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Authority Katrinartún 2 IS-105 Reykjavik Tel. +354 520 3727 / Fax: +354 520 3727 E-mail: fme@fme.is Website: fme@fme.is

Editorial Board: Jón Þór Sturluson Ragnar Hafliðason Sigurður G. Valgeirsson

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### **Contents of the Annual Report**

The 2015 Annual Report of the Financial Supervisory Authority (FME) primarily addresses the period between 1 May 2014 and 30 April 2015. The report describes the main tasks of FME and, in particular, tasks of the supervisory divisions: On-site Inspections and Securities, Off-Site Supervision and Oversight. Furthermore, it discusses the 2014 situation and developments on the credit market, securities market, pensions and funds market, and insurance market. The report will be published on FME's website in Icelandic and English. The website also contains various information on the financial market and the arrangement of official supervision of financial activities.

### FME's Board of Directors and Management

A three-person Board of Directors is ultimately responsible for FME's administration. Its role is to define the priorities in FME's work and to monitor its activities and operations. All major decisions are to be referred to the Board for approval or rejection. The Board appoints a Director General responsible for FME's day-to-day administration. As of May 2015, the Board comprises of Ásta Þórarinsdóttir, economist and Chairman of the Board, Tómas Brynjólfsson, Director General and Vice-Chairman of the Board and Arnór Sighvatsson, Deputy Governor of the Central Bank who is appointed by the Central Bank of Iceland. Alternate members are Friðrik Ársælsson, solicitor, Ástríður Jóhannesdóttir, Manager, and Harpa Jónsdóttir, Deputy Director at the Central Bank of Iceland. From 1 May 2014 to 30 April 2015, in addition to the above-mentioned, the following persons have served on FME's Board: Halla Sigrún Hjartardóttir, Chairman of the Board, Margrét Einarsdóttir, assistant professor and Vice-Chairman and the alternate member Halldór S. Magnússon, formerly a managing director. These members appointment expired at year-end 2014.

### FME Management

Unnur Gunnarsdóttir, Director General Jón Þór Sturluson, Deputy Director General Anna Mjöll Karlsdóttir, Chief Legal Counsel

Halldóra Elín Ólafsdóttir, Director, Off Site Supervision Rúnar Guðmundsson, Deputy Director, Off Site Supervision Lilja Rut Kristófersdóttir, Director, Oversight Sigurveig Guðmundsdóttir, Director, On-Site Inspections and Securities Ingibjörg Sigrún Stefánsdóttir, Director, Finance and Administration Árni Ragnar Stefánsson, Director, Human Resources



### From the Director General

FME was established as an independent supervisory authority for the financial market in Iceland as a whole sixteen years ago. FME was established pursuant to Act No 87/1998, which is still the applicable legal framework for its activities. Pursuant to the Act, FME is tasked with monitoring regulated entities' compliance with applicable Acts, regulations, rules and resolutions and that the activities conform in other ways with sound and proper business practices.

During these 16 years, the general views towards the objectives and purpose of financial supervision has changed substantially and the Authority has been entrusted with various new tasks by law. On the one hand, the general views have changed in that the emphasis is on supervisory authorities identifying and assessing the various inherent risks in the activities of financial institutions and intervening fast with mitigating actions to contain risks from realising and causing harm to the financial markets. This is the essence of risk-based supervision. On the other hand, the current emphasis for supervisory authorities is strategic identification and assessment of the potential impact from the operations and performance of individual regulated entities on financial market stability as a whole and, also, the potential impact of systemic risk on the operations of individual companies. FME has responded to the previous issue with a multi faceted reform programme. The complete adoption of risk-based supervision is planned for next year. In response to the latter issue, FME and The Central Bank of Iceland (CBI) have increased and improved their collaboration in recent years.

At the time of publication of this Annual Report, it has been a little over a year since the Systemic Risk Committee and the Financial Stability Committee, chaired by the Minister of Finance, were established by Act No 66/2014. The financial system is considered to be stable in the absence of interruptions or substantial disturbance and when it is sufficiently resilient to withstand shocks and imbalance without substantial adverse impacts on capital circulation, payment services and risk diversification. With the establishment of the Financial Stability Committee a new authority was not formed. Instead, the participating authorities retain their independence and powers. The board issues recommendations to the member institutions on appropriate actions in the interest of stability and the institutions are obliged to comply with recommendations or otherwise justify publicly why they are not in compliance. At its meeting last April, the Financial Stability Committee agreed unanimously that the following undertakings are systemically important: Landsbankinn hf., Arion bank hf., Íslandsbanki hf., and Housing Financing Fund. FME was entrusted with structuring its supervisory activities accordingly. As regulated entities are aware, that is in full accordance with FME's work on the development of risk-based supervision.

FME's risk-based methodology defines four impact categories. Supervision for the relevant entity is determined by the impact categorisation and reflected in the core supervisory model where minimum supervisory tasks are defined and their frequency determined. The scope and frequency of tasks increases in accordance with their impact assessment. Furthermore, supplementary supervisory tasks are conducted in accordance with the risk level of each entity or market. This was specifically addressed in FME's 2014 Annual Report adding that proactive supervision primarily targets the two higher impact classes. Supervision of other undertakings that are considered to have lower impact on the market in case of operational problems, is primarily reactive supervision, unless specific risks threaten their operations.

This approach corresponds with provisions in a draft amending the Act on Financial Undertakings under discussion at the Icelandic Parlament. The draft contains provisions on extensive modifications to risk management, increase in equity, and improving the quality thereof, including the introduction of capital buffers that can be used before the supervisory authority initiates actions due to inadequate capital. Furthermore, the draft includes detailed provisions on the governance of financial undertakings and the responsibility and composition of the management board and senior management. The proposal entrusts FME with regulating restrictions on financial undertakings' payments of shareholder dividends, variable employee benefits and other payments when the undertaking does not fully meet capital buffer obligations. These rules are all intended to increase the resilience of individual financial institutions so that they are prepared to meet potential difficulties on their own.

The above-mentioned changes all stem from extensive reforms made by the international community of policy making entities in financial services as a result of the grave financial difficulties in the autumn of 2008 and afterwards. Financial services are essential but a certain risk taking is inherent therein and this can spread risk to other entities. It is unavoidable to assume that banks can collapse and even that another systemic shock can occur. Therefore, extensive work on developing new rules for financial markets is under way in order to ensure that the losses from the collapse of banks or other financial undertakings will never again be borne by taxpayers and that depositor's interests be better protected than before. Who should then bear the loss? The answer is the creditors and shareholders who enjoy the profits of success. It is assumed that competent authorities are empowered to restrict their rights with a unilateral decision, e.g. by converting claims to common stock in accordance with recovery and resolution plans. Central Banks will continue to be lenders of last resort but they may not lend undertakings with inadequate capital positions. Winding-up proceedings should begin before that.

I began this address by discussing the Act on Official Supervision of Financial Activities and its current state 16 years after the establishment of FME. I believe it is of the utmost importance to begin a wide-ranging review of the Act in order for it to reflect the role of financial supervision in a modern society and that it protect the authorities independence and necessary professionalism for the Authority to perform its powers and duties. FME has already been empowered by law to intervene in the operations of regulated entities, to apply penalties, and even to intervene in the constitutionally protected freedom of employment. Targeted entities are entitled to appeal to the courts or, as the case may be, to other authorities for review. The annual report contains a summary of a number of cases and decisions that have been before the courts and the Althing Ombudsman in previous years. It is worth noting that during the period in question, disputes cases have decreased steadily and at the same time the cases going against FME at bodies of appeal have decreased.

We at FME are in a precarious situation with wind blowing from every direction. It is not an option to be driven back by the strongest wind blowing. A compass, and training to use it, is needed to advance in the right direction. In our case, that compass is, on the one hand, international standards on best practises for the implementation of supervision and, on the other hand, Icelandic Acts, which still need work to meet modern requirements.





## FME Board of Directors

At the beginning of 2015 a new Board of Directors was appointed. Bottom row of the photograph, from left, shows: Tómas Brynjólfsson, Vice-Chairman, Ásta Þórarinsdóttir, Chairman of the Board, and Arnór Sighvatsson Board Member. On the top row from left are: Friðrik Ársælsson, Alternate Member, Unnur Gunnarsdóttir Director General, Jón Þór Sturluson, Deputy Director General, and Harpa Jónsdóttir, Alternate Member.

The Act on Official Supervision of Financial Activities defines the role of FME's Board stating: 'The Board of the Financial Supervisory Authority is composed of three members, appointed by the Minister for a term of four years at a time. One member of the Board shall be nominated by the Central Bank of Iceland. Alternates shall be appointed in the same manner. The Minister appoints the Chairman of the Board and decides on the remuneration of the members of the Board.



The role of the Board is to specify the points of emphasis in the work of the FME and oversee its activities and operations. Major decisions shall be referred to the Board for approval or rejection.'

The 2012 rules on the activities of the FME's Board address the Board's role in more detail, among other things, the division of duties between the Board and Director General, the Board's role, the Board's decisions in major cases, Board members competence and confidentiality. Furthermore, they address Board meetings, how often they are held and how they are organised. The Board met twelve times in 2014. Examples of the Board's tasks during the year include fourteen adverse decisions relating to eligibility, levying of administrative fines, revoking operating licenses and levying of a supervision fee. The Board also adopted seven guidelines, five rules and granted two operating licenses.



# FME's Tasks

### 1. FME's tasks

### 1.1 Off-Site Supervision

Off-Site Supervision is FME's largest division, responsible for conducting periodic monitoring of regulated entities. The monitoring includes fit and proper assessment of board members and managing directors, reviewing data concerning individual regulated entities' financial position, issuing operating licenses and notifications about qualifying holdings and monitoring that regulated entities operate in accordance with proper and sound business practices. The division comprises financial supervision, legal supervision and special legal issues.

### Periodic monitoring

Pension fund related projects included examinations of lending, investments and work processes. Examinations also included whether, and if so how, pension funds implemented the new Act on Consumer Loans in their lending rules as well as whether the employees at the asset management of pension funds have passed security broking examinations. Governance was examined and meetings were held with internal auditors and directors of the largest pension funds. FME also conducted the OECD self-assessment on the legal environment and supervision of pension funds. FME and OECD concluded the project by hosting a conference on pension funds and the pension market.

Insurance company related projects included an examination on changes in assets to set-off technical provisions, so called benefit funds, and governance. FME and the Icelandic insurance companies participated in the European Insurance and Occupational Pensions Authority (EIOPA) stress test. Meetings were held with internal auditors and executive directors of the largest insurance companies.

Projects concerning supervision of financial undertakings included specific examinations of commercial bank loans for the purchase of equities, management companies' operating authorisation and the presentation of financial information in management companies' marketing material. As part of the Supervisory Review and Evaluation Process (SREP), FME assesses capital adequacy with regard to the risk composition of the financial undertakings concerned. During the year, SREP was conducted for the commercial banks, two savings banks and two loan funds. Off-Site Supervision is responsible for SREP and collaborates with Oversight for the implementation. Work on introducing risk-based supervision has been conducted during the year. Employees of Oversight are involved in on-site inspections at the commercial banks. Moreover, they conduct processing concerning financial undertaking's temporary activities and projects related to covered bond issues.

### Operating licenses and enforcement of rules

Projects included issuing an operating license to Straumssjóðir hf. as a fund management company and issuing a collection license to Orkuveita Reykjavíkur (Reykjavik Energy). FME approved the merger of Sparisjóður Bolungarvíkur ses. (Bolungarvik Savings Bank ses.) and Sparisjóður Norðurlands ses. (Nordurland Savings Bank ses.), approved Lýsing hf. taking over a specific operating unit from MP Bank hf. and changing the legal form of Sparisjóður Norðfjarðar ses. (Nordfjord Savings Bank ses.)(currently Sparisjóður Austurlands (Austurland Savings Bank hf.)) to a public limited company. There were many notifications of new owners of qualifying holdings in regulated entities such as MP Bank hf., Straumur fjárfestingabanki hf. (Straumur Investment Bank), Borgun hf., Jöklar verðbréf (Joklar-Securities hf.), Sjova-Almennar Insurance hf., Íslensk verðbréf hf. (Icelandic Securities hf.) and Fossar markaður (Fossar Markets hf.). The operating license of LBI hf. was revoked in whole during the year and Allra ráðgjöf hf., the insurance broker, relinquished their operating license. Specific examinations of actions to combat money laundering and terrorist financing at three commercial banks were also conducted during the year. Finally, an amicable settlement was reached with Sænes ehf. concerning the infringement of Article 40 of the Act on Financial Undertakings whereby an application for approval of a qualifying holding in Sparisjóður Höfðhverfinga ses. (Höfðhverfingar Savings Bank ses.) had not been submitted. The situation of Sparisjóður Vestmannaeyja ses. (Westman Islands Savings Bank ses.) was deliberated and concluded on 29 March this year with a decision of the FME Board on the basis of Temporary Provision VI to Act No 161/2002 whereby the Savings Bank was merged with Landsbankinn hf.

### Regulation and implementation

The tasks of Off-Site Supervision include having a comprehensive overview of all tasks related to regulation and the issue of guidelines and keeping a record of all Directives and Regulations, including technical standards, that apply and are being prepared on the financial market within the EEA. Guidelines and recommendations from the European financial market regulatory authoroties (EBA, EIOPA and ESMA) are also mapped out.

