

Report on Banking Regulation and Supervision in Iceland: past, present and future

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1. Introduction

In November 2008, as part of its Stand-By Arrangement with the International Monetary Fund, the Icelandic Government undertook to invite an experienced bank supervisor to assess the regulatory framework and supervisory practices in Iceland and to propose needed changes. In particular, the expert was called upon to assess the framework of rules on liquidity management, connected lending, large exposures, cross-ownership, and the “fit and proper” status of owners and managers. It was agreed that the assessment will be made public and should be ready by the end of March 2009.

The undersigned, Kaarlo Jännäri, retired Director General of the Finnish Financial Supervision Authority, was invited to carry out the assessment. The report that follows is my assessment. My work was greatly facilitated by the open and cooperative attitude of the Icelandic authorities and financial sector representatives, as well as contacts with some ordinary clients of the banks. Several European financial supervisors and central banks also contributed to my assessment by sharing their views and experiences of the Icelandic banking crisis with me. Ms. Sigríður Rafnar Pétursdóttir was assigned by the Ministry of Business Affairs to act as my assistant. Her contribution to the report has been invaluable. However, I alone am responsible for the views expressed herein.

The report begins with an overview of the institutional framework in the Icelandic financial regulatory and supervisory field, goes on to describe the crisis and the developments that led to it, and then describes the main elements of the areas on which the assignment was to focus, with the addition of a few items that I considered relevant to the assessment. The final chapter contains my conclusions and main recommendations for the future.

2. Institutional Framework

2.1. The ministries

Several governmental ministries in Iceland have a role to play in regulating the financial sector. **The Prime Minister’s Office (PMO)** has an important role in many areas of policy. In financial sector issues, it is responsible for legislation on the Central Bank and is the official channel between the Central Bank and the Government. It played a central role in financial crisis management, as it held the chairmanship of the **Consultative Group on Financial Stability and Contingency Planning (CG)**, which was established in February 2006 by a Memorandum of Understanding between the Prime Minister’s Office and the Ministry of Business Affairs, Ministry of Finance, Financial Supervisory Authority of Iceland (FME), and Central Bank of Iceland (CBI). The ministries were represented by the Permanent Secretaries, the CBI by one of its three Governors, and the FME by its Director General. The director of the Financial Stability Department of the CBI also participated in the meetings and kept minutes of the meetings. A new committee, **the Coordination Committee (CC)**, was established to deal with the crisis. The new committee is composed of the same officials and institutions as the CG, with the addition of a representative of the Ministry for Foreign Affairs and, as Chairman, Mr.

Mats Josefsson, an experienced Swedish banking expert. The Prime Minister also introduced the emergency legislation on the present crisis to Parliament.

In addition, the Prime Minister and his office were frequently contacted by the banking industry and asked to explain their views. In the aftermath of the banking crisis, the PMO has established a small new department, the Economic and International Finance Department, to deal with matters pertaining to the present crisis. Furthermore, in January the PMO established a new temporary senior position at the permanent secretary level, in order to coordinate the authorities' actions pertaining to the financial crisis and to improve the flow of information between the authorities concerned and the political level.

Among its many other duties, the **Ministry for Business Affairs (MoBA)** is responsible for financial sector legislation (excluding Central Bank and pension fund legislation). This includes legislation on the FME and on financial undertakings such as banks, insurance companies, securities firms, and the deposit guarantee system. The Ministry is also responsible for company law, competition law, and laws pertaining to foreign exchange. By September each year, the FME submits an annual report to the Ministry, which then reports to Parliament on FME's activities. The MoBA appoints the Chairman of the board of the **Depositor's and Investor's Guarantee Fund (DIGF)**. The **Competition Authority** also functions under the auspices of the MoBA.

The Ministry of Finance (MoF) naturally has a central role in fiscal and overall macroeconomic policies and the budget. In cases of financial crisis, the role of the MoF is magnified, as a crisis situation requires that the Ministry take measures to raise funds for recapitalisation of the banking system. As is currently the case in Iceland, the MoF has effectively become the owner of the failed banks. The MoF, using the CBI as its adviser and agent, is also responsible for the Republic's foreign (as well as domestic) financing and debt management. It is also noteworthy that the MoF is responsible for the general legislation pertaining to accounting, including IFRS, as well as for pension fund legislation. The Register of Limited Liability Companies also functions under the MoF. The Ministry appointed a committee that is engaged in negotiations with several foreign governments concerning resolutions to disputes over deposit guarantees and other issues stemming from the banking crisis.

As is mentioned above, the **Ministry for Foreign Affairs (MfFA)** is also involved through its participation in the CC. The MfFA is also involved in the negotiations with foreign governments over issues pertaining to the banking crisis. Through its role over the **Housing Financing Fund (HFF)**, the **Ministry of Social Affairs and Social Security** should be mentioned as a ministry with an important bearing on the circumstances in Iceland's financial markets.

2.2. The Central Bank of Iceland

The present Central Bank Act dates back to 2001. It gives the Central Bank of Iceland (Seðlabanki Íslands, CBI) a degree of independence and sets forth accountability requirements comparable to those in many other industrial countries, although its level of independence is less than that of the European Central Bank and the US Federal Reserve system. The bank's main objective is to promote

price stability. By law, however, the Prime Minister sets the inflation target that the CBI is assigned to achieve. In practice, this happens through a joint declaration by the Government (represented by the Prime Minister) and the Central Bank. A secondary objective of the CBI is to support the economic policy of the Government as long as such support is not inconsistent with the price stability objective.

The law also stipulates that the bank shall maintain external reserves and promote an efficient and safe financial system, including payment systems domestically and with foreign countries. Accordingly, the CBI has the power to set regulations on credit institutions' liquidity and reserve requirements and foreign exchange exposure. Furthermore, if it deems such action necessary in order to protect the safety of the financial system, the CBI may also issue guarantees to credit institutions in liquidity difficulties or grant loans to them against collateral or other conditions laid down by the bank.

Until February 26, 2009, the CBI was administered by a three-member **Board of Governors**. The governors were appointed by the Prime Minister, who also appointed one of the governors as the Chairman of the Board. The governors wielded executive authority in monetary policy and made their decisions by majority vote, although in practice, decisions were almost always made by consensus. The Parliament elects a seven-member **Supervisory Board**, which primarily has a supervisory role. The Supervisory Board is elected after Parliamentary elections; thus its term coincides with that of Parliament. The Central Bank Act stipulated no specific professional or educational requirements for the governors or Supervisory Board members, although the general competency rules for civil service apply.

The amendments made to the Central Bank Act in February 2009 changed the management structure of the CBI by abolishing the Board of Governors and replacing it by one **Governor and one Deputy Governor** appointed by the Prime Minister. The amendments also introduce professional requirements for both officials. In addition, a **Monetary Policy Committee** was established as the decision-making body for monetary and exchange rate policies, paying due respect in its decisions to financial stability as an important objective. The five-member committee is composed of the Governor, as chairman; the Deputy Governor; one senior CBI official appointed by the Governor; and two outside experts appointed by the Prime Minister.

When banking supervision functions were transferred from the Central Bank into the newly established FME in 1999, the bank set up a financial stability function, which was elevated to the status of a department in 2001. The staff of the department originally numbered only four persons, but it has gradually been expanded to the present 10 people out of the total CBI staff of about 115. **The Financial Stability Department** is responsible, *inter alia*, for credit institutions' liquidity rules and for monitoring the institutions' compliance with them. It also sets rules on the activities of payment and settlement systems and carries out systemic oversight of these systems. The department also has the leading role in preparing the CBI's *Financial Stability* report.

Although payment and settlement systems are an extremely important part of the financial infrastructure, this report does not dwell on them in any detail. It should be mentioned, however, that the CBI, FME, and other authorities (as well as the banks) were forced to dedicate substantial resources towards ensuring that payment systems in Iceland functioned during the crisis situation. In particular, it was important to guarantee that domestic and cross-border payments for current transactions functioned in a satisfactory fashion. The CBI and other authorities (and banks) were

most successful in these endeavours and only encountered very temporary difficulties. Future developments within global (and especially European) payment systems will require that the CBI and the Icelandic financial sector demonstrate continuous vigilance and readiness to act, and that they develop the payment system infrastructure.

The adoption of rules for the foreign exchange positions of banks and other financial institutions falls within the remit of the **International and Market Operations Department**.

Central Bank salaries have not been competitive with those in the private banking sector, but overall, the Bank has been able to hold on to its competent staff. Considering the high level of international activity of Iceland's largest banks and the fact that the CBI was managing the smallest freely floating currency in the world, the number of staff appears to have been rather small. The staff is generally very competent, and their numbers are probably sufficient for the future Icelandic financial sector, which will be smaller and less international in scope.

2.3. The Financial Supervisory Authority (FME)

The FME (Fjármálaeftirlitið) was created in 1999 by the merger of the Insurance Supervisory Authority and the Banking Inspectorate of the CBI. The FME is an independent body under the auspices of the Ministry of Business Affairs. The Minister also appoints the **Board of the FME**. The Board has three members, one of whom is appointed on the recommendation of the CBI. Each member has a deputy who is appointed in the same manner as the member. The Minister also appoints one of the members as the Chairman of the Board. The Board is to approve the strategies, operational plan, and organisation of the FME. Major decisions of the FME are presented to the Board for approval or rejection. The Board of the FME hires the **Director General**, who is responsible for the day-to-day operations of the FME and hires the Authority's employees. One of the senior officers of the FME is the **Deputy Director General**.

The legislation on the FME sets forth the required qualifications for Board members and the Director General. Board members must have knowledge of the financial market and be well qualified in the field. In the appointment of Board members, a combination of diverse experience and qualifications is to be sought. The Director General must have a university degree and extensive knowledge and experience in the financial market.

The Board submits the FME's annual budget proposal to the MoBA after consultation with the **Consultative committee of parties subject to supervision**. If the proposal calls for an increase in operating expenditure, the Ministry submits to Parliament a bill of legislation amending the Act on the financing of the FME. The FME has experienced major difficulties in obtaining approval for its budgetary proposal, as the industry – through the consultative committee and other lobbying – had succeeded in curtailing increases in budgetary outlays. Since 2007 there has been a general understanding of the need to strengthen the resources of the Authority. The FME's expenditures are covered by supervisory fees levied on firms subject to supervision; therefore, there is no net burden on the Treasury.

The FME has a staff of about 60 people, as opposed to about 45 two years ago and less than 25 in 1999. About half of these staff members work in banking supervision, and now, in crisis times, the

proportion is even higher. The FME has encountered severe difficulties in hiring competent staff. Due to much higher salary structures in the private financial sector, the turnover in staff exceeded 25% in 2006. Many of the best-qualified experts left the FME for the private sector, and replacing them with people of same skills often proved impossible. Since 2007 the situation has improved, and at present, due to the crisis, recruitment is not considered to be a problem.

Another resource problem that the FME has been struggling with is the technical infrastructure. In particular, building a secure and well-functioning IT system for reporting and analysis of data has been slow due to a shortage of competent IT personnel and equipment. A special IT strategy was initiated in 2006, and by 2008 there were signs that these difficulties were easing. Automated handling of data flows is being enhanced, but some work still needs to be done.

The FME is divided into four units: Credit Market, Insurance Market, Pension Market and UCITS, and Securities Market. The present report focuses on the Credit Market. The organisation along sectoral lines is complemented by groups of experts from different units who examine specific risks (including market risks) across sectors (matrix). For the future, it might be useful to consider changing the organisational structure from sectoral units into functional units: for instance, department for solvency and capital adequacy, department for credit and market risks, and so on. In some countries, at least, this has been found to lessen the danger of compartmentalisation of the supervisory authority along industry lines (banking, insurance, securities), which may adopt slightly different policy lines on the same issue (for instance, fit and proper issues, risk evaluation criteria, and so on). Problems of this kind do not appear very likely, however, in a small organisation like the FME, where experts can easily converse with each other. In late 2007, the FME also set up an internal contingency group with key persons from all sectors, to monitor various risks in the financial system.

In retrospect, it is clear that the FME staff was much too small, both in numbers and variety of skills, to supervise and regulate a banking system as large and internationally active as that in Iceland. Again, it is probable that the present number of staff will be appropriate in the future, even though the staff is currently overburdened due to the crisis situation. Indeed, it appears necessary to alleviate the present situation by transferring responsibility for burdensome forensic investigations of past developments to other bodies that have been established to investigate the events leading to the crisis and **let the FME concentrate on present and future supervisory tasks**. This is already being done to some degree.

2.4. The Depositors' and Investors' Guarantee Fund (DIGF)

The Depositors' and Investors' Guarantee Fund (hereafter **DIGF**) is a private foundation operating pursuant to the Act on Deposit Guarantees and an Investor Compensation Scheme. This Act incorporated provisions of the EU directives on deposit guarantee schemes and investor compensation schemes into Icelandic legislation. The Act provides a minimum level of protection to investors and to depositors in commercial and savings banks in the event that a given company cannot meet its obligations to its customers. The DIGF is under the surveillance of the FME.

Commercial banks, savings banks, companies providing investment services, and other parties engaging in securities trading and established in Iceland are required by law to be members of the

DIGF. The same applies to any branches of such parties within the European Economic Area (EEA). The DIGF is divided into two separate divisions: the Deposit Division and the Securities Division.

By law, the total assets of the DIGF's Deposit Division must amount to a minimum of 1% of the average amount of guaranteed deposits in commercial banks and savings banks during the preceding year, and the total assets of the Securities Division must amount to a minimum of ISK 100 million. Contributions in the form of payments or submission of liability declarations are required from banks by law in the event that the total assets of the Fund do not reach the 1% minimum.

