first half of 2001, or 64.4%, as compared to 65.6% in 2000, cf. Figure 1. During the period 1995-1998 the cost ratio was 66-68%, but it dropped to 62% in 1999, due in part to unusually high trading rate gains that year. As indicated by the above figures, the decrease in this ratio has been rather slow for the past 5-6 years.

1) Commercial banks and savings banks in this analysis include the countries three largest commercial banks and six largest savings banks. The profits and the financial position of the smallest commercial bank, Sparisjóðabanki Íslands hf., and the investment bank Kaupthing hf. are mainly reflected in the figures for the savings banks. The ratios for the first half of the year 2001 have been extrapolated to a one year in order to be comparable to the annual figures for the preceding years.

The above-mentioned figures on ROE and cost ratio vary greatly from one bank to another. Thus ROE for the three largest banks varied from 1% to 20% for the first half of 2001, and their cost ratios from 53-78% for the same period

Figure 2 shows principal operating items as a percentage of total assets of commercial and savings banks. If the situation from 1998 onwards is reviewed, operating costs as a percentage of total assets have decreased steadily, dropping from 3.7% in 1998 to 3.0% in the first half of 2001. Net interest income dropped from 3.3% in 1998 to 3.0% in 2000, but rose again during the first half of 2001 to 3.4%. Other operating income as a percentage of total assets reached a peak of 2.4% in 1999 and has since decreased substantially, amounting to 1.2% during the first half of 2001. Provisions to loan-loss accounts were 0.70% in 1998, 0.64% in 1999 and 0.56% in 2000, but rose to 0.74% during the first half of 2001.

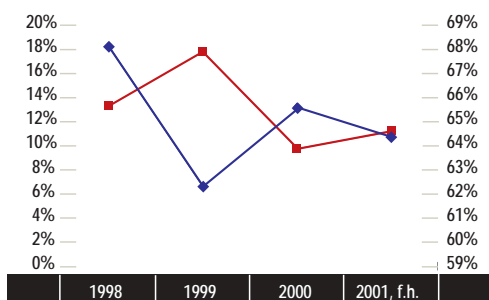


Figure 1. Return on equity (ROE) and cost as a percentage of income from operations of commercial and savings banks.

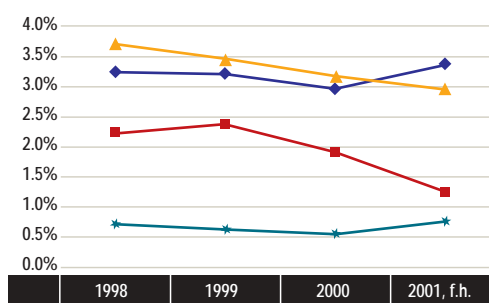


Figure 2. Main operating items as a percentage of total assets of commercial and savings banks.

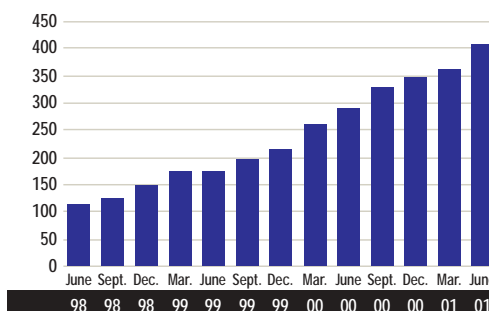


Figure 3. Net liabilities owed by main credit institutions to foreign parties (ISK billions).

Large increase in total assets financed by foreign borrowing

During the above period, total assets have grown substantially, from almost ISK 500 billion at year-end 1998, to almost ISK 900 billion at the end of June 2001, or by 80%. Much of this growth has been financed by foreign borrowing, with a smaller share financed by deposits or domestic security issues. **Figure 3** shows the trend in net liabilities owed by the main credit institutions to foreign parties during recent years. These foreign loans are usually balanced against exchange rate-linked loans to domestic parties, who to a varying extent have income in the currencies involved.

Increased market and credit risk

Growth of total assets consists primarily of credit expansion and increased market security assets. Part of the assets of credit institutions are tied up in market securities, which are subject to market rate fluctuations, cf. **Figure 4**. Thus market securities of commercial and savings banks amounted to over ISK 22 billion at year-end 1995, ISK 105 billion at the end of June 2000 and ISK 112 billion at the end of June 2001. It is interesting to note the increase in shares from the first half of 2000 to the first half of 2001. During this period most credit institutions had a loss on their share holdings, as the Selected Shares Index (ICEX-15) fell by 30% during the period and exchange turnover shrank.

Figure 4. Market value of securities owned by commercial and savings banks (ISK billions).

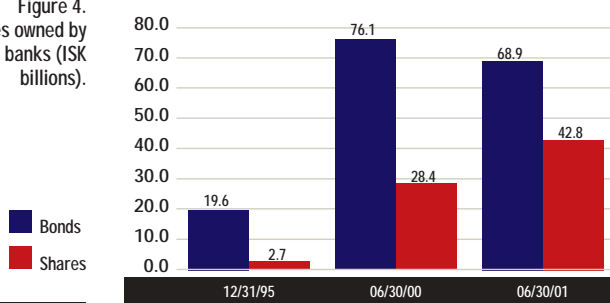
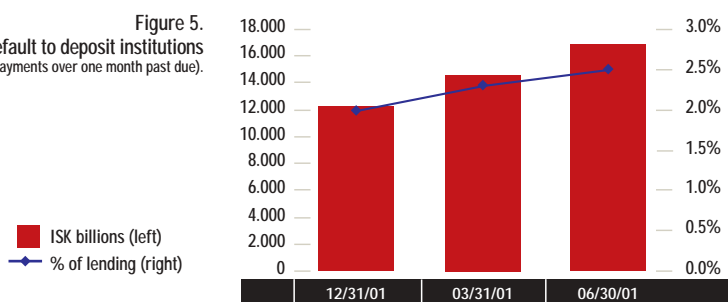


Figure 5. Default to deposit institutions (payments over one month past due).



The growth in lending of the previous years continued into the year 2001. In June 2001 the twelve-month nominal increase in lending by commercial and savings banks was 26%. If the depreciation of the Icelandic króna (ISK) and inflation-linked increases to loans are taken into consideration, the twelve-month growth in lending by commercial and savings banks is 12.5%. Figures for lending trends during the third quarter of 2001 indicate that real lending growth has stopped.

Default increases, as does provisioning

In the past six months, default by borrowers of commercial and savings banks has increased. This trend is an indication of deterioration in the asset quality of these financial institutions. As **Figure 5** shows, total defaults² by households and industries amounted to ISK 16.8 billion at the end of June 2001, or 2.5% of lending, as compared with ISK 12.3 billion, or 2.0%, at year-end 2000. Default by households was proportionally greater than that of industries. Default by households amounted to ISK 7.1 billion, or 4.3% of loans to households, at the end of June 2001, as compared with ISK 5.3 billion, or 3.3% at year-end 2000. Default by industries amounted to ISK 9.7 billion, or 1.9% of industries borrowing, at the end of June 2001, as compared with ISK 7.0 billion, or 1.6% at year-end 2000.

The annual provisions to loan-loss accounts by commercial and savings banks amounted to ISK 4.0 billion in 2000, as compared to ISK 3.6 billion in 1999. The increase amounted to ISK 0.4 billion, or 11%. During the first half of 2001, total provisions to loan-loss accounts by commercial and savings banks amounted to ISK 3.1 billion, or almost 80% of total provisions for the year 2000.

