FJÁRMÁLAEFTIRLITIÐ
THE FINANCIAL SUPERVISORY AUTHORITY, ICELAND

Annual Report 2005

The Period 1 July 2004
to 30 June 2005

CONTENTS

INTRODUCTION

The Annual Report of Fjármálaeftirlitið (FME), the Financial Supervisory Authority of Iceland, presented here gives a summary of the FME's activities from 1 July 2004 to 30 June 2005. The Report also discusses trends and outlook on the Icelandic financial market and gives an account of areas which will be emphasised by the FME in coming months. It contains a list of parties subject to supervision as of 30 June 2005 and an explanation of changes in their operating licences during the period covered by the Report. Changes to financial market legislation and regulations during this same period are also summarized. Extracts from the FME's annual accounts for 2004 are published in the final section of the Report.

As in previous years, the FME's Annual Report is published in Icelandic and English. Both versions are also available on the FME website, www.fme.is. The website also includes a variety of information concerning the Icelandic financial market and arrangements for the public supervision of financial activities.

FME Board of Directors:
Stefán Svavarsson, Certified Public Accountant, Chairman
Lárus Finnbogason, Certified Public Accountant, Vice-chairman
Ingimundur Friðriksson, Deputy Governor of the Central Bank of Iceland

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

** Appointed in July 2005 to replace former Director General, Páll Gunnar Pálsson, who left his position at the end of June 2005.*

1 OVERVIEW OF FME ACTIVITIES FROM 1 JULY 2004 TO 30 JUNE 2005

This section provides general information on the activities of the FME during the period from 1 July 2004 to 30 June 2005 as well as touching on matters under consideration prior to the publication of this report.

1.1 The Credit Market

Emphases for the period:

- *Supervision of risk in the mortgage market.*
- *Consolidated supervision and co-operation with supervisory authorities abroad.*
- *Development of risk assessment in the supervision of credit undertakings.*
- *Supervision of credit risk and the concentration of large exposures.*

The mortgage market underwent a considerable change during the latter half of 2004 when the commercial banks started offering more favorable interest terms than had been available before in the domain of property loans. To meet this new development, the FME issued a discussion paper towards the end of the year introducing stricter supervision and the submission of regular reports on the financing and analysis of loan portfolios.

As of 1 July 2004 the Housing Financing Fund became subject to FME supervision. The fund is now subject to regular supervision in accordance with current legislation on its activities and those of the FME.

The purchase by Icelandic banks of financial undertakings abroad and the purchase by overseas financial undertakings, owned by Icelandic banks, of other financial undertakings have been examined by the FME Specific requirements regarding consolidated risk management were met in all instances and therefore the FME saw no reason to exercise its legal authority to ban these deals.

As the overseas expansion of Icelandic financial undertakings has grown, so has the collaboration between the FME and parallel institutions in the countries where these undertakings are operating or established. The FME's foreign partners rely on the Authority to fulfil certain responsibilities in its capacity as a supervisory authority on a consolidated basis. The FME has signed memoranda of understanding with several financial supervisory authorities abroad and during the year FME participated in supervisory visits by overseas supervisory authorities to subsidiaries of Icelandic banks.

Supervision in the credit market was focused on monitoring the three commercial banks and further developing the risk assessment system and stress tests which are applied by the FME when determining higher minimum capital requirements than the statutory 8%. During the period, work was also continued on risk assessment systems for smaller credit undertakings to be used when prioritizing supervisory activities.

The concentration of large exposures remained a key feature of the supervision of loan risk. Larger and more complex consolidations of financial undertakings demand constant surveillance of this type of risk and also that the existing risk management systems are tailored to the complexity of the operations.

Work on the preparation of new capital requirements rules was continued. An international standard, Basel II, which was issued at mid-year 2004, is being incorporated into the legislation of the EEA with amendments to current directives. The changes are wide-ranging and in many countries the relevant authorities have already drafted rules and organized collaboration with parallel authorities abroad concerning the supervision of international undertakings and the implementation of international standards. The FME has also collaborated with financial undertakings which are likely to apply for using the option included in the new rules to seek permission to use their own risk assessment systems for determining minimum capital requirements.

A legislation concerning the introduction of new international accounting standards was passed by Althingi in the early months of 2005. Pursuant to this Act, the responsibility of monitoring the application of these standards will rest with the Registry of Annual Accounts. The Registry has, by law, the authority to designate the FME as chief supervisor of the application of the accounting standards with the parties subject to its supervision in general. No decisions have as yet been taken on this matter.

In June 2005 the FME introduced a draft proposal for new rules concerning the annual accounts of credit undertakings, which is expected to take effect as of the accounting year 2006. The aim of these new rules is to adapt current rules to the International Financial Reporting Standards (IFRS) and render them applicable to those credit undertakings that do not compose their annual financial statements along the lines supplied by the IFRS.

On 3 November 2004 the FME issued Guidelines no. 2/2004 on Foreign Currency Liquidity Management in financial undertakings. Foreign currencies denominated items have been a steadily increasing part of the activities of Icelandic financial undertakings in recent years. Various types of risk are connected to these activities and the Guidelines are intended to encourage good quality of management and control of foreign currency items.

In January 2005 amendments were made to the FME's rules on additional own funds items for financial undertakings. Following the amendment, financial undertakings may, provided certain conditions are met, include non-innovative hybrid capital in own funds Part A in addition to the previous authorisation to include innovative hybrid capital in own funds Part A.

1.2 The Securities Market

Emphases for the period:

- *Formulation of a transparency policy for the FME's operations in the securities market.*
- *Introduction and implementation of directives on market fraud, prospectuses and takeover rules.*
- *Systematic levying of administrative fines for infringements of rules on insider trading.*
- *Improved collaboration with the Iceland Stock Exchange.*

The FME has published its transparency policy pursuant to Article 72 of the Securities Transactions Act. According to the policy the FME will generally publish the results of its inspections and cases in the securities market.

Considerable resources have been put into implementation of the Market Abuse Directive (MAD), the Prospectus directive and amendments to takeover rules during the period. To complement the implementation of the directives, the FME has issued rules and published a handbook for issuers containing rules on the handling of insider information and insider transactions. The FME has also participated in the implementation of the MiFiD (Directive on Markets in Financial Instruments).

The FME has enforced its policy of imposing administrative fines in order to create an environment to ensure compliance with rules on insider trading and the handling of insider information. The FME believes that systematic sanctions will help support its preventative supervisory measures. An overview of the cases dealt with is given at the end of this section.

As in previous years, the FME has emphasised preventative supervision which has primarily focused on providing seminars for compliance officers and conducting inspections of compliance within securities issuers, outlining in particular the responsibilities of compliance officers, rules on insider transactions and the handling of insider information. During the period, a total of 11 such inspections were conducted.

During the period, the FME also stressed the obligation of issuers to submit lists of insiders to the FME, cf. Act 33/2003 on Securities Transactions. Issuers of listed securities have, on a number of occasions, failed to comply with this obligation as defined in Article 65 of Act 33/2003. The FME has urged issuers to comply with their obligation, since infringements of the provisions contained in Articles 59 and 62-67 of Act 33/2003 may result in administrative fines to be determined by the FME Board of Directors pursuant to Article 74 of the said Act.

During the year the FME entered into an agreement with the Iceland Stock Exchange concerning collaboration in various matters of supervision. The agreement details seperation of responsibility and coordination of supervisory practices in the securities market. This collaboration is a significant feature of vigilant market surveillance activities and encourages more efficient and secure supervision. A large number of cases are based on reports from the Iceland Stock Exchange. The collaboration was further enhanced by the FME's statement of supervisory projects with which the Stock Exchange had been entrusted, based on Article 71 of the Securities Transactions Act.

In June 2005 the FME published its discussion paper no. 1/2005 containing a draft proposal for guidelines on the use of derivatives in UCITS.

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

Administrative fines. Alleged infringements of Article 47 (currently Article 63 and 64) of Act 33/2003 concerning the obligation to notify of insider transactions were examined in a total of 30 instances. Fourteen resulted in the imposition of administrative fines ranging from ISK 20-750 thousand. On eight occasions the offender was a primary insider, but in six cases an issuer. Administrative fines were dropped in two cases following rulings by the appeals committee.

Flagging. Seven cases concerning flagging obligations as defined by Article 27 of the Securities Transactions Act were examined during the period. One was reported to the National Commissioner of the Icelandic Police, remarks were made on five cases, and one was dismissed without comment.

Market abuse. One case of possible market abuse, cf. Article 41 of the Securities Transactions Act, was examined. The case was concluded with remarks.

Insider fraud. Five cases of possible insider fraud were examined. Four of them were concluded upon the FME's examination but one case is still in process.

Takeover. Two cases concerning takeover obligation were examined, but further actions were not considered necessary.

Suspected offers to the public of unlicensed financial services. Overseas companies are increasingly offering their services in Iceland without having obtained the required licences. The FME has received a number of remarks on such practices and taken the appropriate measures. If necessary, the FME issues official warnings against the activities of named undertakings.

1.3 The Pension Savings Market

Emphases for the period:

- *Unprompted supervision.*
- *Overall inspections.*
- *Examinations of obligations.*
- *Examinations of pension fund investments.*

The FME has in recent years increasingly been seeking to shift the emphasis of its pension fund supervision towards unprompted supervision by conducting on-site inspections, examinations of pension fund investments and surveys of obligations and pension rights accounts. However, work relating to comments on amendments to the Articles of Association of pension funds, which the FME is obliged to submit to the Ministry of Finance, took up an exceptional part of the FME's time during the period.

Five on-site inspections were conducted during the period. Remarks, comments and requests for corrective action as a result of these inspections are, as in previous years, of a varied nature but deal for the most part with pension fund investment, internal control, major work procedures, actuarial surveys, pension rights accounts, and the submission of reports to the FME.

Four examinations of pension fund investment were conducted during the period. As before, these investigations have focused on the breakdown of investments, but the pension funds' internal control systems, annual accounts, auditors' reports and investment policies have also been examined. Remarks and requests for corrective action are largely pertaining to investments in unlisted securities and securities issued by a single party. A number of pension funds were reminded of primary provisions of the Pension Funds act which state that by 1 January 2006 the pension funds shall fulfill certain statutory restrictions concerning investment in deposits with commercial banks and savings banks as well as securities issued by them. Most of the above examinations resulted in remarks concerning the pension funds' investment policies, matters of internal control and their annual accounts.

Around 27 pension funds amended their Articles of Association during the period. As provided for in the Pension Funds Act, the approval of such amendments by the Ministry of Finance is conditional upon the FME's opinion. Some of these amendments concern the transfers of pension funds from unit based schemes to age dependent schemes. In the event of extensive or unusual amendments to the Articles of Association of a pension fund, the informal opinion of the FME is generally sought prior to the submission of the amendments for ratification by the Ministry. During the period the FME received a number of such requests. Curtailments of rights were, on the other hand, fewer in this period than in previous years owing to a general recovery in the actuarial positions of the funds.

In relation to on-site inspections of pension funds and the delivery of opinions on amendments to their Articles of Association there has been a special emphasis on examining commitments and pension rights accounts. The pension funds must now submit standardised forms for the results of actuarial surveys to the FME as well as documentation concerning the ratification of amendments to their Articles of Association.

Furthermore, submissions of special report forms for actuarial surveys which the pension funds were expected to return to the FME for the years 2002, 2003 and 2004 were monitored closely during the period.

On two occasions the FME delivered its opinion on rules concerning supplementary pension coverage to the Ministry of Finance in accordance with its advisory function as stipulated by the Pension Funds Act. The depositories of supplementary pension savings also seek assistance from the FME as regards changes to their contract forms, although these do not constitute changes to their rules.

During the period work commenced on a survey of the investment policies of non-guaranteed pension funds. The purpose of the survey is to obtain an overview of the form and content of the investment policies of these funds, to examine the extent to which the investment policies comply with current laws and regulations and whether their material content is appropriate to the activities of the pension funds to which they apply.

1.4 The Insurance Market

Emphases for the period:

- *Examination of risk management and internal control among parties subject to supervision and supervision of business conduct and information requirements.*
- *Examination of life insurance premiums.*
- *Preparation of guidelines on stress tests.*
- *Examination of the operating licenses of insurance companies and ancillary activities*

Special examinations of the operations of six insurance brokers and three insurance companies were conducted during the period. The FME has been preparing guidelines on stress tests and the information concerning risk management with a view to strengthening the supervision of insurance companies risk.

The FME has increased its supervision of the assessment of technical provisions and the submission of accompanying documents. As stated in last year's Report, the aim of new rules in this area is firstly to establish general procedures through harmonisation of work methods; secondly, that there exist observable criteria (limits) for assessing technical provisions and, thirdly, to increase the amount of information on technical provisions supplied by the insurance companies to the FME.

The FME has, for a number of years, conducted special aptitude tests for newly appointed managing directors (CEOs) of insurance companies and insurance brokerages. During the period, the FME submitted such tests to two insurance company CEOs and three prospective insurance brokers. The tests give a comprehensive assessment of the candidates' abilities and knowledge in the field of insurance. The education, work experience and career development of the CEOs shall indicate, without doubt, that the individuals are capable of fulfilling their duties in a satisfactory manner.

In 2005 the FME did for the first time send a report to all domestic insurance companies containing details of remarks and comments on the mandatory submission of documentation pursuant to Article 47 of the Act on Insurance Activities. This new and formal procedure is intended to improve the quality of material, thus leading to better supervision, for instance of risk management.

Preparations for an overall examination of the basis for fixing life insurance premiums (technical provisions), pursuant to Article 55, paragraph 2, of the Insurance Activities Act, were begun during the period. The collection of data and information from a number of insurance companies is currently in progress.

A new law on annual accounts whereby listed consolidations are required to compile their annual accounts and interim financial statements in accordance with the accountancy standard of the International Accounting Standards Board took effect in 2005. The standard affects most insurance companies operating in Iceland as two unlisted consolidations have already decided to take it into use. The FME will assess the impact of the introduction of this standard on insurance companies.

A special examination was conducted during the period into the activities of a captive insurance company in Iceland. The company has its head office in Bermuda but is owned by an Icelandic party (parent company). The insurance company in question underwrites the risks of its parent company in Iceland, including employee accident insurance and liability insurance. The FME was of the opinion that the company needed to apply for an operating licence or a licence to operate a branch. An ensuing disagreement was referred to the appeals committee, which operates in accordance with the Act on Official Supervision of Financial Operations no. 87/1998.

The ruling of the appeals committee, no. 1/2005, is dated 2 June 2005. The appeals committee found that the documentation submitted indicated that the company's activities were conducted in Bermuda and solely concerned primary insurance of the parent company's insurance risk. *"It is the opinion of the committee that underwriting an Icelandic insurance risk does not mean that insurance activities are conducted in Iceland and that insurance contracts should be subject to Icelandic law. Findings to that effect can not be arrived at on the basis of Act 60/1994 and the committee believes that instances of such activity need to be proved more conclusively."* The company does not operate *"a branch in this country and has not sought to establish such operations."* The committee did not find that the company was involved in insurance activities in Iceland as defined by the Insurance Activities Act. The company is, therefore, *"under the present circumstances not obliged to apply for a licence for such operations in this country."*

The FME draws the conclusion from the outcome of this dispute that it is imperative to determine legal provisions on the operations of captive insurance companies which will remove all doubt as to the legal position of the parties concerned. Insurance providers operate in a competitive environment in Iceland and the legislation on insurance activities is intended to improve the legal position of their clients.

1.5 Qualifying Holdings – Operating Licences of Financial Undertakings and Insurance Companies

Emphases for the period:

- *Supervision of the owners of qualifying holdings.*
- *Operating licences of financial undertakings and insurance companies.*

Extensive changes in the ownership of financial undertakings have, as in previous periods, resulted in a number of applications to the FME for the purchase of qualifying holdings. Ongoing supervision of the owners of qualifying holdings is also a fundamental factor and is intended to ensure that the holdings in no respect harm the sound and secure operations of the financial undertaking concerned. Supervisory activity concerning the ownership of financial undertakings has primarily been as follows:

- The FME received 13 approval applications for the acquisition of qualifying holdings in seven financial undertakings.

- Following thorough information and data gathering, most applications for the purchase of qualifying holdings have been approved on the basis of ownership changes, commitment to strengthen specific internal rules within the undertaking, or statements from applicants and FME requirements relating to the management of the holdings.

■ Relationships between parties have also been examined with a view to establishing whether a qualifying holding has resulted from ownership connections or collaboration.

■ Examination has been continued into the business conduct of the boards of directors of financial undertakings in order to assess the role of the owners of qualifying holdings in the management of individual undertakings. This includes whether, and to what extent, statutory internal rules on the role of boards of directors have been introduced and implemented. In this respect it has been examined whether the rules and their implementation meet the minimum requirements set by the FME in its Guidelines no. 1/2003 on Rules pursuant to Article 54, paragraph 2, of Act 161/2002 on Financial Undertakings. Part of the supervision includes regular reports submitted to the FME on special services by financial undertakings to connected parties.

■ Article 39 of the Insurance Activities Act, which concerns the purchase of qualifying holdings in insurance companies, was put to the test during the period. Parties intending to acquire a qualifying interest in an insurance company must seek the advance approval of the FME, which in turn deems whether the party concerned is qualified to do so with a view to ensuring the sound and prudent operation of the company.

The supervisory activities detailed above help create a profile of individual owners of qualifying holdings, which is then used as a basis for assessing their suitability for future ownership of qualifying holdings.

The FME continued its focus on the permissible operations of financial undertakings and insurance companies during the period. Major projects concerning the operating licences of financial undertakings and insurance companies are as follows:

■ Guidelines no. 1/2004, requiring commercial banks, savings banks and credit undertakings to submit six-monthly reports on their participation in business activities, were issued during the first half of 2004. On the basis of these reports, the FME has examined whether, and to what extent, the investments of commercial banks, savings banks and credit undertakings conform to their operating licences as defined by Article IV of the Financial Undertakings Act 161/2002. Disputes that have arisen mainly concern interpretations of what type of activity may be regarded as participation in restructuring enterprises/investment banking, cf. Article 22, paragraph 1; ways of handling investment in holding companies and investment funds, and when an activity may be regarded as a normal extension of the financial services of an undertaking, cf. Article 21, paragraph 2. It is particularly emphasised that commercial banks, savings banks and credit undertakings classify their participation in other activities in accordance with the provisions of the Financial Undertakings Act and that decisions concerning such activities be carefully planned and prepared. The FME's examination into this area is still in progress.