The general rule in the law is that guaranteed deposits shall be paid in full. In the event that the assets of either division of the DIGF are insufficient to pay the total amount of guaranteed deposits and securities, payments from each division shall be divided among the claimants as follows: each claim up to €20,887 shall be paid in full, and any amount in excess of this amount shall be paid in equal proportions, depending on the extent of each division's assets. No further claims may be made against the DIGF at a later stage, even if losses suffered by claimants have not been compensated in full. Should the total assets of the DIGF prove insufficient, the Board of Directors may, if it sees compelling reasons to do so, take a loan in order to compensate losses suffered by claimants.

Deposits in some foreign branches of Icelandic banks were guaranteed in the respective countries of business by top-up agreements with local guarantee funds. With such supplemental deposit insurance, foreign deposit owners are in the same position as other depositors in the countries concerned.

Because payments into the Fund by banks are based on the sum of guaranteed deposits at the end of the preceding year, and because the deposits (especially foreign deposits) of Icelandic banks grew very rapidly, the assets of the Fund in October 2008 amounted only to ISK 15 billion, which was 0.5 % of deposits plus ISK 6 billion in guarantees. This insufficient sum and the potential losses to foreign depositors led to serious problems, which are discussed further in Chapter 3.

The MoBA set up a working group to review the legislation on deposit guarantees in March 2007. The prepared draft bill of legislation was delivered to the Minister in January 2008; however, the bill was not submitted to Parliament. It is expected that Icelandic legislation on deposit guarantee schemes will be amended in the near future. The financing of the Fund is an example of the outstanding issues and developments in EU law in this field that will require close scrutiny.

Iceland's failure to maintain adequate safeguards for depositors has led to a general awakening within the EEA and EU concerning the need to overhaul and harmonise the Deposit Guarantee Systems (DGS), as the situation would obviously be untenable in the other countries as well if a major banking failure were to take place. (This has been demonstrated by many countries' decisions to grant governmental guarantees to all deposits, without any thresholds or maximums.) The **UK Financial Services Authority (FSA)**, in its latest **Financial Risk Outlook**, has drawn attention to the lessons learnt from the Icelandic crisis and makes some proposals for changes in the European framework. The recent report of the so-called **de Larosi re Group** commissioned by the European Commission also focuses attention on the lessons to be learnt from Iceland's experience.

2.5. Cooperative arrangements among the authorities

Given the fairly large number of authorities involved in the financial regulatory and supervisory field, it is important to look at the cooperative arrangements between them. The legislation on the FME stipulates that the FME and the CBI shall cooperate closely and that they shall have a special agreement on cooperation. The current **Cooperation Agreement between the FME and the CBI**, dated October 3, 2006 (see Attachment 1), sets out rules on minimum frequency of meetings and exchange of information between the different levels of the organisations, avoidance of duplication of work, division of labour in oversight and supervision of payment and settlement systems, regular contingency exercises, confidentiality, notification on regulatory measures to be taken, and so on.

In general, cooperation between the FME and the CBI has functioned smoothly on all levels, and contact has been very frequent, especially in 2008. Some delays in exchange of information have taken place, mostly due to uncertainties about the accuracy of data. The party sending the information (in most cases the FME) has not always been willing to send incomplete data to the other party, and this has caused delays in the work processes of the other party. My understanding is that these instances have not caused major harm or problems in decision-making.

Due to banking secrecy considerations, the FME did not divulge the names of large exposures to the CBI or to the CG. When these names had to be discussed in October 2008, at the peak of the crisis, they seem to have come as a surprise to the CBI. Had the names been known earlier, this knowledge might have had some effect on the way the situation was analysed. On the other hand, according to the FME, the CBI had not specifically asked for this information. One of the governors of the Central Bank was a member of the Board of the FME, but the Board did not receive detailed information on large exposures either. Problems due to large exposures were discussed in the Board in general terms, however.

The Memorandum of Understanding between the Office of the Prime Minister, Ministry of Finance, Ministry of Commerce (now entitled the Ministry of Business Affairs), **Financial Supervisory Authority and Central Bank of Iceland on consultation concerning financial stability and contingency plans** from February 2006 (see Attachment 2), which set up the **Consultative Group (CG)** (see Chapter 2.1.), is the most important document establishing cooperation among the Icelandic authorities in this area. The named authorities had been holding informal meetings on these issues for two years before formalising the arrangement through this MoU. The CG held its first meeting on June 1, 2006 and held its last meeting in that setting (its 31st) on October 3, 2008. At first the group met rather infrequently, but as worries about the financial system escalated, meetings were held much more often – weekly, and sometimes daily. As is stated in the MoU, the CG was not a decision-making body, but it was the main forum for the authorities to share information and to discuss ways to tackle a crisis if and when such a calamity were to strike the Icelandic financial system.

It was somewhat unclear to whom the group was to give advice and what its role was in the decision-making process. When the culmination of the crisis was approaching, the FME and the CBI expressed grave concerns and requested information from the ministries on what kind of commitments and actions the government was prepared to take. I had the impression that the sense of urgency was

felt less keenly by some of the ministries' representatives than by the FME and the CBI. On the other hand, the ministries' representatives sometimes felt that they were not receiving enough information about the seriousness of the situation and therefore believed there would be time to prepare for action later. This report makes further reference to the work of the CG in the chapters that follow.

2.6. International cooperation of the Icelandic authorities in the area of financial regulation and supervision

Iceland has been a member of the **European Economic Area (EEA)** since 1994. In effect, EEA membership means that Iceland must incorporate the **European Union directives and regulations** in the financial field into its legal framework. Accordingly, Iceland has implemented EU legislation through its own laws and regulations. The only major omission until recently was the **Directive on Financial Conglomerates**, which was not fully implemented by the FME until September 2008. This may have been a handicap for the supervision of the complicated financial structures that were built around the major banking groups. In practice this was not considered to be a problem.

The EU legal framework is geared towards creating a **Single European Financial Market**; therefore, all financial institutions that have a license from an EU or EEA country may, through what is often referred to as the **European Passport**, do business within the entire area and may also establish and acquire **subsidiaries and branches** in the area with relatively easy administrative procedures. This also enabled the Icelandic banks to expand rapidly in the European markets.

Even if Iceland is not a member of the EU, the Icelandic authorities have been able, as part of the single market, to participate as observers or members in most of the cooperative mechanisms and groups that exist within the Union in the field of financial regulation and supervision. While this report is not intended to discuss all of them, some of the most important bodies deserve mention. The FME is an observer in the **Committee of European Banking Supervisors (CEBS)** and the respective committees in the insurance and pensions field (**CEIOPS**) and securities markets (**CESR**). The FME may also participate in the various working groups of these supervisory committees. The MoBA has access to a number of EU committees in these sectors; e.g., the **European Banking Committee (EBC)** and the respective committees in the insurance and pensions (EIOPC) and securities (ESC) fields. The CBI has observer status in the **Banking Supervision Committee of the European Central Bank System (BSC)**. Iceland also participates in different **EEA working groups**, along with Norway and Liechtenstein; e.g., on financial services.

Nordic Cooperation in the financial field – between ministries, central banks and supervisory authorities – also has a long tradition. A relevant example of this is the **Nordic Financial Crisis Management Exercise** in September 2007, in which the FME, CBI and the MoF participated (this is described in greater detail later in the report).

Unfortunately, the single European financial market construction has some major deficiencies that have surfaced in the present global crisis. In many respects, the crisis in Iceland is a manifestation of these deficiencies. The chief characteristics of these flaws are a common market in financial services and a common legal framework for regulation, but with no common supervisor, no common deposit

guarantee system, no common lender of last resort (except perhaps in the eurozone), and no common mechanisms for solvency support in case of major cross-border bank failures. Instead, reliance is placed on the so-called **Home Country Control Principle**, which implies that it is up to the home country government, supervisor and central bank to take action if things go wrong. The previously mentioned de Larosière Group report highlights these issues.

In legal terms, there is a difference in whether a bank from country A (home country) does business in country B (host country) through a **branch** or a **subsidiary**. A branch is an integral legal part of the bank in country A, while a subsidiary is a legal entity in its own right and receives its banking license from country B. In practice, however, banking groups with cross-border operations within the EEA often have centralised credit, liquidity and risk management strategies and policies, quite regardless of whether their foreign units are branches or subsidiaries. From the supervisory point of view, there is a big difference, however. The host country has legal rights and possibilities to supervise subsidiaries, while branches are under the jurisdiction of the home country with three major exceptions: namely, financial crime, conduct of business rules (customer protection), and liquidity supervision (which is relevant for this report). Consequently, host authorities can supervise branches' liquidity risks in cooperation with the home regulator.

Cross-border banking within the EEA has grown significantly in recent years. This has also led to numerous initiatives aimed at improving and intensifying cross-border cooperation in supervision. On the global level, the **Basel Committee on Banking Supervision** has set standards and recommendations for banking supervision for decades. It can be said that EU standards and regulations are based on Basel Committee work. In the past few years, CEBS has worked extensively on developing cross-border supervisory practices. The latest major initiative is to set up **Supervisory Collages** for major cross-border banking groups. The Nordic countries' experience in joint supervision of the Nordea Group has been a model for this work. The FME was planning to set up supervisory collages by the end of 2008 for the three Icelandic banks with extensive foreign operations, in order to improve the supervision of their cross-border activities. This had also been requested by the FME's European counterparts. The FME has also concluded **Memoranda of Understanding (MoUs)** with many of its counterparts, including the multilateral MoU between the Nordic countries and MoUs with some other countries (such as Switzerland); however, it has no formal MoU with the UK, Germany, Luxembourg, or the Netherlands, in spite of its having had regular contact with the supervisors of those countries. MoUs typically contain provisions for information exchange and regular meetings. They are not binding legal documents, however, and as such, they do not offer any solutions to cross-border problems.

The foreign supervisors and central banks with which I have been in contact have generally commented favourably on the cooperative and friendly attitude of the Icelandic authorities. There was also strong criticism, however, about slow response to inquiries, and it has sometimes been found difficult to make contact with persons with the authority to provide an opinion on behalf of the authorities. In some acquisition cases, the foreign supervisors were not able to obtain enough information on the possible connections and cross-ownership structures between Icelandic investors. There were also difficulties in obtaining information on the financing of the proposed acquisitions from the FME, and in some instances the FME did not have the information.

During the crisis, it was difficult to obtain information and make contact with the right people in Iceland on a bilateral basis. During the crisis, the FME organised three teleconferences for the CEBS network, and these were appreciated as an efficient way to spread information. However, teleconferences with almost 30 participants are not an appropriate way to discuss specific problems individually. Some disappointment has also been expressed about the willingness of the CBI and the FME to share the concerns they had about the Icelandic banks with their EU counterparts before the crisis exploded. There are feelings that the Icelandic authorities were protective of the banks and tried to tone down the worries expressed by their foreign counterparts. This has undermined the credibility of the FME and the CBI in the eyes of their colleagues. The FME and the CBI consider these criticisms to be unfair and unjustified.

One of my recommendations for the future is that Iceland should participate actively in international cooperation on financial regulation and supervision – in particular, within the EEA and the EU. This would rebuild trust between Icelandic and foreign authorities, as well as being the best way for Iceland to try to influence and participate in the formulation of financial regulations and practices within the European Single Financial Market which Iceland is a part of.

2.7. Observations on the institutional framework in Iceland

One feature of the Icelandic institutional framework is the large number of ministries that are involved in the financial sector in one way or another. I suggest that the authorities seriously consider centralising financial sector issues under one ministry. In most countries, this is the Ministry of Finance, but the Ministry of Business Affairs is a possibility as well. At a minimum, central bank legislation and banking legislation could be brought under one ministry. The HFF should also be put under this same ministry in order to ensure that its policies are coordinated with those of the CBI.

In some instances, the present situation – where Central Bank matters are handled by the Prime Minister's Office and the rest of the financial sector by the Ministry of Business Affairs – has caused problems in information flow and unnecessary delays in decision-making. Furthermore, I suggest that accounting and auditing issues, company registry, and company law be placed under one and the same ministry.

Another major issue in light of the crisis experience is the relationship between the Central Bank and the Financial Supervisory Authority. The 1999 separation of banking supervision from the CBI was carried out under circumstances that were quite different from those reigning today. It was then an international trend and fashion to separate the central bank and its monetary policy function from micro-level supervision of individual institutions. This trend has continued until recently. In many countries, however, banking supervision has remained within the central bank, and in some – such as the Netherlands and Ireland – insurance and pension system supervision have also been placed in the central bank. In Finland all financial supervision (banking, insurance, pensions and securities) is in one institution, which is connected administratively to the central bank but is independent in its decision-making. In Iceland, prudential rules and supervision of liquidity, foreign exchange risks, and systemic financial stability were left with the CBI in 1999.

In the present global crisis, the wind in regulatory thinking seems to be changing direction. Many observers and politicians have been suggesting that the central banks should have been more closely involved, at least, in the supervision of the largest so-called systemically important financial institutions. Some central banks, including the European Central Bank (ECB), have been voicing similar thoughts. There are advantages and disadvantages to a closer relationship between supervision and central banking, and in this – as in most things – there is no one truth, and different solutions can work quite well in different countries. In a small country like Iceland, with limited resources, it would be useful to consider carefully whether synergies could be achieved by bringing the CBI and the FME under the same organisational structure in the Irish or Finnish fashion. In particular, this might be a sensible approach if, in the medium term, Iceland were to join the EU and the euro area. In those circumstances, Iceland would not have its own monetary or exchange rate policies; therefore, arguments about potential conflict between monetary and prudential supervisory policies would lose their validity. In my opinion, even without the EU and the euro, a merger or near-merger would be desirable.

