



Annual Report 2003

The period 1 July 2002 to 30 June 2003



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INTRODUCTION

This is the fourth annual report of the Financial Supervisory Authority (FME) providing a survey of its activities from 1 July 2002 to 30 June 2003. The report covers developments and the outlook in financial markets and highlights priorities in the FME's work for the coming months. The report contains a list of parties subject to supervision as of 30 June 2003 and gives an account of changes in the operating licences of these parties over the period covered by the report. The report also publishes a summary of amendments to laws and regulations concerning the financial market during the same period.

The annual report is published in both Icelandic and English and both versions can be found on the FME website, www.fme.is.

FME Board of Directors:

Mr. Stefán Svavarsson, certified public accountant, associate professor at the University of Iceland, Chairman;
Mr. Lárus Finnbogason, certified public accountant, Vice-chairman;
Mr. Ingimundur Friðriksson, assistant governor of the Central Bank of Iceland.

Alternates:

Mr. Benedikt Árnason, head of department, Ministry of Industry and Commerce;
Ms. Þuríður I. Jónsdóttir, district court attorney;
Ms. Lilja Steinþórsdóttir, chief auditor of the Central Bank of Iceland.

Director General: Mr. Páll Gunnar Pálsson

Deputy Director General: Mr. Ragnar Hafliðason

The FME operates in accordance with the Act on Official Supervision of Financial Activities (87/1998). The FME is a public authority governed by a special Board of Directors, but under the administrative jurisdiction of the Minister of Commerce. The Minister appoints the Board for a four-year term. The Board's role is to specify the emphases in the FME's work and follow its activities and operations. It appoints the Director General, who is in charge of day-to-day activities.

As prescribed by law, the Financial Supervisory Authority carries out various types of supervision of financial undertakings, pension funds, insurance companies, insurance brokers and a range of financial activities. The supervision is conducted through specific investigations of parties subject to supervision and regular collection of information on their activities and financial position. The processing of written queries and communications from the clients of these parties is also part of the supervisory function. On its website, the FME publishes summary information from the annual accounts of parties subject to supervision, general guidelines on financial market activities and various discussion documents. Furthermore, it arranges presentations and meetings with management and staff in the financial market and endeavours to initiate discussions on questions concerning the security and competitiveness of the financial market.

The FME operates in accordance with an approved policy outline, which is regularly adapted to changed conditions. It is published on the FME website along with a description of the organisation of the FME.

SURVEY OF ACTIVITIES FROM 1 JULY 2002 TO 30 JUNE 2003

This section provides general information on the activities of the FME during the period from 1 July 2002 to 30 June 2003 as well as touching on matters under consideration prior to the publication of this report. The account of the FME's activities indicates the extent to which it has kept to its policy outline and emphasises that were detailed in Chapter 3 of last year's report.

1.1

Support given to executive boards of financial undertakings – presentations and dissemination of information

Emphases for the period: Increase dissemination of information and dialogue with boards of directors, meetings with board members. Supervision of risk management and internal controls.

During the period, the FME has had meetings with a number of boards and management teams of financial undertakings. During the latter half of 2002 and the first half of 2003 the FME attended 11 board meetings of pension funds operated by commercial banks. The purpose of these meetings was primarily to emphasise the important role the boards play in safeguarding the interests of fund members against other interests that are inevitably entailed in the operations of the financial undertakings managing such funds. At the meetings, special attention was given to the tools available to the boards to assist them in fulfilling their function.

In the springtime, the FME convened two meetings with the **board members of savings banks**, one in Akureyri and the other in Reykjavík. Around 70 people attended to hear a lecture and discuss the role and responsibilities of board members, risk assessment, risk management, internal control and internal auditing. A presentation was also given of the function and work methods of the FME. Similar meetings were held this autumn with the **board members of pension funds**, with a total of 130 people attending the two meetings held. The boards of commercial banks have been invited to the FME's premises for the same purpose. This work will be continued over the coming months.

In addition to what has been detailed above, the FME has improved the access of employees and board members to information on the financial market by updating its website. The website is a valuable source of information for financial market employees as it provides access to information on laws and regulations pertaining to the financial market, information on the operations of undertakings subject to supervision and various information on the activities of the FME.

1.2

Supervision of qualifying holdings

Emphases for the period: Business conduct in the financial market. The issuance of clear rules for owners of qualifying holdings.

The supervision of qualifying holdings in financial undertakings and insurance companies was extensive during the period, as had indeed been anticipated.

Detailed statutory provisions apply to the supervision of qualifying holdings stipulating the obligation to seek the FME's approval prior to the purchase of qualifying holdings and also the obligation of the FME to maintain ongoing supervision of owners of qualifying holdings. The ongoing supervision is intended to ensure that the holdings in no respect harm the sound and secure operations of the financial undertaking or insurance company concerned.

Considerable changes took place in the ownership of financial undertakings and insurance companies during the period and the FME dealt with a **number of applications** relating to ownership changes. Thus 12 applications were processed concerning the acquisition of qualifying holdings in 11 financial undertakings and 9 concerning 4 insurance companies.

In a vast majority of instances, these applications have been approved but a few were rejected. In a few cases, the applicants accepted changes to their plans during the processing of their application. In some cases, the FME based its decisions on statements provided by applicants concerning certain measures to be taken following the acquisition.

In connection with the sale of State holdings in Landsbanki Íslands hf. and Búnaðarbanki Íslands hf. the buyers submitted, as prescribed by law, applications to the FME for authorising them to acquire qualifying holdings in the said undertakings. Owing to the size of the holdings and the importance of these undertakings in the Icelandic financial market the applications were dealt with most thoroughly. The FME's decisions on these matters have been made public, including detailed descriptions of the underlying conditions for approval.

In addition to the above, the FME has in a few instances investigated the size of a qualifying holding and whether the relations of a number of parties give reason to suspect that a qualifying holding is held.

Increased supervision of qualifying holdings in financial undertakings has furthermore resulted in strengthened supervision of the

undertakings themselves. The FME has thus been in a position to make use of the experience gained from supervising qualifying holdings in **formulating guidelines** it has issued concerning the rules of the boards of directors of financial undertakings.

The guidelines stress, for instance, that the board members of a financial undertaking shall not have access to information pertaining to its customers unless it is necessary for the function of the board of directors. The guidelines also seek to ensure effective internal control of transactions with connected parties, including parties connected with members of the board. The submission of regular information to the FME concerning exposures to connected parties has also been established.

1.3

Supervision in individual areas of the financial market

1.3.1 Financial undertakings and the credit market¹

Emphases for the period: Adaptation to new legislation. Introduction of new supervisory procedures intended to support the risk management of financial undertakings. Supervision of loan-loss provisions.

The Act on Financial Undertakings (161/2002) came into force as of 1 January 2003. This Act provides a unified legislation on the establishment and operations of commercial banks, savings banks, credit institutions, electronic money undertakings, securities firms, securities brokerages, and the management companies of UCITS. This legislation entails changes to the operating framework of the said undertakings as well as changes to the powers of the FME.

The FME has adapted its activities to the new legislation. The formation and review of such rules as the Act requires the FME to set is currently in progress. Furthermore, the FME is in the process of formulating new supervisory measures, for instance a new authorisation to stipulate higher capital adequacy ratios for individual financial undertakings.

It also falls within the scope of the FME to ensure that financial undertakings comply with new laws and regulations pertaining to their activities. The FME has thus held **special information sessions** to present the new legislation.

Monitoring of the quality of the loan portfolios of credit institutions was continued, but the effects of the poor quality of loans issued in the period from 1998–2001 are still becoming evident in increased provisions. Favourable external conditions together with improved overall management have, however, rendered the credit institutions fit to meet loan-loss provisions without weakening their capital position. FME surveys have in a number of instances resulted in increased provisions to loan loss accounts. In four cases has the capital adequacy ratio of a financial undertaking been below the statutory limit and special measures needed to be taken in order to correct the position. In a few more cases the FME has expressed its concern on account of the weak capital adequacy ratio of a financial undertaking. A number of comments concerning the large exposures of individual credit institutions have also been made.

1. This chapter deals with supervision of undertakings governed by the Financial Undertakings Act (161/2002), both in the credit market and the securities market.

The FME has been active in developing **new supervisory procedures** for financial undertakings. A new risk assessment system created by the FME was formally introduced. This system is intended to facilitate assessment of the necessary CAR of individual credit institutions, based on information on equity, quality of assets, profitability, liquidity, sensitivity to market exposure and management. The risk assessment system is used in the supervision of financial undertakings and has been met with general approval.

Special stress tests have also been designed for the supervision of financial undertakings. The capital adequacy ratio needed by a financial undertaking in order to offset a given drop in the prices of shares and bonds held by the undertaking as well as a given reduction in non-performing loans and appropriated assets is calculated. The premises for the stress test take aim of realistic conditions. The results of this test support the FME's opinion, as stated in previous annual reports, that the largest commercial banks should aim for a CAR of at least 10% as calculated according to statutory provisions, or 8% excluding subordinated loans.

As provided for by Act 161/2002 on Financial Undertakings, possible decisions by the FME concerning **higher CARs** for individual financial undertakings will be based on the above mentioned risk assessment system and stress test. Rules on such decisions are currently being formulated by the Authority.

The FME has, in addition, endeavoured to strengthen its supervision and **overview of the risk management systems** of larger financial undertakings on a consolidated basis, especially those with overseas activities and subsidiaries abroad. The financial groups are expected to analyse the risk entailed in its operations, itemised according to areas of income and subsidiaries. Assessment is also made of the way in which the undertaking measures and manages such risks. Special report forms have been designed for this purpose in cooperation with the undertakings concerned. For the same purpose, the FME is about to introduce special reports concerning the overseas exposures of larger financial undertakings, i.e. exposures on account of claims and liabilities towards foreign parties.

The FME is responsible for the consolidated supervision of Icelandic financial undertakings operating abroad, whereas their foreign subsidiaries are also subject to supervision in the country where they are licensed to operate. Every effort is made to strengthen **the FME's cooperation with parallel institutions abroad** in the area of consolidated supervision, and work on special bilateral agreements concerning the supervision of specific financial undertakings is now in progress.

The FME has implemented new methodologies concerning **the supervision of information technology**, which includes assessments on information systems.

During the period, the FME supervised the largest merger of Icelandic financial undertakings ever to have taken place in the country, i.e. the merger of Kaupþing bank hf. and Búnaðarbanki Íslands hf. The merger was subject to a thorough scrutiny and specific requirements were made concerning its materialisation and factors relating to risk management and internal control.

Foreign undertakings are increasingly offering their services in Iceland without having adequate authorisation to do so. The FME has had reason to issue **public warnings** against the operations of named undertakings. The FME has on one occasion banned the activities of a domestic financial undertaking abroad.

During the period, the FME has published and worked on **rules and guidelines** concerning financial undertakings. These include rules on the exemption for smaller undertakings to operate internal auditing departments. In this respect, the FME has emphasised that surveys of internal control shall not be conducted by the external auditor of the financial undertaking concerned, as has been permitted until now. Work has also been carried out on the revision of rules on the annual accounts of financial undertakings. These rules allow for improved information on salaries and remunerations paid to the management and auditors of financial undertakings. Work is also being carried out towards a strengthening of rules concerning the depreciations of financial undertakings with a special view to the standards set by the International Accounting Standards Board (IASB).

1.3.2 The securities market

Emphases for the period: Preventive measures to counteract insider fraud and market manipulation. Market surveillance. Adjustment to new legislation on unit trusts and investment funds.

Considerable efforts have been made by the FME in order to improve conduct of business practices among issuers of listed securities and undertakings in the financial market. The principal aim of this work is to reduce the likelihood of insider fraud and market manipulation.

A necessary part of this is to insist that the issuers of listed securities formulate **rules regarding the treatment of insider information** and the dealings of primary insiders. They are also to appoint a compliance officer who ensures compliance with these rules. The FME ratifies these rules and ascertains that they are in full accordance with existing laws and official guidelines. Many issuers have been slow in setting such rules and it has thus been necessary to impose daily penalties. At present, 110 undertakings have submitted their rules and the FME has ratified the majority of those.

The FME has endeavoured to assist the issuers of listed undertakings to establish the framework required by the above mentioned rules. Special presentations have been organised for the compliance officers. The compliance officers have also received visits intended to ensure compliance with the rules. This has often been done in connection with the dealings of primary insiders at delicate times, or when important trading in the securities of the undertaking in question is about to take place.

Following the new Act on Securities Transactions (33/2003), which entered into effect on 1 July 2003, the FME carried out amendments to Guidelines no. 2/2001 concerning the content of rules on the treatment of insider information and the dealings of primary insiders.

In connection with **the market surveillance** of the FME, some 18 cases were formally examined during the period. More than half of these concerned insider trading, nearly a half concerned market information and one concerned rules on public offers. Two of these cases are still under review, in eight cases there was no ground for comment, but a total of seven instances called for remarks and demands for corrective action or guidelines as to the proper conduct of business practices. On one occasion the FME put a stop to a public offering of securities. Insufficient grounds were found for referring the above mentioned cases to the National Commissioner of the Icelandic Police.

The above mentioned cases concerning securities transactions are ones that have received formal procedures involving the parties concerned. During a regular market surveillance, however, numerous cases are inspected without raising the need for a formal examination. A number of cases concerning the conduct of business practices in the securities market will not be detailed here.

The FME has, in addition, assisted foreign supervisory authorities as well as domestic and foreign police in their examination of matters relating to conduct on the securities market.

The FME has also **considered guidelines** on a variety of issues that are of relevance to the conduct of business practices in the securities market. Work has thus been carried out on issuing guidelines for analysts and analysis departments. Work is also being carried out on guidelines for the work procedures of financial undertakings, which cover a range of factors concerning the interaction between a financial undertaking and its customers during securities transactions. These guidelines are based on the core conduct of business rules issued by the Committee of European Securities Regulators (CESR) of which the FME is a member.

The supervision of financial undertakings has specifically focused on business conduct in the securities market. **Inspection of the conduct** of one financial undertaking resulted in a number of remarks and requests for corrective action. Another survey resulted in the revocation of an operating licence.

The Act on Undertakings for Collective Investment in Transferable Securities (UCITS) and Investment Funds (30/2003) entered into force on 1 July last. This Act entails **extensive changes** to current legislations. Pursuant to this new Act, the FME has dealt with applications for operating licences from mutual funds and their management companies, but according to the new legislation all management companies now have the status of financial undertakings with a wider scope for operations than before. The FME has also processed applications from investment funds, which are a new type of funds requiring operating licences. New supervisory functions stipulated by the Act include decisions as to what parties are to apply for operating licences for investment fund activities.

On account of the new Act, the FME has been involved in a variety of communications with the employees and managements of financial undertakings. Prior the entry into effect of the new legislation, the FME conducted a thorough survey of the extent to which mutual funds complied with their own investment policies, but new and more detailed reporting on the investments of mutual funds was introduced towards the end of 2002. The

survey revealed numerous instances of deviation from the investment policies in question. Remarks were made and corrective action demanded, which in many cases relates to the funds' adjustment to the new legislation.

1.3.3 The pension savings market

Emphases for the period: Improved internal control. Monitoring of investment. Better documentation and transparency in actuarial assessment.

