



REPORT ON ICELAND SUPERVISION

Prepared for the Icelandic
Authorities, the FME and the IMF

Banking Supervision

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OVERVIEW

In the aftermath of the Icelandic financial crisis, that has deeply affected the banks and the economy, the Icelandic Authorities have taken actions. Several measures and decisions have been taken. They are summarized in the Icelandic Supervisor, (FME) special Report "Strategy 2010" and in The Central bank document "Financial Stability Report 2010". A Report has been prepared by the former head of the Finnish Supervisory Agency, Mr. Kaarlo Jännäri ("Report on Banking Regulation and Supervision in Iceland: past, present, future" dated March 30, 2009); its proposals have been largely implemented.

In this context, the International Monetary Fund (IMF) has asked the Icelandic Authorities ("Authorities") to perform a self assessment of its compliance with the Basel Committee Core Principles (BCP) for effective supervision.

Moreover, the Authorities and the IMF have requested this self-assessment to be validated by an external expert, Mr. Pierre-Yves THORAVAL¹, to whom a synthetic report has also been asked, as a follow up to the proposals made by Mr. Jännäri that focused on banking supervision.

This work has been done in Reykjavik in March 2011.

The author wishes to thanks the FME, its leaders, and the team which has prepared the self-assessment for their intensive work, their very cooperative attitude, and their dedication.

To understand the specificities of Iceland, a rapid overview of its situation is necessary that will shed some light on the assessment of the Core principles. A rapid analysis of the implementation made by the Authorities on the Jännäri's Report and on the work already done -as seen through the analysis of the Core Principles- will indicate the work that remains to be done and the orientations the Supervisory Authority should follow. Some recommendations and a possible time schedule to fulfill the gaps, conclude this Report.

THE ICELANDIC SITUATION

This Report does not intend to retrace the reasons and the film of the events that hit Iceland at the end of 2008. However, a few words are necessary to understand that if the situation found in 2011 is far from acceptable, if the impressive work done since 2009 is still "work in process" and has not yet produced all its effects, in a few months, if what is still necessary is done with perseverance, the result will be more acceptable. It is difficult to simultaneously build an enhanced supervision and to rebuild a banking system in ruins.

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This is particularly true for the assessment of the BCP that is hence particularly difficult to evaluate today.

The Basel rules stipulate that a Principle can be rated Largely Compliant or LC only if minor defects exist. In its scale², the Committee has voluntarily used a steep curve with a cliff effect between the Materially Non-compliant MNC rating and the LC rating. Hence, due to the extensive work in all domains realized and in progress - but mostly unfinished- it is difficult, if a fair view is wished, to apply as strictly as normally, the Basel rules. The Authorities have been overcharged by the treatment of the technically failed large banks and have been obliged to be creative if not always fully orthodox. In a country where, just after the crisis, the level of non-performing loans was 40% and where the realization of the collateral or the valuation of the assets was more than uncertain, hence most of the normal rules didn't really apply during this exceptional crisis. The supervisors, the number of which was much too low before the crisis (47 persons only at the FME), have been obliged on the spur of the moment to try to cope with the crisis and to build a normal Supervisory Agency. At the end of 2011 the number of the FME staff will be 117. Numerous laws, regulations, and guidance have been issued but sometimes still lack real implementation, something that should be severely remarked elsewhere but that is understandable for this country at this moment. In the FME's own self assessment, it is frequent to see an assessment of the legal framework rated Compliant or Largely Compliant whereas the practices and the procedures are, more often, rated as Materially Non-compliant (MNC). This shows that the main weaknesses, for the time being and for the reasons explained, are more on the processes than on the texts.

If the FME is able to attract enough good personnel and if it keeps on track, in one or two years these gaps will be partially filled and the remaining gaps will become reasonable. However to reach this level, the FME must absolutely adopt a consistent framework, a risk model that is today lacking. If not, its efforts will be inconsistent and less effective. All the large countries surrounding Iceland -which also have a banking crisis- have logically decided to rebuild or to revisit their risk model (cf. annex 2) .

RAPID ANALYSIS OF THE CORE PRINCIPLES (cf. annex 1)

The results, with 12 Principles rated Materially Non-compliant, show "room for improvement".

Total of CP rated C Compliant	2
Total of CP rated LC Largely compliant	11
Total of CP rated NMC Materially Non-compliant	12

However during the last two years, the Authorities and especially the Supervisory Agency or FME (Fjarmalaeftirlitid), have worked intensely in the right direction for most of the actions they have undertaken. The FME has undergone a complete overhaul on the main aspects that needed to be improved, but it still lacks a complete consistent framework to organize the tasks. Additionally, most of the projects

² The scale has 5 grades : C for Compliant, LC for Largely Compliant, MNC for Materially non Compliant, NC for Non compliant and NA for non applicable.

have not had time to be fully implemented. As a result, because an assessment is a photo taken at a precise moment (here March 2011), the global rating is more severe than it is likely to be in one or two years.

Indeed, the FME is trying to change its culture according to its document "strategy 2010: looking ahead to the future" to: be more proactive; "exercise its powers without hesitation"; be stronger and stricter in a timely manner; "take more initiative in developing legislation, rules and guidance"; enhance analytical capability "relying on substantive assessment in its supervision of sound and normal business practices"; and develop "an independent analysis and evaluation" with "professionalism and transparency". The change in culture is perceptible and laws and regulations have been put in place, but the construction of tools, procedures, systems, and above all, the necessary human skilled resources, lag behind. From 47 in the beginning of 2009, the FME is around 107 staff today, planning to have 117 by the end of the year. The difficulty is that the new people have limited knowledge and lack specific training in nearly all the domains and that, presently, 12³ of them are still occupied on the "forensics" of the past crisis.

Presently, for instance, the banking on-site and off-site department has only 28 persons with only few having enough experience to be efficient. Banking supervision is difficult and requires staff with experience. Unfortunately, in a small country, this constraint is difficult to fulfill. But it explains why it is not easy to capitalize on the progresses made.

The main FME projects: "restructuring loan portfolios" (cf. Page 14 of the FME document), "restructuring of the loans portfolios in banks", "rationalization within the banking system", "investigations related to the collapse of banks", have taken more time than expected and are still underway.

One should, however, realize that the average non performing loan (NPL) ratio is 40%, that, nearly, no new loans have been granted in 3 years, but that the apparent profitability of the banking system is not a symptom of good health of the banking system. Around 4500 persons are presently working in banks with a large proportion on the loan restructuring in banks. The absence of new loans is said by bankers to be due to the lack of demand, due to the fears on both sides and on the economic outlook and wages levels. The sentence often heard on both sides is "we have been burnt"! These very impressive figures indicate a quasi comatose state of the banking system. The authorities are trying to find a way to launch a new pump priming initiative (capture the available frozen savings to inject in promising sectors, reduce the external constraint on the currency).

This quite unusual landscape demonstrates that the situation is more than difficult and explains the difficulties in rebuilding the banking supervision.

THE FOLLOW-UP OF THE JANNARI'S REPORT

However, the Authorities have done their best to implement the ideas that were in **Kaarlo Jännäri's Report**.

In his report, Mr Jännäri has proposed several recommendations: (cf. **annex 3**)

³ They will be 17 at the end of the year 2011.

Decrease the number of ministries that have a hand on the Financial Market Legislation or otherwise are involved in the financial markets. It has not been possible to finalize this.

Merge the CBI and the FME or at least bring them under the same administrative umbrella. The Icelandic Authorities deem that the MOU on cooperation between the Central bank and the Supervisory Authority achieves this.

Give more discretionary powers to the FME and encourage it to use its powers more forcefully. An important text has been taken at the end of 2010. The analysis made on the deficiencies in the Core Principles shows the path to follow ardently.

Create a National Credit Registry: this task is under construction. The progress made seems well under way.

Take a tougher stance on large exposures, connected lending and quality of owners is also a work in progress.

Do more on-site inspections to verify off-site supervision and reports. This requirement will take more time to achieve.

As it can be seen, an important number of the recommendations have been implemented or are on the way to be so.

After this preliminary phase to fill the most urgent gaps, **there is a need, now, to strengthen the day-to-day supervision.**

The important number of daily tasks compared with the available labor force really available on March 2011 still partially prevents the implementation of all that is necessary, simultaneously: see for instance the work that remains to be done for a better compliance with the Core principles, but there is no doubt that the FME moves in that direction, though the lack of a global analytic and consistent framework continues to slow significantly the remediation.

Treating at the same time the past (the forensics), the economics of the non-performing loans, the stalemate of the banking system where new loans are so scarce, the building of a completely new supervisory system and the integration of the new staff not yet trained, is indeed quite difficult: too many indispensable projects, too many procedures, guidance, actions, etc. to be done simultaneously.

