ANNUAL REPORT FINANCIAL SUPERVISORY AUTHORITY 2014

FJÁRMÁLAEFTIRLITIÐ
THE FINANCIAL SUPERVISORY AUTHORITY, ICELAND

Annual Report – Financial Supervisory Authority 2014

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Contents of the Annual Report

The substantial discussion in the Annual Report of the Financial Supervisory Authority (FME) for 2014 primarily covers the period from 1 May 2013 until 30 April 2014. 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 2013 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. Various information on the financial market and the arrangement of official supervision of financial activities is also contained on FME's website.

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 2014, the Board of Directors comprises Halla Sigrún Hjartardóttir, Chairman of the Board as of 20 December 2013, Margret Einarsdóttir, assistant professor, Vice-Chairman, Arnór Sighvatsson, Deputy Governor of the Central Bank, appointed by the Central Bank of Iceland. Alternate members are Halldór S. Magnússon, formerly a managing director, Ástríður Jóhannesdóttir, Manager of the National Registry's Legal Department, and Harpa Jónsdóttir, Deputy Director at the Central Bank of Iceland.

During the period from 1 May 2013 to 30 April 2014, in addition to the above-mentioned, Aðalsteinn Leifsson, assistant professor and Chairman of the Board, served on the Board of FME, until he resigned from the Board on 1 October 2013.

FME Management

Unnur Gunnarsdóttir, Director General

Jón Þór Sturluson, Deputy Director General

Heads of divisions

Off-Site Supervision

Halldóra Elín Ólafsdóttir

Oversight

Lilja Rut Kristófersdóttir

On-Site Inspections and Securities

Sigurveig Guðmundsdóttir

Operations and Finance

Ingibjörg Sigrún Stefánsdóttir

Information Technology

Jón Andri Sigurðarson

Chief Legal Officer

Anna Mjöll Karlsdóttir

Human Resources

Árni Ragnar Stefánsson


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KILROY
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FREE HERE

From the Director General

Financial undertakings, such as banks, insurance companies, and pension funds, bear a greater corporate social responsibility, as a rule, than other undertakings. Their boards of directors and managing directors are responsible for their business decisions and activities, including risk taking and compliance with the law. The authorities cannot prevent the failure of undertakings in all circumstances. However, they can contribute to increased resilience for the undertakings and, with the right remedies, limit or mitigate the effect of their failure. The objective of the legal framework and supervision is to restrict the risk taking of the undertakings and mitigate biases in financial incentives, with a view to protecting customers and taxpayers.

Consequently, FME considers effective supervision of risk in undertakings' activities in the financial market no less important than traditional supervision of compliance to laws and regulations. A strong liquidity position and ample equity capital can, under no circumstances, suffice for a financial institution in the absence of the requisite risk management. It is important that FME can prioritise tasks, in order to protect the public from those events that are likely to have the largest consequences. Furthermore, it is important for FME to have knowledge and understanding of the main operational risk factors for financial institution and the legal authority to take orderly and efficient actions, both to protect financial stability and taxpayers' money.

The international focus for the execution of financial supervision has changed and FME has participated in that process. Instead of simply looking in the rear-view mirror, there is an increased focus on the early identification of problems and taking appropriate risk-mitigation actions – before the economy comes to serious harm.

In recent years, FME has carried out a reform program specifically designed to strengthen the Authority's infrastructure. One of which is the introduction of a new focus in supervision with risk-based supervision. The essence of risk-based supervision is the allocation of human resources and funds in the most efficient way for the benefit of the general public. This involves a systematic approach to assessing the risk regulated entities pose to the economy and their customers, in the event of these entities experiencing operational problems. That includes FME categorising regulated entities by the macroeconomic impact foreseeable as a result of interruptions in their activities. This is referred to as impact assessment. Therefore, the impact categorisation of a regulated entity will determine the implementation of its supervision. In addition, risk-based supervision involves a systematic appraisal of risk factors in the activities of regulated entities. The probability of each individual factor resulting in substantial interruptions in activities or stoppages is subsequently assessed. If risk assessment results exceed defined limits, FME takes appropriate risk mitigation measures.

Risk-based supervision can be said to consist of three components. The first is reactive supervision It often involves responses to known risk factors. The second is proactive supervision, where issues, we know from experience to be causes of future problems, are reviewed. The third is forward-looking supervision. In forward-looking supervision, the focus will be on identifying new previously unknown risk factors in the activities of undertakings.

In all the above-mentioned instances, the objective is identifying, assessing, and mitigating risk for those entities that have the most impact on financial stability and consumers. That means we must accept that, with regard to supervision, not all regulated entities are equal.

An important precondition for preventing damage, or minimising its consequences, is having a legislation and an institutional framework that best meets these objectives. An important step in that direction was taken with the enactment of laws on a financial stability council with the objective of supporting the identification of, and response to, systemic risk and, to this end, ensure that the authorities had the necessary access to information. In recent years, FME and the Central Bank of Iceland have strengthened their collaboration, with a focus on identifying risk factors in the financial market. The establishment of a formal financial stability council, chaired by the Minister of Finance, is also conducive to strengthening that collaboration.

However, more needs to be done. This institutional framework is missing an important pillar. That pillar is a permanent body of legislation for the recovery and resolution for financial institutions, in order to protect the general public and taxpayers from harm, in the event of their failure. The focus, in this regard, has principally been on banking activities. Efforts have been made to protect the interests of depositors and safeguard them, in the event of a bank facing operational difficulties, against the effects of investment banking activity losses being transferred to commercial banking activities.

Legislation in other subject areas is also important. Recently, FME has been dealing with the consequences of the failure of the insurance company European Risk Insurance Company hf. (ERIC). The Board of FME withdrew the company's operating licence, on 12 February this year, as they didn't fulfil the solvency requirements. Thereafter, a three-member resolution board was appointed to the company. ERIC was granted an operating licence in Iceland in 2004; however, the company's principal operations have been in the UK market, where it paid into the Financial Services Compensation Scheme – FSCS. The ERIC case has revealed the absence of an Icelandic fund with the role of settling the underwriting liabilities of insolvent insurance companies and ensuring the interests of insurance policy holders and the insured.

I addressed a similar case at FME's annual meeting in 2013, where I pointed out that the legislative framework for the activities of the domestic pension funds was incomplete as regards issues such as investments, risk management, and the responsibility of management in the event of non-compliance with law. This is of a particular concern under the present circumstances, as the funds need to be invested within the regime of capital controls and with the concurrent risk of forming bubbles.

In this annual report, we discuss the health of the Icelandic financial system. The contents include that the total assets of credit institutions at year-end 2013 amounted to ISK 4,141 billion. Thereof, the total assets of the commercial banks amounted to ISK 3,016 billion, and have not changed significantly from the previous year. The capital base of the three large commercial banks at year-end 2013 amounted to ISK 595 billion, compared with ISK 550 billion at year-end 2012, an increase of more than 8% year-on-year. In 2013, the profit of the three largest commercial banks amounted to almost ISK 64 billion, compared with ISK 66 billion in 2012.

The restoration of the Icelandic equity market continued in 2013. Three companies were added to the NASDAQ OMX Iceland All-Share Price Index and equity turnover almost tripled year-on-year, from ISK 88.5 billion in 2013 to more than ISK 251 billion in 2013. Bond turnover decreased for the second consecutive year, decreasing from ISK 2,323 billion in 2012 to ISK 1,822 billion in 2013. At year-end 2013, the market capitalisation of listed companies on the NASDAQ OMX Iceland All-Share Price Index was more than ISK 534 billion, compared with ISK 363 billion at the beginning of that year. The increase of 47.1% is due to new companies being admitted for trading and price increases, for instance, the market capitalisation of some companies more than doubled during the year.

In 2013, the net assets of Icelandic pension funds and private pension fund custodians increased significantly, based on preliminary numbers, or by almost ISK 260 billion. The estimated total assets at year-end 2013 are approximately ISK 2,800 billion. The estimated division of these assets is ISK 2,400 billion in pension funds' mutual insurance divisions, ISK 260 billion in their private pensions and approximately ISK 150 billion in other private pension custodians. The increase in private pensions has, to some extent, slowed due to pay-outs based on a temporary statutory provision that has been extended each year since 2009.

Assets of UCITS and investment funds amounted to more than ISK 350 billion at year-end 2013 having increased by over ISK 28 billion during the year, or by about 8%. The total assets of institutional investor funds amounted to over ISK 300 billion with net assets amounting to ISK 141 billion.

At year-end 2013, the total assets of all insurance companies in Iceland amounted to ISK 163 billion. They increased by ISK 10 billion from the previous year. The companies' equity assets have increased; the percentage of equities in the asset portfolios increased from 12% to 15% during 2013. The percentage of bonds in portfolios decreased from 48% to 47% during the same period. During 2013, the profit from the operations of non-life insurance companies was lower than in the previous year. That applies to both insurance operations and financial activities. However, they are considered historically good results. In recent years, operations of life insurance companies have been characterised by stability. Their profit has increased slightly year-on-year, the increased profits can be attributed to financial operations. Profit from life insurance activities continues to decrease.

At this time, the financial system is characterised by stability. However, we are aware that there is pressure for that to change. Activities are limited by the capital controls, the ownership of the large commercial banks is still transitional, there is uncertainty on the impact from the winding-up of failed financial undertakings, the future liabilities of some pension funds exceed their assets, and their size, proportional to the economy, poses many challenges.

Currently, targeted efforts are on-going to strengthen the framework, based on international models, to promote financial stability, in part due to participation in the European Economic Area. This involves an incredible amount of new rules, which are an unavoidable burden on the activities of banks and other regulated entities and, therefore, affect their operations. One of the many challenges ahead is to ensure that the Icelandic legal framework fulfils international requirements and criteria while, at the same time, taking the small size of the companies and the administration into account. It is also of concern that numerous and complicated burdensome rules encourage shadow banking more than can be accepted. It is hard to envisage how the Icelandic financial system can regain the necessary trust unless the Icelandic authorities have the ambition and stamina to build the framework in accordance with best practises and standards at any time.

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. That includes fit and proper assessment of board members and managing directors, data analysis of individual regulated entities' financial position, issuing operating licences and notifications about qualifying holdings, and monitoring that regulated entities operate in accordance with proper and sound business practices. The division is comprised of *Financial Supervision*, *Legal Supervision*, and *Special Legal Issues*.

Financial Supervision

During the reference period of the report, specific examinations of basic information in capital reports (COREP), information on fund management companies' websites, and the breakdown of investments for UCITS and investment funds fell under the purview of *Financial Supervision*. *Financial Supervision* took part in the Supervisory Review and Evaluation Process (SREP) of the commercial banks, six savings banks, and two securities dealers. As part of the SREP process, FME assesses capital adequacy with regard to the risk composition of the financial undertaking concerned. At the end of last year, responsibility for the execution of the SREP process was transferred to Off-Site Supervision. During the year, Landsbankinn hf. was granted permission to issue covered bonds. Processing related to financial undertakings' temporary ownership in non-financial undertakings, and monitoring that banks sell such ownership interest in companies, is also under the purview of Off-Site Supervision. Eight special examinations of lending and investments were carried out at pension funds and insurance companies, risk management of every pension fund was examined, life insurance companies' outsourcing contracts were examined, and internal audit of the three largest insurance companies was examined. *Off-Site Supervision*, in conjunction with *Legal Supervision*, has been examining pension funds' investments in institutional investor funds that have been increasing recently. In addition, minutes from the boards of pension funds, insurance companies, securities dealers, and management companies were reviewed.

Legal Supervision

The tasks of Legal Supervision included issuing a collection licence to Inkasso ehf. and granting permissions for the mergers of Svarfdaelir Savings Bank with Nordurland Savings Bank ses. and Audur Capital hf. with Virding hf. The operating licence of European Risk Insurance Company hf. (ERIC) was withdrawn as the company did not comply with the minimum solvency provisions of Act No 56/2010 on Insurance Activities and had surrendered its licence to operate. The operating licence of Landsvaki ehf. was also withdrawn as the company had ceased activities and surrendered its' licence to operate. FME also accepted the surrender of the operating licence for Negotium hf.

Specific examinations were also carried out on actions to combat money laundering and terrorist financing at all the commercial banks and four credit undertakings. In addition, the collection activities of Dromi hf. were examined and it was found that the company's collection was in breach of the Act on Debt Collection. Furthermore, specific examinations were carried out at many companies with a view to find out if they exercised activities subject to license without authorisation. During the period, FME has found it necessary, in some cases, to seek the resignation of board members of regulated entities that did not comply with legal eligibility requirements.

Special Legal Issues

The tasks of *Special Legal* Issues included work on rules on proper and sound business practices of financial undertakings and related guidelines. In addition, work has been carried out on rules on large exposures of financial undertakings, rules on the adjusted solvency margin of an insurance undertaking, and rules on the supplementary supervision of financial conglomerates. FME has issued the above-mentioned rules. *Special Legal Issues* was also involved in preparing the issue of two regulations on offers of securities to the public as well as two regulations concerning increased disclosure to investors who invest in UCITS, and their standard notifications. Work has been carried out on guidelines for evaluating relationships between entities that relate to the rules on large exposures and a review of the guidelines on the information systems of regulated entities. Furthermore, work has been conducted on nine discussion documents regarding rules and guidelines FME has issued.

Specific examinations include an examination of how life insurance companies comply with disclosure requirements under the Act on Insurance Contracts, an examination of Sjova's STOFN service, an examination of Dromi's practices during the revocation of loan recalculations and the release of liens, and an examination of the business practices of Lysing hf. *Special Legal Issues* have a comprehensive overview of all tasks related to regulation and the issue of FME guidelines and keep a record of all Directives and Regulations issued within the EEA on the financial market. Guidelines from European regulatory agencies have been mapped out along with technical standards that need to be transposed. Examples of particular acts that have to be transposed in the coming years include CRD IV, Solvency II, AIFMD, EMIR, and a regulation on short selling. 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.

FME is concerned with consumer issues on the financial market. To this end, employees of *Special Legal Issues* monitor consumer protection committees within European supervisory bodies, follow national discourse on consumer interests, as well as accepting suggestions and enquiries from consumers. Suggestions and enquiries are accepted both by email and through a consumer hotline that is open twice a week. These frequently result in specific and general audits being carried out on individual aspects of regulated entities' activities. The results of such audits can take various forms, e.g. comments from the Authority, demands for rectifications, or administrative fines in the case of major shortcomings in business practices. In 2013, a total of 264 enquiries and suggestions were received from consumers on all of FME's markets. It is worth noting that legal proceedings before the Reykjavik District Court are currently on-going where a regulated entity initiated legal proceedings against FME to annul a decision relating to consumer interests on the financial market.