FME is involved in the transposition of EEA acts into Icelandic law and is represented in committees within the Ministry of Finance and Economic Affairs, which works on transposing the above-mentioned acts, and the Authority is furthermore expected to issue multiple rules based on those laws. The implementation of technical standards into FME regulation is planned and the guidelines and recommendations of European regulatory authorities (EBA, EIOPA and ESMA) will be made available to regulated entities through FME guidelines, a circular and an announcement on FME's website. FME furthermore participates in drafting laws and regulations regarding the financial market and submits comments on the above-mentioned to the Ministry and the Althing. FME assesses whether developments in financial activities require amendments to the legal environment or supervisory methods and promotes reforms.

The projects included a rule amendment allowing FME to conclude cases by reaching amicable settlements. Work was also conducted on regulation for transferred credit risk due to securitisation and rules amending Rules No 215/2007 on the Capital Requirement and Risk Weighted Assets of Financial Undertakings, as subsequently amended. Furthermore, work was conducted on regulation for the annual accounts of pension funds. Work was conducted on guidelines for the separation of functions within financial undertakings, updating guidelines on actions to combat money laundering and terrorist financing, guidelines on risk management and actuary functions at insurance companies, guidelines for regulated entities' outsourcing activities, guidelines for the activities of index funds and UCITS ETF's and guidelines on key information. Furthermore, work has been conducted on 12 discussion documents regarding rules and guidelines issued by FME. Rules, guidelines, interpretations and discussion documents are published on FME's website.

Supervision of regulated entities' business practices is also under the purview of Off-Site Supervision and provisions thereof are in all financial market sectorial laws as well as in the Act on Official Supervision of Financial Activities. Its focus has been on the outward facing business practices of regulated entities' activities, i.e. consumer facing activities, in particular financial services consumers.

Tasks related to the supervision of sound and healthy business practices continued to be diverse. It may be noted that a conclusion was reached in September 2014 on FME's demand that Lýsing hf. disclose certain information to their clients, when the Supreme Court dismissed Lýsing's request to annul. Consumer disclosure issues are, and have been, a focal point. On that topic we point to the Authority's examination of insurance brokers' consumer disclosure and a request for corrective action from Vörður tryggingar hf. after changes made to compulsory insurance without prior consulting with policy holders. It may also be noted that following suggestions received about consumers increasingly transferring from one life insurance company to another, FME reiterated on its website the opinion on the importance of consumers making informed decisions when doing so. The emphasis on regulated entities' consumer disclosure will continue.

### 1.2 On-Site Inspections and Securities

### **On-Site Inspections**

The task of On-Site Inspections is to conduct independent examinations of the activities of regulated entities. Examinations can involve any aspect of a regulated entity's activities. The aim of on-site examinations is to confirm that the activities of regulated entities comply with applicable law, regulations and rules whilst examining whether the activities are, in other aspects, in accordance with sound and healthy business practices. Such examinations can also be used to ascertain the information validity in regulated entities' reporting and the regulated entities' compliance with their own processes and rules. FME's on-site examinations may be divided in three: specific examinations, where an examination is focused on specific aspects of a regulated entity's activities; overall examinations, where the examination is focused on the overall activities of a regulated entity; and thematic examinations, where the examination is focused on specific aspects of a few regulated entities' activities. Examinations last year include a valuation audit on Housing Financing Fund's portfolio where the quality of the funds portfolio report was examined and loans to individuals and companies were valuated. A thematic examination was also conducted at insurance companies focused on internal processes and how the companies processed vehicle related losses. FME conducted another thematic examination into new commercial bank lending to legal entities. The objective of that examination was to assess the commercial banks' lending processes in relation to compliance with lending rules. FME carried out on-site examinations at five pension funds with a view to find out if the execution of the funds' risk management satisfied Guideline No 1/2013 on risk management for mutual insurance divisions of pension funds. Conclusions of on-site examinations are generally published on FME's website in the form of transparency announcements in accordance with the FME transparency policy.

### Securities Market

The role of Securities Market Supervision is to monitor trading and activities on the securities market. Tasks of Securities Market Regulation include monitoring investor protection, mandatory bid requirements, market manipulation, insider dealing, treatment of inside information and that issuers comply with their disclosure requirements. Securities Market also monitors NASDAQ Iceland and the Verðbréfaskráning Íslands hf. (Icelandic Securities Depository hf). In the past year, FME has imposed administrative fines and reached settlements with entities due to violations of laws on the securities markets. The violations relate to, among others, major shareholding notification requirements and inside information disclosure. Securities Market also conducts regular examinations of specific aspects of the securities market. For instance, an examination on best practises in securities transactions is currently being concluded. The examination pertains to specific financial undertakings as Article 18 of Act No 108/2007 on Securities Transactions stipulates that a financial undertaking shall take all reasonable steps to obtain the best possible result for their clients, taking into account price, costs, speed and other considerations.

Securities Market is currently undertaking preparatory work for the transposition of European Union regulations and directives into Icelandic laws and regulations. Substantial changes in the securities market legal environment can be expected during the next two years. Acts that will be transposed in to Icelandic law include Regulation (EU) No 236/2012 on short selling, Regulation (EU) No 648/2012 on OTC derivatives (EMIR), Regulation (EU) No 596/2014 on market abuse (MAR), Directive 2014/65/EU and Regulation (EU) No 600/2014 on markets in financial instruments (MiFID2/MiFIR) and Regulation (EU) No 909/2014 on central securities depositories (CSDR). The tasks of Securities Market will increase substantially after the transposition of the above-mentioned acts into Icelandic law. For instance, short sales of financial instruments in Iceland will be monitored for the first time with the transposition of the short sale regulation. Furthermore,

supervisory tasks concerning derivative transactions will increase greatly. For instance, under EMIR all entities involved in derivative transactions must notify specific trade repositories of the transactions and requirements will increase for risk management.

Securities Market participates in diverse foreign cooperation. It is an active participant in the activities of the European Securities and Markets Authority (ESMA). A number of Standing Committees at ESMA attend to specific policy areas such as market abuse, investor protection, securities transaction settlement etc. Furthermore, Securities Market Regulation cooperates closely with the Nordic supervisory authorities monitoring the NASDAQ stock exchanges in the Nordic Region.

### Investigations

The Acts on Financial Undertakings, Securities Transactions, and Insurance Activity oblige FME to carry out preliminary investigation of suspected infringements of those acts. Investigations bear the brunt of that task. However, other divisions of the Authority can initiate investigations. In the event an investigation indicates reasonable suspicion of a violation of specific laws related to the financial market, such as the Act on Securities Transactions and the Act on Financial Undertakings, the matter is either referred for further police investigation or it is dealt with through the process of an administrative fine, depending on the scope of the alleged infringement. In addition, a part of Investigation's tasks is to follow-up on investigations into matters related to the collapse of the financial market.

Notwithstanding the reduction in scope of investigations after the conclusion of investigations in cases relating to the collapse, FME annually receives tens of suggestions from various entities as well as initiating investigations on its own initiative. The most common inspections are alleged infringements of the Act on Securities Transactions, i.e. suspected insider dealing and market manipulation. FME also receives complaints from time to time about alleged unsound business practises and Investigations often participate in those cases. FME has extensive powers to gather data and information and requesting data and information from those concerned is an essential part of case investigation. Care is exercised that such requests be adapted to each relevant case and that the reaction is proportional to the case. In light of the widening scope of the domestic securities market and foreseeable continuing growth in the coming years, the scope of FME investigations will presumably widen accordingly. However as might be expected, there is a certain degree of uncertainty about the number and scope of cases that will be investigated.

### Transposition of directives and regulations

On 1 January 2011, three supervisory authorities were launched for the European Union financial market, the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). The authorities form part of the European System of Financial Supervision (ESFS) and have been granted various powers with respect to the authorities of EU Member States and market participants.

On 14 October 2014, an agreement was reached between ministers of the EU Member States and the EFTA States Iceland, Norway and Liechtenstein on the participation of the EEA-EFTA States in the above-mentioned authorities and the EEA financial supervision regime whereby decision-making in cases relevant to authorities and market participants in the EFTA States is assigned to the EFTA Surveillance Authority (ESA).

Over 100 EU Directives and Regulations for the financial market currently await to be transposed into the EEA Agreement and EEA-EFTA State and EU specialists have recently been working on elaborating the above-mentioned agreement by adapting the acts to the EEA Agreement.

Most notably, three regulations on the above-mentioned supervisory authorities, EBA, EIOPA

and ESMA, a new directive and regulation on banks (CRD IV/CRR), a directive on professional investor funds (AIFMD), a regulation on financial market infrastructure (EMIR), a regulation on short selling, a new directive and regulation on markets for derivatives (MiFID2/MiFIR), a new regulation on market abuse (MAR), a directive on preparedness, recovery and resolution of financial undertakings (BRRD) as well as multiple secondary acts elaborating on their subject matter.

### 1.3 Oversight

The role of Oversight is to analyse the principal risk factors of individual sectors of the financial market along with analysing systemic risk and developments in the financial markets. Oversight communicates information to external parties and other functional units of FME on market risks and conditions, recommends amendments to rules and participates in developing rules and guidelines for risk management in the financial market. Oversight has three teams that further define the division's task in individual policy areas and markets. The three teams are macro-prudential, risk analysis for financial undertakings and risk analysis for insurance companies and pension funds.

One of Oversight's main tasks is conducting a risk assessment for risk factors in the activities of regulated entities; a part of the Supervisory Review and Evaluation Process (SREP). That involves determining how much capital financial undertakings need to hold to cover their risks and, where applicable, requiring rectification in their activities. During the year, a risk assessment was conducted for the four commercial banks, Íbúðalánasjóður (Housing Financing Fund), two savings banks and Lánasjóður sveitarfélaga ohf. (Municipality Credit Iceland). EBA guidelines for the Supervisory Review and Evaluation Process will apply in the EU from 1 January 2016 and FME is preparing for their implementation. Work is also ongoing on developing comparable risk assessments for pension funds and insurance companies based on EIOPA guidelines for the supervisory review process. During the year Oversight considered an application for permission to apply an internal ratings based approach to assess capital requirements for credit risk.

Oversight is involved in various projects related to the CRD IV/CRR Directive and Regulation that, among others, transpose the international Basel III standard on capital adequacy and liquidity requirements of financial undertakings. Projects have included involvement with the draft transposing the EU Directive<sup>1</sup>, review work, revising the CRR translations of the Translation Centre of the Ministry for Foreign Affairs, and studying of EBA technical standards and guidelines. The CRD IV/CRR rules apply from 1 January 2014 in the European Union Member States however, according to the schedule for the enactment of the above-mentioned EEA acts, they will enter into force in Iceland on 1 January 2016. Furthermore, Oversight has been preparing to issue rules and guidelines regarding various risk factors in the activities of financial undertakings and has to that end mainly used EBA guidelines as a basis.

Oversight is also preparing for the implementation of the EU Solvency II Directive, which will change the operating environment of insurance companies considerably. FME heads a committee working on the introduction of new law on insurance activities and the bill should be submitted to Parliament in the fall. The Directive will enter into force within the EU on 1 January 2016. Preparation for the implementation of the Directive began in early 2014 based on EIOPA guidelines. Oversight worked on new Guidelines No 3/2014 for Risk Management of Insurance Companies, whereby previous guidelines were amended to the expected requirements of Solvency II. Since 2011 insurance companies have also reported on their Own Risk and Solvency Assessment (ORSA) that becomes a statutory requirement under Solvency II. In recent weeks, a detailed assessment has been conducted on the companies' reports from 2014 where FME suggestions have been submitted to the company's boards. The requirements for ORSA will increase in 2015.

The European authorities, EBA and EIOPA, have issued harmonised standards for data delivery in XBRL form in conjunction with the implementation of CRD IV and Solvency II. Oversight has worked on implementing those standards in conjunction with a new process for delivering data to FME and reviewing data collection having regard to them.

In May 2014, Act No 66/2014 on Undertakings for Collective Investment in Transferable Securities (UCITS) and Investment Funds was adopted. It covers a forum and information exchange on cases concerning systemic risk, the state and the prospects of individual financial undertakings and the financial system as a whole. Joint working groups of FME and CBI prepare and analyse risk factors ahead of the four annual meetings of the systemic risk board. Oversight supervises that work within FME; risk assessment teams analyse systemic risk, credit risk, liquidity and funding risk, market risk, and matters relating to the financial infrastructure.

Oversight and CBI cooperate on conducting stress tests to examine the impact of domestic scenarios on commercial banks' resilience. The first such stress test was conducted in 2013 with a plan to conduct them annually. Last year, EIOPA arranged a stress test for insurance companies that every Icelandic insurance group underwent and Oversight supervised the conduct thereof. Oversight plans to participate in EIOPA's stress test for defined contribution pension funds.

Oversight is involved in diverse foreign cooperation, including Nordic and Baltic cooperation of financial supervisory authorities and collaboration with various international institutions, in particular EBA and EIOPA. The division is also an active participant in OECD activities in the pension market. In addition, Oversight hosts representatives of foreign regulatory agencies and rating agencies visiting the Authority in connection with gathering information on the state of, and trends in, the Icelandic financial market.