Even if it were decided not to change the present institutional arrangement between the CBI and the FME, the exchange of information between the two should be made more automatic, timely and free of banking secrecy limitations of all kinds, making it fully clear, of course, that banking secrecy would apply fully to information provided to third parties.

3. Background to the banking crisis

There is no one point in time that can be singled out as the starting point for the developments that led to the banking crisis. It is also evident that any analysis of this complicated and multi-faceted event can only be partial and to some degree subjective. On a general level, it is probably fair to say that the **liberalisation of financial markets and capital movements** in the 1990s, together with **EEA membership, created the conditions** that made the phenomenal growth of the financial sector possible.

The **privatisation process** of the banking system at the beginning of this decade was another milestone in this development. This is also where the first potentially “wrong decisions” or mistakes were made. Instead of spreading ownership among several institutional investors and private households, with no one holding a controlling interest, as was the original intention, the government then in power decided in **2002** to allow one investor group, **Samson**, to have a *de facto* controlling interest of 45 % in Landsbanki, then the country’s largest bank. This was largely a political decision. The FME, for instance, was dissatisfied with the result and, in early 2003, gave its approval to the holding by Samson only after lengthy deliberations. The same applied to the acquisition of Búnadarbanki by the “S-group” when that bank was privatised. Some efforts were made to have reputed foreign financial institutions invest in the Icelandic banking system, but with limited success. This is not surprising, as the Icelandic financial market was (and to a large degree, still is) difficult for foreign financial professionals to assess because of the high degree of indexation, the role of the HFF, the small currency and market size, and the volatility of the economy. Even so, it appears that at least one reputable bank was showing interest in entering the Icelandic market, but it was turned down in the end, probably for protectionist reasons.

When the two other major banks, Kaupthing and Glitnir, were created through a process of mergers and ownership changes, the FME was unable to effectively limit the concentration of ownership in these banks because of **the legal precedent created by the 2002 decision**. For the most part, the new owners and the people behind them were not traditional commercial bankers; instead, they had the rather innovative and somewhat adventurous mindset of investment bankers, which favoured a strategy of rapid growth and highly leveraged, aggressive deals.

At the time, the **global financial market was flush with liquidity**; moreover, due to historically low real interest rates, funds were readily available for the international expansion of the Icelandic banks, as investors were hungry for higher returns. The Icelandic banks also enjoyed favourable ratings from the international rating agencies, which greatly facilitated their access to the international bond markets. At the same time, the domestic economy overheated due to **lax monetary and fiscal policies**. Large-scale aluminium and power projects, large salary and wage increases combined with a reduction in both direct and indirect taxes led to a boost in domestic demand that resulted in wide current account deficits. At the same time, **the HFF** started to relax conditions in the mortgage market in order to increase its market share, and the banks joined in to compete aggressively in this rapidly growing market. In many cases, loan-to-value ratios neared 100%, and because real estate prices rose at unprecedented rates, households used the opportunity to raise money by using their homes as collateral to fund their consumption spree. This led to high household indebtedness. Firms also expanded by borrowing.

Most of the new **borrowing** by the corporate sector was **in foreign exchange**. Households also had a rising share of their consumer credit in foreign exchange. Mortgages were increasingly denominated in foreign currencies. Most **mortgages** remain in ISK and are **indexed**, as are term deposits. In my opinion, this state of affairs renders the CBI's interest rate policy rather toothless, as the Central Bank's interest rate decisions affect only a small portion of the domestic money and capital markets. Contrary to traditional theory, increases in ISK interest rates accelerated the boom in consumption due to increased inflows of capital through so-called carry trade and Glacier bonds (Eurobonds denominated in ISK). It should be noted, however, that the CBI strongly disagrees with the above analysis, and admittedly, economists have widely differing views on this.

In addition to their domestic expansion, the **banks grew** even more rapidly and **aggressively abroad**. While the Icelandic banks' assets were less than 100% of GDP at year-end 2000, they were over 8 times GDP by end-2006, peaking in October 2008 at 11 times GDP (partly due to ISK depreciation). Expansion abroad took place through the establishment of branches abroad, but also – and significantly – by acquisitions of foreign entities that became subsidiaries of the Icelandic banks. The UK, the Nordic countries, Luxembourg, the Netherlands, and Germany were the main areas where the Icelandic banks established their presence. In part (particularly in the UK), the banks serviced the Icelandic firms that were growing in these countries, both in retail business and through mergers and acquisitions. They also became involved in financing construction and real estate development, traditionally the riskiest area of banking. Moreover, they financed some of their major clients' purchases of large shareholdings in some European companies, and in some cases there were indications that these clients in fact served as a cover for the banks' own interests in the shareholdings.

By this time, the three big Icelandic banks had **more than half of their business abroad**, and a large part of their domestic business was denominated in foreign currency as well. At the end of 2007, an average of more than 70% of the three largest banking groups' balance sheet totals were in foreign currency.

The rapid international growth of the Icelandic banks did not go unnoticed in the outside world. In the second half of **2005, the first doubts** were raised about the Icelandic banks' ability to fund their phenomenal growth. This was reflected in rising risk premia on Icelandic bonds and other instruments (like CDS, or credit default swaps). In early 2006, increased public attention was drawn to the large refinancing needs of the Icelandic banking sector. Furthermore, concerns over the banks' non-transparent ownership structure and fears of large-scale covert connections between major investor groups were voiced. The international rating agencies began to follow Iceland ever more closely. The ISK depreciated by one-quarter in the first half of 2006. Icelandic banks' access to the European capital markets was seriously hampered. The so-called "mini-crisis" had begun.

The Icelandic authorities did not stand idle in this situation. The previously mentioned Consultative Group (see Chapters 2.1. and 2.5.) was formally established in February 2006. Monitoring of the banks' activities was intensified and a contingency exercise was held. The authorities also increased their external information and communication activities. On a more concrete level, the government borrowed EUR 1 billion, almost doubling the CBI's gross foreign exchange reserves. This was rather modest, however, in comparison to the growth of the banks' foreign liabilities. Additionally, in **February 2006 a working group that had been set up in 2004 delivered a report** on official preparedness in case of possible difficulties in the financial markets. The PMO, MoF, MoBA, FME and CBI had representatives in the group, whose final report was delivered to the Prime Minister, Minister for Foreign Affairs, Minister of Finance, Minister of Business Affairs, Chairman of the FME Board of Directors, and the governors of the CBI. The report highlighted the size of the Icelandic financial sector relative to GDP, the necessity for consultation among various administrative units, and the legislative amendments necessary to expand the FME's power to intervene in banks in the event of serious financial market difficulties. It also touched on what the group considered to be a lack of interplay in the contingency planning of the DIGF, on the one hand, and relevant administrative units, on the other, in case such difficulties should arise. The establishment of the CG was also among the proposals of this working group. The group was of the opinion that the role and responsibility of each administrative unit should be further defined in case of a financial crisis. The report was published on the website of the Prime Minister's Office. **The suggested amendments regarding expanded financial supervisory powers were not submitted to Parliament** in a formal legislative bill after the delivery of the report; however, there was a short discussion of the report in Parliament, prompted by a question from a member of Parliament. This proposal was taken up again in the summer of 2008, at the behest of the CG, and formed the basis for the October 2008 emergency legislation as regards the expansion of the FME's power.

The banks increased their external communication as well and managed to **diversify their funding** from the wholesale euro market to North America, Australia, and Japan, as well as the retail deposit market (Landsbanki, followed by Kaupthing in 2007). The banks also intensified their internal liquidity controls. By the latter half of 2006, the "mini-crisis" had passed. The expansion of the banks continued at a brisk pace until the end of 2007. During 2008 the banks' balance sheets did not grow

any more in euros (there was actually a decline of 7 %), although there was some increase in ISK terms due to depreciation of the króna.

Actually, **beginning in late 2007**, it was the declared policy wish of the authorities that the **banks** should begin **to downsize**, as it had become obvious that, relative to the Icelandic economy, the banks had become so large that the international financial community was losing confidence in the ability and capacity of the Icelandic government and the Central Bank to support them in a crisis. In particular, Kaupthing's August 2007 announcement of its intention to acquire the Dutch investment bank NIBC intensified these concerns, as the deal would have almost doubled the size of the bank, and financing the purchase would obviously have been challenging. Finally, after urging from the Icelandic authorities and to their satisfaction, Kaupthing and the owners of NIBC cancelled the deal in January 2008.

The banks made efforts to downsize their foreign operations, but the results were not very significant. This was not due to a lack of will or effort, perhaps, but more because the global financial market had become so strained that selling assets or segments of operations or discontinuing selected activities was very difficult, if not impossible, without severe losses. For instance, a major real estate related divestment by Glitnir in Norway did not materialise, as the prospective buyer backed out of the deal at the last moment due to the deteriorating overall investment climate. Furthermore, many of the covenants in the Icelandic banks' funding arrangements would have been breached had the banks retrenched rapidly. Breach of covenants would have led to early redemption demands for an important part of the banks' funding; thus the banks were faced with a kind of Catch-22 situation.

In this connection, it is appropriate to note that **consecutive Icelandic governments** with different political compositions – and opposition leaders as well – had underlined the importance of the financial sector and declared their **support** for its continued growth. Those who criticised the banks were not taken seriously or paid much attention. The bankers were virtually considered national heroes; they were lionised by the media, and the nation was proud of the banks' success. Had the supervisory authorities tried to intervene and forcefully tried to stop this development, they would in all probability have failed, as they lacked the legal authority to intervene. Iceland, like the other Nordic countries, is a nation where the actions of **the authorities** must be based on law. **Discretionary powers are strictly limited.** In retrospect, it is easy to assert that the Icelandic banks' expansion abroad should have been restricted, but in the European Single Market framework and with the European Passport, this was simply not something that could be readily accomplished within the existing legal environment.

The banking community and the business community at large had a tendency to **consider the letter rather than the spirit of the law** as setting the boundaries for their actions. Here they were helped by a fair number of diligent legal advisors and international financial consultants. Complicated legal structures and webs of holding companies were established to circumvent many of the restrictions in banking and company law. This is discussed further in the chapter on large exposures, connected lending and ownership issues.

The global financial situation took a dramatic turn for the worse in mid-2007, when major financial centres around the world began to feel the effects of the sub-prime loan problems in the US. Many large European institutions were hit quite hard. In the UK, the nationalisation of mortgage lender

Northern Rock alerted the public and the **UK authorities** to the problems inherent in the **deposit guarantee** scheme. Later on, this would have an important bearing on the fate of the Icelandic banks in the UK market.

Landsbanki introduced its **IceSave accounts** in the UK through its London branch in October 2006. The scheme was introduced in the Netherlands in May 2008. Kaupthing introduced its Edge accounts in Finnish and Swedish branches and subsidiaries in late 2007, and in several other countries, including the UK, in January 2008. These Internet-based accounts became quite successful. In September 2008, the Landsbanki IceSave accounts were valued at £4.8 billion in the UK and €1.7 billion in the Netherlands. Deposits in **Edge accounts** at Kaupthing's branches totalled €1.2 billion at about the same time. This increased reliance on retail deposits was initially encouraged and welcomed – by rating agencies, and by the supervisory authorities in Iceland and abroad – as deposits generally are considered a more stable and reliable source of funding than the volatile capital markets. The Icelandic banks' **aggressive marketing and interest rates above the market norm** irritated domestic banks in the UK and elsewhere, and the media picked up on the subject. This and the rapid growth of these accounts (which numbered approximately 420,000 in branches alone) resulted in more intensive supervision by the foreign supervisory authorities, leading them and the foreign central banks to begin raising questions about Icelandic banks' liquidity and the **safety of the accounts** in view of the modest capacity of the Icelandic DIGF to cover these deposits should the Icelandic banks become insolvent.

On a more general level, deposit guarantee issues had been on the agenda of the EU supervisory community for some time. **The UK Financial Services Authority (FSA) initiated more detailed discussions with Landsbanki** on its liquidity management – first in the UK in **February 2008**, and then in Iceland in **March 2008** – in view of the rapid growth of the IceSave accounts. A plan to transfer IceSave accounts from branches to a UK subsidiary was initiated; however, Landsbanki was unable to go through with the plan due to asset transfer problems connected with covenant issues and due to limits on large exposures. More time would have been needed. Kaupthing also made plans to change its organisational structure so as to transfer its international operations to foreign subsidiaries in the UK and Denmark.

The Nordic countries' and the three Baltic states' central banks, supervisory authorities and ministries of finance held a **cross-border crisis management exercise in September 2007**. The exercise was very successful in bringing out the many difficulties that might complicate and even hinder an efficient resolution of a cross-border banking crisis. The CBI, the FME and the Icelandic Ministry of Finance participated in the exercise, the results of which were discussed at the Consultative Group meeting in November 2007. In the planning and execution of the exercise, Mr. **Andrew Gracie** from the UK firm Crisis Management Analytics was employed as a consultant. The results of the exercise induced the CBI to invite Mr. Gracie to visit Iceland and discuss various risk scenarios for the Icelandic banking sector. In the conclusions of these discussions, which were held at the CBI in **late February 2008**, the **possibility of a bad outcome for the Icelandic banks and economy is described**, along with a less drastic outcome. As it turned out, the bad outcome materialised. Andrew Gracie's conclusions were distributed to and discussed in the Consultative Group in March 2008 and presented by Mr. Gracie at a meeting with the CBI, the FME and the ministries represented in the CG. Later in the same month, the CBI and the FME presented memos with proposals and questions to the ministries on how to tackle a possible crisis. (By mid-November

2007, the FME had already raised somewhat similar questions in writing within the CG.) The CBI and the FME set up a working group to prepare an action plan for crisis management. The working group produced a document for the CG meeting on April 21. This was discussed also in the meetings that followed, and the FME pressed the ministries for answers to the questions about what the government would be willing and able to do to support the banking system in a crisis. During the summer, after a break in June, frequent discussions among the authorities continued, but no clear-cut action plan emerged, even though (for instance, in July and August) the CBI presented written ideas about a coordinated approach by the authorities.