1.2 On-Site Inspections and Securities

On-Site Inspections and Securities is comprised of On-Site Inspections, Securities Market Regulation, and Investigations.

On-Site Inspections

The role of *On-Site Inspections* is to examine the activities of regulated entities. *On-Site Inspections* may carry out examinations of any aspect of a regulated entity's activities. 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 regulated entities' activities. Examples of on-site examinations in the previous year include an overall examination at a pension fund and a management company, an examination of a bank's loan portfolio, and a thematic examination concerning insurance companies' risk management. Conclusions of on-site examinations are generally published on FME's website in the form of transparency announcements.

Securities Market Regulation

The role of *Securities Market Regulation* is to monitor trading and activities on the securities market.

Tasks of *Securities Market Regulation* include, for instance, monitoring investor protection, mandatory bid requirement, market abuse, insider misconduct, treatment of inside information, reviewing and approving issuers' prospectuses and those issuers comply with their disclosure requirement. The number of financial instruments listed on regulated securities markets has increased substantially in recent half-years. That has resulted in an increased workload in reviewing and approving prospectuses. 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, insider trading notification requirements, and inside information disclosure.

Investigations

FME is obliged by the Acts on Financial Undertakings, Securities Transactions, and Insurance Companies to carry out preliminary investigation of alleged infringements of those Acts. *Investigations* bear the brunt of that task. In the event an investigation indicates reasonable suspicion of a violation of special legislation under the purview of FME, the matter is either referred for further investigation at the Office of the Special Prosecutor 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.

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's* tasks include communicating information on market risks and conditions and recommending amendments to rules, and developing rules and guidelines for risk management in the financial market. Furthermore, the division also develops, based on risk assessment, the methodology for setting priorities in supervision.

Oversight has been involved in the SREP process for financial undertakings, the objective of which is to determine how much capital financial undertakings need to hold to cover their risks and what rectifications are required in their activities. *Oversight* has, jointly with On-Site and Off-Site Supervision, executed SREP audits of the four commercial banks, savings banks, and the Housing Financing Fund. Moreover, a variety of specific analyses are performed on various aspects and elements of the financial market. *Oversight* conducted an examination of the loan portfolio of one of the commercial banks, comparable with previous examinations of other commercial banks.

Oversight is involved in various activities related to the EU CRD IV/CRR Directive and Regulation that transpose the international Basel III standard on capital adequacy and liquidity requirements of financial undertakings. The changes relating to CRD IV/CRR include a redefinition of financial undertakings' own funds in order to improve the quality of capital, increased requirements for the amount of capital with the use of capital buffers, issues relating to liquidity, common reporting in Europe, and various delegated acts on specific risk factors in the activities of financial undertakings. Tasks have included involvement with the draft transposing the CRD IV Directive, review work, revising the translations of the Translation Centre of the Ministry for Foreign Affairs, and studying of technical standards. On 1 January 2014, the CRD IV/CRR entered into force 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 2015.

Oversight, in close cooperation with the Central Bank of Iceland, worked on the introduction of liquidity targets and liquidity reports. In November 2013, The Central Bank of Iceland issued new rules on liquidity that entered into force on 1 December 2013, adapted to the above-mentioned. In substance, the new liquidity rules and liquidity targets are based on the international model of the Basel Committee on Banking Supervision. They assume that credit institutions have a stock of high-quality liquid assets to meet their liabilities for the next 30 calendar days without access to new capital and under substantial market stress. Work on the introduction of rules on stable long-term funding (NSFR) is currently on-going jointly with the Central Bank of Iceland.

Oversight is also preparing for the introduction of the EU Solvency II Directive, which will transform the operating environment of insurance companies. In recent half-years, uncertainty has existed on the entry into force of the Solvency II Directive for insurance markets, due to a disagreement within the EU on the treatment of insurance with long-term guarantees on return. In November 2013, this was resolved with an agreement between the European Parliament and the Council of Ministers on entry into force on 1 January 2016, two years later than had previously been foreseen. The Member States are expected to have transposed the Directive by 31 March 2015; FME is heading a committee transposing it in a draft for new legislation on insurance activities.

Risk-based supervision, which Oversight is currently working on transposing, is a supervisory procedure where regulated entities are categorised based on impact assessment and the main risk factors in their operations are evaluated systematically. Risk-based supervision is based on prioritising supervision in subject areas that are very risky and where the potential consequences of setbacks are great. *Oversight* has lead discussions relating to increased and more targeted dialogue between accountants and FME, including matters relating to accounting rules. Moreover, work has been conducted on the development of various rules, including rules on the execution of risk management, rules on supplementary supervision of financial conglomerates, rules on the annual accounts of pension funds, rules on financial undertakings, rules on securitisation, and rules on the risk exposure of financial undertakings.

Oversight is involved in diverse foreign cooperation, including Nordic cooperation of financial supervisory authorities and collaboration with various international institutions. In addition, the division 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.

Oversight supervises the implementation of those aspects of FME’s cooperation agreement with CBI that involve financial stability. The aim of the agreement is to promote a sound, effective, and secure financial system in Iceland, including payment and settlement systems. The first joint meeting on financial stability, pursuant to the collaboration agreement, was held in spring 2011. Generally, the Director General of FME and the Governor of the Central Bank, along with key specialists from each institution, meet biannually in connection with meetings on financial stability, as well as conducting other meetings. The objective of the meetings on financial stability is to assess the scope of systemic risk in the Icelandic financial system. In conjunction with the cooperation, risk assessment teams operate on analysing and assessing systemic risk, credit risk, liquidity and funding risk, market risk, and the financial infrastructure. The key conclusions of the meetings on financial stability are presented to representatives of the central government.

In late 2013, Oversight, in collaboration with the Central Bank of Iceland, submitted the four commercial banks and the Housing Financing Fund to a harmonised stress test that included assessing the impact of the sudden lifting of the capital controls. The data from the stress test is being processed in continued cooperation between parties.

Risk-based supervision

In recent years, quality improvement projects have been carried out specifically designed to strengthen FME’s infrastructure. One of which is the implementation of risk-based supervision. Its core principle is to use allocated human resources and funds in the most efficient way to benefit consumers and the Icelandic economy. That involves a more targeted approach to assessing regulated entities’ risk based on the impact they have on the economy and consumers if they experience operational problems or their activities are interrupted in other ways.

Impact assessment is an essential aspect of risk-based supervision. Regulated entities are categorised into impact groups, based on an assessment of what consequences to financial stability and customers' interests would result from stoppages in the relevant regulated entity's operations. The scope of supervision for the relevant entity is determined by the impact categorisation. 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 stoppages. Risk assessment is thus a part of risk-based supervision.

1.4 Operations and Finance

Operations and Finance supervise finance, operations, quality and security control, information and records management, as well as general office administration. Moreover, *Operations and Finance* supervise two complaints committees hosted by FME.

The responsibilities of *Operations and Finance* include planning and budgeting for the Authority's operations, financial and cost control, and keeping records for financial accounting and payroll services, collections and preparing annual accounts. Moreover, the division is in charge of adopting and developing the Authority's procedures and it supervises safety in the broad sense of the term. The division is also responsible for establishing and developing a policy for filing information and documents.

The primary role of *Operations and Finance* is supporting the other divisions of the Authority and providing a methodology and a framework for the above-mentioned elements in order to increase operational efficiency.

In recent half-years, coordination of the Authority's financial records has been changing as responsibility has increasingly been transferred to managers of individual divisions and the central government's accounting system, Orri, has been adopted simultaneously. Moreover, an electronic acceptance procedure has been introduced and work on the introduction of e-invoice acceptance is on-going. In early 2014, collaboration was started with the Financial Management Authority (FJS) on bookkeeping and payment services. It results in streamlining the activities of the division as well as increasing security and transparency in the Authority's operations.

One of FME's quality improvement projects, included in the preceding years' operational budgets, is the development of the Authority's information and document management system, as that had been, among others, criticised in the report of Althing's Special Investigation Commission on the processes leading to the collapse of the Icelandic banks in 2008. A decision was made to change the priorities and update the existing system, when it became clear that FME would not receive the EU's IPA grant. Therefore, the update of the system is on-going and procedures are being amended at the same time.

Another FME quality improvement project involves the preparation of the introduction of the documented description of the organisation of the Authority and its procedures as well as follow-up. Targeted work has been conducted on documenting procedures and introducing processes and it has mostly concluded.

The Authority's objectives and benchmarks have been specified. The objectives are based on prepared scenarios and they describe the future vision of the managers. The scenarios relate to management, procedures, data gathering, information dissemination, supervision, and confidence.

Complaints committees

In 2013, the number of cases before the Complaints Committee on Transactions with Financial Undertakings was 107, compared with 202 cases in 2012. Therefore, the reduction in cases is substantial, as never before 2012 had there been more cases. However, the number of cases in 2013 was far above the average for the preceding years. As of 2014, the number of cases has again increased, mostly due to legislative changes and the statute of limitations for exchange rate indexed loans. Until 2009, the average number of cases was 21 per year.

The number of cases before the Insurance Complaints Committee in 2013 was more than 400, having decreased slightly year-on-year. Until 2009, the average number of cases was 265 per year.

The supervision and coordination of the complaints committees and communications with financial and insurance undertakings are currently electronic and, therefore, the execution is easier than before and savings in photocopying and postage are great.

One-third of employees have a transportation agreement

In June 2013, FME introduced a transportation policy with the objective of displaying corporate social responsibility and promoting the use of environmentally friendly and efficient modes of transport for employees travelling to and from work and to meetings outside the workplace.

Subsequently, employees were invited to sign a transportation agreement obliging them to use environmentally friendly modes of transport to and from work for an average of 60% of the time. It is safe to say that the employees accepted it enthusiastically. Immediately, in the first 24 hours, almost 20 employees had signed the transportation agreement. At the end of April 2014, 41 employees had an agreement in force, around one-third of employees.

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, in accordance with Act No 99/1999 on Payment of Cost due to Official Supervision of Financial Activities. The following table shows a breakdown of the working hours FME devoted to each main category of regulated entity in 2012 and 2013:

Relative distribution of FME working hours by category of regulated entity*)	**2012**	**2013**
	%	%
Credit institutions	56.7	55.0
Insurance companies and insurance brokers	8.1	12.8
Pension funds	18.8	14.4
Fund management companies	8.5	6.9
Securities dealers and securities brokerages	3.6	3.5
Equity and bond issuers	2.6	4.5
Others	1.7	2.9
	100.0	100.0

*) Work on investigations of failed financial undertakings, which was concluded in February 2013, is not included in the categorisation.

FME's time sheet records also enable analysis of activities by type of task or subject. Such analysis of hours spent in 2012 and 2013 is as follows:

Relative distribution of FME working hours among its main tasks	2012	2013
	%	%
Supervisory tasks	64.8	59.7
Continuous off-site financial supervision	22.2	26.1
On-site examinations	8.1	9.0
Other supervisory activities	34.5	24.6
Regulation	4.1	4.4
General operations	29.3	32.2
Foreign cooperation/communications	1.8	3.7
	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. This also includes most of the investigative work in connection with the banking collapse that concluded in February 2013. 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.

Operations in 2013 and estimates for 2014

According to FME's annual accounts for 2013, operating expenses, including assets purchased during the year, totalling ISK 1,888.1 million and total revenue, including financial income, amounted to ISK 1,824.7 million, of this amount, supervision fees totalled ISK 1,642.7 million. Consequently, there was an ISK 63.4 million deficit to FME's operations in 2013. Equity at year-end was ISK 559.5 million, compared with ISK 622.9 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, in accordance with Act No 99/1999 on Payment of Cost due to Official Supervision of Financial Activities. In recent years, the Authority's operating expenses have been under budget and therefore, equity has accrued in excess of the required legal reserve. The supervision fee for regulated entities has been decreased for two consecutive years in order to satisfy requirements for decreasing equity and the Authority operates with a deficit in order to meet the objective of decreasing equity to the level provided for by law.

According the Authority's 2014 operational budget, which was submitted to the Minister of Finance and Economic Affairs in June 2013, the total expenses for 2014 are estimated ISK 2,022.9 million. According to the 2014 government budget, ISK 1,634.4 million are estimated for FME's general operations during the year, of that, ISK 1,581.4 million will be funded by the supervision fee, a 9.7% decrease year-on-year. Therefore, the estimated deficit will amount to ISK 388.5 million and equity should decrease by ISK 171 million. Accordingly, the objective of the 2015 budget will be to decrease equity by the maximum allowed by law.

2. Financial Market Soundness

2.1 Credit market

At year-end 2013, four commercial banks, nine savings banks, and six credit undertakings operated in Iceland, in addition to the state-owned Housing Financing Fund (HFF), or 19 credit institutions. At year-end 2013, the total assets of credit institutions amounted to ISK 4,141 billion; thereof the total assets of the commercial banks amounted to ISK 3,016 billion, and have not changed significantly from the previous year.

Solvency[1]

At year-end 2013, the capital base of the three large commercial banks amounted to ISK 595 billion, compared with ISK 550 billion at year-end 2012, an increase of 8.2% year-on-year. At year-end 2013, the banks' combined capital adequacy ratio was 26.2%, compared with 24.8% at year-end 2012, having increased by 1.4% year-on-year. The capital adequacy ratio is mainly comprised of Tier 1 capital, approximately 91% of the total capital adequacy ratio.

Profitability

In 2013, the profit of the three largest commercial banks amounted to almost ISK 64 billion compared with ISK 66 billion in 2012. The banks return on equity after tax was 12.1% in 2013 compared with 13.1% in 2012. However, the weighted profitability of core operations[2] after tax was 7.8% in 2013 compared with 10.1% in 2012. The interest rate margin was 3% in 2013 compared with 3.3% in 2012. Operating expenses as a percentage of assets were 2.7% both years.

Liquidity and funding

At year-end 2013, the three large commercial banks' stock of high-quality liquid assets (HQLA) was ISK 555 billion, or approximately 19% of their total assets. New liquidity rules, laid down by the Central Bank of Iceland in consultation with FME, entered into force in December 2013 and are based, in particular, on international targets from the Basel Committee on Banking Supervision.[3] The Liquidity Coverage Ratios of the commercial banks are above 100%, whereas, the minimum required by supervisors is 70% as of January 2014. Stricter rules apply to liquid assets in foreign currencies. The minimum requirement will then be increased by 10% at the beginning of each year until it has reached 100% in January 2017. The requirements for liquid assets are stricter in the new liquidity rules than in the older rules and the banks hold substantial liquid financial asset in excess of the supervisors' requirements.