This is also a reason to build a consistent and complete supervisory framework to organize not only the FME but also all the processes, all the actions, controls, and the quality assurance.

The feeling of the expert is that, more than new texts or new laws, the issue is now to build a consistent supervisory framework to be able to assess in an ordered manner all the risks and to prioritize the tasks and strengthen the processes, which is the only way to deliver a robust global risk assessment and to implement it with an adequate information system while at the same time training enough of the present personnel and the new personnel to come. An assurance quality will complete all this process.

In a quasi Sisyphean enterprise with competing projects it is urgent to order the process and to build a consistent framework to be able to achieve what is expected: a robust and strong supervision.

QUICK ANALYSIS OF THE BCP

A quick analysis of the Basel Core Principle assessment confirms this view: it shows that more than a lack of texts (though some could be adopted), the main issue remains the implementation, still blocked by the lack of qualified personnel, tools, information system, global reorganization of the Departments, and above all of a consistent framework or risk model.

On the CPs, 13 Core Principles have been found compliant or largely compliant.

If the responsibilities and objectives are largely compliant in CP 1, the possible issue of the mandate has been discarded ⁴. The basic functions (activities permissible to banks CP 2, Licensing of new banks CP 3, transfer of significant ownerships CP 4, powers on Major acquisitions CP 5, capital adequacy CP 6) are also largely in line with what is expected. It is also the case for the large exposure limitations CP 10, the controls on the possible abuse of the financial services, the supervisory reporting CP 21, the accounting and disclosure issues CP 22, the corrective and remedial powers of the supervisors CP 23, the consolidated supervision CP 24, and the home/host relationships CP 25 which are normal and largely compliant or compliant with the Basel rules. Of course some minor fixes could be made. But neither texts nor practices seem faulty.

However, **12 CPs have been found materially non-compliant or "MNC"**: CP 7 on the risk management process, CP 8 on credit risk, CP 9 on problem assets and provisions, CP 11 on the controls on exposures to related parties, C12 on country and transfer risks, CP 13 on market risks, CP 14 on liquidity risk, CP 15 on operational risk, CP 16 on interest risk, CP 17 on internal controls and audits, but above all, CP 19 on the supervisory approach and CP 20 on the supervisory techniques.

If the legal framework (the texts) is usually sufficient with a few exceptions –that will be easy to fix-, the issues are in the practice and the procedures that are, more often than not, still too weak, not enough efficient or even non-existent. This is due to the lack of systems, the lacks of tools and information infrastructure, and above all, to the absence of a global risk assessment framework and a lack of sufficient number of trained and skilled personnel to make it effective and efficient. Nevertheless this can be achieved.

QUICK AUDIT OF THE FME

A quick "audit" of the FME shows that the tasks that remain to be done are the following:

⁴ in a country where having too precise texts can be seen as a blocking factor due to cultural habits, the issue of having an extensive and very precise mandate is not deemed absolutely necessary.

There are four main and urgent domains that need remediation:

1/ Have a clear view of the desired future banking (and financial) system.

With the participation of the FME and the related actors, a clear view for the next 10 years of the desirable size of the financial system, of its structure and of its “desired level of risk appetite” should be designed. The country “risk appetite” should be established and indicated. The prudential supervision could then adapt to this fundamental goal.

The supervision to rebuild should be in relation to the future banking and financial system. It is likely that the present system is at the same time too large and too weak for the country. There are presently too many inefficient banks. A downsizing of the present system is the possible option, as well as the restructuring of the banking system. Even if there is a difficult asset valuation problem, works should continue on the “vivisection” in banks to separate the 3 components: active, work in process, bad loans. In order to defreeze the banking system, an as-rapid-as-possible solution for the past problems should be achieved, together with some concentrations, some options for the creditors, and some revival of the economy to start again the distribution of loans. Presently, the system is too inefficient and unable to serve the country’s need.

The FME supervision should fit the country desired needs. The most likely choice is to have a system avoiding exotic products or destinations and that remains mostly domestic -at least for some time. As there is an absolute need to reinforce the FME actions, systems and controls, the reduction in the number of banks will not reduce the burden of the supervisors for some time. The state of the art in banks must also make progress. If presently moving towards more advanced Basel II and III approaches is not possible, it will if the banking system restarts. Monitoring the concentration process, a dangerous moment, will also take time, before pushing some banks to improve their MIS. More, there is the risk that banks have a short memory and decide dangerous moves that will have to be firmly controlled. A monitoring by the relevant authorities must be put in place to avoid future deviations. Of course an efficient oversight, macro, meso (sector) and micro analysis must be put in place. It should be rather easy to build with some crude but efficient indicators ⁵ that would facilitate a review and more proactive and timely actions ⁶.

⁵ For instance: the curve showing total bank assets on GDP, the value added of the financial sector on the total value added, the income of the banking sector relative to the one for all sectors, the volume of the assets and liabilities denominated in foreign currencies compared to the total, the intermediation ratio, the global financing mismatch, the transformation ratio, the growth per year and per quarter of the main elements (loans for instance). But also, in the future, **envisage a risk mapping** (Risk cartography) for the financial sectors and one for the FME. The idea is to be able to answer this question: “Where are the main risks?” or “Where is the dust under the carpet”?

⁶ For instance, establishing a prudential regulation on the net and gross positions in currencies, using the pillar 2 (Target ratio) to impose extra capital charges on “dangerously” booming activities.

In a nutshell the road map is clear: a supervisory approach "suit" that fits the banking system, a downsizing of this system and a revival of the economic activity.

2/ Then, build the necessary framework and infrastructure:

- a) Build the Risk Model (cf. annex 2)
- b) Build the supporting IS/IT system

a) A global supervisory Framework:

It is necessary to do it, even if the number of banks is limited (though the other undertakings such as insurances must also be under this approach). It is indeed the only way to have a robust and complete risk assessment, and an efficient risk process through a supervisory cycle: in fact what it is called in the Basel texts "a supervisory review process" or SREP.

The aim and the priority # 1 are to build the Risk Model, then the SREP and then the Risk-Based system.

The Risk model assures a consistency in the assessment of all the risks and the aggregation in synthetic indicators through internal "ratings" (ranking "à la CAMELS" 1 to 5 and price "à la Target Ratio", own funds Tier 1 in %). This framework is described in **annex 2**.

It is very important for the FME to do it and to do it now because the FME is rebuilding its supervision and this task should be treated as a project in a consistent manner. The review of the BCP indicates that most risks should receive a complete overhaul and this should be done consistently. It is the main task and the most urgent for the year to come and next year.

b) Build the supporting IS/IT system.

To realize this framework, the present IT/IS system must be enhanced, but only a quick audit of what exists and what should be implemented, could give an idea of the size of the task.

If the FME decides, as it is suggested, to build its supervisory framework, it is obvious that what is suggested here is a pre-requisite.

3/ Supplement by building the necessary tools and supervisory processes

- a) The SREP: including the "ORAP 2 form" (Icelandic name to find) supplemented by the ICAAP.

The proposed **supervisory form to be built** is similar for instance to ORAP2 (France), STAIRS2 (Australia), ARROWS2 (the UK). This form contains the Civil Status or "Etat-Civil" (names, codes, licensing history, structure, organization, management, LOB, etc), the capital ownership and repartition, the main figures, the main ratios, a detail of the new ICE rating (the main components leading to a note), the supervisory recent history, the main issues to date, and prudential decisions.

This form is used by all, up to the top management. It should be synthetic and cursive. Ratings are signed off by the different levels.

This form ensures consistency, transparency, accountability, monitoring of the supervisory process and quality assurance.

- b) Tools including monitoring tools, micro/meso/macro up to some type of Early Warning System (EWS)

Monitoring: it can be done with some general templates using the call report system and with specific exceptions templates etc.

Early Warning systems: there are several manners to create a EWS, from very simple martingales to a complete system such as SAABA (France) or PATROL (Italy).

- c) Consistent and efficient Dashboard available for all levels + data-mining.

Several dashboards can be created but it is possible to create a dashboard that can be used with different level of details from the Secretary General to the heads of units and below; indeed it is important that the data used be common within the institution, without double inputting.

4/ Meantime, further domains could also receive attention:

- a) **Solve the Human Resources issues:**

The FME could need a few more people than the 117 expected by the end of this year, to perform all its tasks. It could also be of some help if the FME moved to a more convenient building (room for the newcomers, reputational aspect).

The turnover rate at the FME fluctuates around 12 % with peaks at 19%.