The annual provisions to loan-loss accounts as a percentage of loans amounted to 0.9% in 2000 as compared to 1.1% for the years 1997-1999, and is estimated to be 1.3% for the year 2001. This percentage peaked at 4.1% in 1992, but has since fallen steadily until the year 2000, as previously mentioned. The balance of the loan-loss account is estimated to be 2.5% of total loans at e. o. y 2001. **Figure 6** shows that substantial and rapid credit expansion is followed by increased provisions for these loans. The annual provisions to loan-loss accounts, as a percentage of total loans, likely

² Defaults according to a survey including 97% of total lending by commercial and savings banks. The definition of default in this analysis is having amortisation and interest payments in arrears more than one month past due.

reached a minimum in 2000 and in the coming year the need for provisions will grow, with a corresponding negative effect on profitability and ROE.

Own funds increased by taking subordinated loans

The total own funds³ of commercial and savings banks amounted to ISK 49.1 billion at year-end 2000, as compared with ISK 43.9 at year-end 1999. The increase amounted to ISK 5.2 billion, or 12%. At the end of last June, total own funds of commercial and savings banks amounted to ISK 53 billion.

At year-end 1999, commercial and savings banks had issued subordinated notes, which are classified under Own Funds Tier 2 and 3 in calculating capital adequacy ratio (CAR), amounting to ISK 11.5 billion. At year-end 2000 subordinated Tier 2 and 3 notes amounted to ISK 18.2 billion. The increase thus amounted to ISK 6.7 billion, or 58%. At the end of last June, subordinated notes of commercial banks and the largest savings banks, classified under Own Funds Tier 2 and 3, totalled ISK 19.6 billion.

Near the end of the year 2000, the FME authorised credit institutions to issue subordinated notes included under Own Funds Tier 1 in calculating CAR, on the basis of a new Regulation issued by the Ministry of Commerce. At year-end 2000 one commercial bank had taken advantage of this authorisation to issue subordinated notes Tier 1 for ISK 0.9 billion. By the end of last June, three commercial banks and one savings bank had issued notes included under Own Funds Tier 1, totalling altogether ISK 5.5 billion.

The combined risk-weighted base (the denominator in the CAR) of commercial and savings banks amounted to ISK 605 billion at year-end 2000, as compared with ISK 476 billion at year-end 1999. The increase amounted to ISK 129 billion, or 27%. At the end of last June the combined risk-weighted base of commercial and savings banks amounted to ISK 693 billion, which is a six-month increase of 14.5%.

Capital adequacy ratio improved with sale of assets and by taking subordinated loans

After dropping steadily until mid-2000, the CARs of commercial and savings banks have been increasing up to mid-2001, cf. **Figure 7**. The main

3) Own funds as calculated in the capital adequacy ratio (CAR).

reason for the increasing CARs of the banks is an increase in subordinated loans, which can be included as equity in calculations of capital adequacy. This applies both to taking of traditional subordinated loans included under Own Funds Tier 2 and 3 and those included under Own Funds Tier 1, which were authorised late in the year 2000. One main reason for the higher CARs of savings banks at year-end 2000, as compared to year-end 1999, were capital gains realised from the sale by many savings banks of their holdings in the investment bank Kaupthing hf.

Limited possibilities of taking subordinated loans

According to the rules which apply to subordinated borrowing, there are a number of restrictions on the extent to which this may be included in CAR calculations as a proportion of Tier 1 own funds. By the end of June 2001, many credit institutions had practically exhausted these authorisations. The capital adequacy of most credit institutions can thus only be improved by increasing profitability or by new share capital.

For the past few years, the FME has repeatedly warned of the consequences of deteriorating capital adequacy. Despite the fact that the CARs of credit institutions have increased slightly recently, the FME is of the opinion that most credit institu-

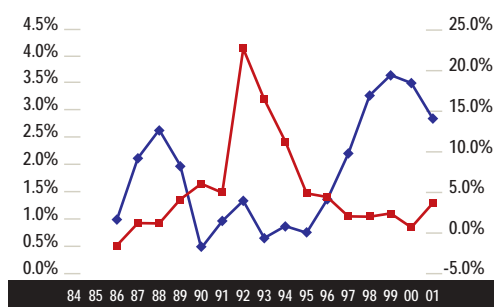


Figure 6. Provisions to loan-loss accounts as a percentage of borrowing and real increase in average lending of commercial and savings banks (values for 2001 are estimated).

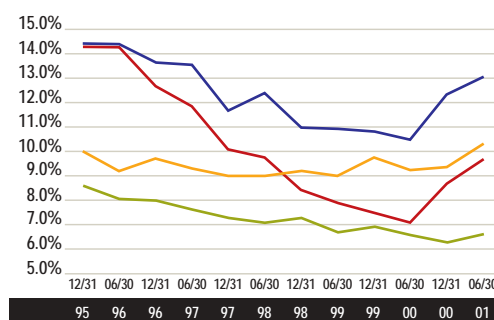


Figure 7. CAR with and without subordinated loans included under Own Funds Parts B and C.

tions need to strengthen their capital adequacy to be better equipped to withstand possible shocks in the near future.

Securities market turnover – need for increased discipline

Activity on the securities market has slowed considerably in recent months, especially on the share market. After fairly steady share trading growth from 1998 to the end of the first quarter of 2000, when turnover on the Icelandic Stock Exchange (ICEX) reached a peak of ISK 75 billion, the share turnover has shrunk and share indices fallen, cf. **Figure 8**. It should, however, be borne in mind that turnover during the third quarter of 2001 and the Selected Shares Index (ICEX-15) at the end of this period are similar to the figures for the second quarter of 1999. Turnover composition by type of securities has changed this year as compared with previous years, as bonds trading has increased while share trading has dropped.

The prime characteristic of the securities market in Iceland is its lack of depth; price formation is weak and is supported by only a few exchange members. A closer look at the share market reveals that trading of shares in the 10 most traded companies, from the beginning of 2001 to the end of August, comprised 65% of total trading. The four largest exchange members handled an average of 95% of the trading in these 10 most traded companies. An inquiry by the FME to the exchange members concerned revealed that almost 40% of

the above-mentioned trading was trading for own account by the members or funds managed by them.

Under such conditions, strong discipline is necessary in order to prevent market abuse and build up a solid and effective market. FME actions have been aimed at achieving this objective. Formal guidelines have been issued on in-house rules of financial companies and for issuers of listed securities. At the same time, the FME has been building up stronger supervision of working practices on the securities market and improving the overview of this same market.

2.2 Pension savings market

Reduced asset growth and negative real rate of return for the year 2000

Net assets for pension payments at year-end 2000 amounted to ISK 566 billion. The real increase of net assets in the year 2000 was 5%, which is considerably less than in the previous year, where the corresponding increase was 20%. The net real rate of return of pension funds for the year was negative by 0.7%.⁴ In **Figure 9**, which shows the net real rate of return of pension funds for the years 1991-2000, this trend becomes clearly apparent. For the past decade, net real rate of return has been at an average of 6.7%. The pension funds have in recent years modified their portfolios and placed an increased emphasis on purchasing listed shares and units in mutual funds. The rules pertaining to the annual accounts of pension funds stipulate that listed shares and unit shares shall be valued at their market price. Increased fluctuations in the return on pension fund investment between years, together with portfolio changes can thus be expected in the future.

