



ICELANDIC STATE FINANCIAL INVESTMENT

*Report on the activities
of ISFI in 2010*

June 2010



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INVESTMENTS

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Director General's report

The management of the Icelandic state's holdings in NBI hf. (Landsbankinn), Arion Bank hf. and Íslandsbanki hf. was transferred to Icelandic State Financial Investments (ISFI) on 4 January 2010. By the end of 2009, the three banks had been operating for about 14 months. For most of this period, the banks worked under the uncertainty of not knowing how they would ultimately be financed. The situation was clarified at the end of 2009, although in the case of Arion Bank, not formally until January 2010.

The banks' financial statements for 2009 provide the first comprehensive picture of their initial performance. It is clear that irregular items had a considerable impact on the operating results of all three banks. There was a great deal of uncertainty regarding the value of the asset portfolios that were transferred from the banks that collapsed in the autumn of 2008 to Arion Bank, Íslandsbanki and Landsbankinn. Valuations changed in all three of the banks in 2009 and this had a significant impact on their operating results. Moreover, imbalances in the currency positions and the CPI indexation balance of the banks also affected operating results.

Looking at the results of core operations for 2009, i.e. once adjusted by removing the effects of irregular items, one can see that returns on equity dropped considerably in the case of Landsbankinn and Arion Bank, and slightly in the case of Íslandsbanki. Similarly, the cost to income ratio for regular operations was considerably higher in relation to the total income and expenses of the banks. This item is discussed in greater detail in chapter 4 of this report.

It should be pointed out that it is difficult to compare the accounts of the three banks, since they use different methods in the preparation and presentation of their results. It is therefore impossible to discern the core operating results without considerable effort. It would be preferable if the accounts of related activities were comparable and transparent.

It is clear that the working environment in the banking sector is a difficult one. The contraction in the economy has an impact on the banks' revenues. Economic sectors are heavily burdened by debt and uncertainty surrounds near-term investments. There is also some uncertainty regarding important categories of the banks' loan portfolios. These include i.a. agreements for foreign currency indexed loans. Similarly, there is some uncertainty regarding the impact of proposed changes to the Icelandic fishing regulatory system on the loan portfolios of the banks in that sector.

A great deal of work is being done in the banks to restructure the loan portfolios. The success of that task will determine how long it will take to restore healthy and trustworthy banks that are capable of channelling savings into investments in the most cost effective manner. It is important to explore every avenue to streamline operations with the aim of developing efficient and profitable operations in the long term.

About the activities of ISFI

ISFI's Board of Directors was appointed and commenced work at the end of September 2009. The board's first task was to set up a Selection Committee and establish its rules of procedure. Work started with the preparation of the appointment of members to the boards of directors of Arion Bank and Íslandsbanki. In addition to this, the post of Director General of ISFI was advertised and a number of preparatory tasks were conducted in connection with the establishment of this new body.

The Director General started work at the beginning of January 2010 and initiated communications with the main parties involved, including i.a. members of the administration working on financial market issues, the banks which ISFI manages stakes in, their boards of directors, and holding companies that own stakes in the banks.

In January, ISFI advertised for working premises and staff. The recruitment process was concluded at the beginning of March and three employees started work at the beginning of April. ISFI established its offices in Borgartún 3. Agreements were negotiated with service providers, such as IT services. ISFI's website has been launched and contains all of the main information about the institute.

Work has been done on developing a strategy for the body. ISFI's objectives have been defined and a disclosure policy has been established.

Annual general meetings (AGMs) could not be held in the three banks, which ISFI manages holdings in, during the course of 2009, and these meetings were therefore held in January and February 2010. It was at these meetings that the annual financial statements for 2008 (covering the period between October and the end of 2008) were approved. The AGMs in which the financial statements for 2009 were approved were held in April and May.

Decisions were made regarding ISFI's nominations to the boards of directors of the banks under the rules of procedure that had been established for ISFI's Selection Committee. One full member and one alternate were nominated to the board of directors of Íslandsbanki in January 2010. In February, four full members and four alternates were nominated to the board of directors of Landsbankinn, and three of these four full members were new to the board. In May, one new full member was appointed to the board of directors of Landsbankinn. One full member and one alternate were nominated to the board of directors of Arion Bank in March.

The remuneration policies were approved by all the banks at the annual general meetings that were held in April and May. It was stipulated that there would be no incentive schemes in the banks, unless the remuneration policies were amended and approved by a shareholders' meeting.

ISFI has acquainted itself with the operations of the three financial undertakings it manages holdings in. Information has been collected and analysed. ISFI is working on establishing a regular procedure for the provision of information by companies. Moreover, ISFI has been collecting information on the savings banks system preparing for the anticipated shareholding of the state in several savings banks.

ISFI has submitted its proposal for the division of tasks between the Ministry of Finance and Icelandic State Financial Investments. There is a need to define what specific tasks need to be executed and how, since, according to the law, ISFI does not have final decision-making powers on all of the issues it handles. To mention the most significant examples: the initial funding of financial undertakings is determined by the Ministry of Finance; additional funding is granted following a proposal from ISFI, which has to be approved by the Minister of Finance, and decisions to sell holdings in a financial undertaking are also made by the Minister of Finance on the basis of ISFI proposals.

1. About ISFI (Icelandic State Financial Investments)

Objectives

Icelandic State Financial Investments (ISFI) is a special state body with an independent Board of Directors. An arm's length principle is applied to relations between ISFI and the government. A professional and a commercial approach guides all decisions that are made regarding the state's shareholdings.

ISFI sets itself the objective of being an active shareholder that firmly implements the state's ownership policy in the holding under its management.

ISFI exercises the state's voting rights. ISFI presents the state's ownership policy to the board members it appoints and makes agreements on general and specific objectives in the management of the financial undertakings in which ISFI has a sufficient weighted vote to command a majority on the board of directors. ISFI endeavours to collaborate with the co-owners to promote the goals of the state's ownership policy.

ISFI exercises the same rights that apply to the owners of share capital under the terms of the Public Limited Companies Act. These include i.a. the selection of board members, in accordance with its voting rights or votes determined by shareholders' agreements, participation in AGM activities, and the convening of shareholders' meetings in accordance with Art.85 of the Public Limited Companies Act and the information disclosure requirements stipulated in Art. 91 of the same act.

ISFI monitors the performance of the boards of directors and senior management of the financial undertakings it manages holdings in. ISFI shall intervene if financial undertakings deviate from the objectives that have been established in the agreements with the boards of directors.

ISFI will submit assessments of how successfully individual financial undertakings are managing to meet their objectives and, on behalf of the state, inform the Minister of Finance of the results of state investments.

Disclosure policy

ISFI places emphasis on transparent decision-making and believes that ensuring an efficient dissemination of information to the public is one of the key elements in rebuilding trust in the financial system.

ISFI will use its website as a platform to publish information on its policies and activities.

ISFI will submit a detailed report of its activities to the Minister of Finance every year, pursuant to Article 8 of the Act establishing Icelandic State Financial Investments. The Minister of Finance will report to the Althing on ISFI's activities and how the state holdings have been managed, as well as the government's future priorities regarding them.

ISFI shall publish summaries of the agreements it makes with the boards of financial undertakings, in accordance with item e) of Article 4 of the Act establishing Icelandic State Financial Investments, 12 months after they are made. These are agreements which establish the minimum general or specific objectives to be met by the financial undertakings, which ISFI holds a majority share/primary capital in.

ISFI will generally publish information on decisions made at shareholder/primary capital holder meetings. An exception will be made if the shareholders' meeting discusses an issue that needs to remain confidential for competitive reasons, in accordance with Article 5 of the Act establishing ISFI.

ISFI shall endeavour to ensure that the financial undertakings it participates in as an owner operate in a spirit of transparency and good governance and that it disseminates information to the public and the media in an efficient manner, within the limits of the law and regulations.

1.1. Establishment and organisation

Icelandic State Financial Investments (ISFI) is a state body with an independent Board of Directors which reports to the Minister of Finance. ISFI exercises the state's ownership function in financial undertakings, while the reconstruction and restoration of the financial system is still in progress. The objective is to ensure that the administration of the holdings is professional, reliable and above criticism.

ISFI is the professional administrative body of state holdings. It operates under special laws which clearly define its functions and it implements the state's ownership policy. ISFI manages the state's holdings in financial undertakings and its Director General exercises the state's voting rights at shareholders' meetings.

ISFI is intended to have a limited lifespan. It is expected to conclude its operations no later than five years after its establishment, after which it will be abolished.

1.2. Board of Directors and staff

ISFI is managed by a three-member Board of Directors and one alternate, appointed by the Minister of Finance. The function of the board is to set the priorities for ISFI's activities and supervise the body's work and management. The board members and Director General must fulfil certain eligibility criteria, in accordance with Article 6 of Act. no. 88/2009 establishing ISFI. One of the requirements is that board members and the Director General must be well qualified and possess an expert knowledge of banking and financial issues. The board shall be formed so as to reflect the broadest work experience and education in this sector as possible, and care shall be taken to ensure that board members have a firm knowledge of good corporate governance.

The Board of Directors of ISFI comprises Thorsteinn Thorsteinsson, business economist, who is chairman, Sonja María Hreidarsdóttir, attorney and vice-chairman, and Sigurdur B. Stefánsson, economist. The alternate appointed by the Minister of Finance was the economist Gudrún Johnsen, but she requested to be relieved of her board duties last March and, as yet, no other alternate has been appointed in her place.

The Director General of ISFI is Attorney Elín Jónsdóttir. The Director General oversees, among other things, ISFI's policy making, communications with the financial undertakings which the state holds a stake in, the negotiation of agreements, the supervision of the implementation of the state's ownership policy, and the management and day-to-day running of the body.

The economists Karl Finnbogason and Snorri Jakobsson are ISFI's experts in the field of asset management. The asset management experts are responsible for and supervise the management of assets in ISFI's care, participate in the implementation of the state's ownership policy, manage the processing and restructuring of asset portfolios, provide information to the owners and prepare proposals related to exiting options and the sale of assets.

Erna Björg Smáradóttir, librarian, is the project manager who is responsible for the storage of ISFI's documents, and supervises the website, keeps minutes at meetings, contributes to the writing of documents and development of work procedures, and the proofreading of texts. She is also in charge of procurement, contracts and general office work.

1.3. Functions of ISFI

The state has injected a considerable amount of the public's money into refinancing and stabilizing financial undertakings since the collapse of the banking system in October 2008. The state's investments in the three commercial banks – Landsbankinn, Arion Bank and Íslandsbanki – currently amount

to ISK 189.9 billion in the form of equity capital contributions and subordinated loans. The supervision of those investments is of paramount importance.

It would be imprudent to take a non-active shareholders role, since the state has considerable financial interests to protect. It is likely that, in the wake of the financial collapse that occurred, considerable adjustments will be made in the financial market with consequent transfers of capital and functions. There is clearly a need to examine the size of the financial system and to evaluate how financial undertakings can be streamlined and restructured to rebuild a healthy and efficient financial system which serves the domestic market. The state has an opportunity to play a proactive role in the restructuring that is currently taking place, not only as regulator and supervisor, but also as a shareholder. ISFI will ensure that the state, in its capacity as owner of the financial undertakings, participates in the restoration of a financial system that takes the community's interests into account in its work.

The state has established an ownership policy for its financial undertakings and it is the role of ISFI to implement that ownership policy. ISFI manages the state's holdings at shareholders' meetings and deals with any transactions related to financial undertakings.

ISFI concludes agreements with the boards of financial undertakings, which the state holds majority stakes in, setting general and specific goals and objectives for the undertakings. It is also responsible for follow-up on how these objectives are met. ISFI's influence in a financial undertaking is proportionate to its level of ownership.

It is ISFI's role to submit proposals for further funding to financial undertakings to the Minister of Finance, if deemed necessary. It is also ISFI's function to submit proposals to the Minister of Finance regarding the sale of state holdings in financial undertakings, i.a. in the private sector.

ISFI serves its Selection Committee by, i.a. providing it with an office and secretarial services and by collecting and preserving information on candidates who express an interest in becoming members of a board of directors.

1.4. Selection of board members

The Board of Directors of ISFI appoints a special three-member Selection Committee which, on behalf of the state, nominates candidates for boards of directors of the financial undertakings under ISFI's management.

ISFI's Selection Committee comprises Kristín Rafnar, Head of Listing at Nasdaq OMX, who is the chairwoman, Dr. Fridrik Már Baldursson, Dean of the School of Business of Reykjavik University, and Helga Valfell, CEO of the New Business Venture Fund.

ISFI's Board of Directors has established rules of procedure which the Selection Committee must follow with regard to, among other things, the criteria to be applied when determining the eligibility of board members. In its nominations, the Selection Committee also has to comply with the eligibility criteria set by the Act on Financial Undertakings and, in the case of public limited companies, the Public Limited Companies Act.

The Board of Directors of ISFI formally requests nominations from the Selection Committee for the appointment of members to the board of directors of the relevant bank or undertaking. The Selection Committee selects two to three candidates for every seat that becomes available. The Selection Committee receives nominations for board memberships from candidates that send their resumes to the Committee, but can also seek eligible members on its own initiative.

When nominating a candidate for board membership, the Selection Committee submits an evaluation of the candidate's abilities with regard to, among other things, how much of an overview, knowledge and experience he/she has in connection with the running of an undertaking and the

working procedures of a financial undertaking. The committee also considers the specific needs of each company individually and shall nominate candidates for board membership who have a broad background in terms of their education and abilities.

1.4.1. Full board members appointed by ISFI

Arion Bank hf.