1.6 International Co-operation

Emphases for the period :

- *Participation in the co-operation of Nordic and European financial supervisory authorities on the harmonisation of supervision in the financial market.*
- *Collaboration with overseas financial supervisory authorities and inspection visits.*

The FME has continued to seek increased co-operation with financial supervisory authorities abroad in order to strengthen its consolidated supervision of the three Icelandic commercial banks and their subsidiaries. For this purpose, the FME has had meetings with relevant European financial supervisory authorities as well as visiting the banks' overseas branches and subsidiaries. The FME has signed specific memoranda of understanding with overseas supervisory authorities regarding the supervision of individual banks. The Authority has also sent its representatives on supervisory visits to undertakings in the credit and insurance markets abroad.

The FME is an active member of joint committees of European financial supervisory authorities, i.e. CEBS (Committee of European Banking Supervisors), CESR (Committee of European Securities Regulators) and CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors). These committees have the function of harmonising supervision in the financial market and thus supporting an effective internal market within the EEA. The committees also serve as advisory bodies to the European Commission on the formulation of a unified legislation for the financial market.

In the credit market, the FME has participated in the work of Groupe de Contact, which is a CEBS sub-committee responsible for drafting proposals for basic principles/guidelines to accompany the introduction of the Basel II (CAD 3) capital adequacy rules.

In the securities market, the FME has participated in three specialist groups within the CESR. One of these groups is currently preparing the introduction of the EU Directive on Markets in Financial Instruments (MiFiD). The FME has also had meetings with financial supervisory authorities in the Nordic countries concerning possible future collaboration on the development and design of a transaction reporting system of the kind stipulated in the MiFiD. There is clearly a demand for harmonised solutions and the Nordic supervisory authorities are determined to meet that demand. Further work on the preparation of this system will be carried out next year. In addition to MiFiD, the FME has participated in counselling work within the CESR concerning the EU Transparency Directive. The FME also participates in the CESR-POL supervisory committee of the CESR, which focuses on increased European co-operation on investigation, improved flow of information between countries and the development of supervisory methods. Furthermore, the FME has worked with the CESR and the European Central Bank on creating a standard for the clearing and settlement of securities transactions.

The FME has worked with a CEIOPS specialist group on Solvency 2 concerning new methods for the supervision of insurance companies and solvency rules. As a follow-up to this work, a so-called Quantitative Impact Study has been launched. In this study, insurance companies have been asked to test the impact of harmonised calculation methods for technical provisions within the EEA. In March 2006 the most suitable method for calculating solvency requirements will be tested.

The FME has enjoyed fruitful collaboration with its sister authorities in the Nordic countries. The Directors General meet once a year to review the year's progress and individual specialists meet regularly to work on specific projects.

1.7 FME Operations in 2004 and Estimates for 2005

For the year 2004 the FME's expenses, including the purchase of assets, amounted to a total of ISK 287.3 million. Income for the year, including interest income, came to ISK 291.4 million, of which income from supervision fees was ISK 288.3 million. This gives an operating surplus of ISK 4.1 million for the year 2004. Not included in the above figures are expenses and income arising from the complaints committees which are hosted by the FME. The FME's capital at the beginning of 2004 was ISK 4.8 million. This was taken into account for the calculation of supervision fees to be levied in 2005, which were approved by Althingi. The income for 2004 was allocated back into the FME's operations during the year. The operating surplus created a capital of ISK 8.9 million for the year 2004, or 3.0% of the Authority's net income.

Key statistical information from the FME's annual accounts is detailed in Chapter 6 of this Report, but the annual accounts are published in their entirety on the FME website.

According to the FME's revised operating plan for 2005, operating costs for the year are expected to total ISK 326.9 million whereas the estimate in the previous plan was ISK 309.1 million. Income, including interest income, is expected to be ISK 301.4 million, of which income from supervision fees should be ISK 298.0 million. Expenses in excess of income are thus expected to reach ISK 25.5 million. Given the positive equity of ISK 8.9 million at the beginning of 2004, the Authority's equity is expected to be negative by ISK 16.6 million at year-end 2005. This has been taken into account when determining the supervision fees for 2006.

1.8 FME Activities

Emphases for the period:

- *Efficient handling of cases.*
- *Development of standards.*

During the period, some 1010 cases were registered with the FME (Table 1). These cases are varied as regards their scope and amount of working hours required. Three major case categories are shown in the Table below. Communications received and submitted by the FME on account of these cases were equally multifarious and their number far greater, as also shown in the Table. For comparison, figures for the preceding 12 months are also included.

Table 1

Various statistics on FME activities	Period	
	1.07.2003-30.6.2004	1.07.2004-30.6.2005
Cases opened during the period	965	1010
Thereof:		
Inspections based on queries to parties subject to supervision *(A single inspection may in some instances include a number of parties subject to supervision at the same time)*	35	56
On-site inspections	50	41
Queries to the FME, complaints and consumer issues *(A number of informal queries is not included)*	229	180
Associated with the above cases are:		
Letters sent	3131	3202
Letters received	2055	1792
Reports from parties subject to supervision	2206	2749

All employees record their work hours in a special system which is linked to the FME's customer relations management system. The work record provides information concerning the division of disposable time between project categories (Table 2). FME projects are now, for the second time, divided into three main categories for the year 2004 in order to obtain a better overview of the nature of the Authority's activities over a longer period of time.

The division described above shows that various mandatory licensing, responses to queries and collaboration take up around 38% of the FME's disposable working time. Communication in this category is largely initiated by other entities than the FME. Around 39% of the working time was spent on individual supervisory projects initiated by the FME. The remaining 23% of the disposable working time were spent on projects relating to the regular collection of data to provide an overview of the activities of individual parties subject to supervision as well as the market as a whole.

Table 2

Proportional division of disposable hours between FME project categories pr. year*):	**2003**	**2004**
Communication: Approval/ counselling	**37,8**	**38,1**
Licensing, comment on licences, approval, validation	13,6	10,7
Responses to queries from parties subject to supervision and their customers	9,2	11,7
Housing of rulings committees	2,6	2,8
International co-operation	12,4	12,9
Actions initiated by the FME: Operations analysis/corrective measures	**34,6**	**38,9**
Supervision based on regularly submitted information (off-site)	7,3	7,1
On-site inspections	14,7	16,2
Supervision based on queries to parties subject to supervision	5,7	6,1
Market surveillance, overview and examination of cases in the securities market	6,9	9,4
Infor/create an overview/develop	**27,7**	**23,0**
Overview / data collection	10,0	10,0
Formulation of supervision and framework for the financial market	12,7	8,5
Transparency, the FME website,introductory meetings, electronic publication of annual accounts, annu al report, annual meeting	5,0	4,4
	100,0	100,0

**) Recorded hours for management, office work and work scheduling are distributed between individual categories.*

The work record also provides information on the division of the FME's activities between groups of parties subject to supervision (Table 3). This information forms the basis for determining the amounts of supervision fees to be remitted by these parties. The table shows the division for the years 2003 and 2004.

Table 3

Proportional division of disposable hours between groups of parties subject to FME supervision:	**2003**	**2004**
Credit undertakings	45,2	47,3
Insurance companies and insurance brokers	22,5	26,7
Pension funds	18,2	17,5
Management companies of UCITS	10,6	7,1
Securities firms and securities brokerages	2,7	0,4
Other	0,8	1,0
	100,0	100,0

Statistics on a number of FME actions also provide an interesting insight into the Authority's operations (Table 4). The number of decisions concerning licences and various validations has grown considerably in recent months and reached a total of 290 during the period. Another large project category is remarks, comments and requests for corrective action, stated either in letters or reports. The total number of such communication during the period was 220. The Table also shows how often the FME imposed day fines and administrative fines.

Table 4

Some statistics on FME actions (number of letters/decisions)	1.07.2003-30.6.2004	1.07.2004-30.6.2005
Licensing (operating licenses, qualifying holdings, etc.), validation, etc.	187	294
Remarks, comments, requests for corrective action (number of letters)	456	224
Day fines	20	2
Administrative fines (solely in a limited area of the securities market)	10	14
Referral to the National Commissioner of the Icelandic Police, according to Article 12 of Act 87/1998	1	1

The FME has a staff of 36. Table 5 shows the division of total staff positions between specialist areas.

Table 5

Personnel	
Total staff positions	35,7
Thereof:	
Business specialists	15,3
Lawyers	8
Actuaries	2
Computer specialists	2
Other specialists	3,8
Office staff	4,6
Average age – years	44,0
Average time of employment - years	9,1
Staff turnover - %	8,3

2 The Financial Market – Trends and Outlook

2.1 The Credit Market

Good performance

The performance of deposit institutions in recent years has been very good, primarily as a result of major increases in trading gains and other irregular income. Their performance in 2004 and the first half of 2005 has, furthermore, been positive even excluding income which tends to fluctuate or be irregular. During the first half of 2005, the return on equity (ROE) for the commercial banks and six largest savings banks was 40%, as compared with 26% in 2004 and 20% in 2003. A major portion of this good performance can be attributed to operations other than traditional banking activities, in particular to trading gains on securities. If only interest rate spread and commission income are considered, ROE (based on pre-tax profits) for the first half of 2005 was just under 12%, as compared to 5% in 2004 and negative ROE of close to 2% in 2003. In recent years, interest rate spread as a proportion of total assets has steadily decreased, with the decrease offset by a corresponding drop in operating expense and provisions for credit losses.

Substantial lending increase

There has been sizeable growth in lending by deposit institutions in recent years. The 12-month increase in lending, based on accounts of parent companies of commercial banks and savings banks, was 64% at the end of June 2005, as compared with 43% at year-end 2004 and 31% at the end of June 2004. Comparable figures for the 12-month lending increase to domestic parties are 53%, 40% and 20% respectively. The increase in domestic lending, particularly during the past 12 months, can be in part attributed to the transfer of housing mortgages from the Housing Financing Fund to commercial banks and savings banks which began in the latter half of 2004. Part of the above-mentioned lending increase is loans made to foreign borrowers, the share of which has increased from 7% of total lending by deposit institutions (parent companies) at the end of June 2003 to 20% at the end of June 2005. This rapid lending increase is a cause for concern, since it is one of the risk factors which experience has shown may indicate upcoming difficulties in the financial system. It is therefore important that the banks maintain the strong equity position they have had recently.

Defaults on lending, which is one measure of asset quality, have been falling steadily in recent years. The default percentage has been decreasing, even if calculated with a time lag of two years, i.e. calculations of defaults as a percentage of total loans outstanding two years earlier, to exclude the impact of major lending growth. Since decreasing defaults can be attributed in part to the current upswing in the domestic economy, they can be expected to increase once more when the economy hits a downturn. Deposit institutions are, however, in better shape to meet such a downturn than before due to better diversification of their loan portfolios, in part due to their increased participation in the housing mortgage market and the increased share of lending to foreign parties. This last factor applies in particular to the largest commercial banks.

Substantial assets in market securities

Based on their consolidated financial statements, the market securities assets of commercial banks and savings banks have increased substantially in absolute terms in recent years, in parallel to their total asset growth. As a proportion of their CAD equity, however, their market securities assets have been decreasing. Market bonds held at own risk comprised 47% of CAD equity at the end of June 2005 as compared with over 80% at year-end 2000. Comparable figures for equities held at own risk were 30% at the end of June 2005 and 55% at year-end 2000. Market risk connected to these security assets has thus decreased in recent years, in addition to which the market risk on these equities is to an increasing extent, linked to parties with operations abroad. Despite the increased risk diversification, market risk connected to securities is considerable.

Major increase in the balance sheet result and foreign financing

In recent years there has been a significant increase in deposit institutions' total assets. This increase has, in particular, been connected with the activities of the largest commercial banks outside of Iceland. According to their consolidated financial statements, at year-end 2000 the total assets of the commercial banks and the largest savings banks were ISK 900 billion (bn) and for the parent companies ISK 670 bn, or the equivalent of 138% and 103% of GDP respectively. Comparable figures for the end of June 2005 were ISK 4,530 and ISK 2,830 bn, representing 488% and 305% of GDP respectively. These figures will clearly increase further during the second half of 2005 due to further acquisitions of foreign financial enterprises by the commercial banks. The increase in total assets is both the result of organic growth, i.e. increases in lending and securities assets, and external growth, through acquisitions of financial enterprises operating abroad.

The above-mentioned growth in the deposit institutions' balance sheets has been financed primarily through borrowing and increases in share capital. The share of deposits in their financing has been dropping and at the end of June 2005 deposits represented only 20% the total assets of commercial banks and savings banks, based on their consolidated statements, as compared to 30% at the end of 2000. For the largest savings banks this percentage is 45-50%. Financing in the form of increased borrowing has been primarily obtained on foreign credit markets. At year-end 2000, the commercial banks' gross foreign debt, based on their consolidated financial statements, amounted to ISK 400 bn and their net debt, i.e. after deducting amounts owed from foreign parties, was ISK 340 bn. Similar figures as of the end of June 2005 were ISK 1,760 gross foreign debt and ISK 750 net foreign debt. Gross debt has thus more than quadrupled, while net debt has more than doubled during this period. Despite a lengthening of average duration and better diversification of lending, both by country and financing market, than before, this comprises a substantial refinancing risk. This risk is considered one of the major risk factors in the banks' operations, and calls for careful risk management.

As previously mentioned, the growth of the banks, especially their external growth, has been partly financed by increasing their equity. At year-end 2000, the book value of equity of the commercial banks and largest savings banks (excluding minority interests in equity of subsidiaries) was close to ISK 56 bn, while at the end of June 2005 it was ISK 332 bn; measured as a percentage of GDP, the figures are 8.6% and 36% respectively. These figures reflect the change which has occurred in the space of a few years in the capacity of the commercial banks and savings banks to increase their activities.

Strong capital position

The overall capital ratio (CAD ratio) of commercial banks and the largest savings banks has been rising since the end of 2000, when it was just under 10%. At the end of June 2005 it was just below 14%. The largest commercial bank, Kaupthing Bank, had a very high capital ratio (15.8%) at the end of June 2005, just before its takeover of Singer & Friedlander in London. Excluding Kaupthing Bank, which accounts for 40% of the above overall capital ratio figure for commercial banks and savings banks, this ratio would be 12.5%. The ratio of Tier 1 capital was 8.1% at year-end 2000 and 10.9% at year-end 2005 (9.2% if Kaupthing Bank is excluded). The minimum ratio allowed, based on the stress test using the references set in FME's rules on a higher capital ratio, was 9.5% at the end of June 2005, but these references assume, for instance, a 25% reduction in the book value of shares held at own risk, 7% reduction in the value of market bonds held at own risk and 20% reduction in the value of non-performing loans and appropriated assets. The minimum ratio has been dropping due to the decreasing ratio of market securities and loans in default to total equity. FME has been examining whether the references in question should be reviewed, for example, whether the using a 25% reduction in the value of equities is a sufficiently cautious reference and whether there is reason to take additional risk factors into consideration, such as fixed interest rate risk, risk due to equity loans and housing mortgage risk. On the whole, the equity position of commercial banks and savings banks appears to be satisfactory as of the end of June 2005.

Developments ahead

In the past years, the income base, of the largest commercial banks in particular, has broadened substantially in connection with their increased activities outside of Iceland. During the first half of 2005 the share of the banks' net operating income from activities abroad was 42% as compared to 25% in 2003. For the largest commercial bank, the share of income from operations abroad was 70% during the first half of 2005 as compared with just under 50% in 2003. In 2005, approximately 50% of the commercial banks' net operating income can be expected to originate from their operations abroad. As a result, the banks will not be as sensitive to fluctuations in the domestic economy. On the other hand, the rapid growth in their foreign operations, especially in acquiring existing financial enterprises, means new risks and calls for more complex and more robust risk management than before.

Figure 1 ROE of commercial banks and largest savings banks based on different weightings of operating income

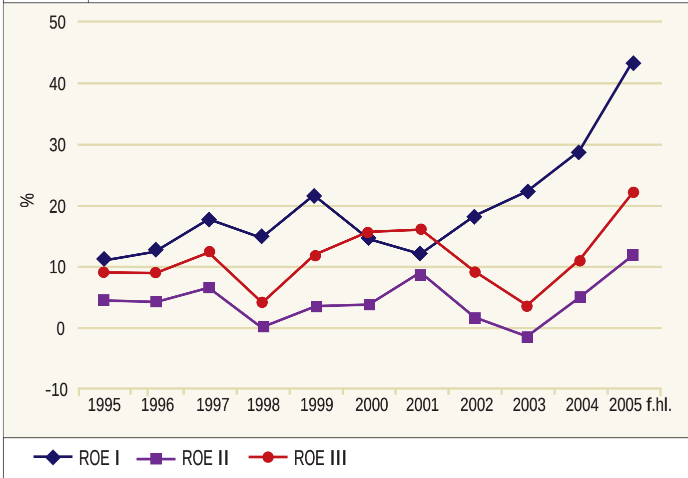


Figure 1 shows return on equity (ROE) on an annual basis for commercial banks and the largest savings banks. ROE I shows the return as shown in annual financial statements, ROE II is return less operating income other than fees and commissions. and ROE III return less trading rate gains. In calculating ROE II and III, no consideration has been had for the impact of lower interest cost and taxes due to assumptions concerning lower income, with the result that ROE II and III are underestimated to some extent. In all cases the figures show return on equity before taxes.

Figure 2 Main Operating Items of Commercial Banks and Savings Banks as a Ratio of Average Balance Sheet Position

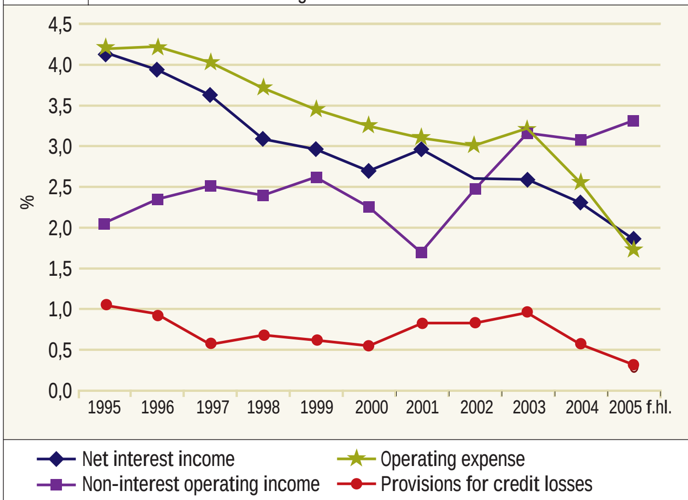


Figure 2 shows the development of major operating items of commercial banks and the largest savings banks as a proportion of their average total assets. Figures for the 1st half of 2005 are extrapolated to an annual basis. The interest rate margin and operating expenses have decreased almost steadily during the period. Credit loss provisions have decreased in the last year or two after increasing from 2000 onwards. The development of non-interest operating income, however, differs significantly from that of other operating items. Non-interest income from operations has grown steeply and steadily after 2001, following the downturn of the preceding years.