### Risk-based supervision

In recent years, FME has worked on the design and implementation of risk-based supervision in accordance with international supervisory practices.

Regulated entities have been categorised into impact groups, based on an assessment of what consequences to financial stability and clients' interests would result from cease of operations in the regulated entity's. Supervision for the relevant entity is determined by the impact categorisation and reflected in a supervisory model containing the minimal supervisory tasks conducted for each entity. The scope and frequency of tasks increases in accordance with their impact assessment.

In addition, risk-based supervision involves a systematic assessment of risk factors in regulated entities' activities and the probability that the relevant factor will cause substantial interruptions in activities or cease of operations. Emphasis is on communication with regulated entities to increase understanding of their activities and the aspects that pose the greatest risk to financial stability and consumers. This means that FME will increase discourse with regulated entities on issues that have a potential for harm regardless of whether they may be considered unlawful. Should risk exceed specific criteria, FME will communicate that immediately and adopt appropriate measures. Work is continuing on drafting procedures to ensure consistent conduct for risk assessments based on guidelines and recommendations from EU supervisory authorities on good supervisory practices.

Work on designing a computer system intended to maintain risk-assessment results and to provide an overview of risk from regulated entities' activities is continuing in conjunction with

the implementation of risk-based supervision methodology. The system is intended to support risk-based supervision methodology and enable the authority to assign human resources and funds in the most efficient way for the benefit of the public.

### 1.4 Office of the Chief Legal Counsel

The Office of the Chief Legal Counsel serves the Director General and other divisions as an advisor on legal issues. The Office reviews agenda items and proposals that are to be submitted to the FME Board for a decision and records Board meeting minutes. The Office is also involved with sanctions and represents FME in legal proceedings, replies to communications from the Althing Ombudsman and information requests submitted to the Authority under the Information Act.

Office of the Chief Legal Counsel supervises comments on bills and regulations on the financial market that are submitted to ministries and the Icelandic parliament and participates in committees. Moreover, the Office is in charge of harmonisation and collaboration with the other divisions of the Authority as well as communications with the Icelandic authorities, foreign supervisory authorities and participates in the forum of the chief legal counsels of the Nordic supervisory authorities.

The projects the Office has carried out during the year include a review of FME's tariffs and transparency policy. The Office participated in a review of Rules No 130/2014 on Transactions by FME Board Members, the Director General and Employees and Rules No 728/2014 on FME's Power to Settle Cases Amicably, as well as making adjustments to the form of, and procedures for, settlements.

During the year, the Supreme Court issued three judgements in cases FME was a party to. Cases No 62/2014 and 161/2014 confirmed FME's claim that costs of bankruptcy proceedings include supervisory fees. In Case No 460/2014, the District Court's dismissal was confirmed as the case had not been brought within the statutory time limit for taking legal action. Reykjavik District Court ruled in Case No E-4177/2013 absolving FME from liability for costs incurred by a party calling on the Althing Ombudsman.

The Althing Ombudsman reached a conclusion in two cases relating to FME: One of the cases, Case No 7241/2012, concluded with an Opinion commenting that specific data on hiring had not been preserved and filed satisfactorily. In the other case, the Althing Ombudsman concluded that FME's procedures had no deficiencies and the matter therefore did not need further inspection. On 7 August 2014, FME published a news update on its website clarifying the issues considered by the Ombudsman in the latter case.

During the year 2014, the Information Committee ruled in nine disputes relating to FME's handling of information requests. FME's position on releasing material was validated in most cases.

### 1.5 Human Resources

The focus of FME is to employ competent and keen staff who are ambitious to perform well. The number of employees and employee turnover has remained stable in the last three years. In 2014, the number of paid positions was 117.5 and employee turnover was around 8%. Employee average age at year-end was 42.2 years and the majority off staff has earned master's degrees.

During the year, employees were encouraged to use active and environmentally friendly modes of transport and to be physically active. FME used various methods to encourage that in close collaboration with FME's transportation committee. For example, a change room was made for employees and at year-end 43 employees had a transportation agreement. Furthermore, FME received the City of Reykjavik 2014 Transportation Recognition for the success of, and the actions to, reduce traffic and support employees in using active modes of transport. FME is knowledge-based and employees are assigned appropriate tasks and challenges with opportunities for professional growth. Educational measures were handled in a similar manner as before with a particular focus on management training. Three large quality improvement projects were concluded during the year, formally implemented and applied to daily operations. One of them concerned risk-based supervision. Performance reviews focused especially on identifying educational needs for that project and increased education is planned there.

Emphasis is on a workplace culture characterised by positivity, trust and open communications and that is for instance reiterated in new values. A new workplace analysis shows that morale at FME is good, 4.22 point out of 5, and that employee happiness and pride has increased year-onyear.

### 1.6 Operations and Finance

The Office of Operations and Finance supervises the Authority's financial accounting and payroll services and the collection of supervision fees and other revenue. It furthermore supervises project tracking, building management services, communications with property owners and other matters such as the cafeteria. The Office is responsible for the Authority's planning and budgeting, financial control, procurement, cost supervision, financial statements and preparing annual accounts. The Authority's project tracking software contains the project plan that the core and support divisions base levying of the supervision fee on pursuant to law and as is described in details below.

### Operations in 2014

According to FME's annual accounts for 2014, operating expenses, not including a special reversal of depreciation of ISK 135.2 million related to revenue collection from fallen financial institutions in previous years, amounted to ISK 1,812.8 million compared with ISK 1,736.2 million in 2013. Therefore, the increase of operating expenses year-on-year is 4.4%. The largest expense item continues to be labour costs amounting to ISK 1,414 million in 2014 compared with ISK 1,341.5 million the preceding year. Total revenue, including financial income and expenses, amounted to ISK 1,693.4 million, of this amount, supervision fees totalled ISK 1,589.9 million and had decreased by 9.2% year-on-year. Thus, there was an ISK 15.8 million surplus from FME's operations in 2014. Expenses from complaints committees hosted by the Authority are included in operating expenses and their labour cost amounted to ISK 20.1 million. The majority of that cost is recovered from those regulated entities that are involved in the cases the committees rule on. FME's equity at year-end 2014 was ISK 575.2 million, as compared to ISK 559.5 million at the beginning of the year. Equity at year-end, less reserves amounting to no more than 5% of next year's supervision fees, reduces supervision fees the following year, pursuant to Act No 99/1999 on Payment of Cost due to Official Supervision of Financial Activities. Thus, the reserves amounted to ISK 82 million at year-end 2014. The 2014 annual accounts are provided on FME's website.

### Financial Supervisory Authority

Annual accounts, revenue and cost breakdowns

	2014	2013
	ISK thousands	ISK thousands
Revenue		
Supervision fee	1,589,938	1,751,593
Other revenue	70,338	29,298
Total revenue	1,660,276	1,780,891
Operating expenses		
Labour costs	1,414,027	1,341,535
Membership fees, travel and meetings, retraining	93,845	88,326
Consumables	25,016	32,127
Purchased services, creation of software and licence	162,430	172,490
Housing costs	91,421	90,324
Operational expenses and compensation due to court	26,105	11,400
	1,812,843	1,736,202
Depreciation/collection related to failed financial institution	s -135,249	151,912
Total operating expenses	1,677,594	1,888,114
Financial income and expenses	33,112	43,797
Earnings (loss)	15,795	-63,426

### 2015 operational schedule

The Authority's expenditure is expected to be ISK 1986.6 million in 2015. The Authority's expected income is ISK 1720.2 million, of that amount the levied supervision fees amount to ISK 1,637 million. The difference is financed with equity from income surplus in the preceding years.

### Distribution of working hours

Record keeping for working hours is connected to FME's project tracking software. Recorded information is, among others, used for annual plans on allocating the Authority's operating expenses between the categories of regulated entities, as laid down in law.

The following table shows a breakdown of the working hours FME devoted to each main category of regulated entity in 2013 and 2014:

Relative distribution of FME working hours among categories of regulated entities *)	2013 %	<b>2014</b> %
Credit institutions	55.0	54.6
Insurance companies and insurance brokers	12.8	11.1
Pension funds	14.4	15.3
Fund management companies	6.9	5.0
Securities dealers and securities brokers	3.5	2.5
Equity and bond issuers	4.5	5.5
Others		6.0
	100.0	100.0

\*) Work on investigations of failed financial undertakings, which was concluded in February 2013, is not included in any of these categories.

FME's time sheet records also enable analysis of activities by type of task or subject. Such analysis of hours spent in 2013 and 2014 is as follows:

Relative distribution of FME working hours among its main tasks	2013 %	2014 %
Supervisory tasks	59.7	58.1
Continuous off-site financial supervision	26.1	29.6
On-site examinations	9.0	8.2
Other supervisory activities	24.6	20.4
Regulation	4.4	5.8
General operations	32.2	31.3
Foreign cooperation/communications	3.7	4.7
	100.0	100.0

Continuous off-site financial supervision refers to various kinds of examinations, monitoring and market surveillance activities that are among others, based on systematic gathering of information and regular reporting to FME. In addition, it covers various specific examinations of the activities, business practices and procedures of regulated entities. On-site examinations refer to examinations at the establishments of regulated entities. Other supervisory activities refer to various licensing, assessment of eligibility, sanctions, information dissemination, queries, etc. General operations refer to work on FME's document management and archiving, IT, management, human resources, educational matters, and other aspects of regular operations and office administration.

Summary of legal proceedings and cases before the Althing Ombudsman that involve FME

Judicial decisions in cases FME was a party to 2012 - May 2015

FME decision confirmed, acquitted, cases dismissed	13 cases
Decision repealed or another adverse conclusion	5 cases
Total	18 cases

These are judicial decisions in cases FME was a party to and most of the cases involved a re-examination of the Authority's decisions. They were mostly conclusions of the Supreme Court. However, in four instances the conclusion of the District Court was final.

Summary of cases before the Althing Ombudsman involving FME

Opinions	7
Letters	13
Total	20

The Althing Ombudsman issues decisions as Opinions or by letter.

**Opinion** The Ombudsman issues his Opinion if he considers an act of a public authority to be in conflict with the law or be otherwise contrary to good administrative practice. Opinions can contain specific or general recommendations to the authorities.

**Letter** Ombudsman can dismiss a case by letter after it is corrected or explained by the authorities. Such letters may contain general comments and suggestions to the authorities.

The Ombudsman has not addressed a communication to FME following a complaint or examination of his own initiative in 2014 or to date in 2015.



## 2. Financial market soundness

### 2. Financial Market Soundness

### 2.1 Credit Market

At year-end 2014, four commercial banks, 7 savings banks and 6 credit undertakings operated in Iceland, in addition to the state-owned Housing Financing Fund (HFF), or a total of 18 credit institutions. At year-end 2014, the total assets of credit institutions amounted to ISK 4,003 billion, thereof the total assets of the commercial banks amounted to ISK 2,993 billion, and they have decreased by 1% from the preceding year.

In recent years, the total assets of credit institutions, as a percentage of GDP, has been decreasing, from 277% at year-end 2009 to 201% at year-end 2014. This is largely explained by the fact that total assets have decreased while GDP has been increasing. Another explanation is credit circulation through entities or activities outside the traditional banking industry.

### **Equity position**

At year-end 2014, the capital base of the three large commercial banks amounted to ISK 639 billion, compared with ISK 595 billion at year-end 2013, an increase of 7.4% year-on-year. Their capital adequacy ratio was 28.5% at year-end 2014 as compared to 26.2% at year-end 2013. The capital base is mainly composed of Tier 1 capital, or approximately 91% of the whole.

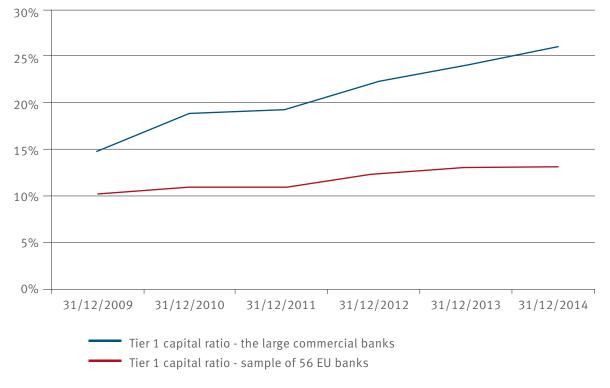


Chart: Capital adequacy ratio trend

The Figure above shows a comparison of the Tier 1 capital ratio at the large Icelandic commercial banks and a sample of 56 EU banks collected quarterly by EBA.

The average ratio of Tier 1 Capital for the large commercial banks was 26.1% at year-end 2014 compared with 13.2% at the EU banks. The comparison shows that the equity position of the Icelandic banks is strong.

### **Operating results**

In 2014, the profit of the three largest commercial banks amounted to over ISK 81 billion compared with ISK 64 billion in 2013. The banks return on equity after tax was 14.4% in 2014 compared with 12.1% in 2013. However, the profitability of core operations was 7.5% in 2014 compared with 7.8% in 2013. The interest rate margin was 2.7% in 2014 compared with 3% in 2013. Operating expenses as a percentage of net operating income were 53.7% in 2014 compared with 55.7% in 2013. Operating expenses as a percentage of assets were 2.6% in 2014 compared with 2.7% in 2013.