Kristján Jóhannsson

Kristján Jóhannsson studied Business Administration and Economics at the Copenhagen Business School and graduated with an MSc in 1981.

Kristján was the chief economist of the Federation of Icelandic Industries between 1981 and 1984. He worked as an assistant professor at the School of Business at the University of Iceland between 1982-1986 and was the Managing Director of AB - Eymundsson between 1984-1990. Between 1990-1992, he worked as an independent consultant in Copenhagen and Reykjavik. In 1991, Kristján became an assistant professor at the University of Iceland where he still works. He was also the head of the Institute of Business Research at the University of Iceland between 1992-2001.

Íslandsbanki hf.

Martha Eiríksdóttir

Martha Eiríksdóttir completed a B.Ed. at Iceland's University of Education in 1981 and a degree in Economics and Business Administration from the University of Iceland in 1987.

Martha worked as Financial Director of Saga Film hf. between 1982-1987. She was Promotion Director at the Icelandic Trade Council between 1987-1988 and head of the Marketing division of Útvegsbanki Íslands hf. between 1988-1990. Between 1990-1994, she was head of the Marketing division of Kreditkort hf. and, between 1994-2000, head of the Affinity/Co-branding division of Europay International in Belgium. Between 2000-2001, she was Managing Director of Veftorg hf. and between 2001-2003 she headed the Sales & Marketing division of Íslandssími. Martha worked as head of Marketing and Business Relations for Landsnet hf. between 2003-2009 and currently works as a freelance project manager.

NBI hf./Landsbankinn

Gunnar Helgi Hálfðanarson, Executive Chairman

Gunnar Helgi Hálfðanarson is the chairman of Landsbankinn's Board of Directors. He graduated in Business Studies at the University of Iceland and holds a master's degree in Business (MBA) from McMaster University in Ontario, Canada. Gunnar Helgi worked as director of Landsbréf hf. from 1989-1999 and headed the Funds' Division of Landsbanki Íslands between 1997-1999. From 1999-2009, he worked as Managing Director at Alliance Bernstein Investments and was stationed in Stockholm where the main emphasis was on developing business relations with the principal banking groups in the Nordic countries and Icelandic pension funds.

Sigríður Hrólfsdóttir, Vice-Chairwoman of the Board of Directors

Sigríður Hrólfsdóttir graduated in Business Studies at the University of Iceland and holds a master's degree in Business (MBA) from the University of California, Berkeley. She worked in the Treasury division of Íslandsbanki between 1994-1998 and Eimskipafélag Íslands from 1998-2004, initially as the head of the Financial Management department and subsequently, from 2000, as head of the Financial Division. She was the CEO of the Investment and Financial division of the Tryggingamiðstöðin insurance company between 2007-2008 and has been the CEO of publishing holding company Árvakur since 2009.

Gudrídur Ólafsdóttir

Gudrídur Ólafsdóttir graduated in Business Studies at the University of Iceland and holds a master's degree in Philosophy and Media Studies from the University of Oslo. She worked as head of the corporate division and vice-CEO at financing company Lýsing between 1993-2007 and as a specialist in Landsbankinn's Corporate division between 2008-2009.

Thórdís Ingadóttir

Thórdís Ingadóttir completed her Candidate of Law degree at the University of Iceland in 1993. She then pursued her studies at the New York School of Law where she was the beneficiary of a Fulbright scholarship. There she completed an LLM in International Legal Studies in 1998. In 2006, she took a doctorate course in Law at the University of Helsinki.

Thórdís worked as a legal consultant for the Single Parents' Society between 1992-1993 and as a member of the law firm of Attorneys, Ásgeir Thór Árnason and Óskar Magnússon, between 1993-1995. At the end of her post-graduate studies at New York University, she worked as a lawyer at the school from 1999-2003 (Project on International Courts and Tribunals (PICT), the Center on International Cooperation). She worked in the legal department of the Icelandic Ministry of Justice and Ecclesiastical Affairs in 2004 and has been a lecturer at the Law Department of the University of Reykjavik since 2004. Thórdís is also the author of numerous specialised articles and publications.

1.5. Communications with financial undertakings

ISFI is responsible for handling the state's dealings with financial undertakings, which the state owns a stake in and which pertain to the state's ownership function. Communications between the state and financial undertakings, which the state holds a stake in, are handled by ISFI.

The ISFI seeks to establish a professional and commercial approach when dealing with the financial undertakings in which the state owns a stake. The ISFI will be guided by the generally accepted principles of good governance in its dealings with the financial undertakings.

ISFI's say in the affairs of financial undertakings at shareholders' meetings is proportionate to the size of its holding. Boards are elected by the shareholders at shareholder meetings. Between shareholders' meetings, the boards of directors of the financial undertakings deal with company issues, such as the appointment of a CEO/Managing Director for a bank. ISFI may not interfere on specific decisions made by the board or senior managements of financial undertakings.

The ISFI will pursue a coordinated approach to the shareholdings under its care but at the same time the approach will be proportionate to the size of its holding.

- In cases in which the state is a majority shareholder, ISFI will seek to reach an agreement with the board of directors on the general and specific operating objectives to be met. Meetings will be held with the boards and senior management of the financial undertakings at least on a quarterly basis in order to obtain information on the management and activities of the company. Following the quarterly meetings the progress in meeting operating objectives is assessed by the ISFI.
- If the state holds a minority stake, ISFI will present the state's ownership policy to the board members it has nominated. ISFI will endeavour to collaborate with the co-owners of the banks to present a common strategy if deemed acceptable to all parties. Meetings will be held with the boards and senior managements of the financial undertakings at least once every quarter in order to obtain information on the management and activities of the company. Meetings with the board members will be held at least once every quarter to assess operations with regard to the objectives set in the ownership policy.

Financial undertakings which ISFI manages holdings in should be aware of the following:

ISFI shall submit an annual report to the Minister of Finance. The contents of these reports shall be based on the annual financial statements of the relative undertakings and the information that has been submitted to ISFI in connection with these annual results. If a financial undertaking presents information, which it would like ISFI to treat as confidential, special care shall be taken to clearly mark all of the submitted documents as confidential.

1.6. Measures to prevent conflicts of interest

ISFI supervises several holdings at once. To reduce the risk of conflicts of interest, ISFI will ensure the following:

- The ISFI shall not appoint members of its staff to the boards of financial undertakings.
- The ISFI shall not appoint the same person to more than one company's board of directors.
- Complete confidentiality shall be observed in the handling of the business and managerial information which ISFI has access to for each undertaking. Care shall be taken to ensure that confidential information is not disclosed to other financial undertakings or leaked in any other way.
- If a financial undertaking has listed securities on the stock exchange, an evaluation will have to be made of whether the ISFI staff members that have access to information on the company should be placed on the insider trading list of the relative company. In each case, however, it will be up to the undertaking itself to decide whether the ISFI employee should be placed on this list. ISFI employees should always be told if the information they are being privy to is classified as inside information.
- ISFI makes decisions as a shareholder, with the interests of the relative financial undertakings as its key consideration, as well as the objective of implementing the state's ownership policy and ensuring that laws and regulations are observed in the activities of the relative undertaking.

2. Savings banks in Iceland

Savings banks in Iceland have not been left unscathed by the problems caused by the collapse of the Icelandic financial system. The emergency legislation (Act no. 125/2008) authorised the Minister of Finance, on behalf of the state, to contribute to a savings bank an amount of up to 20% of the book value of its equity at the end of 2007. Regulations passed on 18 December 2008 set clearer provisions on these contributions and the criteria which the relative savings banks had to fulfil to qualify for a capital contribution from the state. Eight savings banks applied for capital contributions from the Treasury. In most cases there was clearly a need for additional contributions and financial restructuring work proceeded.

2.1. The issue of smaller savings banks

The Central Bank of Iceland (CBI) was the largest creditor of various small savings banks, following the collapse of the Sparisjóðabankinn (formerly Icebank) in March 2009, after which the deposits and claims of the savings banks were transferred to the CBI. The CBI has worked with the Ministry of Finance on the preparation of a refinancing agreement with the savings banks which entails i.a. the restructuring of claims. The proposed agreement is for a part of the debt of the savings banks to be converted into share capital, subordinated loans and general loans. The initial capital would be written off to the extent that the reserve funds are negative. The share capital which the CBI will acquire with this measure is to be taken over by the Treasury and ISFI is to be entrusted with the task of managing the holding. At the end of the restructuring, the said savings banks are expected to withdraw their requests for capital contributions from the Treasury. The proposed arrangements are expected to be discussed at the primary capital holder's meetings in June.

The savings banks in question are: Sparisjóður Bolungarvíkur, Sparisjóður Nordfjardar, Sparisjóður Svarfdæla, Sparisjóður Vestmannaeyja and Sparisjóður Þórshafnar. Three savings banks will settle their debts with the Central Bank of Iceland.

Following a request from the Ministry of Finance, ISFI has worked on a proposal regarding the redemption rights of those savings banks that are partly acquired by the state in this manner. According to the proposal, the right would mean that the savings banks in question would be authorised, under certain conditions, to redeem up to 60% of the share capital that comes into the Treasury's ownership at a pre-determined price. Some 40% is expected to be sold with the aim of broadening the ownership base. The limitation on the redemption right is that it will be cancelled if there is a need for further capital contributions during the state's period of ownership, or if the savings bank in question merges with a commercial bank. A merger with another savings bank would not have any impact on the redemption rights of the savings bank.

2.2. Byr and Sparisjóður in Keflavík

Byr and Keflavík savings banks became the two largest savings banks in Iceland, following the collapse of SPRON. In April 2010, it became apparent that no agreement could be reached with foreign creditors on the financial restructuring of the savings banks, and the boards of the banks requested the Icelandic Financial Supervisory Authority (FME) to take over their operations on 23 April 2010. Interim boards of directors were then appointed for the companies. Two new financial undertakings were founded: the SpKef savings bank and Byr hf. The Icelandic Financial Supervisory Authority transferred the deposits and assets of the savings banks to these new financial undertakings.

The Treasury has allocated minimum initial capital contributions to these new financial undertakings. An opening balance sheet is currently being prepared. A committee between two ministries has been appointed and is working on further solutions with the assistance of the Hawkpoint advisory firm. It is not known whether the Treasury will finance the companies or whether other options will be chosen. If the Treasury partly or wholly acquires one or both of the savings banks, ISFI will be entrusted with the task of supervising the holdings.

2.3. ISFI's function with regard to the savings banks

In addition to the proposals submitted to the Minister of Finance with regard to the redemption rights of specific savings banks, work has been conducted within ISFI to collect information on the position of the savings banks sector and to establish the possible routes to be taken in the operational restructuring of the savings banks, once their financial restructuring has been completed. The government has stressed the need to support the savings banks system. According to a letter of intent between the government of Iceland and the International Monetary Fund (IMF) on 19 April 2010, the government of Iceland intends to allocate an amount equivalent to 1.5% of Iceland's GDP to the savings banks sector, i.e. about ISK 25 billion.

The total assets of the savings banks have decreased significantly over the past 18 months. The largest decrease followed the collapse of SPRON. Before the operations of the Keflavík and Byr savings banks were taken over, their total assets amounted to around ISK 400 billion. There is currently no information as to how the Keflavík and Byr hf. savings banks will be operated. There is therefore no clear picture of what the total size of the savings banks sector will be after the financial restructuring has been completed. It is clear that the common operating costs of the savings banks will have to be curtailed to bring them in line with the current size of the sector. The amendments made to the Act on Financial Undertakings in 2009 enables savings banks to collaborate more on certain tasks than they could before, provided that they meet established business criteria. All avenues will be explored to create more operationally viable units in the long term, through i.a. increased collaboration and/or mergers.

3. Activities of the banks

3.1. Arion Bank

3.1.1. Financing

ISFI manages the Treasury's 13% holding in Arion Bank hf.

Arion Bank hf. was founded with the passing of emergency legislation in October 2008 to maintain domestic deposits and most of the Icelandic assets of Kaupthing Bank. The bank was entirely owned by the state until November 2009, when the state reached an agreement with the Resolution Committee of Kaupthing Bank, according to which Kaupthing Bank (Kaupskil ehf.) acquired an 87% holding in the bank. By the terms of the agreement, Kaupthing's share capital of ISK 66 billion would be paid in the form of cash and loan portfolios, which corresponded to 87% of the bank's equity, while the state would keep 13% of the share capital for a nominal value of ISK 260 million. Moreover, the Treasury boosted the bank's equity and liquidity position through the issuance of subordinated loans amounting to ISK 29.5 billion and liquidity support.