Compared with other economic figures, pension fund assets have increased from 39% of gross domestic product (GDP) in 1990 to over 84% at year-end 2000. Pension fund assets as a proportion of the credit system's total liabilities have risen from 26% in 1991 to 35% in the year 2000, cf. **Figure 10**.

4) Net real rate of return of pension funds is the real return on assets adjusted using the consumer-price index (CPI) after expenses have been deducted from investment income.

Figure 8. Trading of bonds and shares listed on the Iceland Stock Exchange, ISK millions, and the share index, ICEX-15.

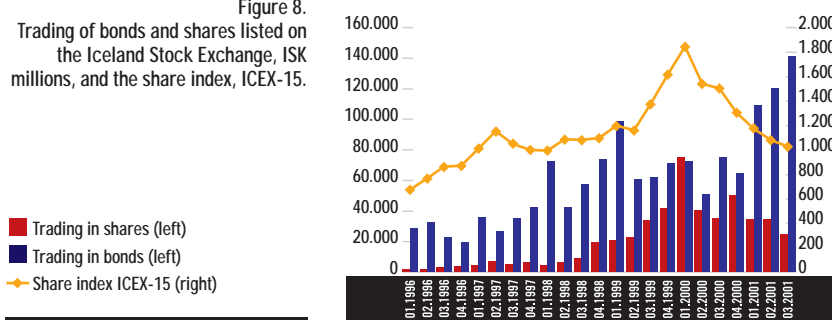
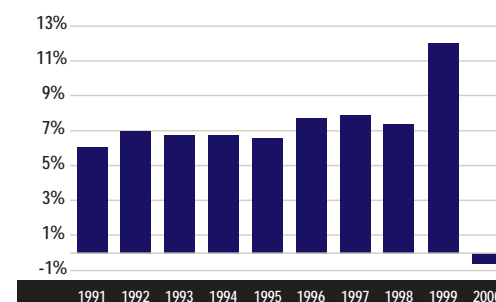


Figure 9. Net real rate of return of pension funds.



Pension fund investment limits

The Pension Fund Act contains provisions regarding investments, which aim to diversify assets over a range of selected securities categories. The provisions furthermore stipulate that investment decisions shall take into consideration risk factors as well as expected rate of return.

At year-end 2000 the FME began an examination of pension fund investment and categorisation of assets. The examination revealed that investments have in some cases not been in line with the Pension Fund Act and categorisation of assets has been flawed. Pursuant to interim provisions in Act 129/1997 the pension funds were not obliged to sell off assets in order to fulfil investment limits if they had exceeded those limits upon the entry into effect of the Act in July 1998. The funds may not, however, purchase securities while they remain above the stipulated level and if they were below the stipulated maximum when the Act came into effect they are obliged to respect the limit.

The main problem area has been the limits for investing in unlisted securities, for which the maximum permitted is 10% of net assets for pension payments. A few pension funds have increased their ownership of unlisted securities since the Act came into effect in spite of having exceeded the limit. The survey has also revealed that unlisted securities are in a number of instances incorrectly categorised as listed securities.

Unlisted securities

The proportion of unlisted securities at year-end 2000 amounted to 10% of the net assets of pension funds and had dropped from 16% at the same time in 1999. Pension funds guaranteed by other parties showed a reduction from 22% at year-end 1999 to 5% at year-end 2000 in their ownership of unlisted securities. This dramatic drop is partly the result of a legal amendment of May 2000, whereby pension funds were permitted to categorise unlisted securities issued to finance public housing loans during the years 1972-1994 as listed securities. The ratio of unlisted securities owned by pension funds not guaranteed by other parties fell from 15% at year-end 1999 to 11% at year-end 2000, see **Figure 11**. At year-end 2000, 25 of 56 fully operating pension funds had holdings of over 10% in unlisted shares. By June 30, 2000 this number had risen to 28.

Shares

Share ownership by Icelandic pension funds as a whole at year-end 2000, both direct ownership and through mutual funds, amounted to ISK 182 billion, or 32% of net assets for pension payments, and had risen from ISK 142 billion, or 27% of assets, at year-end 1999, see **Figure 12**. At year-end 2000, one pension fund out of a total of 56 had exceeded the permitted maximum for share ownership, or 53% of net assets for pension payments, whereas the highest permitted ratio is 50%. Ten pension funds out of a total of 56 had a share ratio higher than 30% of assets at year-end 2000.

Foreign currency assets

Foreign currency assets of pension funds rose from 20% at year-end 1999 to 23% at year-end 2000, but the limit is 50% of total assets as stipulated in the Pension Fund Act. Assets in foreign currencies of eight pension funds exceeded 30%, the highest ratio being 45%. On June 30 this year the ratio of

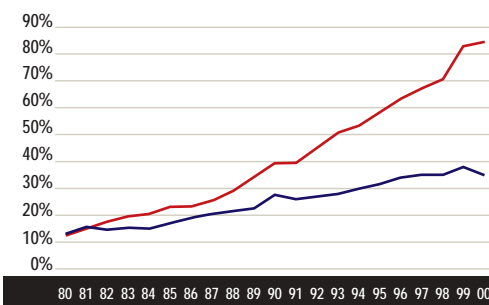


Figure 10. Pension fund assets.

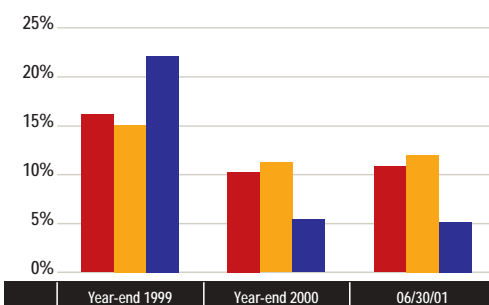


Figure 11. Unlisted securities.

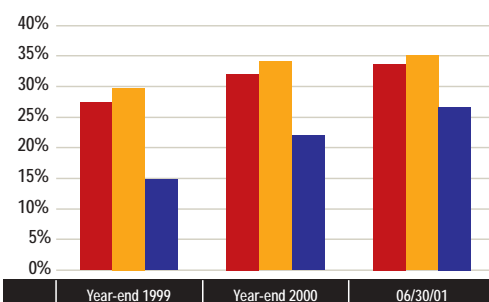


Figure 12. Share ownership.

The minimum premium guarantees the fund members a right to old-age pensions, disability pensions, and pension payments to surviving spouses and/or children. The mandatory pension savings are, partly or wholly, deposited in a mutual insurance fund where the assets are jointly held by all fund members. A number of pension funds now operate an integrated system of mutual insurance funds and individual accounts where a predetermined amount of the premium is deposited in an individual account as a personal pension savings.

foreign currency assets of pension funds had reached 26%. As shown in **Figure 13**, this trend is most evident in the case of pension funds guaranteed by other parties, where the ratio on June 30 this year had reached 24% of assets, compared with 13% at year-end 1999. For pension funds not guaranteed by other parties this ratio was 26% on June 30, 2001, compared with 22% at year-end 1999.

Financial position of pension funds

One of the main characteristics of the Icelandic pension fund system is the principle of full funding. By law, a pension fund is regarded as fully funded if the difference between net assets for pension payments plus future premiums at their present value, on the one hand, and total pension obligations, on the other hand, does not exceed 10%, or over 5% for five consecutive years. All pension funds must commission an actuarial survey of their financial position every year. If such a survey reveals an imbalance in the funding of a pension fund, its articles of association need to be amended in order to correct the balance.