In the year 2006, for instance, the Credit Division (responsible for banking supervision) has experienced a 78% turnover when 7 of 9 employees left the FME. Today, -but this is also due to the increase in the division-, 57% of the staff in the Credit Division has less than 3 years experience in banking supervision, though most of them have an some experience in banking.

However the main permanent issue is to succeed in **training** all the present and future personnel and to keep it.

There is hence a need to enhance the Human Resources efficiency by adopting some **HR mechanisms**: Banking supervision is a difficult job that requires skilled personnel with several years of experience. So it is important that the FME puts in place the dispositive that permits to reduce the turnover and increases the length of station in each job position. During the last 10 years, the FME has experienced a turnover rate that exceeds what is seen in the best supervisory agencies. Today, globally, 35% of the staff has less than 3 years experience. It is feared that the present recruitment will mostly be a "training of personnel" in favor of commercial banks in the years to come -when the banking industry will growth again.

As already noticed by Kaarlo Jänääri, this is due to an insufficiently competitive compensation compared with the commercial banking industry. But it is also due to the lack of rules that limit the possibilities of personnel to quit too easily. Even if the situation is made less acute due to the crisis, this will come to an end and it is time to prepare for this new situation.

Even if it is a change in the Icelandic culture, -and even if it is a situation known elsewhere- the FME should be ready to react strongly and to implement five new approaches that would help it to keep its personnel.

i) The FME could increase the compensation and especially increases bonuses linked to efficiency and qualification. To be effective, the “envelop” should not be too small (15 to 25%)? and the bonuses given to part of the “key” personnel should be significant (+ 25 to 50% of the net salary). Transparent rules must be decided and known by the personnel to be accepted. The idea is to keep the qualified personnel that are absolutely indispensable to maintain the efficiency of the supervision, not to be “nice” with all the personnel. In this token, a legal analysis of what is possible in Iceland should be performed rapidly.

ii) Oblige the people who have received a costly training (for instance abroad) to reimburse the FME if they quit before (date to decide but at least 3 years). This exists but could be enhanced (cf. point vi).

iii) Implement a “cooling” period of 2 years, i.e. the impossibility to work in the commercial financial sector or, as consultant, with Icelandic banks or banks installed in Iceland before two years. A shorter period (say 6 months) is inefficient.

iv) For junior staff, allow a payment for extra hours (above the normal quota). It is also possible to give some days off for part of the extra hours accepted or asked, for instance, for an important development project.

v) “Unequal exchange” of personnel with some banks. Some supervisory agencies exchange their junior non experienced staff (say around 30 years old) for seasoned bankers (say around 40/45 years old). Very strict and special conditions must be attached to this type of exchange program. The present situation of the banking sector does not for the moment allow for a smooth and riskless implementation of such a program now in Iceland, as it requests a “gentlemen agreement” at the top level with the “serious banks only”. But it can be a path for the future.

vi) Practically, a solution could be to **send 3 good and experienced people from the 3 functions** (on-site, off-site and oversight) 3 to 4 months working in friendly and good supervisory agencies. As the people will be integrated in the day to day work “as one of them”, in the recipient supervisory agency, it will be less reluctant to accept. That is one of the reasons the candidates should be already skilled. Avoid young people just arriving from the University: it is a normal temptation but probably less efficient. These 3 persons will comply with rules ii) and iii) and will be charged to gather information, papers, documentation that will be useful later. They will indeed be requested to do training when they return to the FME. This will complete the European Commission TAIEX training.⁷

⁷ The European Commission has proposed to help by offering short term training courses. This training will help the FME to get a better understanding of the State of the art today. However it is just a start. The proposed courses are:

b) Revisit the FME organization for a better efficiency:

As indicated in the Core principles, an effective supervision consists of an adequate mix and balance of on-site, off-site and oversight functions that constitute the “3 legs on which it must stand”.

The organization should also use a 4 eyes (as a minimum) approach for all important supervisory decisions, up to the Board. Having a framework that organizes that process can help. The present organization, perhaps a transitory issue, seems to mingle on-site, offsite and risks. This will not permit in the future to have really high level specialists or to allocate the staff in an efficient manner.

- The supervisory work is organized traditionally within 3 main Departments which have specific and complementary roles:

* *On-site* examiners have a specific role, specific tools and a specific culture and background. In some institutions they are mixed with the off-site people but the evidence shows that having specialized on-site examiners creates more efficiency. These people must have a specific behavior, taste for investigation, they are like police inspectors. Most weaknesses discovered within Supervisory agencies are linked to the lack or the poor quality of this function. In Iceland the main work, but not the only one, is the analysis of the quality of banks organization, the quality of the credit portfolios and provisioning, but also on other risks (liquidity for example or operational risk). It is prudent neither to let inspectors work too long with a unique bank nor to let them do this work all their professional life. Rotation within the Departments is a source of efficiency. Of course during the missions it is beneficial to also have temporary people from the two other Departments, always with a view to spray the same culture and to avoid silos. To be strong, on-site examiners should be strongly supported by the FME management in case of problems - with, of course, some internal mechanisms to avoid deviations.

* The *Oversight* Department or “Surveillance” should at the same time offer specific qualifications and be able to “monitor the forest and not only the trees”. It usually gathers all or most of the specialists (economists, legal, quants, IT etc). They have their own attributions and functions (for instance tool building) but must be used frequently in a cooperative manner by the two other Departments. The aim is to avoid silos.

* TAIEX 1: training course on the supervision today: the 3 functions, the components of a classical risk model, of a classical rating system, building a SREP

* TAEIX 2: study of the state of the Art in building a Risk Model

* TAIEX 3: study of the state if the Art in IT/IS for a risk Model

* TAIEX 4: data quality and quality assurance

* The *Off-site* department functions are well known.

The present "Operation Department" (in fact the administrative Department) can be set aside. The Insurance, the UCITS units, can rejoin the on-site and off-site department, the IT/IS and legal units, can be also set aside or united with the Surveillance for the two latest. In a balanced structure, the repartition between the 3 core Departments is around: onsite: 30, offsite: 35 and oversight: 25 %.

- All these people should **work together and exchange their knowledge as needed**. The worst situation is the "silo" one: every department in its own silo with little or no cooperation and exchanges. Cooperation should be set as a major criterion for performance and for results and compensation. In difficult onsite examinations, specialists of some technical domains should also participate. For instance, in the future, risk market models (or Solvency II internal models) should be examined by the 3 departments, in that case with the Onsite department as leader. For the quarterly or semi-annual forecast analysis, or for an IMF FSAP, the Surveillance will be leader with inputs from the two other departments. For the annual decision on the onsite examination program, the onsite department will be leader with inputs from the two other departments. The idea is to limit the silos and to promote a "client/provider" relationship and an effective cooperative spirit.

- The 3 departments can be, depending on the topic, leaders of a mix team. They should work together to be effective and efficient. Two of them work mainly along the institutions (undertakings) axis, the 3rd along the issues or risks. This is a real matrix organization that enhances effectiveness and efficiency.

c) Use the supervisory framework to **go towards a more risk-based supervision**:

One of the benefits of having a Framework is that it permits to create an "**Engagement Model**", leading to an optimal HR (and other resources) allocation. That's to say it helps to move towards a risk based system, where the allocation of resources put on institutions or issues (and/or by departments) is made in a more risk-based manner. This increases the efficiency of the supervision and reduces its costs.

d) Other tasks:

i - **Review some regulations, guidance, processes and practices** (see details in the BCP assessment).

ii- **Continue to implement Basel II and Basel III. Besides the SREP and ICAAP procedures**, there is a need to continue to implement the Basel reform. For instance, only the Standard Approach exists in Iceland and the only version of the computation of the operational risk is the too simple "Basic Indicator Approach". Some banks have started to work on some Foundation IRB methods for the credit risk but the crisis has legitimately stopped them. Once the crisis is finished, the main banks should advance toward IRB again. In

the same vein, moving some banks under the TSA (the standard approach) for the operational risk should be possible and beneficial. Implementing the new liquidity ratios and enhancing the monitoring of the liquidity risk is also a need, as well as a control of the valuation in the pension funds.

iii- **Implement the Mirroring and cross back-up of the FME and the CBI databases.** No real back-up of data is organized between the Central bank and the FME. It is possible to do that with a minimum of cost, having in each building the other institution's servers as mirrored back-ups. The lack of back-up can be seen as a breach in the BCP requirements. A common project would also demonstrate the wish of the two institutions to work together.

iv- **Perform more Data quality controls:** a request for a TAEIX financing of the data quality has been made. If data quality is a must and if probably there an issue there, this issue is first with the commercial banks. The controls developed by the FME should be run by the banks and any fatal discrepancy should lead to a rejection of the flow of data the bank is about to transmit. In several supervisory agencies it is one of the roles of the on-site to verify the quality of the data. The accounts and the main documents are checked by the examiners on-site and corrections are demanded (often: bad loan classification, bad provisioning, wrong classification by types of agents, wrong credit register reporting etc). Off-site and oversight also should contribute. For instance, the offsite permanent control has exception lists created by an important number of arithmetic, logical and likelihood controls and its results, that it can monitor; but, if needed be, this can be checked onsite if there is a situation that should deserve this more intensive approach.