The most extensive tasks in the supervision of pension funds in recent periods have been detailed **investigations into pension fund investments**. During the last period, older investigations were continued and new ones begun. The principal objective of these investigations is to review the investments of individual pension funds with regard to the provisions of Chapter VII of Act 129/1997 on Mandatory Insurance of Pension Rights and Activities of Pension Funds, which deals in particular with the investment limits of pension funds. The investigations are partly concerned with surveying the breakdown of investments as shown in the quarterly reports submitted by the pension funds to the FME. In the reports, investments are classified in accordance with the provisions of Chapter VII, Article 36, of the Pension Fund Act. These reports provide an invaluable tool for the FME to ensure that pension fund investment is in compliance with law and are also, as such, useful to the management of these funds. A careful itemization is therefore important. As part of the pension fund investment surveys, there was also conducted an examination of their internal control systems, annual accounts, auditors' reports and investment policies.

The FME's investigations were largely focused on pension funds which exceeded the legal limit for investments in unlisted securities and comments on the results of these investigations were mostly on account of such investments. The FME has requested corrective action with the result that today most of the pension funds keep within the legal limit as far as unlisted securities are concerned. The FME has also had reason to comment on investments in securities issued by a single party and overall investments in UCITS. For most of the pension funds examined it was necessary to remark upon a number of factors concerning internal control.

In all instances where pension fund investments have not been in compliance with law, internal control has also been ineffective. Information on the internal control of pension funds has, generally speaking, been rather deficient and reporting has been slack. The FME has also **made a number of remarks and comments** on the breakdown of pension fund investment in the reports. There has been a number of instances where the annual accounts and investments policies of pension funds have not complied with the rules concerning them and a range of remarks and requests for corrective action have thus had to be made.

During the period, the FME has initiated three aggregate investigations of pension funds. Two of those have been completed with remarks and requests for corrective action, whereas one has yet to be concluded. On one occasion, the FME handed over its findings and documents to the National Commissioner for the Icelandic Police.

During the period the FME issued **new special report forms** for submitting the results of actuarial surveys. The reports give a good view of the actuarial position of the pension fund concerned, the preconditions for the assessment and changes from previous periods and are intended to improve the transparency of actuarial surveys. They help to strengthen the supervision of pension fund commitments and should also be valuable to the pension funds as a means of control.

Over 20 pension funds, which is just over one-third of all the pension funds in the country, have amended their Articles of Association. Upon request from the Ministry of Finance, the FME delivers its opinion on the amendments in each case. Some curtailments of rights have taken place, either in the form of changes to multiplication factors or to the periods for pension payments. This is partly due to the fact that in 2002 some funds deviated from the legal limit between assets and pension commitments provided for by Act no. 129/1997 on Mandatory Insurance of Pension Rights and Activities of Pension Funds.

In order to ensure professional conduct in the allocation of premiums for pension savings and supplementary pension coverage, the FME has **drafted formal guidelines** to encourage homogeneity and consistency in the implementation of rules concerning this matter and that this implementation is in harmony with sound and proper business practices. Disputes have arisen as to the interpretation and implementation of Regulation 698/1998 on the provision of premiums for pension savings and supplementary pension coverage. The FME has also come across various problems relating to the conduct of persons employed in concluding, or providing advice on, pension savings contracts and complaints on such conduct have been increasing in recent months.

As stated in Chapter 1.1, the FME has sought to emphasise the role and responsibilities of the executive boards of pension funds and their internal control systems. In this respect, representatives of the FME attended the board meetings of pension funds operated by financial undertakings and also invited the board members of pension funds to meetings at its premises. The main subject at these meetings was the management responsibility of the executive boards of the pension funds, internal control and risk management. Furthermore, representatives of the pension funds were invited to a presentation on a report on the annual accounts of pension funds, published in July 2003.

1.3.4 The insurance market

Emphases for the period: Risk management of insurance companies. Supervision of technical provisions. Improved conduct of selling insurance products.

During the period, the FME conducted a number of **surveys into the risk management** and internal controls of insurance companies and insurance brokers. Remarks and comments were passed when necessary. The FME has in this respect inter alia recommended that insurance companies apply stress tests on their activities in order to highlight the position of the company under different circumstances and help towards better risk analysis. The FME has also sought to strengthen its supervision and overview of the risk management practices of the larger insurance companies on a

consolidated basis, in order to analyse risk in different areas of income and subsidiaries and to appraise the companies' risk assessment and risk management.

The FME has continued its monitoring of **developments in technical provisions** in mandatory motor vehicle insurance. Special statistical analyses were compiled on the status of technical provisions at three of the largest insurance companies. The FME has invited comments from the insurance companies on the results of these analyses and intends, in continuance of that, to carry out a closer examination of certain factors relating to damage assessment. The final results of this examination will be reported directly to the insurance company concerned.

The FME is at present completing its survey of the rise in premiums for mandatory fire insurance and other property insurance during the period. The survey focused on three of the largest insurance companies and the results will be reported to each company concerned.

Two domestic insurance companies obtained their operating licences during the period, Íslandstrygging hf. for non life insurance and Líftryggingamiðstöðin hf. for life insurance. The former is an independent addition to the insurance market, whereas the latter is a wholly-owned subsidiary of Tryggingamiðstöðin hf. The FME has recently processed applications from two new insurance companies. Both these companies are somewhat special in emphasising their intentions to conduct certain insurance activities abroad.

During the period, **insurance brokerage has undergone considerable changes**. Four new insurance brokerages have obtained operating licences and two foreign insurance brokerages have been registered in Iceland. During the period, 10 insurance brokers (individuals and legal persons) relinquished their licences, either unprompted, after consulting with the FME, or upon its request. Another three insurance brokers relinquished their licences last August. A few insurance brokerages have experienced considerable financial difficulties and there are examples of brokerages going into liquidation. The FME does not, however, know of any losses by policyholders on account of such financial difficulties.

Business conduct in **the insurance market** has, as before, come **under scrutiny**. In general, the FME believes that the work procedures of insurance brokers are improving. Some inadequacies in the information and advice given to clients by the employees of insurance companies and insurance brokerages have, however, been brought to the FME's attention or been revealed during routine supervisory activities. Policyholders have, for instance, been advised to move their insurance over to a different company without being fully informed of their legal status or the cost involved. As a result, the FME has published guidelines on the working procedures of independent insurance brokers (7/2002). These guidelines are intended to encourage better working procedures, for instance concerning the information given to clients. In the same vein, the FME has also carried out work on guidelines on the working procedures of insurance salesmen employed by insurance companies.

There have been a few instances of friction between domestic insurance companies and insurance brokers. Various such cases have been reviewed by the FME and the FME has passed its opinions on these issues.

1.4 IMF assessment

Emphasis: Effective supervision promotes the competitiveness of the Icelandic financial market.

A mission from the International Monetary Fund visited Iceland in April 2003. The purpose of the visit was to reassess the stability of the Icelandic financial sector and compliance with international standards and codes concerning banking supervision and other related areas (FSSA, Financial Sector Stability Assessment). This was a follow-up on the assessment of 2001 which resulted in recommendations by the IMF regarding changes in the areas of legislation and supervision as a response to weaknesses in the financial market and its supervision. One of the IMF's suggestions was a considerable expansion of supervisory functions.

A report on the results of the assessment now was published on the website of the IMF in August 2003. The results show that the imbalances identified by the 2001 FSSA has subsided and the financial sector has returned to a more balanced risk profile, to some extent due to preventive supervisory measures. The report praises the swift and extensive **improvements** carried out as regards regulation and the conduct of supervision. It is confirmed that the FME and the operative framework of financial undertakings are capable of measuring up to basic principles for effective supervision on an international level. Only on one occasion does the FSSA find that supervision does not meet international standards, namely in the lack of information provided to the FME by financial undertakings on country risk positions. The FME is currently establishing this type of financial reporting.

The report comments positively on new supervisory procedures developed by the FME. These procedures are detailed in Chapter 1.3.1 above. The present FSSA looks to the FME's measures and procedures in its assessment of the state of the financial sector.

Although the IMF praises Icelandic authorities, including the FME, for measures intended to strengthen the stability of the financial sector, it nevertheless sees **room for ongoing improvement**. The FSSA concludes that the Icelandic authorities need to be prepared to review the size of the FME, as its function of implementing new legislation should not affect its core supervisory activities. It is also pointed out that the FME still has some work to do towards the full implementation of the legislation on financial undertakings, for instance by formulating guidelines and rules. This work has progressed considerably since the date of the FSSA.

The findings of the IMF indicate that the FME and the operative framework of financial undertakings are fully compatible with the best. This is, indeed, very positive for the competitiveness of the Icelandic financial market.

1.5

International co-operation

Emphasis: Harmonisation of supervision and regulation within the European Economic Area strengthens the sensible overseas expansion of domestic undertakings.

Following the EU decision to adopt the accounting standards of the International Accounting Standards Board for the consolidated financial statements of listed companies as of 2005, the international co-operation of the FME has focused, in particular, on financial statements. These changes will have a considerable effect in Iceland and preparations for this are at present directed by the Ministry of Finance. The FME participates in a Nordic work group on financial statements. This group came together in Reykjavík in August 2003 to discuss the implementation of the accounting standards of the IASB and the state of preparedness in each country.

The FME has held a **presentation and forum** on the envisaged changes to financial statements. Specialists from financial undertakings and insurance companies have also been invited to meetings on this issue.

The changes are also being prepared for by the Committee of European Securities Regulators (CESR) which has recently approved core principles for the implementation of the changes and the supervision of financial statements.

The co-operation of financial supervisory authorities in individual areas of the financial market has also changed considerably as a result of **alterations made to decision-making processes** within the European Union. The FME is a member of the Committee of European Securities Regulators (CESR) which has the function of harmonising supervision in the securities market and thus supporting an effective internal market within the EEA. The committee also acts as an advisory body to the European Commission on the formation of a harmonised legislation for the securities market. As part of this, the committee has provided advice concerning rules on market fraud and prospectuses. The committee has also issued core conduct of business rules for securities transactions, which the FME will seek to implement here in Iceland.

Other work groups, modelled on the CESR and with a similar function, are being established for other areas of the financial market – viz. the Committee of Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

stood at ISK 47.9 million. This was taken into account when calculating the amount of the supervision fee for the year 2002, which was then approved by Althingi. The capital and income for the year were allocated back into the FME's operations during the year, so that by year-end 2002 its equity was negative by ISK 1.3 million, or 0.5% of total expenses.

The annual accounts of the FME are published on the FME website, www.fme.is.

According to the FME's reviewed operating plan for 2003, operating costs for the year are expected to total ISK 266.1 million. Income, including interest income, is expected to be ISK 263.7 million, of which income from supervision fees should be ISK 259.7 million. Expenses in excess of income are thus expected to reach ISK 2.4 million. Given the negative equity of ISK 1.3 million at the beginning of 2003, an operational deficit of ISK 3.7 million is envisaged to be carried forward to the operating plan for 2004.

The operating plan for 2004 has been presented to the Minister of Commerce as provided for by law. The plan estimates an increase in the scope of operations by 8.5% over the previous year. Expenses are expected to amount to ISK 288.7 million and income, including financial income, be ISK 292.5 million, of which the levied supervision fees for 2004 should reach around 289.5 million .

According to the Act on Official Supervision of Financial Activities (87/1998), parties subject to supervision are to bear the cost of the FME's operations. The Act on Payment of Cost due to Official Supervision of Financial Activities (99/1999), as subsequently amended, applies to the levying of the supervision fee. The supervision fee is calculated as a percentage of total assets, operating expenses or insurance premiums of parties subject to supervision, in accordance with the nature of their activities. In all cases, however, there is a specific minimum amount.

Employees and work environment

At the beginning of 2003 the FME had 33 staff positions, compared with 31 at the same time in 2002, plus additional two that were divided between three short-term employees. The number of positions was the same by mid-year 2003, but then two short-term employees shared one position. From mid-year 2002 until mid-year 2003, two new employees commenced work at the FME and 3 ceased their employment, thereof one short-term employee. Most FME employees are specialists – around 13 have degrees in business administration, some 8 have a law degree, around 2 are actuaries and another 2 are computer specialists.

Included in the FME's operating plan for 2004, which has been presented to the Minister of Commerce, is a special report on the authority's operations and work environment over the next three years. The report seeks to present a clear picture of trends and outlooks for the FME as well as describing developments in financial supervision in the countries we most frequently use as a basis for comparison. Recent and foreseeable law amendments are discussed and the possible effect they may have on the FME's operations. The report also deals with the internal operations of the FME, work procedures, personnel objectives and operational strategies.

1.6

FME operations

Emphasis: Effective operations and performance management.

Scope of operations and supervision fee

For the year 2002 the FME's expenses, including the purchase of assets, amounted to a total of ISK 266.7 million. Income for the year, including interest income, came to ISK 217.5 million, of which income from supervision fees was ISK 211.1 million. Expenses in excess of income thus amounted to ISK 49.2 million in 2002. The above figures do not include expenses and income arising from the Complaints Committees which are hosted by the FME. At the beginning of 2002 the FME's capital, or accumulated budget surplus,

The website and information on supervisory activities

The Internet home page of the FME, www.fme.is, which has become an important source of information, was thoroughly revised and updated at the end of 2002 in order to make it more accessible. Parties subject to supervision now download all necessary material concerning report submissions from the FME website, where it is also possible to find news, discussion papers, and various statistical information on the activities of parties subject to supervision. The website contains information on the organisation of the Financial Supervisory Authority and its standard procedures. During 2002 the FME received additional premises which vastly improved its meetings and presentation facilities.

Various statistics for the period 1 July 2002 to 30 June 2003

In previous annual reports, the FME has published various statistics on its operations. This information should in no way be regarded as a measurement of success; instead it should be looked upon as an indicator of the scope of its activities and the changes that have taken place.

During the period from 1 July 2002 to 30 June 2003 the FME sent some 3000 letters and received about 2200 letters. During this same period, parties subject to supervision submitted around 1600 reports to the FME as part of the Authority's regular data and information gathering process. The number of letters sent is comparable to the figure for the previous period, but letters received have increased by nearly 400. Reports from parties subject to supervision are around 100 more than in the previous period.

The FME keeps track of all its projects using a special customer relations management (CRM) system. All queries received by the FME and individual projects arising from its activities are registered in the CRM system and then dealt with in accordance with the instructions given to employees. During the 12-month period under discussion here, some 860 cases were opened by the FME, which is similar to the preceding period.

FME receives many types of formal queries concerning activities on the financial market in Iceland. Some queries are also received from abroad in connection with international co-operation on supervision of financial markets and also from various parties distributing information on financial markets and parties involved in financial activities. Domestic queries, on the other hand, are received primarily from parties subject to supervision, their customers or various public bodies. During the period under consideration here, the FME received a total of 146 formal queries, of which 63 were from foreign parties. Comparable figures for the preceding 12-month period were 152 and 62 respectively.

Complaints and consumer issues are another class of queries dealt with by the FME. These involve queries concerning business dealings with financial undertakings which the FME sees cause to investigate. A total of 80 such cases were received during the period mentioned, compared with 55 in the period before.