Figure 3 Household and Corporate Defaults as a Ratio of Total Lending – Commercial banks and largest savings banks (parent companies only)

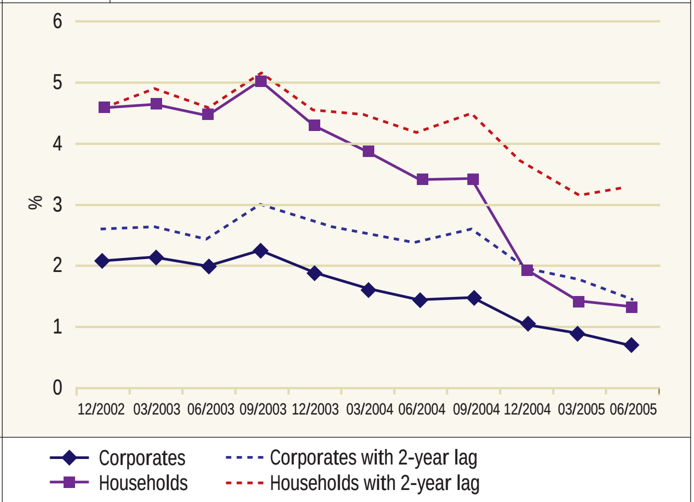


Figure 3 shows defaults to deposit institutions (parent companies only) as a proportion of total loans outstanding at the end of each quarter since year-end 2000 and as a proportion of total loans outstanding with a two-year lag. During this period, household defaults reached a peak in Q3 of 2003, after which they began to decrease. A substantial decrease can be seen in Q3 of 2004, when the banks entered the housing mortgage market.

Figure 4 Market Bonds and Equities Held at Own Risk by Commercial Banks and Largest Savings Banks

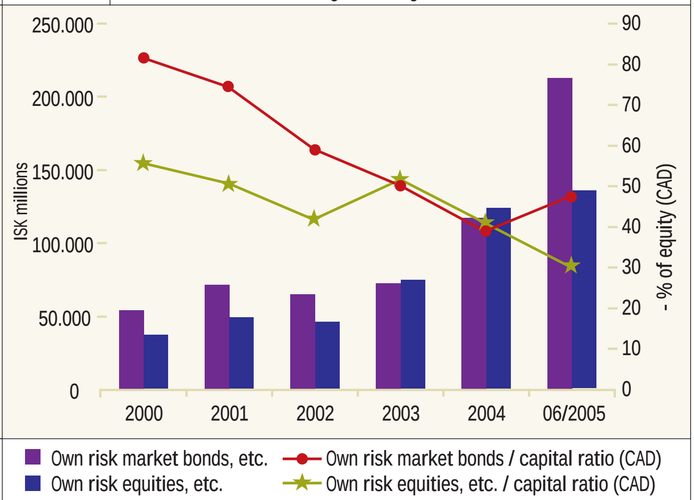


Figure 4 shows the development of market securities holdings of commercial banks and the largest savings banks (from their consolidated accounts), in absolute terms and as a proportion of equity. Market Bonds at own risk amounted to 47% of the capital base at end of June 2005 compared to 81% end of year 2000. Shares at own risk amounted to 30% of the capital base at end of June 2005 compared to 55% end of year 2000.

Figure 5 Deposit Institutions' Balance Sheet Outcome in Absolute Terms and as a Proportion of GDP

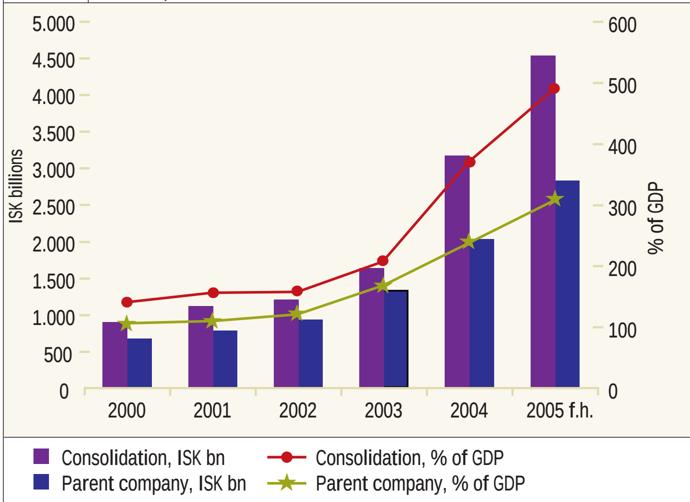


Figure 5 shows the development of deposit institutions' activities based on their balance sheet outcome over a period of almost five years, both in absolute terms and as a percentage of GDP, for the groups and parent companies. The difference between the two is primarily the result of subsidiary operations abroad. The figure clearly demonstrates the major growth in deposit institutions' operations during the period in question and the increased significance of these financial activities for the national economy. The balance sheet total, based on consolidated financial statements, was slightly more than GDP in 2000, while as of the end of June 2005 this figure was close to fivefold GDP.

Figure 7 Book Value of Deposit Institutions Equity in ISK bn and as % of GDP

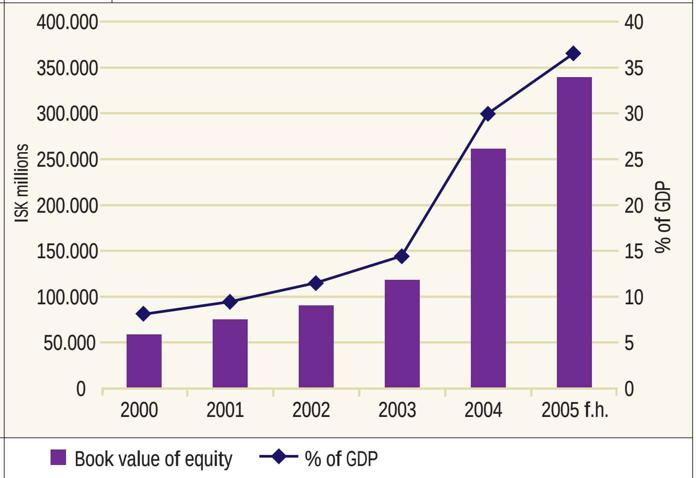


Figure 7 shows how the book value of deposit institutions' equity has developed over a period of just over 5 years in absolute terms and as a proportion of GDP. The development is similar to that of *Figure* 5, i.e. a substantial growth during the period concerned. At the beginning of the period the book value of equity for commercial banks and the largest savings banks was around ISK 56 bn and over 5% of GDP, while the comparable figure at the end of the period are ISK 332 bn, which is over 36% of GDP.

Figure 6 Gross and Net Liabilities of Commercial Banks and Savings Banks Owed to Foreign Parties

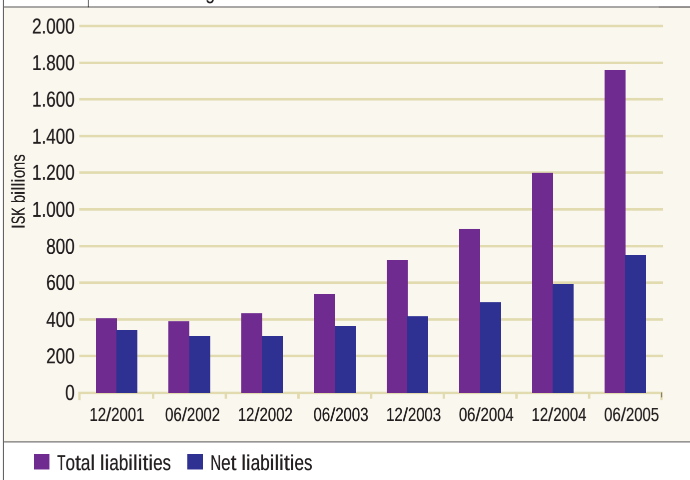


Figure 6 shows how gross and net liabilities owed to foreign parties by commercial banks and savings banks have developed (parent company statements) from 2001 to June 2005. Since the end of June 2004 gross liabilities have doubled, while net liabilities have grown by 50%. The liabilities are practically exclusively connected with the three largest commercial banks.

Figure 8 Commercial Banks' and Largest Savings Banks' Capital Ratios (CAD) With and Without Subordinated Loans

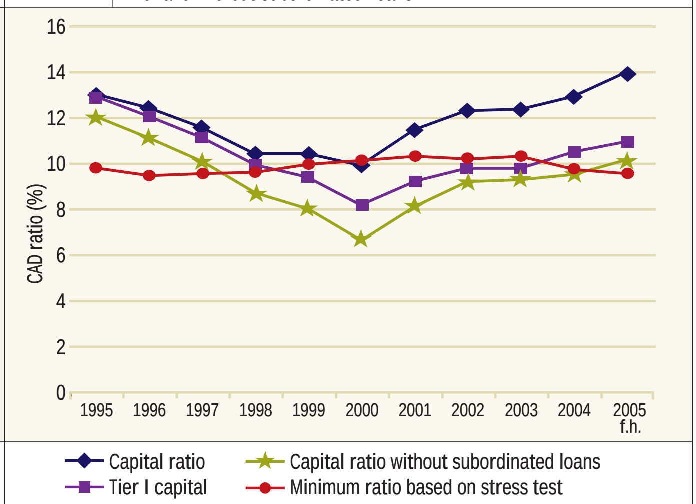


Figure 8 shows how the capital ratios (on a CAD basis) for commercial banks and the largest savings banks have developed during a period of just over 10 years. It shows the CAD ratio, the ratio of Tier I capital, and the equity ratio excluding subordinated loans. Furthermore, it shows the minimum CAD ratio based on a stress test assuming a decrease in the value of certain asset items, cf. FME Rules No. 530/2004. At the end of June 2005, the overall CAD ratio was 13.9%, the ratio of Tier I capital was 10.9% and the capital ratio excluding subordinated loans was 10.1%. The minimum ratio (estimated) using a stress test was 9.5% as of 30 June 2005.

Figure 9 Ratio of Commercial Banks' Income Originating Abroad

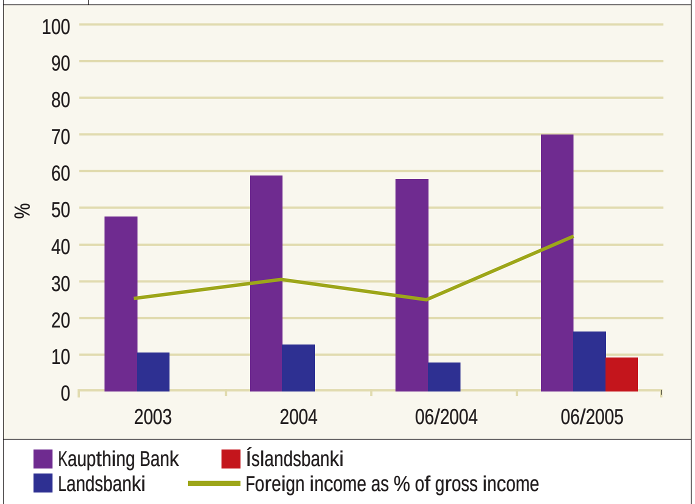


Figure 9 shows the percentage of total income originating from establishments outside of Iceland from the end of 2003 to end of June 2005 for the three commercial banks, plus the banks' weighted average percentage of income originating abroad for the same period. During this period the ratio of foreign income of Kaupthing Bank's total income has grown from 48% to 70%.

2.2 The securities market

Favourable development of the securities market continues

Financial market developments in 2004 and during the year to date have continued to be favourable for investors on both the equity and bond markets. The ICEX-15 index rose by almost 59% during 2004 and from the beginning of this year until mid-October it has climbed by over 36%. Returns on the bond market have also been good, although they are not as high as on the equity market. Bond market turnover has fallen during the year to date.

Total equity trading in 2004 amounted to around ISK 721 billion, as compared to ISK 554 billion in 2003, a YoY increase of around 30%. Total equity trading during the first 6M of 2005 was around ISK 403 billion, as compared to ISK 285 billion during the same period of 2004.

Total bond market trading in 2004 amounted to around ISK 1,496 billion, as compared to ISK 1,024 billion in 2003, a YoY increase of around 46%. Total bond market trading during the first 6M of 2005 was around ISK 573 billion, as compared to ISK 715 billion during the same period of 2004. This is a YoY contraction in turnover of close to 20%.

Number of listed companies on ICEX and their market capitalisation

The number of companies listed on ICEX continued to drop in 2004, falling from 48 to 34, with no new companies listed during the year. Listed companies continued to decrease this year and as of end of October there were only 27 companies listed. There were six delistings and two new listings. Both of the new listings involve foreign parties, Mosaic Fashions hf. in the UK and P/F Atlantic Petroleum of the Faroe Islands. The ICEX management state, how-ever, that they have become aware of interest in new listings on the market and anticipate listings by foreign and domestic companies.

Despite the above-mentioned decrease in the number of listed companies, their market value has never been higher. At the end of June 2004, the market cap of companies listed on ICEX amounted to around ISK 855 billion; at year-end 2004 this figure was close to ISK 1,084 billion and at the end of September 2005 ISK 1,517 billion. Now as before, the largest companies listed on ICEX are financials.

The increase in the market value of listed companies can be in part attributed to the substantial and successful international expansion of Icelandic companies. The majority of companies in the ICEX-15 Index have carried out acquisitions or takeovers of companies abroad. Other factors which can be assumed to have also fuelled this increase are share price rises, as well as mergers of listed companies, i.e. companies which are delisted do not in fact disappear from the market but are rather absorbed by other listed companies. There have been substantial transformations to many listed companies and in some cases the companies' main activities now differ from what they were previously or various other activities have been added. In some instances income composition has changed so that an ever-larger portion of the company's income is derived from its operations abroad. Comparisons between two points in time of a specific index is, however, not always significant due to changes in the companies' main activities.

In 2004 market analysts claimed that the Icelandic equity market was over-valued and forecast a correction ahead. Nonetheless, the market has continued to rise. Companies have been posting good results, even profits exceeding expectations. It is clear that there is plenty of money in circulation and investors are unafraid to take risks. Analysts have agreed that decreases are not expected in the near term, based on the companies' results and operating prospects. It is still worth bearing in mind, however, that there is a considerable amount of leveraged equity purchasing, as well as cross-ownership.

Developments on the Icelandic equity market, which differ from those on most other markets, have drawn attention in other countries. Questions are often asked as to where the money comes from and what is behind the success of Icelandic companies expanding abroad. There is no single, simple answer to these questions. It could be pointed out, however, that Icelandic pension funds invest enormous amounts and that there is a great deal of money in circulation, in part as a result of the transformation of the housing mortgage market and bond market. Up until now, international expansion by Icelandic companies has been highly successful and the companies have been reporting profits even exceeding expectations. The operating basis of expanding companies has changed, with an ever-growing proportion of their income originating abroad. As a result, investors are willing to take greater risks than before. The domestic market in Iceland is limited, which makes it only natural for companies to look abroad for new investment opportunities.

Bond market at a crossroads

In the autumn of 2004, Icelandic banks began competing with the state-owned Housing Financing Fund (HFF) in residential housing mortgages. The public welcomed this increased access to credit and lower long-term interest rates, with many people taking advantage of the opportunity to refinance existing loans or purchase housing. This refinancing was followed by a decrease in household defaults on bank loans. Recently, however, bank overdrafts have increased, with at least part of this used for increased household consumption.

Information disclosure by share issuers

In its previous annual report, FME pointed out that there were substantial deficiencies in information disclosure to regulatory authorities by listed companies. It warned that severe action would be taken against violations of information disclosure provisions. FME has now been authorised to apply administrative fines in cases of violations by listed companies of information disclosure provisions and issuers should expect these to be applied with determination. Furthermore, FME's transparency policy has also come into effect and companies failing to comply can expect public reporting of actions against them by FME. FME is confident that this will increase discipline towards issuers and encourage investor confidence in effective surveillance.

Figure 11 | Number of listed companies on ICEX at end of period

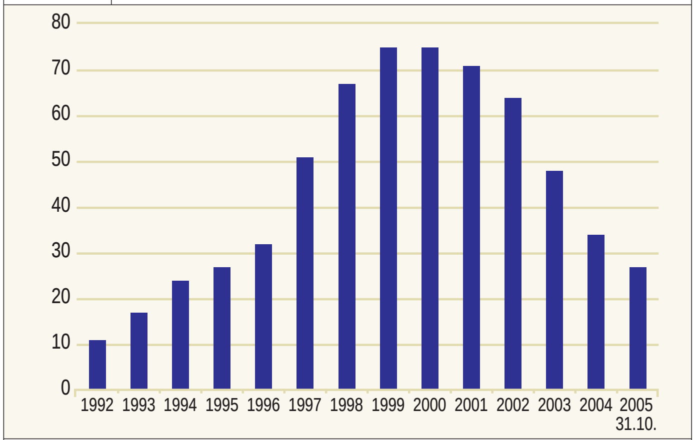


Figure 11. Ever since 2000, the number of listed companies on ICEX has been decreasing. The number of listed companies was highest in 1999 and 2000 at 75. Since that time they have decreased steadily in number, and were 34 at year-end 2004. They have continued to decrease, and were only 27 in end of October 2005. This year a total of nine companies have been delisted from ICEX (Opin Kerfi Group hf., Tangi hf., Hraðfrystistöð Þórshafnar hf., Þormóður rammi-Sæberg hf., Austurbakki hf., Burðarás hf., Líftæknisjóðurinn hf., Landsími Íslands hf. and Samherji hf.) while two new companies have been listed this year (P/F Atlantic Petroleum and Mosaic Fashions hf.). Listed companies on ICEX have not been so few since 1995.

Figure 10 | ICEX Main List and ICEX-15 Indices

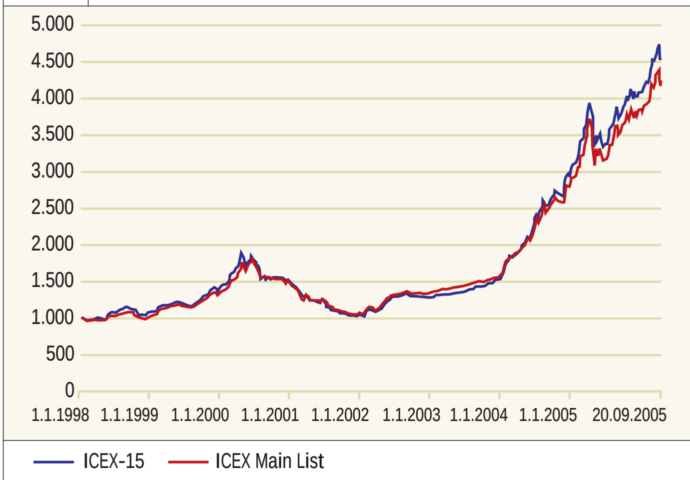


Figure 10. The ICEX Main List index rose by close to 53% YoY in 2004, beating its own earlier 2003 record of a YoY increase of 44% over 2002. In 2005, the index has continued to rise, by over 33% from the beginning of the year until mid-October.