Actuarial surveys of non-guaranteed pension funds for the year 2000 reveal that these funds all show a balance as stipulated by law. On the basis of total obligations the funds show an average surplus of 1.6%, ranging from a deficit of 7.1% to a surplus of 16.9%. Three funds show a surplus in excess of 10% and thus need to increase the pension rights of their members.

Pension funds guaranteed by the National Treasury, municipal authorities or banks are exempt from the provisions regarding full funding. None of these funds accept new members, except for three funds that have availed themselves of the option permitted by law to establish new divisions based on the principle of full funding. The financial position of guaranteed pension funds is generally poor on account of their closures, which entail a faster depletion of assets even though the increase in long-term commitments has been reduced. These include a total of 14 funds, which operate 18 defined benefit divisions. Of these, 12 show a deficit ranging between 62% and 93.5% whereas the remaining 6 show a balance. Special attention must be given to the worst placed divisions, which are able to meet only a small part of their pension obligations. Their assets will be depleted within a few years unless employers speed up their payments to the funds.

The pension burden of pension funds, i.e. pension payments as a ratio of premiums, is a useful gauge for predicting the position and future prospects of pension funds. The pension burden increases with the age of the fund and a heavy burden means a speedier depletion of the fund's assets. The pension burden of non-guaranteed pension funds is 35.3%. The pension burden of funds that are guaranteed by other parties is, on the other hand, 56%. Not included in that figure is the Civil Servants' Pension Fund, which has payments and premiums far exceeding those of all the other funds together. The total pension burden of Icelandic pension funds is 36.7%.

Figure 13. Assets in foreign currencies.

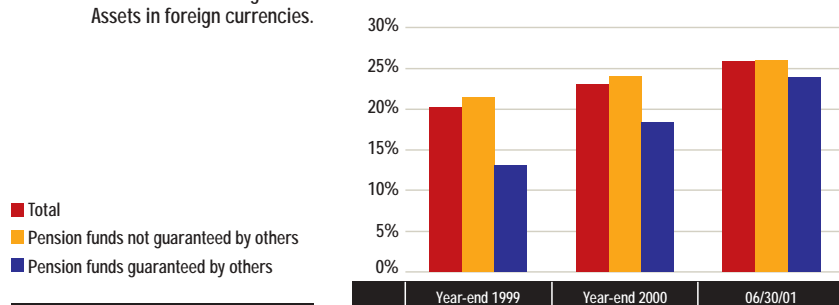
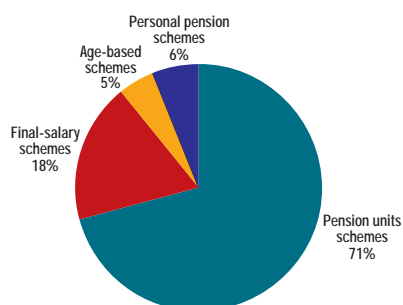


Figure 14. Pension schemes.



Supplementary pension savings

At present there are 50 depositories for supplementary pension savings, of which 24 are pension funds. Depositories, other than pension funds, include banks, savings banks, securities firms and life-insurance companies.

Supplementary pension savings with depositories other than pension funds have grown from ISK 600 million at year-end 1999 to ISK 2 billion at year-end 2000, according to information collected by the FME from the parties concerned. The supplementary pension savings with pension funds, excluding the 7 funds operating purely as personal pension savings funds prior to the entry into effect of Act 129/1997, grew from ISK 970 million to ISK 1.9 billion during that same period.

Supplementary pension savings can stem from two different sources, i.e. premiums in excess of the mandatory 10% minimum premium as well as the mandatory 10% premium. A number of pension funds make use of the option made available by law to define minimum pension guarantee as lower than 10% while offering at the same time a part of the minimum pension guarantee in the form of a conditional personal pension account. The part of the premium which is in excess of the minimum mandatory requirement forms a private account or supplementary insurance cover. By law, a fund member may, at no extra cost, divert his/her premium payments for supplementary insurance cover and any other type of personal pension savings to a different depository than the one receiving the mandatory premium.

The above figures reveal a considerable growth in supplementary pension savings, but there is still scope for a further increase as only around 40% of the population avail themselves of this option at present.

Number and structuring of pension funds

On July 1, 2001 the number of pension funds was 54, compared with 60 at year-end 1999. Of the 54 pension funds, 11 no longer receive premium payments, which leaves a total of 43 fully active funds. Of the 54 (43) pension funds, 40 (30) are pension funds without employer guarantee, while 14 (13) funds are guaranteed by other parties.

Despite the merger of some of the smaller pension funds between 1999 and mid-year 2001, there are still well over ten small pension funds in full operation. One of the legal conditions for the granting of operating licences is that the minimum number of fund members be no less than 800 unless the fund has other means for spreading its risk on account of pension obligations. At present, fourteen pension funds are below this member limit but manage to meet this condition through insurance, co-operation with other pension funds or the guarantee of municipal authorities.

A number of pension funds operate more than one mutual insurance fund, providing for varying pension rights and 24 pension funds also operate private pension schemes.

The total assets of pension funds at year-end 2000 by schemes is as follows: Pension units schemes hold 71% of all assets, final salary schemes 18%, age-based units schemes 5% and personal pension

schemes 6%, cf. **Figure 14**. In a pension units scheme, premiums are converted into units which form the basis for calculating pension rights. The age-based pension scheme is also a units scheme, but premiums paid at an earlier age carry greater weight than premiums paid late in a fund member's career. In a final salary scheme the amount of premiums paid guarantees the fund member a certain percentage of a successor's salary or some other pay guidelines. Assets in age-based schemes have increase by 3% at the expense of assets in the more traditional units schemes. Apart from that, the division of assets between schemes has remained relatively unchanged since 1999.

2.3 Insurance market

Fewer insurance companies

Currently there are 14 authorised Icelandic insurance companies. They underwrite almost exclusively domestic risks and are all domestically controlled. Only eight of these companies are expected to carry risk in 2002.

Three limited-liability insurance companies and a small mutual offer all types of non-life insurance. These three receive 97% of the premiums earned by Icelandic insurance companies. Two of them are listed on the stock market and the third intends to apply for listing. There are three life assurance companies, all in the majority ownership of other financial enterprises. Two companies in run-off are owned by other insurance companies.

Special legislation on fishing boat insurance companies was repealed in mid-2000. The portfolios of the three pure boat insurance companies which were still in operation have been transferred to the non-life insurance company Sjóvá-Almennar tryggingar hf. Sjóvá-Almennar tryggingar hf. has purchased the marine insurance company Sam-ábyrgðin hf. and a merger of the two has been authorised by the FME.

Iceland's natural catastrophe insurer (Viðlagatrygging Íslands) which operates under special legislation, has a specific role and is omitted from the following discussion of insurance companies' operations. Premiums for natural catastrophe insurance amounted to ISK 750 million in the year 2000, while claims were ISK 2.6 billion, in particular due to the earthquakes in southern Iceland in June 2000. Its own capital and reserves amounted to ISK 5.15 billion.

Premiums for insurance policies mediated by brokers during the year 2000 amounted to ISK 1.3 billion, primarily to insurers in other EEA member states. In addition, policyholders can deal directly with insurers in other member states; the extent of such business is not known.

The following section provides details of the activities of Icelandic insurance companies as they are presented in their annual accounts for the year 2000. All amounts have been adjusted to price levels in 2000. Changes in amounts from one year to the next are thus changes in excess of price level changes.