A variety of statistics in addition to the above can be obtained from the FME's CRM system on tasks dealt with by the Authority. During the period there was, for example, a total of 38 cases concerning on-site inspections, compared with a previous total of 45, and 40 cases were registered concerning applications for operating licences, compared with 29 in the period before.

Fines

Regular reports submitted by parties subject to supervision are a key feature of effective supervision in the financial market and must, therefore, be given the priority and attention they deserve. The provisions of Regulation 560/2001 on the application of fines and financial penalties in official supervision of financial activities were enforced for the first time during the first half of 2002 as a result of failures to submit requested reports. During the period in question, the FME has on 13 occasions determined to impose fines as provided for by the Regulation.

2.1

The credit market

Increased profitability

The profitability of credit institutions has increased substantially in the past year or two. The cumulative pre-tax profits of commercial and savings banks² for the year 2002 amounted to ISK 14.2 billion (bn) as compared with ISK 7.4 bn in 2001. Return on equity rose from 13.5% to 18.4% between 2001 and 2002, cf. **Figure 1**. Net income from operations rose considerably during this period, primarily as a result of increases in other operating income. Net interest income rose slightly, but dropped as a percentage of the average total assets on the balance sheet. Provisions for loan losses increased by ISK 1.5 bn from ISK 8.0 bn in 2001 to ISK 9.5 bn in 2002.

During the first half of 2003 the total pre-tax profits of commercial banks and savings banks amounted to ISK 9.5 bn. During the first half of 2003, return on equity was 19.5% on an annual basis. Return on equity continued to increase from 2002, primarily due to the credit institutions' net profits from trading activities. For the first time since 1998, operating expenditure as a percentage of the average total assets on the balance sheet has increased, cf. **Figure 2**. The percentage dropped from 3.7% in 1998 to 3.0% in 2002 then rose to 3.3% during the first six months of 2003. As a percentage of net operating income, however, operating expenditure has continued to drop, cf. **Figure 1**, as a result of more rapid growth of income than operating expenditure. Net interest income as a percentage of average total assets on the balance sheet was similar during the first half of 2003 to that of 2002, or 2.6%, while other income has grown substantially, from 2.4% in 2002 to 3.1% during the first half of 2003, cf. **Figure 2**. The increase in other income is primarily the result of sizeable growth in profits from trading activities, cf. the discussion below for more details.

The above-mentioned figures on ROE and cost ratio vary from one credit institution to another. The median ROE during the first half of 2003 was 19.7% for the three largest commercial banks and 9.9% for the six largest savings banks.

Other operating income increasing

Operating income, other than net interest income, of the main credit institutions increased from ISK 16.8 bn in 2001 to ISK 28.4 bn in 2002, or by 69%. Net losses from trading activities amounted to ISK 2.7 bn in 2001, while profits were ISK 7.1 bn in 2002, which is an upswing of ISK 9.8 bn from one year to the next, and accounts for the increase in other operating income between the years. During the first half of 2003, other operating income was ISK 19.8 bn, or 70% of the total year's income for 2002; of this trading rate gain on financial activities contributed ISK 7.5 bn. The increased exchange rate gain on financial activities is primarily the result of increasing trading book gains, due to positive trading book share and bond price developments. **Figure 3** shows the developments of individual operating income items in commercial

2) References to commercial banks and savings banks in this chapter are based on the consolidated statements of the commercial banks and the six largest savings banks, unless expressly stated otherwise. Figures from previous years include the banks' predecessors who at that time had the status of credit institutions, such as, for instance, FBA and Kaupthing Bank.

3) The share of these banks in other operating income of commercial and the six largest savings banks is close to 90%.

banks with the exclusion of Icebank.³ It shows clearly the fluctuation which has occurred in profits from the trading book activities in recent years, in accordance with price developments on the Icelandic equity and bond markets.

The sensitivity of the commercial banks to changes in market securities prices varies greatly. As an example, the percentage of trading book profits relative to the pre-tax profits of the leading commercial banks varied from 8% to 120% in 2002. Other things being equal, the recent downward slide in market securities should have had a widely varying impact on the performance of the individual banks that year.

Figure 1 Return on equity and operating expenses as a percentage of gross income of commercial and savings banks.

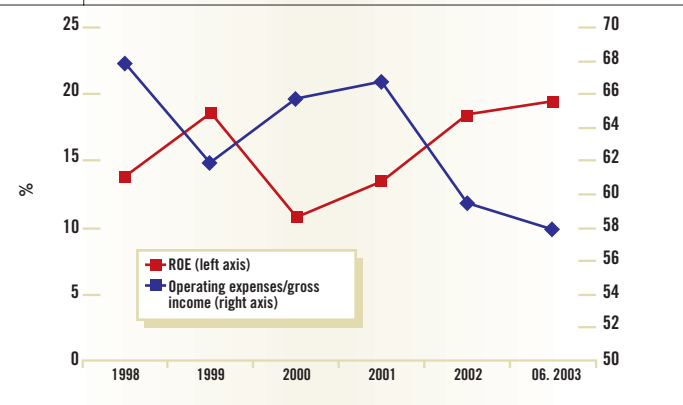


Figure 2 Major operating items as a percentage of average total assets of commercial and savings banks.

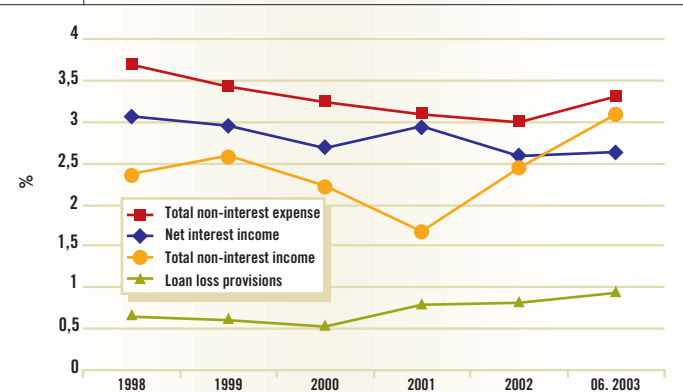
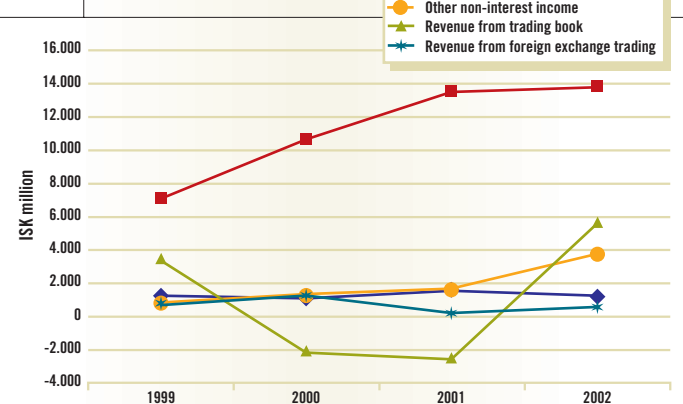


Figure 3 Total non-interest income itemized.



Lending problems have likely reached a peak

As **Figure 4** shows, the 12-month nominal increase in lending amounted to 12.3% at the end of June 2003, 4.6% at the end of March 2003 and 5.1% at year-end 2002. Furthermore, information on growth of lending in recent months indicates increased lending growth. It appears that the slow growth of lending in the past year or two, at least by comparison with the expansionary period from 1998 to 2001, has come to an end and ahead is raising growth in lending.

As can be seen in **Figure 5**, total defaults⁴ by individuals and enterprises to deposit institutions at the end of June 2003 amounted to ISK 27.1 bn, or 3.3% of loans, which is a drop of 0.8% from the default peak in September 2002. Defaults by individuals were proportionally greater than that by enterprises. Defaults by individuals at the end of June 2003 were thus 6.4% of loans to individuals, while defaults by enterprises were 2.4% of loans to enterprises. By comparison, defaults by individuals at the end of March 2003 were also 6.4% of loans to individuals while defaults by enterprises were 2.6% of loans to enterprises. Thus defaults by enterprises have decreased between the first and second quarters, while defaults by individuals have remained unchanged. It is likely that the default percentage of both individuals and enterprises will drop slowly in the next year or two.

Since the year 2000, non-performing loans⁵ and appropriated assets have grown as a percentage of lending by commercial and savings banks, cf. **Figure 6**. These were 3.4% at the end of last June, 3.4% at year-end 2002, 2.7% at year-end 2001 and 1.9% at year-end 2000. It therefore comes as no surprise that the annual loan-loss provisions as a percentage of average loans has also increased since 2000. In 2002 this percentage was 1.2%, it was 1.2% in 2001 also, but only 0.8% in 2000. FME expects loan-loss provisions for 2003 as a percentage of average loans to amount to close to 1.3% and then to decrease in 2004.

It is clear from the above that financial undertakings have, in the past few years, struggled with increased lending problems, parallel to the economic downturn following the last expansionary phase. In this connection, FME has directed its attention, in particular, at the credit risk of financial undertakings and carried out detailed studies of the quality of the loan portfolio. According to the information above (**Figures 4, 5 and 6**) there are various indications that lending difficulties have reached a peak and a period of lending growth has now begun, which will be measured in double-digit numbers. Under such conditions it is important that lending decisions are taken with care to minimize future credit losses.

Relative decrease in market risk between periods

Part of the assets of credit institutions are tied up in market securities, which are subject to market rate fluctuations. As **Figure 7** shows, the net bond assets⁶ of commercial and savings banks were ISK 84 bn at the end of June 2003, as compared with ISK 73 bn net bond assets at the end of June 2002. Net bond assets of commercial and savings banks thus increased by ISK 11.1 bn or 15.3% during the period. The net share assets⁷ at the end of June 2003 amounted to ISK 50.7 bn as compared to ISK 53.8 bn at the end of June 2002,

4) The definition of default used here is any payment more than one month in arrears. Kaupthing Bank is included in the figures for end of March 2002 and later.
5) Non-performing loans net of specific loan-loss provisions.
6) Bonds less forward contracts and swaps entered into against bond assets.
7) Shares less forward contracts and swaps entered into against shares. Based on parent company statement.

Figure 4 Total loans of deposit institutions and 12-month nominal increases in loans.

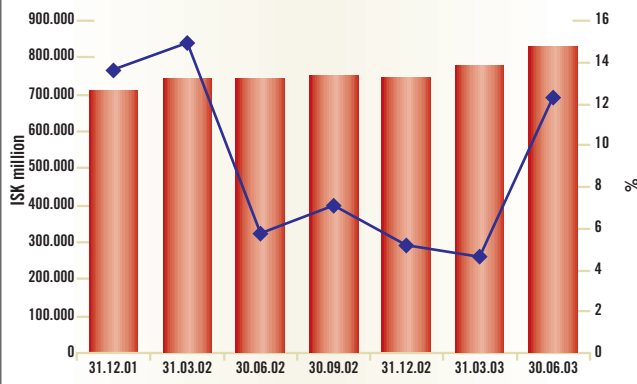


Figure 5 Defaults to deposit institutions in ISK millions and as a percentage of total loans (payments over one month past due).

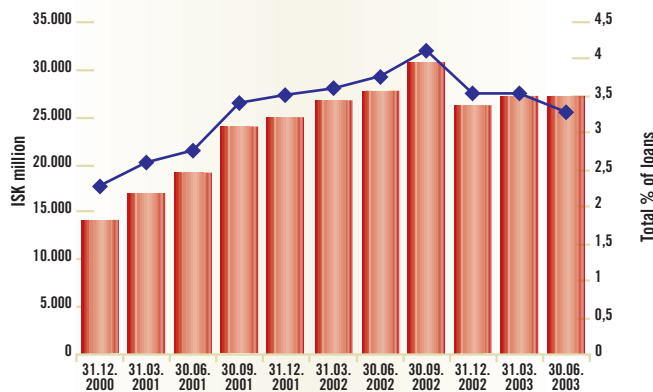


Figure 6 Non-performing loans and appropriated assets including annual loan loss provisions.

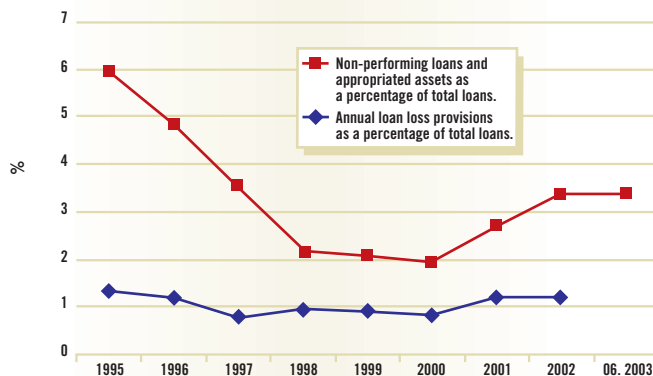
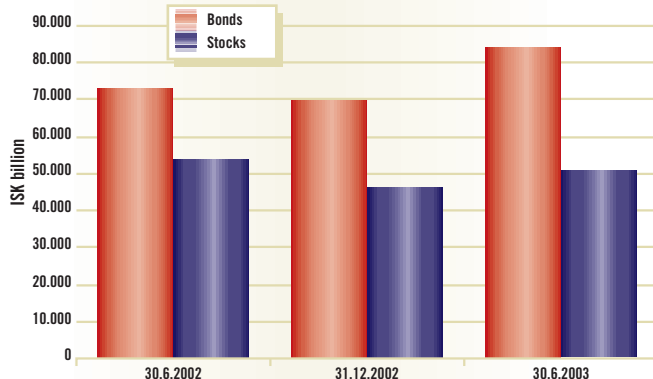


Figure 7 Net market value of securities owned by commercial and savings banks (ISK bn).



which is a drop of ISK 3.1 bn or 5.7%. A comparison of bond and share assets as a proportion of capital required by law shows a decrease between accounting periods. Net bond assets as a proportion of required capital was 75% at the end of June this year as compared with 81% at the end of June 2002. Net share assets as a proportion of required capital was 45% at the end of June this year as compared with 60% at the end of June 2002. The above figures show a relative drop in credit institutions' market risk between accounting periods. The increased share transactions in the 3rd quarter of 2003 by commercial banks, however, is an indication that market risk linked to share ownership has increased since June 2003.

Icelandic banks increasingly dependent on supply of foreign loans

In the first half of 2003, commercial banks' ⁸ net liabilities owed to foreign parties increased once more, cf. **Figure 8**. At the end of June 2003, commercial banks' net liabilities owed to foreign parties amounted to ISK 364 bn, an increase of 17.8% from the end of the year 2002. By comparison, the banks' total assets have grown by 14.7% during the same period. Latest figures on commercial banks' net liabilities owed to foreign parties indicate a continuing increase. The banks' growing foreign debt has resulted in their increasing dependence on the supply of foreign credit for refinancing. In view of this, FME will continue to watch the banks' liquidity management, in particular with regard to foreign refinancing risk.

Equity increases but subordinated loans remain unchanged

The equity position of commercial and savings banks, ⁹ as required by law, amounted to ISK 111.8 bn at the end of last June, as compared with ISK 96.6 bn at the end of June 2002, which is a rise of ISK 15.2 bn or 15.7%.

