Developments leading up to the Icelandic banking crisis in October 2008

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1. Foreign expansion and concerns in 2006 about growth

1.1. Strategic expansion for diversification and economies of scale

Landsbanki's history spans three centuries. The bank, which was established by an act of parliament and started operation in 1886, was for parts of its early history both a commercial bank and the national bank of Iceland. Through most of its history the bank remained wholly owned by the state, but in 1997 incremental privatization was started, culminating at the end of 2002 when the government's remaining 48,5% stake was sold to a group of private investors. The bank remained however focused on its home market until the turn of the 21st century.

Starting in 2000 Landsbanki gradually expanded its operations abroad. The bank's strategic reason for geographic expansion was to achieve more diversification, geographically and across sectors as well as greater economies of scale. The Icelandic economy has historically been focused on a few key industries and this was reflected in the bank's lending portfolio. As the Icelandic market went through an important phase of consolidation, creating stronger and more stable financial institutions, the banks thus had to look abroad for further growth opportunities. Importantly, if the banks wanted to develop profitable fee-generating services which did not require an expansion of the existing balance sheet, the domestic market offered rather limited opportunities for growth and diversification of risk.

By the turn of the century Iceland had been a member of the European Economic Area for 8 years and a number of key state owned enterprises had been privatized or were in the process of being sold. The economy had been diversifying from being almost totally dependent on its fishing industry and aluminium exports to a growing importance of services. Long-term prospects for the economy were good, due to a rich resource base in fishing and power generation as well as a young labor pool, with employment and education levels among the highest in the OECD. From the early 1990s governments had thus emphasized liberalization and diversification of the economy and by 2000 financial services were both the focus of privatizations and viewed as a potential growth industry. A token of this was the complete privatization of the banking industry in 2002-2003.

In 2005 the Prime Minister, Mr. Halldor Asgrimsson of the Progressive Party, commissioned a study on prospects for establishing an international financial services center in Iceland, with members from the private sector, universities, industry associations, permanent secretaries from the PM's office and key ministries, as well as the Central Bank governor. The study report, issued in 2006 stated:

> "The domestic financial industry has grown much more rapidly than GDP over the last decade and been a significant contributor to economic growth, progress and improved standard of living. The committee finds that in addition to a higher state of evolution of this part of the economy, which will continue to contribute to growth of the economy, there is a chance to take advantage of the opportunity to develop further an international financial industry in Iceland which would contribute at least equally to economic growth, if the authorities will work diligently towards this goal. Financial industry is a high value added sector; incomes within this industry are high and the educational standard of employees on the average higher than in other industries. As of now, about 3% of the workforce is employed in the financial sector but these workers earn 6% of total salary incomes of domestic workers. Likewise, the share of the financial sector in GDP has grown to about 8% in the span of a few years and surpassed the share of the fishing industry in 2005. The committee strongly advices that if the government should advance policies in order to attract international financial services to Iceland, all such actions and decisions should be designed to

> promote services which are likely to enrich society and further enhance Iceland's reputation internationally."[1]

The committee also concluded that in order to promote successfully the development of an international financial industry in Iceland, key elements of such a strategy would include further liberalization in full accordance with EEA regulation and improvements in the tax system to make Iceland a more competitive base for financial firms. Good access by firms to the government bureaucracy and open dialogue was also considered to be an important factor.

In April 2007 the incoming coalition government announced increased emphasis on high-tech industry and the financial sector, in its policy statement:

> "The Government wants to create optimum conditions for ongoing growth, exports and international expansion by Icelandic companies, i.e. through measures to boost the hi-technology sector…One implication of the transformation of Iceland's business sector in recent years has been to increase the importance of various international service activities, including financial services. The Government aims to ensure that such activities can continue to grow in Iceland and break new ground in competition with other market areas, and that companies expanding abroad will continue to see benefits in being headquartered in Iceland. A priority will be to strengthen the Financial Supervisory Authority to enable the Icelandic financial markets to enjoy complete confidence."[2]

While successive governments had promoted policies to encourage further growth in high-technology and the financial sector, the domestic economy offered somewhat limited

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[1] Alþjóðleg fjármálastarfsemi á Íslandi, Nefnd forsætisráðherra um alþjóðlega fjármálastarfsemi, October 2006, found at http://www.forsaetisraduneyti.is/media/frettir/Skyrsla.pdf

[2] Policy Declaration of the Government of the Independence Party and the Social Democratic Alliance 2007, found at http://eng.forsaetisraduneyti.is/news-and-articles/nr/2646

opportunities for diversification. Landsbanki balanced international strategy was thus aimed at diversifying the asset base and creating a European bank, with strong roots in the Icelandic economy, offering integrated financial services to medium-sized corporations, institutional investors and individuals.