During the **early months and spring of 2008**, it became quite **clear to the CBI and the FME that the situation was becoming more difficult**, as they were receiving increasingly alarmist comments and questions from international banks and foreign authorities. In particular, some central banks expressed concerns about the rapid growth of retail deposits in the Icelandic banks and their subsidiaries and their increased collateralised borrowing from central banks. **The European System of Central Banks (ESCB) was becoming very concerned** about the relatively **large amounts** that the Icelandic banks were borrowing from the system **through the Central Bank of Luxembourg**. The use of central bank facilities against approved collateral is quite a normal way to manage liquidity, but the amounts involved and the quality of the collateral became the issue with the ESCB. A significant part of the collateral offered by the Icelanders consisted of claims against other Icelandic banks, so-called “love letters”. Furthermore, on the domestic front, in their operations with the CBI, the banks had used claims against each other or employed claims against Iceland’s Icebank as collateral (i.e., they issued paper to Icebank, which issued its own paper to them, to be used as collateral for borrowing at the CBI). The ECB and the Central Bank of Luxembourg held discussions with the Icelandic authorities and banks, and it was agreed in principle that this sort of procedure would be scaled down. This was done, but later in the autumn two Icelandic banks exceeded the agreed limits.

In late 2007 and early 2008, **the banks** – individually and together, under the umbrella of the Icelandic Financial Services Association (SFF) – **also approached the government and the CBI**, expressing their concerns about the situation facing them and asking the government to relax monetary policy and take action to support them if the situation should deteriorate.

In addition to the ECB and Luxembourg, the UK authorities voiced their concerns in the spring of 2008. When the Prime Minister of Iceland met with the British Prime Minister in April 2008 the financial situation, among other topics, was discussed. The CBI had discussions with the Bank of England, ECB, the Nordic central banks, and the Federal Reserve Bank of New York concerning the possibility of entering into **swap agreements** to bolster the foreign exchange reserves. Some of the foreign central banks suggested that an analysis of the situation by the International Monetary Fund might be helpful.

The IMF sent a small team to Iceland in **early April 2008**. The appraisal found the banks vulnerable to potentially significant liquidity pressures, but also found the banks’ situation reassuring in many ways. They concluded as well that the authorities’ legal powers are weak, as the FME does not have the authority to intervene and take over a bank. They saw the envisaged central bank swap arrangements as merely buying time to address the fundamentals of the situation, notably the large size of the banks relative to the capacity of the Central Bank and the size of the economy. In order to obtain fuller information, it was agreed to conduct a Financial Sector Assessment Program (FSAP)

update and have Iceland's Article IV Consultation discussions during the summer. This preliminary assessment of the Icelandic situation did not convince the major central banks, and only the central banks of Denmark, Norway and Sweden entered into swap arrangements with the CBI in May. The FSAP update and the Article IV Consultation in the summer did not change the attitude of the large central banks.

The Swedish Central Bank, Sveriges Riksbank, also made an assessment of the Icelandic financial situation for the Nordic swap agreement in April 2008. The assessment was updated in August and September. The Swedish experts expressed concerns similar to those of the IMF, and they seemed to feel that the situation was difficult but not impossible to handle.

The swap lines with the three Nordic central banks brought some confidence to the market for awhile. Before its summer recess in early June, Parliament approved legislation empowering the government to borrow up to ISK 500 billion to bolster the reserves of the CBI. The CBI and its foreign advisors soon concluded, however, that **money was not available to Iceland at reasonable rates in the international capital markets** at that time. These conclusions were shared with Iceland's political leaders, who agreed with the assessment. Consequently, the CBI sought to strengthen its reserves by issuing short-term notes on the European market and borrowing from several foreign banks. The amounts involved were rather insignificant, however, relative to the potential need in case of liquidity problems at the major banks. One unfortunate coincidence in this process was that a CBI loan from one German Landesbank led to the closing of the country limit for Iceland at that bank, and it did not renew a credit line to one of the Icelandic banks as a result. The Landesbank in question did not give any hint of this eventuality to the CBI.

The CBI also reopened discussions of a possible swap line with the US Federal Reserve in September, when the Fed made such agreements with the three Nordic central banks and the Reserve Bank of Australia. These discussions did not lead to a positive outcome. All in all, it can be said that, by **September 2008, Icelandic banks, the CBI, and the Republic were no longer considered creditworthy by the international financial community**. The only hope was that existing credit lines would remain open and deposits in foreign branches would not begin to diminish. That hope was crushed by the bankruptcy of US investment bank **Lehman Brothers on September 15, 2008**. This event had grave consequences throughout the global financial system.

The Icelandic banks' exposures to Lehman Brothers were not very significant and, as such, should not have had a major effect on the credibility of these banks. It was the impact of this event on the global financial markets that brought the Icelandic banks down, however. The already chilly financial markets froze out of fear. There was no longer any confidence between market participants and no counterparty was trusted to be absolutely credible and creditworthy. In these circumstances, it was not surprising that the Icelandic banks would be among those worst hit. Their credibility was already under suspicion, and their assets were known to be extremely vulnerable to price shocks if confidence in the global economy should be severely impaired. After all, Iceland is a very small country in the far reaches of the cold North Atlantic, and it has few friends in high places outside the Nordic countries.

On Thursday, September 25, after the news of Lehman's failure and its not being rescued by the public sector, **Glitnir** told the CBI that it was not able to meet a **loan payment of €600 million due on October 15**, and requested an emergency loan from the CBI to meet this obligation. The CBI

reported this to the FME the next day, and on Monday, **September 29, the government made a public statement that it intended to take over Glitnir** by contributing new share capital in the amount of €600 million, thereby acquiring a 75% stake in the bank. The government and the CBI had turned down Glitnir's request for a loan, both because it was clear that this would only carry the bank through to January, when new large repayments were due, and because it was obvious that the bank's existing credit lines were closing. Over the weekend, the Government, banks, the CBI and the FME engaged in hectic discussions, at different levels and in different groupings.

After the announcement on September 29, **Iceland's credit ratings fell**, and the covenants in many credit lines were breached, closing them for Icelandic banks. **Landsbanki** was severely hit, as it had large amounts of **Glitnir shares as collateral** for loans extended to Glitnir's owners. Landsbanki also suffered an **outflow** of some £500 million **from its IceSave accounts** during the week following the announcement. A major owner of Glitnir challenged the Government's takeover bid in public, further undermining the already dwindling trust in Iceland's ability to honour its financial obligations.

The first days and weekend of October were, if possible, even more hectic than the previous weekend. **The British FSA was very concerned about the IceSave accounts**, and on Friday it demanded that additional cash liquidity reserves be paid to an account with the Bank of England by Monday morning, so as to meet potential further outflows from these accounts. This amount was calculated at about £200 million. **The ECB also asked the Icelandic banks to shorten their debts at the ESCB.** The MoBA sent a letter to the UK authorities on Sunday, stating that the Icelandic Government stood ready to support the DIGF in raising the necessary funds, so that the Fund would be able to meet the minimum compensation limits in the event of the failure of Landsbanki and its UK branch. Landsbanki requested that the CBI and the Government grant it a loan of £200 million against ISK collateral to meet the UK's demand. The Government and the CBI refused to lend the money. Neither was a loan of €500 million against bond collateral granted. The situation at Landsbanki was considered to be beyond repair.

Kaupthing was also having **difficulties with liquidity requirements, particularly in the UK**, at its subsidiary Kaupthing, Singer & Friedlander (KSF). Kaupthing requested a loan of €500 million from the authorities, pledging shares in its Danish subsidiary FIH as collateral. After consulting the Government, the CBI decided to grant the loan because the collateral in this case was considered to be stronger and Kaupthing's overall situation was such that it was thought to have a fighting chance.

During the weekend, the three banks – separately, in pairs, and all together – presented the authorities with several different plans involving mergers and other solutions, but they were all deemed unrealistic by the authorities. Furthermore, the FME and a group of economists appointed by the Prime Minister presented different plans. The authorities and the political leaders decided, however, to introduce **emergency legislation** in Parliament, which would enable the FME to intervene in the banks' operations and take them over. This kind of legislation had already been proposed in 2006, and an updated version had been worked on during the summer of 2008. Over the weekend the bill was finalised. It was **passed speedily by Parliament on the evening of Monday, October 6.**

The next day **the FME**, based on the authority contained in the new legislation, **took control of Landsbanki and Glitnir**, after the Board of Directors of the two banks had asked it to intervene in accordance with the new Act, and appointed a resolution committee for both banks to replace their

boards of directors. On Wednesday, October 8, **the UK authorities**, using the powers under the UK Anti-Terrorism, Crime and Security Act of 2001,¹ **froze assets relating to Landsbanki in Britain**. This included restricting the ability of the Icelandic authorities to deal with Landsbanki assets in the UK.

The **British FSA determined that the Kaupthing subsidiary KSF was in breach of liquidity regulations**. Therefore, also on October 8, the FSA prevented KSF from accepting further deposits and filed an application with the UK court, which placed it into administration. Thereby **Kaupthing** was also effectively taken out of business, and **the FME**, at the request of the Board of Directors of the bank, **took control** and nominated a resolution committee for it on October 9, 2008. All three banks were now in the hands of the Government. The banks were partitioned into “old and new banks”, with the old banks basically composed of the three banks’ foreign assets and liabilities and the new banks handling domestic business. The extremely complicated legal and financial work to sort the details of this basic plan is underway, and its importance cannot be overestimated. The staff of the FME and the other authorities deserve credit for the work they did during these hectic days (and nights).

The situation for Iceland was and is an unprecedented calamity for a developed country. The banking system was in ruins, and the State had lost its international creditworthiness. Foreign payments could not be effected, and importation of basic necessities was threatened. The only realistic way out of this catastrophe was to try to regain some international credibility by entering into negotiations with **the IMF concerning a program to stabilise the economy**. Negotiations led speedily to a Stand-By Arrangement. Approval by the Executive Board of the IMF was delayed by about two weeks, however, because the EU countries wanted assurances that the Icelandic government would and could stand behind the DIGF’s commitments vis-à-vis European depositors at branches of Icelandic banks, in accordance with EU directive. There was a brief dispute over the interpretation of that directive. Agreed principles were reached on deposit guarantees between Iceland and the EU. In practice, this entails Iceland’s covering the guarantee up to €20,887 per depositor, with the UK, Dutch and German governments lending the necessary funds to Iceland. The exact terms and amounts needed under these loans are still under negotiation, but the agreement paved the way for approval of the Stand-By Arrangement on November 19, 2008.

The Nordic countries (including the Faeroe Islands), Poland, and Russia have also promised to lend money to Iceland to pave the way for the reconstruction of the Icelandic financial system and economy. These loans are estimated to total about USD 3 billion.

When judging the reasons for the Icelandic banking crisis and the events leading to it, one should not forget the international setting in which it happened and which made it possible. It would not have been possible without the overall laxity in the global financial markets and the bubbles it produced, which were bound to burst at some point in time. When greed gave way to fear and the bubbles started bursting, there was no way the Icelandic banks could have been saved. This is not to say that Icelandic banks were innocent victims of the circumstances. They made the gravest mistakes themselves by going along with the global euphoria and forgetting that conquering the world is not

¹ While a section of this legislation contains anti-terrorism provisions, the freezing order was made under separate provisions conferring the power to freeze assets where the UK authorities believe action has been taken, or is likely to be taken, that is to the detriment of the UK economy.

possible without a strong home base and own resources. The nation, up to its highest echelons, supported and admired the banks, and many are still in a state of denial regarding their own part in this tragedy. The CBI and the FME tried to raise words of caution, but it was too little and too late, and it is doubtful whether they could have stopped these developments even if they had had the power to do it.

4. Liquidity Management

When the CBI Act was passed, it was considered important that the **CBI have the best means possible for guarding the liquidity position of credit institutions and the system as a whole. Therefore, responsibility for liquidity risk supervision was assigned to the CBI instead of the FME.** The CBI is authorised by law to issue rules on credit institutions' minimum or average liquid assets, which must be available at all times for the purpose of meeting foreseeable payment obligations over a specified period of time. The CBI has set Rules on Liquidity Ratios. According to these rules, liquid funds shall be classified into the following four periods: a) liquid within one month, b) liquid after one month and up to three months, c) liquid after three months and up to six months, d) liquid after six months and up to twelve months. The rules define which assets and liabilities shall be regarded as liquid. The CBI performs stress tests on liquidity risk on a parent company basis, based on different scenarios. It collects monthly reports on liquidity for parent companies and calculates their liquidity ratio as defined in the rules. If the liquidity ratio falls short of the minimum ratio set in those rules, the CBI may impose periodic penalties and debit calculated penalties from the respective company's current accounts with the CBI. At least once a year, an internal auditor (or chief accountant in smaller banks) shall examine the methods for reporting liquidity and send the CBI a written statement on the examination.