### Funding and liquidity

The three large commercial banks all considerably exceed the supervisors' liquidity rules. Total liquidity ratios have been around and over 100% since CBI's new liquidity rules entered into force in December 2013. The minimum ratio established by the rules is 80% in 2015. At the end of February 2015, the banks held liquid financial assets amounting to ISK 145 billion in excess of supervisors' liquidity rules. That included approximately ISK 87 billion in foreign currency. The banks all maintain high foreign currency liquidity ratios, over 200%, while the minimum established by the rules is 100%.

The three large commercial banks' customer deposits amounted to approximately ISK 1,536 billion at year-end 2014 and thereof around 70% were liquid within 30 days. The total amount of deposits covered in part by the Act on Deposit Guarantees and the Investor-Compensation Scheme amounted to ISK 1,163 billion. Thereof, deposits amounting to ISK 384 billion are insured for the EUR 20,887 minimum amount of cover. Insured deposits would amount to ISK 644 billion if a EUR 100,000 maximum amount of cover applied.

CBI Rules No 1032/2014 on Foreign Currency Funding Ratios entered into force on 1 December 2014. The purpose of the funding ratio is to ensure a minimum of one year for stable funding in foreign currencies. It therefore limits the ability of commercial banks to rely on unstable short-term funding to finance long-term liabilities in foreign currencies. The funding ratio is based on the Basel Committee's Rules on Net Stable Funding Ratio (NSFR). The four commercial banks have submitted reports since January 2015 and they all exceed supervisors' minimum requirements. According to the rules, the minimum ratio for 2015 is 80%.

The three large commercial banks all have sound funding as is apparent in their high capital ratios. The majority of the banks' funding is customer deposits (52%), borrowing (17%) and equity (20%).

The three banks have all issued covered bonds in recent years. Furthermore, Arion Bank hf. and Íslandsbanki hf. have issued short-term notes, but in small amounts. As of yet, no bank has issued non-indexed long-term bonds in ISK.

In January 2015, Arion Bank hf. announced it had repurchased a part of previously issued bonds amounting to NOK 59 million (approximately ISK 1 billion). The bonds were purchased at a price of 102.5, corresponding to a spread of 2.79% over NIBOR. In March 2015, the bank issued bonds for EUR 300 million (approximately ISK 44 billion) for three years. The issue had a fixed 3.125% premium over interbank rates and sold at a rate corresponding to a 3.10% premium over interbank rates

In March 2014, Íslandsbanki hf. issued bonds for SEK 300 million at 330 basis points over STIBOR and in May 2014 the bank issued bonds for EUR 100 million at a 3% fixed rate for two

years. In April 2015, the bank increased its bond programme with a SEK 150 million floating rate issue for four years with a 310 basis point premium over 3 month STIBOR. It sold at a price of 100.48.

Landsbankinn hf. has not issued any foreign market bonds. However in August 2014, the Irish Stock Exchange in Dublin confirmed the bank's base prospectus for a potential foreign currency issue. This is an EMTN programme that allows the bank to issue notes in the equivalent amount of up to EUR 1 billion in various currencies and at fixed or floating rates. By listing the note programme in a foreign stock exchange the bank is able to issue foreign currency bonds when terms are favourable.

The terms the banks have been given in foreign markets until now have been somewhat unfavourable and will likely not improve until a plan is made available concerning the proposed lifting of capital controls and the Treasury credit rating improves. The credit rating for Íslandsbanki hf. was recently upgraded to BBB-/F3 with a stable outlook and that should normally improve the terms of the bank's notes.

One of the largest risk factors in the banks' funding has been related to secured bonds Landsbankinn hf. issued in foreign currencies to settle a liability with LBI hf. The risk exposure has decreased and on 8 May 2014 the bank and LBI hf. reached an agreement on amendments to the settlement bonds negotiated in December 2009. The agreement is an important step towards further strengthening the bank's foreign currency funding and should make fund raising at more favourable terms on the international financial market easier for the bank.

### Credit risk and asset quality

The three large commercial banks' customer lending amounts to ISK 2,000 billion at year-end, or 6.9% more than at year-end 2013 when lending was ISK 1,871 billion. Household and corporate indebtedness as a percentage of GDP has been improving. The percentage of defaulted and frozen loans has decreased from autumn 2008 after a reorganisation of the finances of disadvantaged borrowers. However, many borrowers remain highly indebted and it is uncertain whether they can meet their loan obligations in the future.

The main focus for the three large commercial banks has been to restructure the largest borrowers and their defaults have decreased from the collapse of the banks in autumn 2008. Reorganisation for smaller borrowers has been more gradual. However, the pace of reorganisation has improved recently.

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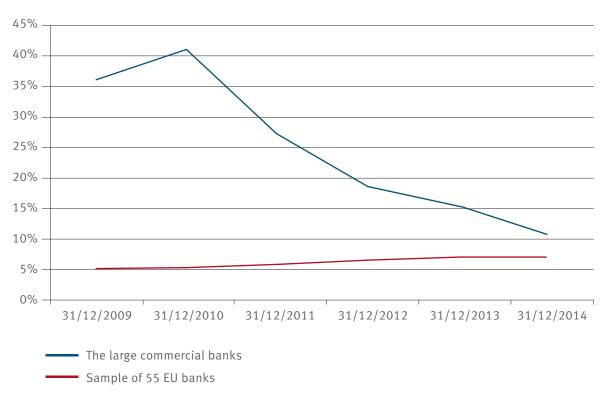


Chart: Impaired bank loans as a percentage of the gross loan portfolio without provisioning.

The Figure above shows a comparison of the large commercial banks and 55 EU banks, based on a summary from EBA. It seems the results of loan restructuring have been satisfactory. In recent years, the default rate has been decreasing rapidly in Iceland whilst it has been increasing in most Member States.

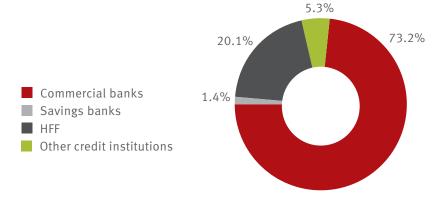
### Housing Financing Fund (HFF)

At year-end 2014, the total assets of the Housing Financing Fund amounted to ISK 825 billion, compared with ISK 863 billion at year-end 2013. The profit in 2014 amounted to ISK 3.2 billion, compared with a loss of ISK 4.4 billion in 2013. The profit in 2014 is mainly due to a reversal of an approximately ISK 4 billion depreciation, that had been charged, after two large matters of dispute related to the collapse of the banks concluded in the year. At year-end 2013, the fund's equity ratio was 4.5%, however, the long-term objective of the fund, pursuant to Article 7 of Regulation No 544/2004 on the Finances and Risk Management of the Housing Financing Fund, is maintain a the equity ratio over 5%. The Fund has substantial prepayment risk in the current interest rate environment and the funds interest rate margin is only 0.18%. HFF is designated as a systemically important financial undertaking. The government's actions to decrease the principal of indexed loans substantially impact the operational capacity of the fund in the future. As a result of the actions, the HFF loan portfolio is estimated to decrease by ISK 34-36 billion and net interest income is estimated to decrease by approximately ISK 1 billion per year. An agreement has been reached with the Ministry of Finance for compensation for these actions, however, the liability of the Treasury is not accounted for in the fund's annual accounts. The fund's losses from actions on using private pension savings for early repayment of HFF loans is estimated to be about ISK 300-400 million per year. The Treasury is not expected to compensate the fund for that loss. The actions concerning the principal decrease and private pension funds will have a stronger adverse impact on the fund's going concern than previous actions as the fund cannot repay its own liabilities to meet repayment and early repayments of its loans. The Treasury will need to continue supporting the fund's operations.

### The savings banks

During 2014, the savings banks' loss after tax amounted to ISK 1.7 billion, compared with a profit of ISK 136 million the previous year. The savings banks' return on equity was negative 43.2%<sup>4</sup> in 2014, compared with a positive return of 3.2% in 2013. At year-end 2014, the total assets of the savings banks amounted to ISK 56.4 billion, compared with ISK 57.8 billion at year-end 2013. The book value of the savings banks' equity at year-end 2014 amounted to ISK 3.9 billion compared with ISK 4.7 billion at year-end 2013. The capital adequacy ratio at year-end 2014 was on average 8.1%<sup>5</sup>, compared with 14.2% at year-end 2013. In general, the financial position and operational feasibility of the savings banks is of concern. However, the liquidity position of the savings banks appears to be acceptable.

Chart: Total assets of the credit companies on a consolidated basis as of 31 December 2014.



### **Executive summary**

Despite their strong equity position, satisfactory liquidity position, and decreasing default rate, there are certain issues which cause uncertainty and could have a negative impact on the banks' operations in coming half-years. Most notably, uncertainty concerning the proposed lifting of capital controls. In that regard, the results of the resolution of the failed financial undertakings and the possible impact on financial stability is a major risk factor. Uncertainty also concerns loan portfolio quality, long-term funding in foreign currencies; funding stability and the economic conditions of the major trading countries. The large commercial banks' core operations must be improved as their profits in recent financial statements mostly stem from non-recurring items. Therefore, it is important for the banks to maintain sound equity and liquidity positions and that they show care in distributing their equity. It is likely that the Treasury will need to continue supporting the operations of HFF. The financial position and operational feasibility of the savings banks is of concern.

### 2.2 Securities market

### Securities market trends

The Icelandic stock market continued improving in 2014. Two companies were added to the all-share index on the stock exchange and equity turnover increased by 15.7%. Bond turnover decreased for the third consecutive year.

### Equity market trends

30

Equity turnover increased from ISK 251 billion to more than ISK 290 billion in 2014. The increased

turnover is mainly due to the addition of two new companies to the all-shares index, HB Grandi hf. and Sjova-Almennar Insurance hf., in addition to N1 hf. being listed at year-end 2013.

Icelandic equities began the year 2014 gradually and had a negative return in the first half of the year, for the first time since 2010. Equity owners benefited more in the second half of the year and the OMXIGI all-share index, which measures the average return of all companies listed on the main market with regard to dividends, had increased by 12.4% at year-end. The stock market continued with positive signals in the first quarter of 2015. The OMXIGI index has increased by more than 9% from the beginning of the year.



Figure 1: NASDAQ OMXIGI trend

At year-end 2014, the market capitalisation of listed companies on the NASDAQ OMX Iceland main market was more than ISK 661 billion, compared with ISK 534 billion at the beginning of the year. The almost 24% increase is mainly due to the admission of two new companies to trading and a substantial increase in the equity value of Össur hf. The market value of companies listed on the Icelandic equity market equalled about 35% of GDP at year-end 2014, meaning the ratio inched closer to our neighbouring countries where the ratio is 40–70%.

During 2014, dividend payments and own stock repurchases were substantial; the total value of dividends and repurchases amounted to approximately ISK 20 billion.

### Bond market trends

Annual bond turnover decreased by 15.9% year-on-year. This is the third consecutive year bond turnover decreases substantially year-on-year. This decrease is attributable to decreased turnover in housing and housing authority bonds and indexed Treasury notes. Non-indexed Treasury note turnover was similar as in 2013.

The yields of non-indexed bonds fluctuated somewhat in 2014. The yield decreased slightly in the first quarter but then increased in the second quarter. The third and fourth quarters had more substantial decreases. During the year, yields on OMXI3MNI and OMXI1YNI decreased by 25

and 6 points respectively and yields on OMXI5YNI and OMXI10YNI decreased by 66 and 63 points respectively. However, yields on indexed bonds increased somewhat during the year, OMXI5YI by 67 points and OMXI10YI by 26 points. During the first quarter of 2015, yield fluctuations have been quite substantial. The yield on non-indexed bonds has increased while the yield on secured notes has decreased.

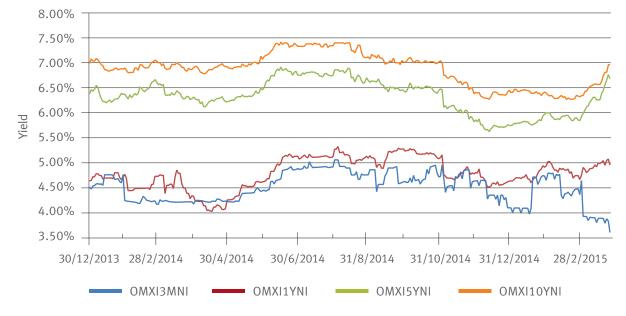


Figure 2: Yields as reflected in NASDAQ OMX Iceland non-indexed bond indices

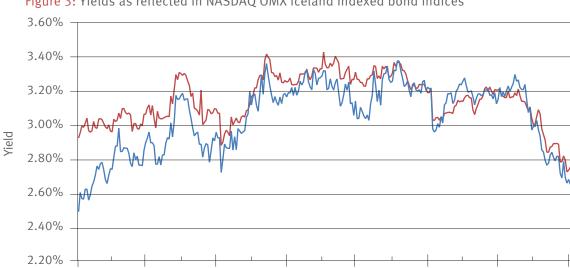


Figure 3: Yields as reflected in NASDAQ OMX Iceland indexed bond indices

30/12/2013 28/2/2014 30/4/2014 30/6/2014 31/8/2014 31/10/2014 31/12/2014 28/2/2015

At year-end 2014, the total market capitalisation of all listed bonds amounted to approximately ISK 2,008 billion, compared with ISK 1,892 billion at year-end 2013, an increase of 6.1%. The increase is mostly due to bonds issued by banks and savings banks and corporate bonds, the net total of these issues amounted to approximately ISK 152 billion. The division of the market value of issued bonds at year-end 2014 is approximately 76.6% issued by domestic public entities and 23.4% issued by private and foreign parties. The comparable ratios at year-end 2013 were 90% and 10% respectively. Therefore, the ratio of public entity issues has decreased by more than 13 percentage points during 2014.