In the same token, the Oversight should build tools such as a synthetic balance-sheet with absolute and relative variations (quarterly and annual) and exception lists (10 largest increases, 10 largest decreases for some important variables). The received call reports must be monitored at each period both from an individual point of view and from a global more macroeconomic point of view.

MAIN RECOMMENDATIONS for the FME ⁸

- 1-Start to build as soon as possible a new Global Consistent Framework (or Risk model) that covers all the risks, allowing to build an internal rating (a "CAMELS"), then a supervisory review process up to a pillar 1 + pillar 2 valuations (Target Ratio) and Supervisory Cycle;
- 2-Develop a robust IT/IS to support this move;
- 3- Solve the issues indicated pages 10 to 14;
- 4- Correct the most important deficiencies in the BCP;
- 5- Fix later the secondary deficiencies found in the BCP assessment.

⁸ This also presumes that the macro conditions in the banking sector will change and improve as indicated page 3 but it is a task in which the FME is not the only actor.

Items 2 and 3 are mostly pre-requisites to do what is proposed in item 1. Items 4 and 5 will follow as by-products.

AGENDA

Planning

- **First Year: design of the framework** and tests.

Solve at the same time the main other issues (organization, training etc).

This could take perhaps more than one year to finish all but the important thing is to launch a consistent unique project "SUPERVISION 2012" as everything is dialectically linked.

* Build a risk Model: this is the Core of the system: 3 months of blue print design + 9 months at least including all the SREP process (and of course a view on all the sub processes and procedures to mount of to strengthen accordingly, using some kind or PERT analysis: inputs, processes, desired outputs; quality assurance).

* In parallel, build the supporting IT/IS necessary to permit this Model (pre-analysis to be done to evaluate the necessary time). Find the less costly solution.

* Fix the most important deficiencies in the BCP, related mainly to the principles evaluated materially non compliant.

* Continue to implement the other recommendations (training, organization etc).

- **Following years: 1- 3 Years: implementation** of the complete system (including for insurances and other undertakings).

* implementing the framework

* finalizing the CAMEL-like rating and checking its stability and efficiency

* strengthening the SREP + ICAAP process up to a complete pillar 1 and a pillar 2 analysis

* build all the other tools and procedures for monitoring (peers groups, EWS, dashboards).

* implement new stricter regulations and fix the other BCP deficiencies

* moving later towards Basel II and III more "advanced" approaches: IRBF and the TSA, because the Present unique approach implemented in Iceland, the Basic Indicator Approach (BIA) for the operational risks, does not permit banks and the FME to make progress.

In the middle term (5 years?) this is a preliminary step for the largest banks to move towards more advanced approaches. This time is also necessary for the FME to build up its own validation capacity (on and offsite).

CONCLUSION:

The Icelandic Authorities and its supervisor, the FME, have done substantive work after the 2008 crisis. Still, an important work remains to be performed to have a supervisory system that is really efficient and compliant with the international rules, as demonstrated by the assessment of the BCP. The work on the banking system itself must continue as expeditiously as possible towards a revival.

Some years of hard work will be necessary but if done in an ordered manner, firmly and constantly, it should be successful. The FME staff is eager to make progress.

The FME and its Board have taken decisions in the right direction and the efforts must go on but, now, in a more organized manner and with still some more resources.

A respected, confident and strong regulator and supervisor is a public asset. It will be needed when the financial sector will restart again, to avoid the mistakes made in the past.

*

ANNEXE 1: the assessment of the BCP: A considerable work is underway but there is still room for improvement.

SYNTHETIC FORM: RATINGS GIVEN FOR THE BASEL CORE PRINCIPLES;

ICELAND MARCH 2011

C: Compliant LC: Largely Compliant MNC: Materially non compliant NC: Non-compliant NA: not applicable

<i>CP rated MNC</i>	<i>12</i>
<i>CP rated LC</i>	<i>11</i>
<i>CP rated C</i>	<i>2</i>
<i>Total</i>	<i>25</i>

The main deficiencies are on the Supervisory approach CP 19 and the supervisory techniques CP 20; as a result, all the risks assessments (CP 7, 8, 9, 11 to 19) need a serious improvement. There is, indeed, room for improvement.

*The FME has worked expeditiously these last two years but there is a need - now that some extra resources have been given and that some training is planned- to focus on the **building of a global consistent risk and process framework or Risk Model** to assemble all the pieces that exist or that will have to be constructed. The IT/IS will have to work in accordance to the needs. Then the FME will be able to develop its own Supervisory review process (or SREP).*

Short of this, the FME will lose part of its efforts to build a robust supervision that is needed for the country.

*Synthetic assessment*⁹

<i>Core Principle</i>	<i>Description</i>	<i>Rating</i>
CP1	<i>Responsibilities and objectives</i>	LC
CP2	<i>Permissive activities</i>	LC
CP3	<i>Licensing</i>	LC
CP4	<i>Transfer of significant ownerships</i>	LC
CP5	<i>Major acquisitions</i>	LC
CP6	<i>Capital Adequacy</i>	LC
CP7	<i>Management process</i>	MNC
CP8	<i>Credit Risk</i>	MNC
CP9	<i>Problem assets, provisions and reserves</i>	MNC
CP10	<i>Large exposure limits</i>	LC
CP11	<i>Exposures to related parties</i>	MNC
CP12	<i>Country and transfer risk</i>	MNC
CP13	<i>Market risk</i>	MNC
CP14	<i>Liquidity risk</i>	MNC
CP15	<i>Operational risk</i>	MNC
CP16	<i>Interest rate risk</i>	MNC
CP17	<i>Internal control and audit</i>	MNC
CP18	<i>Abuse of financial services</i>	LC
CP19	<i>Supervisory Approach</i>	MNC
CP20	<i>Supervisory techniques</i>	MNC

⁹ The complete detailed assessment (243 pages) has been given to the FME.

<i>CP21</i>	<i>Supervisory reporting</i>	<i>LC</i>
<i>CP22</i>	<i>Accounting and disclosure</i>	<i>LC</i>
<i>CP23</i>	<i>Corrective and remedial powers of supervisors</i>	<i>LC</i>
<i>CP24</i>	<i>Consolidated supervision</i>	<i>C</i>
<i>CP25</i>	<i>Home-host relationships</i>	<i>C</i>

And by essential criteria:

CORE PRINCIPLE #	Rapid description of the criteria and of the EC essential criteria	Legal Framework (first note) and Practices and procedures (second note)	Global Rating
CP 1	Responsibilities and objectives	LC	LC
EC1 1(1). 1	Responsibilities and objectives: clear definition	C + LC	LC
EC 1(1).2	Minimum prudential standards in laws	C + C	C
EC 1(1).3	Legal framework : minimum update	LC+ LC	LC
EC 1(1).4	Public disclosure on financial strength and performance of the banking industry	LC + LC	LC
EC 1(2).1	Independence	LC+LC	LC
EC 1(2).2	Accountability	LC+LC	LC
EC 1(2).3	Credibility	LC+LC	MNC
EC 1(2).4	Financing and staff	LC+LC	LC
EC1 1(3). 1	Licensing authority	C + LC	C
EC 1(3).2	Authority to issue prudential rules	C + LC	LC
EC 1(3).3	Possibility to obtain information from banks	C+ LC	LC
EC 1(4).1	Possibility to apply supervisory judgment	C + C	C
EC 1(4).2	Full access to banks' Boards, management	C+NA	C
EC 1(4).3	Powers for prompt remedial action or sanctions	C+LC	LC
EC1 (5). 1	Protection to the supervisory authority and staff	NC + MNC	MNC
EC 1(5).2	Financial protection	LC + LC	LC
EC 1(6).1	Arrangement between financial domestic authorities	LC+ LC	LC
EC 1(6).2	With foreign supervisors	C+LC	LC
EC 1(6).3	Transmission of confidential information to peer authorities	C+C	LC
EC 1(6).4	Possibility to deny any demand for information	LC+NA	LC
CP2	Permissible activities	LC	LC
EC 2 1	Definition of the term "bank"	C + C	C
EC 2 2	Permissible activities for banks	LC+LC	LC
EC 2 3	Use of the word : "bank"	C + LC	C
EC 2 4	Taking of deposits reserved to licensed institutions	C+LC	LC
EC 2 5	List of operating banks	C+LC	LC
CP 3	Licensing	LC	LC
EC3 1	Licensing authority	C + C	C
EC 3 2	Criteria for licensing	C + LC	LC
EC 3.3	Consistency of the licensing criteria	C+C	C
EC 3.4	Powers to reject a license application	LC +LC	LC
EC 3.5	Effective supervision not hindered by structures	LC+LC	LC
EC 3.6	Identification of shareholders	C+LC	LC