At the end of June 2003, commercial and savings banks had issued subordinated notes, which are classified under Own Funds Tier 1 in calculating capital adequacy ratios (CARs), amounting to ISK 6.2 bn as compared to ISK 6.1 bn at the end of June 2002. Subordinated notes classified as Own Funds Tier 2 and 3 in calculating CARs amounted, at the end of June 2003, to ISK 28.7 bn as compared with ISK 28.2 bn at the end of June 2002. It is evident from the above that the increase in required capital was not financed with subordinated loans but rather with earnings from operations and the issue of new shares in connection with mergers and acquisitions.

The combined risk-weighted asset base of commercial and savings banks amounted to ISK 1,017 bn at the end of June 2003, as compared with 845 bn at the end of June 2002, which is an increase of ISK 171 bn, or 20%.

CARs acceptable

As **Figure 9** shows, the CARs of the commercial banks were between 9 and 10% in 1995-2000, while CARs excluding Tier 2 and 3 subordinated loans declined steadily. From 2001 onwards CARs of commercial banks have been rising and reached a peak

⁸ Based on parent company statement.

⁹ Íslandsbanki, Kaupthing Búnaðarbanki, Landsbanki and the six largest savings banks.

of 12.3% at year-end 2002, with CARs excluding Tier 2 and 3 subordinated loans amounted to 9.2%. At the end of June 2003, the CARs of commercial banks were 10.6% and CARs excluding subordinated loans Tier 2 and 3 were 7.8%.

Since 1995, the CARs of savings banks have dropped from over 14% to 10.5% and, excluding subordinated loans Tier 2 and 3, to 7.1% at the end of June 2000. The CARs have risen again since mid-year 2000 and at the end of June 2003 were 13.6% and 10.6% excluding subordinated loans Tier 2 and 3.

In recent years, FME has warned against the possible effects of low CARs, pointing out in this connection that a large financial undertaking with dependable risk management should aim at

Figure 8 Net liabilities of credit institutions to foreign parties (ISK bn).

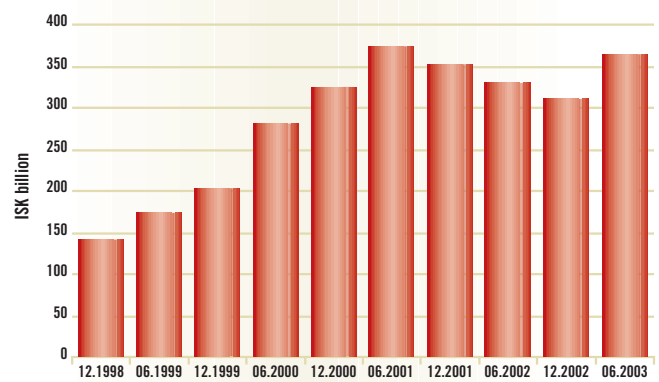


Figure 9 Capital adequacy ratio with and without subordinated loans.

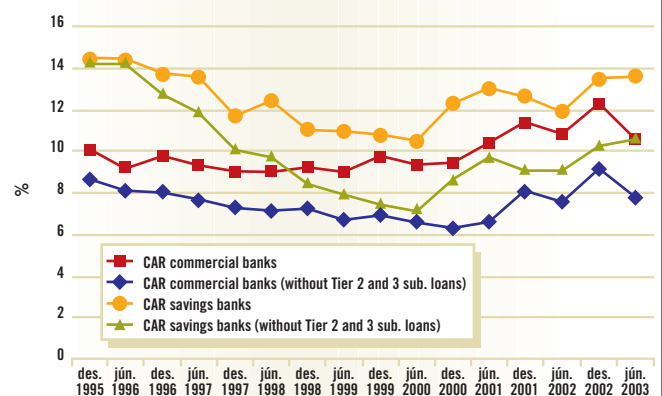
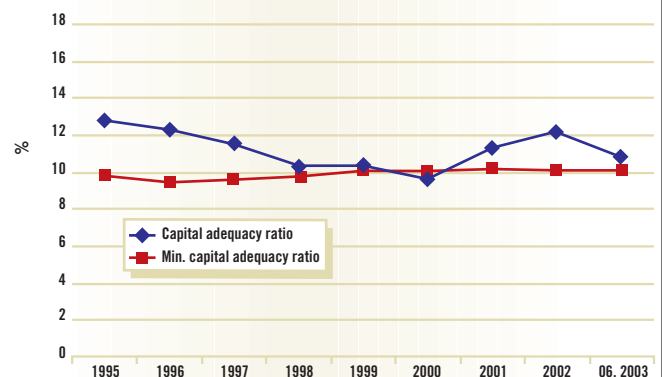


Figure 10 Stress test for commercial banks (assuming a 20% decrease in the value of stocks held, 10% decrease in bonds, and 20% reduction in non-performing loans and appropriated assets).



a minimum CAR of 10%, or 8% excluding subordinated loans Tier 2 and 3. This definition applies to the commercial banks and, as indicated in the above, their combined CAR this past June was acceptable.

FME regularly performs a stress test on commercial banks and the largest savings banks. The stress test indicates the minimum CAR a financial undertaking must have to withstand a certain fall in the market value of securities and writing-down of loans and appropriated assets, in order that its CAR will not drop below the mandatory 8% level. **Figure 10** shows the outcome of a stress test of commercial banks based on a 20% drop in equities, 10% drop in bonds and 20% write-down of non-performing loans and appropriated assets. At the end of June 2003, the calculated minimum CAR was,

according to the stress test, 10.1% while the required by law CAR for the same point in time was 10.7%. **Figure 11** shows the outcome of a compatible stress test of the six largest savings banks. At the end of June 2003, the calculated minimum CAR was, according to the stress test, 11.3% while the required by law CAR for the same point in time was 13.6%. The calculated minimum CAR of the largest savings banks is thus just over 1% higher than that of the commercial banks.

It should be borne in mind with regard to the above results of the stress test, that the results vary depending upon the individual commercial bank or savings bank. Furthermore, the results for the largest savings banks are not typical of the smaller and medium-size savings banks.

Figure 11 Stress test for the six largest savings banks (assuming a 20% decrease in the value of stocks held, 10% decrease in bonds, and 20% reduction in non-performing loans and appropriated assets).

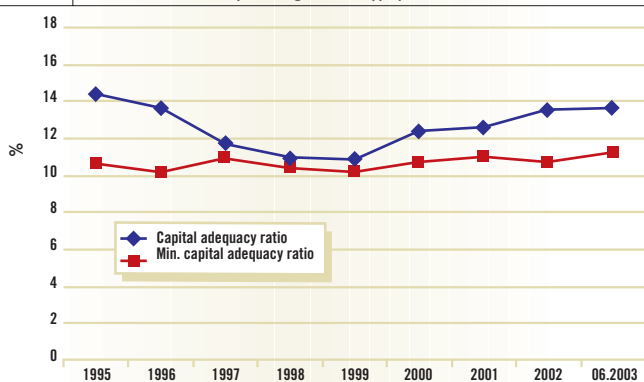


Figure 12 Equities – Average price of trades on and off the ICEX.

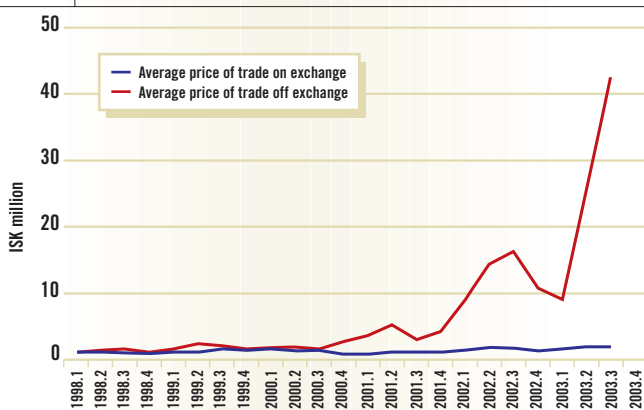
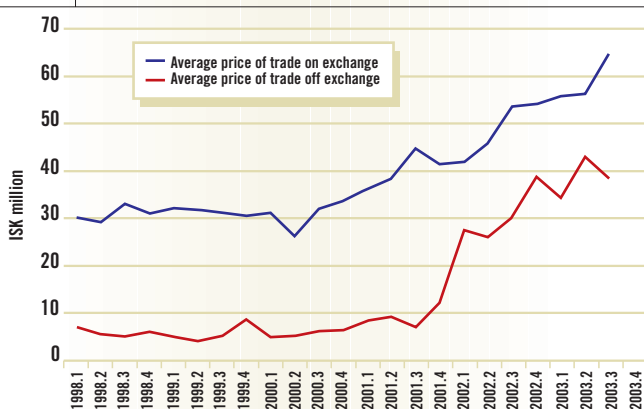


Figure 13 Bonds – Average price of trades on and off the ICEX.



2.2

The securities market

Further increases in turnover on the securities market

The total turnover of equities and bonds on the Iceland Stock Exchange (ICEX) has been growing steadily from the second quarter of 2000 after a considerable downturn. The growth has continued up until the 3rd quarter 2003 and appears likely to continue. Total equity and bond turnover at the end of September 2003 is more than it was for all of 2002. The year 2003 has been characterised by mergers of companies and considerable restructuring of ownership, which explains to a large extent the increase in equity turnover. Equity turnover as a proportion of the total ICEX securities turnover was 18.6% in 2001, 28.4% in 2002 and is now 31.9%, after the end of Q3 of 2003. Prior to that, the share of equities in total turnover had been greatest in 2000, when it was 37.2%. Equity trading has thus been growing steadily after the downturn which occurred in 2001. Bond trading is flourishing as never before, and has hardly declined despite the increase in equity turnover. Bond demand has been high, which can mainly be attributed to the increased involvement of foreign investors and pension funds. This demand has resulted in a drop in bond yields.

Rise in average price of transactions in listed securities

Both 2002 and 2003 have been characterised by extensive restructuring of the share market, as a result of mergers of companies and large-scale transactions with major holdings in a number of companies. An increasingly large portion of equity trading is off-market. As **Figure 12** shows, the average value of on-market equity transactions in each quarter changes little from one quarter to the next. The average transaction price is lowest during Q4 of 2000, around ISK 0.8 million, and highest during Q3 of 2003, around ISK 2.0 million. An examination of the average value of off-market equity transactions, however, reveals quite a different picture. The lowest average transaction value was during Q1 of 1998, around ISK 1.1 million, and highest in the Q3 of 2003, ISK 42.5 million. The increases are greatest in 2002 and 2003, as mentioned previously.

The development of the average value of bond transactions in each quarter reveals a different picture, as **Figure 13** shows. The average bond transaction on ICEX increases fairly steadily from Q2 of 2000, when the average transaction value was ISK 26.3 million. The average value of on-exchange bond transactions

during Q3 of 2003 was, however, around ISK 64.7 million. The average value of off-exchange bond transactions has also increased substantially. It was lowest in Q2 of 1999, around ISK 4.1 million, and highest in Q2 of 2003, around ISK 43.1 million. The increases have been greatest from Q3 of 2001 onwards, as the figure shows, and are the result of increased demand by foreign investors and pension funds, as previously mentioned.

If the above figures on transaction values are ignored and only the number of transactions is considered, both on-exchange and off-exchange, it turns out that since 2001 over 50% of equity transactions have taken place on ICEX; for the first three quarters of 2003 this proportion is 64%. An examination of bond trading also reveals a growing number of on-exchange transactions, with the proportion rising from 13% in 1999 to 54% in 2002. During the first three quarters of 2003 this proportion was 52%. This development, i.e. that the majority of transactions take place on-exchange, is a positive one and encourages better price formation with the above financial instruments.

Equity indices

The share indices, i.e. the ICEX Main List and ICEX-15, have continued to rise in 2003, continuing a fairly steady upward trend from Q3 of 2001, cf. **Figure 14**. The ICEX-15 reached a peak of 1,848 in September 2003; it previously reached almost 1,889 points, in February 2000. At the end of year 2002 the index was 1,436 points. The year 2003 has been characterised by major transfers of holdings on the equity market, with share prices rising in their wake. During this year all three petroleum companies in Iceland, which were listed on ICEX and formed the Oil Distribution sector index, were de-listed in the space of three months. The reduction in the number of listed companies on the ICEX reduces the number of companies behind each sector index. As an example, there are only two companies which currently comprise the Pharmaceutical index, one in Services and Commerce, and one in the Building and Contractors index.

The Number of Listed companies on ICEX continues to drop

Listed companies on ICEX continue to decrease in number, continuing a steady trend since 2001, cf. **Figure 15**. At the end of Q3 of 2003 there were 52 listed companies. The number of listed companies was greatest in 1999 and 2000. A further decrease is foreseeable, as the delisting of two companies has already been approved for the final quarter of 2003 and another for the first quarter of 2004. The delisting of at least two additional companies is expected although formal application for delisting has not yet been made. A total of 13 companies were delisted during the first three quarters of 2003. Now as before, there are two reasons for delisting, i.e. on the one hand mergers with other listed companies and, on the other hand, failure to continue to fulfil the requirements for broad-based ownership. Since 1999, new listings of companies have been few. So far in 2003, for example, only one new company has been listed on ICEX. No end to this development, i.e. the decline in number of listed companies on ICEX, is in sight, but there is no cause for alarm since the experience of other countries shows that the number of listed companies on the stock exchange varies. A decline in the number of listed companies usually means the departure of companies whose shares were little traded and their price

formation thus leaving something to be desired. These companies have generally found it beyond their capacity to fulfil market demands for information disclosure, which have formed an ever greater and more costly aspect. The companies remaining on ICEX are thus likely to be the ones with more efficient price formation, which better fulfil the demands made for information disclosure.

Information disclosure

The demands concerning information disclosure made of companies with financial instruments listed on ICEX are continually increasing. These companies need to be conscious of the demands made of them and provided for by law and in the ICEX rules. Unfortunately these are not always complied with, as there are still, for example, cases of primary insider trading as well as trading by the companies themselves at sensitive moments, such as just prior to the publication of company statements. It is only recently that companies with financial instruments listed on ICEX have appointed a compliance officer. The compliance officer is, for instance, to authorise insider trading and assess whether insider information is available in the company. Primary insiders must realise, however, that they are responsible for evaluating independently information which they have at their own disposal and can be expected to be unavailable to the compliance officer.

Figure 14 The ICEX-Main index and the ICEX-15 index.