### 2.3 Pension funds

According to preliminary numbers, the assets of pension funds and other custodians of private pension savings, in the form of mutual insurance and private pension schemes, amount to approximately ISK 3,088 billion at year-end 2014. The increase from the preceding year amounts to over ISK 250 billion, almost 10%. Presumably approximately ISK 200 billion are due to good returns last year and approximately ISK 50 billion due to the difference between members' contributions and pensions paid. During the year, 26 mutual insurance funds were in operation, thereof 16 offered private pension schemes as well. There were 7 other custodians of private pension savings operating last year. The number of pension funds has decreased substantially in recent years and is likely to decrease further due to increased demands for streamlining, transparency and information disclosure.

At year-end 2014, pension savings in the form of mutual insurance and private pensions as a percentage of GDP are estimated to be almost 155%. As before, comparing pension fund savings with other countries, this ratio is among the highest. That comparison does not include pension savings for public entities, insurance companies and financial undertakings. In comparison to other countries, it is also notable that the assets of the Icelandic pension funds were larger than the assets of banks and savings banks, which amounted to ISK 3,050 billion at year-end. Of the ISK 3,088 billion assets of the pension funds, an estimated ISK 2,635 billion is held by pension funds' mutual insurance divisions, ISK 282 billion with their private pension schemes and approximately ISK 171 billion with other private pension custodians (see Figure 1).



Figure 1 Division of assets between mutual insurance and private pensions.

Figure 2 shows a summary of net real return of the pension funds mutual insurance divisions in the preceding four years. The final numbers for return in 2014 are not available, however, preliminary numbers indicate a 7.3% real return. Returns have improved after the difficult years following the collapse of the banks. To assess their results one must bear in mind that the pension funds are long-term investors with long-term objectives and their annual real return target is 3.5%. For the last 20 years, the funds' annual real return has averaged 3.9%, which is higher than the above-mentioned return target. The average real return in the last 10 and 5 years was 2.3% and 5.0% respectively. The preliminary numbers as a whole indicate a positive return for all of the pension funds asset classes. The foreign equity index increased substantially last year, which is a large part of the good return of the pension funds' mutual insurance divisions as almost a quarter of their assets were foreign assets. The returns of domestic equity and bonds were quite acceptable as well. The pension funds' assets. In recent years, the capital controls have restricted the funds' investment opportunities and reduced their capacity to diversify risk.

As might be expected, good returns in recent years will improve the actuarial position of the pension funds' mutual insurance divisions. The actuarial position of pension funds not guaranteed by an employer is expected to become positive and the deficit of government employee funds is expected to decrease. However, the average lifespan in Iceland has grown longer in recent years, and is presumed to continue growing longer, causing the pension funds' liabilities to increase substantially. Most of our neighbouring countries have already taken the future growth of average lifespan into consideration for the calculation of pension funds' liabilities. Therefore, now is an opportune time to respond to developments in the growth of average lifespans when the actuarial position of the Icelandic pension funds is calculated. Recently, conclusions were published on future life expectancy that have to be taken into account in actuarial examinations in 2015. FME has advised the managers of the pension funds to conduct a special assessment on pension fund liabilities in 2014 to assess the expected impact of new life expectancy statistics.

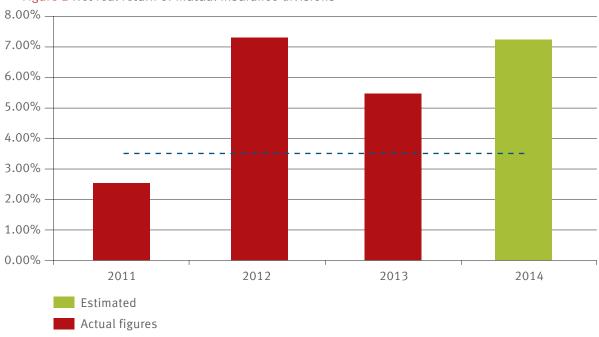


Figure 2 Net real return of mutual insurance divisions

34

– – 3.5% target

A large-scale project on research entitled 'Retirement Savings Adequacy in Iceland' concluded last year. The main objectives of the project included assessing the members' estimated old-age pensions as a percentage of wages (pension ratio) by age group from 35 years-old until pensionable age. The importance of pension funds for the future acquisition of pension entitlement was also assessed. The project was prepared and conducted in collaboration with the Organisation for Economic Cooperation and Development (OECD). FME was the guarantor for the project with a grant from the EU. The project was conducted by the Icelandic Pension Funds Association under the management of FME and according to OECD guidelines. A considerable amount of data was collected on the entitlement of members in close collaboration with almost every pension fund and custodian of private pension savings, and in consultation with the Data Protection Authority. The OECD guidelines are intended to facilitate cross-border comparability of pension adequacy for assessing future old-age pensions from social security, mutual insurance and private pension schemes. The conclusions of the research were manifold, including the fact that future pension ratios are comparable with other countries that have participated in similar research. The research also confirmed Iceland's unique position with regard to the large role of pension funds in the acquisition of pension income. Figure 3 clearly shows the small percentage of social security in Iceland compared with other countries when future old-age pensions are assessed.

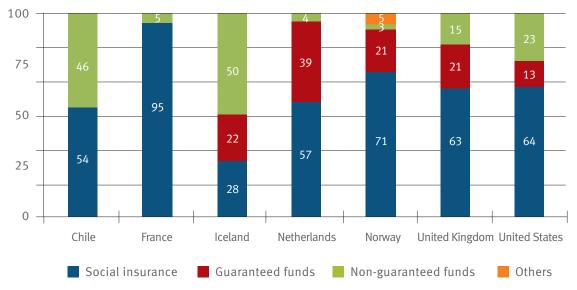


Figure 3 Forecast future division of old-age pension by country

The conclusions of the research indicate both strengths and weaknesses in the Icelandic pension system that can contribute to rational and constructive discussion on future pension matters. The report is made available on the websites of FME and the Icelandic Pension Funds Association.

### 2.4 UCITS and alternative investment funds

Fund management companies are financial undertakings that have been granted operating licenses pursuant to the Act on Financial Undertakings and operate funds for collective investment pursuant to the Act on Undertakings for Collective Investment in Transferable Securities, Investment Funds and Institutional Investor Funds. Undertakings for Collective Investment (UCITS) and investment funds shall be approved by FME and are subject to stringent requirements for their organisation, activities and management. However, pursuant to applicable legislation Institutional

investor funds are only required to notify the Authority and are subject to restricted supervision, mostly related to information disclosure.

There were nine fund management companies regulated by FME at year-end 2014.

The principal activities of fund management companies involve managing UCITS, investment funds, and institutional investor funds.

The number of UCITS decreased by four during the year and there were 53 UCITS and fund divisions active during the year. The number of investment funds increased by four during the year and there were 48 investment funds and fund divisions active during the year. At year-end 2014, total assets of UCITS and investment funds amounted to ISK 365 billion. Of these, assets of UCITS were just over ISK 200 billion and assets of investment funds just over ISK 165 billion.

UCITS and investment funds' assets increased by almost ISK 10 billion during year and that increase is substantially lower than in recent years. UCITS' assets decreased by approximately ISK 37 billion during the year, almost 16%, and that was the second consecutive year their assets decrease after substantial increases since 2008. However, assets of investment funds increased by ISK 47 billion during the year, or approximately 40%.

The number of regulated institutional investor funds increased by four during the year and there were a total of 74 institutional investor funds operated by 13 entities during the year. Their total assets amounted to ISK 308 billion; net assets amounted to ISK 136 billion. The funds' assets changed slightly year-on-year. The increase of total assets amounted to ISK 2 billion and their net assets decreased by almost ISK 5 billion. Institutional investor funds are funds that are only open to institutional investors. Investments of institutional investor funds are not subject to any restrictions that apply to the investments of UCITS and investment funds. Furthermore, institutional investor funds are not subject to any restrictions on borrowings that apply to the borrowings of UCITS and investment funds. Moreover, institutional investors enjoy less investor protection than retail investors.

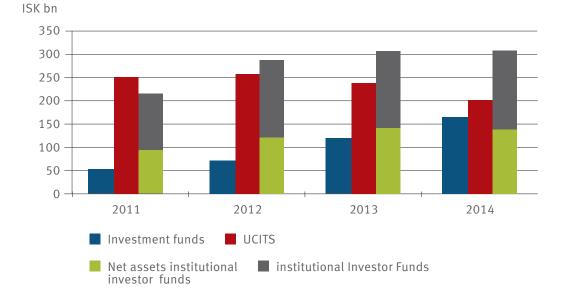


Figure Asset trend for UCITS, investment funds and institutional investor funds

#### UCITS and investment funds' asset breakdown

The investments of investment funds are less restricted than UCITS, both for individual issuers, asset classes, percentages in listed and unlisted financial instruments and borrowing is also authorised. Therefore, they are inherently riskier.

The asset breakdown of UCITS is substantially different from the asset breakdown of investment funds and more than 90% of UCITS assets are securities issued by the State or with State guarantees and deposits. However, investment funds' assets are substantially more varied. Approximately 40% is in equities, almost 30% in deposits and cash, 10% in securities issued or guaranteed by the State and approximately 15% are holdings in other funds.

Institutional investor funds mainly hold their assets in equities, mortgage backed bonds, other collective investment undertakings, and loan contracts.

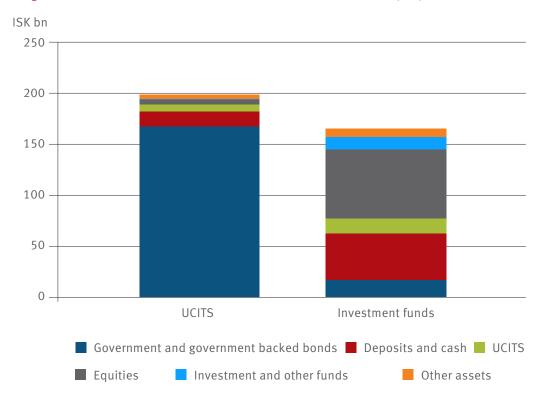


Figure Asset breakdown of UCITS and investment funds as of 31/12/2014

#### 2.5 Insurance market

At year-end 2014, 12 insurance companies had an operating licence from FME, of which four operate on the non-life insurance market and five operate on the life insurance market. In addition, Íslensk endurtrygging hf. and Trygging hf. are reinsurance undertakings that only settle older reinsurance obligations. Furthermore, Viðlagasjóður Íslands (Iceland's Natural Catastrophe Insurance) operates in accordance with special legislation. All of the life insurance companies are subsidiaries of non-life insurance companies, except Okkar líftryggingar hf., a subsidiary of Arion Bank hf.

The shares of Sjova-Almennar Insurance hf. were admitted to trading on the main market of NASDAQ OMX Iceland. Tryggingamiðstöðin (TM Insurance hf.) and Vátryggingafélag Íslands (VIS Insurance hf.) were admitted to trading in spring 2013 and the three largest insurance companies are therefore listed on an exchange. The listing of the companies has diversified their ownership. The largest shareholders in the above-mentioned companies are pension funds, investment funds and investment companies.

At the beginning of 2014, as noted in the previous annual report, the operating license of the non-life insurance company European Risk Insurance Company hf. (ERIC) was revoked since the company did not meet the statutory minimum solvency margin. The company had no activities in Iceland, but sold, in particular, liability insurance in the United Kingdom. The company is removed from all aggregates for 2014 in the subsequent discussion. Work on the settlement of the company's bankruptcy estate is currently ongoing in collaboration with British authorities.

The pending application of the EU Solvency II Directive at the beginning of next year has an increasing impact on the activities of insurance companies. Four key functions are stipulated in the Directive, i.e. risk management, internal auditing, compliance, which includes internal control, and actuarial functions. FME has recommended that these functions be staffed this year (2015) and the companies have begun preparation.

The European Insurance and Occupational Pensions Authority (EIOPA) submitted every insurance company to a stress test in the middle of 2014. In each market the largest life insurance and nonlife insurance companies were selected, that is companies with a combined market share of over 50% in their respective markets. The objective of the stress test was to assess the general stress tolerance of the insurance sector and identify the major weaknesses considering the Solvency II Directive. The results overall showed that the insurance market in Europe is generally stable with regard to the expected Solvency II rules.

At year-end 2014, the total assets of all insurance companies in Iceland amounted to approximately ISK 165 billion, increasing by over ISK 5 billion from the previous year. Figure 1 shows the development of assets and asset breakdown of insurance companies in 2011–2014. The asset portfolios of the insurance companies have not changed substantially, however, as expected, equities have become a larger part of their asset portfolios. Almost half of the insurance companies' assets comprises equities.