The proportional distribution of the three large commercial banks' funding as of year-end 2013 is comparable with the previous year. Equity is 19%, subordinated loans 2%, borrowing 18%, other liabilities 13%, and customer deposits 48%.

Standard & Poor's has assigned a BB+ rating to all of the three large commercial banks, one rank below the Icelandic state. These are the first credit ratings that the banks are assigned from an international credit-rating agency.

Both Arion bank hf. and Islandsbanki hf. have issued bonds in foreign markets. In March 2013, Arion bank hf. issued a NOK 500 million bond for three years at 500 basis points over NIBOR. The bonds of Arion bank hf. are listed on the Norwegian stock exchange. In December 2013, Islandsbanki hf. issued a SEK 500 million bond for four years at 400 basis points over STIBOR. In March 2014, the bank's issue was raised by SEK 300 million at 330 basis points over STIBOR, 70 basis points lower than the December 2013 issue. The bonds of Islandsbanki hf. are listed on the Irish stock exchange.

1 Unless otherwise stated, the following discussion mainly involves the three large commercial banks.
2 Income from core operations: Net interest income, net fee and commission income. Core operating costs: compensation of employees, administrative expenses, and depreciation and amortisation expenses.
3 http://www.bis.org/publ/bcbs238.pdf.

During the year 2013, Landsbankinn hf. prepaid about ISK 50 billion of a bond issued to the old bank thereby decreasing asset encumbrance to approximately 29% at year-end 2013. The asset encumbrance of Arion Bank hf. is similar to Landsbankinn hf., the asset encumbrance of Islandsbanki hf. is approximately 12%. According to a study[4] issued by the Bank for International Settlements in May 2013, the median asset encumbrance, based on a sample of 60 large European banks, was 28.5% at year-end 2011.

Balance-sheet size

In recent years, the total assets of credit institutions, as a percentage of GDP, have been decreasing, from 277% at year-end 2009 to 232% at year-end 2013. This is largely explained by the fact that total assets have not changed significantly while GDP has been increasing.

At year-end 2012, the total assets of the Icelandic banking industry are 173%, as a percentage of GDP, and 225% if the Housing Financing Fund is included. For comparison, the weighted average of the banking industries in the 27 EU countries, as a percentage of GDP, was 350% at the end of June 2012. It must be borne in mind that cross-border activities are substantial in most of the EU banking industry.

Credit risk and asset quality

The three large commercial banks' customer lending amounts to approximately ISK 1,871 billion, or 4.5% more than at year-end 2012 when lending was ISK 1,791 billion. If the Arion bank hf. acquisition of retail loans from Dromi hf. and Hildur ehf. is not included, lending, in real terms, decreased by approximately ISK 50 billion.

Uncertainty remains for the quality the loan portfolios of the three large commercial banks notwithstanding a decrease in household and corporate indebtedness, as a percentage of GDP, due to, among others, restructuring of their liabilities. Defaults are at historic highs and the durability of restructuring is not secure as the indebtedness of those borrowers who have completed restructuring remains high.

Housing Financing Fund (HFF)

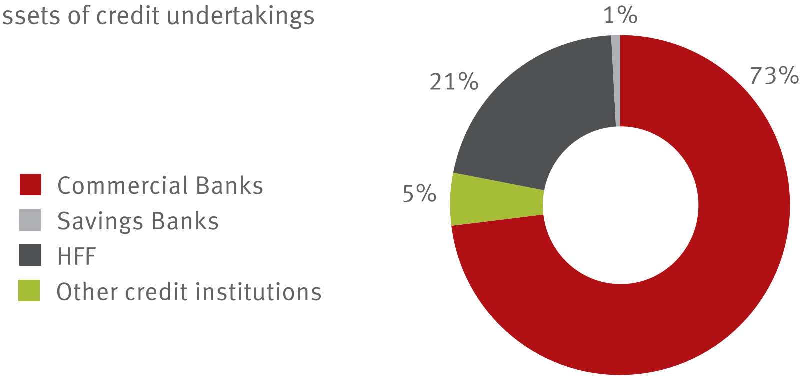
At year-end 2013, the total assets of the Housing Financing Fund amounted to ISK 863 billion, compared with ISK 876 billion at year-end 2012. The losses in 2013 amounted to ISK 4.4 billion, compared with a loss of ISK 7.9 billion in 2012. At year-end 2013, the fund's equity ratio was 3.4%. However, the fund is required to, in accordance with Article 7 of Regulation No 544/2004 on the Finances and Risk Management of the Housing Financing Fund, to endeavour to keep its equity ratio over 5%. The Fund has prepayment risk, especially in the current interest rate environment. Furthermore, the Fund's interest rate margin is only approximately 0.3% and, therefore, it remains necessary for the Treasury to continue supporting the Fund. Therefore, the Fund's difficulties are substantial and its future is uncertain.

The savings banks

During 2013, the savings banks' profit after tax amounted to ISK 136 million, compared with ISK 363 million the previous year. The savings banks return on equity after tax was 3.2% in 2013 compared with 8.7% in 2012. The total assets of the savings banks at year-end 2013 amounted to ISK 57.8 billion compared with ISK 56.5 billion at year-end 2012. The book value of the savings banks' equity at year-end 2013 amounted to ISK 4.7 billion compared with ISK 4.4 billion at year-end 2012. The capital adequacy ratio at year-end 2013 was 14.2% compared with 14.1% at year-end 2012. Therefore, the savings banks' financial situation remains fragile. However, the liquidity position of the savings banks is very satisfactory and they are all well above the supervisors' minimum requirements.

4 Bank for International Settlements. 'Asset encumbrance, financial reform and the demand for collateral assets: Report submitted by a Working Group established by the Committee on the Global Financial System.' CGFS Papers, No 49, May 2013.

Chart 1 Total consolidated assets of credit undertakings at year-end 2013.



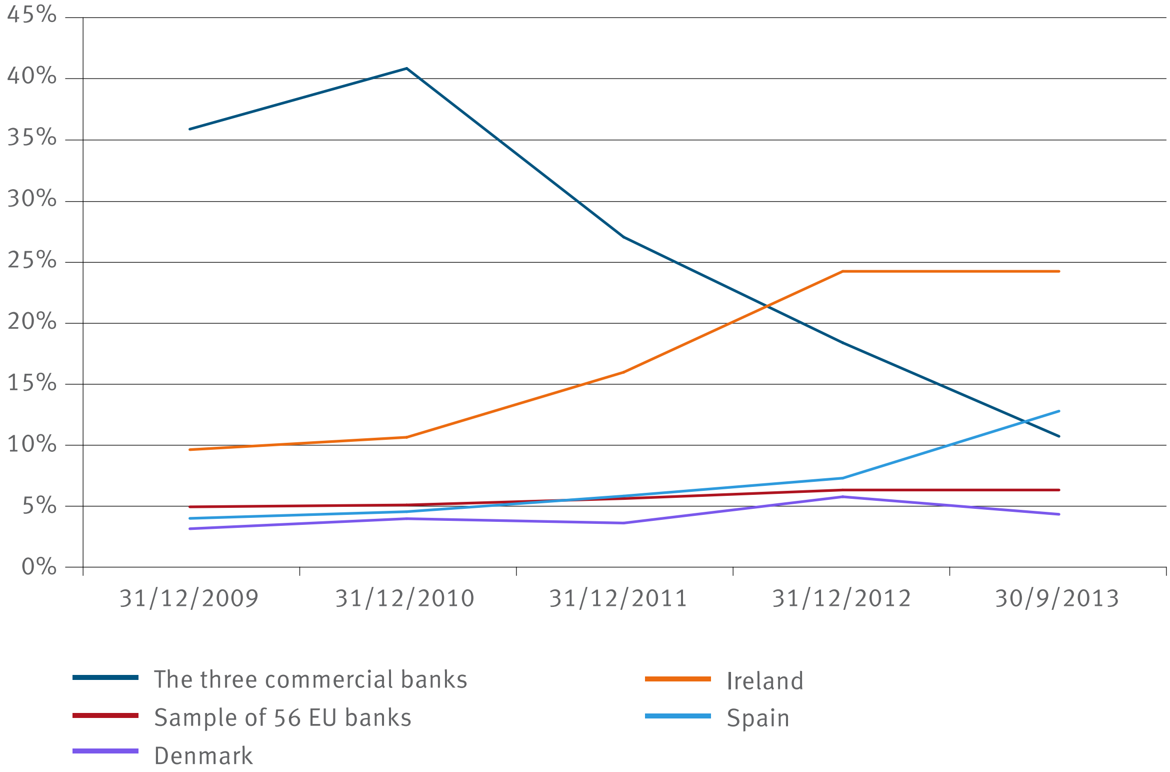
Impaired loans and Past due (›90 days) loans to total loans

The ratio of impaired loans and Past due (›90 days) loans to total loans at the three large commercial banks has decreased significantly in recent half-years. At year-end 2012, the weighted average default rate was 18.6% and 10.9% at the end of the third quarter 2013.[5] Comparison with EU banks, based on a sample from the European Banking Authority (EBA) of 56 banks, shows that this ratio was 6.5% at year-end 2012 and 6.6% at the end of the third quarter 2013.

The main focus for the three large commercial banks has been to restructure the largest borrowers and their default has decreased substantially from the collapse of the banks in autumn 2008. Restructuring for smaller borrowers has progressed at a slower pace.

Comparison with various EU countries is shown in a chart below. It seems the results of loan restructuring have been satisfactory. The default rate has been decreasing in Iceland in previous years, at the same time that it has been increasing in most Member States.

Chart 2 Default rate trend



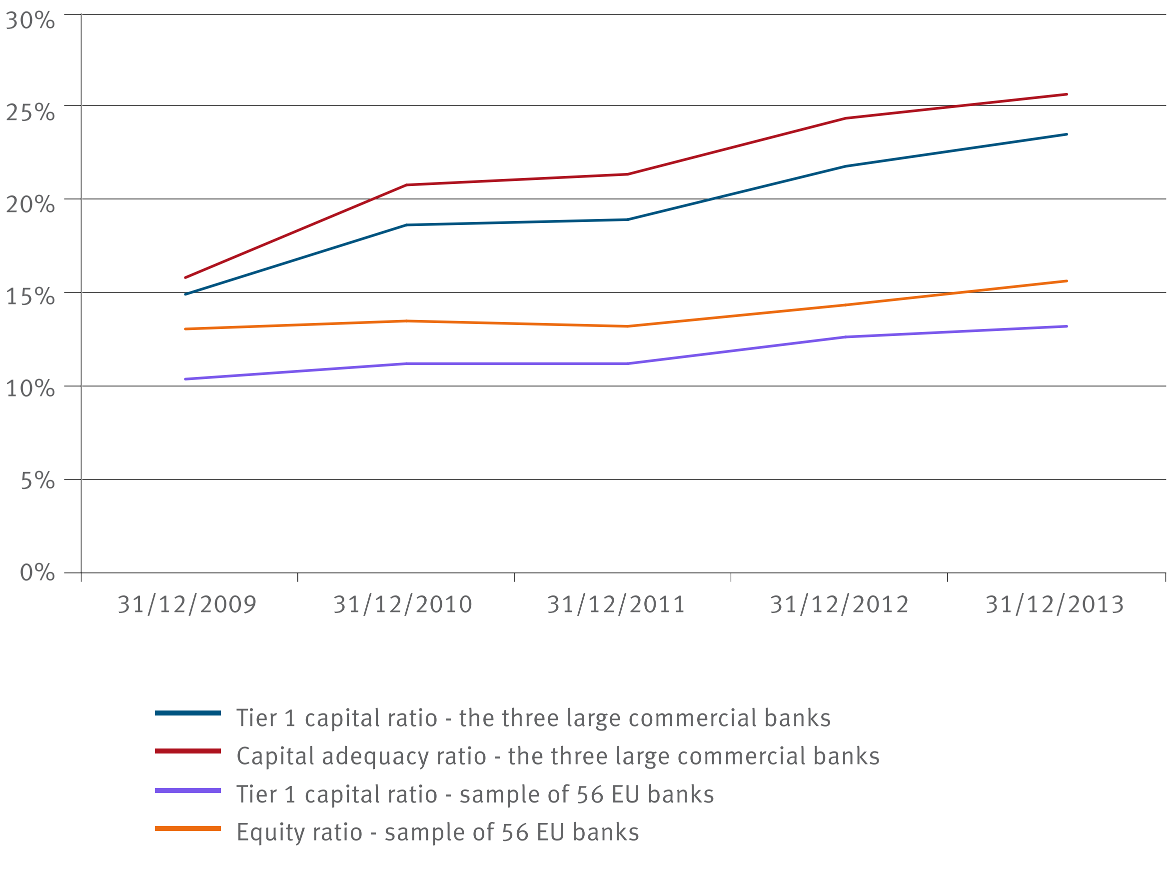
5 Comparison with other countries is based on claim value to ensure statistical significance.

Trend for the capital adequacy ratio

The capital adequacy ratio of the three large commercial banks has increased in recent half-years. The weighted capital adequacy ratio was 26.2% at year-end 2013 and 24.8% at year-end 2012. Comparison with EU banks based on an EBA sample of 56 banks, shows that their weighted capital adequacy ratio was 14.4% at year-end 2012 and 15.7% at year-end 2013.

The chart below shows a comparison of the Tier 1 capital ratio and the total equity ratio, at the three large commercial banks and for a sample of 56 EU banks collected quarterly by EBA, respectively. The comparison seems to show that the equity position of the Icelandic banks is very satisfactory.

Chart 3 Capital adequacy ratio trend



Credit market summary

Despite their strong equity position, satisfactory liquidity position, and decreasing default ratio, there are certain issues that cause uncertainty and could have a negative impact on the banks' operations in coming half-years. Most notably, uncertainty concerning the proposed lifting of the 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 concerning loan-portfolio quality; long-term funding in foreign currencies; funding stability; and the economic conditions of foreign markets. Furthermore, it is important for the banks to have a solid equity position due to the Basel III regulatory framework being transposed in most European countries in compliance with the EU CRD IV/CRR Directive and Regulation.

Core Principles for Effective Banking Supervision

In September 2012, the Basel Committee on Banking Supervision issued revised Core Principles for Effective Banking Supervision. The core principles were originally issued in 1997 and have been revised thereafter. The latest revision before 2012 was in 2006. Supervisors in individual states use the core principles as criteria for assessing the quality of supervision systems and supervision implementation as well as developing objectives in those subject areas. These are also applied by the International Monetary Fund and the World Bank as criteria for assessing the same aspects in connection with the Financial Sector Assessment Programme (FSAP).