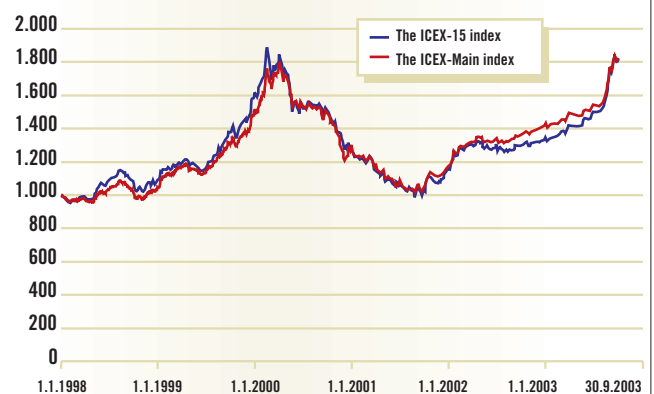
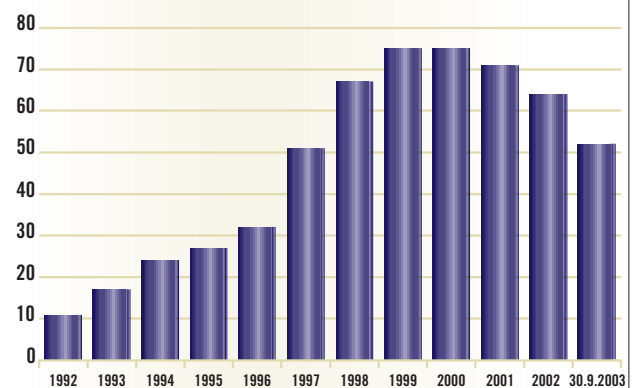


Figure 15 Number of listed companies on the Iceland Stock Exchange.



2.3

The pension savings market

Negative real rate of return for the third year in a row

The net assets of pension funds for pension payments at year-end 2002 amounted to ISK 678.9 bn as compared with ISK 644.7 bn at the end of 2001. The real increase on net assets during 2002 was about 3%. Premiums rose slightly over the previous year, from ISK 62.7 bn in 2001 to ISK 67.0 bn in 2002. Pension payments in 2001 were ISK 22.2 bn and ISK 25.8 bn in 2002. The net real rate of return in 2002 was negative by 3%. The year 2002 is the third in a row for the pension funds with a negative rate of return. **Figure 16** shows the ten-year average net rate of return for three different periods from 1991 to 2002.

Figure 16 Ten year average real return of pension funds.

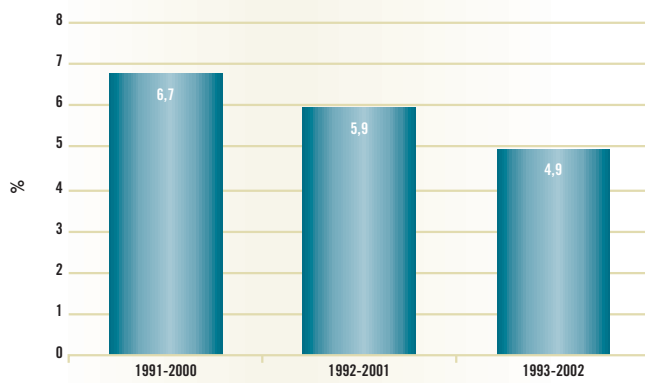


Figure 17 Actuarial status at year-end 2002.

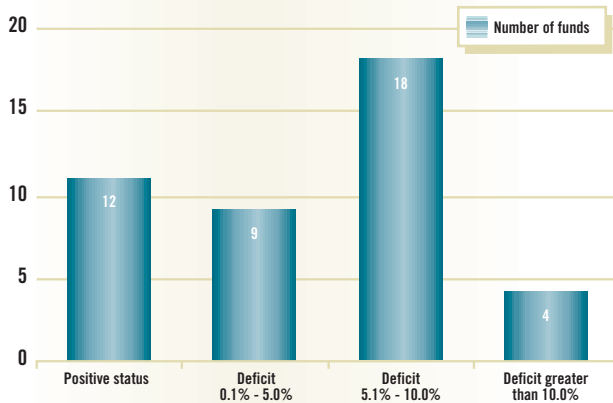
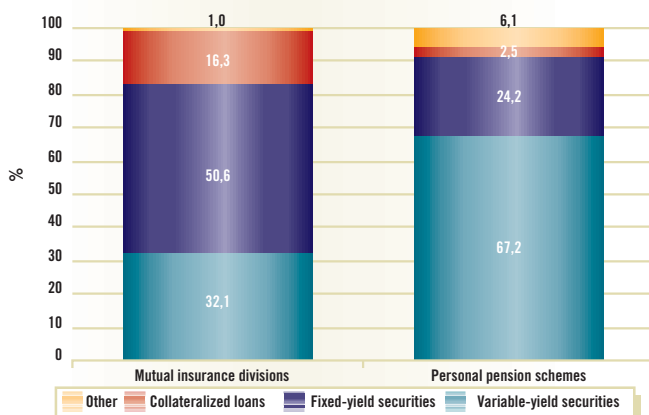


Figure 18 Asset classes at year-end 2002



Poor financial position of pension funds

According to the Pension Funds Act, the net assets of a pension fund, plus future premiums at their present value, must be equal to the present value of expected pension obligations. If the difference between assets and obligations amounts to more than 10%, according to an annual actuarial evaluation, the fund's articles of association must be amended to correct the imbalance. The same applies if the imbalance has been 5-10% for five consecutive years.

The pension funds may never reduce members' rights beyond the minimum pension coverage defined in the Pension Fund Act. Should a pension fund find itself in a situation where pension coverage are at a minimum and it is not possible to alter the articles of association to correct the imbalance, FME must assess the possibilities of the fund in question to continue its activities in each instance. In many instances pension funds grant their members rights exceeding those provided for in the minimum provisions of the Pension Funds Act.

Figure 17 gives a summary of the actuarial situation of pension funds not guaranteed by other parties at year-end 2002. An actuarial evaluation, carried out annually, is based on the rights provided by the fund in question as defined in its articles of association. Of 43 divisions, 4 were operated with a deficit in excess of 10%, 18 with a deficit ranging from 5.1%-10%, 9 with a deficit 0.1%-5% and 12 had an operating surplus.

The mutual insurance divisions of pension funds, whose obligations are guaranteed by the state, municipalities or banks, are exempt from the provisions regarding full funding. These funds do not accept new members. The financial position of mutual insurance divisions of pension funds guaranteed by other parties are in almost all instances very poor. At year-end 2002, 14 divisions out of 17 showed a deficit ranging from 51%-100%, 2 of them had deficits in the area of 0.1%-50% and 1 division was in balance.

Pension fund assets

Since the end of 2000, investments of pension funds and their classification have been under examination by FME. The main comments made by FME in these investigations have been on investments in excess of authorisations in unlisted securities following the entry into force of the Pension Funds Act. At the end of June 2003, the proportion of unlisted securities of net assets had dropped to around 6% for the funds as a whole, as compared to 9% at year-end 2001 and 8% at year-end 2002. The holdings of most pension funds now comply with the provisions of the Act.

Figure 18 gives a breakdown of pension funds' investments at year-end 2002, showing the relative proportion of personal pension savings and mutual pension savings. As is evident from this figure, the proportion of variable-yield securities was considerably higher in the personal pension divisions than in the mutual divisions. The proportion of fixed-yield securities, however, is considerably higher in the mutual divisions than in the personal pension divisions. Variable-yield securities include equities and unit certificates in UCITS. Many UCITS are comprised exclusively of fixed-yield securities, and this should be borne in mind when comparing the assets of the divisions. At year-end 2002, about 89% of personal retirement savings was deposited with pension funds which operated exclusively as personal pension funds prior to the entry into force of the Pension Funds Act, all of them operated by commercial banks.

Figure 19 shows the proportion of exchange rate-linked assets of total securities assets of mutual insurance divisions (15.6%) and personal pension schemes (26.6%) at year-end 2002. As is evident from this figure, the proportion of exchange rate-linked securities was considerably higher in the personal pension schemes than in the mutual divisions.

The proportion of exchange rate-linked assets of net assets of pension funds was 16% at year-end 2002 and had risen by six percentage points year-on-year. By the end of last June, this proportion had reached 17%, cf. **Figure 20**, and can be expected to rise further this year. According to authorisations in the Pension Funds Act, up to 50% of assets may be in foreign currencies.

Pension schemes

On 1 July 2003, the number of pension funds in operation was 50, but 11 of these no longer receive premiums, leaving a total of 39 fully active funds. A few funds operate more than one mutual insurance division, providing for varying pension rights. At year-end 2002, there were a total of 60 financially separate mutual insurance divisions and 44 financially separate personal pension schemes operated by pension funds.

The breakdown of the total assets of pension funds at year-end 2002 by pension schemes is as follows: pension unit schemes ISK 438 bn (64.5%), final salary schemes ISK 140 bn (20.6%), age-based schemes ISK 51 bn (7.5%) and personal pension schemes ISK 51 bn (7.3%). **Figure 21** gives a breakdown by pension scheme since 1999. As it indicates, the trend is towards an increase in personal pension schemes and age-based schemes at the cost of the traditional pension unit schemes. There are 19 mutual insurance divisions with final salary schemes, of which 17 have obligations guaranteed by other parties. The B-division of LSR is by far the largest of them; its assets form around 65% of the total assets of divisions in the final-salary schemes.

Supplementary pension cover and personal pension savings

At year-end 2002 there were 48 depositories for pension savings, i.e. 17 pension funds, 23 savings banks, 5 commercial banks and securities firms and 3 life insurance companies.

Personal pension savings have been growing steadily each year since 1999, when FME began requesting information expressly on personal pension savings from pension funds and other depositories for pension savings. Pension savings on deposit with parties other than pension funds amounted to ISK 0.6 bn at year-end 1999, ISK 2 bn at year-end 2000, ISK 5.5 bn at year-end 2001 and ISK 9.1 bn at year-end 2002. Pension savings with other pension depositories than funds operating purely as personal pension savings funds prior to the entry into effect of Act No. 129/1997 amounted to ISK 1 bn at year-end 1999, ISK 1.9 bn at year-end 2000, ISK 3.4 bn at year-end 2001 and ISK 5.6 bn at year-end 2002, cf. **Figure 22**. By far the greatest portion of personal pension savings are on deposit with the six pension funds operating purely as personal pension funds prior to the entry into force of Act No. 129/1997. At year-end 2002, personal pension savings in their custody amounted ISK 44.3 bn. Total personal pension savings on deposit with pension funds and other depositories thus amounted to ISK 58.9 bn at year-end 2002.

Figure 19 Exchange rate dependent assets at year end 2002.

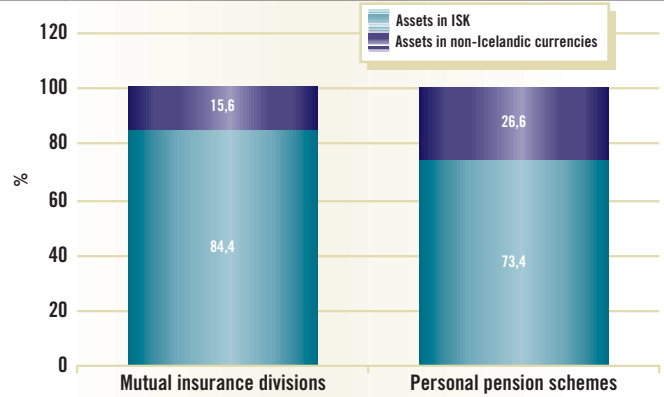


Figure 20 Exchange rate dependent assets as a percentage of total assets.

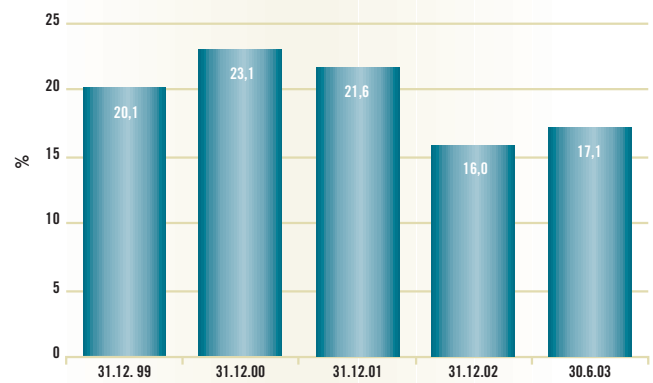


Figure 21 Pension schemes.

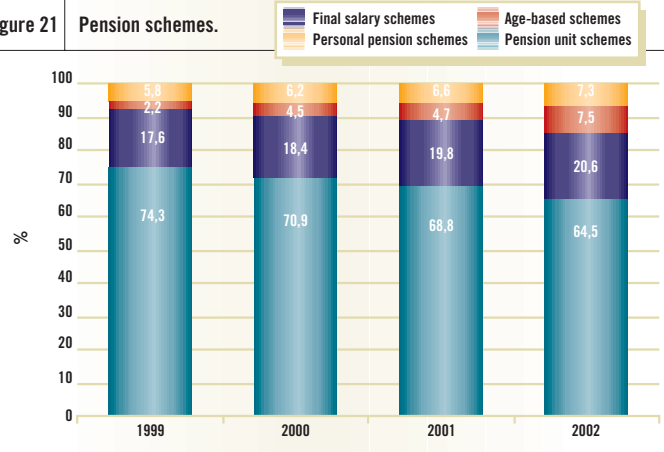
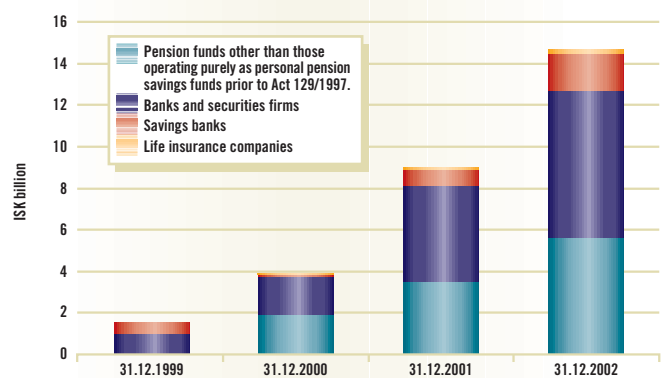


Figure 22 Pension savings by depositories other than pension funds operating purely as personal pension savings funds prior to the entry into effect of Act 129/1997.



Contributions to personal pension savings amounted to ISK 9.7 bn in 2001 and ISK 14.2 bn in 2002, thus increasing by 46% year-on-year. Of 2002 premiums ISK 6.2 bn were placed with pension funds which previously operated purely as personal pension funds (of this ISK 1.5 bn went to personal savings for minimum pension guarantee), ISK 2.3 bn to other pension funds and ISK 5.7 bn to other depositories for pension savings.

Personal pension rights can arise from supplementary contributions in excess of the mandatory 10%, on the one hand, or from the mandatory 10% premium for minimum pension cover on the other. Personal savings from the 10% mandatory premium are divided between a minimum pension cover (personal savings for minimum pension guarantee) and a private account for supplementary insurance cover. Six pension funds avail themselves

of the legal authorisation to define minimum pension cover as lower than 10% and offer a minimum pension cover which is an integration of personal and mutual savings. A fund member may request that the portion of his/her mandatory minimum premium defined as personal savings be diverted to another depository for pension savings at no charge.

2.4

The insurance market

Increase in number of consolidations of insurance companies

There are currently 14 insurance companies with operating licences in Iceland, of which 10 accept new insurance risks. Two insurance companies, Íslensk endurtrygging hf. and Trygging hf. are in a run-off. The insurance portfolios of Vélbátaábyrgðarfélag Ísfirðinga and Vélbátaábyrgðarfélagið Grótta have been transferred to Sjóvá-Almennar tryggingar hf. On 30 July 2002, a new company, Íslandstrygging hf., received an operating licence for non-life insurance operations and later that year, on 12 November, Líftryggingamiðstöðin hf. received an operating licence for life insurance operations. The life insurance company is a 100%-owned subsidiary of Tryggingamiðstöðin hf. Three life insurance companies are now subsidiaries of non-life insurance companies and one is the subsidiary of a bank.