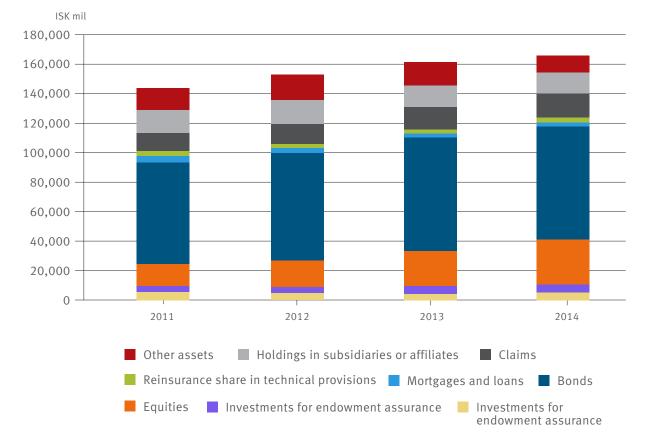


Figure 1 Insurance companies' assets and asset breakdown 2011–2014

Figure 2 shows a breakdown of balance sheet liabilities for life and non-life insurance companies for the same period. The equity position has improved steadily while technical provisions have remained almost unchanged, with their value decreasing in terms of fixed price levels.

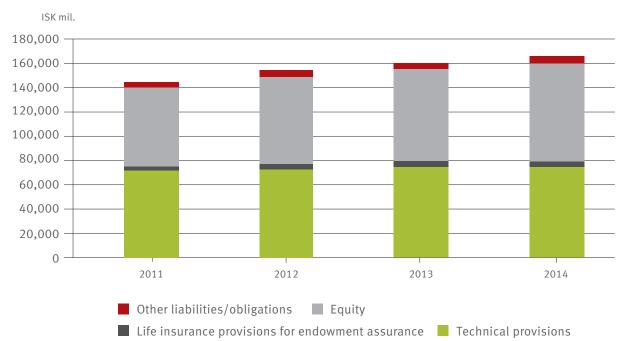


Figure 2 Insurance companies' equity and liabilities 2011–2014

#### **Operations of non-life insurance companies**

For the second consecutive year, the performance of the non-life insurance companies was worse than the preceding year. On the one hand, the performance reflects insurance operations and on the other hand returns on investment assets. During 2014, the performance of these main aspects varied by company, however, losses were prevalent during the year and catastrophes adversely affected the insurance operations. However, in a historical context the performance is acceptable. Figure 3 shows the development and breakdown of profit for 2011–2014.

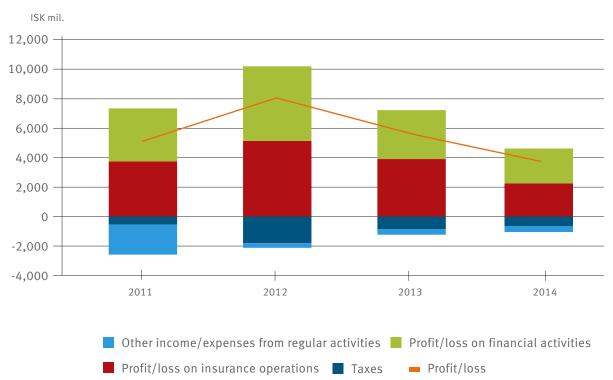
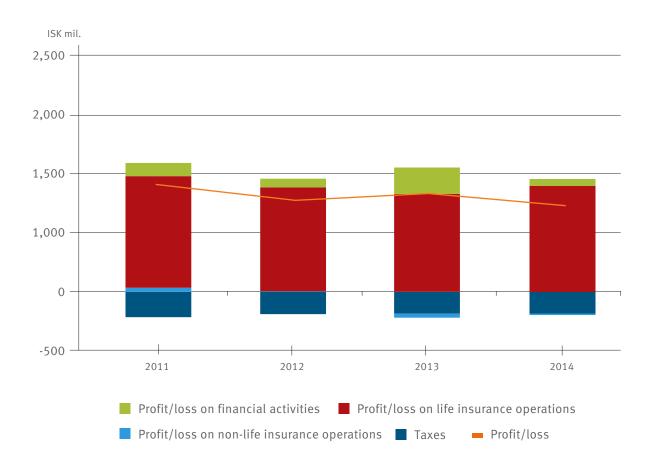


Figure 3 Performance of non-life insurance companies 2011–14

The solvency ratio of the four non-life insurance companies currently operating in the public market, i.e. the solvency as a percentage of the minimum solvency margin, was between 329% and 461% at year-end 2014, meaning the companies are sound. A few non-life insurance companies paid dividends last year, for the first time since the collapse of the banks. Net dividend payments (subtracting dividend payments from subsidiaries) amounted to almost ISK 3 billion.

#### **Operations of life insurance companies**

In recent years, operations of life insurance companies have been characterised by stability, as can be seen on Figure 4. In contrast to non-life insurance companies their profits have remained stable between years. Profits from life insurance operations have increased while profits from financial activities have decreased substantially.



#### Figure 4 Performance of life insurance companies 2011–2014

At year-end 2014, the life insurance companies' solvency ratio was between 131% and 249%. However, a low solvency ratio does not correctly reflect the companies' risk. Due to the small size of the market, the required solvency margin is, for most of them, determined by a minimum amount that is currently, according to the EU Directive on insurance markets, EUR 3.7 million or ISK 568 million.





#### 3 Events of the past year

#### 3.1 Highlights from May 2014 to end of April 2015

#### European Risk Insurance Company hf.

At the beginning of May 2014, FME published a press release on the status of European Risk Insurance Company hf. (ERIC) after having revoked the operating license on 12 February 2014 and having appointed a resolution board for the company. It stated the resolution board had collaborated with the British Financial Services Compensation Scheme (FSCS) since the company had paid into that fund for its British activities.

#### Temporary suspension of trading

On 6 May, it was announced on FME's website that the Authority had decided to temporarily suspend trading in the Landsbref LREAL ETF fund, operated by Landsbréf hf., in light of the fund's asset allocation at the end of day 5 May 2014 and the suspension of trading in HFF bond classes. It was further announced that FME had decided to temporarily suspend trading in all HFF bond classes that have been admitted to trading on the NASDAQ OMX Iceland main market. The announcement stated the FME decision was made to safeguard investor equality. The trading was reauthorised the following day.

#### Informational seminar for issuers' compliance officers on the regulated securities market

On 14 May 2014, FME hosted a well-attended informational seminar for issuers' compliance officers. Future changes were presented on legislation concerning the securities market, treatment of inside information and insider trading as well as issuers disclosure requirements.

#### Guidelines for risk management and the scope of tasks for a actuaries at insurance companies

On 23 May 2014, FME issued new Guidelines for Risk Management and the scope of tasks for actuaries at insurance companies. The Guidelines were based in part on FME Guidelines No 1/2011 on the Risk Management of Insurance Companies.

#### FME grants Alda Asset Management hf. additional operating authorisation

On 10 June 2014, FME reissued the operating license for Alda sjóðir (Alda Asset Management hf.) taking into account additional operating authorisation concerning asset management, investment advice and custody and management of financial instruments in joint investments. Alda Asset Management hf. had received an operating license on 14 December 2012 as a fund management company pursuant to Point 7 of Article 4(1) of Act No 161/2002 on Financial Undertakings.

## FME publishes annual accounts and information on the performance of Icelandic insurance companies' lines of business

On 12 June 2014, FME published annual accounts and information on the performance of Icelandic insurance companies' lines of business. The income statements, balance sheets and cash flows were published. When the insurance company was part of a consolidation the consolidated accounts were published.

#### FME issues revised guidelines on actions to combat money laundering and terrorist financing

On 11 June 2014, FME issued revised guidelines on actions to combat money laundering and terrorist financing.

#### FME addresses the pension funds' situation in 2013

On 24 June 2014, FME published its summary of the situation of Icelandic pension funds in 2013. The summary noted, among other things, that the pension system is sound and continues to grow in terms of the economy.

#### FME grants Reykjavik Energy a collection license

On 24 June 2014, FME granted Reykjavik Energy a collection license pursuant to Act No 95/2008 on Debt Collection.

#### FME approves takeover of specific operating unit

On 27 June 2014, FME approved Lýsing hf. taking over a specific operating unit from MP Bank hf. pursuant to Act No. 161/2002 on Financial Undertakings.

#### FME approves the merger of Svarfdaelir Savings Bank with Nordurland Savings Bank ses.

On 30 June 2014, FME approved the merger of Svarfdaelir Savings Bank with Nordurland Savings Bank ses. on the basis of Article 106(1) of Act No 161/2002 on Financial Undertakings. Nordurland Savings Bank ses. assumed all the rights and obligations of Svarfdaelir Savings Bank and the banks merged under the name Nordurland Savings Bank ses.

#### CRD IV technical standard on supervisory reporting published in the Official Journal of the EU

At the beginning of July 2014, it was announced on FME's website that one of the most extensive technical standards for the CRD IV legislation had been published in the Official Journal of the EU as the Commission's Implementing Regulation (EU) No 680/2014. The technical standard therefore became a formal part of EU legislation.

#### FME grants Straumssjóðir hf. an operating license as a fund management company

At the end of July 2014, FME granted Straumssjóðir hf. an operating license as a fund management company.

#### No deficiencies in FME's proceedings

On 7 August 2014, it was noted on FME's website that the Althing Ombudsman had concluded an examination of a case into a decision by FME's Board, from 11 September 2013, to sanction a few individuals for breaches of Article 45(1) of Act No 108/2007 on Securities Transactions. The Althing Ombudsman did not find a reason to examine the case further after examining the case material and FME's explanations and notified FME of its conclusion.

#### FME issues new rules

On 11 August 2014, it was announced that FME had issued new rules on transferred credit risk due to securitisation and rules amending Rules No 215/2007 on the Capital Requirement and Risk Weighted Assets of Financial Undertakings, as subsequently amended. And, that rules allowing FME to conclude cases by reaching settlements had also been published.

## IMF conducts an audit on FME compliance with the core principles for effective banking supervision (BCP)

At the beginning of September 2014, it was announced that the International Monetary Fund (IMF) had published the results of their audit, conducted in the first half of the year, on FME compliance with the 29 Basel Core Principle for Effective Banking Supervision. The IMF results were, compliant with seven of the principles, all essential criteria were met, and largely compliant with nine of them. Thirteen principles were materially non-compliant.

#### Overall results of financial undertakings' annual accounts etc. 2013

On 10 September 2014, FME published a report on the overall results of the 2013 annual accounts of financial undertakings, i.e. commercial banks, savings banks, credit undertakings (collectively referred to as credit institutions), securities dealers, securities brokers, and fund management companies, as well as information on the total assets of UCITS and investment funds operated by individual fund management companies and total assets of professional investor funds operated by fund management companies and other operators. In addition, there was detailed information on payment institutions and co-operative deposit departments.

#### Consultation due to Discretions and Options in CRD IV

On 11 September 2014, it was announced that FME had sent a circular to financial undertakings referring to previous communication on the implementation of the CRD IV legislation, Directive 2013/36/EU and Regulation (EU) No 575/2013; with this legislation the Basel III standards will be established in a harmonised way within the European Economic Area.

#### FME receives the City of Reykjavik 2014 Transportation Recognition

On 22 September 2014, it was announced that FME had received the City of Reykjavik 2014 Transportation Recognition in the category of small workplaces. Landspitali - The National University Hospital of Iceland received the Transportation Recognition in the category of large workplaces.

#### Recommendation to regulated entities on virtual currencies

At the end of September 2014, an article was published on FME's website noting that FME had sent regulated entities a recommendation at the end of August pointing out EBA's Opinion on 'virtual currencies', encouraging regulated entities to avoid the risk exposure that would result from virtual currency trading.

#### Lýsing hf. submits to FME requirements for disclosure to clients

On 20 August 2014, the FME board decided to levy periodic penalty payments per day on Lýsing amounting to ISK 200 thousand and that the levy would commence eight days after the decision was published if FME's requirements from their decision on 11. September 2013 were not met.

#### FME makes note of legislation on the publication of public investment advice

On 1 October 2014, with cause FME made note of the applicable legislation on public investment advice and noted that Point 12 of Article 2(1) of Act No 108/2007 on Securities Transactions contained a definition for public investment advice.

#### Surrender of operating license for insurance brokers

In the beginning of October 2014, it was announced that Sigbór Hákonarson, who had an insurance intermediary operating license pursuant to the provisions of Act No 32/2005 on Insurance Intermediation, had surrendered his license pursuant to Article 36 of that Act.

#### Allra-ráðgjöf ehf.

On 3 October 2014, it was announced that Allra-ráðgjöf ehf., which had an insurance intermediary operating license pursuant to the provisions of Act No 32/2005 on Insurance Intermediation, had surrendered their license pursuant to Article 36 of that Act.

#### First meeting of the systemic risk board

In the beginning of October 2014, it was announced that the first meeting of the newly formed systemic risk board had been held on 2 October. The board serves the financial stability council

and submits recommendations to it. The board's role is to assess the situation and prospects of the financial system, systemic risk and financial stability in Iceland.