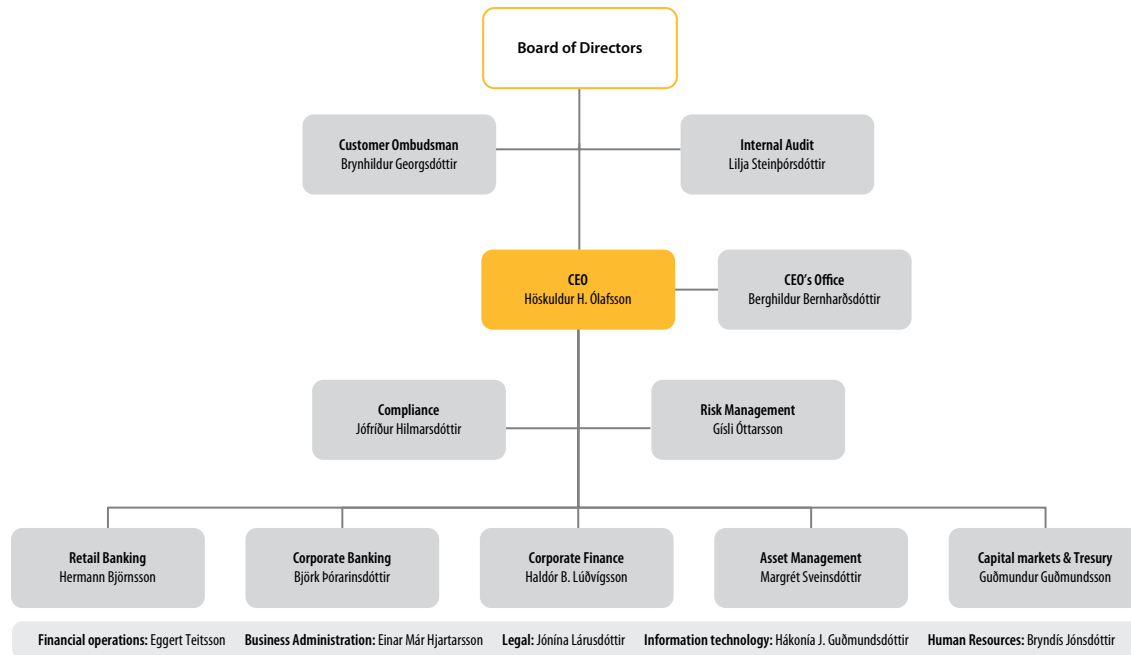
Kaupskil ehf., a subsidiary of Kaupthing Bank, was founded at the request of the Icelandic Financial Supervisory Authority to manage Kaupthing Bank's holding in Arion Bank. Kaupskil ehf., has the option to buy the state's holding in Arion Bank.

3.1.2. Organisation

Arion Bank provides comprehensive financial services and its activities are divided into ten divisions, comprising five profit centres: Retail Banking, Asset Management, Corporate Banking, Corporate Finance, Treasury & Capital Markets, and five cost centres; Finance, Back Office, Legal Services, Information Technology and Human Resources. The number of employees working at the bank at the end of 2009 was 1100.

Table 1: State's capital contributions to Arion Bank hf.

Arion Bank		
State's ownership		13%
Share capital		ISK 2 bn.
Nominal value of the state's shares		ISK 0,26 bn
Nominal value of Kaupskil's shares		ISK 1,74 bn
Share premium		ISK 73,9 bn.
State's capital contribution		ISK 39,4 bn
State's shares		ISK 9,9 bn.
Subordinated debt		ISK 29,5 bn.
Figures in billions ISK		
	31.12.2009	31.12.2008
Total assets	757.344 kr.	641.203 kr.
Equity	90.034 kr.	76.946 kr.
Capital ratio	13,7%	10,6%
Tier I capital ratio	13,7%	10,6%
Tier II capital ratio	0,0%	0,0%
Figures in millions ISK		
Capital contributions	The share capital was paid in two instalments:	
	1. ISK 775 million was paid in cash for share capital at the rate of ISK 1 per share.	
	2. A nominal value of ISK 71,225 million was paid in the form of Treasury bonds for share capital at the rate of ISK 6 per share, but the issued share capital amounted to ISK 12.65 bn. until 8 January 2010 when it dropped to ISK 2 bn.	
	In November 2009, the Resolution Committee of Kaupthing Bank agreed to Kaupthing Bank (Kaupskil) acquiring an 87% stake in Arion Bank in exchange for the payment of ISK 66 bn. in the form of loan portfolios. This payment was made on 8 January 2010 and cancelled most of the state's obligations with regard to the share capital contributions it had made in the form of a bond. A euro-denominated subordinated loan of ISK 29.5 bn. was issued to the bank at the date of issue, amounting to the equivalent of 4% of its Tier II capital, to boost its capital adequacy ratio. The maturity date of the bond is 31.12.2019. In total the state's capital contributions amount to ISK 39.4 bn.	

Chart 1: Organisation chart of Arion Bank

Board of Directors	Alternates
Monica Caneman, Chairwoman	Jóhannes R. Jóhannesson,
Guðrún Johnsen, Vice-Chairwoman	Ólafur Helgi Ólafsson
Kristján Jóhannsson	Agnar Kofoed-Hansen,
Steen Hemmingsen	María Grétarsdóttir
Theodór S. Sigurbergsson	Guðrún Björnsdóttir
Colin C. Smith	Jón G. Briem

Auditor: Ernst & Young

Headquarters: Borgartún 19, 105-Reykjavík

3.1.3. Measures taken since the financial collapse

The bank is founded on the basis of the domestic activities of Kaupthing Bank. There is clearly a need for the three new banks to learn from the shortcomings of the banks' activities before the financial collapse. Necessary changes have to be made to their activities so that they can regain trust and credibility. There have been numerous changes in the nature and scope of the bank's operations. The bank's operations are now solely focused on the domestic market and a great deal of time is devoted to restructuring of the loan portfolio. As a result of this change in focus organisational changes are necessary. In light of this, ISFI requested information on what measures have been taken since the financial collapse. The following is a summary of the answers received from Arion Bank.

Organisation

- The Compliance Officer, who formally reported to the head of Legal Services, now reports directly to the CEO of the bank.
- The Finance and Management division has been split into three: i.e. Finance, Back Office and IT departments.
- The Corporate Advisory Division is now called the Corporate Finance Division and performs a double function, i.e. conventional corporate advisory and the handling of solutions for indebted companies (financial restructuring).

- There have been many changes in the management team of the bank. Many directors and executives have terminated their employment. Only two of the eleven managing directors who worked for Kaupthing Bank are still employed there.

Risk and credit management

- In the spring of 2009, the Oliver Wyman advisory service conducted a detailed examination of Arion Bank's risk management at the request of the Icelandic Financial Supervisory Authority and, in mid summer 2009, submitted an analysis of the principal elements that needed to be improved.
- Risk management has been reorganised and strengthened.
- The bank's lending regulations were reviewed with the participation of Risk Management. Lending and write-off authorisations were reviewed.
- Credit committee meetings have been standardised and the focus on Risk Management's findings at meetings has been sharpened.
- The post of Credit Risk Manager has been created with the aim of further improving the supervision of new lending and loans that have already been issued.
- Authorisations for capital markets trading in futures by trading securities have been restricted, insurance requirements have become more stringent and working procedures have been enhanced.
- Risk Management has facilitated a number of changes in the IT system, which will enhance the quality of data and make it more accessible. The objective of the changes is to improve the provision of information to management and analyse the risk in the areas that are most crucial for the bank in its new form.

Compliance and internal auditing

- The CEO of the bank has reviewed and endorsed a new Internal Control and Procedural Handbook.
- The work of the auditing department has been strengthened with the addition of two employees; there were eight in the department in October 2008 and there are now ten.
- The Board of Directors and Audit Committee of the bank have placed a lot of emphasis on the importance of auditing in the internal supervisory process.
- The CEO has emphasised the reform process, in response to opinions issued by Internal Audit.
- The Compliance Officer is more independent than before and reports directly to the CEO of the bank.
- Compliance is more vigilant and organised in its work. The Compliance Officer now submits more regular reports to the CEO and Board of Directors of the bank and meets with the CEO once a month.
- The briefing and following up of employees has been improved by i.a. conducting tests on the net.

General

- A Customer Ombudsman, who reports directly to the board of directors, has been appointed.

3.1.4. Gender equality policy and gender ratios

ISFI requested information on the bank's gender equality policy, which can be summarised as follows: Information was requested on the gender distribution in senior management. The objective was to obtain information to be able to compare the gender ratios in the different banks. The published information only covers the senior management and boards of directors presented in the organisation charts.

A Gender Equality Committee within Arion Bank has been entrusted with the task of drawing up a gender equality strategy. The work of the Gender Equality Committee is focused on eight areas: (1) equal pay rights, (2) equal representation on committees, (3) job vacancies, (4) work groups, (5) staff training and continuing education, (6) education on gender equality, (7) reconciling family and professional life and (8) intimidation and sexist/sexual harassment.

- The Gender equality strategy will be reviewed every three years. The Gender Equality Committee shall comprise five members selected from the staff for a term of two years. The employees' Council of Shop Stewards appoints two members and the bank appoints three members.
- The Gender Equality Committee works on behalf of the CEO of the bank. The Gender Equality Committee is responsible for drawing up the gender equality strategy, as well as its implementation and supervision. The gender equality strategy shall be approved by the CEO of the bank and presented to the board of directors. The gender equality strategy shall be sent to the Icelandic Centre for Gender Equality, as shall any amendments made to the strategy during the three-year period leading up to the review of the strategy.
- The Gender Equality Committee shall follow developments in the field of gender equality in general and review its gender equality strategy in line with any amendments to the legislation or other changes. The Gender Equality Committee shall act as the link between the bank and the Centre for Gender Equality . The Gender Equality Committee has set itself the goal of being nominated for the Gender Equality Award within three years.
- The bank's Gender Equality Committee is responsible for drawing up the gender equality strategy. Its implementation is the responsibility of the specific divisions within the bank, directors, heads of divisions and other executives, who work in collaboration with the Gender Equality Committee.
- The Gender Equality Committee sets time limits on each specific task and once a year reports to management on the progress made.

Table 2: Gender distribution in the senior management of Arion Bank

Arion Bank – gender distribution in senior management¹					
	Male	Female	Total	% Male	% Female
Board of Directors	4	2	6	67%	33%
CEO	1	0	1	100%	0%
Senior management*	6	9	15	40%	60%
Total	11	11	22	50%	50%

*Staff in organisation chart in May 20

3.2. Íslandsbanki

3.2.1. Financing

ISFI manages the Treasury's 5% holding in Íslandsbanki hf.

Íslandsbanki was founded with the passing of emergency legislation in October 2008 to maintain domestic deposits and most of the Icelandic assets of Glitnir. The bank was entirely owned by the state until October 2009, when the state reached an agreement with the Resolution Committee of Glitnir Bank, under which Glitnir Bank was to acquire a 95% holding in the bank. According to the agreement, Íslandsbanki's debt to Glitnir was cancelled and most of the state's capital contribution was paid back, although the state continued to hold 5% of the bank's share capital for a nominal value of ISK 500 million. Moreover, the Treasury boosted the bank's equity and liquidity position, through the issuance of i.a. subordinated loans amounting to ISK 25 billion.

ISB Holding ehf., a subsidiary of Glitnir Bank, was founded, at the Financial Supervisory Authority's request, for the purpose of managing Glitnir's holding in Íslandsbanki.

1. Source: information published on the bank's website on 31 May 2010.

Table 3: State's capital contributions to Íslandsbanki hf.

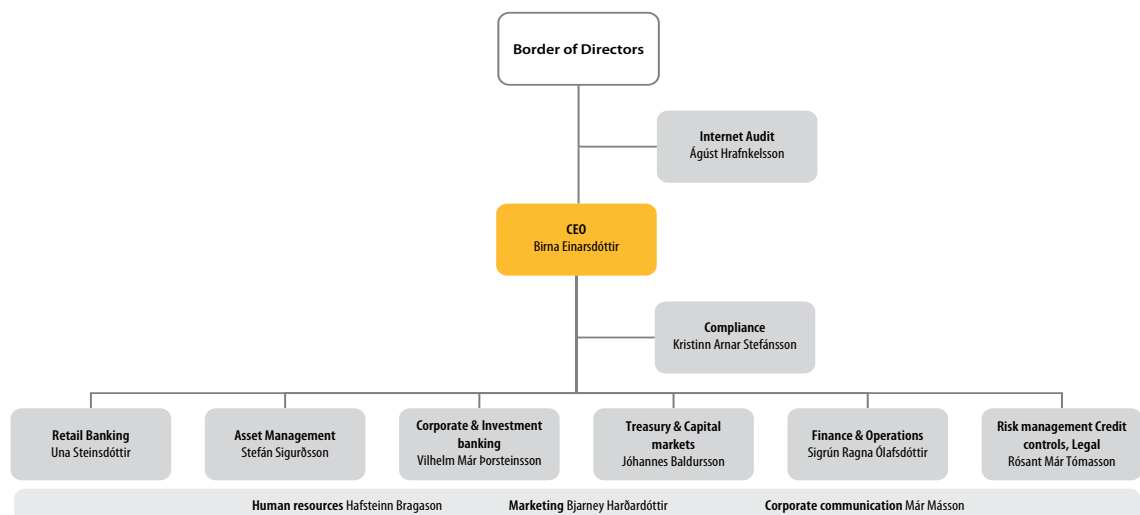
Íslandsbanki hf.		
State's ownership		5%
Share capital		ISK 10 bn.
Nominal value of the state's shares		ISK 0,5 bn
Nominal value of ISB holding shares		ISK 9,5 bn
Share premium		ISK 55 bn.
State's capital contribution		ISK 28,25 bn
State's shares		ISK 3,25 bn.
Subordinated debt		ISK 25 bn.
Figures in billions ISK		
	31.12.2009	31.12.2008
Total assets	717.342 kr.	658.003 kr.
Equity	92.103 kr.	68.030 kr.
Capital ratio	19,8%	13,4%
Tier I capital ratio	15,6%	13,4%
Tier II capital ratio	4,2%	0,0%
Figures in millions ISK		

Capital contributions The share capital was paid in two instalments:
 1. ISK 775 million was paid in cash for share capital at the price of ISK 1 per share.
 2. A Treasury bond of a nominal value of ISK 64,225 million was paid for share capital at the price of ISK 6.96 per share. In October 2009, creditors (the Resolution Committee of Glitnir Bank) agreed to acquire 95% of the share capital in exchange for forgiveness of debt. This completely cancelled the state's obligation with regard to the share capital contributions it had made in the form of a Treasury bond. A euro-denominated subordinated loan of ISK 25 billion was issued at the date of issue, amounting to the equivalent of 4% of Tier II capital, to boost the bank's capital adequacy ratio. The maturity date of the bond is 31.12.2019.
 The **Total** state investment therefore amounts to ISK 28.25 bn.