The following section provides a more detailed account of the activities of Icelandic insurance companies as presented in their financial statements for 2002, and including information on the performance of the main insurance sectors which FME has published on its website. All amounts have been adjusted to 2002 price levels. Changes in amounts from one year to the next are thus changes in excess of price level changes. Iceland's natural catastrophe insurance (Viðlagatrygging Íslands) operates under special legislation, has a specifically limited role and is therefore omitted from the following discussion of insurance companies' operations. Premiums for natural catastrophe insurance in 2002 amounted to ISK 855 million, while claims were ISK 172 million, a slightly better outcome than in the previous year.

Figure 23 shows that investments in variable-yield securities have increased steadily since 1998. Investments in fixed-income securities and mortgages declined last year. Insurance companies' holdings in affiliated companies increased by ISK 739 million and holdings in subsidiaries by ISK 310 million. These two items have, however, fluctuated in connection with ownership changes during the reporting period.

Good performance in non-life insurance operations

The year 2002 was characterised by better performance in non-life insurance operations than in previous years. Insurance companies attribute the good performance in motor vehicle insurance to last year's favourable climate conditions. The property insurance performance, however, was unsatisfactory, in the opinion of the insurance companies, and at the end of the year the companies raised their premiums for the main classes of property insurance, in particular for mandatory fire insurance.

Figure 24 shows how the profits of their principal activities have developed since 1998. Profits from non-life operations have, during this period, never been greater, increasing by 87% over

Figure 23 Development of several classes of investments at 2002 prices.

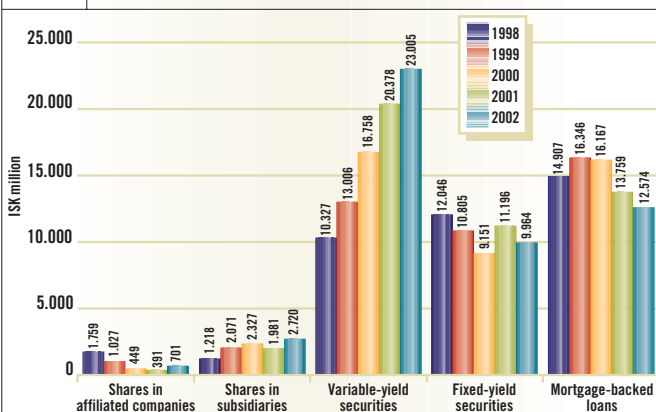


Figure 24 Net income from principal activities of insurance companies at 2002 prices.

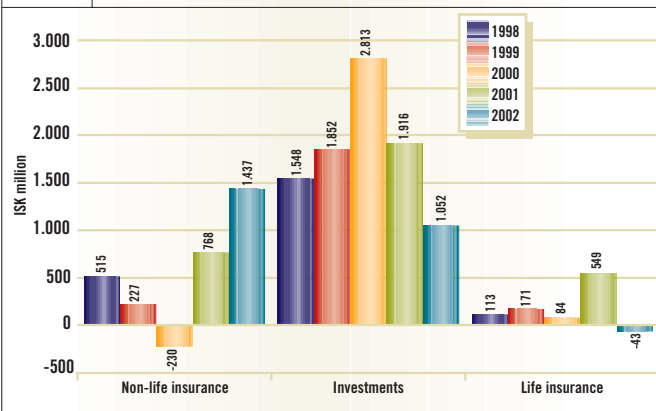
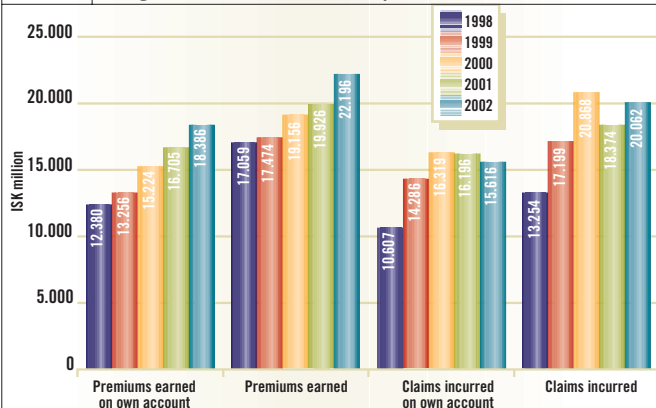


Figure 25 Trends in premiums and claims for non-life insurance, with gross and net amounts at 2002 prices.



the previous year. Profit from investments, however, dropped by 45% and has never been lower during this period. Life insurance operations returned a loss in 2002 for the first time during the period.

Figure 25 shows the development of premiums and claims in non-life insurance since 1998. The companies' premium income continues to grow. The reinsurance portion of premiums was 16% in 2001 and increased to 17% last year.

Total claims paid in 2002 increased from the previous year, while claims incurred for own account dropped by 4%. This difference is due to the increased participation of reinsurers in claims, which increased from 12% in 2001 to 22% in 2002.

Improved performance in motor vehicle insurance

Premiums for mandatory motor vehicle insurance amounted to ISK 8.8 bn last year as compared with ISK 8.2 bn in 2001. Incurred claims amounted to ISK 7.7 bn, a drop of almost ISK 1 bn from the previous year. Profits in this class, after allowing for reinsurance, operating expenses, investment cost, allocation of dividends and discounts, and change in equalisation provisions, amounted to around ISK 1 bn. In 2001 profit from mandatory motor vehicle insurance was ISK 42 million, while the previous years this field had operated at a loss.

Figure 26 shows annual premiums earned, claims incurred and profit/loss on mandatory motor vehicle insurance since 1998.

Provision for claims in compulsory motor vehicle insurance last year amounted to 65% of the provisions of non-life insurance as a whole, or ISK 24 bn of ISK 37 bn. The growth in provisions for claims from the previous year was 1.8% in 2002, as compared with a growth of 5.3% in 2001 and 11.2% growth in 2000. **Figure 27** shows the development of provisions for claims in compulsory motor vehicle insurance since 1998.

Claims for optional motor vehicle insurance increased last year, rising from ISK 2.0 bn to 2.2 bn. In the past two years optional motor vehicle insurance has returned a profit. **Figure 28** shows the development of premiums, claims and profit/loss in optional motor vehicle insurance since 1998.

Poor performance in property insurance

At the end of 2002 the insurance companies raised premiums in several classes of property insurance. The companies were of the opinion that the claim frequency had increased permanently.

Figure 29 shows developments since 1998, revealing that this class has been operating at a loss since 2000. That year there was a sizeable jump in the claims amount, and since then claims amounts have been substantially higher than in 1998-1999. Operating expenses in property insurance in 2002 was ISK 638 million, a rise from ISK 469 million in the previous year.

Figure 26 Compulsory motor vehicle insurance at 2002 prices.

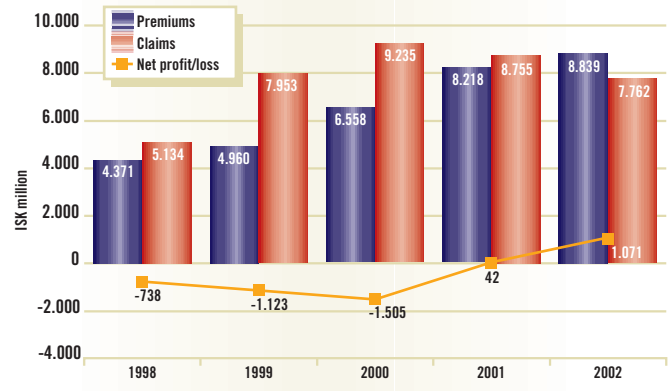


Figure 27 Provision for claims for compulsory motor vehicle insurance at 2002 prices.

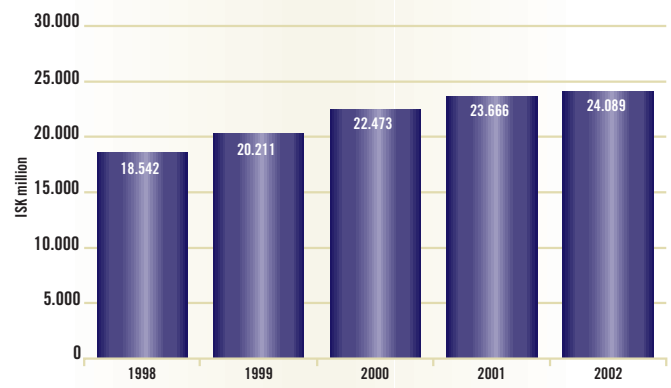


Figure 28 Optional motor vehicle insurance at 2002 prices.

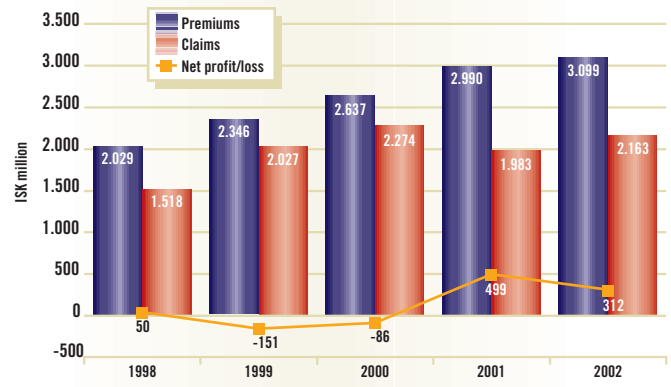
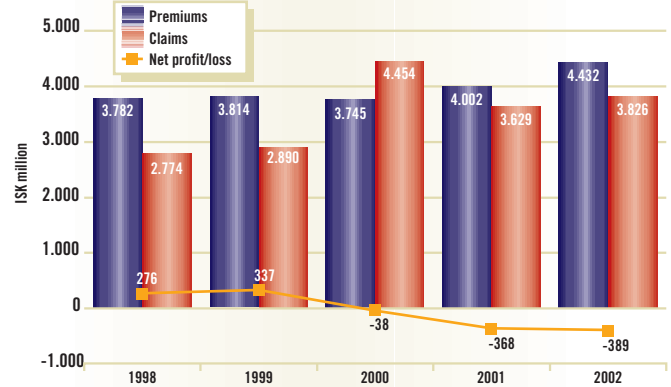


Figure 29 Property insurance at 2002 prices.



Provisions for claims rises while equalisation provisions decline

Figure 30 shows the developments in recent years in claims provisions and equalisation provisions, ending in 2002. The growth of claims provisions has slowed, however, with the real increase 1.7%, as compared with 7.2% the previous year. Equalisation provisions, however, decreased more rapidly than in the previous year, by 7.2% as compared with 4.9%.

Figure 31 shows the share of the main classes of non-life insurance in claims provisions and equalisation provisions.

Classes which have relatively low claims provisions as compared to their share of premiums are settled in a fairly short time, e.g.

property insurance, while e.g. amounts due to each claim in accident claims of mandatory motor vehicle insurance are reserved for several years. Classes which have a relatively high equalisation provisions are characterised by infrequent claims, where individual claims can be very costly. Equalisation provisions are relatively low in classes where claim frequency is high but the average claims are generally lower.

Good prospects for non-life insurances operations in 2003

Sjóvá-Almennar tryggingar hf., Tryggingamiðstöðin hf. and Vátryggingafélag Íslands hf. are the only insurance companies listed on the market, which thus issue interim financial statements. Their interim statements also give a picture of the activities of their life insurance subsidiaries Sameinaða líftryggingarfélagið hf., Líftryggingamiðstöðin hf. and Líftryggingafélag Íslands hf.

A comparison of the six-month statements of these three consolidations, compared with the same period last year at fixed prices, shows that premiums in non-life insurance increased by 2.7% while claims dropped by 24.5%. Profits of non-life operations were 75% higher during the period, and the outlook for 2003 thus appears likely to prove favourable for non-life insurance companies.

In total, life insurance operations of the afore mentioned three life insurance companies returned a loss of ISK 47 million for the period; comparison figures for 2002 are not available.

In closing it could be added that during the first six months of 2003 the companies' claims provisions have increased by 2.4% in real terms but this figure cannot be compared with last year's increase because part of claims provisions from the first half of the year are settled during the latter half.

Figure 30 Main components of technical provisions at 2002 prices.

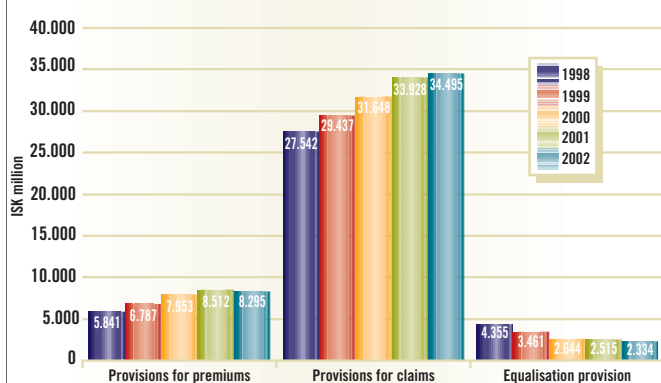


Figure 31 Insurance classes' shares in premiums, claims provisions and equalisation provisions, 2002.

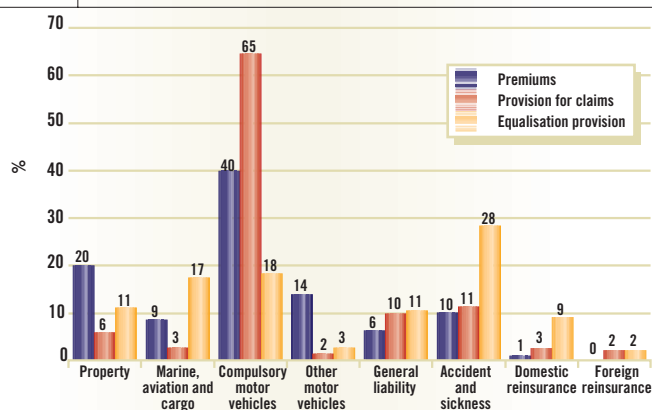
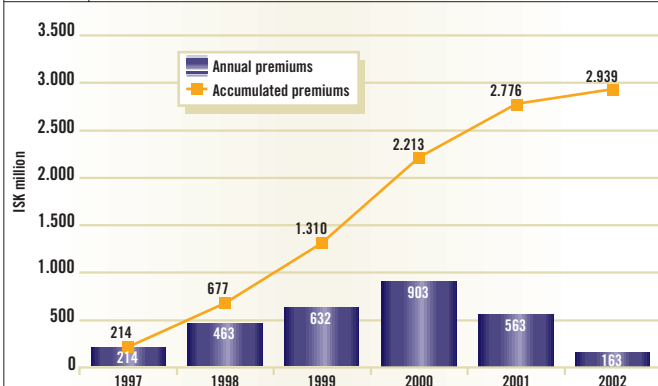


Figure 32 Insurance brokerage premiums earned by foreign companies due to new personal insurance contracts at 2002 prices.