One reason for the core principles revision in 2012 was to draw lessons from the financial crisis that started in 2007 with the objective that revised rules promoted, to the extent possible, satisfactory financial supervision and a sound financial system. The revised rules are comprised of 29 core principles, compared with 25 core principles in the 2006 standard. However, in practice, four core principles were not added, rather a few of the principles in the 2006 version were divided, and 28 of the existing 29 core principles correspond to the older rules. Furthermore, the existing core principles are more thorough than before. Under each core principle there are several essential criteria (EC), in total 225 (185 in the previous standard), an average of eight essential criteria for each core principle.

The core principles are divided into two main groups. One group focuses on the institutional framework, e.g. supervisory powers, responsibilities, and functions (Core Principles 1 to 13), the other group focus on the legal and regulatory framework regarding prudential regulations and requirements for banks (Core Principles 14 to 29).

One of the introductory chapters to the Core Principles contains guidelines on how to assess compliance with the rules and grading in that context. The following grade-scale applies to each core principle:

- *Compliant (C)*
  - *– All essential criteria are met*
- *Largely compliant (LC)*
  - *– Minor shortcomings from essential criteria but supervision still achieves the set supervisory goals*
- *Materially non-compliant (MNC)*
  - *– Severe shortcomings in the execution of supervision*
- *Non-compliant (NC)*
  - *– Non-compliant with the core principle*

The requirements of the Basel rules for effective banking supervision are not only to fulfil the essential criteria provided for in the rules. In addition, the precondition to comply with the rules is that the state, where the banking supervisor operates, has sufficient infrastructure. The following elements, which are outside the jurisdiction of the supervisor, are specified in one of the introductory chapters of the rules:

- sound and sustainable macroeconomic policies;
- a well-established framework for financial stability policy formulation;
- a well-developed public infrastructure;
- a clear framework for crisis management, recovery and resolution;

- an appropriate level of systemic protection (or public safety net); and
- effective market discipline.

In 2011, an independent foreign individual, Pierre-Yves Thoraval, on behalf of the government, assessed FME's compliance with the Basel rules. The assessment was based on the 2006 version of the rules. The audit's findings were that FME was fully or largely compliant with more than half of the Core Principles (13 of 25) but was materially non-compliant with 12 Core Principles. As a result of these findings, an extensive quality improvement project was carried out with the objective of improving issues that were considered insufficient in the above-mentioned audit, and it should conclude in 2016. This quality improvement project was specifically discussed in FME's last annual report.

During the first half 2013, FME requested an IMF audit on the follow-up to the Basel rules based on the 2012 version of the rules. Final results from that audit are expected mid-year 2014. The preliminary results indicate that some progress has been achieved in fulfilling the requirements of the rules. However, substantial reforms are still required at FME. Various aspects in need of improvement are not under the jurisdiction of FME, they include legal powers and the division of responsibilities between institutions.

2.2 Securities market

Securities market trends

The restoration of the Icelandic equity market continued in 2013 and three companies were added to the NASDAQ OMX Iceland All-Share Price Index. Equity turnover almost tripled year-on-year, which is, among others, attributable to increased investment opportunities and increased investor interest in equities. However, bond turnover decreased for the second consecutive year.

Equity market trends

Equity turnover in 2013 increased 184% year-on-year, from ISK 88.5 billion to more than ISK 251 billion. The increased turnover is due in part to the listing of new companies on the market, as shares of TM Insurance hf., VIS Insurance hf., and N1 were all admitted to trading in 2013. In the first quarter of 2014, another two companies have become listed companies on NASDAQ OMX Iceland's main market, Sjova- Almennar Insurance hf. and HB Grandi hf.

In the beginning of 2013, the selected share index, OMXI6, rose fast and closed at 1,235.76 points in the middle of March of that year. At that time, the index had risen 16.6% since the beginning of the year. The index was fairly volatile for the rest of the year, peaking in the beginning of December, at 1266.3 points. The index ended in 1,259.60 points, equivalent to an 18.9% increase since the beginning of 2013. However, the increase in first quarter 2013 has reverted completely but the equity market has not experienced the same vigour in first quarter 2014 as it did in the same period in the preceding year. At the end of March 2014, the OMXI6 closed at 1,160.97 points, having decreased by 7.7% since the beginning of the year.

Chart 1 NASDAQ OMXI6 trend

At year-end 2013, the market capitalisation of listed companies on the NASDAQ OMX Iceland All-Share Price Index was more than ISK 534 billion, compared with ISK 363 billion at the beginning of the year. The increase was 47.1% and is, in part, due to new companies being admitted for trading and price increases. For instance, the market capitalisation of some companies more than doubled in the year. At year-end 2013, the market capitalisation of companies listed on the NASDAQ OMX Iceland All-Share Price Index was approximately 29% of the estimated 2013 GDP. This ratio, for comparison, is between 40% and 70% in neighbouring countries. It can be assumed that the ratio will fall more in line with neighbouring countries as more companies decide to list their shares on the market. It bears mention, in this context, that two to five companies will list their shares this year. Sjova-Almennar insurance hf. and HB Grandi hf. have already joined the group of listed companies on the main market with a combined market capitalisation of approximately ISK 72 billion. Moreover, it has been announced that a further two companies will be added to the NASDAQ selected share index OMXI6, bringing the total to eight companies instead of the previous six.

Bond market trends

Annual bond turnover decreased by 21.6% year-on-year, which corresponds with the trend in the preceding year. During 2013, the turnover was approximately ISK 1,822 billion, compared with ISK 2,323 in 2012. The decrease was greatest in the turnover of non-indexed Treasury notes and indexed housing and housing authority bonds. That is, among others, due to investors' increased interest in other markets as investors showed increased interest in both equities and real estate in the preceding year. As in previous years, turnover was by far the highest in non-indexed Treasury Notes, which comprised over 63.4% of total turnover in listed market bonds.

During 2013, the yield increased on most non-indexed short-term bonds, more on the short end of the yield curve than the long end. Yields on OMXI3MNI and OMXI1YNI increased by 76 and 104 points respectively, however, yields on OMXI5YNI and OMXI10YNI increased by 34 and 10 points respectively. Yields on indexed bonds increased as well, OMXI5YI increased by 51 points and OMXI10YI by 52 points.

Chart 2 Yields on non-indexed NASDAQ OMX Iceland bond indicesd

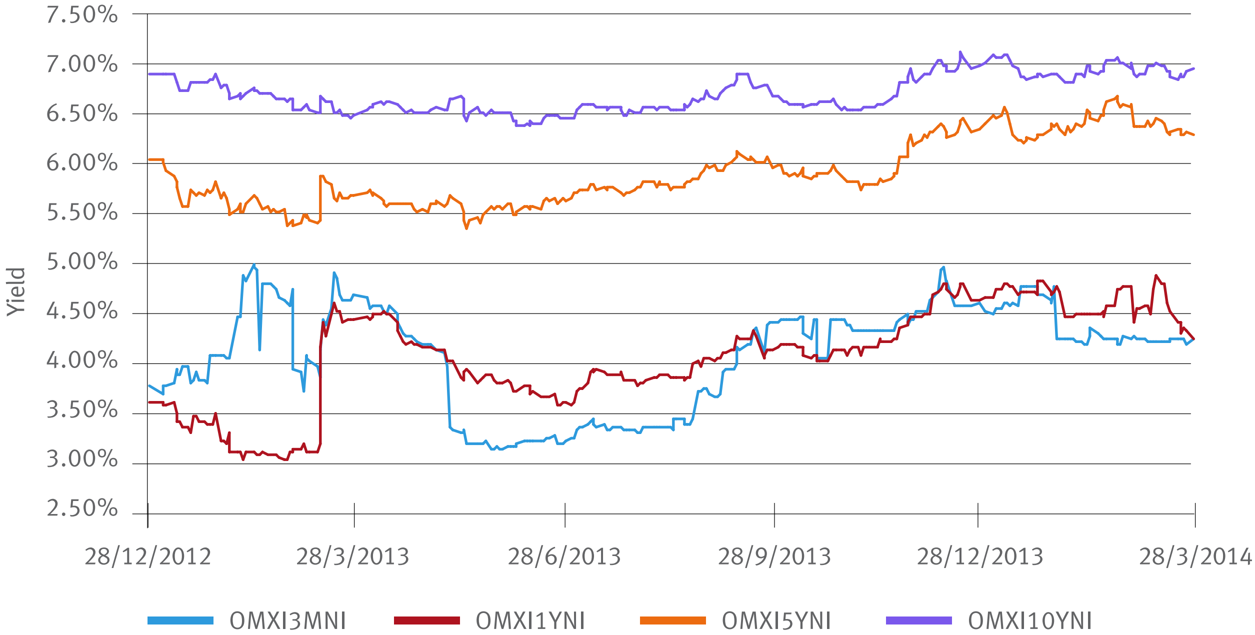
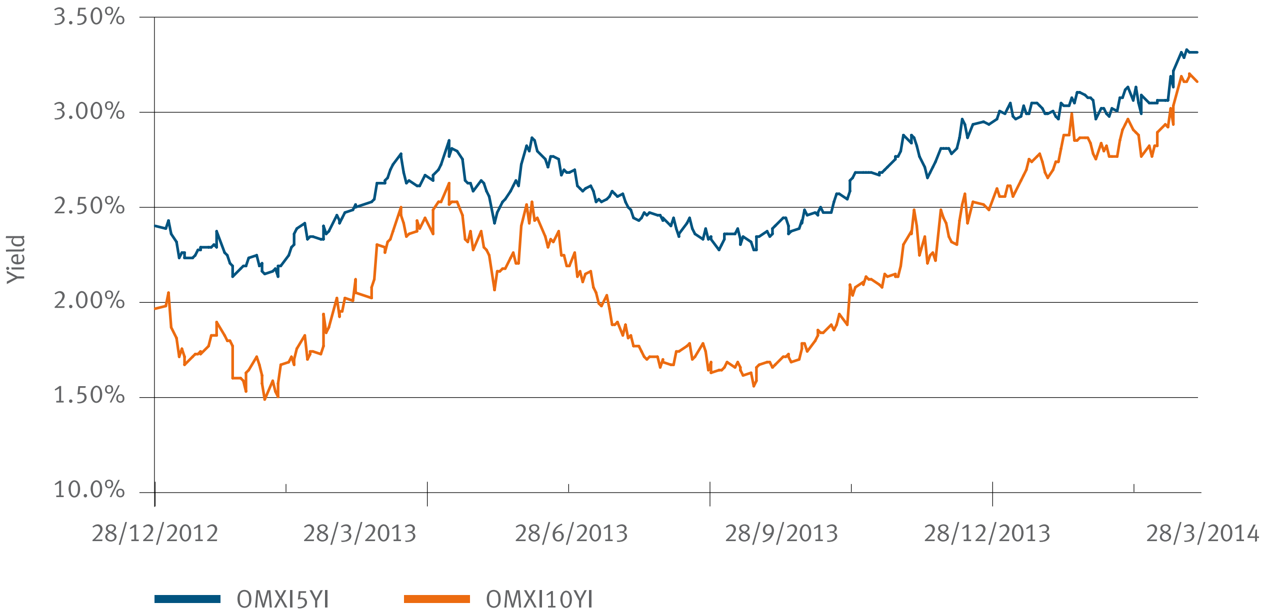


Chart 3 Yields on indexed NASDAQ OMX Iceland bond indices



At year-end 2013, the total market capitalisation of all listed bonds amounted to approximately ISK 1,892 billion, compared with ISK 1,866 billion at the beginning of the year, an increase of 1.4%. The increase is due to issues from the banks and other companies, as these parties issued approximately ISK 60 billion during the year, predominantly new issues of covered and asset-backed bonds. However, the market value of housing and housing authority bonds decreased significantly year-on-year, by more than ISK 55 billion. Furthermore, the value of treasury bills decreased by more than ISK 17 billion.

The division of the market value of issued bonds is approximately 82.1% issued by public entities and 17.9% issued by private parties. Therefore, the percentage of private party issues increases by approximately 3.5% from the preceding year when it was approximately 14.4%.

Survey of regulated entities' attitude towards FME

At year-end 2013, FME conducted an attitude survey among regulated entities. The objective of the survey was to assess the attitude of this important group towards the Authority and the group's confidence in it. The survey was an anonymous on-line survey. Questions were submitted to 106 regulated entities and 185 individuals responded to the survey.

Respondents included chief executive officers, bank presidents, and others in similar positions. Respondents also included managing directors, compliance officers, risk-management employees, liaison officers, and other employees. Credit institutions, followed by employees of pension funds and employees of insurance companies and insurance brokers, employed the majority of respondents. The percentage composition of respondents is an excellent reflection of the composition of regulated entities.

In response to the question about confidence in FME, 42% were either very confident or somewhat confident in FME. The percentage is 79% with the addition of the neutral respondents.

In response to the question: 'How well or poorly do you think FME meets the requirements for regulatory supervision?', 38.6% responded that they felt the supervisor met them very well or somewhat well. The percentage is 77% with the addition of the neutral respondents.