The duty to strive at all times to have sufficient liquid funds to meet payment obligations is stipulated in a simple provision in the Act on Financial Undertakings. On the basis of a general authorisation to adopt guidelines on matters relating to regulated entities, the **FME** has issued **guidelines** on best practice for managing liquidity in financial undertakings. The current edition of these guidelines was **issued in June 2008**. The guidelines apply to both parent companies and consolidated financial institutions, as applicable, and are based on the Basel Committee's Sound Practices for Managing Liquidity in Banking Organizations. The following are the key instructions included in the FME guidelines:

- A structure must be developed for managing liquidity within individual banks. Strategies must be agreed and maintained, limits on the size of their liquidity positions set and reviewed regularly, and adequate information systems must be in place for measuring, monitoring, controlling and reporting liquidity risk.
- Net funding requirements must be measured and monitored. Stress testing is vital for analysis of liquidity. All assumptions utilised in managing liquidity must be reviewed regularly to determine that they continue to be valid.
- Efforts to establish and maintain relationships with liability holders should be reviewed periodically, to maintain diversification of liabilities and to ensure the capacity to sell assets.
- Contingency plans that address the strategy for handling liquidity crises must be in place, and they should include procedures for making up cash flow shortfalls in emergency situations.

FME Guidelines on criteria for stress testing, concentration risk and interest rate risk, which are based on EU directives, also underline the need for contingency planning for possible liquidity crises.

- Liquidity positions in foreign currency must be measured and monitored. Assessment of aggregate foreign currency liquidity needs must take place, but a separate analysis of the respective bank's strategy for each currency must also be undertaken. Limits on the size of cash flow mismatches over particular time horizons for foreign currencies, both in aggregate and for each significant individual currency in which the bank operates, must be set and reviewed regularly.
- An adequate system of internal controls for liquidity risk management must be established within each bank. Regular independent reviews and evaluations of the system's effectiveness must be performed, ensuring that appropriate revisions or enhancements to internal controls are made. The results of such reviews should be made available to the FME.
- Each bank should have in place a mechanism for ensuring that there is adequate disclosure of information regarding liquidity.
- The FME intends to collect liquidity reports on a consolidated basis at regular intervals, as opposed to the practice at the CBI, which collects monthly reports on liquidity for parent companies only.
- It is stated in the guidelines that the FME and the CBI will share the information collected on liquidity, in accordance with their reciprocal duty to exchange information. As a supervisor of financial activities, the FME has quite extensive rights as regards access to information.

Recently, the **CBI and FME** have improved their monitoring of group liquidity. **A joint task force was set up in February 2008.** Current legislation obliges the CBI and the FME to cooperate closely and exchange information on matters regarding the financial market, including liquidity management. Information disclosed between these parties is subject to the confidentiality provisions stipulated in legislation on the CBI and the FME.

The CBI may advance loans to banks in accordance with its Rules on Facilities for Financial Undertakings. Interest rates on CBI facilities are subject to the decision of the bank at any time and are published in an announcement on its website. Financial collateral arrangements for CBI facilities are subject to a law implementing the EU directive on such arrangements. Securities eligible as collateral for CBI facilities are defined in the rules, as are the eligibility requirements for such securities and limitations thereon.

The CBI may determine that credit institutions shall be obliged to maintain funds in reserve requirement accounts with the bank. It is also authorised to determine that a specific portion of an increase in deposits or disposable funds of each company shall be placed as required reserves with the bank. The CBI has adopted rules on minimum reserve requirements. The following liabilities items constitute the reserve base of a financial undertaking subject to those requirements: a) deposits, b) debt securities issued, c) money market instruments. Liabilities towards the CBI, repurchase agreements (repos) and liabilities of a financial undertaking subject to minimum reserve requirements towards another financial undertaking subject to minimum reserve requirements are not included in the reserve base. A reserve ratio of 0% applies to the following items in the reserve base: 1. Deposits with an agreed maturity of more than two years. 2. Deposits redeemable at notice

of more than two years. 3. Debt securities issued with an agreed term of more than two years. A reserve ratio of 2% applies to all other items included in the reserve base. It is noteworthy that branches of Icelandic financial undertakings that operate outside Iceland have been exempt from minimum reserve requirements since May 2008.

The CBI's liquidity rules and reserve requirements are based on those of the Bundesbank and, more recently, those of the ECB. The CBI rules on access to central bank financing closely follow the ECB practice as well. In some respects, the CBI rules have actually been tighter than those at the ECB. The CBI relaxed some of its rules in late 2007 and in 2008, in line with most other central banks, as the global financial markets were growing tighter and demand for central bank liquidity facilities increased. The banks were also pressuring the CBI to follow the international trend in this respect. In retrospect, it is easy to say that maintaining a tougher stance might have been preferable. In particular, the decision to exempt deposits in foreign branches of Icelandic banks from reserve requirements was ill-advised. The CBI was also confronted with the fact that, as was the case in Luxembourg and the ECB, the three banks were issuing paper to each other (or Icebank) and using these "love letters" as collateral for their ISK funding at the CBI. The CBI responded by setting up a timeline for gradual tightening of the eligibility rules on collateral in the spring of 2008.

As is noted above, the CBI collected periodic data on the liquidity situation of banks, but the rules applied to the parent bank, not the whole group. This was due to reluctance to burden the subsidiaries with a double layer of rules (Icelandic rules and those of their domicile country). Some subsidiary information was included in the liquidity reports, however, but only for informational purposes. As liquidity issues became more and more critical in late 2007, this situation was considered unsatisfactory, and the FME was also very concerned. The CBI and the FME agreed to start collecting data on a consolidated basis in the joint group established in February 2008, and reporting intervals were shortened. In the spring, weekly reports on 0-8 days' liquidity and monthly reports on 1- to 18-month consolidated liquidity at the group level were added to the monthly parent bank reports on 1- to 12-month liquidity. A questionnaire on the liquidity management of the three banks was prepared, and in the summer, the banks were requested to present their contingency plans for review. Information on the liquidity situation of the banks' major owners was also requested.

Both the CBI and the FME **stress-tested** the banks' liquidity situation. The banks passed the tests even if, under the worst scenario, one of them should run into difficulties. In retrospect, it is easy to say that the test **scenarios were not difficult enough**, even if they closely followed international best practice. Reality turned out to be worse than anyone had expected. Another flaw in the analyses and the scenarios was that the liquidity estimates were based on figures supplied by the banks, and there had **not been time or opportunity to go on-site to check the reliability of the data**. On-site checks were planned for October 2008. Banks reported funding facilities as secured which were in fact not secured, and they optimistically overestimated inflows from amortisations. This was partly envisaged, and the authorities made some corrections to the figures. In case of at least one of the banks, there might also have been a deliberate misunderstanding of what was to be reported, and consequently, the bank reported misleading figures. As is mentioned earlier, internal auditors are required to perform an annual check to ensure that the procedures for producing these reports are reliable. The results are submitted to the CBI. Only minor deficiencies in the procedures have been

reported by the internal auditors. **The CBI should have explicit legal rights to do on-site inspections to verify liquidity management procedures of the banks.**

The banks' **contingency plans also proved overly optimistic**, and in one case they were not even approved by the bank's own board, which may indicate that the banks did not allot enough time and resources to liquidity considerations. One could also conclude that **the CBI and the FME should have intensified their liquidity supervision much earlier** and, in particular, should have dedicated more resources to check the reliability of the data on-site. On a positive note, I found the technical **competence of the CBI and FME staff on liquidity issues good**. Generally speaking, the flow of information between the two authorities was satisfactory, but banking secrecy regulations have been interpreted too strictly.

5. Rules and regulations on foreign exchange risk

Promoting financial stability is amongst the CBI's main roles. By law, the CBI is authorised to impose upon credit institutions rules relating to foreign exchange balance. **The current rules date from mid-year 2008**. They address the foreign exchange balance of financial undertakings (parent companies) and other authorised intermediaries in foreign exchange transactions. The foreign exchange balance of these undertakings must always remain within the following limits:

1. The general foreign exchange balance shall be neither positive nor negative in an amount exceeding 10% of own funds.
2. The CBI may authorise a financial undertaking to maintain a special positive foreign exchange balance apart from the general foreign exchange balance provided for in Item 1 above, for the purpose of hedging against the impact of changes in the exchange rate of the ISK on its capital adequacy ratio, provided that the undertaking submits a report stating the premises and calculations used to determine the size of the foreign exchange balance and that it makes particular mention of it in its reports to the CBI.
3. As regards other aspects of risk management pertaining to exchange rate-linked items, including the open foreign exchange position in individual currencies, the undertaking shall adhere to the internal procedures it has set on the basis of the Act on Financial Undertakings.

Should the foreign exchange balance deviate from the limits set forth in the CBI rules, the undertaking concerned must take action so as to eliminate the difference within a maximum of three business days. If it fails to rectify its foreign exchange balance within the stated time limit, periodic penalties may be imposed.

As regards the open foreign exchange position, the following exposures shall be included in calculations:

1. Net current position; i.e., all assets less liabilities, including accrued interest that is not yet due. The allowance account for credit losses shall be deducted from assets in this connection.
2. Net forward position; i.e., the financial undertaking's exposure in forward rate agreements, futures and currency swaps, insofar as these agreements are not included in its net current

position. Currency swaps shall be treated as assets in one currency and as liabilities in another currency.

3. Irrevocable guarantees and similar instruments that are certain to be called and unlikely to be reclaimable.
4. Total net delta value of currency options. Institutions trading in options shall calculate the delta value in accordance with FME Rules on the Capital Requirement and Risk-Weighted Assets of Financial Undertakings.
5. The market value of other derivative contracts in foreign currency.

In calculating the open position in individual currencies, basketed currency units must be broken down according to the weight of each component currency.

Parties subject to the CBI rules shall submit monthly reports on foreign exchange balance to the bank within 10 business days of the close of each month, at the risk of incurring periodic penalties.

The IMF Stand-by Arrangement for Iceland entails continuing restrictions on movement of capital between Iceland and other countries and the subsequent lifting of those restrictions as soon as sufficient stability has returned to the foreign exchange market. After the financial crisis hit Iceland in the fall of 2008, the Foreign Exchange Act of 1992 was amended, authorizing the CBI (upon consent of the MoBA) to adopt rules restricting cross-border movement of capital. Such rules were adopted in November and revised in December.

Iceland's foreign exchange market opened in stages during the 1990s. The major banks' foreign exchange balances were very close to zero until 2005, when they started to go long on foreign exchange. This was largely due to their increased international operations, which led to a need to hedge their own funds or capital against fluctuations in the ISK exchange rate. The three major banks had permission to maintain a separate positive foreign exchange balance to protect their capital adequacy ratio. In late 2007 and early 2008, the CBI had some concerns about large foreign exchange transactions by the banks, and the FME was requested to investigate whether one of the banks was trying to manipulate the market in order to gain by weakening the ISK. The investigation did not uncover evidence to that effect. After the collapse of the banks, there have been claims that it probably was one of the major owners of the bank who was building a large position against the ISK, using the bank as the counterparty in the transactions, and consequently the bank's foreign exchange position report did not show any change in the bank's net position.

In June the CBI lowered the limit on the maximum net foreign balance from 30% to 10% of own funds in order to increase activity in the market by limiting the banks' ability to maintain an open position against the ISK. While there were frequent cases of exceeding the limits, no penalties were imposed, as the banks were generally able to correct the situation within the three-day limit. In March and September of 2008, when volatility in the currency market was high and the swap market was no longer functional, the banks had difficulty adjusting their positions. As a general observation, it can also be noted that one of the three banks was a net provider of foreign exchange to the market, while another was buying up currency in large amounts, particularly at year-ends.

The CBI's foreign exchange regulations and reporting requirements were in line with international practice. **However, the accuracy of the reports was not independently verified by on-site visits or by the internal or external auditors. The CBI should have explicit legal rights to do on-site inspections of the foreign exchange risk procedures of the banks.**

An issue related to foreign exchange exposures is the **choice of the accounting currency**. Had the banks been allowed to replace the ISK with the euro as their accounting currency, this would have marginally alleviated their need to hedge their capital against movements in the ISK rate. Kaupthing formally requested to change its accounting currency to the euro. The Registry of Annual Accounts did not grant permission. The Registry's assessment was based on the requirements of the law. One element in the assessment was the CBI's negative opinion on the request.

Households normally have no way to hedge against foreign exchange risks; therefore, **lending to them in foreign currencies** is not very prudent from a risk point of view. This is why there are restrictions on such lending in many countries. This might have been advisable in Iceland also, although the EEA and EU legal framework would have made it difficult to enforce such rules.

6. Credit risk, large exposures and connected lending

By law, financial undertakings must at all times have a secure risk management system in place for all their activities. Documented internal processes are required to assess the necessary size, composition and internal distribution of the capital base in light of the risks entailed by the business activity at any time. The internal processes must be reviewed regularly. FME Guidelines further address internal controls and risk management, placing emphasis on efficiency and transparent mapping of duties and responsibility. Guidelines dating from 2007 deal with criteria for stress testing, concentration risk and interest rate risk. These are part of FME's Supervisory Review and Evaluation Process (SREP) and are based on EU directives (2006/48/EC and 2006/49/EC). CEBS Guidelines on technical aspects of stress testing and management of concentration risk under the supervisory review process are also a part of the FME Guidelines. Regular performance of stress testing for credit risk under FME surveillance is required. Stress testing is considered a crucial part of a financial undertaking's risk management.

The capital base of a financial undertaking shall correspond to a certain minimum of a so-called risk base, which is the aggregate of weighted risk factors, such as credit risk, equity risk, interest risk, currency risk, commodity risk and operating risk, entailed by the business activities of a financial undertaking. FME has adopted detailed rules on risk factors, risk weightings and the calculation of the risk base in accordance with EU law. In 2007, the FME adopted Guidelines on criteria for strengthening coherence in supervisory practices, which implement CEBS Guidelines on the application of the supervisory review process under Pillar 2. The board of directors and managing director must regularly assess equity requirements, with reference to the respective undertaking's level of risk. If the board or the managing director has reason to expect that the capital base will be less than the minimum required by law, the FME must be notified immediately. The external auditor of the respective undertaking has a comparable obligation.