3.2.2. Organisation

Chart 2 Organisation chart of Íslandsbanki

Íslandsbanki provides comprehensive financial services and its activities are divided into six divisions. These comprise four profit centres: Retail Banking, Asset Management, Corporate Banking, Treasury & Capital Markets and two cost centres: Finance & Operational, and Risk Management & Credit Control. At the end of 2009, the bank counted 900 employees.



Board of Directors	Alternates
Fridrik Sophusson, Executive Chairman	Anna Skúladóttir
John E. Mack, Vice-Chairman	Gudmundur Ragnar Jónsson
Neil Graeme Brown	María Guðrún Sigurdardóttir
Martha Eiríksdóttir	Katrín Ólafsdóttir
Árni Tómasson	Eiríkur Hilmarsson
Raymond J. Quinlan	Baldur Pétursson
Marianne Økland	Thórdís Bjarnadóttir

Auditors: Deloitte hf.

Headquarters: Kirkjusandur 2, 155-Reykjavík

3.2.3. Measures taken since the financial collapse

The bank is founded on the basis of the domestic operations of Glitnir Bank. There is clearly a need for the three new banks to learn from the shortcomings of the banks' activities before the financial collapse. Necessary changes have to be made to their activities so that they can regain trust and credibility. There have been numerous changes in the nature and scope of the bank's operations. The bank's operations are now solely focused on the domestic market and a great deal of time is devoted to restructuring of the loan portfolio. As a result of this change in focus organisational changes are necessary. In light of this, ISFI requested information on the measures that have been taken since the financial collapse. The following is a summary of the answers received from Íslandsbanki.

Risk and credit management

- The regulations governing loans to connected parties have been tightened
- The approval of loans between risk committee meetings has been abolished
- Foreign loans are only granted against income in foreign currency
- The bank no longer issues loans against collateral in shares
- A coordinated approach has been applied to credit matters
- Lending procedures have been reviewed and the decision-making process is more documented
- Creation and setup of Market supervision
- Product approval procedure established
- Risk categories updated

Compliance

- Independent compliance officer – reports directly to the CEO of the bank
- Substantial increase in staff

Asset Management & funds

- The majority of the members of the board of directors of IS Funds are independent
- Creation of risk committee for Asset Management
- Creation of risk committee for IS Funds
- New work procedures and regulations applied
- Risk Management doubled – Risk Manager appointed
- New name for asset management company and increased independence

General

- Increased transparency
- Open sale processes
- Regulations published on website
- Midengi holding company founded
- Quality manager appointed and quality committee founded
- Data warehouse improvements

3.2.4. Gender equality policy and gender ratios

ISFI requested information on the bank's gender equality policy. It also requested information on the gender distribution in senior management. The objective was to obtain information that would enable comparisons to be made between the banks. The published information only covers the senior management and board of directors presented in the organisation charts.

The bank has drawn up and implements a gender equality policy, which is part of the bank's personnel policy.

Table 4: Gender distribution in the senior management of Íslandsbanki

Íslandsbanki – gender distribution in senior management ²					
	Male	Female	Total	% Male	% Female
Board of directors	5	2	7	71%	29%
CEO	0	1	1	0%	100%
Senior Management	8	3	11	73%	27%
Total	13	6	19	68%	32%

*Employees who appear in the organisation chart, May 2010

3.3. NBI hf. - Landsbankinn

3.3.1. Financing

ISFI manages the Treasury's 81.3% holding in NBI hf. (hereinafter referred to as "Landsbankinn").

Landsbankinn was founded with the passing of emergency legislation in October 2008 to maintain domestic deposits and most of the Icelandic assets of Landsbanki Íslands hf. The bank is owned 81.33% by the state and 18.67% by Landsskil ehf., a subsidiary of Landsbanki Íslands, which was founded, at the request of the Financial Supervisory Authority, to manage the old bank's holding in Landsbankinn (NBI). The state's capital contribution amounted to ISK 122 billion, some ISK 775 million of which was paid in cash and ISK 121,225 million of which was paid in the form of a bond.

Table 5: State's capital contributions to NBI hf. - Landsbankinn

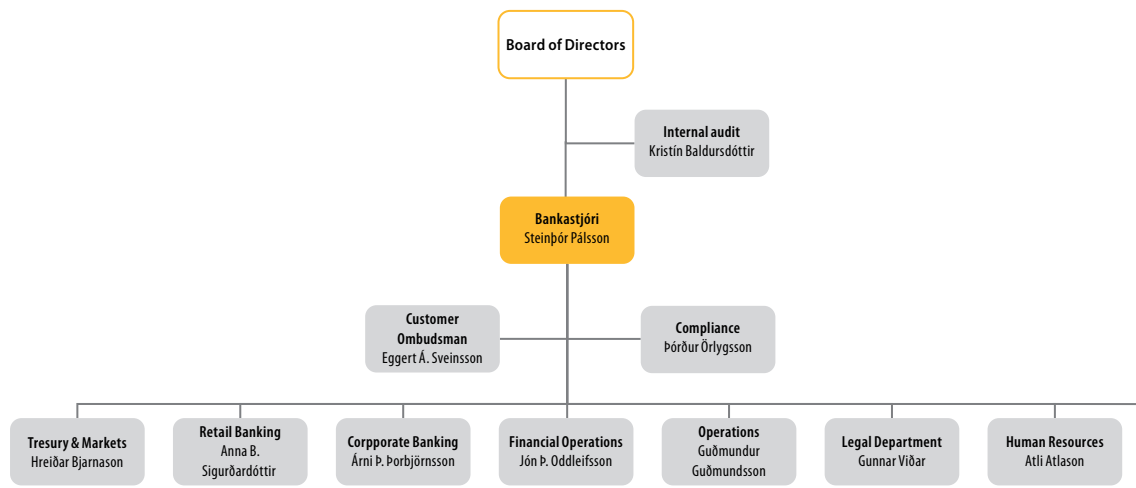
NBI hf. - Landsbankinn		
State's ownership		81,33%
Share capital		ISK 24 bn.
Nominal value of the state's shares		ISK 19,5 bn
Nominal value of ISB holding shares		ISK 4,5 bn
Share premium		ISK 126 bn.
State's capital contribution		ISK 122 bn
State's shares		ISK 122 bn.
Figures in billions ISK		
	31.12.2009	31.12.2008
Total assets	1.061.101 kr.	1.037.391 kr.
Equity	157.592 kr.	143.285 kr.
Capital ratio	15,2%	13,1%
Tier I capital ratio	15,2%	13,1%
Tier II capital ratio	0,0%	0,0%
Figures in millions ISK		

***Capital contributions:** The share capital was paid in two instalments:
1. ISK 775 million was paid in cash for share capital at the price of ISK 1 per share.
2. A Treasury bond of a nominal value of ISK 121,225 million was paid for share capital at the price of ISK 6.47 per share.
The state's total capital contribution amounts to ISK 122 bn.

3.3.2. Organisation

Landsbankinn provides comprehensive financial services and its activities are divided into seven divisions, three of which are profit centres: Retail Banking, Corporate Banking, Treasury & Capital Markets; and four of which are cost centres: Finance, Operations, Legal and Human Resources. The bank employed 1160 people at the end of 2009.

2. Source: information published on the bank's website on 31 May 2010.

Chart 3 Organisation chart of Landsbankinn

Board of Directors	Alternates
Gunnar Helgi Hálfðanarson, Chairman	Andri Geir Arinbjarnarson,
Sigríður Hrólfsdóttir, Vice-Chairman	Guðrún Ragnarsdóttir
Guðrídur Ólafsdóttir	Jón Sigurdsson
Thórdís Ingadóttir	Einar Jónsson
Lárentínus Kristjánsson	

Auditors: KPMG hf.

Headquarters: Austurstæti 11, 155-Reykjavík

3.3.3. Measures since the financial collapse

The bank is founded on the basis of the domestic operations of Landsbanki Íslands. There is clearly a need for the three new banks to learn from the shortcomings of the banks' activities before the financial collapse. Necessary changes have to be made to their activities so that they can regain trust and credibility. There have been numerous changes in the nature and scope of the bank's operations. The bank's operations are now solely focused on the domestic market and a great deal of time is devoted to restructuring of the loan portfolio. As a result of this change in focus organisational changes are necessary. In light of this, ISFI requested information on the measures that have been taken since the financial collapse. The following is a summary of the answers received from Landsbankinn.

Organisation

- The number of managing directors has been reduced and their areas of responsibility more sharply defined.
- There have been many changes in the management team of the bank. Many directors and executives have terminated their employment. Only three of the eleven managing directors who worked for Landsbanki Íslands hf. are still employed there.
- The Private Banking division, Asset Management division, International division and Securities Division have been dismantled and placed under other activities. Part of the Legal Department was merged with the IT division and is now called Operations.
- Finance division: A new Financial division was founded covering, Accounting, Treasury and Securities Operations which were partially transferred to the Treasury & Capital Marketing division at the beginning of 2010. The Finance Division now covers accounting, the economics department and Planning.
- Treasury and Capital Markets: The main functions of the division are to manage the liquidity of the bank and handle capital markets. The division also includes the investment banking

department, which, among other things, handles the sales of companies that temporarily come under Landsbankinn's ownership.

- Corporate Banking: Has not changed substantially in form, although an additional unit founded under the name of Corporate Development deals with i.a. the restructuring of indebted companies.
- Retail Banking: Handles business with individuals and services in branches, in addition to marketing and website issues, as well as private banking services. The Retail Banking division took over part of the functions previously performed by the Legal division in connection with the bank's branch network.
- Legal Division: Provides, among other things, legal advice to the bank. The division operates legal collection services and the processing of specific loans.
- The Human Resources division operates as before, but now also handles the functions of the property division and archives.
- Operations Department: is founded on the IT division, which was abolished and therefore deals with IT and technical issues, the headquarters' Back Office and the Middle Office for the bank's branch network, which was transferred from the Legal Division.
- The Finance Division has been reorganised with the aim of increasing the emphasis on planning and a special department has been created for this purpose.

Risk and credit management

- The bank's risk management covers credit control, market risk, liquidity risk and management risk. The division has been strengthened and a new head has been appointed. Risk Management now reports to the CEO of the bank, unlike in the past when it reported to two of the bank's cost centres.
- The Risk Committee was founded and commenced work in March 2009.
- New lending rules were approved in April 2009.
- The credit limits of all employees were reviewed in May 2009.
- New regulations regarding large risk liabilities were set in August 2009.
- New regulations regarding operating risks came into effect in October 2009.
- New market risk rules were approved in December 2010.

Compliance and internal auditing

- The bank's Compliance Officer now reports directly to the CEO of the bank, but previously came under the Legal Division. This means that the Compliance Office is more independent in its work. The information flow to the Compliance Officer has also been approved.
- Regulations as a whole have been revised and further revisions are being made, since the Board of Directors of the bank approved new general lending and risk rules in February 2010.
- Internal auditing has been strengthened and a new head has been appointed.

General

- Departments have been set up to deal with the specific debt problems of businesses and individuals.
- A Customer Ombudsman has been appointed. He/she is appointed by the bank's board of directors and reports directly to the CEO of the bank.
- The ideology and policies of the bank have been reviewed by, among other people, employees with a broad experience in policy-making.
- Landsbankinn has committed itself to ensuring that, by the end of 2013, neither gender will make up less than 40% of the work force employed in the senior management of the bank and its subsidiaries.
- Dozens of work processes have been revised, changed or adjusted to more rigorous requirements and criteria.
- The weight of the International Division and international trade in the more complex financial instruments has been reduced.

3.3.4. Gender equality policy and gender ratios

ISFI requested information on the bank's gender equality policy, and the answers it received are summarised below. It also requested information on the gender distribution in senior management.

The objective was to obtain information that would enable comparisons to be drawn between the banks. The published information only covers the senior management and board of directors as they are presented in the organisation charts.

Landsbankinn has established a gender equality policy and appointed a Gender Equality Committee. The gender equality policy states i.a.:

- The bank's salary policy, facilities and working environment shall be equal for men and women. No staff member shall be discriminated against on the grounds of their gender or other considerations in salary and benefit decisions, nor in the assignment of duties, transfers or dismissals.
- Endeavours shall be made to promote equal opportunities in the assumption of responsibilities in i.a. gender representation on boards, as well as in the bank's work groups and committees.
- Bullying, prejudice and sexual harassment are not tolerated in the bank. Employees who are subjected to harassment of this kind can approach their immediate superior, shop steward, union chairman and/or head of the Human Resources division, who will investigate the issue and deal with it through the appropriate channels.
- Landsbankinn places its emphasis on ensuring that the staff of the bank possesses professional know-how through the continuing education and training of its staff, the bank shall ensure that everyone has equal opportunities in education and training.
- Landsbankinn has an active Gender Equality Committee. The committee is appointed for a term of two years and comprises four members. Two are nominated by the bank's employees' association and two are members of the bank, nominated by the head of the Human Resources division. The committee sets tasks for itself and elects a chairperson.
- Landsbankinn emphasises the need to comply with non-discrimination laws and regulations in all cases. The Gender Equality Committee shall be aware of the laws and government regulations regarding non-discrimination issues and monitor any amendments to them. It shall also ensure the bank's non-discrimination policy is implemented and investigate any indication that non-discrimination legislation and rules are not being observed in the bank.
- The gender equality policy of Landsbankinn shall be accessible to all staff members and reviewed at least once every two years. In order to ensure that non-discrimination laws are being observed, the Gender Equality Committee shall conduct regular assessments of aspects related to this policy.