The development of the ICEX-15 index has been similar; it rose by close to 59% YoY in 2004, following a rise of 56% YoY in 2003. In 2005, the index has continued to rise, by over 36% from the beginning of the year until mid-October.

Figure 12 | Market Value of Listed Equities – ISK bn

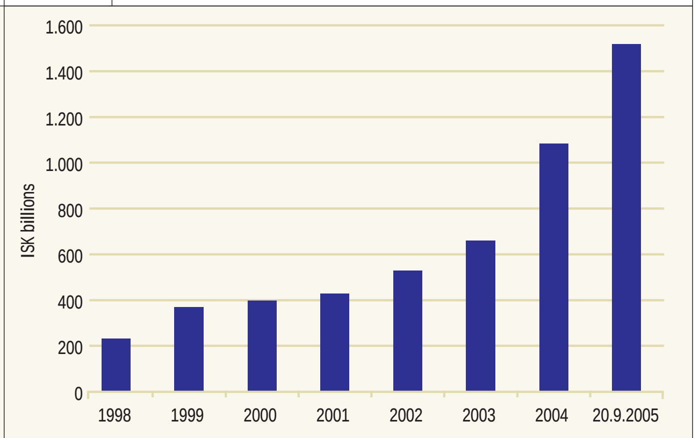


Figure 12. The market value of equities listed on ICEX has grown steadily, despite the reduction in the number of companies. From 1999 to 2001 the annual YoY increase was 7-8%, from 2001 to 2003 this was 23-25%, and then came a major jump of 65% between 2003 and 2004. During the year to date, or until mid-September 2005, this increase has been close to 40%; at that time the market value of listed equities was ISK 1,517 billion.

Figure 13 | Market Value of Listed Bonds – ISK bn

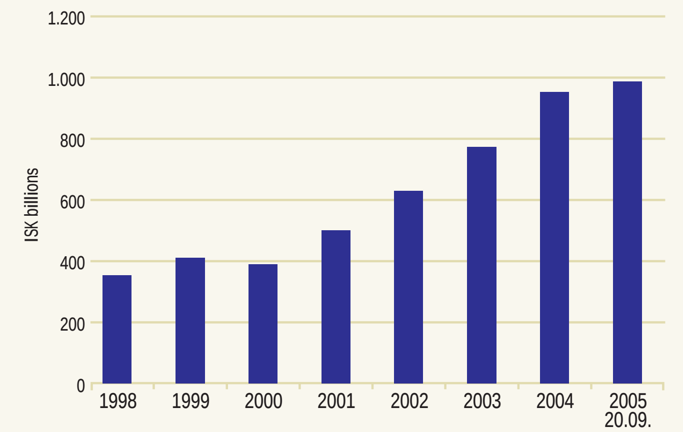


Figure 13. The market value of bonds and bills has grown steadily since the year 2000. The YoY increase between 2000 to 2004 has averaged around 25%. During the year to date, the growth in market value of listed bonds and bills has slowed substantially, with the increase during the year to date only 3.6% (as of 20 September). At that point in time the market value of listed bonds and bills amounted to some ISK 987 billion.

2.3 The pension savings market

Pension funds report good real returns

In 2004, the return on pension funds' investments was positive for the second consecutive year. The funds' net real return was 10.4%, or only slightly below that of 2003, when it was 11.3%. All mutual insurance divisions and personal pension schemes showed positive returns in 2004. The mutual insurance division funds' net real return was 10.6% and that of the personal pension schemes 8.6%. Those statements available from the pension funds indicate continuing good returns during the first half of 2005. Pension fund returns must be viewed in a longer-term perspective, as the returns of the past two years are very high in an historical context. Pension funds' average real return during the past 10 years was 5.8%. At year-end 2004, the funds' net assets were ISK 987 billion, or the equivalent of 112% of GDP. It is clear that during 2005, they reached the ISK 1000 billion level. Contributions fell slightly in 2004 from those of 2003, or from ISK 73.6 billion to ISK 72.4 billion. Pensions paid during 2004 amounted to ISK 31.2 billion, as compared to ISK 28.7 billion in 2003. The funds' disposable assets based on cash flow in 2004 amounted to ISK 455 billion as compared to ISK 273 billion the previous year.

Pension funds' financial position deteriorates

Despite their good returns, the actuarial position of pension funds without employer guarantees was somewhat poorer at year-end 2004 than at year-end 2003. The reasons for the funds' poorer actuarial position are, in particular, altered assumptions of their actuarial examinations due to increased life expectancy, and a rising disability frequency. Furthermore, it could be pointed out that wage increases during the latter part of working life have a negative impact on the actuarial position of funds with even accumulation of rights, and wages have risen substantially in the past decade. In view of the above, pension funds will proceed cautiously in increasing rights, since this trend shows no sign of ending and it is important to take a long-term perspective of the funds' operations. The actuarial position of funds guaranteed by employers did not change significantly from year-end 2003 to year-end 2004; most of these funds have a deficit of 50-100%, which needs rectification.

Pension funds' assets

The asset composition of pension funds has changed substantially since the Pension Fund Act, which lays down the funds' investment authorisations, came into force in 1998. A larger portion of the funds' assets is now variable-yield securities, with a corresponding drop in fixed-income securities which were previously the mainstay of the funds' assets. This development is still visible. For example, the share of equities and unit share certificates in mutual funds increased from 2003 to 2004, although this can be partly explained by the major increases on the domestic equity market during this period. Loans to members have been decreasing in recent years, although the drop between 2003 and 2004 can be partly explained by the increased competition facing pension funds from other parties on this market. During this period the funds have been forced to lower their interest rates and provide better terms in order to retain their share of the market. Pension funds' investments on foreign markets have increased substantially in recent years. At year-end 1999 the share of exchange rate linked assets in pension funds' total assets was 19%, while for mutual insurance divisions this figure was 23.4% at year-end 2004 and 27% for the funds' private pension schemes. Falling inflation-indexed interest rates on the domestic bond market will continue to exert pressure on the funds to increase their investments in variable-yield securities and on foreign markets, in particular having regard to the 3.5 % real rate of return upon which the funds' actuarial examination is based.

Fewer pension funds

As of 1 July 2005, there were 46 pension funds in operation. Of these, 37 are still fully operational, while 9 no longer receive contributions. The obligations of 14 of the 46 pension funds are guaranteed by another party, i.e. the state, a local authority or a bank. Many of the funds operate more than one division. As of 1 July 2005, there were 52 mutual insurance divisions and 37 private pension schemes, or a total of 89 divisions operated by pension funds. Pension funds have been steadily decreasing in number in recent years; at year-end 1999, for example, they were 66 in number. Since larger funds can diversify their risk better and operate more efficiently, the reduction in the number of pension funds is a positive trend. There have been two mergers during the year to date. One of them was a merger of the country's third- and fourth-largest pension funds, with the merged fund remaining the third-largest at year-end 2004. If this merger is taken into consideration, the ten-largest pension funds owned 75% of the net assets of all pension funds at year-end 2004.

Supplementary pension cover and personal pension savings

Pension funds, commercial banks, savings banks, securities firms and life insurance companies are authorised to accept premiums for pension savings and supplementary insurance cover in addition to the mandatory minimum coverage, in accordance with the provisions of Act No. 129/1997, on Compulsory Insurance of Pension Rights and Activities of Pension Funds. At year-end 2004, there were 50 parties offering pension savings schemes and supplementary insurance cover: 20 pension funds, three commercial banks, 23 savings banks, one securities firm and three life insurance companies. At the end of 2004, the accumulated pension savings in the custody of parties other than pension funds amounted to ISK 28.6 bn while those in the custody of the pension funds amounted to ISK 82 bn. Total personal pension savings were therefore ISK 110.5 at year–end 2004 as compared to ISK 83.1 at year end 2003. Since the net assets of pension funds amounted to ISK 986.5 billion at year-end 2004, the total pension savings for both supplementary and minimum pension coverage amounted to ISK 1015.1 billion at year-end 2004.

Figure 14 Pension Funds' Net Assets

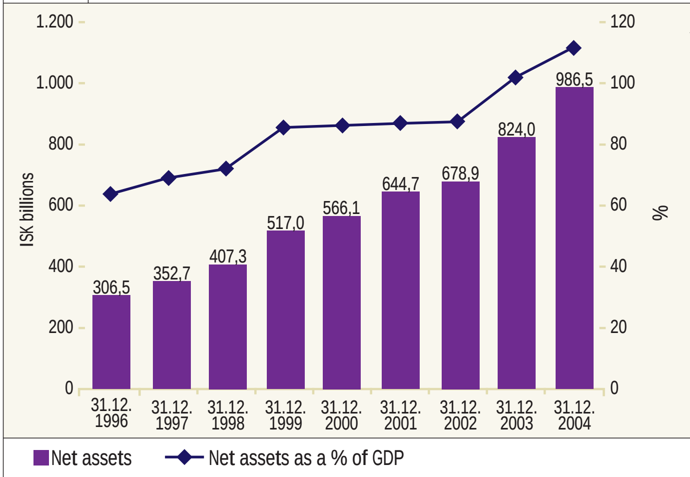


Figure 14. Net assets of pension funds for payment of pensions at year-end 2004 amounted to ISK 986.5 bn, as compared with ISK 821.3 bn at year-end 2003. The increase of 20.1% represents a real increase of 15.6% when adjusted using the CPI. At year-end 2004, the net assets of pension funds were equivalent to 111.5% of GDP, as compared to 101.3% at year-end 2003.

Figure 15 Pension Funds' Net Real Return

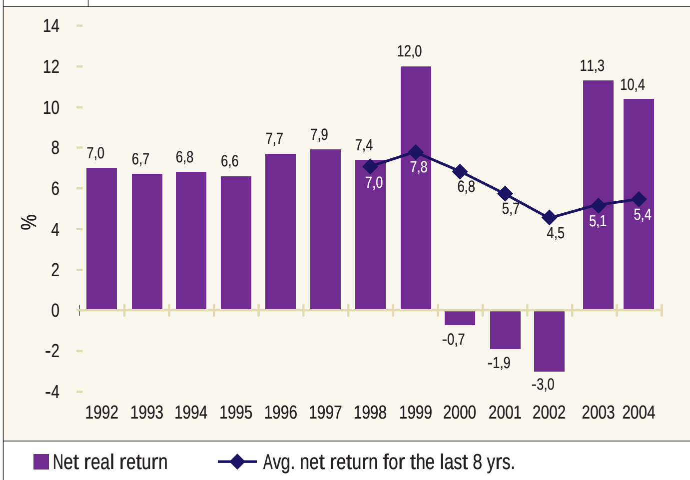


Figure 15. Pension funds' net real return on investments was 10.4% in 2004, as compared to 11.3% in 2003. Pension funds' real net rate of return is their rate of return adjusted for inflation using the CPI after deducting costs from their investment income. As pension funds are long-term investors, it is necessary to examine their rate of return over a period of several years in assessing how successful they are. At year-end 2004, the five-year average return was 3.2% and the average for the last ten years 5.8%.

Figure 16 Returns of Mutual Insurance Divisions and Private Pension Schemes in 2002, 2003 and 2004

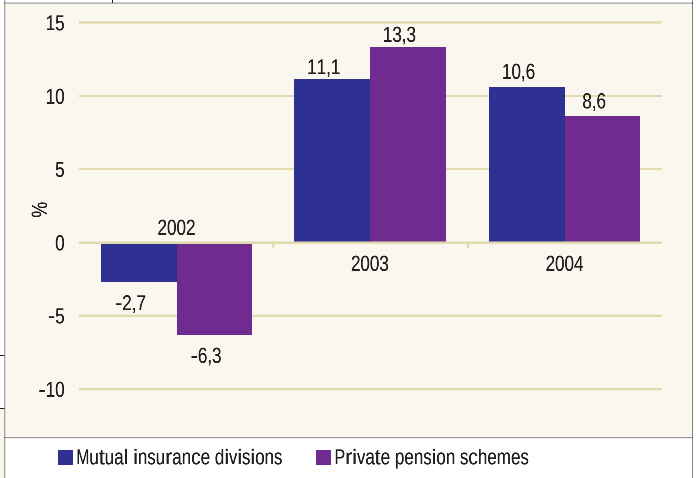


Figure 16. In 2004, the return on the assets of mutual insurance divisions was better than that of private pension schemes. The net real return for mutual insurance divisions was 10.6% as compared with 11.1% in 2003. The net real return for private pension schemes was 8.6% in 2004, as compared to 13.3% in 2003. The greater fluctuations in the returns of private pension schemes reflect their more risk-seeking investment strategies as compared with mutual insurance divisions, which illustrates the importance of considering investment strategy and asset composition in assessing the success of investments.

Figure 17 Actuarial Position of Pension Funds not Guaranteed by Other Party

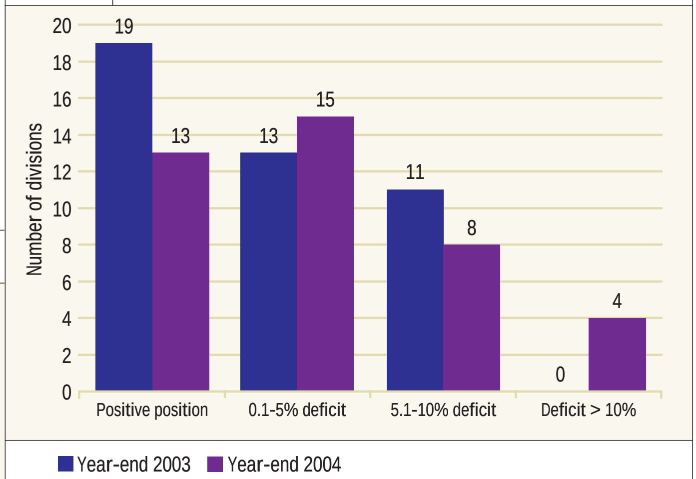


Figure 17. The actuarial position of pension funds not guaranteed by employers deteriorated in 2004. At year-end 2004, there were 32 such funds, operating 40 divisions. Thirteen of these divisions had a positive balance of up to 10%, while 23 showed deficits ranging from 0.1 to 10%. Four divisions had a deficit greater than 10%. According to the Pension Fund Act, if the difference between a fund's assets and obligations amounts to more than 10% in an annual actuarial assessment, the fund's statutes must be amended in order for it to achieve a balance. The same applies if a difference between 5 and 10% lasts for a continuous five-year period. The last four divisions therefore have to alter their statutes in order to achieve a balance between their assets and obligations.

Figure 18 Pension Funds' Asset Composition at Year-end 1997, 2003 and 2004

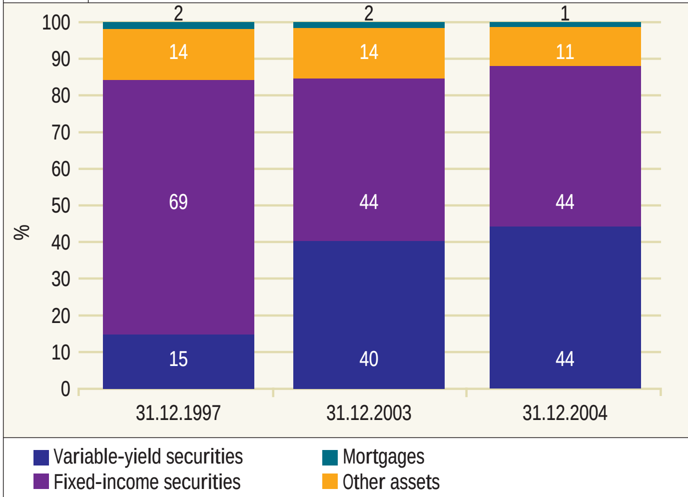


Figure 18. Pension funds' asset composition changed substantially from year-end 1997 to year-end 2004. The share of variable-yield securities has been growing steadily, increasing from 15% at year-end 1997 to 44% at year-end 2004. The share of fixed-income securities decreased from 69% at year-end 1997 to 44% at year-end 2004. The percentage of loans to members at year-end fluctuated from 13% to 16% from 1997 to 2003, but had fallen to 11% at year-end 2004.

Figure 20 Equities and Unit Share Certificates of Mutual Funds as a Ratio of Net Assets at Year-end

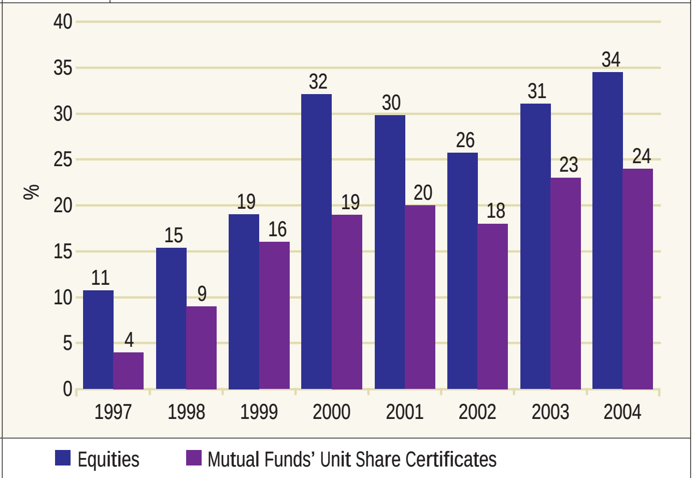


Figure 20. The proportion of shares in limited companies and in closed-end mutual funds, as well as in unit share certificates in UCITS, has increased greatly since 1997. These securities are considered variable-yield securities. From year-end 1997 to year-end 2003 the proportion of shares rose from 11% to 31% and the proportion of unit share certificates from 4% to 23%. These proportions also rose from year-end 2003 to year-end 2004, increasing from 31% to 34% and from 23% to 24% respectively. Unit share certificates are classified according to their underlying assets pursuant to the Pension Funds Act. In accordance with the above, part of the funds´'ab shareholdings are also shown under the columns for unit share certificates in the figure.