Limits on exposures are addressed in the Act on Financial Undertakings. Exposures include lending, securities assets, holdings and guarantees granted by a financial undertaking on account of individual customers or financially linked parties, as well as other obligations of the same parties towards the financial undertaking. The term "large exposure" refers to any exposure amounting to 10% or more of a financial undertaking's own funds. By law, exposure resulting from a single client or a group of clients who are internally linked shall not exceed 25% of a financial undertaking's own funds. The aggregate of large exposures shall not exceed 800% of own funds.

The FME has adopted the Rules on Large Exposures Incurred by Financial Undertakings, as the law requires. The rules also apply to a consolidation of a financial undertaking, parent company and subsidiaries, and they include, for example, a definition of financially linked parties and a more detailed definition of the term exposure, in which reference is made to the FME Rules on the Capital Requirement and Risk-Weighted Assets of Financial Undertakings. The FME Rules on Large Exposures stipulate that exposures to a parent company or a subsidiary of a financial undertaking and/or one or more subsidiaries of the parent company may not exceed 20% of own funds. However, this rule is subject to exceptions. The FME Rules state that certain exposures may be exempted, when calculating the ratios referred to above.

If exposures exceed the limits set above, the FME must be notified without delay. It may grant the undertaking a time limit for bringing its obligations into line with the law. Furthermore, at least quarterly (that is, at the end of March, June, September and December), financial undertakings shall submit to the FME a report on large exposures of clients or group of connected clients. Financial undertakings shall make use of sound management and information systems, as well as internal control mechanisms that identify and record all large exposures and subsequent changes to them in order to monitor them.

The FME Guidelines on financial undertakings' rules of procedures require financial undertakings to specify in their rules of procedure the customers who are classified as **related parties**, for the purpose of enhancing credibility by affirming that business practices are proper and sound. Related parties are parties whose relationship with the financial undertaking is of such a nature that services provided to them, or to companies related to them, could raise questions concerning conflicts of interests. In determining the identity of related parties, it is important to take into account whether the parties in question could in any way benefit from their position beyond other customers of the financial undertaking; that is, with regard to terms, renegotiation and balance. The FME considers related parties to include (this is not an exhaustive list):

- Principal and alternate members of the board, executives, key employees and their close family members;
- Similar parties in subsidiaries and affiliated companies;
- Shareholders owning, directly or indirectly, a holding of 5% or more in the financial undertaking, or those numbering among its ten largest shareholders;
- Undertakings in which the above parties own at least a 10% share, where they are employed, or where they serve as board members. However, this does not apply to shareholders numbering among the ten largest shareholders of the financial undertaking.

According to the FME Guidelines, financial undertakings should instruct their internal auditors to conduct regular reviews of services to related parties, e.g. as regards terms, renegotiations and balances. The FME also requires financial undertakings to appoint an external auditor to review

services to related parties and compare them with comparable business transactions with other customers and to submit a reasoned report on the terms, renegotiations and balances of the parties in question (arm's length principle). The report of the auditor should include information on the identities of the parties used for comparison in each case. The FME requests that the reports prepared by external auditors based on such reviews be sent to the FME on an annual basis in cases of financial undertakings with total assets exceeding ISK 50 billion (on a consolidated basis) and every other year in the case of other financial undertakings.

According to the Act on Financial Undertakings, an operating license shall not be granted if close links between a financial undertaking and individuals or legal entities obstruct supervision of the undertaking by the FME. The same shall apply if legislation or rules applying to such linked parties obstruct supervision. Close links shall be considered to exist when two or more individuals or legal entities are linked by:

- a. business interests; i.e., a direct or indirect holding of at least 20% of share capital or control of 20% of the voting rights in an undertaking; or
- b. control; i.e., connections between a parent company and subsidiary, or comparable links between an individual or legal entity and an undertaking; a subsidiary of a subsidiary shall also be regarded as a subsidiary of the parent company that is at the head of these companies.

When two or more individuals or legal entities are permanently linked to the same person by a controlling connection, this shall also be regarded as a close link between those parties.

The **rules and regulations are in line with EU directives and the Basel recommendations**. In the autumn of 2007, the FME conducted a major on-site inspection of the credit risk and internal credit controls and procedures of the six largest banks. These inspections led to the conclusion that, on the whole, the credit quality of the banks' portfolios was fairly good, but that procedures and internal controls left much to be desired. These results were discussed bilaterally with the major banks and more generally with the Icelandic Financial Services Association in early 2008. Each bank was asked to take corrective action to improve the situation. It was the intention of the FME to carry out on-site inspections in the autumn of 2008 to check whether the improvements had been made. In particular, deficiencies were found in the handling, valuation and recording of collateral. Now, in retrospect, it is easy to contemplate that the **evaluation of credit portfolio quality was too optimistic**. This is not surprising, as the macroeconomic environment deteriorated with unexpected force. The quality of loans on the books of the banks has proven much poorer than expected, and the same applies to collateral quality. In particular, because much of the collateral has been and is in equities, its value, under the present circumstances in Iceland and internationally, has deteriorated sharply.

Another major area in **need of improvement was the treatment of large exposures and connected lending**. The banks disagreed with the FME on the definition of large exposures and how to connect borrowers. The quality of reporting on large exposures was also an area of disagreement. There were differences among the banks and their willingness to accept the FME's findings; however, all of them did agree to improve on their procedures.

The large exposure question has been a major bone of contention between the banks and the FME for years. The extremely complicated webs of holding companies, foreign Special Purpose Vehicles (SPVs) and subsidiaries, and constant changes in ownership structures made it very difficult to

establish unequivocally what should be included in a large exposure. **The banking culture in Iceland** seems to have been **rather immature** in that the banks did not give much consideration to the underlying purpose of the regulations and sought ways to circumvent them as much as they could if it served their (or their owners' and customers') perceived interests. **The legalistic tradition and the lack of power** also hindered the FME from imposing its view on banks. The new Basel II rules under the so-called Pillar 2 should give the supervisor greater discretion to intervene when the composition of the credit portfolio is cause for concern. The EU directives offer countries the possibility of adopting provisions more stringent than those in the directives. Iceland has not made use of this option.

At the end of June 2008, there were a total of 23 exposures over the 10% limit of own funds in the three large banks (6 to 10 in each bank). They constituted between 94 and 174% of the banks' own funds. What is striking about these exposures is that the majority of them are to holding companies or other institutions or individuals whose main activity is investing in shares or other venture capital or speculative activities. Only a few are to companies engaged in traditional production or other "tangible" business. In most cases, the assets pledged as collateral for these loans are shares in the companies in which these customers had invested the funds borrowed. Many of these companies are sound enterprises and thus the collateral has real value, but some are of more dubious quality, in particular in the present global circumstances.

Even if the number of large exposures in these banks was small, it is still **very unusual that banks as large as these should have so many large exposures of this nature**. My judgment is that their **behaviour** in this regard **has been very imprudent**. The FME was well aware of this situation and was in the process of intensifying its work on inspecting the real extent of large exposures by beginning to collect data on exposures between 3 and 10% of own funds in July 2008. This additional information leads one to believe that some of these might be connected to the large exposures that are over the 10% threshold, which further aggravates the situation. One cannot but conclude that **stronger regulation on large exposures would have been needed** under circumstances like those reigning in Iceland. The Basel II framework should provide the possibility for this.

The 25 and 800% limits in the Basel and EU frameworks were originally set this high in order to allow small local banks to assist local clients in need of funding (for example, farmers or small local businesses) for investment in productive capacity such as harvesters or new machinery. Never was it intended that these limits should be used by large banks for highly leveraged international deals. Indeed, it is seldom that one sees large exposures of this type in the best-managed large banks in Europe or elsewhere.

The FME had been working especially on the large exposure question since 2006. Some of the **customers with large exposure had loans from more than one** of the banks. This meant that, on the national banking sector level, some of these customers were critically large from a systemic point of view as well. In Iceland, with a relatively small market and small number of banks and major companies and borrowers, **it would be possible to establish a national credit registry**, which would help in monitoring large exposures and credit risk at the national level and would also help the banks in their credit risk assessments. Consequently, I propose that Iceland consider establishing a centralised credit registry, which could be operated by the FME.

The issue of **connected lending** can be seen as twofold. First is the issue of connecting lending so as to determine large exposures (similar to the problem of connecting parties for qualifying holdings). Difficulties in this regard are discussed above. Suffice it to say that the complicated webs of holding companies and constantly changing names and compositions of these and their relations to each other made it extremely difficult for the FME to ascertain all the connections with legal certainty. The pattern used by some of the major investor groups to disguise true, effective connections is familiar from many countries and is a sign of poor corporate culture. In order to fight such practices, a fundamental change in corporate culture, tighter rules on transparency, more vigilance, and greater discretionary powers to the supervisors are the only remedies.

The second aspect of connected lending is the supervision of lending to parties that are connected to the bank as owners, employees or members of the board and those parties that are closely connected or controlled by these, such as family members or companies over which the aforementioned parties exercise control. These are referred to as **related parties** in the FME regulations. These are sometimes large exposures as well, but the emphasis here is on the conditions of lending to these parties as compared to borrowers who are not connected to the bank. It is important to ascertain that lending to related parties is done under same conditions and scrutiny as that to any other customer of comparable credit standing. In this regard, **the FME rules are well in line with international practice**. The **requirement that external auditors**, in addition to the banks' internal audit function, **verify and ensure that the rules are followed is a commendable one**. These rules have been in force since 2006, and the first reports by the external auditors are for that year and were submitted to the FME in spring 2007. The reports were of rather poor quality, and the FME had to request several times that the external auditors improve them. Only in the beginning of 2008 were the submitted reports deemed acceptable by the FME. Based on these reports, the FME could conclude that, overall, conditions in connected lending did not differ materially from conditions in comparable non-connected loans. There seems to be some favouritism, however, when it comes to requirements for additional collateral and extensions of payment schedules.

The reports for 2007 were submitted in April 2008. The analysis of these reports is underway. The preliminary assessment is that their quality is now much better, but it is still too early to draw final conclusions because of the delay in work on the reports caused by the present circumstances. The FME is of the opinion that **the regulations on connected lending need improvement** and should be examined when the regulatory environment in Iceland is reviewed.

7. Cross-ownership

In this chapter, the term "cross-ownership" refers to cross-ownership between banks and cross-ownership between banks and their owners.

The FME has been monitoring cross-ownership closely. Consequently, **direct cross-ownership between banks** in the last couple of years has been **fairly limited** and mainly for trading purposes. For instance, in Landsbanki special "hedge accounts" were established to give transparency to these trading positions. It can also be said that the three large banks' ownership structures do not feature the same owners to any considerable degree. Even if it is clear and understandable that many institutional and private investors had shareholdings in all of the banks, major owners did not belong

to the same groups. Direct cross-ownership between banks cannot be perceived as having been a problem.

The fact that **banks were financing purchases of their own and other banks' shares** by their owners and other clients is quite another matter. As a consequence, the banks had **large indirect risks in each other's shares**. For example, Landsbanki's situation became untenable when the announcement was made that the Government would take over 75% of Glitnir because Landsbanki held a large amount of Glitnir shares as collateral for a large loan to one of Glitnir's major owners. Even more imprudent was the **widespread habit of accepting their own shares as collateral for loans that often had been taken in order to buy those same shares**. Perhaps they also used this method as a means of artificially boosting their capital adequacy. Such purchases could be "hidden" in their foreign subsidiaries in order to make them less detectible. The banks could also directly own up to 10% of their own shares. All in all, it can be said that supervision of these types of cross-ownership should have been tighter and the rules more stringent.

Prior to 2006, there was also a problem with cross-ownership between a bank and its major shareholder when Kaupthing was a major owner of its major owner, Exista. This cross-holding was dismantled following the FME's comments on the matter. Consequently, Kaupthing paid out as a dividend the Exista shares it owned. This unbundled the cross-ownership but kept Exista and Kaupthing within the same "family".

In a small economy like Iceland, with only a few banks and only a few larger investor groups, **this type of cross-breeding problem is difficult to avoid if there is not a comprehensive regulatory and supervisory framework** to counter such concentration of risks deriving from cross-ownership, collateral structures, large exposures, and complicated webs of holding and other in-between companies. Like the FME, the **Competition Authority** is also struggling with similar issues. The Competition Authority has made proposals for the expansion of its powers. I recommend that the FME's rules and powers be considered when these proposals are examined, and that cooperation between these two authorities be intensified.

8. Fit and Proper rules for owners and management and qualifying holdings

Most financial undertakings operate as limited liability companies; therefore, general company law applies to these financial undertakings, to the extent that special provisions do not apply. The requirements that apply to eligibility of board members and managing directors of financial undertakings are stricter than those stipulated in general company law, due to the special nature of their operations. If eligibility requirements are not met, the FME may revoke the operating licence of the undertaking concerned. Board members and the managing director:

- shall be legally competent and, in the preceding five years, they may not have been declared bankrupt nor, in connection with business operations, have been sentenced by a court of law for criminal activities.
- must possess sufficient knowledge and experience to be able to fulfil their position in a satisfactory manner. No particular academic degree is required by law.
- may not have conducted themselves in any manner that would give cause to expect them to abuse their position or injure the undertaking.