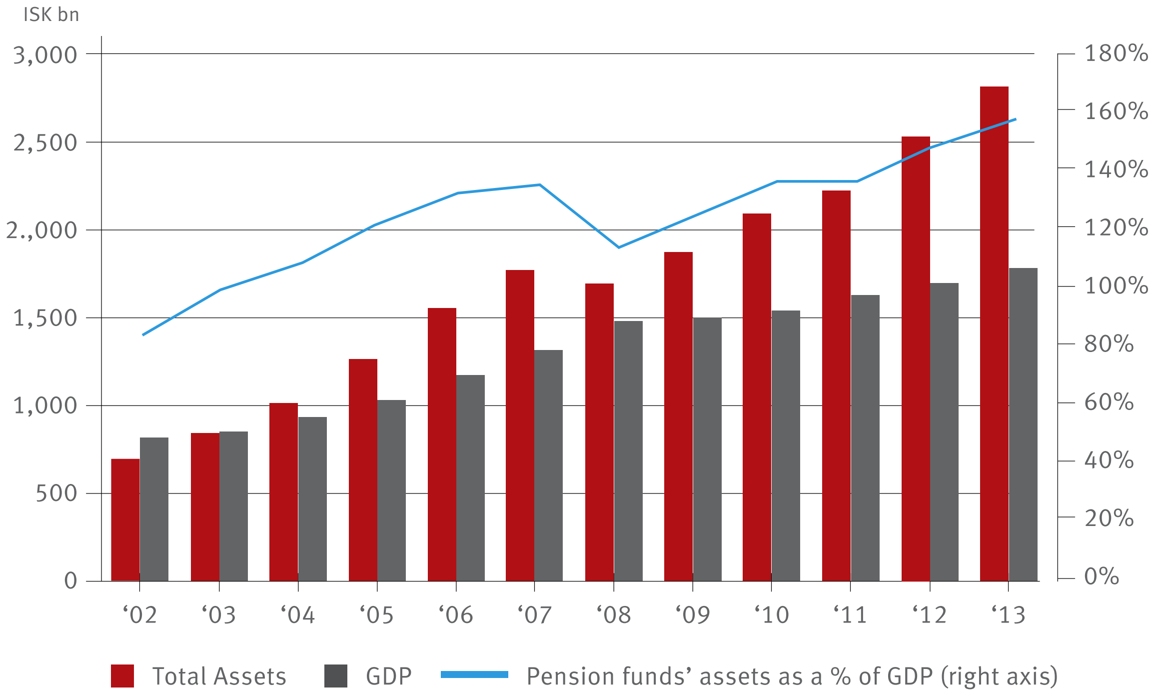
FME's website received fairly general satisfaction, with 55.7% being very or somewhat satisfied with the website. The percentage is 85.4% with the addition of the neutral respondents.

2.3 Pension funds

At year-end 2013, there were 27 pension funds operating 80 mutual and private pension fund divisions. The number of funds decreased during the year when five municipal funds merged with the Pension Fund for Municipal Employees. The number of other private pension fund custodians decreased by one, to seven at year-end.

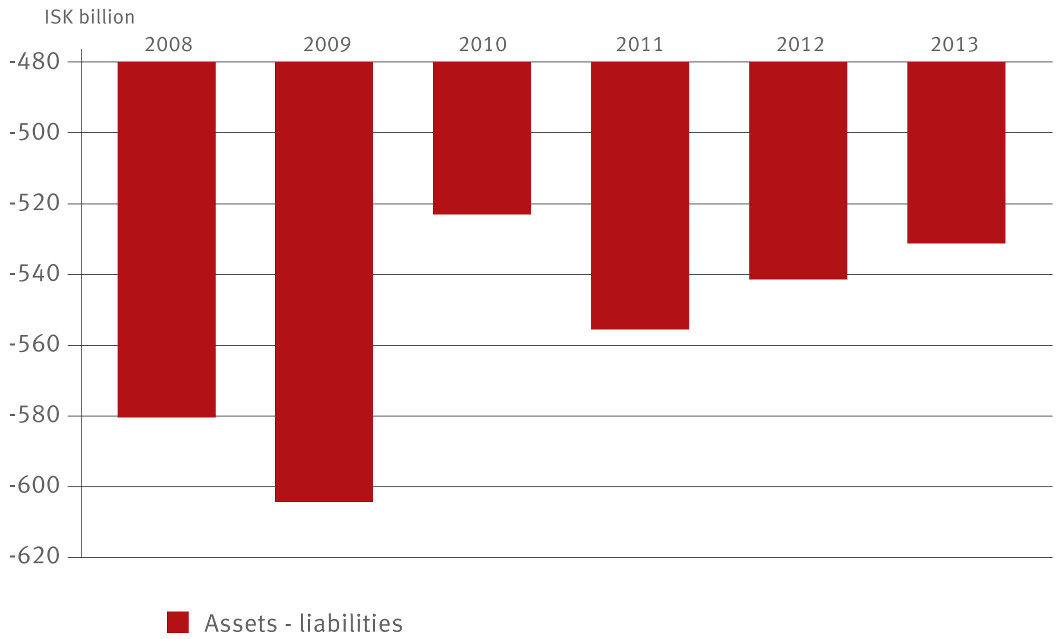
In the preceding year, the net assets of Icelandic pension funds and private pension fund custodians increased significantly, based on preliminary numbers, or by almost ISK 260 billion. The estimated total assets at year-end 2013 are almost ISK 2,800 billion. The estimated division of these assets is ISK 2,400 billion with pension funds' mutual insurance divisions, ISK 260 billion with their private pensions and approximately ISK 150 billion with other private pension custodians. The greatest increase is with the pension funds' mutual insurance divisions, or almost 11%, and somewhat less with private pension custodians, or approximately 7%. The increase in private pensions has slowed somewhat due to payouts based on a temporary statutory provision that has been extended each year since 2009. Based on the above-mentioned numbers for the net assets of pension funds, it can be assumed that these assets were 158% of GDP at year-end 2013, see Chart 1. As before, this proportion is among the highest of OECD countries, next after the Netherlands, which have had the highest proportion of assets in so-called autonomous pension funds. For this comparison, it must be borne in mind, that the public in many countries has retirement benefits with the employer and with various pension products that are not reflected in OECD comparative figures. Furthermore, it is important to consider other aspects than the size of the pension system as well. It is no less important to consider the pension amount participants in Iceland can expect to receive at retirement, both from pension funds and through social security.

Chart 1 Assets of pension funds and private pension custodians / GDP



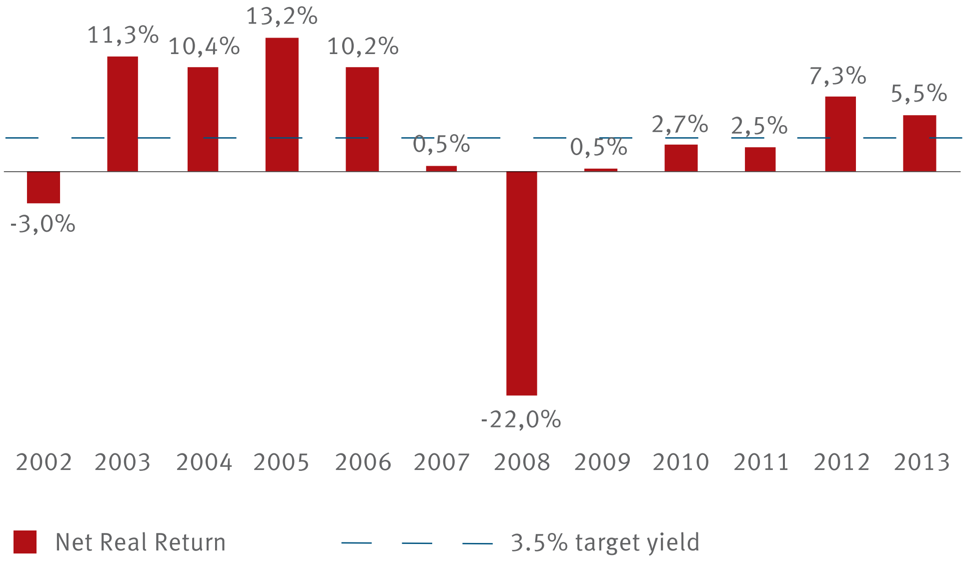
It is clear for everyone to see that, despite the significant assets in the pension fund system, the mutual insurance divisions have a large deficit, i.e. their liabilities are substantially higher than their assets. As before, the deficit is largest with State and municipality guaranteed pension funds, or approximately ISK 480 billion and approximately ISK 50 billion for funds without guarantees, based on preliminary numbers for assets and accrued liabilities at year-end 2013. Stakeholders have an urgent task in finding reasonable solutions to this problem. The pension funds’ actuarial status has improved following the great crisis when the banks collapsed, as can be seen in Chart 2. There are two reasons for that, a curtailment of the rights in many pension funds without guarantees and the funds’ good returns in the preceding three years. The 2013 numbers are preliminary numbers.

Chart 2 Assets less accrued liabilities



Other things being equal, the long-term annual return on the funds' mutual insurance divisions needs to exceed the funds' target return in order to decrease their actuarial deficit. Most funds have used 3.5% as a viable long-term target for real return. This is an internationally accepted long-term target for financial market return where the division of assets is 60% bonds and 40% equities. Chart 3 shows an overview of the returns on mutual insurance divisions from 2002 to 2013. The final numbers for real return in 2013 are not available; however, preliminary numbers indicate a 5.5% real return. When evaluating their performance, it is necessary to consider that pension funds are long-term investors. For the last 20 years, the funds' annual real return has averaged 3.9%, despite the crises following the banking collapse, which is higher than the above-mentioned return target. The average real return in the last 10 and 5 years was 3.6% and 2.6% respectively.

Chart 3 Net real return for pension funds' mutual insurance divisions 2002-2013



Given the limits on pension funds' foreign investments, it is evident that the funds' need for investment has to be channelled into the domestic securities and real estate market. Therefore, it is important to have sufficient investment opportunities to prevent the development of market imbalances that could result in the formation of bubbles in individual asset classes. In addition, sufficient risk diversification needs to be insured for the pension funds' assets.

There have not been substantial changes to the asset portfolios of the pension funds and custodians. Almost half the pension funds' assets are assets with State or municipal guarantees and almost 23% of assets are denominated in foreign currencies, mostly in equity portfolios. A large percentage of private pension custodians' assets are deposits and securities with State and municipal guarantees; their foreign assets are insignificant.

Investments by pension funds in the Icelandic Enterprise Investment Fund and in newly listed companies on the domestic equity market have been successful recently and have played their part in the funds' good returns. The pension funds have increased their holdings in listed Icelandic shares, in line with the increase of listed companies on OMX Nordic. At year-end 2013, the funds held approximately one-third of all listed shares in Iceland. They held almost half and more than half in individual listed companies.

The past year has been marked by the increase of partnerships limited by shares or institutional investor funds being established around unlisted assets, which are financed by issuing listed bonds, thereby converting unlisted assets into listed assets (i.e. securitisation). The investments of the pension funds include the listed bonds of institutional investor funds or public limited companies that hold either real estate or mortgage backed loan contracts. In fact, the pension funds are increasing their exposure to unlisted assets without the resulting exposure of the increased weighting of unlisted securities appearing in their asset portfolios by investing in listed bonds issued by private companies or funds.

2.4 UCITS and alternative investment funds

There were nine fund management companies regulated by FME at the end of 2013. The principal activities of fund management companies involve managing UCITS, investment funds, and institutional investor funds.

The number of UCITS increased by one during the year; the number of operational UCITS and feeder UCITS was 57 at year-end. The number of investment funds increased by 16 during the year; the total number of operational investment funds and fund divisions was 44 at year-end. At year-end 2013, total assets of UCITS and investment funds amounted to ISK 356 billion. Of these, assets of UCITS were just over ISK 238 billion and assets of investment funds just over ISK 118 billion.

The number of regulated institutional investor funds increased by 23 during the year; 70 institutional investor funds were operated by 11 entities at year-end. Their total assets amounted to ISK 306 billion; net assets amounted to ISK 141 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.

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

During the year, assets of UCITS and investment funds increased by over ISK 28 billion, or by 8%. The holdings of UCITS decreased during the year, making this the first time since 2008 that their assets decrease year-on-year. However, holdings of investment funds increased by ISK 47 billion during the year, or approximately 65%. More than 90% of UCITS holdings are securities issued by the State or with State guarantees and deposits. However, investment funds' holdings are substantially more varied. Approximately 45% are in equities, based on size, followed by deposits, UCITS, and securities issued by the State or with a State guarantee, or approximately 13-15% in each asset class.

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

Chart 1 Trend of UCITS and investment funds' assets (ISK billion) at year-end

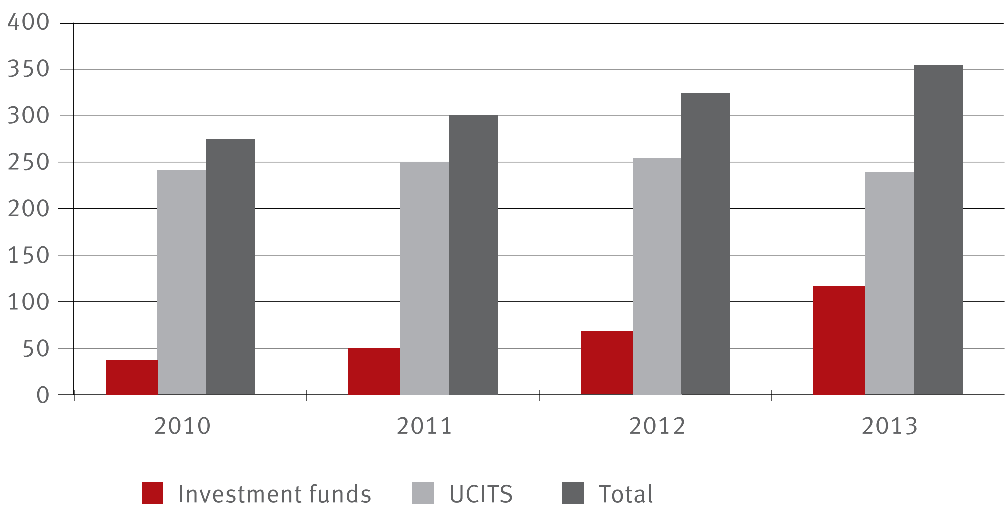
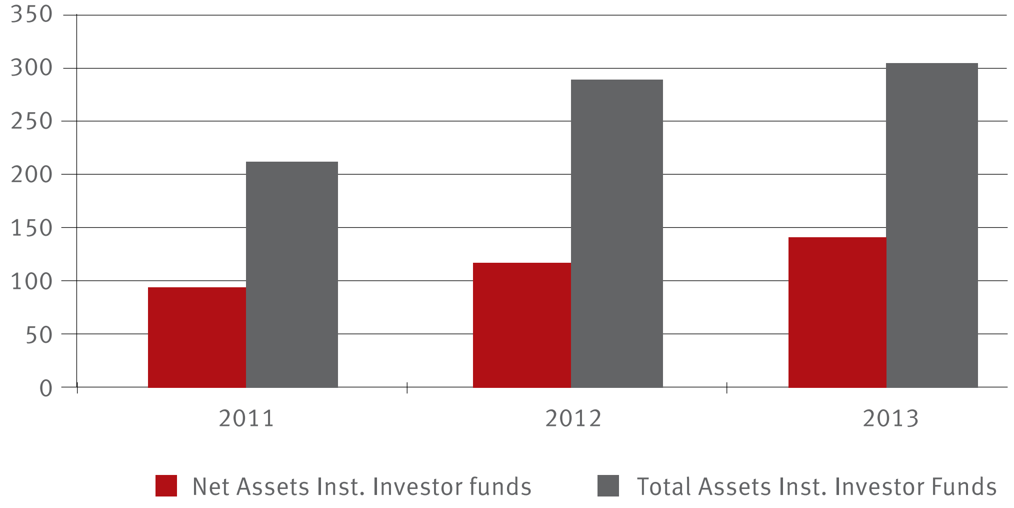


Chart 2 Trend of institutional investor funds' assets (ISK billion) at year-end



2.5 Insurance market

On the insurance market in general

At year-end 2013, 13 insurance companies had an operating licence from FME, of which five operate on the life insurance market and five operate on the non-life insurance market. All of the life insurance companies are subsidiaries of non-life insurance companies, except Okkar liftryggingar hf., a subsidiary of Arion Bank hf. Islensk endurtrygging hf. and Trygging hf. only settle older reinsurance obligations and the last one, Iceland's Natural Catastrophe Insurance, operates in accordance with special legislation.