Figure 19 Assets of Mutual Insurance Divisions and Private Pension Schemes at Year-end 2003 and 2004

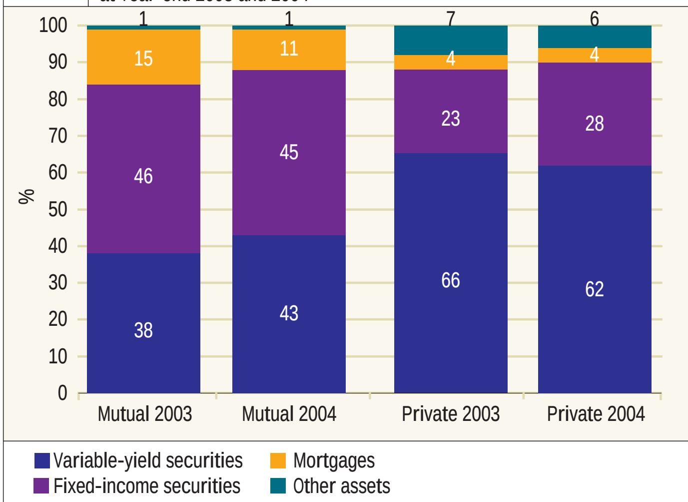


Figure 19. The share of variable-yield securities increased substantially from year-end 2003 to year-end 2004 in mutual insurance divisions, growing from 38% to 43%. This ratio dropped from 66% to 62% for private pension schemes during the same period. The private pension schemes' higher proportion is an indication that they have generally adopted riskier investment strategies than the mutual insurance divisions. This is normal in view of the fact that the operations of private pension schemes involve reception and safekeeping of savings for supplementary insurance cover, while those of the mutual insurance divisions concern savings for minimum insurance cover. High proportion of variable-yield securities is also partly due to the fact that a major portion of the accumulated savings in the former schemes is in the custody of pension funds which operated as purely private pension schemes prior to the entry into force of the Pension Funds Act in 1998.

Figure 21 Exchange-rate Linked Assets as a Ratio of Net Assets at Year-end 2002, 2003 and 2004

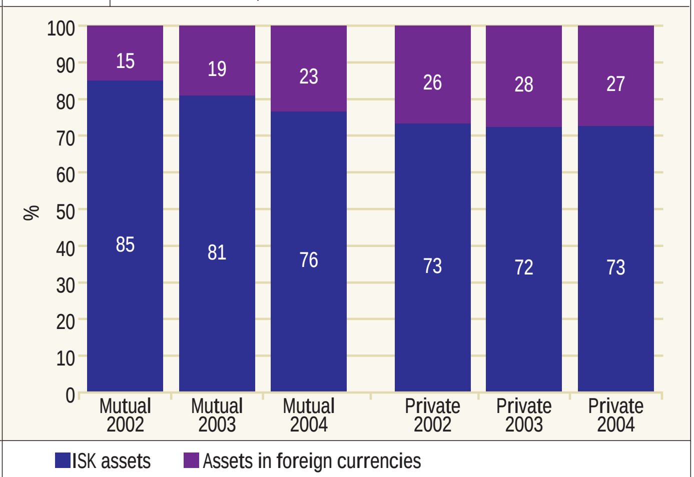


Figure 21. At year-end 2004, pension funds' exchange rate linked assets comprised around 24% of their net assets as compared to 20% at year-end 2003 and 16% at year-end 2002. According to the Pension Funds Act, the ratio of exchange rate linked securities of net assets may not exceed 50%. The funds thus still have considerable leeway to increase this portion and the ratio of exchange rate linked assets can be expected to increase still further in coming years.

Figure 22 Unlisted Securities as a Ratio of Net Assets

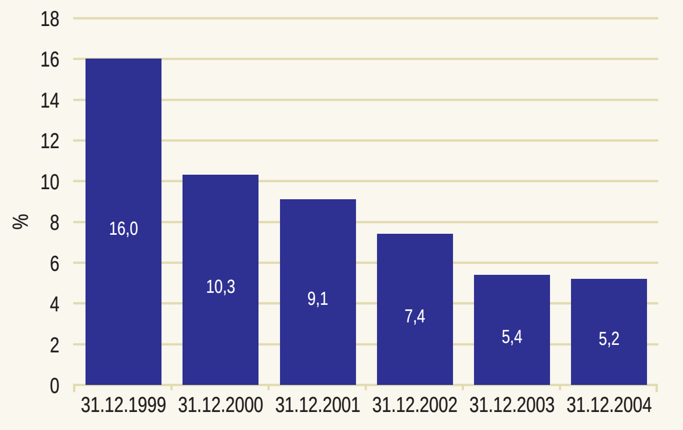


Figure 22. The proportion of unlisted securities in pension funds' net assets changed little from year-end 2003 to year-end 2004, and has in fact dropped sharply since the Pension Funds Act came into force in 1998. The ratio dropped by 0.2%, or from 5.4% to 5.2% from year-end 2003 to year-end 2004. This proportion may not exceed 10% under the Pension Funds Act and funds have been modifying their assets to comply after the Act became law. Some pension funds still exceed the 10% level, but the law does not require those funds which owned unlisted securities prior to the entry into force of the Act to sell them. Mortgage assets, chiefly loans granted to fund members, which fulfil specific conditions set by the Act, are not considered unlisted securities pursuant to the Act.

Figure 23 Pension Funds at Year-end 1999 Pension Funds at Year-end 2004

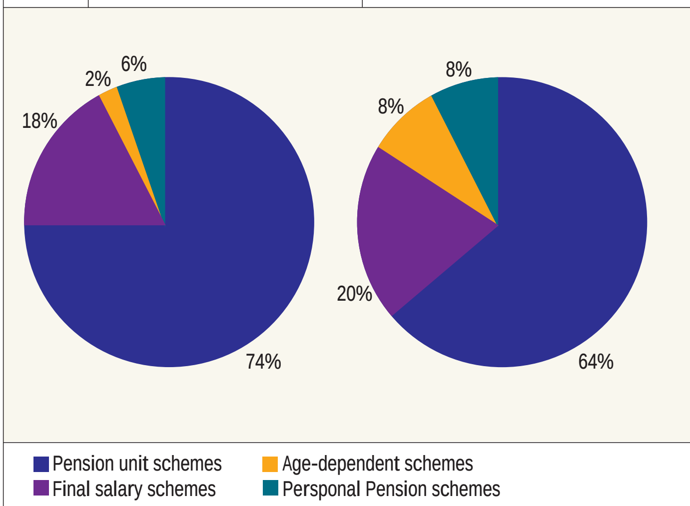


Figure 23. At year-end 2004, 64% of the total assets of the pension funds were part of a pension units scheme or system of even acquisition of pension rights, 20% were assets of final salary schemes, 8% were assets of age-dependent schemes and 8% were assets of personal pension schemes. A substantial change has taken place since year-end 1999, when 74% of the funds' assets were in pension units schemes, 18% in final salary schemes, 2% in age-dependent schemes and 6% were private pension savings. The main change is the decrease in the pension units schemes, with an according increase in the age-dependent and personal pension schemes. In 2005 four pension funds adopted age-dependent schemes and at least five additional funds will adopt age-dependent schemes prior to the end of 2005.

Figure 24 Depositaries' Relative Share of Private Pension Savings

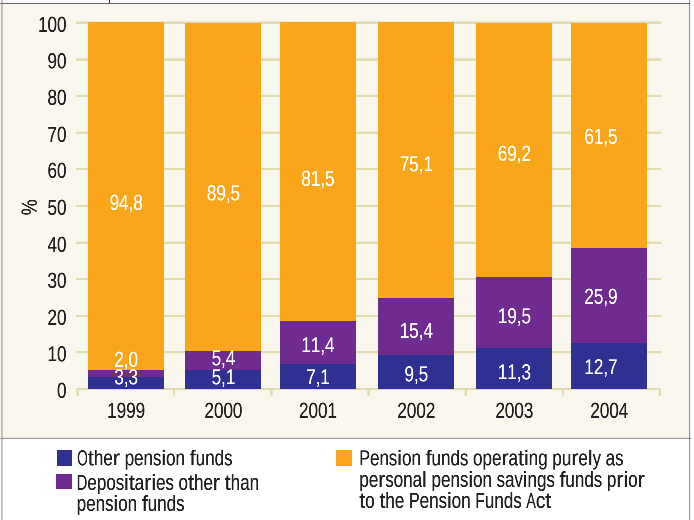


Figure 24. At year-end 2004, total personal pension savings amounted to ISK 110.5 billion as compared to ISK 83.1 bn at year-end 2003. The greatest share of these savings, 61.5%, is still in the custody of private pension schemes of pension funds which operated as purely personal pension savings funds prior to the entry into force of the Pension Funds Act in 1998. Around 13% of these savings were in the custody of other pension funds and 26% in the custody of other depositaries at year-end 2004, as compared with 11% and 20% at year-end 2003. In 1999, pension funds and other depositaries began general activities involving the receipt and custody of supplementary pension savings, in accordance with a special authorisation in the Pension Funds Act.

Figure 25 Private Pension Savings on Deposit with Funds Other than Pension Funds Operating

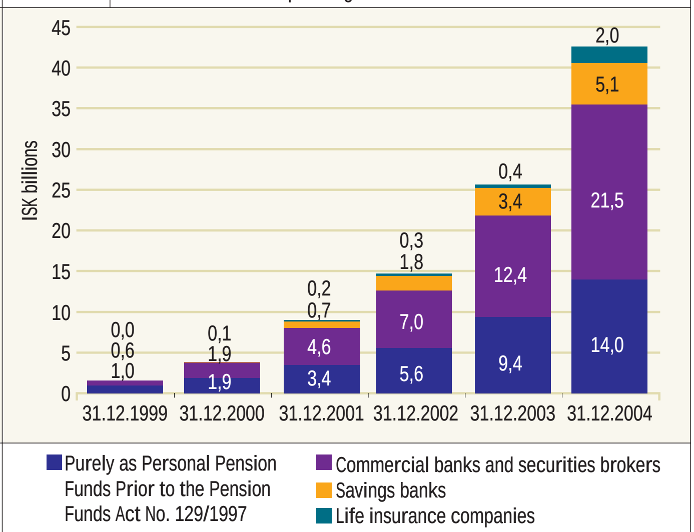


Figure 25. Total personal pension savings on deposit with depositaries other than pension funds which operated purely as personal pension savings funds prior to the entry into force of the Pension Funds Act amounted to ISK 42.5 billion at year-end 2004, as compared to ISK 25.6 billion at year-end 2003. The increase from 2003 to 2004 was 66%, while it was 75% between 2002 and 2003. The largest share of these savings, ISK 21.5 billion, is in the custody of banks and securities houses; at year-end 2003 this figure was ISK 12.4 billion. The next largest portion is held by private pension schemes of pension funds of ISK 14 billion at year-end 2004 as compared with ISK 9.4 billion at year-end 2003. The savings banks held ISK 5 billion at year-end 2004 and life insurance companies held ISK 2 billion.

2.4 The Insurance Market

Non-life operations continue to depend on investment income*

According to the rules which up until now have applied to annual financial statements of non-life insurance companies, their operations are divided into insurance activities and financial activities. Insurance activities include the operation of their insurance portfolio, i.e. premiums, claims, operating costs and investment income on insurance operations, which is the imputed return on the company's technical provisions. Financial activities include income and cost resulting from investments net of investment income transferred to insurance operations.
The Financial Supervisory Authority compiles a summary of insurance activities with a breakdown by insurance class, which it publishes on its website. The largest item in the non-life insurance companies' activities is motor vehicle insurance, followed by property insurance. These two classes also generally have the largest changes in premiums. A subsequent section takes a closer look at non-life insurance and life insurance classes.

In the annual accounts of life insurance companies, their income and expenses from investments are recognised under life insurance activities, after deducting from this section of the accounts investment income which has been entered against other operations.

Insurance companies' profits on financial activities in 2004 amounted to close to ISK 10 bn, the highest ever. Profit on non-life insurance activities, however, was ISK 666 million. This profit is the result of investment income of ISK 4.5 bn in connection with non-life insurance activities. In this environment, it is large insurance companies in particular which return a profit. The current conditions are unfavourable for smaller companies, insofar as their possibilities to profit on investments are more limited. In recent years, insurance companies have been profiting on sales of equities which have been recognised at purchase price. The larger companies own more securities of this type.

There has been little change to insurance companies' asset composition in 2004, with the exception that the share of fixed-income securities increased at the cost of their assets in affiliated companies. Market conditions would appear to have resulted in the insurance companies' increased investment in fixed-income securities. It should also be pointed out that rules on assets which insurance companies are required to own, to balance against their technical provisions, limit their possibilities of investing in equities. In this respect, the rules applicable to insurance companies are more stringent than those which apply to pension funds, which could explain why developments here appear to differ from those of pension funds.

New international financial reporting standards (IFRS) which entered into effect in 2005 can be expected to affect how assets and investment income are recognised. The standards are mandatory for consolidated accounts of listed companies. Only one insurance company is listed on the Iceland Stock Exchange, ICEX, but despite this most of the other insurance companies will be adopting the standards. This is due to the fact that they are subsidiaries of companies applying IFRS in their accounts or are a consolidated company which applies the standards as a result of its co-operation and ownership links with financial undertakings.

* *Iceland's natural catastrophe insurance (Viðlagatrygging Íslands) is generally omitted in the following figures.*

FME is currently working on reinforcing supervision of insurance companies' asset side, in part through introducing guidelines on stress tests. The guidelines reflect international developments which have been changing solvency requirements for insurance companies to include risk factors other than insurance risk to an increasing extent.

Profit on mandatory motor vehicle insurance falls

After the positive trend of the past two years, claims increased once more in 2004. Mandatory motor vehicle insurance still returned a profit but, as before, this is primarily the result of investment income. In fact, practically all of insurance companies' profit on non-life insurance operations comes from motor vehicle insurance. It should also be mentioned that, despite the overall profit in mandatory motor vehicle insurance, three of five companies reported losses in this class.

Motor vehicle insurance is the insurance class where competition in the insurance market appears to be stiffest; premiums at fixed price levels fell by 4%. The combined market shares of the three largest insurance companies, Sjóvá-Almennar tryggingar hf. (38.5% market share), TM Insurance Ltd. (22.7%) and VÍS Insurance Ltd. (33.4%) of mandatory motor vehicle insurance dropped from 97.5% the previous year to 94.6% now. The fourth party on the market is Vörður Íslandstrygging hf., formed by a merger of Vörður Íslandstrygging hf and Íslandstrygging hf.

Changes in premiums in other non-life insurance classes in 2004 were slight. It is noteworthy that property insurance reported a substantial loss after the turnaround of 2003. Profit in 2003 was the result of good results in fire insurance and household and family insurance. The total fire insurance profit last year was only ISK 7 million while losses on household and family insurance amounted to ISK 69 million. Other property insurance subclasses have most often reported losses during the past five years.

Insurance companies' equity position strengthens

According to Act No. 45/2005, amending Act No. 144/1994, on Annual Financial Statements, as subsequently amended, listed consolidated companies must apply IFRS to their annual financial statements. Unlisted consolidated companies may also adopt the standards. This the largest insurance companies will do, as previously mentioned; the standards will also affect smaller companies which are subsidiaries of the insurance companies and other financial undertakings.

As a result of IFRS, for instance, it will no longer be possible to recognise equalisation provisions under technical provisions. Thus equalisation provisions amounting to around ISK 3 billion at year-end 2004 will disappear and become part of the companies' equity. In all probability, however, the companies will not be able to include what were previously equalisation provisions in their solvency margin, according to a recommendation from the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) concerning the implication of the IFRS for the prudential supervision of insurance undertakings.

In recent years companies' technical provisions have remained practically unchanged while their equity position has strengthened. The ratio of technical provisions to equity was 152% in 2004. The increased equity results in a stronger solvency position, while on the other hand, in 2004 required solvency was calculated in accordance with new rules (Solvency I) which came into effect as a result of Act No. 37/2003, amending Act No.60/1994, on Insurance Activities, as subsequently amended.

The impact of Regulation No. 954/2001, on the calculation of adjusted solvency of insurance companies, has been steadily increasing due to ownership links on the insurance market. The rules are intended to prevent holdings in groups which appear and are recognised directly or indirectly by more than one party, or through mutual financing, from being included more than once in solvency calculations. In several instances, FME demanded that intangible assets resulting from the acquisition of a subsidiary by a parent company be deducted from the group's adjusted solvency margin.

Changes on the life insurance market

The activities of life insurance companies were originally limited to selling simple mortality risk insurance. In recent years the market for unit-link insurance, as well as health, income and sickness insurance, has grown rapidly. As things now stand, around one-third of the premiums paid to life insurance companies (excluding the accident and sickness policies of non-life insurance) are for mortality risk insurance, another third for unit-link insurance and 28% for health, income and sickness insurance. This can be explained by the fact that unit-link insurance and policies linked to health or sickness are relatively new in Iceland and the market is therefore still growing. This is also an indication that a growing number of people wish to purchase further insurance coverage, upon taking out their pensions or in case of health failure, than is available through pension funds or the State Social Security Institute.

FME has now, for the first time, compiled information on the operations of the various subclasses of life insurance, as has been done for many years for various non-life insurance classes. This information can be accessed in the document Classes of Insurance available on the FME website.

The health, income and sickness insurance class returned the least profit to the insurance companies. As the pension funds have become uncomfortably aware of, the base which has been used to calculate the probability of disability here in Iceland has proved to be an unsatisfactory reflection of Icelandic reality in recent years. The Danish base has been used, but the incidence of disability in younger age groups is considerably higher in Iceland than in the Danish model. This has affected income insurance, and several companies have raised their premiums in this class.

FME has begun an examination of the insurance companies' basis for premiums in mortality risk insurance. FME intends to examine whether insurance companies can make use of mortality figures from their own policy holders instead of using mortality figures for the nation as a whole, as is current practice.

FME will also examine the operating costs of life insurance companies, where sales cost is a major factor. Sales cost can be rather high if policies are frequently cancelled soon after being taken out. In 2000 the operating costs of life insurance companies comprised 38% of premiums paid, while the claims ratio was only 20%. This is a considerably lower claims ratio and higher operating cost ratio than has existed for non-life insurance companies in recent years. In 2004, the operating cost ratio had fallen to 24%, or to the same ratio as for non-life insurance companies, while the claims ratio had risen to 28%.

This change can conceivably be attributed to some extent to the previously mentioned change in company activities, since operating costs of unit-link insurance is lower than for other types of life insurance and the ratio of claims paid is higher in health, income and sickness insurance.

Fewer insurance intermediaries face operating difficulties

The outcome of operations of domestic insurance intermediaries varied in 2004. In contrast to previous years, there were no insurance intermediaries facing operating difficulties, as far as is known. Several insurance intermediaries have mentioned to FME that they were considering becoming agents for insurance companies instead of operating as independent insurance intermediaries following the entry into force of the Act on Insurance Mediation, No. 32/2005. As agents, they would not need to be licensed by FME nor pay the cost of mandatory professional indemnity insurance and surveillance fees. It will be worth monitoring future developments in this respect, i.e. whether the Act on Insurance Mediation, No. 32/2005, results in a drop in the number of insurance intermediaries or strengthen their position.