Declining sales by insurance brokers to foreign insurance companies

The premiums collected by Icelandic life insurance companies totalled ISK 2.3 bn last year, as compared to ISK 1.9 bn the previous year. Since 1997, insurance brokers have sent a total of ISK 2.6 bn in premiums for new personal insurance contracts to foreign insurance companies. In 2002, however, premiums for new contracts amounted to only ISK 163 million. The peak in selling new personal insurance contracts of foreign insurance companies was reached in 2000, when ISK 809 million went to foreign companies.¹⁰ Sales by brokers in domestic supplementary pension savings has, on the other hand, increased in recent years. Figure 31 shows the development in premiums of insurance brokers to foreign companies for new contracts at 2002 prices.

¹⁰ Which amounts to ISK 903 million at 2002 prices.

The FME bases its operations on clear emphases that form the cornerstone of its long-term activities. These emphases remain unchanged from the ones formulated for the previous year, and new tasks will be based on them. This chapter describes the operational emphases of the FME as well as tasks relating to them on the work agenda.

3.1 Risk management and internal control – the role of boards of directors

The FME has encouraged every party subject to supervision to have the board and the management capable of providing the company with a strong structure, clear policy, effective internal rules and work procedures, a suitable information system and internal auditing. This enables the managers themselves and other employees to correctly evaluate the risk involved in activities and to manage it in accordance with the strengths of the enterprise.

Examples of general actions during the last period:

- Meetings with members of the board of directors.
- Risk assessment systems for parties subject to supervision, stress tests for supervision.
- Strengthening of supervision on a consolidated basis.

The FME will continue to **strengthen its relations with the boards** of directors of undertakings in the financial market. Periodic meetings are being planned for the members of the board of directors of parties subject to supervision in order to share with them the experience gained from FME inspections and to communicate important issues.

The FME intends to **increase the weight of new procedures** for monitoring risk management, establish a grading system for a larger number of supervisory areas, and develop stress tests that will be helpful for purposes of supervision.

The FME will continue to **strengthen its overview and supervision of consolidated undertakings** in the financial market. Co-operation with supervisory institutions abroad will be reinforced in order to ensure the effective supervision of consolidated undertakings that have gained a foothold in foreign markets.

3.2 Conduct of business practices in the financial market

The FME monitors activities in the financial market to make sure they are in accordance with proper and sound business practices. Rapid developments in the financial market call for a constant monitoring of business conduct in order to respond to changed circumstances.

Examples of general actions during the last period:

- Preventative supervision of insider dealings.
- Strengthened supervision of the owners of qualifying holdings.
- The adoption of guidelines concerning the boards of directors of parties subject to supervision. Increased monitoring of dealings with connected parties.

- The formation of guidelines concerning supplementary pension savings contracts.
- The formation of guidelines concerning the brokerage and selling of insurance.

The FME will continue to focus on the **preventative supervision** of business conduct in the financial market in order to minimise the risk of insider fraud, market manipulation, or insufficient information being passed on the clients of undertakings in the financial market. The FME will seek to implement its newly obtained powers to impose administrative fines on such parties that do not comply with legal provisions concerning information on insider trading.

In this respect, the FME aims to **formulate guidelines on transactions in the securities market** based on the core principles that the Committee of European Securities Regulators (CESR) has approved and adopted. These core principles touch on a number of issues concerning relations between financial undertakings and their clients, such as advice and the completion of contracts. A number of these core principles needs to be taken into consideration during the next revision of the legislation.

Over the coming months it will also be necessary to look to the introduction of, and compliance with, new directives on market abuse and prospectuses that will apply within the European Economic Area. These directives allow, for instance, for the harmonisation and strengthening of supervision and strategies.

Attention will be given to the **authorised activities of financial undertakings**. Supervision of the temporary activities of financial undertakings related to investment banking will be strengthened. The separation of interests within commercial banking, on the one hand, and investment banking on the other, will also receive attention.

Emphasis will still be placed on **monitoring the business conduct of owners** of qualifying shareholdings. There have been considerable changes in the ownership of financial undertakings in recent months and from previous experience the FME sees reason to look into the effect this may have on the operations of the undertakings concerned.

3.3 Market discipline

The FME emphasises the need to encourage increased transparency in the activities of parties subject to supervision. Doing so leads to increased discipline exerted by the market, accompanied by the restraints of internal control and the official supervision of financial activities.

Examples of general actions during the last period:

- Increased transparency in the actuarial surveys of pension funds with the introduction of new types of reports. Discussion paper on new pension fund reporting on actuarial surveys.
- An increase in educational activities by the FME towards of parties subject to supervision.

The FME will participate in preparing the introduction of the accounting standards of the International Accounting Standards Board (IASB) in accordance with Iceland's obligations to apply these standards to the consolidated financial statements of listed companies as of the year 2005. The FME formulates **rules on the annual accounts of financial undertakings** and pension funds and intends, in this capacity, to monitor closely the way in which financial undertakings prepare for this change. Other procedures for the enforcement of the international accounting standards (IAS) have not yet been laid down. It is of primary importance that these changes are adequately managed and that they will result in harmonised and transparent financial statements.

The FME wishes to stress the importance of establishing a dialogue on ways to **improve information** and reporting on operations and the results of supervision, especially in the securities market. Special attention needs to be paid to the FME's confidentiality obligation while at the same time drawing up specific rules on information in this area.

The FME fulfils its role in shaping a competitive financial market through its participation in the co-operation of European supervisory authorities in individual areas of the financial market. This co-operation, which is detailed in Chapter 1.5, is intended to **encourage the harmonisation of rules concerning the financial market and homogeneity of supervisory procedures**. If these plans come to fruition, it will be beneficial to financial undertakings in Iceland as well as their customers. Work on introducing the accounting standards of the IASB is a step in the same direction.

The increased overseas expansion of Icelandic financial undertakings gives rise to ongoing comparisons between the Icelandic and foreign financial markets. The FME intends to look for comparisons with similar institutions abroad in order to help strengthen the competitiveness of the domestic financial market.

3.4

Competitiveness of the financial market

The FME has a role to play in creating a competitive financial market in Iceland. This is done by participating in the shaping of an effective financial market and compliance with perspectives of customer interests and security in financial services.

Examples of general actions during the last period:

- The strengthening of effective supervision leads to positive results in the IMF's assessment of financial sector stability.
- Increased co-operation with supervisory authorities in countries where domestic undertakings have started operations.

4.1

Number of parties subject to supervision

On 30 June 2003 the number of parties subject to supervision by the Financial Supervisory Authority was as follows:

	Number 30.06.2003	Operate in accordance with Act No:	
Commercial banks	4	161/2002 on Financial Undertakings	
Savings banks	24	161/2002 on Financial Undertakings	
Credit undertakings	9	161/2002 on Financial Undertakings	
Deposit departments of co-operative societies	7	22/1991, as subsequently amended	
Securities companies	7	161/2002 on Financial Undertakings	
Securities brokerages	2	161/2002 on Financial Undertakings	
Mutual funds	10	30/2003 on UCITS and Investment Funds *)	
Management companies of UCITS	6	161/2002 on Financial Undertakings	
Stock exchanges and other regulated OTC markets	1	34/1998, as subsequently amended	
Central securities depositories	1	131/1997, as subsequently amended	
Pension funds	51	129/1997, as subsequently amended	
Insurance companies	14	60/1994, as subsequently amended	
Insurance brokerages	19	60/1994, as subsequently amended	
Other parties subject to supervision	5	Various Acts	
Total	160		

*) Act No. 30/2003 on UCITS and Investment Funds took effect on 1 July 2003.

4.2

Changes in operating licences, names and number of parties subject to supervision during the period 1 July 2002 to 30 June 2003**The credit market**

Eignarhaldsfélagið Alþýðubankinn hf. merged with Þróunarfélag Íslands on 7 October 2002 and operated under the name of the latter until 25 February 2003 when the name was changed to Framtak Fjárfestingabanki hf. The Act on Financial Undertakings (161/2002), which entered into force on 1 January 2003, states that the Harbour Improvement Fund and the Tourism Fund shall not be counted as financial undertakings, but both funds had until then operated in accordance with the Act on Credit Institutions other than Commercial Banks and Savings Banks (123/19993). On 11 February 2003 the FME approved the incorporation of two savings banks, Sparisjóður Kaupþings and the nb.is savings bank.

On 27 May 2003 the FME approved the merger of Kaupþing banki hf. and Búnaðarbanki Íslands hf. under the name of Kaupþing Búnaðarbanki hf. On 20 September 2002, by special contract between the two undertakings, Íslandsbanki hf. took over all commitments of the deposit department of the co-operative society Kaupfélag Eyfirðinga towards its depositors. On 31 December 2002 the deposit department of the co-operative society Hreyfill was closed and deposits paid out to its clients.

The securities market**Securities companies**

On 3 October 2002 the Minister of Commerce licensed the undertaking Arion verðbréfavarsla hf. to operate as a securities company in accordance with Act 13/1996.

Securities brokerages

Annar hf.-Verðbréf relinquished its licence to operate as a securities brokerage to the FME on 30 June 2003.

Pension savings market

On 24 February 2003 the Ministry of Finance ratified amendments to the Articles of Association of the Almenni lífeyrissjóðurinn VÍB hf. and Lífeyrissjóður arkitekta og tæknifræðinga, which were merged under the name of Almenni lífeyrissjóðurinn as of 1 January 2003.

The insurance market**Insurance companies**

On 30 July 2002 the Minister of Commerce granted Íslandstrygging hf. a license to operate as an insurance company in non-life insurance. On 6 November 2002 the Minister of Commerce granted Líftryggingamiðstöðin hf. a licence to operate as an insurance company in the area of non-life insurance.

Insurance brokerages

During the period, the Minister of Commerce granted the following operating licences to insurance brokerages: Tryggingar og ráðgjöf ehf. on 26 September 2002; DDF Vátryggingamiðlunin ehf. on 12 November 2002; Tryggingamiðlun Reykjavíkur ehf. on 10 March 2003; and Tryggingaþjónustan ehf. on 14 May 2003.

The FME listed the following undertakings in its Register of Insurance Brokerages during the period: Besso Limited, London, on 30 September 2002; Aon Limited, London, on 6 June 2003.

During the period, the following companies relinquished their licences to operate as insurance brokerages to the Ministry of Commerce: Tryggingamiðlunin Gildi ehf. on 28 August 2002;

<p>Íslenska váttryggingamiðlunin ehf. (ÍSVÁ ehf.) on 10 October 2002; Váttryggingamiðlunin ehf. on 18 October 2002; Nor Finans á Íslandi ehf. on 26 February 2003. On 15 January 2003 the operating licence of Den Danske Forsikringsmægler A/S in Iceland was cancelled.</p> <p>The following individuals relinquished their operating licences for insurance brokerage during the period: Valur Arnþórsson on 27 July 2002; Örn Gústafsson on 3 September 2002; Ingi Eldjárn Sigurðsson on 22 November 2002; Kristinn Rúnar Sigurðsson on 13 February 2003; Trausti Sigurðsson on 24 February 2003.</p>	<p>Byggðastofnun Reykjavík Lánaþjófur landbúnaðarins Selfoss Glitnir hf. Reykjavík Lýsing hf. Reykjavík SP-Fjármögnun hf. Reykjavík</p>																																																
<p>Other parties subject to supervision</p> <p>On 1 July 2002 the name of Verðbréfaþing Íslands was changed to Kauphöll Íslands hf. (The Iceland Stock Exchange Ltd.)</p>	<p>DEPOSIT DEPARTMENTS OF CO-OPERATIVE SOCIETIES</p> <p>Kaupfélag Árnesinga Selfoss Kaufélag Austur-Skaftfellinga Höfn Kaufélag Fáskrúðsfirðinga Fáskrúðsfjörður Kaufélag Héraðsbúa Egilsstaðir Kaufélag Skagfirðinga Skagafjörður Kaufélag Suðurnesja Reykjanesbær Kaufélag V-Húnavetninga Hvammstangi</p>																																																
<p>4.3</p>	<p>List of parties subject to supervision as of 30 June 2003</p>																																																
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PENSION FUNDS		
Almenni lífeyrissjóðurinn	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 starfsmanna Oluverzlunar Íslands	Reykjavík	
Eftirlaunasjóður starfsmanna Útvegsbanka Íslands	Reykjavík	
Frjálsi lífeyrissjóðurinn	Reykjavík	
Íslenski lífeyrissjóðurinn	Reykjavík	
Lífeyrissjóður Akraneskaupstaðar	Akranes	
Lífeyrissjóður Austurlands	Neskaupstaður	
Lífeyrissjóður bankamanna	Reykjavík	
Lífeyrissjóður Bolungarvíkur	Bolungarvík	
Lífeyrissjóður bænda	Reykjavík	
Lífeyrissjóður Hf. Eimskipafélags Íslands	Reykjavík	
Lífeyrissjóður Flugvirkjafélags Íslands	Reykjavík	
Lífeyrissjóður hjúkrunarfræðinga	Reykjavík	
Lífeyrissjóður lækna	Reykjavík	
Lífeyrissjóður Mjólkursamsölnunnar	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 hf.	Reykjavík	
Lífeyrissjóður starfsmanna Húsavíkurkaupstaðar	Reykjavík	
Lífeyrissjóður starfsmanna Kópavogsbæjar	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 Tanmlæknafélags Íslands	Reykjavík	
Lífeyrissjóður verkfræðinga	Reykjavík	
Lífeyrissjóður verslunarmanna	Reykjavík	
Lífeyrissjóður Vestfirðinga	Ísafjörður	
Lífeyrissjóður Vestmannaeyja	Vestmannaeyjar	
Lífeyrissjóður Vesturlands	Akranes	
Lífeyrissjóðurinn Framsýn	Reykjavík	
Lífeyrissjóðurinn Lífiðn	Reykjavík	
Lífeyrissjóðurinn Skjöldur	Reykjavík	
Sameinaði lífeyrissjóðurinn	Reykjavík	
Samvinnulífeyrissjóðurinn	Reykjavík	
Séreignalífeyrissjóðurinn	Reykjavík	
Söfnunarsjóður lífeyrisréttinda	Reykjavík	
Tryggingasjóður lækna	Reykjavík	
INSURANCE COMPANIES		
Alþjóða líftryggingarfélagið hf.	Reykjavík	
Íslensk endurtrygging hf.	Reykjavík	
Íslandstrygging hf.	Reykjavík	
Líftryggingamiðstöðin hf.	Reykjavík	
Líftryggingafélag Íslands hf.	Reykjavík	
Sameinaða líftryggingarfélagið hf.	Reykjavík	
Sjóvá-Almennar tryggingar hf.	Reykjavík	
Trygging hf.	Reykjavík	
Tryggingamiðstöðin hf.	Reykjavík	
Vátryggingafélag Íslands hf.	Reykjavík	
Vélbátaábyrgðarfélagið Gróttá	Reykjavík	
Vélbátaábyrgðarfélag Ísfröðinga	Ísafjörður	
Viðlagatrygging Íslands	Reykjavík	
Vörður vátryggingafélag	Akureyri	
INSURANCE BROKERAGES		
Aon Limited	London	
Alþjóða fjárfestinga- og vátryggingamiðlunin ehf.	Kópavogur	
Alþjóðleg miðlun ehf. (Operating licence relinquished 22.8.2003)	Reykjavík	
Árni Reynisson ehf.	Reykjavík	
Besso Limited	London	
DDF Vátryggingamiðlunin ehf.	Reykjavík	
Fjárfestingamiðlun Íslands ehf.	Kópavogur	
Heath Lambert Norway AS	Oslo	
Howden Insurance Brokers Ltd.	London	
Marsh Ltd.	London	
Nýja vátryggingaþjónustan hf.	Reykjavík	
Provins Insurance AB	Svíþjóð	
Tryggingamiðlun Reykjavíkur ehf.	Reykjavík	
Tryggingastofan ehf. (Operating licence relinquished 18.8.2003)	Reykjavík	
Trygg miðlun ehf.	Reykjavík	
Tryggingamiðlun Íslands ehf.	Reykjavík	
Tryggingar og ráðgjöf ehf.	Reykjavík	
Tryggingaþjónustan ehf	Reykjavík	
UIB Nordic AB (Registered 27.8.2003)	Svíþjóð	
Willis AB	Stokkhólmur	
INSURANCE BROKERS COVERED BY PROFESSIONAL LIABILITY INSURANCE OF INSURANCE BROKERAGES		
Árni Reynisson, <i>Árni Reynisson ehf.</i>		
Eiríkur Hans Sigurðsson, <i>Nýja vátryggingaþjónustan hf.</i>		
Halldór Sigurðsson, <i>Alþjóðleg miðlun ehf. (Operating licence relinquished 22.8.2003)</i>		
Hákon Hákonarson, <i>Tryggingar og ráðgjöf ehf.</i>		
Karl Jónsson, <i>Tryggingamiðlun Íslands ehf.</i>		
Leo Árnason (Operating licence relinquished 19.08.2003), <i>Tryggingastofan ehf.</i>		
Ólaf Forberg, <i>Alþjóða fjárfestinga- og vátryggingamiðlunin ehf.</i>		
Ómar Einarsson, <i>Nýja vátryggingaþjónustan hf.</i>		
Sigurður Rúnar Ástvaldsson, <i>Trygg miðlun ehf.</i>		
Sigþór Hákonarson, <i>DDF Vátryggingamiðlunin ehf.</i>		
Þorlákur Pétursson, <i>Fjárfestingamiðlun Íslands ehf.</i>		
OTHER PARTIES SUBJECT TO SUPERVISION		
Íbúðalánasjóður - húsbrefadeild	Reykjavík	
Nýsköpunarsjóður atvinnulífsins	Reykjavík	
Póstgíró - Íslandspóstur hf.	Reykjavík	
Tryggingarsjóður innstæðueigenda og fjárfesta	Reykjavík	
Tryggingasjóður sparisjóða	Reykjavík	