The Gender Equality Committee, which formally commenced work on 1 January 2010, comprises the following members for the next two years:

- Atli Atlason, Director of Human Resources
- Bergthóra Sigurdardóttir, Human Resources Manager
- Helga Jónsdóttir, FSLÍ representative
- Andrés Erlingsson, FSLÍ representative

The Board of Directors of the bank has set itself the target of increasing the number of women employed in the senior management of the bank and the companies under its control to a minimum of 40% by the year 2013.

Table 6: Gender distribution in the senior management of Landsbankinn

Landsbankinn – gender distribution in senior management³					
	Male	Female	Total	% Male	% Female
Board of Directors	2	3	5	40%	60%
CEO	1	0	1	100%	0%
Senior management*	10	3	13	77%	23%
Total	13	6	19	68%	32%

*Employees who appear in the organisation chart, May 2010

³ Source: information published on the bank's website on 31 May 2010.

4. Operations of the banks

4.1. Results for 2009

All of the three banks returned profits in 2009, with total net profits amounting to ISK 51 billion. Table 7 shows the returns of the three banks. Íslandsbanki's return on equity was 35%, Arion Bank about 17% and Landsbankinn 10%.

Table 7: Return on equity (ROE) of Arion Bank, Íslandsbanki and Landsbankinn in 2009.

(ISK m.)	Arion banki	Íslandsbanki*	Landsbankinn
Equity 31.12.2008	76.946 kr.	68.030 kr.	143.285 kr.
Profit/(loss)	12.871 kr.	23.982 kr.	14.332 kr.
ROE	16,7%	35,3%	10,0%

* On the basis of the equity at 31.12.2008, Íslandsbanki's ROE was 35.3% in 2009. The bank's published returns, however, are based on the average equity, which yields a ROE of 30%. To ensure consistency, the figures in this table are based on the equity positions at 31.12.2008.

One should bear in mind that the results of the banks for 2009 are characterised by irregular items linked to settlements between the new banks and the old ones. A large part of the income of the banks last year is due to a revaluation of the booked value of loans and receivables, as assets were transferred from the old banks to the new banks with considerable "discounts" in their book value. The impact the revaluation of assets had on income was particularly marked in the case of Landsbankinn (NBI) and Arion Bank. Moreover, changes in the ISK exchange rate had a considerable impact on the results of the banks in 2009. Currency volatility had a positive effect on the results of Arion Bank and Íslandsbanki, but a negative effect on the results of Landsbankinn (NBI). The above ROE and profit tables do not therefore give a clear picture of the bank's earnings from what may be called regular operations or core activities.

The impact of the revaluation of assets will probably continue to be reflected in the results of the banks for some time, but will not have any lasting effect on their operations in the long term. It is very important to work towards an evaluation of the returns from core operations in order to be able to ascertain the solidity of the foundations core activities rest upon. To get a clearer picture of core operations, the following chapter uses the terms **operations corrected for irregulars** and **core operations**. They are defined as follows:

Operations corrected for irregulars

The term **operations corrected for irregulars** here refers to the results of operations of the bank, excluding the impact of the revaluation of assets, currency fluctuations and, in some cases, the impact of subsidiary operations in unrelated activities. We then calculate the return on equity and cost income ratio corrected for irregulars. These are the figures which shareholders and managements need to bear in mind when determining future operations. The figures that are quoted were taken from published annual accounts.

Core operations

Core operation has a narrower definition than operations corrected for irregulars as defined above, i.e. it is adjusted to the revaluation of assets and the impact of currency volatility as before, but also to returns from investments and other income. Core income⁴ is therefore net interest

⁴ Core income = Net interest income + Net commissions + Dividends

Core cost = Salaries and related expense + administration expense + depreciation and amortisation of property and intangible assets.

income plus net commission income. Core cost is defined as salaries and salary-related costs, administrative costs and the depreciation and amortisation of property and intangible assets.

What constitutes the core operations of a bank may be open to debate. For this reason, the two above definitions have been presented. One can therefore say that these define the maximum and minimum thresholds, although the evaluation of core operations is a somewhat subjective process. The former definition is considerably broader than the definition of the core operations and is widely used in the banking sector.

ISFI has examined the accounts of the three banks and endeavoured to adjust them to the aforementioned irregular items. It is not easy to draw comparisons between the financial results of the three banks, since they apply different accounting methods to their results and their presentation. It should be pointed out that this is only an approximation with figures taken from their official annual statements but as has already been mentioned it is difficult to compare them due to different accounting methods. A common methodology has been applied here to ensure equality when the results are corrected for irregular items. Since the same methodology has been applied to all banks, the comparison is limited by the bank that provides the least information.

The chapters below represent an endeavour to draw a picture of the core earnings and income from the regular operations of the three banks. The purpose of this is to define the position of core operations and draw conclusions on the tasks that lie ahead in the restoration and streamlining of the banks.

Although the three banks are involved in similar activities and have all commenced operating in a similar manner, their accounts are not very suitable for comparisons. The most detailed information comes from Arion Bank and the most limited data comes from Íslandsbanki.

When comparing the annual financial statements of the three banks, one should bear the following factors in mind:

Entry of revalued assets

The banks record impairments and increases in value or the revaluation of overtaken assets in different ways in their accounts. Landsbankinn enters changes in the net value of loans and receivables resulting from the bank's takeover of the assets of Old Landsbanki Íslands in interest income in its income statement. In the case of Íslandsbanki and Arion Bank, the gross increase in value of loans and receivables from the acquisition of loan portfolios is registered as a separate entry in the income statement. The counter entry, due to the impairment of the aforementioned asset portfolios, is recorded as impairment losses on financial assets, along with other impairment entries, such as impairment on new loans and specific impairments, for example, currency volatility. In the case of Íslandsbanki and Arion Bank it is therefore not possible to see the net impact of the revaluation of assets on results, although it is possible to estimate it.

Settlement agreements with old banks

The agreements, which Landsbankinn and Arion Bank have made with the respective resolution committees of the old banks, take into account changes in the value of specific asset portfolios. In the case of Landsbankinn, it issued a contingent bond to the Old Landsbanki Íslands. In the case of Arion Bank, it is in the form of a claim against Kaupthing Bank, which can decrease in value in the event of a downward revaluation of the assets.

Exchange rate volatility had a positive effect on the results of Arion Bank and Íslandsbanki, but a negative effect on the results of Landsbankinn (NBI).

As in the case of the revaluation of assets, Landsbankinn only enters the net foreign exchange gain (loss) in its income statement. Arion Bank and Íslandsbanki enter gross foreign exchange gain (loss), but in return subtract the foreign exchange gain that has been generated by

foreign loans to customers with incomes in Icelandic króna under impairment. Landsbankinn only books the net revaluation of assets and foreign exchange gain (loss), but in the income statements of Arion Bank and Íslandsbanki, the two gross figures are entered. This difference in accounting methodology explains why the impairment on loans and receivables of Íslandsbanki and Arion Bank are considerably higher than Landsbankinn in **table 14**.

Of the three banks, exchange rate volatility has affected Arion Bank the most. The total positive impact of exchange rate volatility on the results of Arion Bank amounts to a total of ISK 10,250 m. On the other hand ISK 1,535 m. have been entered into the accounts under impairment, due to foreign exchange gains stemming from foreign currency loans to customers who only have income in Icelandic króna. The net impact exchange rate volatility had on the results of the bank therefore totalled ISK 8,715 million. Exchange rate volatility also had a positive net effect on the results of Íslandsbanki to the tune of ISK 2,945 m., once the counter impairment entry is taken into account. Exchange rate volatility had a negative net impact of ISK 2,814 m. on the results of Landsbankinn.

Inflation had a positive impact on the results of Landsbankinn and Íslandsbanki, but a negative effect on the results of Arion Bank

Inflation had a positive impact on the results of Landsbankinn and Íslandsbanki. Landsbankinn's CPI indexation balance was positive by ISK 71.8 billion at the end of 2009, and Íslandsbanki's was positive by ISK 27 billion, while Arion Bank's balance, on the other hand, was negative by ISK 14.7 billion. It is difficult, however, to determine with any great precision what impact the inflation rate had on the results of the banks last year, since only the CPI indexation balance has been presented at the end of the year.

Subsidiaries in unrelated operations are included in the income statement of Arion Bank

The operating income and expenses of unrelated activities, conducted by a number of subsidiaries that are temporarily under the ownership of Arion Bank, have been entered into the bank's income statement. This practice is not followed by Íslandsbanki and Landsbankinn.

Highest interest spread in Íslandsbanki

The interest spread varied greatly between the banks in 2009. Íslandsbanki's interest spread was 4.7%, compared to 1.7% in the case of Arion Bank and 1.4% in Landsbankinn. These calculations are based on the net interest income in relation to the average carrying amount of total assets, but in the case of Landsbankinn, the figures have been adjusted to take into account changes in the value of loans and receivables.⁵ Landsbankinn (NBI hf.) took over a large portion of the assets of Landsbanki Íslands hf. It takes a considerable amount of time to restructure the loan portfolios and strike an equilibrium between borrowing and lending interest. At the beginning of 2009, Arion Bank took over all the deposits and liabilities of SPRON, which has, as in the case of Landsbankinn, probably detracted some of the attention away from core operations. The two above factors at least partly explain why there is such a vast difference in the interest spreads of Íslandsbanki, on one hand, and Arion Bank and Landsbankinn on the other.

4.2. Arion Bank

4.2.1. Operations of Arion Bank corrected for irregulars

Arion Bank's operating income in 2009 amounted to ISK 49,635 m. and its operating expenses amounted to ISK 34,228 m. Equity at the end of 2008 amounted to ISK 76,946 m. Earnings from the operations of Arion Bank in 2009 amounted to ISK 12,871 and the return on equity was 16.7%.

⁵ This item is directly entered as interest income in the case of Landsbankinn, unlike the other two banks; it therefore has to be adjusted to enable comparisons.

Looking at the impact of the revaluation of assets and exchange rate volatility on operations in 2009, one can see that, according to the bank's financial statements, the value of loans and receivables increased by ISK 20,199 m. This is, however, offset by the booked impairment on loans and receivables, which amounted to ISK 11,474 m. A change in the value of the contingent claim in the settlement between Kaupthing Bank and Arion Bank amounted to ISK 10,556 m. The correction due to foreign exchange gains amounted to ISK 10,250 m.

The operating income and expenses of Arion Bank include the income and expenses of subsidiaries that are temporarily owned by the bank and work in unrelated operations. The operating income of these subsidiaries amounts to ISK 17,838 m. and operating expenses to ISK 15,686 m. and their salary costs to ISK 2,340 m.

Once one excludes the impact of the subsidiaries temporarily owned by the bank, the revaluation of loans and receivables and exchange rate volatility, the bank's profits amount to ISK 6,100 m. and ROE **7.9%**. The positive impact of the revaluation of assets and exchange rate volatility on profits therefore amounts to ISK **6,771 m.** The cost to income ratio corrected for irregulars is **69.3%**. The calculation method applied in this approach can be seen in **table 8** below.

Table 8: Operations of Arion Bank corrected for irregulars

Income corrected for irregulars	2009
Operating Income	49.635
Income due to revised estimates of future cash flow from loans	-20.199
Net impairment losses on financial assets	11.474
Value changes in contingent claim	10.556
Subidiaries income	-17.838
Net foreign exchange gains-(losses)	-10.250
Corrected operating income	23.378
Operating expenses	-34.228
Subidiaries expenses	15.686
Saleries expense of subsidiaries	2.340
Corrected operating expenses	-16.202
<i>Cost/income ratio corrected for irregulars</i>	69,3%
Profit (loss) before taxes	7.176
Profit (loss) after tax	6.100
<i>ROE corrected for irregulars</i>	7,9%
Equity 31.12.2008	76.946

All figures are in ISK millions.

4.2.2. Core operations of Arion Bank

The cost-to-income ratio of Arion Bank in relation to total operating income and total expenses is 69%. In order to draw a comparison with the other two banks, though, the figures need to be corrected to take into account the impact of the unrelated operations of the subsidiaries temporarily owned by the bank, which are included in the total income and expenses. Once that adjustment has been made, the cost-to-income ratio of Arion Bank is 59% compared with the 55% of Landsbankinn and 35.8% of Íslandsbanki.

It is interesting to examine the core cost to income ratio⁶. The core cost to income ratio has a narrower definition than the cost to income ratio corrected for irregulars, i.e. it is adjusted to take into account

⁶ Core cost to income = Core income/Core costs
 Core cost income = Core revenues/Operating costs
 Core revenues = Net interest income + Net commissions + Dividends

the revaluation of assets and the impact of exchange rate volatility, as before, but also returns on investments, see calculations in **table 9**. If one only looks at the income generated by core operations, i.e. interest income and commission income, without taking into account irregular income and expense items, the cost to income ratio is **81%**. The return on core operations is **3.8%**. See calculation in **table 9** below.

Table 9: Core operations of Arion Bank

Core operations	2009
Net interest income	12.146
Net fee and commission income	5.862
Total core income	18.008
Salaries and related expenses	-10.413
Salaries expense of subsidiaries	2.340
Other administrative expenses	-5.317
Depreciation	-1.161
Total core cost	-14.551
<i>Core cost/income ratio</i>	81%
Profit (loss) before taxes	3.457
Profit (loss) after tax	2.938
<i>Core ROE</i>	3,8%
Equity 31.12.2008	76.946

All figures are in ISK millions.