Figure 26 | Profits on Insurance Companies' Main Areas of Activity, 2004 price levels

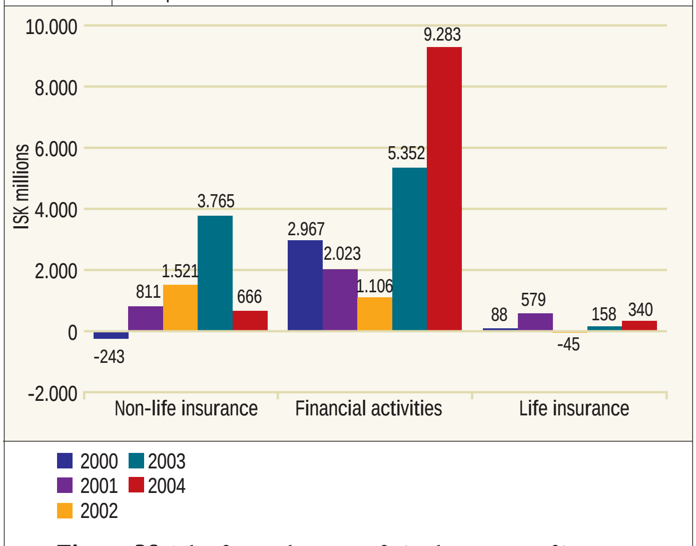


Figure 26. The figure shows profit in three areas of insurance activities since 2000. Profit on financial activities has increased by 75%, and profit on life insurance activities by 115%. Non-life insurance operations, on the other hand, were not especially successful, compared to the good results here in the past two years.

Figure 27 Share of Various Asset Items in Insurance Companies Assets 2000-2004

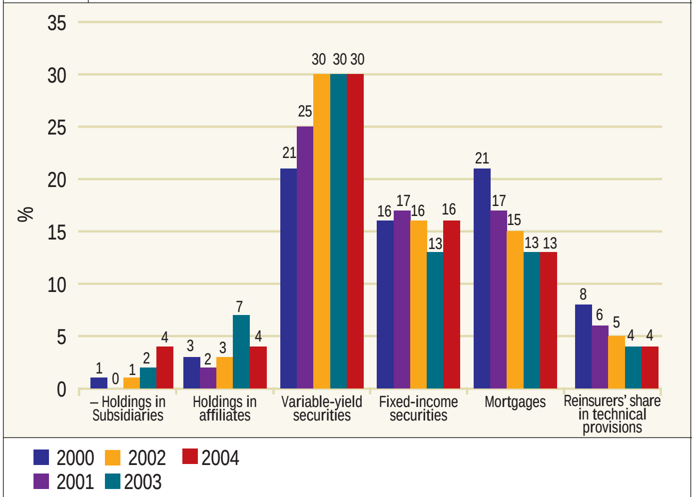


Figure 27. The figure shows development of several asset items as a ratio of total assets. There was relatively little change in asset composition in 2004, although the most noteworthy aspect is the increase in fixed-income securities, which is the opposite of the trend for pension funds. It should be borne in mind that the rules on insurance companies' investments in equities are more restrictive than for pension funds.

Figure 29 Market Share of Three Largest Insurance Companies in Motor Vehicle Insurance 2000-2004

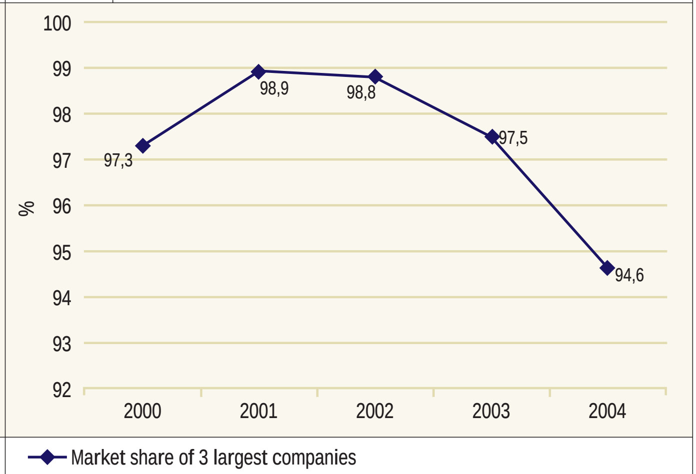


Figure 29. The figure shows the market share of the three largest insurance companies of earned premiums paid in motor vehicle insurance since 2000. The market share of these three companies has dropped since 2001 and in 2004 fell below 95%, as a result of the growth of the three companies' competitors.

Figure 28 Mandatory Motor Vehicle Insurance Operations, 2004 price levels

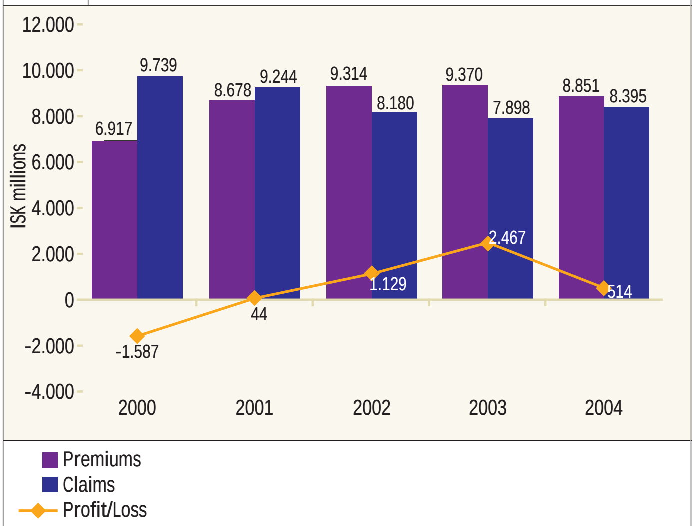


Figure 28. The figure shows the development of earned premiums, claims and profit/loss on mandatory motor vehicle insurance since 2000. Claims have been rising again in this class, reversing the favourable trend of the preceding two years. Profit in 2004 was therefore considerably less than in 2002-2003.

Figure 30 Premiums in Main Non-life Insurance Classes 2000-2004, 2004 Price Levels

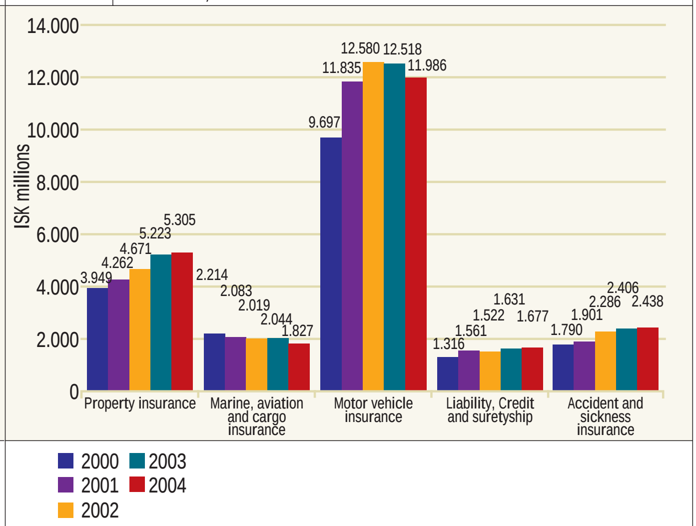


Figure 30. The figure shows the development of premiums in non-life insurance classes since 2000. The greatest changes have occurred in property insurance and motor vehicle insurance. Premiums in property insurance rose substantially in 2002, while at the same time premiums in motor vehicle insurance dropped, probably due to stiffer competition.

Figure 31 Profit/Loss in Main Non-life Insurance Classes 2000-2004, 2004 Price Levels

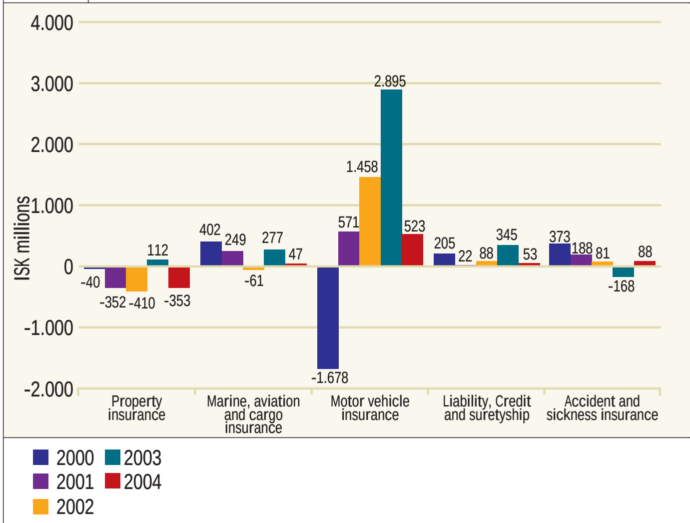


Figure 31. The figure shows the outcome of the main classes of non-life insurance since 2000. The greatest fluctuations are in the largest class, motor vehicle insurance, which has provided the greatest share of profit in non-life insurance for the past four years. There has been a considerable loss on property insurance for most years of that period.

Figure 33 Principal Items of Technical Provisions 2000-2004, at 2004 price levels

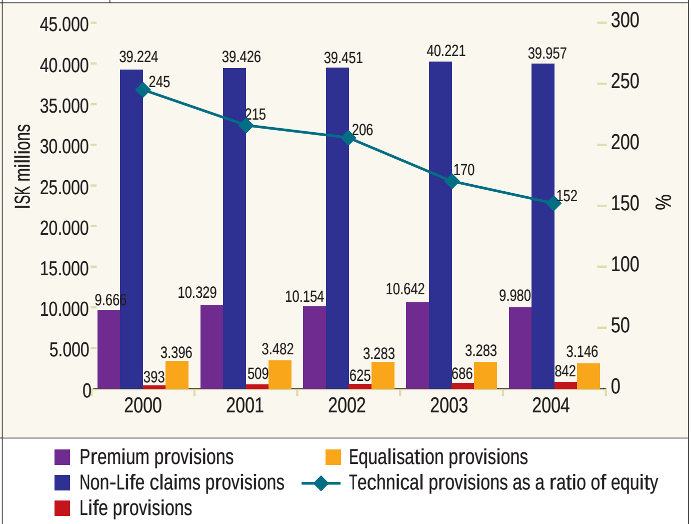


Figure 33. The figure shows the development of the major items in technical provisions and in the ratio of technical provisions to equity since 2000. These items show little change and, as the figure indicates; technical provisions have not increased in line with the companies' increase in equity. As a result, their solvency situation has generally improved in the past five years.

Figure 32 Profit/Loss in Main Property Insurance Sub-classes 2000-2004, 2004 Price Levels

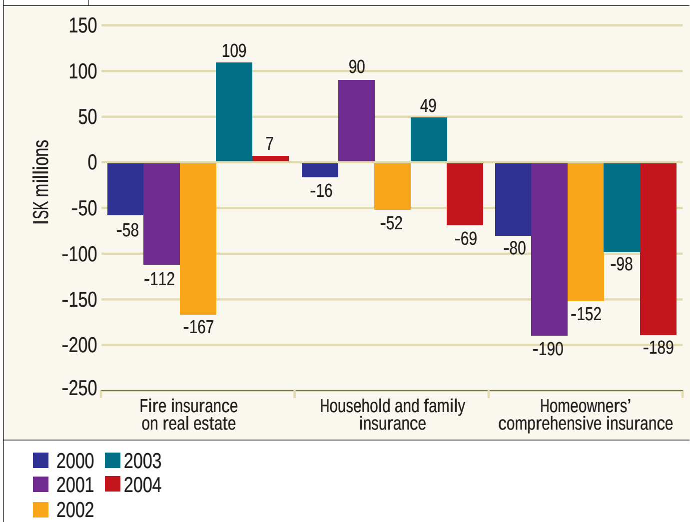


Figure 32. This is an illustration of the outcome of property insurance for the insurance companies. There have always been large losses on homeowners' comprehensive insurance while the outcome in real estate fire insurance has improved. Household and family insurance has fluctuated greatly.

Figure 34 Breakdown of written Premiums According to Life Insurance Class 2004

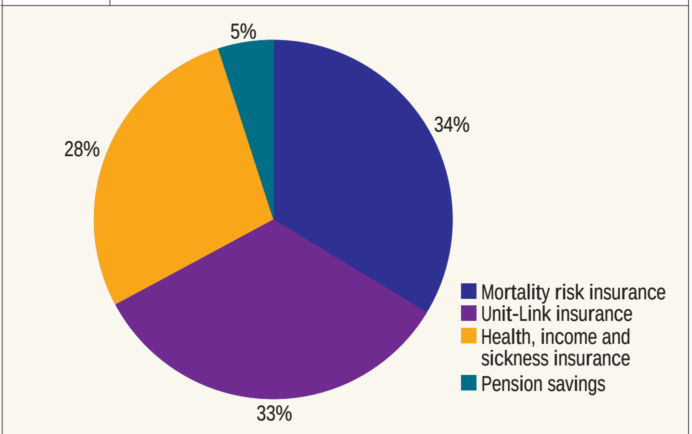


Figure 34. The figure shows a breakdown of life insurance premiums into main classes. The three largest classes are very similar in size.

Figure 35 Claims and expense ratios in life and non-life insurance 2000-2004

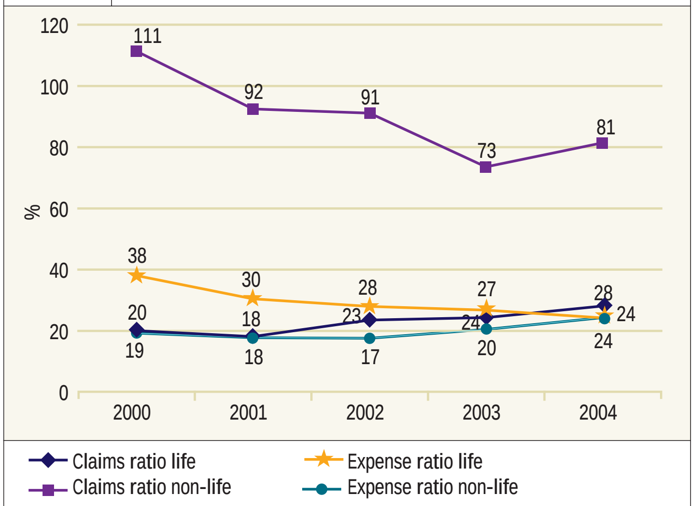


Figure 35. A comparison of the ratio of claims and operating costs of premiums in life and non-life insurance activities shows that the claims ratio is always considerably higher for non-life insurance companies. At the beginning of the period, the operating cost ratio was considerably higher for life insurance companies, while last year the ratio was 24% for both types of operation.

3 EMPHASES IN THE FME'S WORK IN COMING MONTHS

3.1 Growth of Financial Undertakings in Iceland, international Activities and Changes in Supervision

Emphases for the period:

- *Increased weight of consolidated supervision.*
- *Closer collaboration with international supervisory authorities.*

The financial market in Iceland has undergone significant changes since the creation of the European Economic Area in the beginning of 1994. The EEA facilitated free flow of capital between countries and this freedom has revolutionized the Icelandic financial market. Icelandic banks and businesses make business news headlines internationally and their equity and businesses has proliferated.

Kaupthing Bank began the international expansion of Icelandic banks with the establishment of Kaupthing Luxembourg S.A in 1998. Then Íslandsbanki followed suit in 1999 with the purchase of Raphael & Sons Plc. and Landsbanki bought the UK based Heritable Bank in the year 2000. These initial moves paved the way for the mass expansion of Icelandic banks and businesses abroad which since then has taken place. Búnaðarbanki Íslands hf. established Bunadarbankinn International S.A. Luxembourg in the year 2000 and 2002 saw the establishment of Kaupthing Sverige A.B. Landsbanki then bought Bunadarbankinn International S.A. from Kaupthing Bank and changed its name to Landsbankinn Luxembourg S.A. The next milestones were laid in 2004 when Kaupthing Bank bought the FIH Bank in Denmark and established Kaupthing Bank Oyj in Finland and Íslandsbanki bought Kreditbanken in Norway. 2005 was a particulary eventful year with the high points being Íslandsbanki's purchase of BN Banken in Norway, Landsbanki's purchase of Teather & Greenwood in the UK and Kepler Securities in France and Kaupthing Bank's purchase of Singer & Friedlander in the UK. This is nowhere near to being a complete overview of the activities conducted by the commercial banks in their subsidiaries, branches or offices abroad. Over a period of 18 months, i.e. from early 2004 to the latter half of 2005, the total assets of the three major banks have tripled according to their consolidated financial statements - primarily as a result of increased activities abroad.

All these changes have had a sizeable impact on the revenue composition of the commercial banks. During 2003, around 75% of the banks' revenue stemmed from domestic activities, whereas by 30 June 2005 the comparable ratio had dropped to 59% of total income. In regards to Kaupthing Bank, foreign income now makes up for 70% of the bank's total revenue.

Through the purchase of international financial undertakings, the commercial banks have strengthened their profitability and further distributed the risk at their income and assets. In this respect, the internationalisation of the commercial banks is a positive contribution towards financial stability. On the other hand, the banks have become a more prominent feature on the economic scene and all fluctuations in their profit margins are, therefore, likely to have a greater impact than before.

The FME has emphasised the importance of improving the competitiveness of the Icelandic financial market through its collaboration with European financial supervisory authorities. The aim is to harmonise rules in the financial market and create unity in supervisory procedures within the EEA. The FME has in this manner supported the banks in their expansion. The role of the FME has changed from being a supervisory body for financial undertakings in Iceland to carrying the responsibility for the supervision of multinational financial enterprises on a consolidated basis. Supervision of this nature means that the FME is responsible for the supervision of all financial risk of a consolidated undertaking. The overseas expansion has also caused the FME's interaction with a number of supervisory authorities within the EEA to change from focusing almost solely on the structuring and development of financial supervision, for instance in the Nordic countries, to close collaboration on the supervision of consolidated undertakings. The FME intends to develop further its methods of supervision on a consolidated basis by continuing the development of risk assessment systems and stress tests with regard to new types of risk and markets where financial undertakings from Iceland are heading.

3.2 Basel II Strengthens Financial Undertakings

Emphases for the period:

- *Introduction of new international Capital Standards.*
- *Increased emphasis on risk management and internal control within financial undertakings.*

A new international framework for capital adequacy rules, Basel II, was issued at mid-year 2004 and will be incorporated into EEA legislation by amending current Capital Requirements directives. The original Basel II framework applies to international banks but within the EEA this standard will be applicable to all credit undertakings and securities companies.
Since the changes will be extensive, the FME has, like authorities in most other countries, worked on drafting proposals for rules and organising collaboration with parallel authorities abroad on the supervision of internationally active undertakings and the application of international standards. Collaboration has been established with financial undertakings that are likely to apply for using the option to use an Internal Ratings Based approach for determining minimum capital requirements. Time will be spent over the coming months on introducing the new rules in Iceland, but they are to become effective as of the beginning of 2007.