Increased turnover in non-life insurance

For non-life insurance, the year 2000 was characterised by growth in premiums, claims and return on investment. Earned premiums increased by 10% in excess of price level changes over the pre-

vious year, or by ISK 1.5 billion, amounting to ISK 17.1 billion. The premium increase was almost totally from motor vehicle insurance. Incurred claims increased by 21%, amounting to ISK 18.7 billion. The greatest increase in claims was in property insurance, although motor vehicle claims also rose sharply. Trends in both premiums and claims differed greatly between insurance classes, as discussed in more detail below. After deducting the reinsurers' share from premiums and claims, own premiums amounted to ISK 13.6 billion and own claims to ISK 14.6 billion.

Figure 15 shows trends in premiums and claims for non-life insurance in recent years, with gross and net amounts.

In addition to premiums and claims, operating costs, investment income and changes to equalisation provisions have a substantial effect on profitability of insurance activities. Operating costs were ISK 3.2 billion and have been increasing steadily in recent years. Bad claims ratios required resorting to equalisation provisions in all insurance classes, most in compulsory motor vehicle insurance and in domestic reinsurance. The equalisation provisions were reduced by ISK 200 million in each of these two classes.

Individual classes of non-life insurance

Figure 16 shows the trend in earned premiums in the main classes of non-life insurance. It also shows the relative importance of individual classes.

Premiums earned for direct insurance in the year 2000 totalled ISK 16.1 billion, while the corresponding claims were ISK 17.9 billion. Premiums for reinsurance written by Icelandic insurers were just over ISK 1 billion, while claims were ISK 0.8 billion.

Compulsory motor vehicle insurance is the most extensive direct insurance class. Here earned premiums increased by ISK 1.4 billion over the previous year, or by 32%, due to the combined effect of large premium increases and an increase in the number of vehicles. The share of compulsory motor vehicle insurance of gross direct insurance premiums was 37%, while in 1999 it was 29%. Motor vehicle insurance of all types comprised over half of gross direct insurance premiums in 2000, whereas it was 43% in 1999.

Figure 15. Trends in premiums and claims for non-life insurance, with gross and net amounts at 2000 prices.

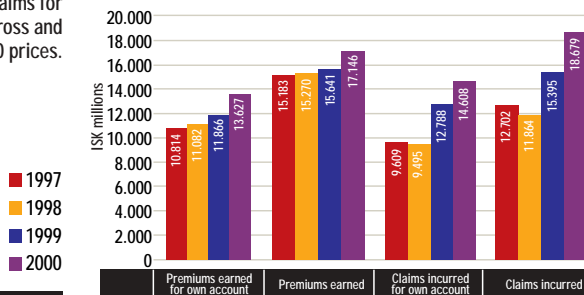


Figure 16. Premiums earned in the main non-life classes at 2000 prices.

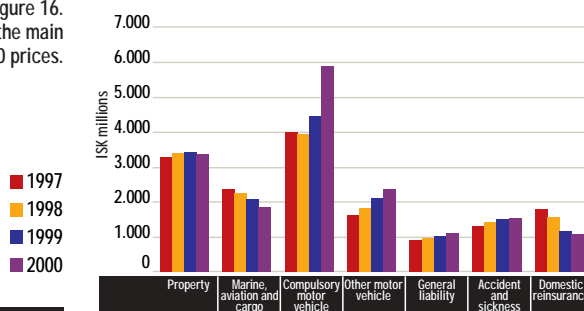


Figure 17. Claims incurred at 2000 prices.

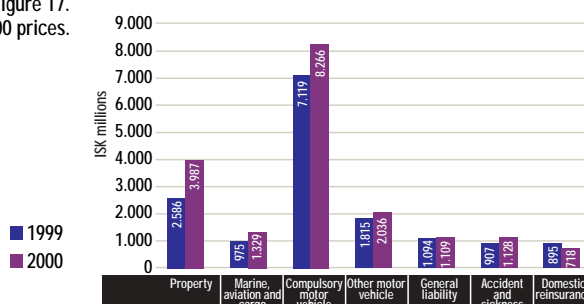


Figure 17 shows a breakdown of incurred claims by insurance class. Property insurance claims amounted to ISK 4 billion, increasing by ISK 1.4 billion or 54% over the previous year. The increase was due partly to major claims of which a substantial portion is covered by reinsurers, so that the increase has only a very slight effect on profitability of property insurance in the accounting year. There was also a substantial increase in claims in marine, aviation and cargo insurance (36%) and accident and sickness insurance (24%).

Claims incurred in compulsory motor insurance increased by 16% from the previous year and amounted to ISK 8.3 billion. These claims consisted of an increase of ISK 2.7 billion of the provision for claims outstanding and by paid claims of ISK 5.6 billion. The proportion of paid claims due to claims occurring before the year 2000 was 62%, while 38% of the payments were because of claims that occurred within the accounting year. At the end of the year 2000, total compulsory motor insurance claims that occurred within the accounting year were estimated at ISK 9.6 billion, of which 2.1 billion had already been paid within the same year.

In compulsory motor vehicle insurance and property insurance, claims were substantially higher than premiums. The loss ratio in compulsory motor vehicle insurance did, however, decrease from that of the previous year, since premiums increased greatly as previously mentioned. Further increases in premium income are foreseeable in this class, as price increases in the year 2000 will not be fully realised until the year 2001. The loss ratio should thus decrease further during the current year, unless claims developments worsen dramatically. A major part of the claim's increase in property insurance is recovered from reinsurers. Net claims were 96% of own premiums.

Expansion in life insurance

Written life insurance premiums were ISK 1.4 billion, which is an increase of ISK 0.4 billion over 1999. Growth continues in life insurance with policyholders' investment risk, where life insurance provisions at year-end 2000 amounted to ISK 0.7 billion. The extent of life insurance activity is, however, only a fraction of that of non-life insurance.

5) These figures are the aggregated results of all the insurance companies. No consideration is made for insurance companies owning holdings in other insurance companies, so part of the profit is reported twice.

Increased profit

Total profit of insurance companies⁵ was ISK 1.5 million in the year 2000. **Figure 18** shows how profit has developed in recent years.

In the profit and loss accounts income from investments is divided by a fixed rule between insurance operations and financial activities, and the profit of each part calculated separately. This division affects neither total investment income nor the result of the profit and loss account.

Figure 19 shows that profit of insurance operations has decreased constantly, while this is balanced out against increased earnings from financial operations. The half-year financial accounts of the three major insurance companies at mid-year 2001 showed considerable changes. The calculated profit from insurance operations had increased, while financial operations showed losses after investment income was transferred to insurance operations.

Economic situation of insurance companies

The cumulative assets of insurance companies totalled ISK 63.3 billion at year-end 2000, an increase of ISK 6.6 billion over the previous year. In accordance with the nature of insurance activities, investments were the companies' largest asset item, amounting to ISK 44.7 billion. Technical provisions were the largest liabilities item, ISK 43.8 billion. Roughly speaking, investments and technical provisions comprise close to 70% of the balance sheet.

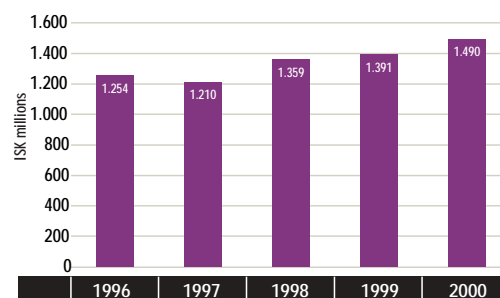


Figure 18. Total profit of insurance companies at 2000 prices.