EC 3.7	Minimum capital	C+C	C
EC 3.8	Fit and proper test on management	C+LC	LC
EC3.9	Review of banks plans	C + LC	LC
EC 3.10	Review of pro forma and projections	C + LC	LC
EC 3.11	Contact with the host regulator (foreign banks)	LC+LC	LC
EC 3.12	In case of false information	C+C	LC
EC 3.13	Control of the knowledge of activities by the Board	C+C	LC
CP 4	Transfer of significant ownerships	LC	LC
EC 4. 1	Clear definition of significant ownership and controlling interest	C + NA	C
EC 4.2	Requirements to obtain notification on changes in ownership	C + LC	LC
EC 4.3	Power to reject changes in ownership	C+LC	LC
EC 4.4	Information on shareholders	C+LC	LC
EC 4.5	Power to take actions to modify, or address a change of control	C+LC	LC
CP 5	Major acquisitions	LC	LC
EC 5.1	Definition of criteria for prior approval	LC+NA	LC
EC 5.2	Criteria by which to judge individual proposals	LC+NA	MNC
EC 5. 3	Prohibition of major acquisitions	LC +LC	LC
EC 5.4	Adequate resources to handle the acquisition	LC+LC	LC
EC 5.5	Clear definition for which cases a notification after the acquisition is sufficient	LC + LC	LC
EC 5.6	Possible actions on non-banking activities	C+LC	LC
CP 6	Capital Adequacy	LC	LC
EC 6.1	Minimum capital adequacy ratio	LC +LC	LC
EC 6.2	For internally active banks the ratio is not lower than the Basel requirement	LC + LC	LC
EC 6.3	Power to impose a specific capital charge or a limit on risks	LC+ LC	LC
EC 6.4	The ratio reflects the risk profile	LC + LC	LC
EC 6.5	Possible higher adequacy standards	LC+LC	LC
EC 6.6	Possible measures if a bank fall below the minimum capital ratio	C+LC	LC
EC 6.7	Rigorous standards if banks use IRB approaches	C+NA	NA IRB not in place
CP 7	Risk Management process	MNC	MNC
EC 7. 1	Power to require banks to have and strengthen their risk management processes	LC + MNC	MNC
EC 7.2	Banks have appropriate risk management strategies approved by their Boards	LC + MNC	MNC

EC 7.3	Risk management strategies, policies etc are documented, reviewed and updated. Review of the adherence.	LC+ MNC	MNC
EC 7.4	Understanding by the Board of the risks	LC +MNC	MNC
EC 7.5	Banks have internal process for assessing their overall capital adequacy	LC+MNC	MNC
EC 7.6	Independent validation and testing of models by banks	NA+NA	MNC/NA
EC 7.7	Adequate information systems in banks	LC +MNC	MNC
EC 7.8	Process to control new products in banks	NC + NC	NC
EC 7.9	Independent risk evaluation and internal control function	LC+MNC	MNC
EC 7.10	The supervisors issues standards on risks	LC+LC	LC
CP 8	Credit Risk	MNC	MNC
EC 8.1	Control of risks, strategies, implication of the Board	LC+MNC	MNC
EC 8.2	Credit risk environment policy and control	LC+MNC	MNC
EC 8.3	Credit decisions free of conflict of interest	LC+LC	LC
EC 8.4	Full access to information by the supervisor	C + C	C
CP 9	Problem assets, provisions and reserves	MNC	MNC
EC 9.1	Requirement for managing problem assets. Review provisioning, write-offs	LC + LC	MNC
EC 9.2	Adequacy of the classification and provisioning	LC+MNC	MNC
EC 9.3	Off-balance sheet	LC+LC	LC
EC9.4	Provisions and write reflecting recovery and repayment expectations	LC +MNC	MNC
EC 9 5	Early identification of deteriorating assets	LC + MNC	MNC
EC 9.6	Information of supervisors	LC+ MNC	LC -
EC 9.7	Powers to increase provisions and reserves	LC +MNC	MNC
EC 9.8	Assessment by the supervisor of the adequacy if provisioning	LC+LC	LC
EC 9.9	Banks to have a valuation of the risk mitigants	LC+MNC	MNC
EC 9.10	Criteria for impairment	LC+MNC	MNC
EC 9.11	Boards to receive timely information on the portfolios (level of provisions, major problems etc)	LC+LC	LC
EC 9.12	Classification , provisioning etc of Large exposures	LC+LC	LC
CP 10	Large exposure limits	LC	LC
EC 10.1	Definition of group of connected counterparties	LC+LC	LC
EC 10.2	Prudent set of limits on LE	C +LC	LC
EC 10.3	Information in banks IS	C+LC	LC
EC 10.4	Policies and procedures in banks for thresholds	NA+LC	LC

	and concentration		
EC 10.5	Information gathering and remedial powers by the supervisor	LC+MNC	MNC
CP 11	Exposures to related parties	MNC	MNC
EC 11.1	Clear and comprehensive definition of “related parties”	LC+NA	LC
EC 11.2	Connected lending: Regulations on arm’s length lending	MNC+LC	MNC (arm’s length)
EC 11.3	Prior approval by Board	LC+LC	LC
EC 11.4	Exclusion of the process of granting for benefiting connected lending parties	C+LC	LC
EC 11.5	Limits or deduction of those exposures	MNC+MNC	MNC
EC 11.6	Processes to identify individual exposures to related parties	MNC+MNC	MNC
EC 11.7	The supervisor obtains and review information on related parties	NA+LC	LC
CP 12	Country and transfer Risk	MNC	MNC
EC 12.1	Identification, measurement and control of this risk	MNC +MNC	MNC
EC 12.2	Monitoring in banks’ MIS	MNC+MNC	MNC
EC 12.3	Oversight of the country risk provisioning	MNC+MNC	MNC
EC 12.4	Information to the supervisor	MNC+MNC	MNC
CP 13	Market Risk	MNC	MNC
EC 13.1	Suitable policies and process in banks	MNC+MNC	MNC
EC 13.2	Market risk limits approved by the Board	LC+MNC	MNC
EC 13.3	System and controls in place with MTM frequent and reliable valuations	LC+MNC	MNC
EC 13.4	Scenario, stress-testing, measure of market risk integration in banks’ the risk management	LC+MNC	MNC
CP 14	Liquidity Risk	MNC	MNC
EC14.1	Liquidity guideline for banks	LC +MNC	MNC
EC 14.2	Liquidity management and processes in place in banks	MNC + MNC	MNC
EC 14.3	Understanding by the Board in its oversight of the liquidity risk	MNC+MNC	MNC
EC 14.4	Banks to establish policies and processes	MNC+MNC	MNC
EC 14.5	Information on foreign currencies liquidity transformation	MNC+MNC	MNC
EC14.6	Contingency liquidity plans	MNC+MNC	MNC
CP 15	Operational risk	MNC	MNC
EC 15.1	Risk management policies and processes to	LC+MNC	MNC

	identify and mitigate operational risk		
EC 15.2	These strategies, policies, etc. are approved and reviews by the Board	LC +MNC	MNC
EC 15.3	Operational risk policies implemented	LC +MNC	MNC
EC 15.4	Quality, completeness etc. of the contingency plans	LC+ MNC	MNC
EC 15.5	IT/IS policies and processes in place	LC+NC	NC
EC 15.6	Reporting mechanisms in place	NA+MNC	MNC
EC 15.7	Legal risk	LC+LC	LC
EC 15.8	Outsources activities	MNC+MNC	MNC
CP 16	Interest rate risk in the Banking Book	MNC	MNC
EC 16.1	Approval by the Board of the strategy and policies for the interest risk	LC+LC	LC
EC 16.2	Comprehensive measurement systems	LC+MNC	MNC
EC 16.3	Periodical stress-tests and loss vulnerability	LC+MNC	MNC
CP 17	Internal control and audit	MNC	MNC
EC 17.1	Laws and regulation ensure an effective control	LC+MNC	MNC
EC 17.2	Effective adequate internal controls	LC+MNC	MNC
EC 17.3	Responsibility and understanding of boards and managements	LC+LC	LC
EC 17.4	Possible changes in the composition of Boards and senior managements	LC+LC	LC
EC 17.5	Appropriate balance in the skills and resources of the back offices control functions	MNC+MNC	MNC
EC 17.6	Compliance function	MNC+MNC	MNC
EC 17.7	Effectiveness of the internal audit function	LC+MNC	MNC
CP 18.	Abuse of financial services	LC	LC
EC 18.1	Responsibilities and powers of the supervisors	LC+NA	LC
EC 18.2	Banks to have in place adequate policies and processes	C+LC	LC
EC 18.3	Reporting (incidents, frauds, suspicious transactions)	C+LC	LC
EC 18.4	KYC policies and processes	C+LC	LC
EC 18.5	Correspondent banking due diligences	LC+LC	LC
EC 18.6	Controls and systems in place at banks for controlling financial abuses, money laundering	C+LC	LC
EC 18.7	Adequate enforcement powers	C+C	C/LC
EC 18.8	Banks to have requirements for internal audits, and/or external experts; policies to designate compliance officer, screening, training on KYC, AML	C+LC	LC
EC 18.9	Clear policies in banks to report; dedicated officers, adequate MIS	C+LC	LC