One of the innovative features of Basel II is that financial undertakings which pass validation by the FME will be authorised to apply their own risk assessment instead of the fixed risk weights provided for in the current rules. Larger financial undertakings regard this as an opportunity and the more prominent Icelandic banks aim to follow this course. In its efforts to promote the competitiveness of the Icelandic financial market the FME intends to ensure that this option will be available. The Authority will carry out the required validation work in cooperation with sister institutions abroad which are responsible for supervising the activities of foreign subsidiaries of Icelandic banks.

Basel II emphasises risk management and internal control in financial undertakings. Recommendations and general criteria in this area, which the FME has been following in recent years, will be formalised and given increased weight within the supervisory functions. At the same time, financial undertakings will be expected to carry out independent assessments of their capital requirements and possibly also set higher capital targets than stated in the general rules. This assessment will also be subjected to official supervision.

3.3 Reinforced Supervision in the Financial Market following Amendments to the Securities Transactions Act

Emphases for the period:

- *Greater transparency and better information flow.*
- *Increased introductory and educational activities.*
- *Increased demand for compliance with rules.*

On 1 July this year, the FME received extended authorisation as regards the publishing of information on the results of inspections in the securities market. In line with the FME's transparency policy all such results will, as a rule, be published. The FME believes that the publication of inspection results, as well as the systematic imposition of administrative fines, will help increase overall market discipline. The FME's authority to impose administrative fines was also extended to include infringements of the obligation to publish insider information (Article 59 of the Securities Transactions Act) and the obligation to investigate primary insiders. A special emphasis will be placed on regular submissions to the FME of lists over insiders, cf. Article 65 of the Securities Transactions Act, which is an obligation that issuers have tended to neglect. Work on granting the FME further authorisation to conclude cases by administrative fines is currently in progress.

The FME intends to increase its introductory and educational activities in the securities market through organised meetings and news items on its website. This is necessary as a follow-up to the introduction of a new legislation, to maintain awareness of the regulatory framework in the market, and to clear up any of the uncertainties that are bound to arise as to the interpretation of rules. Authorising the FME to provide information on the securities market and the Authority's transparency policy have created opportunities to educate the market on various aspects of supervision.

The FME has introduced the preparation of a transaction reporting system to accompany the implementation of the MiFiD directive, but Article 25 of that directive stipulates that the FME be notified of all market transactions. This allows the FME to develop a powerful electronic supervision system which has already been introduced to undertakings in the market. A special workgroup with participation from market representatives has been set up to manage this project. Work on the reporting system will demand much time and effort, but in the long run it will vastly improve the supervisory functions of the FME and overall convenience and efficiency. Work on the implementation of the MiFiD is expected to take up a considerable amount of time during the year.

The FME intends to continue its inspection and ongoing supervision of the securities divisions of financial undertakings.

3.4 Supervision in the Pension Savings Market

Emphases for the period:

- *Greater prioritization of supervision.*
- *Introduction of fit and propriety test for CEOs.*
- *Emphasis on monitoring risk management.*

By year-end 2005 all Icelandic pension funds are expected to have undergone overall inspections or more specific examinations of their investments. Due to the numerous fully-operational pension funds, however, it will be necessary to prioritize their supervision in the future. A special pension fund classification, based on risk and other factors, is currently being planned. Special examinations of the form and content of pension fund investment policies will be conducted during the last months of 2005 and the beginning of 2006.

More detailed information on loans to pension fund members will be gathered - in particular information on credit terms. Following this project, it is to be expected that such information will form part of the regular data submissions required of the pension funds.

In 2006 special fit and propriety tests for the managers of pension funds will be introduced. Similar tests have been given to executives in insurance companies and the FME believes the results obtained from such assessment to be generally positive.

A needs analysis for a pension fund database was carried out at the beginning of 2005. The latter half of the year and the early months of 2006 will be devoted to developing this database.

The deadline for implementing a unified European legislation on occupational retirement provision (Directive 2003/41/EC) expired at the end of September 2005. A Ministry of Finance team, including a representative from the FME, was given the task of defining the scope of this Directive in Iceland. The team found that the Directive does not cover Icelandic pension funds or any other domestic pension savings depository. Despite this, the Directive must be incorporated into Icelandic legislation and the FME will participate in that work. A workgroup with the task of establishing a joint understanding of the Directive between member states is currently working under CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors) of which the FME is a member. The FME intends to keep a close watch as to the work and results presented by this group. The International Organisation of Pension Supervisors (IOPS) was recently established and the FME is currently considering possible membership.

For the last couple of years, supervision of pension funds has focused on internal control and the responsibilities of boards of directors. This needs to be emphasised further in coming years as well as the risk management of the pension funds. Improved life expectancy and growing likelihood of invalidity have led to deterioration in the actuarial position of the funds despite good rates of return. Dropping interest rates at home have forced the pension funds into taking more risk, for instance through investment in shares and foreign securities.

3.5 Special Monitoring on Account of Amendments to Legislation in the Insurance Market

Emphases for the period:

- *Monitoring the implementation of the Act on Insurance Contracts.*
- *Monitoring the implementation of the Act on Insurance Mediation.*
- *Risk assessment and stress testing.*

A new Act on Insurance Contracts no. 30/2004 will enter into effect as of 1 January 2006. The FME is expected to monitor compliance with the information requirements stated in the law. As well as emphasising to insurance providers and insurance brokers the importance of careful preparation for the new legislation, the FME has been involved in various communications concerning the new legislation, including specific provisions, legal differences, insurance period and the revision of insurance contracts. The FME has also monitored the preparations of insurance companies for the new legislation. It is important that the parties subject to supervision comply with the Act right from its entry into effect.

The new legislation will apply to all insurance contracts that are signed as of 1 January 2006 as well as insurance contracts that are either renewed or extended as of that date and all other insurance contracts that are valid on that date (cf. Article 146 of the Insurance Contracts Act). As of 1 January 2006 the legal position of individuals will be covered by the new Act. Insurance providers and other bodies involved in preparing, drawing up and assisting in the implementation of insurance contracts need to be aware of the legal position of the insured. The revision of insurance terms (policy conditions) must be completed and the necessary notifications need to be made before the entry into effect of the legislation.

During the period 2004 – 2005 the FME has stressed the importance that parties subject to supervision start preparing for the new legislation in good time. It has also emphasised the importance for insurance providers to inform their clients of changes in legal position in relation to all insurance contracts made after 1 January 2005. This appears to have been effective. The FME has recently been involved in clarifying certain issues that insurance providers have brought up concerning the entry into effect of the new legislation. It is important that insurance providers and their representatives comply with the law in every respect.

A new Act on Insurance mediation no. 32, dated 11 May 2005, has entered into effect. The law, which was published on 25 May 2005, applies to insurance brokerage – including the activities of insurance brokers and insurance agents. The Act contains various innovations concerning insurance brokers, insurance companies, insurance agents and insurance salesmen, for instance on ability requirements that must be met and the duty to keep clients informed. The FME needs to monitor compliance with conditions relating to operating licenses and personnel qualifications, that registration is in order and that there is sufficient flow of information.

In its communications with insurance brokers and insurance providers, the FME has stressed the importance that preparations for the new legislation be started in good time. The new Act entails certain changes in the legal position of the parties concerned.

The FME believes that any failure in the implementation of the above legislation or the Insurance Contracts Act can have serious repercussions for parties subject to supervision. They will not be able to claim insufficient knowledge of the provisions contained in the legislation as they have been given ample time for adjustment.

Certain domestic insurance companies have been licensed to provide services without being established in certain EEA member states. Some of these companies have expressed wishes to offer insurance services abroad in order to meet the needs of Icelandic enterprises involved in overseas operations.

This has created a need for new emphases in the supervision of the insurance companies operating abroad. Risk management and compliance with the rules of the state in which the companies operate need particular consideration. The FME must be familiar with the rules that apply in different states as it is responsible for supervising the activities of Icelandic insurance companies abroad on the basis of the rules of the European Economic Area.

4 PARTIES SUBJECT TO SUPERVISION

4.1 Number of Parties Subject to Supervision

As of 30 June 2005, the number of parties subject to supervision by the Financial Supervisory Authority was as follows:

	Number *30.06.2005*	Operate in accordance with
Commercial banks	4	Act 161/2002 on Financial Undertakings
Savings banks	24	Act 161/2002 on Financial Undertakings
Credit undertakings	9	Act 161/2002 on Financial Undertakings
Deposit departments of co-operative societies	3	Act 22/1991 on Co-operative Societies
Securities companies	7	Act 161/2002 on Financial Undertakings
Securities brokerages	3	Act 161/2002 on Financial Undertakings
Management companies of UCITS	6	Act 161/2002 on Financial Undertakings
*UCITS (Total number 10, including 4 departmentalized)**		Act 30/2003 on UCITS and Investment Funds
*Investment Funds (Total number 13, including 3 departmentalized)**		Act 30/2003 on UCITS and Investment Funds
Stock exchanges and other regulated OTC markets	1	Act 34/1998 on Stock Exchanges and Regulated OTC Markets
Central securities depositories	1	Act 131/1997
Pension funds	47	Act 129/1997
Insurance companies	13	Act 60/1994 on Insurance Activities
Insurance brokers	8	Act 32/2005 on Insurance Brokerage
Other parties subject to supervision	4	Various Acts
Total	130 *)	

**) UCITS and investment funds are operated by management companies. The number of those funds is not included in the total number of parties subject to supervision. Several of these funds operate in more than one division.*

4.2 Changes in the Operating Licences, Names and Number of Parties Subject to Supervision from 1 July 2004 to 30 June 2005

The Credit Market

On 24 November 2004 the name of the savings bank Sparisjóður Hólahrepps was changed to Sparisjóður Skagafjarðar. On 18 March 2005 the name of Kaupþing Búnaðarbanki hf. was changed to Kaupþing banki hf. The English version of the bank's name remains unchanged, Kaupthing Bank.

On 15 April 2005 the operations of the deposit department of the co-operative society Kaupfélag Fáskrúðsfirðinga were wound up.

The Securities Market

Securities companies

On 26 October 2004 the name of the securities company Fjárvernd-Verðbréf hf. was changed to NordVest Verðbréf hf.

On 22 December 2004 the FME granted a licence to Verðbréfaþjónusta sparisjóðsins hf. to operate as a securities company in accordance with Act 161/2002 on Financial Undertakings.

Management companies of UCITS

On 5 October 2004 the FME granted an extended licence to the management company of Kaupþing Búnaðarbanki to operate as a management company of UCITS based on Act 161/2002 on Financial Undertakings. The extended operating licence covers asset management, investment consultancy, custody and management of financial instruments in joint investments. On 27 May 2005 the name of the company was changed to Rekstrarfélag Kaupþings banka hf. (Kaupthing Bank Management Company).

On 23 February 2005 the name of SPH Rekstrarfélag hf. was changed to Rekstrarfélag Sparisjóðsins hf.

On 26 May 2005 the FME issued a licence for the management company of SPRON hf. to operate as a management company of UCITS in accordance with Act 161/2002 on Financial Undertakings.

UCITS and Investment Funds

Pursuant to Act 30/2003 on Undertakings for Collective Investment in Transferable Securities (UCITS) and Investment Funds UCITS shall be established and operated by a management company. Such funds are, therefore, not autonomous legal entities or limited companies as stipulated in previous legislations on UCITS. On the basis of the above legislation, the FME validates UCITS and investment funds (or their departments) which issue unit share certificates and grants operating licences to investment funds issuing shares.

The FME validated the investment fund KB Erlend Hlutabréf at the end of November 2004 and the investment fund KB Samval in January 2005. Both these funds are operated by the Rekstrarfélag Kaupthing Bank. The following investment funds, which were all operated by the same management company, were wound up before year-end 2004: Ævileið 3, Ævileið 4, Íslensk skuldabréf langtíma and Íslensk skuldabréf skammtíma.

In August 2004 the operations of four departments within the UCITS Landssjóður, i.e. Fjárvörsludeild I-IV, were wound up, but the UCITS is managed by Landsvaki hf.

Operating UCITS and investment funds, together with their departments, are included with the relevant management companies in the list over parties subject to supervision below in this Report.

Pension Funds

The pension fund Eftirlaunasjóður slökkviliðsmanna á Keflavíkurflugvelli merged with the pension fund Lífeyrissjóður starfsmanna sveitarfélaga as of 1 July 2004.

Pension fund Gildi-lífeyrissjóður was established on 1 June 2005 through the merger of the pension fund Framsýn and the pension Lífeyrissjóður sjómanna.

The Insurance Market

Insurance companies

On 8 September 2004 the insurance licence of Vélbátaábyrgðarfélag Ísfirðinga g.t. was revoked upon request by the company's board of directors, but its insurance portfolio had been transferred to Sjóvá-Almennar tryggingar hf. in the year 2000.

In September 2005 licences were issued on behalf of Sjóvá-Almennar tryggingar hf., Vátryggingafélag Íslands hf. and Tryggingamiðstöðin hf. to operate insurance services without an establishment in specified countries within the European Economic Area.

In October 2004 Sjóvá-Almennar tryggingar hf. was granted a supplementary operating licence for credit insurance and legal assistance, i.e. classes 14 and 17 as defined by Article 22, paragraph 1, of the Insurance Activities Act.

In March 2005 Tryggingamiðstöðin hf. was granted a supplementary operating licence for financial insurance, i.e. class 16 as defined by Article 22, paragraph 1, of the Insurance Activities Act.

In May 2005 the FME authorised the transfer of the insurance portfolio of Vörður Vátryggingafélag hf. to Íslandstryggingar hf. and the merger of the two companies as of 1 January 2005 under the name Vörður Íslandstrygging hf.

Insurance brokers

The new Insurance Mediation Act 32/2005, which entered into effect on 25 May 2005, brought certain changes concerning the operating licences of foreign insurance brokers in Iceland. As a result of these changes, the activities of seven foreign insurance brokerages which operated in Iceland in accordance to the former legislation are now supervised by authorities in their home countries instead of being directly supervised by the FME.

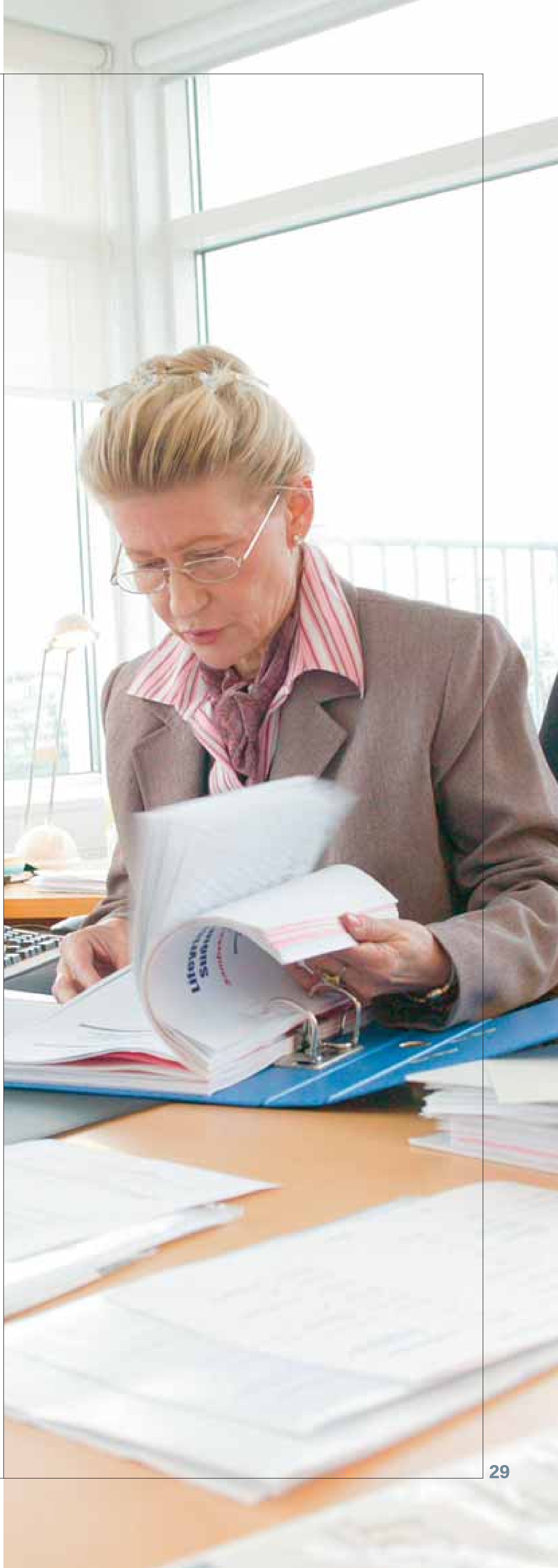
In March 2005 Vilhelmína S. Kristinsdóttir resigned her licence to operate as an insurance broker.

In May 2005 Trygg miðlun ehf. resigned its licence to operate as an insurance brokerage.

In May 2005 Guðmundur Þór Magnússon was granted an operating licence as an insurance broker.

Other parties subject to supervision

On 18 February 2005 the FME removed Póstgíróstofa Íslandspósts hf. from its list over parties subject to supervision as it no longer holds or accepts any deposits.