At the beginning of 2014, the operating licence of European Risk Insurance Company hf. (ERIC), a non-life insurance company, was withdrawn, as the company did not meet the minimum solvency margin required by law. 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 preceding years, in order to facilitate comparison between years in the subsequent discussion, since the annual accounts for 2013 have not been completed.

At end of last year, the total assets of all insurance companies in Iceland amounted to ISK 163 billion, increasing by over ISK 10 billion from the previous year. Chart 1 shows the development of assets and asset breakdown of insurance companies in 2010-2013. The companies' equity assets have increased; the percentage of equities in the asset portfolios increased from 12% to 15% during the year. During the same time, the percentage of bonds in the portfolios decreased from 48% to 47%.

Chart 1 Insurance companies' assets and asset breakdown 2010-2013

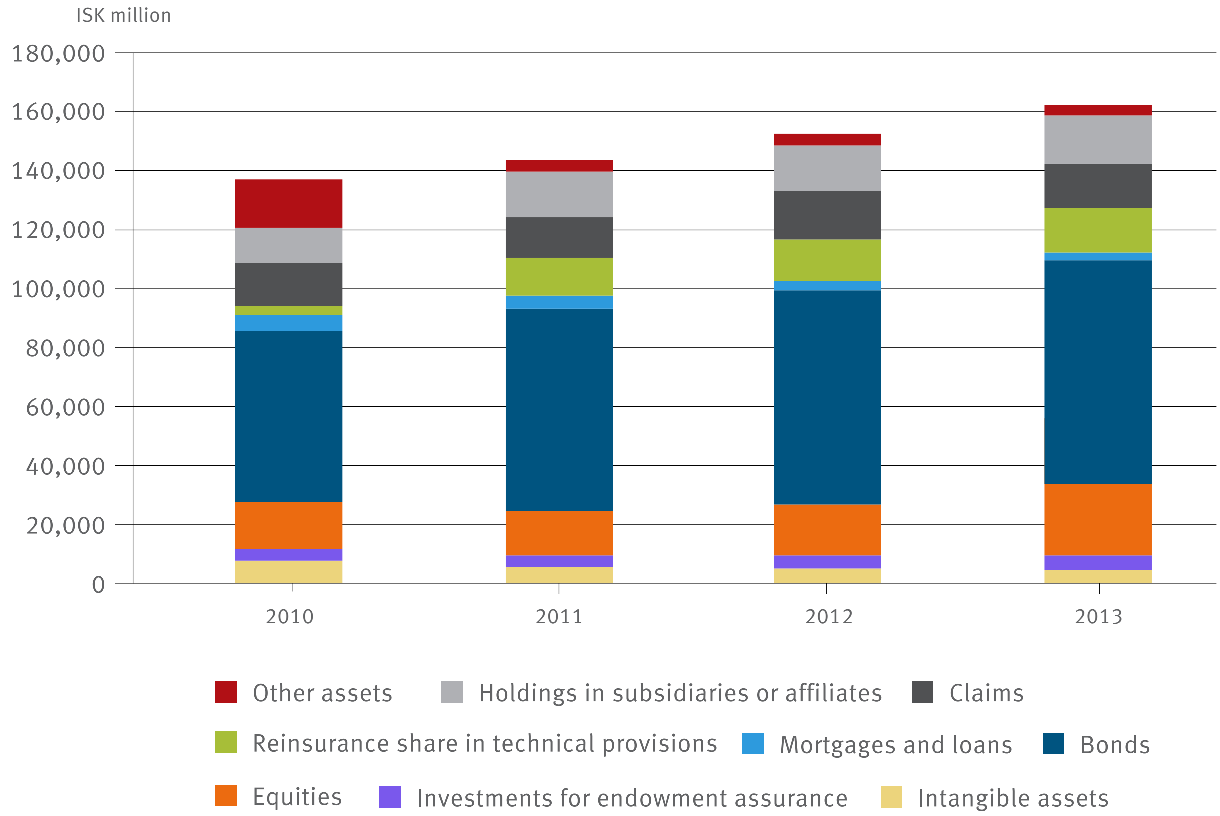
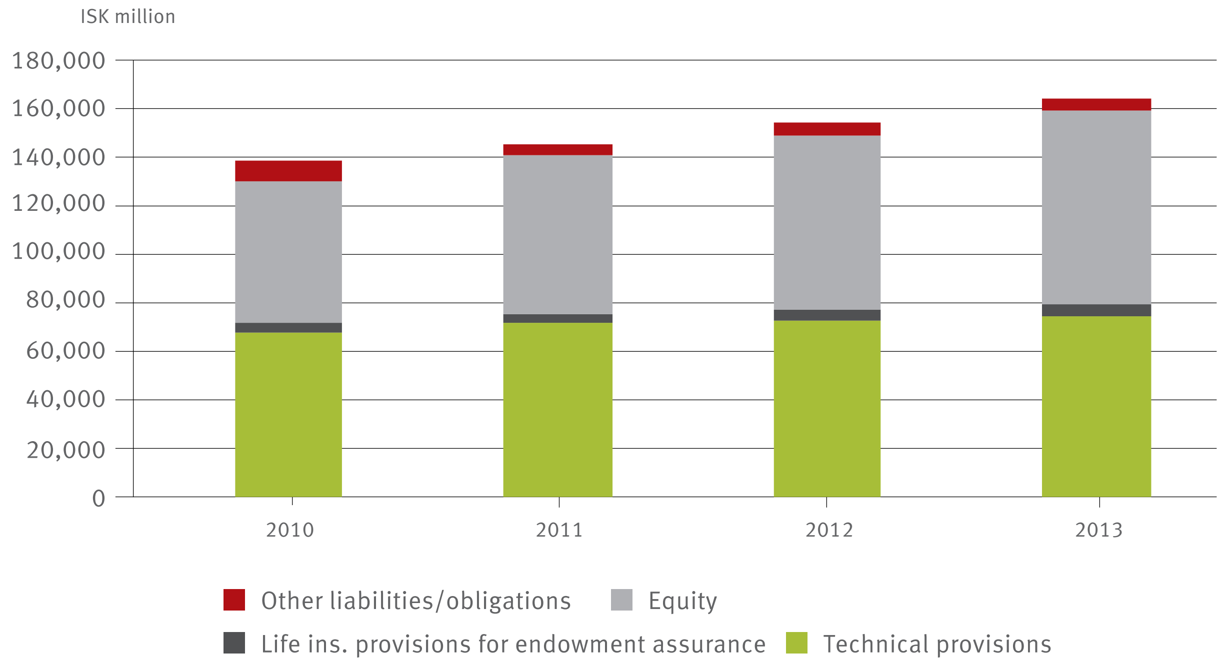


Chart 2 shows a breakdown of balance sheet liabilities for the same period. The equity position has improved steadily while technical provisions have remained almost unchanged, with their value decreasing in terms of fixed price levels.

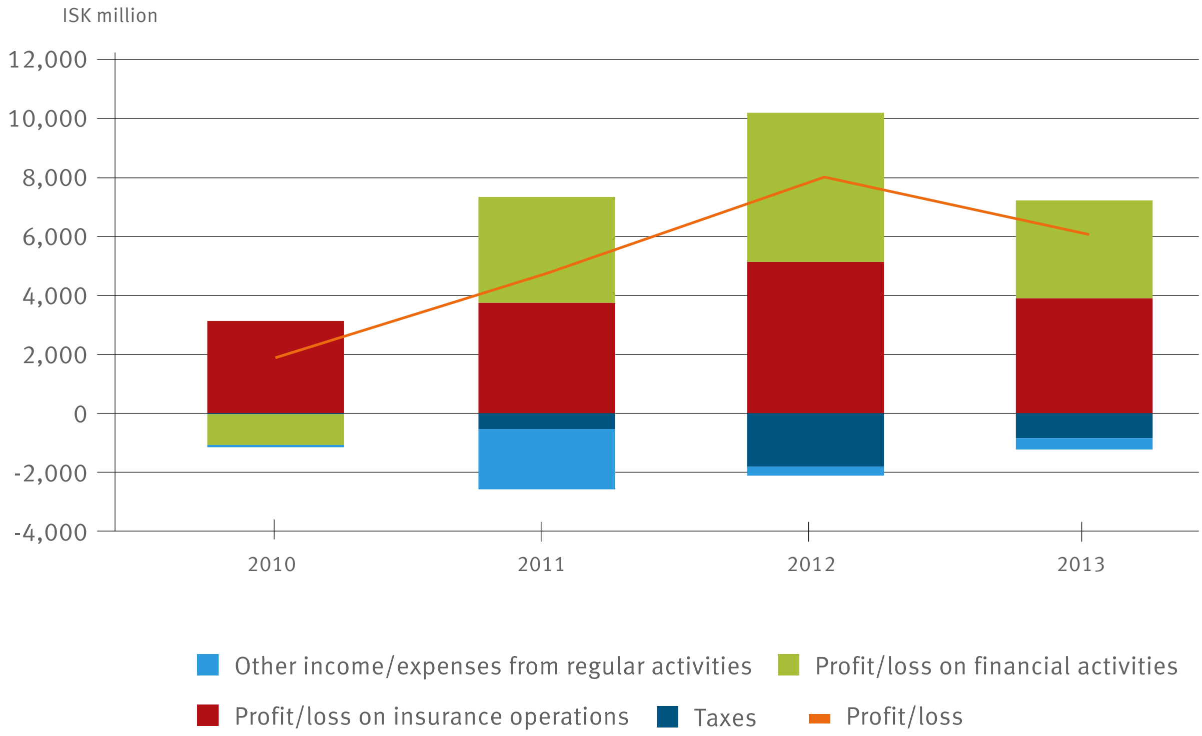
Chart 2 Insurance companies' equity and liabilities 2010-2013



Operations of non-life insurance companies

During 2013, the profit from the operations of non-life insurance companies was lower than in the preceding year, both from insurance operations and financial activities. However, the results are still considered historically good. Chart 3 shows the development and breakdown of profit for 2010-2013. Increased volatility can be expected in profits from financial operations as equity holdings increase.

Chart 3 Performance of non-life insurance companies 2010-2013

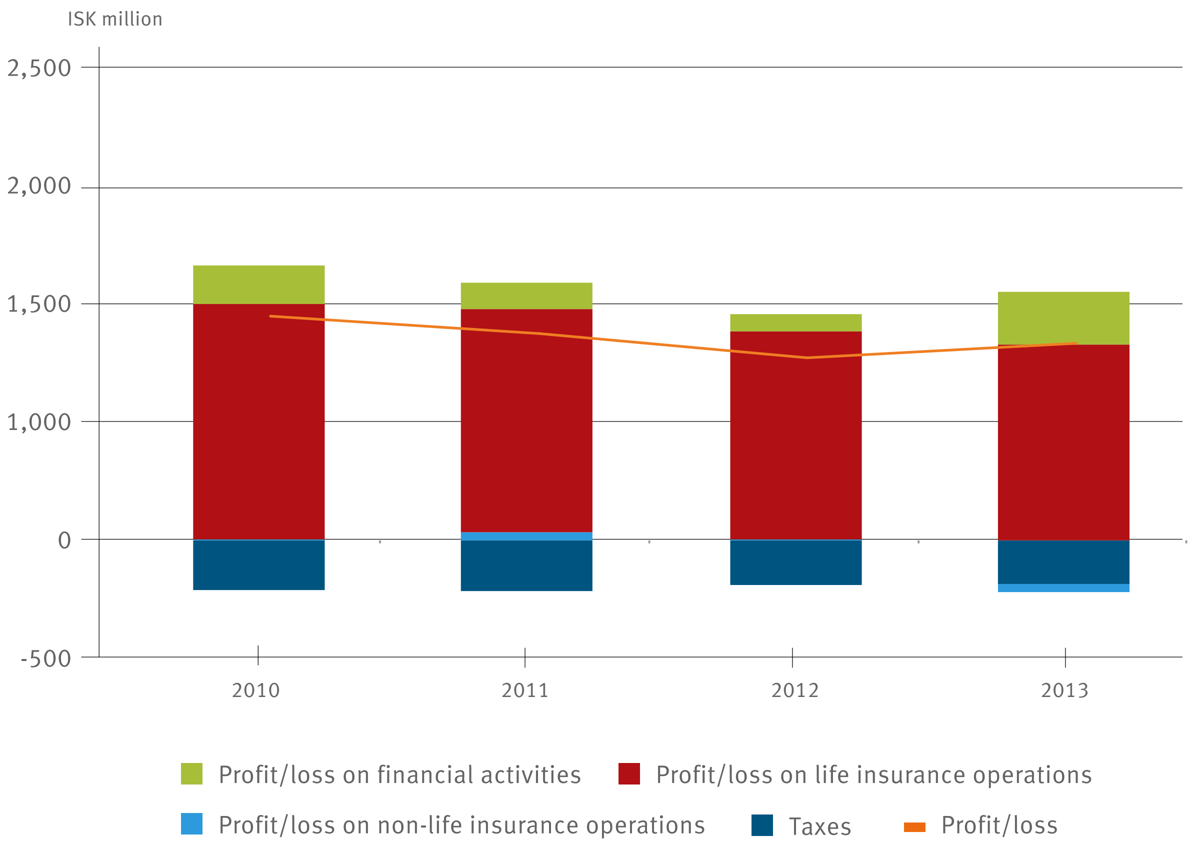


The solvency ratio of the four non-life insurance companies currently operating in the public market, i.e. the solvency as a percentage of the minimum solvency margin, was between 335% and 553% at year-end 2013, meaning the companies are sound. Some of them have announced dividend payments for 2013, which would be the first time since the collapse of the banks that the non-life insurance companies pay a dividend.