5.1

General

Review of the financial legislation in Iceland

An extensive restructuring of the Icelandic financial legislation was completed in 2002 and on 1 January 2003 the Act on Financial Undertakings (161/2002) entered into force. The parliamentary bill for this legislation has been prepared by the so-named bank law committee. The Financial Undertakings Act repeals earlier legislations concerning commercial banks and savings banks, credit institutions other than commercial banks and savings banks, electronic money undertakings, and parts of the legislation on securities transactions. The term 'financial undertaking' covers commercial banks, savings banks, credit institutions, securities firms, securities brokerages, electronic money undertakings, and the management companies of UCITS. The Act on Securities Transactions (33/2003) and the Act on Undertakings for Collective Investment in Transferable Securities (30/2003) entered into force on 1 July 2003. The FME has been working on the review of rules that is required to set pursuant to the new legislation for the financial market. Rules and regulations pertaining to the new legislation that have already been issued are detailed below. Older rules and regulations that are allowed for in the new legislation will continue to apply until its review is completed.

Act on Official Supervision of Financial Operations (87/1998).*Amendments:*

- Act no. 50/2003: The act stipulates that the FME shall issue notifications on individuals and legal persons that parties subject to supervision are to investigate in particular as to business relations. Financial undertakings are obliged to prevent any kind of capital transfer, such as the handing over of valuables, withdrawals, transfer payments, registration of assets, as well as other transactions, and in so doing prevent that those parties receive payments or are in some other way able to make use of funds.

Act on Payment of Cost due to Official Supervision of Financial Activities (99/1999).*Amendments:*

- Act no. 157/2002: The percentage of supervision fee as provided for in Article 5 of Act 99/1999 is brought into line with the estimated operating costs of the FME, cf. Article 2 of Act 99/1999.

Agreement on Co-operation between the Financial Supervisory Authority and the Central Bank of Iceland

The Agreement has been reviewed and now contains clearer provisions regarding the co-operation of these parties on the assessment of possible systemic risks in the financial market and reactions to such situations. Additionally, a special agreement was confirmed between these two institutions relating to back-office systems.

5.2

The credit market

Act on Deposit Guarantees and Investor Compensation Scheme (98/1999).*Amendments:*

- Act no. 139/2002: Provisions on amendments to Article 8 of the Act, stating that all obligations entered into prior to the revocation of a licence or the exclusion of a branch from the scheme shall enjoy insurance coverage in accordance with Chapter III of the Act.

Act on Financial Undertakings (161/2002).

The Act on Financial Undertakings (161/2002) consolidates in a comprehensive overall legislation on financial undertakings the Act on Commercial Banks and Savings Banks (113/1996), Act on Credit Institutions other than Commercial Banks and Savings Banks (123/1993), Act on Electronic Money institutions (37/2002), and provisions concerning the establishment and operations of securities firms and securities brokerages contained in the Act on Securities Transactions (13/1996). The Act enacts a number of changes that take aim of new and altered market conditions, articles were added to meet new requirements and others removed that no longer apply. Examples of new provisions include that the power is now given to the FME to issue and revoke operating licences. This power was earlier vested with the Minister of Commerce. The FME is also given the authority to demand a capital adequacy ratio higher than 8% for financial undertakings that are considered to be in an inadequate financial position with regard to risk levels. The Act also provides a clearer definition than the previous legislation on what kinds of violations are punishable and specifies classes of violations.

Regulation on Deposit Guarantees and Investor Compensation Scheme (120/2000).

Amendments:

- Regulation 864/2002: Amendments to three provisions in Regulation 120/2000.

Regulation on the Solvency Ratio of Financial Undertakings (530/2003).

The rules now cover financial undertakings instead of credit institutions, securities companies and securities brokerages. Electronic money institutions are exempt, however, as they are covered by special equity capital rules in accordance with Article 80 of the Financial Undertakings Act (161/2002). New types of undertakings covered by the rules are the management companies of UCITS.

Regulation on the Solvency Ratio of Financial Undertakings (530/2003).

The rules now cover financial undertakings instead of credit institutions, securities companies and securities brokerages. Electronic money institutions are exempt, however, as they are covered by special equity capital rules in accordance with Article 80 of the Financial Undertakings Act (161/2002). New types of undertakings covered by the rules are the management companies of UCITS.

Regulation on large exposures of financial undertakings (531/2003).

The rules (previously a regulation issued by the Ministry of Commerce) now cover all financial undertakings instead of credit institutions and undertakings offering securities services. New types of undertakings covered by the rules are the management companies of UCITS and electronic money undertakings.

Rules on the auditing of credit institutions (540/2003).

The rules now apply to all financial undertakings, whereas previously they covered credit institutions, securities companies and securities brokerages. New types of undertakings covered by the rules are the management companies of UCITS and electronic money undertakings.

Act on Deposit Guarantees and Investor Compensation Scheme (98/1999).

Amendments:

- Act no. 139/2002: Provisions on amendments to Article 8 of the Act, stating that all obligations entered into prior to the revocation of a licence or the exclusion of a branch from the fund shall enjoy insurance coverage in accordance with Chapter III of the Act.

Act on Financial Undertakings (161/2002).

The Financial Undertakings Act (161/2002) unifies in a comprehensive overall legislation on financial undertakings the Act on Commercial Banks and Savings Banks (113/1996), Act on Credit Institutions other than Commercial Banks and Savings Banks (123/1993), Act on Electronic Money Undertakings (37/2002), and the provisions concerning the establishment and operations of securities firms and securities brokerages contained in the Secures Transactions Act (13/1996).

Act on Undertakings for Collective Investment in Transferable Securities (30/2003).

The Act introduces an amendment to the directive on joint investment while at the same time creating a more favourable environment for the operation of joint investment funds in Iceland and encouraging more effective consumer protection.

Act on Securities Transactions (33/2003).

The Act presents a comprehensive legislation containing rules of conduct in the securities market and provisions on the rights and obligations of financial undertakings licensed to trade in securities. The provisions of the Act are based on the current legislation on securities transactions (13/1996) and the Act on Activities of Stock Exchanges and Regulated OTC Markets (34/1998).

Regulation on Deposit Guarantees and Investor Compensation Scheme (120/2000).

Amendments:

- Regulation 864/2002: Amendments to three provisions of Regulation 120/2000.

Regulation on Securities Transactions (630/2003).

This regulation specifies which parties can be defined as professional investors in accordance with Article 2, subparagraph 7c, of the Securities Transaction Act (33/2003) and the conduct of public offering of securities. The regulation repeals the regulation on takeover bids (432/1999) and the regulation on public offering of securities (477/2001).

Regulation on examinations in securities transactions (633/2003).

The regulation deals with the conduct of examinations in securities transactions, cf. Article 53 of the Financial Undertakings Act (161/2002). These examinations are called securities transaction exams. The employees of a financial undertaking who are in charge of day-to-day trading in financial instruments (cf. Article 3, item 6.1 of the Financial Undertakings Act) shall have passed a securities transaction exam. This regulation repeals Regulation 506/2000 on examinations in securities brokerage.

Rules on Index Funds (331/2003).

The rules apply to index funds operating in accordance with the Act on mutual funds (10/1993). This Act contains provisions to the effect that mutual funds, or individual departments of such a fund, are permitted to invest up to 35% of their assets in securities issued by a single party, provided that the Articles of Association and investment policy of the fund, or the department in question, state that its portfolio should reflect a specific securities index.

Rules on the Solvency Ratio of Financial Undertakings (530/2003).

The rules now cover financial undertakings instead of the previous credit institutions, securities firms and securities brokerages. Electronic money undertakings are exempt, however, as they are covered by special equity capital rules in accordance with Article 80 of the Financial Undertakings Act (161/2002). New types of undertakings covered by the rules are the management companies of UCITS.

Rules on large exposures incurred by financial undertakings (531/2003).

The rules (previously a regulation issued by the Ministry of Commerce) now cover financial undertakings instead of the previously stated credit institutions and undertakings offering securities services. New types of undertakings covered by the rules are the management companies of UCITS and electronic money undertakings.

Rules on the auditing of financial undertakings (532/2003).

The rules now cover financial undertakings instead of credit institutions before, i.e. securities firms and securities brokerages. The management companies of UCITS and electronic money undertakings are new types of undertakings covered by the rules.

Rules on the auditing of credit institutions (540/2003).

The rules now apply to financial undertakings, whereas previously they covered credit institutions, securities companies and securities brokerages.

5.4 | The pension savings market

Act on the Mandatory Guarantee of Pension Rights and the Operation of Pension Funds (129/1997).

Amendments:

- Act no. 73/2003: this Act amends domestic legislation to the extent required by the Vaduz Agreement, primarily provisions concerning trading in financial instruments, service contracts, investments and establishment rights.

Regulation on the mandatory guarantee of pension rights and the operation of pension funds (391/1998).

Amendments:

- Regulation 293/2003: Amendments to three provisions of Regulation 391/1998.

Rules amending Rules no. 55/2000 on the annual accounts of pension funds (765/2002).

The FME has issued Rules no. 765/2002 amending Rules no. 55/2000 on the annual accounts of pension funds. The amendments concern the repeal of provisions concerning inflation statements. Amendments are also made to Appendix III by introducing rules for annual financial statements that include a special principle for the computation of net real returns of pension funds that calculate the exchange rate of their assets on a daily basis, cf. also Act 10 of Rules 765/2002.

5.5

The insurance market

Act on Insurance Activity (60/1994).

Amendments:

- Act no. 29/2003 amending the legislation on Insurance Activity. The Act amends the insurance legislation as required by the enactment of the so-called Fourth Directive on motor vehicle insurance, i.e. 2000/26/EU, including the handling of claims for losses abroad, claims settlement officers, claims settlement centres and information centres. The enactment of the Directive also resulted in amendments to the Traffic Act (50/1987) with Act no. 26/2003. A new regulation on mandatory motor vehicle insurance 392/2003 came into effect pursuant to these amendments.
- Act no. 34/2003 amending the legislation on Insurance Activity. The amendment is the result of the enactment of the EU directive on the restructuring and dissolution of insurance companies 2001/17/EU. The principal aim of the directive is to ensure reciprocal recognition of measures taken by EU member states and co-operation concerning the financial restructuring and dissolution of insurance companies and a specific minimum coordination of domestic rules.
- Act no. 37/2003 amending the legislation on Insurance Activity pursuant to the enactment of the EU directive on the minimum solvency of insurance companies 2002/12/EU and 2002/13/EU. Minimum amounts are upgraded.

Regulation on calculating the solvency ratio of insurance companies (459/2003).

Regulation on assets included in the solvency ratio of insurance companies and the calculation of minimum solvency (632/2003).

Regulation 699/2003 amending Regulation 646/1995 on matching assets on the technical provisions of insurance companies.

5.6

FME Guidelines

The FME has issued general guidelines in a range of areas pertaining to the financial market. FME guidelines are based on legal authority granted by Article 8, paragraph 2, of the Act on Official Supervision of Financial Operations (87/1998).

This provision authorises the FME to issue and publish general guidelines on the operations of parties subject to supervision, on the condition that the area under discussion concerns those parties as whole or in individual groups.

Guidelines no. 2/2001 on the content of the rules of securities issuers concerning the handling of insider information and insider trading, with amendments.

Guidelines no. 2/2001 were republished with amendments pursuant to Act 39/2002 and the new Securities Transactions Act (33/2003) which entered into force on 1 July last. Amendments to the guidelines are in line with amendments to laws, such as the wording of the provision on insider fraud, the scope of the rules, and the definition of concepts. In addition, there are amendments to the wording of the provision authorising the custodian of rules to reject insider trading, which has met with some criticism.

Guidelines no. 7/2002 on the working procedure of independent insurance brokers.

In its communications with consumers and insurance brokers, the FME has become aware of a certain lack of rules on a range of issues concerning insurance mediation. The guidelines have to a large extent arisen from concerns expressed and observations made to the FME during its supervision of insurance brokers.

Guidelines no. 1/2003 on rules for financial undertakings, cf. Article 54, subparagraph 2, of Act 161/2002.

Article 54, paragraph 2, of Act 161/2002 stipulates that the executive boards of financial undertakings shall adopt rules of procedure which detail the areas of responsibility of board members. The guidelines deal with specific issues which have come under discussion in communications between the FME and financial undertakings.