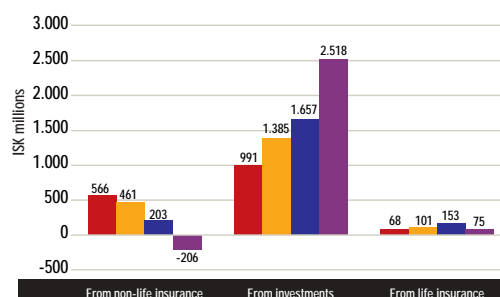


Figure 19. Total profit from principal activities of insurance companies at 2000 prices.

Figure 20 shows development in the main investment items. Growth in investments was particularly in variable-yield securities, while the share of fixed-yield securities decreased. Automobile loans, which are the majority of mortgage-secured loans, were of a similar amount at the end of 2000 as they were the previous year, while mortgage-secured loans as a whole have somewhat decreased.

Figure 21 shows own capital and reserves as well as technical provisions. Both items have grown steadily. Some capital is, however, reported twice because of holdings which insurance companies have in other insurance companies.

Gross provisions for claims for all insurance classes were ISK 32.7 billion or three-quarters of the technical provisions. Thus, the claims provision is a good half of the balance sheet total. Claims provi-

sion in compulsory motor vehicle insurance is ISK 20.1 billion, of which ISK 12.6 billion was due to claims that occurred before the beginning of the year 2000. The claims provision in compulsory motor insurance comprises almost one-third of the aggregated balance sheet total of the non-life insurance companies.

The reinsurers' share of technical provisions is entered as an asset item in the annual accounts; it amounted to ISK 5.5 billion at year-end 2000. Own technical provisions thus totalled ISK 38.3 billion. **Figure 22** shows the development of the principal components of own technical provisions.

Provision for unearned premiums increases in accordance with the increase in the number of insured motor vehicles and the premium level of motor vehicle insurance. Claims provisions increase in accordance with incurred claims. Own provision for claims in compulsory motor vehicle insurance rose by ISK 2.5 billion during the year 2000. The rise in property insurance claims is not reflected in own provision for claims, since the increase will mostly be recovered from reinsurers, as previously mentioned.

Figure 20.
Principal classes of investments
at 2000 prices.

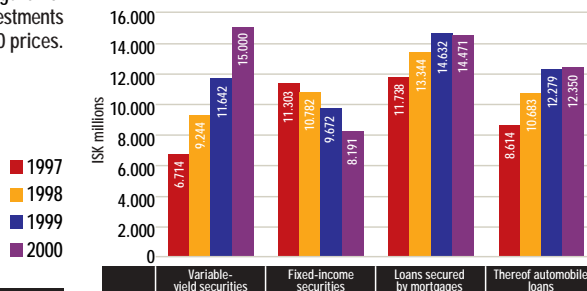


Figure 21.
Own capital and reserves, and
technical provisions at 2000 prices.

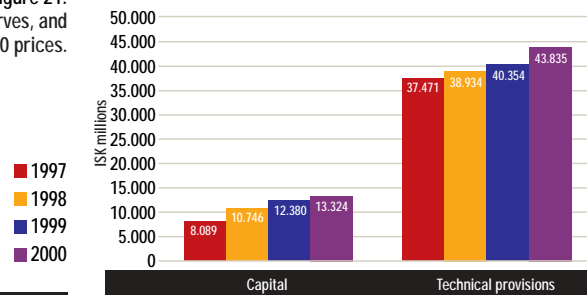
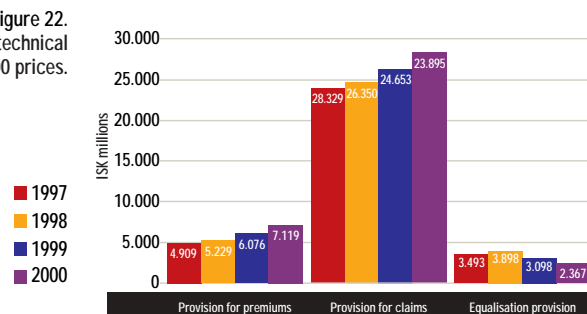


Figure 22.
Main components of technical
provisions at 2000 prices.



3. The FME's Supervisory Emphasis

The FME defines four major areas of its supervisory emphasis: Risk management and internal control, conduct in the financial market, market discipline and competitiveness of the financial market. These areas of emphasis will continue to form the basis of the FME's supervisory measures and apply to all sectors of the financial market.

3.1 Risk management and internal control

Since its foundation, the FME has regarded it as one of its major roles to assist financial institutions⁶ in ensuring that their management is competent to provide the company with a solid organisational structure, clear policies, efficient internal rules and procedures, adequate information systems and internal auditing. The executives and other employees are thus provided with the tools necessary to correctly assess the risk entailed in the operations and to manage this risk in line with the company's strengths.

Co-ordination between sectors

The FME's assessment has revealed that the formulation and development of risk management and internal control varies between sectors of the financial market. In its supervisory capacity, the FME can help by communicating knowledge and experience gained in the different sectors.

At present, the FME has introduced a draft proposal on internal control and risk management within financial institutions. Experience has also made clear the need for harmonising the relevant legislations. In this respect, decisions need to be reached as to whether the legislation governing insurance companies and securities firms should contain provisions regarding the presence of internal auditors within the companies who are directly responsible to the boards of directors.

Fit and proper

The FME has considered the competence of boards of directors and executives and an assessment of this must now accompany all applications for operating licences. The FME has also held meetings with the boards of directors of financial institutions in order to emphasise their roles and responsibilities. The FME intends to carry out further work in this area.

6) Financial institutions here refers to companies in all sectors of the financial market, i.e. credit institutions, securities firms, insurance companies, insurance brokerages and pension funds.

Defaults and provisioning

In accordance with previous warnings by the FME concerning the growth in lending and the capital position of credit institutions, emphasis has been placed on monitoring the development of defaults and provisioning at financial institutions. This work will continue over the months ahead. It is of particular importance to stress that the boards of directors, management and external auditors of financial institutions notify the FME should serious difficulties arise. When risk management and internal control fails, it can be difficult to foresee such difficulties.

3.2 Conduct in the financial market

The FME emphasises the good conduct of business practices in the financial market, as one of its responsibilities is to supervise that financial operations are in conformity with sound and proper business practices.

Securities market

Last year the FME emphasised the establishment of a more efficient control of conduct in the securities market. At the same time, it followed up on recent amendments to the legislation on securities transactions, which have strengthened the trading framework and created improved conditions for effective supervision. The aim is to gain a better overview of the conduct of parties subject to supervision and suggest corrective action where needed. A further goal is to strengthen the supervision of insider trading and the public offer of securities.

Supervision and overview of the financial market is closely linked with supervision in other areas, such as the financial position of credit institutions and insurance companies and the investments of pension funds.

Other financial markets

Conduct in other sectors of the financial market needs consideration. The FME has reason to believe that corrective action is needed regarding the brokerage and sale of life insurance, as the availability and sale of participating life insurance has increased considerably in recent years. This applies in particular to the obligation of insurance companies and insurance brokers to provide the insured with appropriate information. The need for establishing guidelines which detail the obligations of these parties, to supplement the provisions of laws and regulations, is currently under review.