Operations of life insurance companies

In recent years, operations of life insurance companies have been characterised by stability, as can be seen on Chart 4. However, their profit, as opposed to the profit of the non-life insurance companies, has increased slightly year-on-year, with the increase resulting from increased profits from financial operations while the profit from life insurance activities continues to decrease. It is worth noting that 13% of the life insurance companies' asset portfolios are in equities. Therefore, the largest proportion of equity assets in the insurance market belongs to non-life insurance companies.

Chart 4 Performance of life insurance companies 2010-2013



At year-end 2013, the life insurance companies' solvency ratio was between 111% and 311%. 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 EU regulations on insurance markets, EUR 3.7 million or ISK 610 million.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3 Events of the past year

3.1 Highlights from May 2013 to end of April 2014

Rules on the calculation of the adjusted solvency margin of insurance companies

In the beginning of May 2013, FME announced that the Authority had laid down rules on the calculation of the adjusted solvency margin of insurance companies. The Rules, which are No 334/2013, were published in the electronic issue of the Official Journal of Iceland on 17 April 2013.

Landsbankinn authorised to issue covered bonds

On 6 May 2013, FME announced on their website that the Authority had authorised Landsbankinn hf. to issue covered bonds. The bank was authorised to raise ISK 10 billion in this manner.

Cautionary announcement to investors

In mid-May, FME reiterated, in a news update on its website, the importance for investors to review the regulatory framework for initial public offerings. Furthermore, FME reaffirmed its opinion that the behaviour where an investor submits a higher offer than he can honour, could be considered market manipulation, as defined by Article 117 of the Act on Securities Transactions, as that would provide a false or misleading indication of the demand for financial instruments. The end of the news update stated that FME is currently reviewing the procedure for initial public offerings, having regard to the above-mentioned.

Issuers' disclosure requirements

At the end of May 2013, FME arranged a seminar for issuers on the regulated securities market. The seminar reviewed issuer's disclosure requirements, rules on the treatment of inside information and insider trading, and guidelines for implementation of the rules. In addition, it addressed FME cases involving sanctions, sanctioning powers, and their application.

Legal proceedings related to exchange rate-indexed loans

In mid-May 2013, FME published a summary on the state of legal proceedings related to exchange rate-indexed loans. The summary was compiled in response to a number of inquiries and suggestions the Authority had received concerning the processing of cases related to exchange rate-indexed loans.

Preparation for Solvency II

On 14 May 2013, during the consultation phase of EIOPA's draft guidelines for preparation for Solvency II, FME hosted a presentation on the draft. Representatives from the insurance companies and the Icelandic Financial Services Association were invited to attend. The objectives of the guidelines were reviewed as well as the reasons EIOPA decided to lay down guidelines to coordinate the insurance market's preparation for the entry into force of the Solvency II Directive. Following the general review, the substance of three guidelines on governance, Own Risk and Solvency Assessment (ORSA), and data submission was presented.

FME reimburses

The decision, of FME's board of directors, to levy a supplementary supervision fee, pursuant to Article 7 of Act No 99/1999, on a particular pension fund, for costs related to the Authority's Advisory Committee's assessment of eligibility of board members, was repealed by the judgment of the Reykjavik District Court on 25 March 2013. FME decided to accept the judgment and reimburse the relevant cost. In addition, the Authority reimbursed all entities that had paid a similar fee in relation to the Committee's activities, the fee having been levied in 2010 and 2011. In all, 13 entities were involved and they were reimbursed ISK 14 million plus interest.

Amendments to issuers' disclosure requirements

At the end of May 2013, FME published an announcement highlighting amendments to issuers' disclosure requirements under the Act on Securities Transactions that had entered into force the preceding March. The announcement dealt with, among others, various duties of issuers.

Compilation of insurance companies' annual accounts and performance by lines of business

At the beginning of June 2013, FME published a compilation of annual accounts and information on the performance of Icelandic insurance companies by lines of business for the 2012 fiscal year, in a standardised form, as had been done the preceding years.

Informational seminar for issuers on the regulated securities market

On 30 May 2013, FME arranged an informational seminar for issuers on the regulated securities market. Many compliance officers, and other employees, from issuers attended. The topic of the seminar was the treatment of inside information and insider trading as well as issuers' disclosure requirements.

Deputy Director General engaged

Dr. Jón Þór Sturluson was engaged to be FME's Deputy Director General on 12 June 2013. Dr. Sturluson was selected from a group of 15 applicants following a comprehensive hiring procedure. Dr. Sturluson earned a bachelor's and a master's degree in economics from the University of Iceland and subsequently completed his doctorate at the Stockholm School of Economics. Dr. Sturluson has extensive knowledge of the financial market and of contributing factors for financial stability and macro prudential indicators, from teaching, research, and various consulting projects. Dr. Sturluson served on the Board of Governors of the Central Bank of Iceland for two years, served as assistant to the Minister of Business Affairs, and as an advisor on the economy and government finances to the Minister for Foreign Affairs.

Seminar for the authorities on the treatment of inside information etc.

On 24 June 2013, an announcement on FME's website stated that in the second half of April, FME had conducted an informational seminar for the authorities on the treatment of inside information etc. The topic was FME's Rules No 1050/2012 on the Treatment of Inside Information and Insider Trading, as well as Guidelines No 2/2012 on the implementation of the Rules. Subsequently, on 20 June 2013, FME sent a circular to the authorities highlighting the Rules that had been discussed.

FME's transportation policy

On 28 June 2013, it was reported on FME's website that the Authority had published a transportation policy with the objective of displaying corporate social responsibility and promoting the use of environmentally friendly and efficient modes of transport. As a part of the transportation policy, FME made transportation agreements with those employees who used environmentally friendly modes of transport on average 60% of the time, or three days a week. At that time, 20 employees had signed a transportation agreement, 18% of FME's employees. At the end of April 2014, 41 employees had joined the agreement, one-third of employees.

Merger of Svarfdaelir Savings Bank with Nordurland Savings Bank ses.

On 4 July 2013, FME authorised the merger of Svarfdaelir Savings Bank with Nordurland Savings

Bank ses. (previously Thorshofn Savings Bank) pursuant to 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.

State of the Icelandic pension funds

On 10 July 2013, FME published a summary of the state of Icelandic pension funds for the year 2012, consistent with previous years.

Rules on large exposures

On 12 July 2013, FME announced Rules No 625/2013 that the Authority had laid down on large exposures of financial undertakings. The new Rules superseded the previous Rules No 216/2007 on Large Exposures of Financial Undertakings. It was verified, during the revision of the Rules, that applicable banking directives had been transposed. Norwegian and Danish rules on large exposures were taken into consideration.

Legal proceedings between Stapi and FME

On 8 July 2013, the Reykjavik District Court pronounced its judgment in the court case of Stapi Pension Fund vs. FME. The Authority was absolved from the claim to annul their decision regarding Stapi's requirement to conclude an agreement with their host in such a way that it fulfilled the requirements of Guidelines No 1/2005 on information systems of regulated entities. Stapi's claim also contained a demand to repeal the decision on periodic penalty payments per day, imposed by FME for the purpose of enforcing the above-mentioned rectifications. Stapi Pension Fund appealed the judgment of the District Court to the Supreme Court. On 27 February 2014, the Supreme Court pronounced its judgment annulling FME's decision to levy periodic penalty payments per day, by reference to FME's obligation to investigate certain assertions made by Stapi before making their decision. Furthermore, all of Stapi's assertions should have been included in a memorandum submitted to the Board of FME proposing the levy of periodic penalty payments per day.

Rules on proper and sound business practices

On 17 July 2013, FME announced Rules No670/2013 that the Authority had laid down on proper and sound business practices. The Rules provide principles that are generally considered proper and sound business practices in the activities of financial undertakings. Furthermore, it was announced that guidelines to complement the rules would be published and, to that end, the Icelandic Financial Services Association and the Consumer Agency would be consulted, among others.

FME reimburses

On 23 July 2013, FME announced that, as a result of the Supreme Court's judgments in 2010, the Authority had decided to reimburse a supplementary supervision fee levied on 22 credit institutions at year-end 2010 for work on analysing the impact of exchange rate-indexed loans on the state of credit institutions. The reimbursement was in accordance with the provisions of Act No29/1995 on Reimbursement of Overcharged Taxes and Fees. The decision on the reimbursement was made after due consideration, as well as taking into account the opinion of the Althing Ombudsman, that a legal basis had not existed for the charge at the time FME collected the supplementary supervision fee.

FME issues a cautionary announcement regarding the execution of an initial public offering

On 27 August 2013, FME issued a cautionary announcement regarding the execution of initial public offerings. The Authority indicated to investors that, among others, their subscriptions were binding and that the issuer could request they fulfil the obligations inherent in the subscription. FME stated that, if investors intended to participate in initial public offerings, FME considered it important for them to review the rules that apply to initial public offerings, and that Act No108/2007 on Securities Transactions applied to public offerings and the admission of a financial instrument to trading on a regulated securities market. Furthermore, FME reaffirmed that certain investor behaviour, while subscribing and making offers, could be considered market manipulation, as defined by Article 117 of the Act, and referred to an announcement published on FME's website earlier in the year.

Furthermore, it was impressed upon issuers that they should not publish information, regarding the results of public offerings, such that it would reflect demand in a false or misleading manner. FME pointed out, that, in its assessment, any subscription that did not comply with the terms of the public offering, and was cancelled or invalidated for any reason, was not such as to correctly reflect demand.

Response to an open letter to FME

On 29 August 2013, FME published a response to an open letter to the Authority dated 22 August 2013. The letter, that concerned the business practices of Lysing hf., contained multiple enquiries to the supervisor. FME pointed out, that the Authority was not authorised to comment publicly on specific cases of individual regulated entities and could, therefore, only attempt to make general information on the supervision of trade practices available, having regard to enquiries for the supervisor.

Overall results of financial companies' annual accounts

On 18 September 2013, FME published a report on the overall results of the annual accounts of financial undertakings for 2012, including various condensed information on commercial banks, savings banks, credit undertakings (collectively referred to as credit institutions), securities dealers, securities brokers, and fund management companies, as well as on UCITS and investment funds.

The surrender of operating licences for multilateral trading facilities

On 19 September 2013, FME stated, in a news update, that the Authority had accepted the surrender of the operating licences of Arion Bank hf., Islandsbanki hf., and Landsbankinn hf. to operate multilateral trading facilities. FME accepted the surrender of the licences as a result of the banks boards of directors' unambiguous consent to surrender them.

Chairman of the Board of FME resigns

On 1 October 2013, it was announced that Aðalsteinn Leifsson had resigned due to a planned move to a foreign country at year-end, as Leifsson had accepted the position of Director of the Secretary-General's Office of EFTA. Furthermore, it was announced that Margrét Einarsdóttir, Assistant Professor at the Reykjavik University Law Faculty and Vice-Chairman of the Board, would assume the position of Chairman of the Board until the Minister had again appointed someone to the position.

Information concerning temporary activities of financial companies

On 2 October 2013, 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 part of other activities of financial undertakings. The summary showed, among others, the number of financial undertakings' holdings in temporary activities on 1 November 2011, 1 September 2012, and 1 September 2013.

Presentation of a report on the breakdown of investments and liabilities of institutional investor funds

On 4 October 2013, FME held a presentation for institutional investor fund management companies on the form for reporting investment and liability breakdowns for institutional investor funds.

Temporary suspension of trading

On 8 November 2013, it was announced that FME had decided to temporarily suspend trading in bonds with the symbol FAST-1 12 1, which had been admitted to trading on NASDAQ OMX Iceland hf. It was the decision of FME, with reference to an announcement from FAST-1 slhf., that the bond did not meet the requirements made for admission to trading. On 14 November 2013, it was announced that the Authority had decided to authorise the resumption of trading in the bond FAST-1 12 1 on NASDAQ OMX Iceland hf., as the uncertainty relating to the pledging of the bonds had been alleviated.

Introduction and use of cloud computing

On 21 November 2013, FME invited regulated entities to a presentation on important issues to take into account, for the introduction and use of cloud computing. Lectures were delivered by representatives from Syndis slf., an information security-consulting firm.

Authorisation to possess a qualifying holding

In mid-November 2013, FME published a news update to the effect that it had granted Saenes ehf. authorisation to possess a qualifying holding in Hofdhverfingar Savings Bank.

Inkasso granted a collection licence

On 2 December 2013, FME granted Inkasso ehf. a collection licence pursuant to Act No 95/2008 on Debt Collection.

Presentation on EIOPA's preparatory guidelines for the Solvency II Directive

On 29 November 2013, FME held a presentation for insurance companies and auditors on EIOPA's preparatory guidelines for the Solvency II Directive. It was in continuation of a presentation FME held in May 2013, when the guidelines were presented for the first time while in the consultation phase with stakeholders.

For the record on FME's investigations

On 10 December 2013, FME published a news update, on its website, regarding comments made about FME's investigations. It stated among others: 'The media has periodically reported that the actions of FME have been overly rigorous after the financial collapse, in particular with regard to investigations into alleged violations of those who were in control of the banking industry leading up to the financial collapse. It must be acknowledged that individuals accused of contributing to the events occurring in Iceland in autumn 2008, will seek every effort to defend themselves and their cause, given the principle that accused individuals are permitted to defend themselves by almost all appropriate means.' In this regard, FME stated it would like to reiterate that FME employees have carried out investigations on events preceding the financial collapse with integrity and have submitted multiple complaints and referrals to the Special Prosecutor, as that is one of FME's roles in accordance with law. That it was then the role of the Special Prosecutor to investigate further and determine the continuation of the case. That it had been established that many of the cases referred by FME to the Special Prosecutor had proceeded before the courts. Moreover, courts and the Althing Ombudsman had confirmed many of FME's findings. However, that it was clear that FME is not infallible and judgments in some cases had been unfavourable to the Authority. Such incidents would be reviewed with a view to drawing lessons from them and following the precedents set by them.

Regulation on key information for holders of unit certificates

On 11 December 2013, FME emphasised that Regulation No 983/2013 on Key investor Information had been published in the Official Journal of Iceland on 6 November 2013, with entry into force on 1 February 2014. The regulation is the transposition of Commission Regulation (EU) No 583/2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website.

European Banking Authority's warning on virtual currencies

In the second half of December 2013, FME communicated the European Banking Authority's (EBA) warning on virtual currencies, such as bitcoin. EBA had indicated that consumers did not enjoy the same level of protection in trading bitcoins as is afforded by the supervision of financial activities and the legal environment for trading in financial instruments. Therefore, consumers are exposed to the risk of losing their funds. It was noted that EBA is currently working on an assessment of the relevant aspects of virtual currencies with regard to whether it is possible and desirable to address them specifically in legislation, including in terms of supervision.