EC 18.10	Whistleblowing	C+C	C
EC 18.11	Information given to the financial intelligence unit, sharing of information to judicial authorities	C+C	C
EC 18.11	Domestic and international cooperation	C+C	C
CP 19	Supervisory approach	MNC	MNC
EC 19.1	Understanding of the risk profiles of individual banks and banking groups	NA+MNC	MNC
EC 19.2	Macro-supervision , meso-supervision and Oversight: Trends, developments of risks in the whole banking system including for non financial institutions	NA+MNC	MNC
EC 19.3	Methodology for determining and assessing all risks (Risk Model)	NA+MNC	MNC
EC 19.4	Banks compliance with regulations	NA+MNC	MNC
EC 19.5	Notification of activities changes, structures etc of banks including breaches of requirements	LC+MNC	MNC
EC 19.6	Adequate information system that helps the identification of follow-up areas	NA+MNC	MNC
CP 20	Supervisory techniques	MNC	MNC
EC 20.1	Appropriate mix of on-site and off-site supervision	NA+MNC	MNC
EC 20.2	Planning for on-site and off-site. Objectives and information sharing between the different functions	NA+MNC	MNC
EC 20.3	On-site work	NA+MNC	MNC
EC 20.4	Off-Site work	NA+MNC	MNC
EC 20.5	Risk-based supervision and appropriate contacts with bankers. Understanding of the risk-profile	NA+MNC	MNC
EC 20.6	Ongoing quality assessment of the Brads and Management	NA+MNC	MNC
EC 20.7	Reliance on banks internal auditors and audit function	NA+MNC	MNC
EC 20.8	Communication to the banks of the supervisor findings (written and oral)	NA+LC	LC
CP 21	Supervisory Reporting	LC	LC
EC 21.1	Reporting from banks	C+LC	LC
EC 21.2	Accounting standards used	C+C	C
EC 21.3	Valuation rules used	C+LC	C
EC 21.4	Adequate frequency for collecting and analyzing data	C+LC	LC
EC 21.5	Same basis and consolidated data	NA+LC	LC
EC 21.6	Powers to request more information	C+C	C

EC 21.7	Access to data in banks	C+C	C
EC 21.8	Timely and accurate information. Enforcement	C+LC	LC
EC 21.9	Confirmation of the validity and integrity of information received. Means used	C+MNC	LC
EC 21.10	Clear definition of the scope and use of external experts in supervisory tasks	C+C	C
EC 21.11	External experts to inform promptly the supervisor	C+C	C
CP 22	Accounting and disclosure	C	LC
EC 22.1	Power to hold Banks responsible for the reliability of financial data	C+C	C
EC 22.2	Banks responsible for the quality and verification of the public financial statements	C+C	C
EC 22.3	Realistic and prudent accounting rules	LC+C	LC
EC 22.4	External audit: scopes and standards	C+LC	MNC
EC 22.5	Areas covered by the audits	C+C	LC
EC 22.6	Power to reject external auditors	LC+C	LC/MNC
EC 22.7	Banks to produce annual audited financial statements	C+C	C
EC 22.8	Periodic public disclosures by banks (comparability, relevance, reliability, timeliness)	C+C	C
EC 22.9	Scope and content of the disclosed information	C+LC	LC/MNC
EC 22.10	Reviews and enforcement on compliance with disclosure standards	C+LC	LC
EC 22.11	Publication of aggregate information on the banking system	C+LC	LC
CP 23	Corrective and remedial powers of supervisors	C	LC
EC 23.1	Remedial supervisory action (powers, timely manner, checks on remedial actions)	C+LC	LC
EC 23.2	Time and manner in bank's resolution	LC+C	LC
EC 23.3	Appropriate range of supervisory tools in remedial actions	C+LC	LC
EC 23.4	Range of possible measures.	LC+C	LC/C
EC 23.5	Powers of the supervisor on the minimum capital ratio (early, options)	C+LC	C-
EC 23.6	Actions and penalties against the bank or the individuals	C+C	C/LC
CP 24	Consolidated supervision	C	C
EC 24.1	Understanding of banks structures and activities	C+C	C
EC 24.2	Powers to review group activities and foreign banks incorporated	C+C	C
EC 24.3	Supervisory framework for non-banking	C+LC	LC

	activities		
EC 24.4	Powers on consolidated supervision	C+C	C
EC 24.5	Cross domestic flows of information; Home/host information	C+C	C/LC
EC 24.6	Power to limit activities and to monitor them	C+C	C
EC 24.7	Foreign operations	C+C	LC
EC 24.8	Foreign operations controls by banks	C+C (NA in practice)	LC
EC 24.9	Ability for the Home supervisor to close or limit foreign offices	C+C	C
EC 24.10	Oversight of bank's foreign operations related to risk	NA+LC	LC
CP 25	Home-host relationships	C	C
EC 25.1	Adequate exchange of information between Home and Host	C+C-	C -
EC 25.2	Relevant other supervisors, MOUs	C+C	C
EC 25.3	Information given to the hosts	LC+LC	LC
EC 25.4	Information given by the hosts	C+NA	C/NA
EC 25.5	Foreign banks subject to the same rules	MNC+NA	MNC/NA
EC 25.6	Licensing: no objection from the Home	MNC+NA	LC
EC 25.7	On-sites access to the Home	NA+NA	NA no foreign branch
EC 25.8	Shell banks	NA+NA	NA : none
EC 25.9	Consultation Home/host before action	NA+NA	NA

ANNEXE 2: BUILDING A GLOBAL FRAMEWORK OR “RISK MODEL” AT THE FME: a necessity.

WHAT IS IT, WHY IT IS IMPORTANT NOW?

A “Risk Model” is a consistent analytic framework that permits and guides the analysis and the prudential actions; it allows assessing the banking risks, to evaluate them, “price them” and to lead to proactive (and if possible risk-based) actions in a consistent manner, along what is called a SREP: a Supervisory review process. One should not be afraid by the name given traditionally: of “Risk Model”; it is more a consistent framework than an econometric model. In countries such as Ireland and the UK, the Supervisors are presently rebuilding their “Risk Model” for good reasons. In all large supervision, the implementation of Basel II has given the opportunity to materially update their risk Model, such as Australia (STAIRS2), Canada, France (ORAP2), England (ARROWS2) etc.