Increased awareness

Consumers are increasingly turning to the FME with complaints concerning their dealings with certain financial institutions. Such cases can lead to corrective action in a particular area, but the FME does not have power of arbitration in legal disputes between a client and a financial institution. Under the auspices of the FME two complaints committees operate, the Insurance Complaints Committee and the Complaints Committee on Transactions with Financial Institutions, to which consumers can turn with their grievances.

3.3 Market discipline

The FME emphasises increased transparency in the operations of financial institutions. This means stricter discipline from within the market itself in addition to the discipline imposed by internal control and official supervision of financial operations.

Accounting

The notion of market discipline applies to auditing and harmonising of financial statements. The FME has proposed a review of provisions regarding the valuation of securities in its rules on the annual accounts of financial institutions. Increased harmonisation of financial statements in the market also needs to be encouraged, for example in relation to innovations in financial services. The FME has submitted for comments and published on its website a draft proposal on the publication of information regarding financial documents in annual accounts.

Transparency in insurance

The FME has previously stressed the importance of increased transparency in the operations of insurance companies. A special committee is at present reviewing the regulation on the annual accounts of insurance companies other than life insurance companies. This committee has, for example, discussed how best to improve the information given in the notes to the annual accounts, particularly as regards technical provisions and its development. The FME has also proposed the drafting of specific rules on technical provisions.

The FME regards increasing transparency of the actuarial surveys of pension funds as a matter of considerable urgency. At present, the FME is following the work of a group of actuaries which is working on this matter.

3.4 Competitiveness of the financial market

The policy and operations of the FME assume that the authority plays an important role in creating a competitive financial market in Iceland. It also points out that the role of the FME is to participate in the shaping of the financial market and to advocate consumer interest in the safety of financial services.

Principles on effective financial supervision

A prerequisite for a competitive financial market is the existence of laws and regulations that make comparable demands on the operations of financial institutions as exist in competing markets. Effective official supervision of the financial market is also of primary importance, as is the fact that such supervision complies with the basic principles of effective financial supervision, as determined by international organisations of supervisory authorities in all sectors.

As mentioned in chapter 1.3, the International Monetary Fund conducted a survey of the Icelandic financial market at the end of last year and published a report on its findings last May. Part of the survey investigated compliance with the basic principles of effective supervision. Although the IMF considers the FME to be in a strong position to fulfil its duties, it made a range of comments and suggestions for improvement and in order to encourage enhanced security. Corrective measures as proposed by the IMF will strengthen the Authority and help to create a more competitive financial market.

International co-operation and transparency in supervision

The FME participates in a variety of international co-operation in order to benefit from the knowledge and experience of foreign financial markets – again with the principal aim of ensuring the competitiveness and safety of the Icelandic financial market.

Furthermore, the FME enhances transparency in supervision, e.g. by issuing its annual report and making information available on the website.

4. Parties Subject to Supervision

4.1 Groups of institutions subject to supervision

Parties subject to supervision June 30, 2001

	Number	Act no:
Commercial Banks	4	113/1996
Savings Banks	24	113/1996
Other Credit Institutions		123/1993
Investment Banks	5	123/1993
Investment Funds	4	123/1993
Leasing Companies	3	123/1993
Co-operative Societies	9	22/1991
Securities Firms	7	13/1996
Securities Brokerages	4	13/1996
Mutual Funds (UCITS)	9	10/1993
Mutual Funds (UCITS) Management Companies	5	10/1993
Stock Exchanges and Regulated OTC markets	1	34/1998
Central Securities Depositories	1	131/1997
Pensions Funds	54	129/1997
Insurance Companies	14	60/1994
Insurance Brokerages	16	60/1994
Other parties subject to supervision	4	
Total	164	

4.2 List of parties supervised by the FME

	Head Office		Head Office
COMMERCIAL BANKS		Sparisjóður vélstjóra	Reykjavík
		Sparisjóður Þórshafnar	Þórshöfn
Búnaðarbanki Íslands hf.	Reykjavík	Sparisjóður Öndurfarðar*	Flateyri
Íslandsbanki - FBA hf.	Reykjavík	Sparisjóðurinn í Keflavík	Keflavík
Landsbanki Íslands hf.	Reykjavík		
Sparisjóðabanki Íslands hf.	Reykjavík		
SAVINGS BANKS		OTHER CREDIT INSTITUTIONS	
Sparisjóður Bolungarvíkur	Bolungarvík	Investment Banks	
Sparisjóður Hafnarfarðar	Hafnarfjörður	Eignarhaldsfélagið Alþýðubankinn hf.	Reykjavík
Sparisjóður Hornafjarðar og nágrennis	Höfn	Frjálsi Fjárfestingarbankinn hf.	Reykjavík
Sparisjóður Hólahrepps	Sauðárkrókur	Greiðslumiðlun hf. - VISA Ísland	Reykjavík
Sparisjóður Húnaþings og Stranda	Hvammstangi	Kaupþing hf.	Reykjavík
Sparisjóður Höfðhverfinga	Grenivík	Kreditkort hf. - EUROPAY Ísland	Reykjavík
Sparisjóður Kópavogs	Kópavogur		
Sparisjóður Mýrasýslu	Borgarnes	Investment Funds	
Sparisjóður Norðfjarðar	Neskaupstaður	Byggðastofnun	Reykjavík
Sparisjóður Norðlendinga	Akureyri	Ferðamálasjóður	Reykjavík
Sparisjóður Ólafsfjarðar	Ólafsfjörður	Hafnabótasjóður	Kópavogur
Sparisjóður Ólafsvíkur	Ólafsvík	Lánasjóður landbúnaðarins	Selfoss
Sparisjóður Reykjavíkur og nágrennis	Reykjavík		
Sparisjóður Siglufjarðar	Siglufjörður	Leasing Companies	
Sparisjóður Strandamanna	Hólmavík	Glitnir hf.	Reykjavík
Sparisjóður Suður-Þingeyinga	Laugar	Lýsing hf.	Reykjavík
Sparisjóður Súðavíkur*	Súðavík	SP-Fjármögnun hf.	Reykjavík
Sparisjóður Svarfdæla	Dalvík		
Sparisjóður Vestfirðinga	Þingeyri		
Sparisjóður Vestmannaeyja	Vestmannaeyjar		

*Temporarily not in operation since June 15, 2001.

Head Office

Head Office

CO-OPERATIVES SOCIETIES

Kaupfélag Árnesinga	Selfoss
Kaupfélag Austur-Skaftfellinga	Höfn
Kaupfélag Eyfirðinga	Akureyri
Kaupfélag Fáskrúðsfirðinga	Fáskrúðsfjörður
Kaupfélag Héraðsbúa	Egilsstaðir
Kaupfélag Skagfirðinga	Skagafjörður
Kaupfélag Suðurnesja	Reykjanesbær
Kaupfélag V-Húnavetninga	Hvammstangi
Samvinnufélagið Hreyfill	Reykjavík

SECURITIES FIRMS

Burnham International á Íslandi hf.	Reykjavík
Fjárvernd - Verðbréf hf.	Reykjavík
Íslensk verðbréf hf.	Akureyri
Jöklar - Verðbréf hf.	Reykjavík
Landsbréf hf.	Reykjavík
MP Verðbréf hf.	Reykjavík
Verðbréfastofan hf.	Reykjavík

SECURITIES BROKERAGES

Annar hf. - verðbréfamiðlun	Reykjavík
Íslenskir fjárfestar hf.	Reykjavík
Vaxta ehf. - verðbréfamiðlun	Kópavogur
Verðbréfamiðlun Lifiðnar og Sameinaða lífeyrissjóðsins ehf.	Reykjavík

MUTUAL FUNDS (UCITS)

Hávöxtunarfélagið hf.	Reykjavík
Heimasjóðir VÍB hf.*	Reykjavík
Landssjóður hf.	Reykjavík
Landssjóður2 hf.*	Reykjavík
SPH Verðbréfasjóðurinn hf.*	Reykjavík
Verðbréfasjóðir VÍB hf.	Reykjavík
Verðbréfasjóður Búnaðarbankans hf.	Reykjavík
Verðbréfasjóðurinn hf.	Reykjavík
Ævisjóðurinn hf.*	Reykjavík

*National funds only marketed in Iceland.