New chairman of the Board of FME

At the end of December 2013, Halla Sigrún Hjartardóttir was appointed chairman of the Board of FME by the Minister of Finance and Economic Affairs. She assumed the chairmanship from Aðalsteinn Leifsson.

Cooperation between the Law Institute and FME

In mid-January 2014, it was announced that the University of Iceland's Law Institute and FME had started cooperating for the purpose of promoting research in the field of financial law. The Law Institute has engaged Arnaldur Hjartarson, lawyer and LLM, as a full-time specialist in financial law research, including the operating environment of financial undertakings and supervisors, in accordance with the contract. Moreover, the contract provides for seminars and informational meetings for FME employees in connection with ongoing research projects and as agreed by the parties to the contract. The contract stipulates a yearly ISK 8 million grant to the Law Institute for two years, a total of ISK 16 million during the contract period.

Legal entity defined as entity financially connected to insiders

On 17 January 2014, FME published an interpretation entitled Legal entities defined as entities financially connected to insiders. The interpretation noted the definition of financially connected insiders, in particular legal entities under the direct or indirect control of insiders or other entities financially connected to insiders.

Authorisation of the merger of Audur Capital and Virding

On 17 January 2014, FME authorised the merger of Audur Capital hf. and Virding hf. in accordance with Act No 161/2002 on Financial Undertakings. In connection with the merger, Virding hf. assumed all the rights and obligations of Audur Capital hf. The companies merged under the name Virding hf.

Status of the European Risk Insurance Company addressed

On 6 February 2014, FME published a news update on its website, to the effect that UK web media had reported that morning on the status of the European Risk Insurance Company hf. (ERIC), which was said to be an Icelandic insurance company active in foreign countries. The media stated that the company had ceased to sell new insurance policies. FME stated that it should be noted that the decision to cease selling new insurance policies from ERIC had been made by a board meeting on 4 February 2014 and announced to partners the preceding day. It was noted that FME was monitoring the activities and status of ERIC and was in communication with the company, as provided for by law.

The operating licence of European Risk Insurance Company withdrawn

On 12 February 2014, FME withdrew the operating licence of ERIC as an insurance company as the company did not comply with the minimum solvency provisions of Act No 56/2010 on Insurance Activities and had surrendered its licence to operate as an insurance company in accordance with Article 90(1) of the same Act. FME appointed a resolution board for the company, in accordance with Article 91 of the Act on Insurance Activities.

New rules for supplementary supervision of financial conglomerates

On 18 February 2014, FME announced that the Authority had issued new Rules No 165/2014 on Supplementary Supervision of Financial Conglomerates, superseding the previous rules on the same issue.

International conference on pension market issues

On 28 February 2014, FME and the Icelandic Pension Funds Association, in conjunction with the International Organisation of Pension Supervisors (IOPS) and the International Association of Insurance Supervisors, held a conference entitled Regulatory and Supervisory Challenges for the Icelandic Pension Industry. Approximately 120 people attended the conference, including approximately 50 foreign guests. The issues included challenges in the pension market, growing obligations due to increased longevity, and the pension funds' foreign investments. The annual meeting of the Technical Committee of IOPS was held the preceding day; FME was the host of the meeting this time. IOPS works in close collaboration with OECD on various strategic issues related to the pension funds that were addressed by this meeting.

FME lays down guidelines for large exposures

In early March 2014, FME announced that the Authority had laid down Guidelines No 1/2014 on Assessing the Relationship Between Parties Related to Rules on Large Exposures.

New FME guidelines for own risk and solvency assessment of insurance companies (ORSA)

On 10 March 2014, FME announced in a news update that the Authority had issued new guidelines for implementing Own Risk and Solvency Assessment of insurance companies (ORSA) that are published on the Icelandic website under: Þjónustugátt – leiðbeiningar og gátlistar (i.e. Service – Instructions and Checklists).

Public warning on virtual currencies

On 19 March 2014, FME issued a public warning on virtual currencies. It stated among others: 'With regard to news on the planned distribution of virtual currencies to Icelanders (Auroracoin), the Icelandic authorities warn of possible risks related to purchasing, holding, and trading in such currencies.' The warning was signed by FME, the Central Bank of Iceland, the Consumer Agency, the Ministry of Finance and Economic Affairs, and the Ministry of the Interior, which also issued a warning.

New guidelines on information systems of regulated entities

On 21 March 2014, it was announced on FME's website that new Guidelines on the Information Systems of Regulated Entities had been issued.

Interpretation on the recognition of markets

On 8 April 2014, FME published an interpretation on the recognition of markets. The interpretation addresses which markets FME recognises and deems valid pursuant to Act No 129/1997 on Mandatory Insurance of Pension Rights and on Activities of Pension Funds and pursuant to Act No 128/2011 on Undertakings for Collective Investment in Transferable Securities, Investment Funds and Professional Investor Funds.

New rules on the safe preservation of the funds of payment institutions and electronic money institutions

On 11 April 2014, it was announced on FME's website that, at the beginning of the month, Rules No 322/2014 on the Safe Preservation of the Funds of electronic money institutions and Rules No 323/2014 on the Safe Preservation of the Funds of payment institutions, had been published in the Official Journal of Iceland. The Rules circumscribed the manner in which funds, received by electronic money institutions and payment institutions, should be preserved, as well as for which investments they were authorised.

New transparency policy adopted

On 16 April 2014, the Board of FME approved a new policy on the public disclosure of conclusions of cases and examinations, in accordance with Article 9a of Act No 87/1998 on Official Supervision of Financial Activities. The policy is known as the FME's Transparency Policy.

3.2 Summary of decisions and transparency notifications from 1 May 2013 to end of April 2014

8 May 2013: Follow-up on an examination on certain aspects of the activities of Arctica Finance hf.
15 May 2013: Conclusion of an examination of Lysing hf. on certain aspects of actions to combat money laundering and terrorist financing
17 May 2013: Conclusion of an overall examination at the Farmers' Pension Fund
22 May 2013: Conclusion of an examination of Borgun hf. on certain aspects relating to actions to combat money laundering and terrorist financing
31 May 2013: Conclusion of an examination of the lending of Almenni Pension Fund to individuals
6 June 2013: Conclusion of an examination of the lending of the Pension Fund of Commerce to individuals
12 June 2013: Conclusion of an examination of the lending of the United Pension Fund to individuals
14 June 2013: Conclusion of an examination of supervision of money laundering and terrorist financing at Islandsbanki hf.
24 June 2013: Examination of settlement of claims at VIS Insurance hf.
25 June 2013: Follow-up on an examination by FME of the activities of Stafir Pension Fund
26 June 2013: Follow-up on an overall examination by FME at the Westman Islands Pension Fund
1 July 2013: Conclusion of an examination of the activities of GAM Management hf.
2 July 2013: Conclusion of an examination of the lending of TM Insurance hf.
2 July 2013: Administrative fine for infringements of Articles 126 and 127 of Act No 108/2007 on Securities Transactions
9 July 2013: Conclusion of an examination of the interconnection of large exposures at Arion Bank hf.

25 July 2013: Friendly settlement for infringement of Article 87 of Act No 108/2007 on Securities Transactions
21 August 2013: Friendly settlement for infringement of Article 128 of Act No 108/2007 on Securities Transactions
21 August 2013: Friendly settlement for infringement of Article 128 of Act No 108/2007 on Securities Transactions
26 August 2013: Follow-up on an overall examination by FME at the Farmers' Pension Fund
27 August 2013: Friendly settlement for infringement of Articles 126 and 127 of Act No 108/2007 on Securities Transactions
27 August 2013: Friendly settlement for infringement of Article 127 of Act No 108/2007 on Securities Transactions
29 August 2013: Conclusion of an examination on the implementation of amendments to marriage assurance at Liftryggingafelag Islands hf.
9 September 2013: Conclusion of an examination of supervision of money laundering and terrorist financing at Arion Bank hf.
18 September 2013: Friendly settlement for infringement of Article 128 of Act No 108/2007 on Securities Transactions
18 September 2013: Friendly settlement for infringement of Article 128 of Act No 108/2007 on Securities Transactions
20 September 2013: Administrative fine for the infringement of HS Orka hf. of Article 128(2) of Act No 108/2007 on Securities Transactions
25 September 2013: Conclusion of an examination of the lending of the Pension Fund for State Employees (LSR) to individuals
30 September 2013: Conclusion of an examination of Straumur Investment Bank hf. on certain aspects of actions to combat money laundering and terrorist financing
1 October 2013: Administrative fine for the infringement of several individuals of Article 45(2) of Act No 108/2007 on Securities Transactions
14 October 2013: Friendly settlement for infringement of Article 128 of Act No 108/2007 on Securities Transactions
29 October 2013: An examination of the practices of Dromi hf. in relation to the revocation of loan recalculations and the release of liens
11 November 2013: Conclusion of an examination of the STOFN service of Sjova-Almennar Insurance hf.
12 November 2013: Friendly settlement related to the debt collection activities of Dromi hf.
18 November 2013: Friendly settlement for infringement of Articles 125 and 126 of Act No 108/2007 on Securities Transactions
19 November 2013: Conclusion of an examination of the loan portfolio audit of Islandsbanki hf.
26 November 2013: Friendly settlement for infringement of Article 86 of Act No 108/2007 on Securities Transactions
17 December 2013: Conclusion of an audit of the risk management of insurance companies
20 December 2013: Transparency announcement concerning an examination of the business practices of Lysing hf. as a result of the Supreme Court's judgment in Case No 672/2012
9 January 2014: Friendly settlement for infringement of Article 68(2) of Act No 108/2007 on Securities Transactions
13 January 2014: Conclusion of an examination of MP banki hf. on certain aspects of actions to combat money laundering and terrorist financing
13 January 2014: Conclusion of an examination of Valitor hf. on certain aspects of actions to combat money laundering and terrorist financing
14 January 2014: Conclusion of an examination of the lending of Festa Pension fund to individuals

14 January 2014: Conclusion of an examination of the lending of Stafir Pension Fund to individuals
20 January 2014: Conclusion of an examination of the investments of the Pension Fund of Vestfjords
24 January 2014: Conclusion of an examination of the lending activities of MP banki hf.
19 February 2014: Follow-up on an examination of the loan portfolio audit of Islandsbanki hf.
13 March 2014: Conclusion of an examination of the activities of Virding hf.
31 March 2014: Administrative fines for violations against Article 122(1) of Act No 108/2007, on Securities Transactions

3.3 Summary of issues of Fjármál and articles from 1 May 2013 to end of April 2014

FME's electronic journal, Fjármál (i.e. financial affairs), written by the Authority's specialists, is now in its third year of publication. The journal has been well received and has been cited on multiple occasions in the media. Every issue of Fjármál is available on FME's Icelandic website under the heading útgefið efni – vefrit FME (i.e. published material – FME's web journal). An overview of articles published between 1 May 2013 and the end of April 2014 follows.

Fjármál August 2013

Eru fjárfestingarsjóðir að rétta úr kútnum?
Kristján Andrésson, financial supervision specialist

CRD IV and other legislative changes on the European financial market in the near future
Hjálmar Stefán Brynjólfsson, lawyer with Off-Site Supervision

European Supervisory Authorities and Iceland's involvement
Sigurður Freyr Jónatansson, risk analysis specialist

Fjármál November 2013

Investment authorisations of pension funds
Arnar Jón Sigurgeirsson, specialist with Off-Site Supervision

Rising age of the population – increasing liabilities of the pension funds
Björn Z. Ásgrímsson, specialist with Oversight

The state of the Icelandic banking industry in comparison with the banking industry on the European continent
Kristján Ólafur Jóhannesson, specialist with Oversight

Several key aspects of Basel III in the context of CRD IV
Hjálmar Stefán Brynjólfsson, lawyer with Off-Site Supervision

Fjármál February 2014

Modifications to capital adequacy rules with a single European regulatory framework – capital buffers
Arnar Þór Sæþórsson, lawyer with Oversight

Future changes in the securities market
Páll Friðriksson, Director of Securities Market Regulation

Is cloud computing an efficient solution for companies in the financial market?
Stella Thors, specialist with Information Technology

4. 4. Entities regulated by FME

4.1 Number of FME regulated entities

Categories of regulated entities at year-end	Notes	2010	2011	2012	2013
Subject to licence or operating under specific legislation:					
Commercial banks		5	5	4	4
Savings banks		12	10	9	8
Credit undertakings		8	8	6	6
Housing Financing Fund (HFF)		1	1	1	1
Deposit departments of co-operative societies		1	1	1	1
Securities dealers		12	13	11	10
Securities brokers		3	2	2	2
Fund management companies	1)	8	9	10	9
Institutional investor funds - legal entities			3	4	7
Stock exchanges		1	1	1	1
Securities depositories		1	1	1	1
Pension funds	2)	33	33	32	27
Insurance companies		13	13	13	13
Insurance brokers		6	6	11	11
Entities with debt collection licenses		6	4	4	5
Payment institutions				1	1
Guarantee funds		2	2	2	2
Total		*112*	*112*	*113*	*109*
Other regulated entities:					
UCITS (not legal entities)	3)	49	56	56	57
Investment funds (not legal entities)	3)	21	24	28	44
Institutional investor funds (not legal entities)	3)		28	43	63
Custodians of private pension savings	4)	19	18	15	14
Issuers of listed shares		11	12	15	18
Issuers of listed bonds		49	47	49	57
Agent of foreign payment institution				1	1
Holding companies	5)	6	7	12	12
Financial undertakings in winding-up proceedings		13	11	14	15
Total		**281**	**299**	**346**	**390**

1) Furthermore, see the number of UCITS and investment funds and institutional investment funds lower 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 higher 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) Excluding two foreign custodians of private pension savings, the parties included here are also included in the figures for parties higher in the table.
5) Holding companies in the financial sector and insurance sector and mixed holding companies at year-end, in accordance with the detailed definition in Acts No 161/2002 and No 56/2010. These active shareholders hold more than 50% in the regulated entities. Active shareholders who hold between 10% and 50% are not specified 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:

	30/6/10	30/6/11	31/12/12	31/12/13
Foreign banks without establishments	225	222	224	239
UCITS (no. of divisions in parentheses)	47 (313)	47 (367)	53 (352)	56 (370)
Securities dealers/brokers (Investment firms)	1,995	2,113	2,020	2,148
Insurance companies with establishments	2	2	2	2
Insurance companies without establishments	384	405	377	381
Insurance brokers and insurance agents	5,025	5,158	4,990	5,030

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