#### Agreement on the implementation of regulations on European financial supervisory authorities

On 14 October 2014, it was announced that Bjarni Benediktsson, Minister of Finance and Economic Affairs, had attended a meeting, in Luxembourg that day, of ministers of finance of EFTA and EU member states. An agreement was reached at the meeting between parties on the main points of implementing three regulations on European financial supervisory authorities.

## FME deems Ingimundur hf. and Ármann Ármannsson eligible to own a qualifying holding in Straumur Investment Bank hf.

In mid-October 2014, FME concluded that Ingimundur hf. and Ármann Ármannsson were eligible to own a qualifying holding of up to 20% in Straumur Investment Bank hf. The holding of Ingimundur hf. would be direct while the holding of Ármann Ármannsson would be indirect.

## FME deems Varða Capital ehf. and related entities eligible to own a qualifying holding in Straumur Investment Bank hf.

On 15 October, it was announced that FME had concluded that Varða Capital ehf, 2G ehf., Steinhaufen Holding ehf., Grímur Alfreð Garðarsson, Jónas Hagan Guðmundsson and Edward Mac Gillivray Schmidt, were eligible to own a qualifying holding of up to 20% in Straumur Investment Bank hf.

## FME deems Sigla ehf., Snæból ehf., Gana ehf., Finnur Reyr Stefánsson and Tómas Kristjánsson eligible to own a qualifying holding in Straumur Investment Bank hf.

On 15 October 2014, it was announced that FME had concluded that Sigla ehf., Snæból ehf., Gana ehf., Finnur Reyr Stefánsson and Tómas Kristjánsson were eligible to own a qualifying holding of up to 20% in Straumur Investment Bank hf.

## FME deems the holding company Mata hf. eligible to own a qualifying holding in Straumur Investment Bank hf.

In mid-October 2014, it was announced that FME had concluded that the holding company Mata hf. was eligible to own a qualifying holding of up to 20% in Straumur Investment Bank hf.

## FME deems Lífeyrissjóðurinn Festa (Festa Pension Fund) eligible to own a qualifying holding in Joklar-Securities hf.

In mid-October 2014, FME announced it had concluded that Festa Pension Fund was eligible to own a qualifying holding of up to 50% in Joklar-Securities hf.

## FME deems Lífeyrissjóður Vestmannaeyja (Westman Islands Pension Fund) eligible to own a qualifying holding in Joklar-Securities hf.

In mid-October, FME announced it had concluded that Westman Islands Pension Fund was eligible to own a qualifying holding of up to 50% in Joklar-Securities hf.

#### Notification of the full withdrawal of the operating license of LBI hf.

On 22 October 2014, FME announced that it had fully withdrawn the operating license of LBI hf. (LBI) pursuant to Point 6 of Article 9(1) of Act No 161/2002 on Financial Undertakings. FME had previously, by letter dated 15 September 2011, withdrawn the operating license of LBI hf. in part, pursuant to the same authority.

## FME deems SVN eignafélag ehf. eligible to own a qualifying holding in Sjova-Almennar Insurance hf.

In the second half of October 2014, FME announced it had concluded that SVN eignafélag ehf., identification No 630800-2770, was eligible to own a qualifying holding of up to 20% in Sjova-Almennar Insurance hf.

#### Operating authorisation of financial undertakings made available on FME's website

On 12 November 2014, FME made the operating authorisation of financial undertakings available on the Authority's Icelandic website under the item Eftirlitsstarfsemi (Supervisory Activities) and thereunder Starfsleyfi (Operating Licenses).

## FME deems Straumur Investment Bank hf. eligible to own a qualifying holding in Icelandic Securities hf.

On 17 November 2014, FME published an article announcing that the Authority had concluded that Straumur Investment Bank hf. were eligible to own a qualifying holding of up to 25% in Icelandic-Securities hf. pursuant to Chapter VI of Act No 161/2002. Straumur Investment Bank hf. acquired a 100% interest in the company Gunner ehf., which owns a 64.3% interest in the company Íslensk eignastýring ehf that owns a 21.83% interest in Icelandic-Securities hf. Straumur Investment Bank hf. therefore was an indirect owner of a qualifying holding in Icelandic Securities hf.

#### Advisory opinion of the EFTA Court published

On 24 November 2014, the Ministry of Finance and Economic Affairs, FME and CBI issued a joint press release on the advisory opinion of the EFTA Court concerning a case pending before the Reykjavik District Court against Landsbankinn hf. The release stated: "The case centres on whether, during the period of validity of the previous Act on Consumer Loans, No. 121/1994, the bank provided satisfactory information during the negotiation of contracts for consumer loans that were linked to the consumer price index. The Act was passed in order to incorporate the provisions of Council Directive 87/102/EEC on consumer credit (the Consumer Credit Directive) into Icelandic law."

The EFTA Court concluded that it is not compatible with the Directive base the calculation on 0% inflation if the known rate of inflation at the time of the credit agreement is not 0%.

The press release noted that the opinion of the EFTA Court is an advisory opinion and that it is the role of the Icelandic courts to decide, on the basis of Icelandic law, how much the EFTA Court's opinion will affect their judgements in legal disputes about price indexation.

#### Results of a stress test for European insurance companies

On 1 December 2014, it was announced on FME's website that the European Insurance and Occupational Pensions Authority (EIOPA) had published the results of a stress test for insurance companies within the European Economic Area. All active consolidations of Icelandic insurance companies participated in the core module. EIOPA also specifically tested the impact of low interest rate environments in the relevant states.

## FME has deemed Íslensk eignastýring hf., Gunner ehf. and Straumur Investment Bank hf. eligible to own a qualifying holding in Icelandic Securities hf.

On 4 December 2014, it was announced on FME's website that the Authority had concluded on 24 November that the companies Íslensk eignastýring hf., Gunner ehf. and Straumur Investment Bank were eligible to own a qualifying holding of up to 33% in Icelandic-Securities hf.

#### FME and CBI renew their cooperation agreement

On 1 December 2014, FME and CBI signed and renewed their cooperation agreement. On the same occasion, CBI and FME signed an agreement on the implementation of liquidity oversight and supervision.

## Reiteration to insurance market consumers on the importance of making informed judgements when changing life and/or sickness insurance

At the beginning of December 2014, FME published a short update to the effect that FME noted that clients of insurance companies (insurance policy holders) with life and sickness insurance had transferred between insurance companies in considerable numbers in recent months. It was noted that under those circumstances the importance of informed judgement for insurance applications should be emphasised.

## FME publishes information on contributions to, and the combined market share of, foreign insurance companies in Iceland 2008–2012

On 10 December 2014, FME published quantitative information on the activities of foreign insurance companies in Iceland 2008–2012. These companies have headquarters within the European Economic Area and are authorised to operate in Iceland pursuant to Chapter IX of Act No 56/2010 on Insurance Activities. The information was based on data submitted by the financial and/or insurance supervisory authorities in the relevant states.

## Information session with regulated entities concerning the progress of the implementation of CRD IV and related data delivery

On 10 December 2014, FME hosted a presentation for regulated entities on the financial market that are required to submit data on the basis of CRD IV and its implementing technical standards.

## FME has deemed Íslensk eignastýring hf., Pivot ehf. (previously Gunner ehf.) and Straumur Investment Bank hf. eligible to supplement a qualifying holding in Icelandic Securities hf.

At the beginning of the year, FME announced that the Authority had concluded on 19 December 2014 that the companies Íslensk eignastýring hf., Pivot ehf. and Straumur Investment Bank were eligible to supplement a qualifying holding up to 100% in Icelandic-Securities hf. pursuant to Chapter VI of Act No 161/2002.

#### FME deems Eignarhaldsfélagið Borgun slf. eligible to own a qualifying holding in Borgun hf.

At the beginning of 2015, FME announced that the Authority had concluded, on 22 December 2014, that Eignarhaldsfélagið Borgun slf. were eligible to own a qualifying holding of up to 25% in Borgun hf. It stated that Eignarhaldsfélagið Borgun slf. had previously held a 24.96% interest in Borgun hf.

#### Minister of Finance and Economic Affairs appoints new Board of FME

At the beginning of 2015, it was announced on FME's website that the Minister of Finance and Economic Affairs had appointed a new Board of FME as the terms of office for the previous Board had expired at year-end. Ásta Þórarinsdóttir is the new Chairman of the Board of FME. In addition to the chairman, the following members and alternates joined the Board: Tómas Brynjólfsson, Member (Deputy Chairman), Arnór Sighvatsson, Member, Friðrik Ársælsson, Alternate, Ástríður Jóhannesdóttir, Alternate and Harpa Jónsdóttir, Alternate.

#### FME issues two guidelines

On 8 January 2015, FME issued two new guidelines; one pertaining to regulated entities' outsourcing

activities and the other to insurance companies' internal auditing.

#### EBA issues Guidelines on the Supervisory Review and Evaluation Process

In mid-January 2015, FME's website noted that the EBA, European Banking Authority, had issued new guidelines on the Supervisory Review and Evaluation Process (SREP); a continuing process for all aspects of supervision relating to regulated entities that is intended to display its overall profile.

#### Information on a party not authorised in intermediate insurance

On 26 January 2015, it was announced on FME's website that the Authority had received information to the effect that Vátryggingaráðgjöf Stefáns Gissurarsonar ehf. provided consumer service according to Article 1(1) of Act No 32/2005 on Insurance Intermediation. It stated: "By reference to the above-mentioned and Article 59(2) of Act No 32/2005 on Insurance Intermediation, FME notes that a named party is not authorised to intermediate insurance and therefore not subject to FME supervision."

## FME decisions on the allocation of the assets and liabilities of commercial banks after the financial shocks in 2008

At the end of January 2015, FME published a summary concerning FME's decision on the allocation of the assets and liabilities of commercial banks after the financial shocks in 2008. The reason being public debate in the preceding days. The summary showed material aspects concerning the role and decisions of FME's Board on the allocation of the assets and liabilities of the three commercial banks that collapsed in autumn 2008.

#### Comment on a headline on mbl.is

On 2 February 2015, an article was published on FME's website commenting on an article on Morgunblaðið's website with the headline: Examine a leak from FME. It was noted that the headline implied that data with information subject to bank secrecy had been divulged by FME. It was noted that in its statements and replies to the media, FME had clearly stated that there was no indication of the data being leaked from FME. In the assessment of FME nothing in the article on mbl.is corroborated the headline.

#### Icelandic pension system meets main OECD requirements

On 4 February 2015, it was announced that FME and the Icelandic Pension Fund Association had published new research on pension adequacy. The research was part of a multi-national project with a harmonised methodology concerning adequacy of retirement savings in the OECD states. One of the main conclusions of the research was that the Icelandic pension system meets the main OECD requirements.

#### Report on the implementation of the EMIR Regulation

On 2 March 2015, it was announced on FME's website that the European Commission had published a report for the European Parliament and the Council pursuant to Article 85(2) of Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (the European Market Infrastructure Regulation (EMIR)). Central counterparty (CCP) means a legal entity that interposes itself between the counterparties to the contracts, becoming the buyer to every seller and the seller to every buyer. The report assessed the progress and effort made by CCPs in developing technical solutions for the transfer by pension scheme arrangements of non-cash collateral as variation margins, as well as the need for any measures to facilitate such solution.

#### Temporary operations of credit institutions

On 3 October 2015, FME published summary information on the holdings of commercial banks, savings banks, and credit undertakings in companies that they had acquired temporarily through acquisitions and that were considered to be part of other activities of financial undertakings.

#### Líftryggingamiðstöðin hf. granted a license for a new insurance class

It was announced that FME had, on 9 January 2015, approved the license application from Líftryggingamiðstöðin for a new insurance class. The company's operating license was reissued taking that into account.

#### New draft directive on new rules to fight money laundering and terrorist financing (AMLD)

On 10 March 2015, it was announced that the Committee of Permanent Representatives of EU Member States (COREPER) had, at its meeting on 4 February, agreed a negotiating mandate on new rules to fight money laundering and terrorist financing. The agreement contained recommendations on a new anti-money laundering directive. Following the meeting on 10 February 2015, the Council of the European Union had adopted the agreement and that it was currently pending adoption in the European Parliament. The article stated: "Should the Parliament adopt the recommendations without amendments, the Directive will be published in the Official Journal of the EU and thereby enter into force."

## FME deems Eignarhaldsfélagið Borgun slf. eligible to supplement a qualifying holding in Borgun hf.

On 18 March 2015, it was announced on FME's website that the Authority had concluded that Eignarhaldsfélagið Borgun slf. were eligible to supplement a qualifying holding up to 33% in Borgun hf. pursuant to Chapter VI of Act No 161/2002 on Financial Undertakings.

#### FME closely follows cases concerning exchange-rate-linked loan dispute resolution

On 19 March 2015, a news item was published on FME's website in response to discussions in the media on the recent conclusions in cases concerning exchange-rate-linked loans. FME wanted to draw attention to the fact that the Authority closely follows cases concerning exchange-rate-linked loan dispute resolution, including the most recent judgements in legal disputes. It was noted that FME is bound by an obligation of confidentiality concerning activities of individual regulated entities pursuant to Article 13 of Act No 87/1998 on Official Supervision of Financial Activities. However, FME could announce that it had recently been in communications with the relevant financial undertakings and would respond to case developments to the extent authorised by law and required by the case.