A managing director is called to a meeting at the FME for an eligibility assessment within 30 days of the date that notification is sent on his/her appointment. Relevant laws and regulations are discussed and statements regarding legal and financial competence are submitted, as are written answers to a questionnaire. If the outcome of the assessment is negative, the managing director may repeat the test. A managing director who has held a similar position at a comparable company in the last 12 months may apply for an exemption from such an assessment.

The FME does not assess the eligibility of board members of a financial undertaking in the same manner as it does for managing directors. Board members are required to submit written answers to a questionnaire, as well as statements regarding their legal and financial competence. These requirements must be satisfied within four weeks of the date the respective board member is appointed, or they must accompany the application for an operating licence.

By law, the board of a financial undertaking shall adopt its own rules of procedure, prescribing the implementation of its tasks in detail. The FME must be supplied with these rules, which shall include stipulations on the following:

- special eligibility of board members.
- handling of information on individual customers by the board.
- participation of board members in the boards of subsidiaries and affiliated companies.
- implementation of rules on handling business dealings with board members.

The FME has issued Guidelines on the contents of rules of procedure regarding special eligibility of board members. The guidelines stipulate, for example, that rules of procedure shall state that board members are obliged to notify the board of parties connected to them. Connected lending and customers classified as related parties are discussed in Chapter 6 of this report.

An agreement by a financial undertaking for loans, guarantees, options or similar dealings with a managing director (or spouse) shall be subject to the approval of its board. A decision thereupon must be recorded. Dealings between a financial undertaking and its personnel shall comply in other respects with rules adopted by the undertaking's board.

Parties proposing to acquire a qualifying holding in a financial undertaking must seek the FME's approval in advance. Furthermore, FME approval shall be sought when a natural or legal person increases its holding to such an extent that its direct or indirect share in the undertaking's equity, guarantee capital or voting rights exceeds 20%, 25%, 33% or 50%, or comprises such a large proportion that the financial undertaking constitutes a subsidiary company of the undertaking.

According to the Act on Financial Undertakings, the term "qualifying holding" refers to a direct or indirect holding in an undertaking which represents 10% or more of its share capital, guarantee capital or voting rights, or another holding that enables the exercise of a significant influence on the management of the company concerned. The term "indirect holding" in the Act was defined in greater detail in 2006. According to comments in the legislative bill, it had proven difficult for supervisors to verify whether or not qualifying holdings had been acquired, e.g. by parties acting in concert.

An application to the FME from parties intending to acquire a holding in a financial undertaking must be accompanied by exhaustive information. The FME assesses whether an applicant is eligible to own the holding, with consideration given to the sound and prudent operation of the financial undertaking. In assessing the eligibility of an applicant, the following factors must be considered:

- The financial position of the applicant and parties with which he/she has close links.
- The knowledge and experience of the applicant.
- Whether such a holding by the applicant creates a risk of conflicts of interest in the financial market.
- The size of the holding or voting rights in which the applicant intends to invest.
- Whether such a holding by the applicant could be expected to impede supervision of the financial undertaking concerned. In assessing this, consideration shall be given to the applicant's earlier dealings with the FME or other public authorities, to whether close links between the applicant and individuals or legal entities could, in the FME's estimation, obstruct its normal supervision work, and whether the laws or rules to which the applicant is subject could obstruct normal supervision.
- Whether the applicant has provided the FME with the required information together with supporting documentation and whether this information has proven to be correct.
- Any punishment to which the applicant has been sentenced, and whether he/she is the object of a criminal investigation.

During the eligibility assessment, the FME is required to consult with supervisory authorities abroad if an applicant is a financial undertaking or insurance company licensed to operate in another state of the European Economic Area, the parent company of such a party, or a natural person or legal entity that controls the party, and if, as a result of such a holding, the company invested in can be deemed a subsidiary of or controlled by the party in question.

If the applicant is deemed ineligible, the application shall be rejected. However, the FME may approve an application despite an applicant's being deemed ineligible to own the holding, on the condition that the applicant take measures intended to limit the detrimental effect of his/her ownership, e.g. to entrust the holding to a special holding company that has no other activities, or to appoint individuals whom the FME deems eligible as his/her representatives on the company's board.

Authorisation to acquire or supplement a qualifying holding in a financial undertaking shall be valid for six months after the FME's approval has been given. If a party fails to seek the FME's authorisation despite being required to do so, the voting rights accompanying the shares that exceed the authorised limits shall be invalid. If a party owning a qualifying holding utilises or is in a position to utilise his holding in a manner detrimental to the sound and prudent operation of the undertaking, the FME may take measures, such as deciding that the shares shall not be accompanied by voting rights.

At least once a year, each financial undertaking must notify the FME of shareholders with qualifying holdings in the company and of the shareholdings owned by each of them.

There are certain limitations on financial undertakings' investments in individual undertakings that are not financial undertakings or undertakings connected with the financial sector; that is, as regards qualifying holdings. A financial undertaking must supply FME with a detailed summary of holdings in other financial undertakings that it has acquired or accepted as collateral. If a financial undertaking intends to purchase or exercise a qualifying holding in a foreign financial undertaking, it must so notify the FME in advance. The FME may prohibit such action if it has legitimate grounds to presume that supervision of operations will be impeded or flow of information will be poor.

The FME's rules and practice for checking the fitness and propriety of managing directors for banks are quite comprehensive and more stringent than in many countries; however, these have only been applied to banks since 2005. Consequently, only one of the managing directors of the three banks had undergone this procedure; the others had held their positions since before 2005.

The vetting done on managing directors does not go beyond them to other members of the management group. It is viewed as an obligation of the managing director and the board to ensure that the banks' other top officials fulfil the fit and proper requirements. In the future, consideration should be given to subjecting the other management group members to the same testing procedure as the managing directors. This has already been suggested for the management groups of the three "new banks".

Among major banks in Iceland, it has not been customary to disclose the name of a proposed new managing director to the FME in advance. In many countries, disclosure of such major nominations – and possibly discussion of the proposed candidate prior to a formal announcement – is a part of the informal code of conduct. In the future, it could prove beneficial to follow this convention in Iceland.

The procedure for the banks' board members seems reasonably good. As an informal procedure, I recommend that the chairman of the board of a major bank also have an interview with the FME Director General at the commencement of his/her tenure as chairman.

The propriety and definition of a qualifying holding is a much more complicated matter. The FME has invested considerable effort in clarifying the procedure and requirements in this field. This is closely connected to the issue of cross-ownership, which is discussed in Chapter 7 of this report.

The **FME conditions for approval of a qualifying holding conform to EU regulations** and therefore comply with accepted European practice. In my opinion, it is **critical** that the background and, in particular, the **financial situation and soundness of the applicant** be thoroughly scrutinised and that the **funding of the proposed ownership** be **fully disclosed** to the supervisory authority. The FME's practice has been to request complete disclosure of this information; however, some doubts remain about the fullness of the disclosures. It is also important that **the FME use boldly its right to refuse a qualifying holding** in cases where it is convinced that such a holding would somehow impede the efficient supervision of the bank in question. The supervisory authority should be courageous in using the discretionary powers it has. **If the legal profession has a very narrow interpretation of the degree of discretion permitted by law, as seems to be the case in Iceland, this situation should be rectified for the future.**

To some extent, the FME was prevented from acting forcefully on qualifying holding applications because of **the precedent of the Landsbanki-Samson and Búnadarbanki-S-group cases from 2002**. If

my understanding is accurate, these decisions were to a large extent politically motivated, against the wishes of the FME management (see Chapter 3). Nevertheless, in a few cases the FME turned down intended purchases of qualifying holdings. One of these concerned Glitnir. In addition, some fines and restrictions on voting rights were imposed for non-compliance with the rules on notification of qualifying holdings.

9. Other issues

Several issues that have relevance to the supervisory and regulatory framework in Iceland are not addressed in detail in this report but are nonetheless worth mentioning and require attention. The most important of these is perhaps the requirement for more – and more reliable – **disclosure and transparency regulation and culture**. This is a very broad area and touches not only on banking and finance but also on the economy as a whole, as well as **corporate culture and corporate governance**. To improve on these, it is necessary to have a critical overview, not only of banking legislation, but also of **company law, accounting legislation, the role of internal and external auditors, and stock exchange regulations**. **Minority rights** in publicly quoted companies are also a part of this. The application and understanding of the requirements of the **IFRS (International Financial Reporting Standards)** should be mentioned. All the issues listed above form the basis of a well-functioning and efficient market economy system (as different from an oligopolistic, inefficient, and non-transparent economic system). In the banking area, **Pillar 3 of Basel II**, if properly implemented, should give the FME new possibilities to foster the principles of transparency and sound corporate governance. The role of external auditors in fostering disclosure and transparency should be critically assessed, and the requirements for their cooperation with the FME may need strengthening.

In this report, I have not dwelt specifically on **interest rate risk**, which is an important area of banking supervision. This is due to the fact that, in the Icelandic crisis, liquidity, credit and **reputational risks** were those that brought the system down. However, **interest rate and credit risks** would have been **a major challenge** for the Icelandic banks if they had been able to weather the liquidity storm that hit them. This is because they had – and have – major interest rate mismatches and credit risks on their books (due to the present global crisis, credit quality has deteriorated sharply) that will undermine their profitability **in the future**. **Country risk**, in the conventional sense, was also of lesser importance in the Icelandic case. In the main, Icelandic banks were only active in other industrial countries, so their biggest country risk was ultimately Iceland itself.

10. Conclusions and proposals for the future

The collapse of the Icelandic banking sector resulted from a combination of several factors. An analysis of the Norwegian banking crisis in the late 1980s concluded that it was caused by bad banking, bad policies and bad luck. This saying can also be applied to Iceland. In retrospect, it is easy to say that **banking was bad** because the owners and managers of banks adopted an aggressive policy of rapid international growth based on high leverage and investment in growth areas that turned into bubbles. The global liquidity glut, low interest rates, and the hectic search for higher returns through complicated structured products made it relatively easy for Icelandic banks to fund

their phenomenal growth, given their relatively favourable credit ratings. Iceland's membership in the EEA also made it possible for the banks to exploit the European Passport to enter the EU financial markets without major constraints. In the euphoric stage of rapid growth, risk controls and contingency plans were considered a nuisance, and the quality of the banks' assets and the collateral used to protect them did not withstand the pressure when the prevailing emotion in the overheated global financial market turned from greed to fear. The banks' funding sources began to dry up, and asset quality deteriorated rapidly. Iceland's government and central bank were unable to support the overgrown banking sector in its difficulties. The banks had grown too big for Iceland. Iceland was the smallest economy in the world with a freely floating currency. Once the trust and confidence of the international financial markets was lost, the game was over and only the IMF and foreign governments were left to help Iceland to help itself out of the doldrums.

Then there were the **bad policies**. The money and financial market in Iceland is highly indexed or foreign exchange-based. As a result, the CBI's monetary policy only affects a small fraction of the financial system. This is further aggravated by the fact that the public sector had actually two different monetary policies, as the State-owned Housing Financing Fund's (HFF) actions could run counter to the monetary objectives of the Central Bank. The high degree of foreign currency-denominated lending domestically also made the economy susceptible to fluctuations in the external value of the Icelandic króna. During the boom years, macroeconomic policies in general were too lax and accommodating. The CBI's foreign exchange reserves could not grow in tandem with the economy's overall dependency on international developments. In addition, the CBI's human resources may have been too small for a country with a freely floating currency and a large banking system that was more international than domestic but was nonetheless viewed by foreigners as Icelandic. The FME, too, was too small to supervise a complex banking system like that in Iceland. The powers of the supervisors were too limited, and the Nordic tradition of jurisprudence did not allow much leeway into discretion. The tycoons of the financial system could circumvent the underlying purpose of the regulations by sticking to the letter of the law with the help of diligent lawyers and complicated corporate structures. The supervisors were too timid and lacked legal authority in their efforts to intervene in these developments, but the overall national pride in the success of the banks would probably have made it futile even to try while the going was good and success followed success. By the time the tide turned, it was too late, and there was too little that could be done to avoid catastrophe.

Finally, the **bad luck**. Since the Great Depression of the 1930s, the modern world has not seen a financial global crisis like the one we are experiencing right now. It may very well be that this crisis will turn out to be even worse than that of the 1930s. In these circumstances, the efforts of the Icelandic banks to retrench in late 2007 and 2008 were rather futile. Finally, the collapse of Lehman Brothers on September 15, 2008 struck the final blow to the ability of the Icelandic banks and the authorities to save the system. There might – just might – have been a possibility for the Icelandic banks to survive if the almost total freezing of the international financial markets had not taken place and confidence in Iceland had not been lost. Even in that case, they probably would have needed government support to maintain their solvency, as credit losses would have risen due to the deterioration of their loan portfolios. Now that the blaming game continues at high speed in Iceland, it is perhaps beneficial to bear in mind that most, if not all, Icelandic players in this game must also look in the mirror. Placing the blame solely on external circumstances is not appropriate.

I assume that the **future banking system** in Iceland will be very different from the old one. The banks will be traditional commercial banks based on domestic Icelandic markets. The little international business they have will be based on servicing their domestic clients in their international activities, mostly related to exports and imports. They will not have any major foreign subsidiaries or branches. There might also be a foreign-owned bank – hopefully one owned by a respectable and reliable major international bank – among the few major banks in Iceland. This simpler and smaller banking system will be easier to supervise. The lessons from the crisis will move the corporate culture in a more positive direction so that consciousness of risks and the benefits of effective regulation and supervision will be better appreciated.