4.3. Íslandsbanki

4.3.1. Operations of Íslandsbanki corrected for irregulars

The operating income of Íslandsbanki for 2009 amounted to ISK 45,036 m. and its operating expenses amounted to ISK 16,113 m. Equity at the end of 2008 amounted to ISK 68,030 m. Profits from the operations of Íslandsbanki in 2009 amounted to ISK 23,982 m. and the return on equity was 35.3%.

Looking at the impact of the revaluation of assets and exchange rate volatility on operations in 2009, one can see that, according to the bank's financial statements, the value of loans and receivables increased by ISK 18,419 m. and foreign exchange gains amounted to ISK 10,852 m. This is, however, offset by the booked impairment on loans and receivables, which amounted to ISK 26,326 m. The positive impact of the revaluation of loans and receivables and exchange rate volatility amounted to ISK **1,901 m.**

The operating income of the bank from regular activities, as defined above, is ISK 42,091 m. and net earnings amount to ISK 22,081 m. Return on equity is therefore **32.5%**. The cost to income ratio corrected for irregulars was **38.3%**. The calculations of the operations of Íslandsbanki corrected for irregulars can be seen in **table 10**.

As mentioned above impairments include impairment on i.a. new loans and other specific impairments. It is therefore impossible to see the net impact the revaluation of assets had on the results of Íslandsbanki and Arion Bank. The effects of the revaluation of assets is therefore underestimated by the impairment on new loans and specific impairments in this approach. Earnings corrected for irregulars are therefore slightly overestimated in the cases of Íslandsbanki and Arion Bank.

Table 10: Operations of Íslandsbanki corrected for irregulars

Income corrected for irregulars	2009
Operating Income	45,036
Income due to revised estimates of future cash flow from loans	-18,419
Net impairment losses on financial assets	26,326
Net foreign exchange gains-(losses)	-10,852
Corrected operating income	42,091
Net operating expenses	-16,113
<i>Cost/income ratio corrected for irregulars</i>	38,3%
Profit (loss) before taxes	25,978
Profit (loss) after tax	22,081
<i>ROE corrected for irregulars</i>	32,5%
Equity 31.12.2008	68,030

All figures are in ISK millions.

4.3.2. Core operations of Íslandsbanki

The cost-to-income ratio of Íslandsbanki is 35.8% in relation to the bank's total income which amounted to ISK 45,036 m. and total expenses which amounted to ISK 16,113 m. If one only looks at the core income, i.e. interest income and commission income, without taking other income into account, such as revalued assets, the foreign exchange gain and returns on investments, the cost-to-income ratio is **41.3%** and return on equity is **28,7%**. See calculation in **table 11** below.

Table 11: Core operations of Íslandsbanki

Core operations	2009
Net interest income	31,984
Net fee and commission income	7,061
Total core income	39,045
Salaries and related expenses	-8,036
Other administrative expenses	-8,077
Total core cost	-16,113
<i>Core cost/income ratio</i>	41,3%
Profit (loss) before taxes	22,932
Profit (loss) after tax	19,492
<i>Core ROE</i>	28,7%
Equity 31.12.2008	68,030

All figures are in ISK millions.

4.4. Landsbankinn

4.4.1. Operations of Landsbankinn corrected for irregulars

Landsbankinn's operating income in 2009 amounted to ISK 30,725 m. and its operating expenses totalled ISK 16,854 m. Equity at the end of 2008 amounted to ISK 143,285 m. Profits from the operations of Landsbankinn in 2009 amounted to ISK 14,332 m. and the return on equity was 10%.

Looking at the impact of the revaluation of assets and exchange rate volatility on operations in 2009, one can see that, according to the bank's financial statements, the increase in the net value of loans and receivables was ISK 23,772 m., which was booked as interest income. Impairment on loans and receivables amounted to ISK 6,577 m. Interest expenses include an entry of ISK 10,241 m. for the contingent bond of Landsskil; which is the old Landsbanki's part of the revaluated loans and receivables.

Unlike Íslandsbanki and Arion Bank, exchange rate volatility had a negative impact on the operating results of Landsbankinn.

Taking the aforementioned entry into account, the bank's profits, according to this approach, are lower by ISK **5,173 m.** Net earnings, according to this calculation, were ISK 9,159 m. and the return on equity corrected for irregulars was **6.4%**. The cost-to-income ratio on regular operations was **59.5%**. The calculation method applied here can be seen in **table 12** below.

Table 12: Operations of Landsbankinn corrected for irregulars

Income corrected for irregulars	2009
Operating Income	30.725
Income due to revised estimates of future cash flow from loans	-23.772
Net impairment losses on financial assets	6.577
Value changes in contingent bond	10.241
Net foreign exchange gains-(losses)	2.814
Corrected operating income	26.585
Net operating expenses	-16.854
<i>Acquisition-related costs</i>	1.044
Corrected operating expenses	-15.810
<i>Cost/income ratio corrected for irregulars</i>	59,5%
Profit (loss) before taxes	10.775
Profit (loss) after tax	9.159
ROE corrected for irregulars	6,4%
Equity 31.12.2008	143.285

All figures are in ISK millions.

4.4.2. Core operations

The cost-to-income ratio of Landsbankinn is 55% in relation to the bank's total operating income, which amounted to ISK 30,725 m. and total expenses which totalled ISK 16,854 m. Looking solely at the core income i.e. interest income and commission income, excluding irregular income and expense items, the cost to income ratio is **79%**. The return on core operations was **2.4%**. See calculation in **table 13**.

Table 13: Core operations of Landsbankinn

Core operations	2009
Net interest income	28.105
Net fee and commission income	4.213
Income due to revised estimates of future cash flow from loans	-23.772
Value changes in contingent bond	10.241
Total core income	18.787
Salaries and related expenses	-8.468
Other administrative expenses	-6.064
Depreciation	-1.278
Acquisition-related costs	1.044
Total core cost	-14.766
<i>Core cost/income ratio</i>	79%
Profit (loss) before taxes	4.021
Profit (loss) after tax	3.418
<i>Core ROE</i>	2,4%
Equity 31.12.2008	143.285

All figures are in ISK millions.

4.5. Operating results of the banks and cost of equity

4.5.1. Operating results of the banks

From the above summaries it can be surmised that the operating results of the banks presented in the financial statements do not tell the full story. According to the calculation of core revenues, as they are defined here, only one of the three banks achieved adequate return on equity and the core cost to income ratio was far too high in the case of two of the banks, see charts 4 and 5. It matters little whether the narrow or broader definition of core operation is applied, the same basic outcome is reached in both cases.

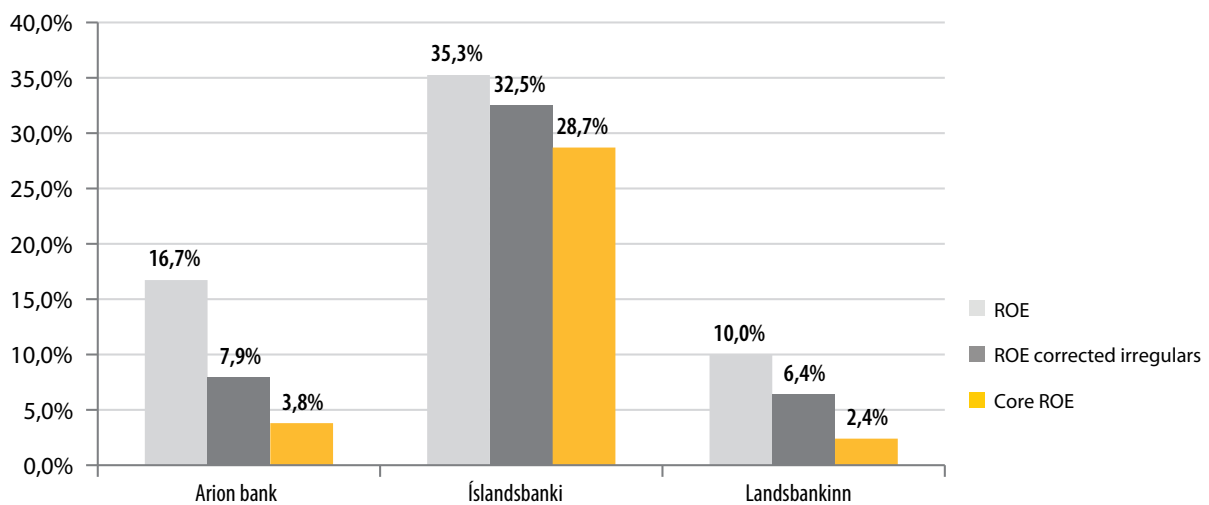
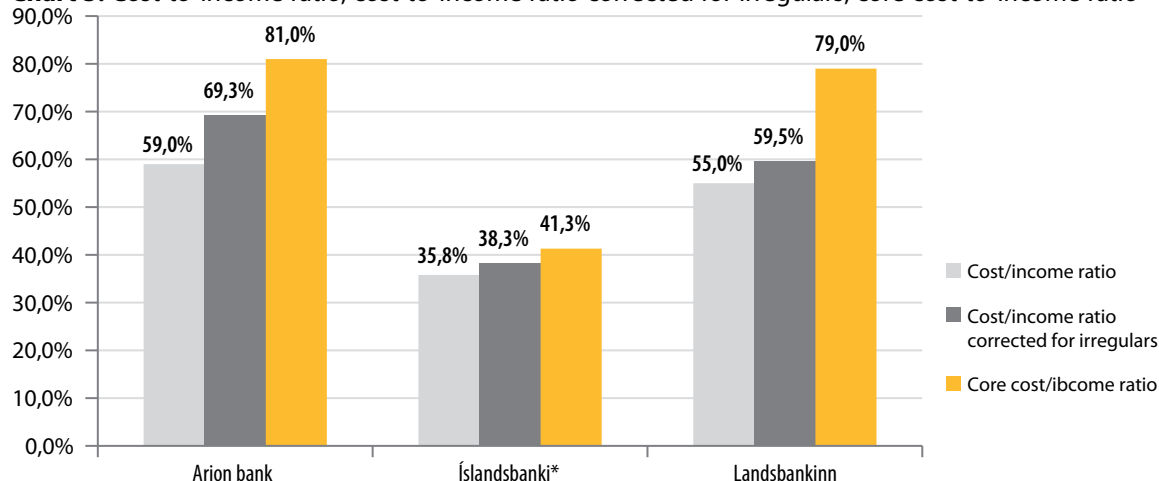
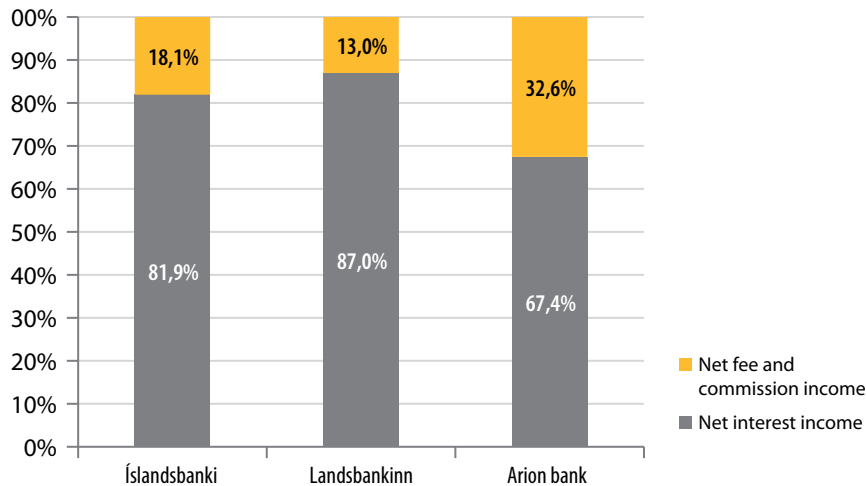
Chart 4: Return on equity, return on equity corrected for irregulars, core return on equity

Chart 5: Cost-to-income ratio, cost-to-income ratio corrected for irregulars, core cost-to-income ratio**Table 14:** Main components from income statement in ISK m.

	Íslandsbanki	Landsbankinn	Arion bank
Net interest income	31.984 kr.	28.105 kr.	12.146 kr.
Net fee and commission income	7.061 kr.	4.213 kr.	5.862 kr.
Net gain (loss) financial assets designated at a fair value through profit or loss	143 kr.	4.020 kr.	397 kr.
Net gain on financial assets held for trading	142 kr.	2.876 kr.	1.240 kr.
Other income	2.760 kr.	902 kr.	21.201 kr.
Income due to revised estimates of future cash flow from loans	18.419 kr.	*	20.199 kr.
Net impairment losses on financial assets	-26.326 kr.	-6.577 kr.	-11.474 kr.
Net foreign exchange gains-(losses)	10.852 kr.	-2.814 kr.	10.250 kr.
Value changes in contingent claim		*	-10.556 kr.
Effects of subsidiaries			369 kr.
Total operating income	45.036 kr.	30.725 kr.	49.635 kr.
Profit/(loss)	23.982 kr.	14.322 kr.	12.871 kr.
Profit/(loss) corrected for irregulars	22.081 kr.	9.159 kr.	6.100 kr.
<i>Effects of revaluation and exchange rate</i>	1.901 kr.	5.163 kr.	6.771 kr.
Profit/(loss) of core operations	19.492 kr.	3.418 kr.	2.938 kr.
<i>Difference in core profit and published profit</i>	4.490 kr.	10.904 kr.	9.933 kr.