#### Why conduct financial supervision?

On 23 March 2015, FME hosted a conference in conjunction with the Ministry of Finance and Economic Affairs concerning the objective of effective financial supervision, recent updates in the field of supervision and international supervision, within Europe and the position of Iceland in relation to that. The recent IMF audit on the effectiveness of bank supervision in Iceland with regard to best execution criteria and FME improvement projects.

#### FME decision on Westman Islands Savings Bank

On 29 March 2015, FME published on its website a news release noting that the board of FME had at its meeting that day, on the basis of an authority pursuant to Temporary Provision VI of Act No 161/2002 on Financial Undertakings, come to a decision on a merger without liquidation of Westman Islands Savings Bank ses. into Landsbankinn hf. with an acquisition of assets and liabilities and winding up the savings bank.

#### Presentation on recently implemented data delivery procedures

In mid-April 2015, FME announced on its website that regulated entities in the credit and insurance markets had been invited to a presentation on recently implemented data delivery procedures at FME and a review of its data collection pursuant to the requirements of CRD IV and Solvency II. After the meeting, that was part of a co-operation project of FME and the Icelandic Financial Services Association, the entities were asked to submit recommendations, suggestions and comments concerning FME data collection to the Icelandic Financial Services Association.

#### Second meeting of financial stability committee in 2015

FME's website reported on the second meeting of the financial stability committee in 2015, held on Tuesday 14 April at the Ministry of Finance and Economic Affairs. In the opinion of the financial stability committee the financial system risk remained substantially unchanged from the preceding meeting.

#### Rules on the annual accounts of pension funds

On 17 April 2015, FME announced on its website that Rules No 335/2015 on Annual Accounts of Pension Funds had been issued. FME issues rules on the structure of annual accounts, the contents of individual items on the balance sheet, the statement of changes in net assets for the payment of pensions, the cash flow statement, explanations and the assessment of individual items pursuant to Article 40(5) of The Pension Act, No. 129/1997. The previous Rules No 55/2000 had not been updated for some time, even though amendments had been made to the Act on Annual Accounts after they were issued.

#### FME issues Guidelines on the Activities of Index Funds and UCITS ETF's

On 21 April 2015, FME announced on its website that Guidelines on the Activities of Index Funds and UCITS ETF's had been issued.

#### Change in the legal form of Nordfjord Savings Bank ses.

On 16 April 2015, FME approved the merger of Nordurland Savings Bank ses. and Austurland Savings Bank hf. and in conjunction with the merger the legal form of Nordfjord Savings Bank ses. was converted from a private non-profit institution to a public limited company.

#### Eligibility to own a qualifying holding

On 16 April, FME concluded that the companies Fossar Finance ehf., H3 ehf. and Kormákur Invest ehf. were eligible to own a qualifying holding in the securities broker Fossar Markets hf.

## Results of IMF's audit on FME compliance with the core principles for effective banking supervision

At the beginning of September 2014, IMF published on its website the results of the fund's audit on FME compliance with the 29 core principles for effective banking supervision; the Basel Core Principles issued by the Basel Committee on Banking Supervision in 2012. The fund's audit was conducted in the first half of 2014 and was discussed in an insert in the last FME Annual Report. The IMF results were, compliant with seven of the principles, all essential criteria were met, and largely compliant with nine of them. Thirteen principles were materially non-compliant.

On the one hand, the recommendations for corrective action included in the IMF audit concerned aspects of FME activities and, on the other hand, aspects concerning governance infrastructure including FME's statutory powers. The recommendations comprise five main groups:

#### Corrective actions requiring amendments to law

The issues in question require amendments to Act No 87/1998 on Official Supervision of Financial Activities and Act No 161/2002 on Financial Undertakings. The issues concerning Act No 87/1998 are, in particular: Delegation of tasks and collaboration, independence of authorities supervising financial markets, guidelines, risk-based supervision and prudential requirements and regulatory powers. The issues concerning Act No 161/2002 are: Capital buffers, liquidity supervision, FME's recourse pursuant to Temporary Provision VI, risk-based supervision, prudential requirements, concentration risk, related party transactions and external auditors. FME informed the Ministry of Finance and Economic Affairs of IMF's recommendations concerning the above-mentioned aspects in October 2014. The Ministry is currently working on transposing EU Directives and Regulations on the financial market and involve most of the above-mentioned issues. In particular CRD IV/CRR and BRRD.

## Issuance of rules/guidelines addressing regulated entities concerning various risk factors in their activities

FME is working on preparing to issue rules and guidelines addressing regulated entities concerning various risk factors in the activities of financial undertakings. The work is mostly based on EBA guidelines.

#### That the implementation of risk-based supervision be concluded

FME is working on implementing risk-based supervision in accordance with a prepared implementation plan. Regulated entities are categorised into impact groups, based on an assessment of what consequences to financial stability and consumers' interests would result from cease of operations in the relevant entity's operations. Work is ongoing on preparing detailed procedures for assessing specific risk factors in the activities of financial undertakings. Work has also begun on designing a computer system intended to maintain risk-assessment results and to provide an overview of risk from regulated entities' activities.

## That FME adopt more detailed internal operating procedures concerning principles of supervision of specific risk factors in the activities of regulated entities

FME is working on preparing detailed operating procedures for the Authority's employees concerning principles of supervision of specific risk factors in the activities of financial undertakings The operating procedures will take into account those Rules and Recommendations FME is preparing for issue as discussed above.

## That FME continue developing a policy of continuing education and human resources with the objective of encouraging employees' professional growth and that the Authority retain employees

FME has worked on further development of the human resources policy. That work is in the final stage. And, work is ongoing on the definition of employee positions and the required education and experience as well as work that is ongoing on identifying educational needs.

#### 3.2 Summary of decisions and transparency notifications from 01 May 2014 to end of April 2015

**2 May 2014:** Conclusion of an examination on aspects of the activities of the Lífeyrissjóður starfsmanna ríkisins (Pension Fund for State Employees)

**og May 2014:** Conclusion of an examination of the investments of the Lífeyrissjóður hjúkrunarfræðinga (Pension Fund for Nurses)

16 May 2014: Conclusion of an examination of the lending of General Pension Fund to individuals
26 May 2014: Revaluation of whether Icelandic Securities Depository hf. satisfies international recommendations on secure securities settlement

**12 June 2014:** Transparency notification concerning comments on the business practices of Vörður tryggingar hf.

**7 July 2014:** Amicable settlement for the infringement of Sæness ehf. of Article 40 of Act No 161/2002, on Financial Undertakings

*9 July 2014:* Amicable settlement for the infringement of Marel hf. of Article 122 of Act No 108/2007 on Securities Transactions

**1 September 2014:** Conclusion of an examination of the lending of the Lífeyrissjóður bankamanna (Bank Employees' Pension Fund) to individuals

**1 September 2014:** Amicable settlement for the infringement of Eik fasteignafélag hf. of article 122 of Act No 108/2007

*9 September 2014:* Conclusion of an examination on certain aspects of the activities of Festa Pension Fund

30 September 2014: Lýsing hf. submits to FME requirements for disclosure to clients

3 October 2014: Conclusions of an examination of the credit portfolio of Landsbankinn hf.

**23 October 2014:** Amicable settlement for the infringement of N1 hf. of Article 87 of Act No 108/2007 on Securities Transactions

**31 October 2014:** Conclusion of an examination of the investments of the Lífeyrissjóður tannlæknafélags Íslands (Dentists' Pension Fund)

**6 November 2014:** Amicable settlement for the infringement of Fjarskipti hf. of Articles 122 and 128 of Act No 108/2007 on Securities Transactions

**10 November 2014:** Conclusion of an examination of Arion bank hf., Íslandsbanki hf. and Landsbankinn hf. on certain aspects of actions to combat money laundering and terrorist financing

**13 November 2014:** FME has deemed Straumur Investment Bank hf., Sigla ehf. and Ark ehf. eligible to own a qualifying holding in MP Bank hf.

**20 November 2014:** Conclusion of an examination of the lending of Lífsverk Pension Fund to individuals

29 January 2015: Conclusions of an examination of the credit portfolio of HFF

**27 February 2015:** Conclusion of an examination of the lending activities of MP Bank hf.

13 March 2015: Conclusion of an audit of the risk management of several pension funds

**31 March 2015:** Amicable settlement for the infringement of FAST-1. slhf. of Articles 122 and 128., cf. articles 129 and 130 of Act No 108/2007 on Securities Transactions

**29 April 2015:** Amicable settlement for the infringement of X of Article 3 of Act No 95/2008

#### 3.3. Summary of issues of Fjármál and articles from 1 May 2014 to end of April 2015

FME's electronic journal, Fjármál (i.e. financial affairs), is now in its fourth year of publication. Specialists at the Authority contribute the content. Every issue of Fjármál is available on FME's Icelandic website under the heading útgefið efni under vefrit FME (i.e. published material and FME's web journal). An overview of articles in the three issues published after the last annual meeting follows.

#### Fjármál July 2014

Professional investor funds' listed bond issues Hörður Tulinius, specialist with On-Site Inspections and Securities

#### Supervisory authorities' independence

Margrét Sigurðardóttir, lawyer with the Office of the Chief Legal Counsel

Book review: The Bankers' New Clothes: What's Wrong with Banking and What to Do about it

#### Fjármál November 2014

Is compulsory membership to a specific pension fund justifiable? Gunnar Þór Ásgeirsson, lawyer with Off-Site Supervision

EBA is preparing new guidelines for the Supervisory Review and Evaluation Process Kristján Ólafur Jóhannesson, specialist with Oversight

#### Do insurance companies impact financial stability?

Sigurður Freyr Jónatansson, specialist with Oversight

Jean Tirole, Nobel Prize winner in Economic Sciences 2014: An influencer for financial market regulation and supervision Jón Þór Sturluson, Deputy Director General of FME

International conference of financial supervisory authorities in Iceland

#### Book review: House of Debt: How They (and You) Caused the Great Recession, and How We Can Prevent It from Happening Again

Einar Jón Erlingsson, specialist with Oversight

#### Fjármál April 2015

#### **Eligibility assessment for board members and directors** Arndís Kristjánsdóttir and Helga Rut Eysteinsdóttir lawyers with Off-Site Supervision

#### Are pensions in Iceland adequate?

Björn Z. Ásgrímsson, pension fund risk analysis specialist

#### **New rules of law for insiders and the treatment of inside information** Páll Friðriksson, Manager of Securities Market Regulation

### Are the assessment presumptions for the capital requirements of Icelandic banks sufficiently sound? Guðmundur Örn Jónsson, specialist with Oversight

Why conduct financial supervision?

Photographs from a conference



# 4. Entities regulated by FME

#### 4. Entities regulated by FME

#### 4.1 Number of FME regulated entities

Categories of regulated entities at year-end	Notes.	31/12/2011	31/12/2012	31/12/2013	31/12/2014
Subject to licence or operating under specific					
Commercial banks		5	4	4	4
Savings banks		10	9	8	7
Credit undertakings		8	6	6	6
Housing Financing Fund (HFF)		1	1	1	1
Deposit departments of co-operative societies		1	1	1	1
Securities dealers		13	11	10	9
Securities brokers		2	2	2	2
Fund management companies	1)	9	10	9	10
Institutional investor funds - legal entities		3	4	7	9
Stock exchanges		1	1	1	1
Securities depositories		1	1	1	1
Pension funds	2)	33	32	27	26
Insurance companies		13	13	13	12
Insurance brokers		6	11	11	9
Entities with debt collection licenses		4	4	5	6
Payment institutions			1	1	1
Currency exchange establishments					1
Guarantee funds		2	2	2	2
Total		112	113	109	108
Other regulated entities:					
UCITS (not legal entities)	3)	56	56	57	53
Investment funds (not legal entities)	3)	24	28	44	48
Institutional investor funds (not legal entities)	3)	28	43	63	65
Custodians of private pension savings	4)	18	15	14	13
Issuers of listed shares		12	15	18	17
Issuers of listed bonds		47	49	57	60
Agent of foreign payment institution			1	1	1
Holding companies	5)	7	12	12	10
Financial undertakings in winding-up proceed- ings		11	14	15	11
Total		299	346	390	386

1) Furthermore, see the number of UCITS and investment funds and institutional investment funds below in the table.

2) Many pension funds have more than one division. By including the divisions, the number of pension funds would increase by approximately

50 for each year shown in the table.

3) Funds that are not legal entities but operated by fund management companies. See the number of management companies above in the

table. Several UCITS and investment funds have more than one division. The number of divisions is reflected in the figures in the table.4) Commercial banks, savings banks, and two foreign custodians of private pension savings. Excluding the two foreign custodians of pension savings, all included in the above totals.

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

#### 4.2 Activities of foreign entities in Iceland

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

	30/6/11	30/6/12	31/12/13	31/12/14
Foreign banks (credit and financial institutions)	222	224	239	254
without establishments				
Foreign banks without establishments				193
Foreign electronic money institutions without				38
establishments				
UCITS (no, of divisions in parentheses)	47 (367)	53 (352)	56 (370)	65 (410)
Securities dealers/brokers (Investment firms)	2,113	2,020	2,148	2,280
Insurance companies with establishments	2	2	2	2
Insurance companies without establishments	405	377	381	352
Insurance brokers and insurance agents	5,158	4,990	5,030	5,223