4.3 **List of Parties Subject to Supervision as of 30 June 2005**

COMMERCIAL BANKS

	Head offices
Íslandsbanki hf.	Reykjavík
Kaupþing banki hf.	Reykjavík
Landsbanki Íslands hf.	Reykjavík
Sparisjóðabanki Íslands hf.	Reykjavík

SAVINGS BANKS

nb.is-sparisjóður hf.	Reykjavík
Sparisjóður Bolungarvíkur	Bolungarvík
Sparisjóður Hafnarfjarðar	Hafnarfjörður
Sparisjóður Hornafjarðar og nágrennis	Höfn
Sparisjóður Húnaþings og Stranda	Hvammstangi
Sparisjóður Höfðhverfinga	Grenivík
Sparisjóður Kaupþings hf.	Reykjavík
Sparisjóður Kópavogs	Kópavogur
Sparisjóður Mýrasýslu	Borgarnes
Sparisjóður Norðfjarðar	Neskaupstaður
Sparisjóður Norðlendinga	Akureyri
Sparisjóður Ólafsfjarðar	Ólafsfjörður
Sparisjóður Ólafsvíkur	Ólafsvík
Sparisjóður Reykjavíkur og nágrennis	Reykjavík
Sparisjóður Siglufjarðar	Siglufjörður
Sparisjóður Skagafjarðar	Sauðárkrókur
Sparisjóður Strandamanna	Hólmavík
Sparisjóður Suður-Þingeyinga	Laugar
Sparisjóður Svarfdæla	Dalvík
Sparisjóður Vestfirðinga	Þingeyri
Sparisjóður Vestmannaeyja	Vestmannaeyjar
Sparisjóður vélstjóra	Reykjavík
Sparisjóður Þórshafnar	Þórshöfn
Sparisjóðurinn í Keflavík	Keflavík

Other Credit Undertakings

Byggðastofnun	Reykjavík
Frjálsi fjárfestingarbankinn hf.	Reykjavík
Greiðslumiðlun hf. - VISA Ísland	Reykjavík
Kreditkort hf. - EUROPAY Ísland	Reykjavík
Lánasjóður landbúnaðarins	Selfoss
Lánasjóður sveitarfélaga *(Licenced August 17th 2005)*	Reykjvaík
Lýsing hf.	Reykjavík
MP Fjárfestingarbanki hf.	Reykjavík
SP-Fjármögnun hf.	Reykjavík
Straumur Fjárfestingarbanki hf.	Reykjavík

DEPOSIT DEPARTMENTS OF CO-OPERATIVE SOCIETIES

Kaupfélag Austur-Skaftfellinga	Höfn
Kaupfélag Skagfirðinga	Skagafjörður
Kaupfélag V-Húnvetninga	Hvammstangi

SECURITIES COMPANIES

Arion verðbréfavarslan hf.	Reykjavík
NordVest Verðbréf hf.	Reykjavík
Íslensk verðbréf hf.	Akureyri
Jöklar - Verðbréf hf.	Reykjavík
Verðbréfastofan hf.	Reykjavík
Verðbréfaþjónusta Sparisjóðsins hf.	Reykjavík
Virðing hf.	Reykjavík

SECURITIES BROKERAGES

	Head offices
H.F. Verðbréf hf.	Reykjavík
Íslenskir fjárfestar hf.	Reykjavík
Vaxta hf. - verðbréfamiðlun	Kópavogur

MANAGEMENT COMPANIES OF UCITS

UCITS and investment funds operated by them

Íslensk verðbréf – Eignastýring hf. — Akureyri

Verðbréfasjóður ÍV *(Departmentalised UCITS):*

- Verðbréf 1 - ríkisskuldabréf
- Verðbréf 2 - skuldabréf
- Verðbréf 3 - peningamarkaður
- Verðbréf 4 - hlutabréf
- Verðbréf 5 - heimasjóður
- Verðbréf 6 - alþjóðlegur sjóður

Fjárfestingasjóðir ÍV *(investment fund and department):*

- Hlutabréfasjóður ÍV

Landsvaki hf. — Reykjavík

Landssjóður *(Departmentalised UCITS):*

- Skuldabréfadeild
- Reiðubréfadeild
- Markaðsbréfadeild 1
- Markaðsbréfadeild 2
- Markaðsbréfadeild 3
- Markaðsbréfadeild 4
- Sparibréfadeild
- Landsbanki Global Equity Fund
- Fjárvörsludeild 5
- Fjárvörsludeild 6
- Vísitölubréf

Landssjóður2 *(Departmentalised UCITS):*

- Fyrirtækjabréfadeild
- Peningabréf
- Úrvalsbréfadeild

Rekstrarfélag Kaupþings banka hf. — Reykjavík

Kjarabréf	*(UCITS):*
Markbréf	“
Ríkisverðbréfasjóður langur	“
Ríkisverðbréfasjóður millilangur	“
Úrvalsvísitölusjóður	“
Áskriftarsjóður ríkisverðbréfa	“
Eignastýringasjóður	*(Investment fund):*
Einingabréf 9	“
Hávaxtasjóður	“
ÍS-15	“
KB erlend hlutabréf	“
KB samval	“
Peningamarkaðssjóður	“
Skammtímasjóður	“
Ævileið 1	“
Ævileið 2	“
KB langtímasjóður	*(Validated by FME 17.08.2005)*

	Head offices
Rekstrarfélag ÍSB hf.	Reykjavík
Verðbréfasjóðir ÍSB *(Departmentalised UCITS):*	
Sjóður 1 - íslensk skuldabréf	
Sjóður 5 - ríkisskuldabréf	
Sjóður 6 - hlutabréf á aðallista	
Sjóður 7 - húsbréf	
Sjóður 9 - peningamarkaðsbréf	
Sjóður 11 - löng skuldabréf	
Sjóður 12 - ÍSB heimssafn	
Sjóður 19 - ÍSB fjármál	
Sjóður 20 - ÍSB heilsa	
Sjóður 21 - ÍSB lífsstíll	
Sjóður 22 - ÍSB tækni	
Fjárfestingasjóður Íslandsbanka *(UCITS and department):*	
Sjóður 10 - úrval innlendra hlutabréfa	
Rekstrarfélag Sparisjóðsins hf.	Reykjavík
SPH Verðbréfasjóðurinn *(Departmentalised UCITS):*	
Fjármálasjóðurinn	
Hátæknisjóðurinn	
Úrvalssjóðurinn	
Skuldabréfasjóðurinn	
Alþjóðasjóðurinn	
Lyf- og líftæknisjóðurinn	
Rekstrarfélag SPRON hf.	Reykjavík

STOCK EXCHANGES AND REGULATED OTC MARKETS

Kauphöll Íslands hf.	Reykjavík

CENTRAL SECURITIES DEPOSITORIES

Verðbréfaskráning Íslands hf.	Reykjavík

PENSION FUNDS

Almenni lífeyrissjóðurinn	Reykjavík
Eftirlaunasjóður F.Í.A.	Reykjavík
Eftirlaunasjóður Reykjanesbæjar	Keflavík
Eftirlaunasjóður Sláturfélags Suðurlands	Reykjavík
Eftirlaunasjóður starfsmanna Hafnarfjarðarkaupstaðar	Hafnarfjörður
Eftirlaunasjóður starfsmanna Íslandsbanka hf.	Reykjavík
Eftirlaunasjóður starfsmanna Olíuverslunar Íslands	Reykjavík
Eftirlaunasjóður starfsmanna Útvegsbanka Íslands	Reykjavík
Frjálsi lífeyrissjóðurinn	Reykjavík
Gildi-lífeyrissjóður	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 Mjólkursamsölunnar	Reykjavík
Lífeyrissjóður Neskaupstaðar	Reykjavík
Lífeyrissjóður Norðurlands	Akureyri
Lífeyrissjóður Rangæinga	Hella
Lífeyrissjóður starfsmanna Akureyrarbæjar	Akureyri

	Head offices
Lífeyrissjóður starfsmanna Áburðarverksmiðju ríkis.	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 *(Merged with Lífeyrissjóður Suðurnesja August 1st 2005)*	Selfoss
Lífeyrissjóður Suðurnesja *(Merged with Lífeyrissjóður Suðurnesja August 1st 2005)*	Keflavík
Lífeyrissjóður Tannlæknafélags Íslands	Reykjavík
Lífeyrissjóður verkfræðinga	Reykjavík
Lífeyrissjóður verslunarmanna	Reykjavík
Lífeyrissjóður Vestfirðinga	Ísafjörður
Lífeyrissjóður Vestmannaeyja	Vestmannaeyjar
Lífeyrissjóður Vesturlands	Akranes
Lífeyrissjóðurinn Lífiðn	Reykjavík
Lífeyrissjóðurinn Skjöldur	Reykjavík
Sameinaði lífeyrissjóðurinn	Reykjavík
Samvinnulífeyrissjóðurinn	Reykjavík
Söfnunarsjóður lífeyrisréttinda	Reykjavík

INSURANCE COMPANIES

Alþjóða líftryggingarfélagið hf. *(heitir KB líftryggingar hf. as of 12. sept. 2005)*	Reykjavík
European Risk Insurance Company hf.	Reykjavík
Íslensk endurtrygging hf.	Reykjavík
Líftryggingamiðstöðin hf.	Reykjavík
Líftryggingafélag Íslands hf.	Reykjavík
Sjóvá-Almennar líftryggingar hf.	Reykjavík
Sjóvá-Almennar tryggingar hf.	Reykjavík
Trygging hf.	Reykjavík
Tryggingamiðstöðin hf.	Reykjavík
Vátryggingafélag Íslands hf.	Reykjavík
Vélbátaábyrgðarfélagið Grótta gt. *(No new insurance contract concluded since 2001)*	Reykjavík
Viðlagatrygging Íslands	Reykjavík
Vörður Íslandstrygging hf.	Reykjavík

INSURANCE BROKERAGES

	Head offices
Árni Reynisson ehf.	Reykjavík
DDF Vátryggingamiðlunin ehf.	Hafnarfjörður
Fjárfestingamiðlun Íslands ehf.	Kópavogur
Nýja vátryggingaþjónustan ehf.	Reykjavík
Olaf Forberg	Kópavogur
Tryggingamiðlun Íslands ehf.	Reykjavík
Tryggingamiðlun Reykjvíkur ehf.	Reykjavík
Tryggingar og ráðgjöf ehf.	Reykjavík

Insurance Brokers covered by Professional Liability Insurance of Insurance Brokers

Árni Reynisson	- Árni Reynisson ehf.
Eiríkur Hans Sigurðsson	- Nýja vátryggingaþjónustan ehf.
Hákon Hákonarson	- Trygging og ráðgjöf ehf.
Guðmundur Þór Magnússon	- Trygging og ráðgjöf ehf.
Karl Jónsson	- Tryggingamiðlun Íslands ehf.
Ómar Einarsson	- Nýja vátryggingaþjónustan ehf.
Sigþór Hákonarson	- DDF Vátryggingamiðlunin ehf.
Þorlákur Pétursson	- Fjárfestingamiðlun Íslands ehf.

OTHER PARTIES SUBJECT TO SUPERVISION

The Housing Financing Fund	Reykjavík
New Business Venture Fund	Reykjavík
Insurance fund for depositors and investors	Reykjavík
The Savings banks' insurance fund	Reykjavík

4.4 Activities of Foreign Financial Undertakings in Iceland

Pursuant to the legal framework established by the Agreement on a European Economic Area, various foreign financial undertakings, i.e. credit undertakings, UCITS, various funds, investment firms, insurance companies, insurance brokers and insurance agents may offer their services in Iceland on the basis of an operating licence granted in their home state. The numbers of foreign parties who have given notice that they intend to offer services in Iceland pursuant to the above are as follows:

Foreign banks	103
UCITS	35
Other funds	8
Investment companies	726
Insurance companies with establishments	2
Insurance companies without establishments	225
Insurance brokers and insurance agents	2,277

5 AMENDMENTS TO ACTS AND REGULATIONS

5.1 General

Act No. 99/1999, on payment of Cost due to Official Supervision of Financial Activities

Amendments:

Act No. 134/2004: The percentage of the supervision fee, provided for in Article 5 of Act No. 99/1999, is changed to reflect FME's estimated operating costs, cf. Article 2 of Act No. 99/1999.

5.2 The credit market

Act No. 161/2002, on Financial Undertakings

Amendments:

Act No. 130/2004: Amendments were made in January 2005 to the Act on Financial Undertakings. This involved the implementation of Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, on the one hand, and Directive 2001/24/EC of the European Parliament and of the Council on the reorganisation and winding up of credit institutions, on the other.

Rules No. 156/2005, on Additional Own Funds Items for Financial Undertakings.

Amendments were made in January 2005 to FME's Rules on Additional Own Funds Items for Financial Undertakings. Following the changes, financial undertakings may, upon fulfilling certain conditions, include in Tier 1 capital non-innovative hybrid capital in addition to the innovative hybrid capital which could previously be included under Tier 1 capital. The total of both types of bonds may not exceed 33% of Tier 1 capital in calculations of their capital adequacy ratio, while the total innovative hybrid capital may not exceed 15% of Tier 1 capital. The above limits apply to both a parent company and group.

5.3 The Securities Market

Act No. 33/2003, on Securities Transactions

Amendments:

Act No. 31/2005: This Act transposed provisions of EU Directives on market abuse and takeovers into the Icelandic Act on Securities Transactions. Changes were also made to provisions of the Act on public offers to transpose the EU Directive on prospectuses, which will take effect on 1 January 2006.

The Act amended the Chapter on takeovers extensively, for instance, by introducing a presumption concerning connections between parties which could result in a takeover bid obligation.

The Chapter on market abuse provides FME, for instance, with increased surveillance authorisations, e.g. to impound assets and for access to data from telephone and telecom operators. Furthermore, FME is authorised to levy administrative fines for violations by issuers of disclosure requirements or failure by insiders to fulfil their obligation to investigate.

Changes to the Chapter of public offers are aimed at co-ordinating the contents of prospectuses with those of EU Member States, but apply only to public offers of over ISK 200 million.

FME is also granted authority to increase information disclosure to the public on issues concerning the securities market.

Act No. 34/1998, on the Activities of Stock Exchanges and Regulated OTC Markets.

Amendments:

Act No. 66/2005: The Act authorises FME to grant financial undertakings licensed to trade in securities or a regulated securities market a license to operate a multilateral trading facility (MTF), offering systematic trading in securities which are not listed on a regulated securities exchange. Basically the same rules will apply to MTFs as to regulated securities exchanges, with the exception of rules on flaggings and takeover obligations.

Amendments:

Act No. 31/2005: The Act transposes provisions of the Directive on takeover bids, increasing the requirements for information disclosure in annual reports and at Annual General Meetings concerning various aspects which can affect the success of a bid.

The Act repeals Chapter IV, which concerns rules for official listing of securities on a stock exchange, as of 1 January 2006.

Regulation No. 630/2005, on Insider Information and Market Abuse

The Regulation is intended to transpose additional provisions of the EU Directive on market abuse, as well as three subdirectives and one regulation issued by the Commission based on the Directive on market abuse. This Regulation therefore covers insider information, methods of making information public and postponing making insider information public, and market abuse in transactions with financial instruments.

Rules No. 670/2005 on Treatment of Insider Information and Insider Trading

These rules are adopted with reference to amendments to the Act on Securities Transactions. The rules provide, for instance, for measures to prevent insider information from spreading to persons other than those who need it in their work, insider trading, including how the obligation of primary insiders to investigate shall be applied, and the position of the compliance officer, definition of financially connected parties, notifications of transactions by primary insiders, managers and financially connected parties.

5.4 The Pension market

Act No. 129/1997, on Mandatory Guarantee of Pension Rights and the Operations of Pension Funds.

Amendments:

Act No. 148/2004: The Act amends the first sentence of the second paragraph of Article 36 of Act No. 129/1997, on Mandatory Guarantee of Pension Rights and the Operations of Pension Funds, which deals with restrictions on pension funds' investments.

5.5 The Insurance Market

Act No. 30/2004, on Insurance Contracts

Amendments:

A new Act on Insurance Contracts, No. 30/2004, will come into effect as of 1 January 2006. Preparations by insurance companies for the entry into force of the Act have been underway. The Act will also result in changes to the Act on Insurance Activities No. 60/1994, as several provisions of this Act will be transferred unchanged to the Act on Insurance Contracts.

Act No. 32/2005, on Insurance Mediation

Amendments:

Act No. 32/2005, on Insurance Mediation. The Act transposes Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on insurance mediation.

Act No. 130/2004, on Insurance Activities

Amendments:

Act No. 130/2004, amending the Act on Insurance Activities, No. 60/1994, due to the transposition into Icelandic law of provisions of Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, and Directive 2001/24/EC of the European Parliament and of the Council on the reorganisation and winding up of credit institutions.

Regulation on Professional Liability Insurance for Insurance Mediation, No. 592/2005

The Regulation was issued following the adoption of the Act on Insurance Mediation, No. 32/2005.

Regulation on Custody Accounts of Insurance Intermediaries and Insurance Agents, No. 590/2005

The Regulation was issued following the adoption of the Act on Insurance Mediation, No. 32/2005.

5.6 FME Guidelines

FME has issued general guidelines in a number of areas of the financial market. Such guidelines are issued by virtue of legal authority in the second paragraph of Article 8 of Act No. 87/1998 on Official Supervision of Financial Activities.

This provision authorises FME to issue and publish general guidelines on the activities of parties subject to supervision, provided that their substance concerns a group of parties subject to supervision.

Guidelines no. 2/2004, on Foreign Currency Liquidity Management of Financial Undertakings

The guidelines encourage sound practices in foreign currency liquidity management by financial undertakings. The guidelines are primarily directed at commercial banks, due to their involvement in exchange-rate linked transactions, but can also apply to other financial undertakings, in whole or in part, depending upon the nature and scope of exchange rate linked items in their activities.

Guidelines no. 3/2004, on excerpts from mutual funds' prospectuses

The guidelines are intended to explain and define the content and format of the principal aspects which should be included in excerpts from mutual funds' prospectuses.

Guidelines no. 4/2002, on annual accounts of insurance companies (reissued)

On 15 February 2005, a modification was made to Guidelines no. 4/2002, on annual accounts of insurance companies, concerning the interpretation and implementation of Regulation 613/1996, on annual accounts and consolidated accounts of insurance companies other than life insurance companies.

Guidelines no. 1/2005, on the operation of information systems of regulated entities

The guidelines cover all information systems of significance for the activities of regulated companies and can also apply to their subsidiaries.

6 HIGHLIGHTS OF FME'S ANNUAL FINANCIAL STATEMENTS 2004

The highlights of FME's annual financial statements for 2004. The annual financial statements were adopted by FME's Board of Directors and endorsed by the National Audit Bureau on 8 June 2005. The annual financial statements are published in full on FME's website: www.fme.is

Profit and Loss Account 2004

	Amounts in ISK	
Financial income:	**2004**	**2003**
Income from supervision fees	288.322.000	259.834.124
Other income	6.739.399	5.046.237
	295.061.399	264.880.361
Financial expenses:		
Salaries and related expenses	203.358.665	188.445.405
Complaints Committees	6.352.568	4.743.138
Administrative expenses	12.247.771	10.816.105
Travel and personnel related costs	20.002.527	19.282.708
Expert services purchased	10.786.225	2.814.802
Operation of equipments	6.120.186	7.093.573
Other operating expenses	2.940.401	3.342.205
Housing	25.234.206	21.438.239
Transfers	541.000	491.610
	287.583.549	258.467.785
Purchased assets	6.031.909	3.213.175
	293.615.458	261.680.960
Operating profit before net interest income	1.445.941	3.199.401
Interest income (interest expenses)	2.673.284	2.871.844
Profit for the year	4.119.225	6.071.245

Balance Sheet, 31 December 2004

	Amounts in ISK	
Assets	**2004**	**2003**
Current Assets		
Accounts receivables	1.768.996	1.572.477
Other receivables	1.583.841	496.104
Cash and cash equivalents	13.879.935	5.363.962
	17.232.772	7.432.543
Total Assets	17.232.772	7.432.543
Equity and Liabilities		
Equity		
Equity at the beginning of the year	4.758.380	(1.312.865)
Profit for the year	4.119.225	6.071.245
Equity	8.877.605	4.758.380
Current Liabilities		
Treasury	294.883	706.387
Accounts payable	1.755.462	403.200
Other short-term debt	6.304.822	1.564.576
Liabilities	8.355.167	2.674.163
Equity and Liabilities	17.232.772	7.432.543