* Income due to revised estimates of future cash flow from loans is booked under interest income and the value changes in contingent claim is booked under interest expenses in the case of NBI

Chart 6: Breakdown of core revenue of the banks

The operations of the banks are currently founded on three pillars: revalued assets and foreign exchange gains, retail banking activities and commission income from asset management. The largest and most important income component, revalued assets, is only a short-term one. If it were not included in the calculation, the operations of two of the three biggest banks would be less than adequate. The core cost to income ratio indicates that there is a need to respond to the changes in operations and to reduce costs.

4.5.2. The Icelandic state's investments in the banks

The state's total investments in the banks amount to ISK 190 b. Its share capital contributions amount to ISK 135 b. and about ISK 55 b. is in the form of subordinated loans, see table 15. Initially this figure was expected to reach ISK 385 b., but that was at the time when it was assumed that the state would fully own Landsbankinn, Arion Bank and Íslandsbanki.

Table 15: State's contributions to the banks (in ISK m)

Shares and subordinated debt of the state (m. ISK)					
Bank	Nominal value of shares	Shares	State's shares	State's ownership	Subordinated debt
Landsbankinn (NBI)	24.000 kr.	150.000 kr.	122.000 kr.	81,33%	
Arion bank	2.000 kr.	75.862 kr.	9.862 kr.	13%	29.500 kr.
Íslandsbanki	10.000 kr.	65.000 kr.	3.250 kr.	5%	25.000 kr.
Total	36.000 kr.	290.862 kr.	135.112 kr.		54.500 kr.

In the wake of the foundation of the new banks, the Treasury issued Treasury bond series RIKH 18 1009 for the amount of ISK 287 billion to enable the banks to meet the capital adequacy ratio levels imposed by the Financial Supervisory Authority (FME). The date of issue of the bond series was 2 September 2009 and the maturity date of the principal and final due date is 9 October 2018. After agreements were reached between the resolution committees and the state on the participation of the old banks as owners of the new banks, a part of the issued series was paid back to the state. The interest on the Treasury bond series is variable and is based on the interest rate applied to the current accounts of banks in the Central Bank of Iceland. The first day of interest is 9 October 2008. The first interest payment is 9 October 2009. The interest rate applied to the period between 9 October 2008 up to and including 8 October 2009 is 13.285%. As of 9 October 2009, the interest period is monthly, and becomes due on the 9th of each month for the succeeding 8 months. Interest is paid once a month, and the second due interest date is therefore on 9 November 2009. The average interest rate on the bond series from 1 January to 31 December 2009 was 12.3%.

4.5.3. Cost of equity

The state's minimum rate of return must take state's cost of funding into account in the three banks in addition to premium. The Treasury issues Treasury notes and Treasury bills to finance its operations. The average yield of the RIKB10-1210 Treasury note series on the bond market was 8.25% in 2009. The risks inherent in operating a bank must be considered to evaluate the risks the state takes by investing in the three banks.

Generally speaking, fluctuations in the banking sector are considered to be similar to those in the economy as a whole. The so-called beta which measures fluctuations in the share price of specific share in relation to the market is generally around 1 in the case of banks, the same as the market. The beta benchmark for J.P. Morgan, which is a bank with mixed operations, for example, is 1.16 and the beta of Goldman Sachs, which is an investment bank, is 1.34. Historical data covering the period between 1928 and 2000 indicates that it is reasonable to require a yield of 6 to 8% on shares beyond the risk-free rates of Treasury securities⁷. The required rate of return for banks in mixed operations would be, according to this, **15.25%** if we require the return on equity to exceed the Treasury bond yield by 7% and the fluctuations in bank prices in mixed operations to be broadly the same as those of the market.

The Norwegian bank DnB Nor sets itself the target of a long-term return of 13%⁸. Like the Icelandic banks, DnB NOR is partly owned by the Norwegian state (34%). DnB NOR's yield is somewhat lower than the yield set in Iceland, but the interest rates in Norway are generally lower than they are here.

The restructuring of bank operations after the financial collapse is an extensive and complex task. A lot of work clearly remains to be done. It is likely that regular bank operations will pick up, once the restructuring of loan portfolios has been completed, provided the economic situation continues to improve. Some measures will clearly need to be taken to ensure that the operations are satisfactory.

Despite the fact that the Icelandic state's investment in the restoration of the three banks is considerably lower than initially anticipated, it nevertheless constitutes a substantial sum. The amount which the state has allocated to the restoration of the banks is 40% of the state's expected income in 2010, and, by comparison, this is close to double the amount which the state intends to allocate to the running of the healthcare system in 2010. It therefore matters a great deal to the taxpayer to know that this money is being used efficiently and yields the best possible dividends, considering the scope and nature of the operations the state is investing in.

⁷ http://pages.stern.nyu.edu/~adamodar/New_Home_Page/valquestions/RiskPrem.htm

⁸ DnB NOR BANK, Annual Report 2009, page 4.

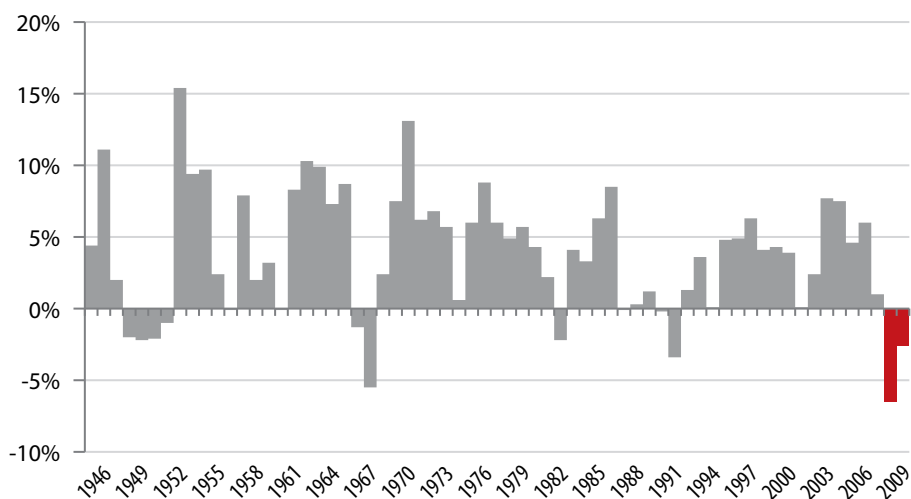
5. The working environment for Icelandic financial undertakings

Greatest contraction in GDP since the foundation of the republic

GDP contracted by 6.5% last year. This was considerably less than the 10% contraction initially predicted by the Central Bank of Iceland and the International Monetary Fund at the beginning of 2009. The fact that the contraction was only 6.5% should be of some comfort. Nevertheless, this is the highest contraction since the foundation of the republic, as can be seen in graph 7.

Measured in foreign currency, the contraction was even greater, since the Icelandic króna depreciated by 50% between mid 2008 and mid 2010. The weakening of the króna greatly catalysed the economy's adjustment to the new reality that struck in the wake of the collapse of the banks. There was a vast contraction in foreign consumer good imports and the competitive position of export and production companies improved significantly. New opportunities were created, while others were lost. There were many job losses in the financial services sector, since a large part of the operations of the old banks in Iceland were in services to foreign branches and foreign legal entities.

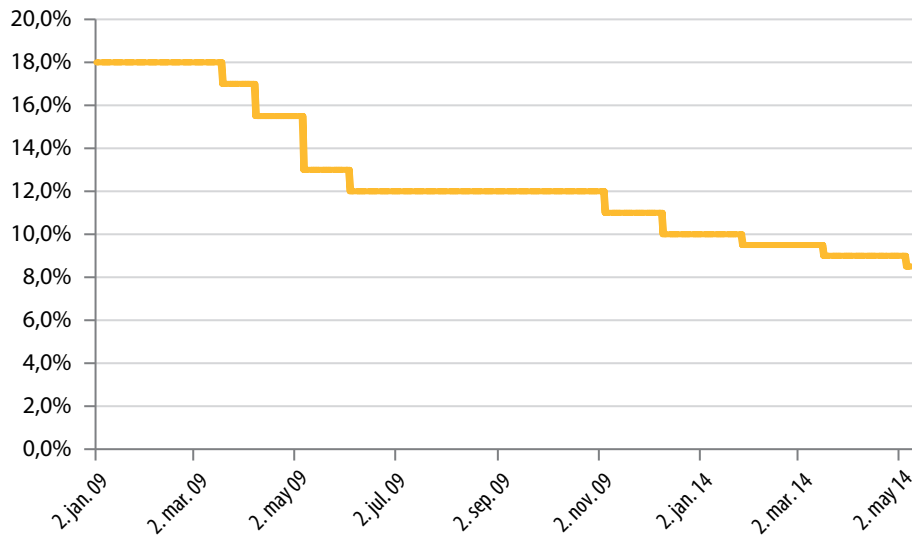
Chart 7: Changes in GDP between 1946-2010



Source: Statistics Iceland

Little demand for credit

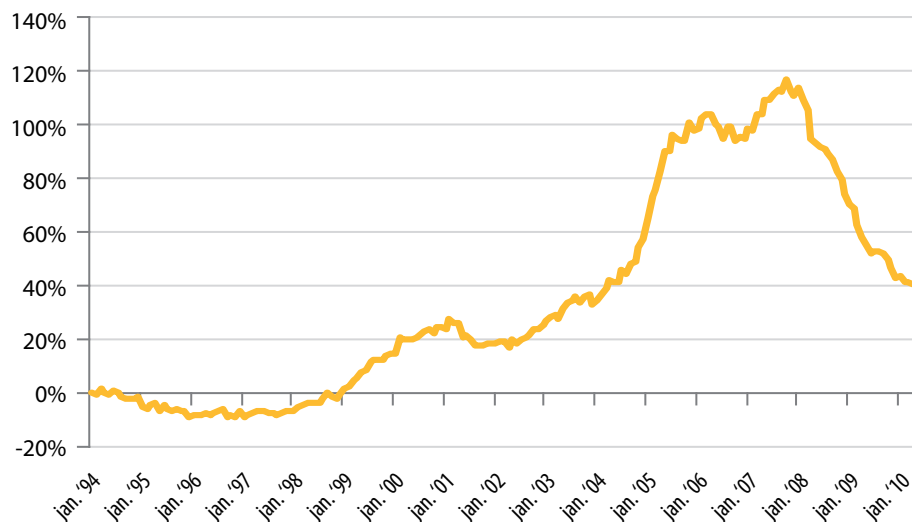
The external environment was unfavourable for financial undertakings last year. The interest rates of the Central Bank of Iceland, which sets the benchmark rates, were high in the first half of the year, which made the financing of the banking sector difficult. A large part of the loan portfolios of the new banks were in foreign currencies, while most of the funding at the beginning of the year was domestic. These currency imbalances were reduced, however, when an agreement was reached in the latter half of the year between the resolution committees of the old banks, the new banks and the state. The poor demand for credit, due to serve contraction in the economy and high interest rates, also reduced earnings. New loans were at a minimum and it was therefore difficult to obtain satisfactory premium on deposits.

Chart 8: Benchmark interest rates of the Central Bank of Iceland (Repo rate)

Source: Central Bank of Iceland

Falling prices on the real estate market

Property market prices declined dramatically between 2004 and 2008, and graph 9 shows property price increases in real terms since 1994. Property prices in 2008 were almost 120% higher than their real value in 1994. This increase is equivalent to an annual average rise of 7.2% in real terms, while, by comparison in the same period, real wages increased by 37% or by an annual average of 2.25%. An increasingly large part of wages therefore went into paying off houses. From the above, one can see that a property bubble had formed in the housing market and that it could only burst. Since the end of 2008, property prices have fallen by 35% in real terms. In other words, housing prices today are merely 65% of what they were in 2008. The loans from financial institutions to individuals are in most cases issued against collateral in property so the value of the individual loan portfolios of the banks has therefore clearly fallen drastically.

Chart 9: Accumulated real housing price increases since 1994

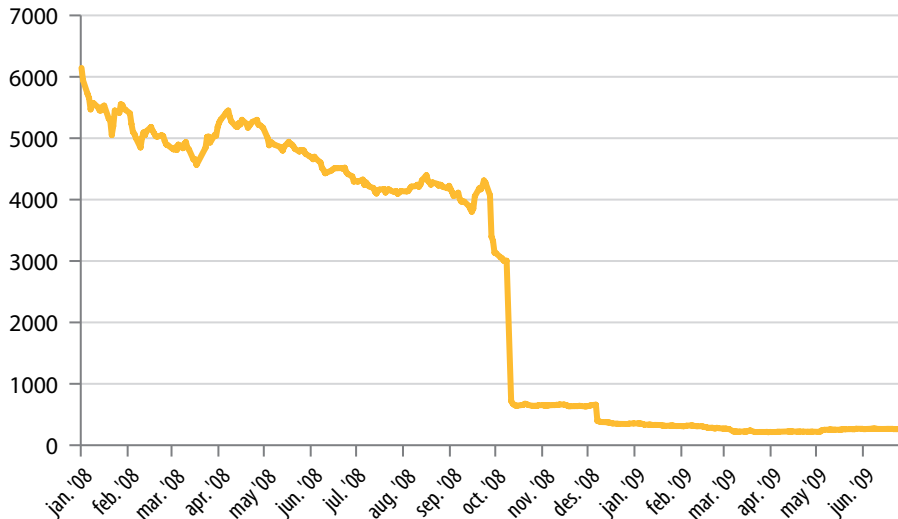
Source: Icelandic Property Registry, Statistics Iceland

Collapse of the equity market:

The equity market in Iceland has been very badly hit. One could say that it virtually disappeared in the wake of the collapse of the banks in autumn 2008. In 2009 the volume of equity trading was only 1.8% of the total turnover on the securities market. At the beginning of 2008, 27 companies were listed on

the Stock Exchange's Main List and there are only 10 companies left today. The OMX-15 selected share index dropped by 95.7% from the beginning of 2008 until it was discontinued in mid 2009 and a new selected share index was founded (OMX-6). A considerable part of loans issued by the old banks were to holding companies. The investments of these holding companies were both in listed and unlisted shares, but the collapse of the stock market clearly had a drastic impact on the value of the loan portfolios to holding companies.