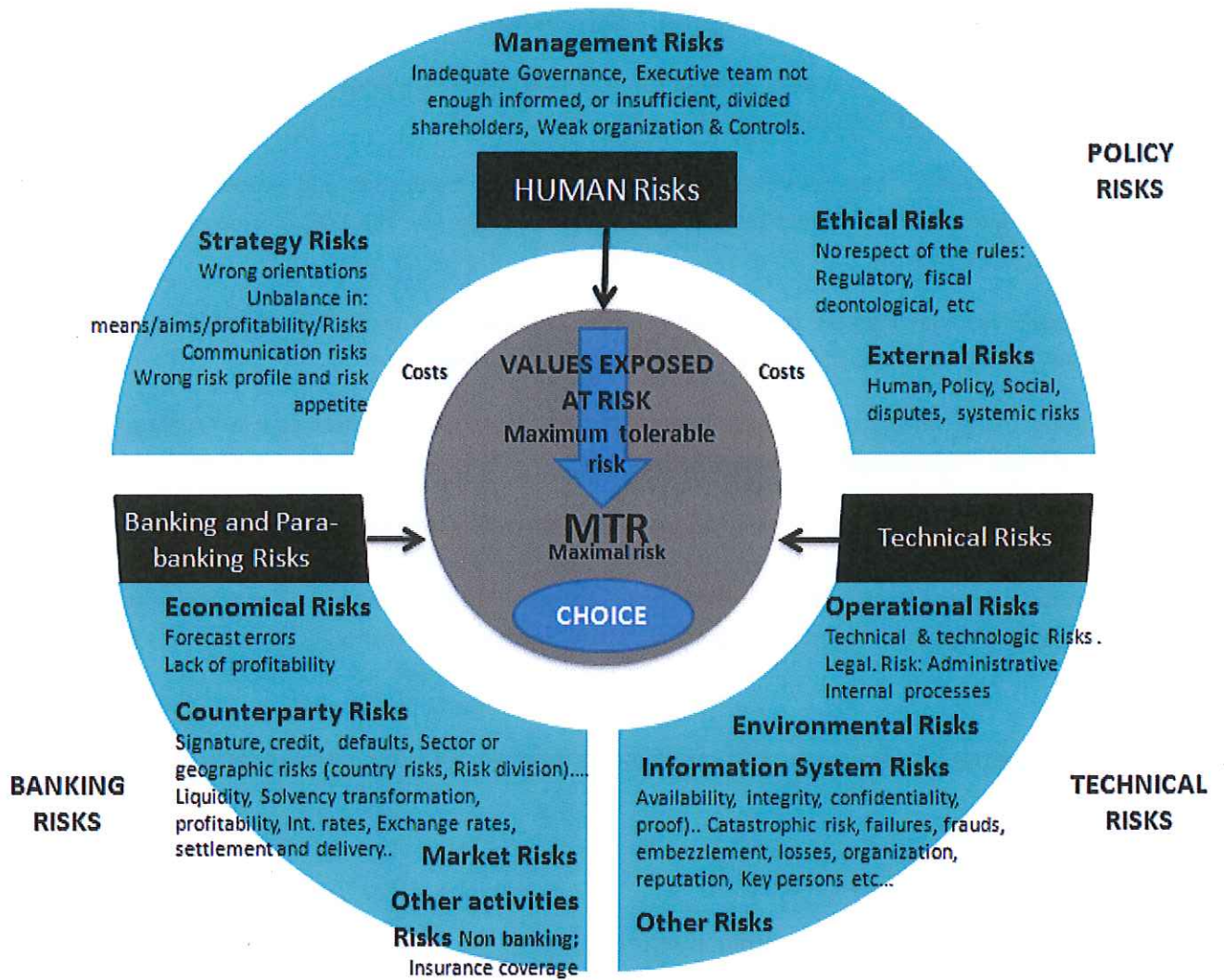
A Risk Model is not necessarily a quantitative “model” with numerous “equations”, it is more a consistent framework that helps to assess all the risks a supervisor has to take into consideration in a consistent manner. The idea is indeed to locate and assess if possible all the risks a financial institution is facing. So it deals with the volume and the types of the risks, the Exposures at default and tries to assess the possible risk of events (PD) and in that case, the possible losses (LGD to use the Basel concepts) and the various deficiencies. Of course some risks, more qualitative, are more difficult to value but still they must receive an assessment. There are techniques to do that. Even if the number of financial institutions is not important in Iceland (45), this framework is necessary to have a consistent system. Besides, this framework can be used for the other undertakings under the FME supervision (such as insurances) with minimum adaptation.

The Financial institutions are facing numerous risks. It is traditional to represent the main risks (policy, technical and economic risks), in a chart such as the following: this is however the **French view** in which *the main risk is above all the human risk* (policy/politics, management), the other traditional risks (technical and economical) being more obvious.

The Risk Constellation: the French view

The human risk is predominant in nearly all causes. All the risks can be analyzed in the same manner: a value exposed at risk and limits including a maximum tolerable risk. The aim is to be able to maintain the risks within the desirable boundaries.

The "Risk Constellation":



After an assessment, the issue is to start from the "intrinsic" risks (the gross risks) and to subtract the mitigants (quantitative such as collateral, mortgages, guarantees) and the qualitative qualities/defaults (on procedures, process, and controls) to get the net risks.

Then the issue is to aggregate in a consistent manner all the risks assessments to have a global aggregate rating and a "price" expressed through the Target ratio, the ratio that includes the capital charges for the pillar 1 (quantitative) and the pillar 2 (qualitative), and, later, the new capital buffers of Basel III (procyclicality, systemic risks, SIFIs). A formulaic rule is necessary for an adequate aggregation.

Following the UK view, the following risks – this is only an abstract only- should be envisaged:

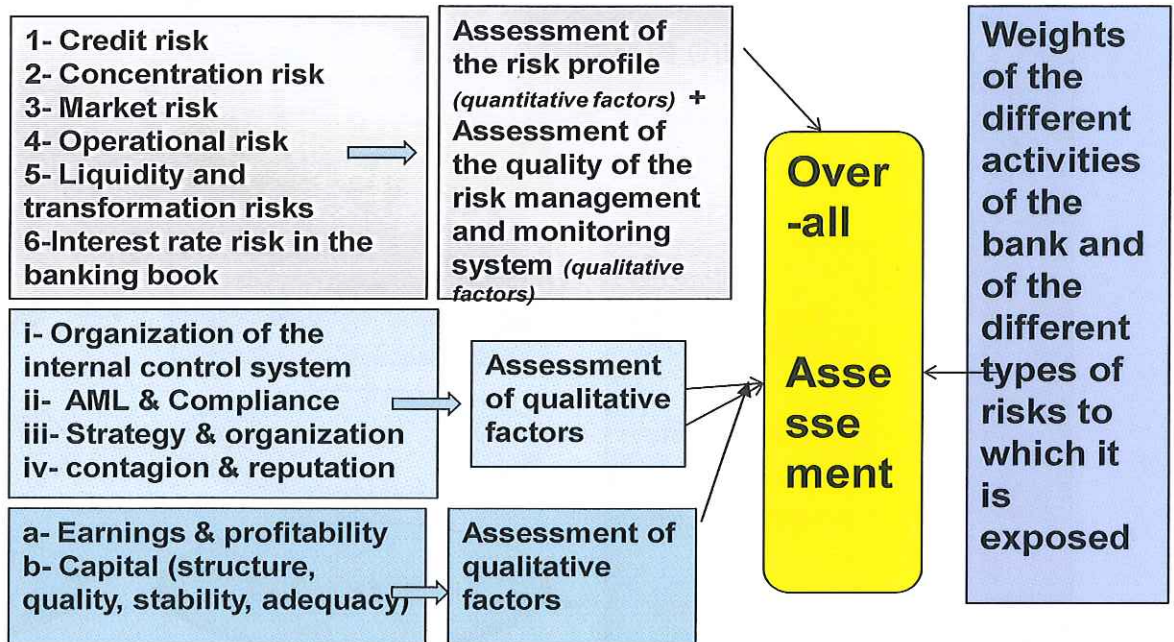
- *Environmental risks*: macro, meso or sectoral- and micro analysis at the consolidated and solo levels + an economic analysis (GPD ratios, growth, trends, “fractals”, etc.).
- *Economic and financial analysis*: based on financial disclosures and prudential reporting + external market data and other stress-tests. It takes into consideration the LOB or Lines of business, the bank’s Charter, its sensitivity.
- *Results of the analysis made onsite, offsite and oversight analysis* (concentration, division, portfolio analysis, provisions, EL, UL), credit, market and operational risks, etc.
- *Other risks*: Analysis of the effectiveness and efficiency of the processes (Governance, internal control, legal, ERM, IT/IS, reputation, conduct of business).
- *Analysis of all the **net** risks and model (assessment) of the add-ons*: extra capital charges (including liquidity, transformation, interest risk, ALM, AML, currencies, business model, etc.): sustainability and profitability. Adequacy of the controls to the businesses, risk appetite, risk management and compliance, understanding by the Board and top management, quality of the teams etc. Effectiveness and efficiency.

Following the American view, the risks elements to take in a Risk Model should be:

- * Risks;
- * Organization and pillar 2 elements;
- * Economic elements (capital, profitability).