The macroeconomic setting of the future is more difficult to forecast, but I think there is a high probability that Iceland will join the **EU** and adopt the **euro** in the next five years or so. This would solve the problem of the small and volatile currency. Before projecting that far, however, the problem of **indexation** must be tackled, as well as the **role of the HFF**. The ISK must be returned to full convertibility as soon as possible, either as a freely floating or a managed currency, in order to free up the full potential of the Icelandic economy in international trade and commerce.

With this sort of vision in mind, I would summarise my **major recommendations for the future** as follows. In the body of the report are a number of other, more minor, recommendations.

1. **Decrease the number of ministries** that have a hand in financial market legislation or are otherwise **involved in the financial markets**.
2. **Merge the CBI and the FME**, or at least bring them under the same administrative umbrella (as in Finland and Ireland).
3. **Give more discretionary powers to the FME** and encourage it to use its powers more forcefully.
4. **Create a National Credit Registry at the FME** to diminish credit risks in the system and to provide a better overview of large exposures at the national level.
5. **Lay down tougher rules and, subsequently, apply strict practice on large exposures, connected lending and quality of owners**, using discretionary best judgment when necessary.
6. **Conduct more on-site inspections** to verify off-site supervision and reports, particularly on credit risk, liquidity risk and foreign exchange risk.
7. **Review and improve the deposit guarantee system**, closely following the developments within the EU.
8. **Participate actively in international cooperation on financial regulation and supervision**, particularly within the EEA and EU.

In closing, I also wish to underline the fact that, in a market economy, banks themselves are responsible for their actions. As in any other firm, the owners set the strategies of the enterprise, and management has the duty to implement the strategy and to make the day-to-day business decisions. If strategies and their implementation fail, a bank can also fail. The supervisory authorities

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are not there to guarantee that a bank can never go bankrupt. They are there to ensure that the banks act within the remit of the laws and regulations that the people, through parliament and government, have set up for them in order to protect the public interest. The supervisory authorities need adequate powers and resources and public support to do this efficiently. The present global crisis and the Icelandic experience indicate that the laws and regulations and the support, powers and resources of the supervisory authorities have been inadequate – and not only in Iceland. It is certainly in the interest of the international community to take stock of and learn from the Icelandic experience.

I hope this report and my recommendations will be helpful for the rebuilding of the Icelandic financial system.

In Reykjavik on March 30, 2009

Yours sincerely,

Kaarlo Jännäri

Cooperation Agreement between the Financial Supervisory Authority and Central Bank of Iceland

The Board of Directors of the Financial Supervisory Authority (FME) and the Board of Governors of the Central Bank of Iceland, hereafter named the contracting parties, have made the following Cooperation Agreement, in accordance with Article 15, paragraph 4 of Act No. 87/1998 on Official Supervision of Financial Activities and Article 35 of Act No. 36/2001 on the Central Bank of Iceland.

The Agreement concerns the contracting parties' cooperation on oversight and supervision but does not affect in other respects their legal and contractual obligations.

1. Aim of the Cooperation Agreement

The aim of the Agreement is for cooperation between the contracting parties to be guided by the following principles:

- Clarifying the responsibility of each party and division of tasks between them, both with respect to each other and vis-à-vis companies in financial markets and the general public.
- Ensuring that all duplication of tasks in their joint activities shall be kept to an absolute minimum, both to prevent inconvenience for stakeholders and to minimise the cost of the contracting parties' activities.
- Smooth and swift information exchange between the parties.
- Reciprocal provision of information at the first possible instance when indications of difficulties in financial markets arise.
- Ensuring coordinated responses by the FME and Central Bank to conceivable systemic risks in financial markets.
- Promoting efficiency and safety of payment and settlement systems and ensuring that the systems fulfil the demands made towards them.

2. Roles and division of tasks of contracting parties

- 2.1 The activities and role of the FME are governed by the legislation in force concerning it, currently Act no. 87/1998 on Official Supervision of Financial Activities, provisions of specific laws, and regulations and rules set on the basis of those laws.

The activities and role of the Central Bank are governed by the legislation in force concerning it, currently Act no. 36/2001, provisions of specific laws, and regulations and rules set on the basis of those laws.

- 2.2 The contracting parties shall respect each other's field of operation. They shall attempt to define clearly the fields of operation and responsibility of each party when their tasks overlap.

Translated from the Icelandic. In the event of any discrepancies between the translation and the text in Icelandic, the original text shall take precedence.

3. Division of tasks in connection with oversight and supervision of payment and settlement systems

- 3.1 Among the principles set out by the Bank for International Settlements (BIS) are that central banks should ensure that the payment systems they operate comply with the Core Principles and oversee compliance with them by third-party systems.

In accordance with the BIS principles, the Central Bank of Iceland performs systemic oversight of the activities of important payment and settlement systems with respect to their safety, effectiveness and efficiency. In doing so, the Central Bank focuses in particular on system structure, operational risk and the main operational inputs. Furthermore, the Bank monitors compliance with legal and regulatory provisions on payment system operations. Above all, Central Bank oversight extends to the payment systems themselves, but not to the infrastructure or organisation of individual participants. Central Bank involvement does not limit the responsibility of individual owners or operators of payment systems.

- 3.2 The FME supervises implementation of rules governing payment and settlement systems by individual participants in them.

The FME monitors the risk of each participant, i.e. arrangements for risk management and internal audit to ensure compliance with the rules in effect within the systems.

- 3.3 Contracting parties shall maintain a joint contingency plan for payment and settlement systems which is approved by both the Director General of the FME and the Board of Governors of the Central Bank.

4. Meetings of the contracting parties

- 4.1 The Director General of the FME and the Board of Governors of the Central Bank shall hold meetings to discuss issues concerning the state of the financial markets and companies operating in them, and exchange information which is not communicated regularly in accordance with Article 5 of this Agreement. These meetings shall be held as a rule at least every four months. Attendance on the part of each contracting party will depend upon the agenda and be at their discretion in each instance.

- 4.2 Topics discussed at the regular meetings of the contracting parties in accordance with Article 4.1 shall include the Central Bank's evaluation of developments in the operating environment of companies in financial markets and the conceivable impact on their profitability. The FME's evaluation of the financial position of the main parties subject to official supervision shall also be discussed, especially those engaged in transactions with the Central Bank.

- 4.3 FME and Central Bank experts on indications of systemic risk in financial markets shall hold meetings at least every four months. Other expert staff of the contracting parties shall hold regular meetings as deemed appropriate. Each contracting party shall nominate contacts in connection with this work.

- 4.4 The Central Bank and FME shall hold regular contingency exercises, normally every other year. In this context, reference is made to the Memorandum of Understanding between the Office of the Prime Minister, Ministry of Finance, Ministry of Commerce, Financial Supervisory Authority and Central Bank of Iceland, on consultation concerning financial stability and contingency plans, from February 21, 2006.

5. Notification, information exchange and acquisition of information by the contracting parties

- 5.1 The contracting parties agree that access to information is necessary in order for them to be able to perform their duties according to law and this Agreement. The contracting parties shall consult with each other concerning the acquisition of regular information about companies in the financial markets. It is underlined that the contracting parties shall not seek similar information separately, and that each shall collect the information most pertinent to it.

The Appendix to this Agreement specifies the data to be collected by the respective contracting parties, and states which information shall be provided to the other and in what form, i.e. paper, e-mail or any other form. The Appendix shall be reviewed regularly.

As a rule it shall be aimed to send the information, which one contracting party acquires and provides to the other in accordance with this Article, at the first possible instance and no later than one week after it is available. Presentation of material shall be at the discretion of the sender.

- 5.2 If examinations by the FME reveal suspicions about shortcomings in the financial position of parties which are subject to official supervision and are engaged in transactions with the Central Bank or operate extensively in the markets, or about the risk of a systemic crisis in the financial markets in other respects, the FME shall immediately notify the Board of Governors of the Central Bank.

If examinations by the Central Bank reveal suspicions of shortcomings in the financial position of companies in the financial markets, or of serious difficulties in the financial markets in other respects, the Central Bank shall immediately notify the Director General of the FME.

In the above cases, the Director General of the FME and the Board of Governors of the Central Bank shall respond in accordance with their institution's respective internal procedures.

- 5.3 The contracting parties shall inform each other if they become aware of any infringement of the rules that are in effect within the payment and settlement systems.

Furthermore, contracting parties shall at least annually outline to each other the implementation of their oversight and supervision of payment and settlement systems.

- 5.4 The contracting parties shall provide each other with full access to data which they store and are used in their own activities in accordance with Article 2.

6. Setting of rules

The contracting parties shall inform each other of rules that they plan to set concerning the activities of companies in financial markets.

7. Cooperation on measures

- 7.1 In their cooperation the contracting parties shall seek to develop methodologies to predict, as early as possible, problems in the operating environment in financial market and in the activities of individual companies.

- 7.2 The contracting parties shall outline to each other measures that they intend to adopt which have a significant bearing upon the activity of financial market companies or the financial market operating environment.

When substantial difficulties occur in the operation of a company which is important in the financial markets, such as when it is faced with liquidity problems or bankruptcy, the contracting parties shall consult about their actions. The same applies when the problems concern more companies in the financial markets, or the financial markets as a whole. If the Central Bank considers the possibility of providing a loan or guarantee to a credit institution in accordance with Article 7, paragraph 2 of Act no. 36/2001, it will act in close collaboration and consultation with the FME on resolving the problem that may have arisen.

- 7.3 If a systemic risk is present or pending, the experts referred to in Article 4.3 shall collaborate on proposals for joint measures by the FME and Central Bank, and other responses.

- 7.4 Each contracting party is independently responsible for measures which it is authorised to adopt in accordance with its role according to Article 2.

8. Participation in international cooperation

Contracting parties shall consult with each other on participating in international cooperation and attending meetings connected with the role of them both. Furthermore, each contracting party shall inform the other of matters which arise in international cooperation and concern the role of the other.

9. Confidentiality

Information provided by one contracting party to the other is confidential by law. Such information shall only be used in the contracting parties' activities.

The contracting parties shall ensure that they do not disclose information on the basis of the Information Act without consultation with the party that acquired it.

10. Other matters

This Agreement replaces the Cooperation Agreement from March 28, 2003, the Agreement on Payment and Settlement Systems of the same date and the Memorandum of Understanding between the FME and Central Bank of Iceland on contingencies to meet conceivable problems in the financial markets' operating environment from the same time.

This Agreement shall be reviewed if so requested by either of the contracting parties.

Appendices and protocols to this Agreement may be amended with the signatures of the Director General of the FME and the Board of Governors of the Central Bank.

Reykjavik, October 3, 2006

Financial Supervisory Authority:

Central Bank of Iceland:

Appendix: Data acquisition by the contracting parties

Translated from the Icelandic. In the event of any discrepancies between the translation and the text in Icelandic, the original text shall take precedence.

Memorandum of Understanding
between the Office of the Prime Minister, Ministry of Finance, Ministry of
Commerce, Financial Supervisory Authority and Central Bank of Iceland,
on consultation concerning financial stability and contingency plans

Purpose

Since the establishment of the Financial Supervisory Authority (FME) at the beginning of 1999 it has cooperated closely with the Central Bank of Iceland on tasks relating to financial stability, including contingency plans for meeting conceivable financial shocks. Over the past two years, informal consultations have also taken place between the Office of the Prime Minister, Ministry of Finance, Ministry of Commerce, FME and Central Bank of Iceland on the same issues. The purpose of this Memorandum of Understanding (MoU) is to formalise consultations in this area, in an effort to sharpen the division of responsibilities, prevent work duplication and increase transparency. The MoU does not limit the scope of any signatory for making independent decisions on measures on the basis of its role and responsibilities.

Consultative group

A solid legal, regulatory and supervisory framework for the activities of financial undertakings and markets is a prerequisite for financial stability, and a secure and efficient financial system is an important precondition for macroeconomic growth and welfare. Parties to the MoU contribute together towards ensuring that these preconditions are in place, on the basis of their mandatory roles and tasks. Furthermore, they seek to coordinate their responses to a conceivable shock to the financial system.

The forum for consultation is the consultative group of the Office of the Prime Minister, Ministry of Finance, Ministry of Commerce, FME and Central Bank of Iceland. The consultative group shall meet at least twice a year. However, it shall be convened immediately at the proposal of the Director of the FME and/or the Board of Governors of the Central Bank on account of developments involving the position of financial undertakings or markets. The representative of the Office of the Prime Minister shall chair the group's work. In preparing presentations and in discussions, all parties shall honour prior confidentiality by which they are bound.

At its meetings, the consultative group's tasks shall include:

- The position and outlook in financial markets
- Major changes in financial market legislation, regulations and working procedures
- Questions concerning international cooperation, particularly within the European Economic Area.

Contingency plans and procedures

The consultative group is a forum for the exchange of information and views. Its role is consultative and it does not make decisions on measures. The consultative group prepares and maintains a list of main contacts. It can arrange and participate in contingency exercises such as those which have been conducted in cooperation between the FME and the Central Bank.

If circumstances arise in which the financial system is considered to be at risk due to a shock to a financial undertaking or market, the matter shall be addressed by the consultative group without delay. Responses to such problems depend on the circumstances at any time but the fundamental principal is that the owners and management of financial undertakings, and market agents, should resolve their problems themselves.

Review of the MoU

The MoU shall be reviewed at the request of a party to it.

Further cooperation between the FME and Central Bank

The FME and Central Bank closely monitor, and aim to contribute to, the soundness of the Icelandic financial system, in their respective ways in accordance with their roles. Cooperation between them is governed by an official Memorandum of Understanding, originally made in 1999 and currently dating from 2003, which specifies aims that include ensuring coordinated responses by the FME and Central Bank to conceivable systemic risks in financial markets.

February 21, 2006