Chart 10: Development of the Stock Exchange's selected share index (OMX-15) since 2008 until it was discontinued in mid 2009

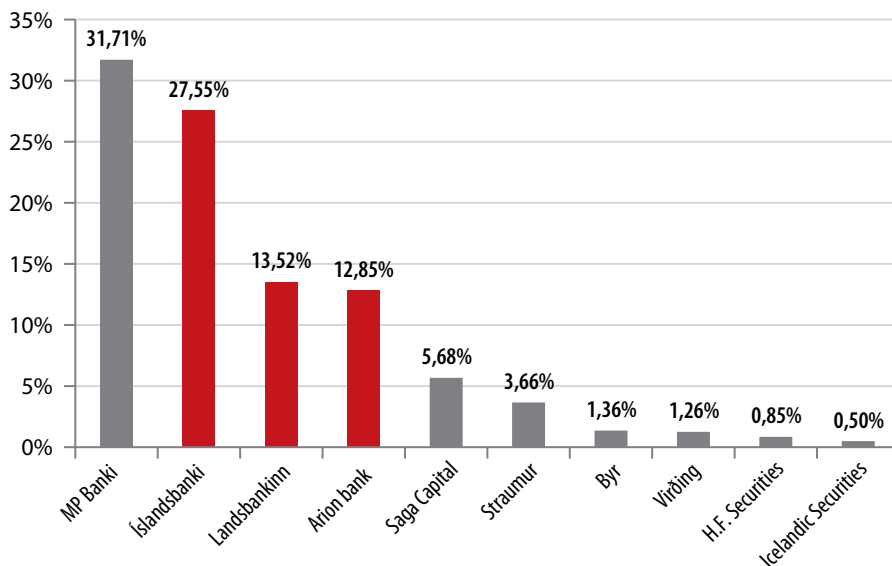


Source: OMX Nordic in Iceland

Lively Treasury bond market

The bond market was characterised by high turnovers and increases in 2009. Almost all of the trade in the securities market last year was in the bond market, i.e. 98.2%. The turnover amounted to ISK 5,450 million, which is equivalent to almost four times the GDP. There was a great demand for government-backed bonds, since there were few other investment options available. The environment was also favourable since the substantial interest rate cuts of the past year enticed investors to seek the yields offered by the bond market. On the market side, the gamma government bond index rose by 16.5% in 2009, which is equivalent to a 9.3% increase in real terms.

Chart 11: Market shares of main entities in the bond markets 2009

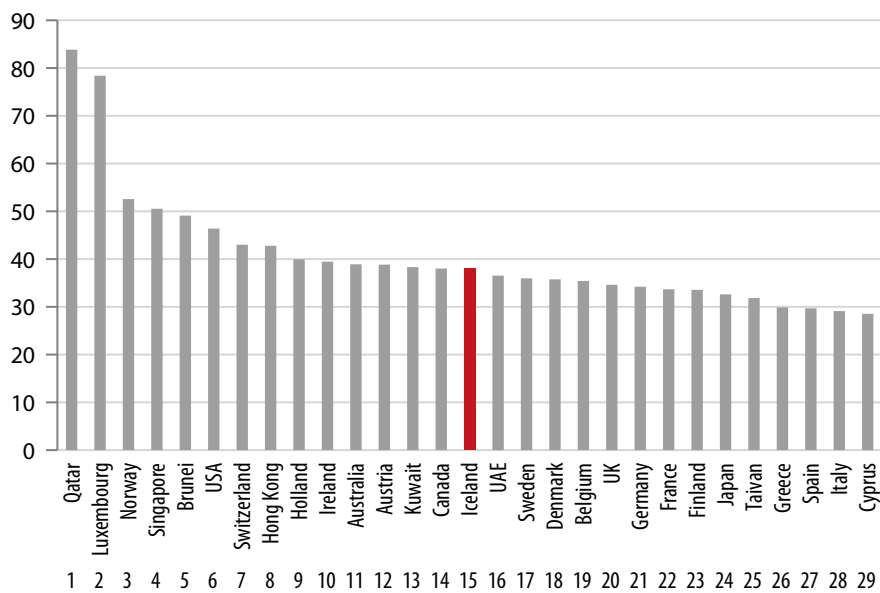


Source: OMX Nordic in Iceland

Jobs in the financial sector

Many jobs have been lost in the financial sector's recent transformations. Jobs in the financial sector are generally well paid and countries that boast the highest GDPs per capita, such as Luxembourg and Switzerland, also have the highest percentage of people working in the financial sector (**see graph 12**). In 2007, Iceland boasted the sixth to seventh highest GDP per capita in the world, and was similar to Switzerland and Ireland. In 2009, Iceland's GDP per capita was fifteenth in the world, according to the International Monetary Fund (**see graph 12 and 15**). It may come as a surprise that Iceland has not fallen further in this classification and that its GDP per capita is still higher than Denmark and Sweden. The reason for this was that, with the depreciation of the króna, it was cheaper to live in Iceland on foreign currency than it was before and therefore the GDP per capita did not decrease so much, once it had been adjusted to purchasing power.

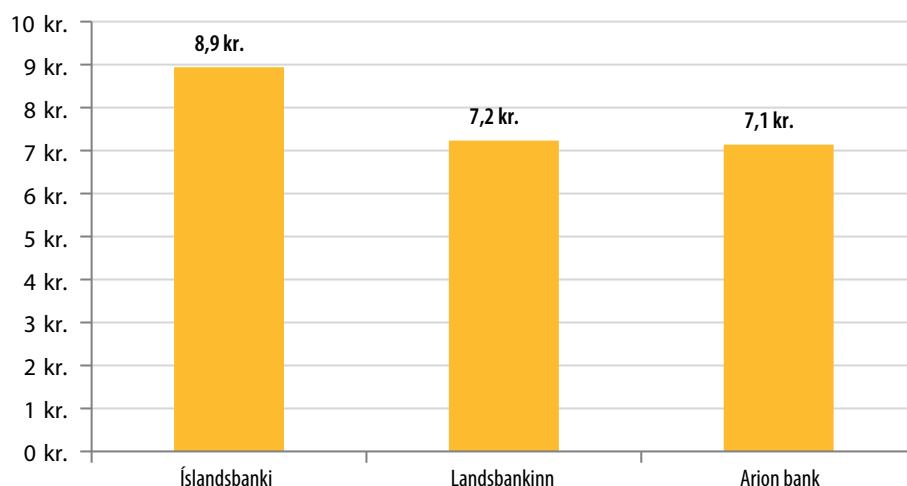
Chart 12: International comparisons of GDP per capita in thousands of dollars for 2009, adjusted to purchasing power



Source: International Monetary Fund (IMF)

Table 16: Salaries and related expenses (in ISK million)

	Íslandsbanki	Landsbankinn	Arion bank
Salaries and related expenses	8.036 kr.	8.468 kr.	8.073 kr.
Average number of employees 2009	899	1171	1131
Average salaries per employe	8,9 kr.	7,2 kr.	7,1 kr.

Chart 13: Salaries and salary-related expenses per employee:

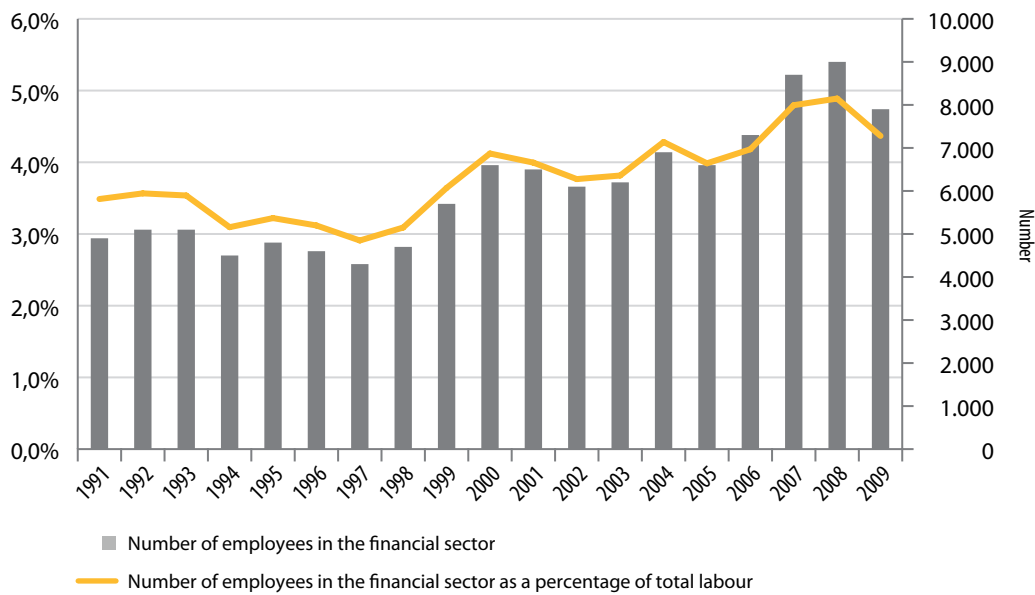
Source: Eurostat and Statistics Iceland

The percentage of people working in the financial sector is among the highest in the world

Banking activities were revolutionised by the advent of information technology. Traditional banking jobs such as cashier work and various types of servicing jobs have been supplanted by online banking and other IT solutions. These technological developments, in Iceland as elsewhere, have resulted in a reduction in the number of branches and traditional jobs in the financial services sector. Employees in the financial services sector made up 3.5% of the total workforce in the early 1990's, but fell to 3% by the middle of that decade.

Following the increase in securities trading and investment banking activities at the beginning of this century, this percentage rose to 4%. That percentage rapidly increased from 2006 onwards and had reached about 5% in 2008. The new activities that were built up called for increasingly educated and specialised staff. Many young university graduates therefore sought employment in the banks and investment banking activities grew from strength to strength.

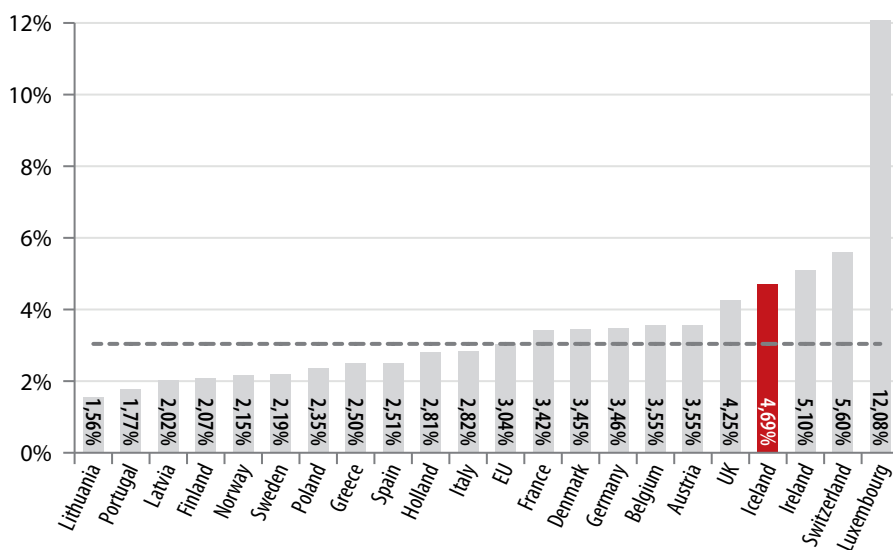
The external environment of financial undertakings has undergone great transformations since the collapse of the banks, but changing the infrastructure requires more time. Despite the collapse of the banks, the number of people working in financial services, as a percentage of the total labour force, is similar to what it was in 2007, when the plan was to turn Iceland into an international financial centre. The changes in the external circumstances of Icelandic financial undertakings more or less happened overnight. It takes considerably more time for people to acquire the expert knowhow and education required in the new areas. Considering the current size of the Icelandic banking system, the number of people employed in this sector is clearly high.

Chart 14: Employees in the financial services sector as a percentage of the total labour force 1991-2009

Source: Statistics Iceland

The average percentage of people working in financial services in the EU is 3% of the labour force. The percentage is somewhat lower in eastern Europe but higher in northern Europe. The percentage of people employed by the financial services sector in Iceland is therefore one of the highest, i.e. about 4.7%. In the UK, which can be called the financial centre of Europe, the percentage is 4.25% and in the banking nation of Switzerland it is 5.6%. The percentage of employees in financial services is considerably higher in Iceland than it is in other Nordic countries and the peer countries Iceland is most often compared with.

A lot of work clearly still needs to be done to adapt the activities of financial activities in Iceland to the changes that have taken place.

Chart 15: Employees in the financial services sector as a percentage of the total labour force in 2009

Source: Eurostat and Statistics Iceland

Publisher:
Bankasýsla ríkisins
Borgartúni 3, 105 Reykjavík
Telephone: +354 550 1700
E-mail: bankasysla@bankasysla.is
Website: www.bankasysla.is
Editor: Elín Jónsdóttir