MUTUAL FUNDS (UCITS) MANAGEMENT COMPANIES

Kaupþing-eignastýring ehf.	Reykjavík
Landsvaki ehf.	Reykjavík
Rekstrarfélag Verðbréfasjóðs Búnaðarbankans hf.	Reykjavík
Rekstrarfélag VÍB hf.	Reykjavík
SPH Rekstrarfélag ehf.	Reykjavík

STOCK EXCHANGES AND REGULATED OTC MARKETS

Verðbréfaþing Íslands hf.	Reykjavík
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CENTRAL SECURITIES DEPOSITORIES

Verðbréfastofa Íslands hf.	Reykjavík
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PENSION FUNDS

Almennur lífeyrissjóður VÍB hf.	Reykjavík
Eftirlaunasjóður F.Í.A.	Reykjavík
Eftirlaunasjóður Reykjanesbæjar	Keflavík
Eftirlaunasjóður Sláturfélags Suðurlands	Reykjavík
Eftirlaunasjóður slökkviliðsmanna á Keflavíkurflugvelli	Keflavík
Eftirlaunasjóður starfsmanna Hafnarfjarðarkaupstaðar	Hafnarfjörður
Eftirlaunasjóður starfsmanna Íslandsbanka hf.	Reykjavík
Eftirlaunasjóður starfsm. Ólíuverzlunar Íslands	Reykjavík
Eftirlaunasjóður starfsmanna Útvegsbanka Íslands	Reykjavík
Frjálsi lífeyrissjóðurinn	Reykjavík
Íslenski lífeyrissjóðurinn	Reykjavík
Lífeyrissjóður Akraneskaupstaðar	Akranes
Lífeyrissjóður arkitekta og tæknifræðinga	Reykjavík
Lífeyrissjóður Austurlands	Neskaupstaður
Lífeyrissjóður bankamanna	Reykjavík
Lífeyrissjóður Bolungarvíkur	Bolungarvík
Lífeyrissjóður bænda	Reykjavík
Lífeyrissjóður Eimskipafélags Íslands	Reykjavík
Lífeyrissjóður Flugvirkjafélags Íslands	Reykjavík
Lífeyrissjóður hjúkrunarfræðinga	Reykjavík
Lífeyrissjóður lækna	Reykjavík
Lífeyrissjóður Mjólkursamsölnunar	Reykjavík
Lífeyrissjóður Neskaupstaðar	Reykjavík
Lífeyrissjóður Norðurlands	Akureyri
Lífeyrissjóður Rangæinga	Hella
Lífeyrissjóður sjómanna	Reykjavík
Lífeyrissjóður starfsmanna Akureyrarbæjar	Akureyri
Lífeyrissjóður starfsmanna Áburðarverksmiðju ríkisins	Reykjavík
Lífeyrissjóður starfsmanna Búnaðarbanka Íslands	Reykjavík
Lífeyrissjóður starfsmanna Húsavíkurbæjar	Reykjavík
Lífeyrissjóður starfsmanna Kópavogskaupstaðar	Kópavogur
Lífeyrissjóður starfsmanna Reykjavíkurapóteks	Reykjavík
Lífeyrissjóður starfsmanna Reykjavíkurborgar	Reykjavík
Lífeyrissjóður starfsmanna ríkisins	Reykjavík
Lífeyrissjóður starfsmanna sveitarfélaga	Reykjavík
Lífeyrissjóður starfsmanna Vestmannaeyjabæjar	Vestmannaeyjar
Lífeyrissjóður Suðurlands	Selfoss
Lífeyrissjóður Suðurnesja	Keflavík
Lífeyrissjóður Tannlæknafélags Íslands	Reykjavík
Lífeyrissjóður verkfræðinga	Reykjavík
Lífeyrissjóður verslunarmanna	Reykjavík
Lífeyrissjóður Vestfirðinga	Ísafjörður
Lífeyrissjóður Vestmannaeyja	Vestmannaeyjar
Lífeyrissjóður Vesturlands	Akranes
Lífeyrissjóðurinn Eining	Reykjavík
Lífeyrissjóðurinn Framsýn	Reykjavík
Lífeyrissjóðurinn Hlíf	Reykjavík
Lífeyrissjóðurinn Lifiðn	Reykjavík

	Head Office		Head Office
Lífeyrissjóðurinn Skjöldur	Reykjavík	Renta ehf.	Reykjavík
Sameinaði lífeyrissjóðurinn	Reykjavík	Trygg miðlun ehf.	Reykjavík
Samvinnulífeyrissjóðurinn	Reykjavík	Tryggingamiðlun Íslands ehf.	Reykjavík
Séreignalífeyrissjóðurinn	Reykjavík	Tryggingamiðlunin Gildi ehf.	Reykjavík
Söfnunarsjóður lífeyrisréttinda	Reykjavík	Vátryggingamiðlunin ehf.	Reykjavík
Tryggingasjóður lækna	Reykjavík		

INSURANCE COMPANIES

Alþjóða líftryggingarfélagið hf.	Reykjavík
Bátatrygging Breiðafjarðar	Stykkishólmur
Íslensk endurtrygging hf.	Reykjavík
Líftryggingafélag Íslands hf.	Reykjavík
Samábyrgðin hf.	Reykjavík
Sameinaða líftryggingarfélagið hf.	Reykjavík
Sjóvá-Almennar tryggingar hf.	Reykjavík
Trygging hf.	Reykjavík
Tryggingamiðstöðin hf.	Reykjavík
Vátryggingafélag Íslands hf.	Reykjavík
Vélbátaábyrgðarfélagið Gróttu	Reykjavík
Vélbátaábyrgðarfélag Ísfirðinga	Ísafjörður
Viðlagatrygging Íslands	Reykjavík
Vörður vátryggingafélag	Akureyri

INSURANCE BROKERS

Alþjóða fjárfestinga- og vátryggingamiðlunin ehf.	Kópavogur
Alþjóðleg miðlun ehf.	Reykjavík
Árni Reynisson ehf.	Reykjavík
Fjárfestingarmiðlun Íslands ehf.	Kópavogur
Guðjón Styrkársson	Reykjavík
Heath Lambert Norway AS	Oslo
Howden Insurance Brokers Ltd.	London
Ísvá ehf.	Reykjavík
Marsh Ltd.	London
Nýja vátryggingaþjónustan hf.	Reykjavík
Provins Insurance AB	Sweden

OTHER SUPERVISED PARTIES

Póstgíró, Íslandspóstur hf.	Reykjavík
Íbúðalánasjóður	Reykjavík
Nýsköpunarsjóður atvinnulífsins	Reykjavík
Tryggingasjóður innstæðueigenda og fjárfesta	Reykjavík

November 2001

Publisher: The Financial Supervisory Authority, Iceland

Layout: Gott fólk McCann-Erickson

Photographs: Eddi

Printing: Litróf