The overall assessment process



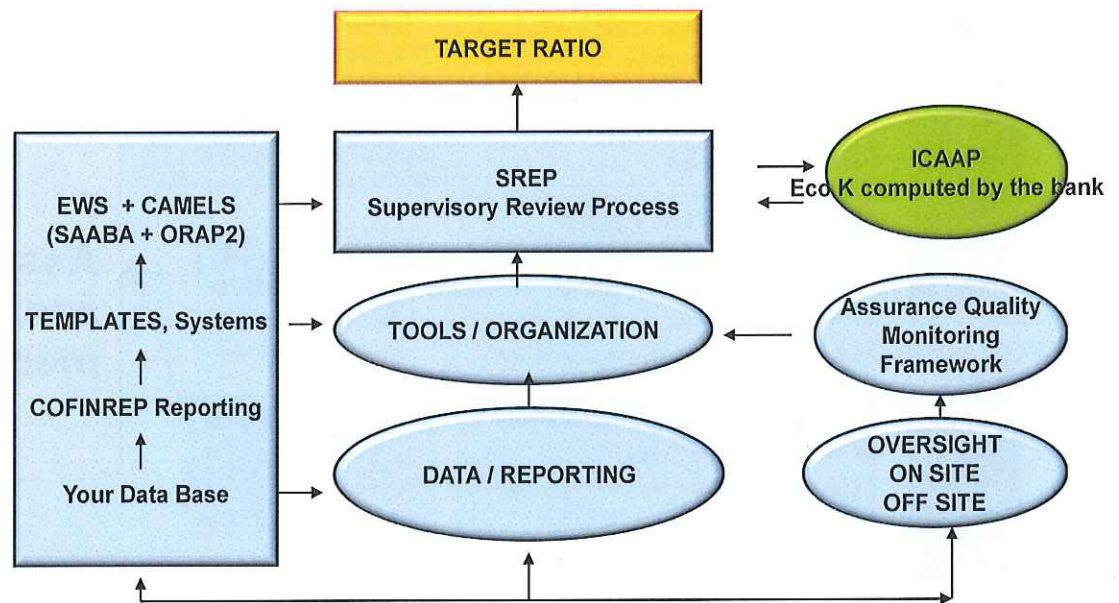
As it can be seen, the differences in the approaches are in fact not so important.

When we are asked to help to build a Risk Model, we try to fit with the local culture and need.

Globally, the issue is to integrate in a global framework, all the available tools, all the necessary tools if not yet available, to determine the supervisory process and to reach a robust assessment (ranking and prices) up to a "Target ratio" which is the price in capital charges given by the supervisors through the SREP process along pillars 1 and 2, as described below:

BUILDING A GLOBAL SYSTEM (cont'd)

Architecture of a global RBA



In the middle is the process up to the SREP and the computation of the "Target Ratio", the ratio that, at the end of the process, the Supervisor imposes to a banking group; on the left are the technical elements that are needed and on the right side, the internal and external resources that work on the evaluation: the main FME Departments, including the new quality assurance, with some external consideration to the work made by banks with their own economic capital calculation or ICAAP.

Presently the FME has only some pieces of what is necessary to assemble.

Only a risk model is able to compile in an ordered and consistent manner all these elements along the Pillar 1 and 2. Each sub-element is assessed and "rated". The "model" allows to aggregate risks in a single element (a ranking – "à la CAMELS2"-, a PD % 1 year or, better, a target ratio: the price imposed by the regulator in terms of capital, according to the assessments of all the risks).

The global assessment also allows for a better resources allocation: a more risk based supervision. Then the Model becomes an “engagement” model (to “engage” resources in a more logical manner). And more, a SREP supervisory review model where the necessary actions are based on a consistent analysis and not on a basic –usually too late- reaction. At the end of such a process, there is a synthetic form (cf. France ORAP2) that regroups in a few pages (with possible data mining) the most important elements including the rating given and the actions that have been planned and done recently and the one that are proposed for an efficient proactive action. This tool insures quality assurance and top management control.

The recent experience indicated that when there is crisis, it is also **always** because the Risk model is absent or faulty, even if other causes exist (lack a balanced organization between on-site, offsite and oversight, gaps and holes in the scope and field of the institutions to monitor, etc.).

To evidence this: the work presently done by the Irish and the British Supervisory Agencies to redo their Risk Model.

Today, the FME has only: a limited structured (historical) efficient data base, an IS that must progress, very insufficient tools (for the time being, only a small template with few indicators), no structured vision on how to assemble and assess all the risks with a synthetic yardstick, no quality assurance. Using what is called here improperly ICAAP (because banks cannot build really an ICAAP, having not moved under advanced Basel III approaches) does not really permit the FME, with its own tools, to challenge efficiently what is given as a guess-estimate by banks. Due to the absence of a framework (a Risk Model) its pillar 2 is presently largely given by the commercial banks.

It is of the utmost importance for the FME to consider seriously its need to build a consistent risk model as done everywhere in the efficient supervisory agencies all over the World. After the crisis, seeing all the efforts made by the FME now, but also the lack of effort - as evidenced in the analysis of the Core principles- , it is exactly the right moment to build one. The relatively small number of banks in Iceland just only facilitates the implementation.

The lack of such a Model would impair seriously the FME’s ability to progress rapidly.

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Annex 3: List of Kaarlo Jännäri's 2009 recommendations and how they have been implemented at March 2011 (source MBA):

1. **Decrease the number of ministries** that have a hand on the Financial Market Legislation or otherwise are **involved in the financial markets**.

This recommendation has not been implemented. Legislation pertaining to the financial market (credit institutions, financial institutions, insurance undertakings, securities market, official supervision of the aforementioned) falls under the ambit of the Ministry of Economic Affairs. The legislation on the operations of pension funds – large players and institutional investors – falls under the Ministry of Finance and legislation on the Housing Finance Fund, Iceland's largest financial undertaking, falls under the Ministry of the Interior.

2. **Merge the CBI and the FME** or at least bring them under the same administrative umbrella (like in Finland and Ireland).

This recommendation has been implemented to a large degree. The Icelandic ministries were restructured in autumn 2009 and the Ministry of Economic Affairs established. Legislation on the FME (The Icelandic Financial Supervisory Authority) and the Sí (the Central Bank of Iceland) fall under the Ministry of Economic Affairs. January 6th 2011 the Financial Supervisory Authority and the Central Bank of Iceland concluded a new cooperation agreement that provides for closer and more systematic collaboration than stipulated in a previous agreement.¹⁰ Further work on streamlining the cooperation between these two supervisory entities in order to fill any regulatory gaps is underway.

3. **Give more discretionary powers to the FME** and encourage it to use its powers more forcefully.

The Act on Financial Undertakings was amended by Act No. 75/2010. Considerable amendments were made to the act, including implementing this and the next two points of Kaarlo Jännäri's recommendations. A more thorough analysis of amendments can be made, if requested.

An updated English translation of the act is available on the Ministry's web page.

4. **Create a National Credit Registry** to diminish credit risks in the system and have a better overview of large exposures at the national level.

See point 3.

5. **Take a tougher stance on large exposures, connected lending and quality of owners** using discretionary best judgment when necessary.

See point 3.

6. **Do more on-site inspections** to verify off-site supervision and reports.

¹⁰ The cooperation agreement can be found under following link: <http://www.fme.is/?PageID=581&NewsID=596>

The FME has increased its efforts regarding on-site inspections on supervised entities. As an example the FME, during the period July 2009 to June 2010, carried out six on-site inspections on credit institutions. These inspections included all major operations of the credit institution in question, i.e. financial position, main activities and loan portfolio assessment. During the same time external experts, appointed by the FME, performed specific value assessments on the assets of several other financial companies. The FME aims at improving the supervisory framework and tools used when performing on-site inspections and at the same time to increase the number of on-site inspections. Furthermore, the FME strives to shorten the time spent on on-site inspections and to have such inspections more incisive. The goal is to perform an on-site inspection annually on all systemic important supervised entities.

7. **Review and improve the Deposit Guarantee System** following closely the developments within the EU.

A draft bill of law on a revised DGS is currently pending in the Icelandic parliament. The bill "transposes" the Directive 2009/14/EC as well as a number of proposals included in the COM's proposal of 12 July 2010 (amending Directive 94/19/EC & 2009/14/EC).

8. **Participate actively in international cooperation** as regards financial services, in particular within the EEA and EU.

Insomuch as budgetary and human resource constraints allow, the Ministry takes part in relevant European committees and working groups, such as the EBC (European Banking Committee) and its sister groups and the EFTA Working Group on Financial Services.

The FME has already increased its participation in international cooperation meetings. According to the budgets for the years 2010 and 2011 the number of such meetings attended by the staff of the FME were scheduled 132 and 160 respectively compared to 100 and 120 for the years 2006 and 2007.

ANNEX 4: LIST OF CONTACTS

- MOF: Ministry of Finances (responsible for the legislation regarding Pension Funds)
- MEA: Ministry of Economic Affairs (responsible for the legislation regarding the Financial Sector in Iceland, other than Pension Funds)
- The FME: the Financial Supervisory Authority: the Board
- The FME Staff: top management and the staffs involved in the BCP self-assessment
- The Central Bank: CBI
- A large commercial bank
- The Bankers Association: SFF Samtök Fjarmalafyrirtaeja
- An independent consultant