1.1.1. Heritable bank acquisition and growth

During the period 2000 – 2007 Landsbanki made several small and medium sized acquisitions in the UK, Ireland, Luxembourg and France, focused on implementing a balanced growth strategy, for a total value of approximately EUR 520 m. (taking into account the full purchase price of these assets.) The strategy consisted of acquiring small, efficiently run companies or platforms that would support long-term organic growth. In each case the bank retained existing management and added key employees with relevant experience in order to promote new services while cultivating existing product lines and customer relationships. All the while, Landsbanki group was able to offer centralized risk control, compliance, audit and accounting, as well as joint support for IT and marketing. In addition to external growth the bank also grew organically through an expanding branch network in the UK, Holland, Norway, Finland, Canada and Hong Kong.

Landsbanki's first foreign acquisition was Heritable Bank in London. The acquisition was initiated in 2000 and completed in 2002, for a total consideration of GBP 25.9 m. Heritable was founded in Glasgow in 1877 and relocated to London in the 1950s. The bank had traditionally been involved in bridging finance and asset finance. At the time of the acquisition Heritable's balance sheet was approximately GBP 175 m. In the years following the acquisition Heritable focused primarily on its Structured Property Finance business, which involves lending to residential and to a lesser extent commercial property development, both in the form of senior and mezzanine debt.

Starting in 2003, Heritable introduced a number of new business lines, as the bank also began taking wholesale deposits, with retail deposits being added in 2004. Typical customers for the wholesale deposit business were local authorities, building societies, corporations and universities, while the retail savings business offered competitive returns on savings accounts to account holders, providing service by telephone or postal mail.

Starting in 2004 Heritable ventured into the mortgage lending business, focusing on buy-to-let, self certified and status mortgages. In April 2005 Heritable acquired Key Business Finance Corporation, which specialized in short term financing to law firms. Following this transaction the balance sheet of Heritable grew to GBP 450 m. and eventually approached GBP 1 bn. In 2006 the bank launched its Asset Finance business, focused on financing of small ticket items such as vehicles (approximately 60% of the business) as well as industrial equipment, telecoms etc.

1.1.2. Other major acquisitions

Following its initial expansion abroad, Landsbanki grew both organically and by acquisition. In April 2003 the bank acquired the business of Bunadarbanki Luxembourg for a total consideration of EUR 15.3 m. The Luxembourg branch offered private banking, wealth management and other banking services, primarily to clients in Iceland, Scandinavia and Northern Europe.

In February 2005 Landsbanki started assembling the pieces of a corporate and investment banking platform with the acquisition of British stockbroker Teather & Greenwood for a consideration of GBP 42.8 m.

In September 2005 Landsbanki added another piece by acquiring the European securities company Kepler Equities SA (previously known as Julius Bär Brokerage). Initially

Landsbanki acquired 81% of the total shares for a consideration of EUR 81.6 with an agreement to acquire the remaining shares, held by employees, over a five-year period. With offices in Amsterdam, Frankfurt, Madrid, Milan, Paris, Zurich and Geneva and a sales team in New York, Kepler provided Landsbanki with an extended platform from which to develop a Pan-European corporate and investment banking presence.

In November 2005 Landsbanki acquired 50% share in the Irish stock-broking and corporate finance firm Merrion Capital for an initial consideration of EUR 55.3, agreeing to acquire the remaining 50% over the next three years for a price to be determined by future profits. The Merrion acquisition created a new opportunity in the Irish financial services market, with an emphasis on corporate finance, wealth management and fund management services and complemented the acquisition of Kepler and Teather & Greenwood. These businesses were thus instrumental in expanding the bank's investment banking, wealth management and brokerage platform.

In August 2006 Landsbanki acquired a Guernsey-based bank, Chesire Guernsey Ltd. for a consideration of GBP 1.2 m in addition to the approximately GBP 20 m net asset value of the company. This allowed Landsbanki a fast-track entry into the offshore banking sector as well as a possibility to develop further its deposit program, including internet based deposit accounts.

Finally, in May 2007 Landsbanki offered to buy all shares in British investment bank and brokerage firm Bridgewell for a consideration of GBP 60.3 m. The acquisition was completed in August 2007. Bridgewell was merged with Teather & Greenwood to form Landsbanki Securities UK, which instantly became the second largest brokerage firm in the UK by number of clients, behind JPMorgan Cazanove.

In August 2005 the investment firm Burdaras, largely owned by Landsbanki and Straumur Investment Bank was split in two and the entities merged with the two major owners. Among the assets allocated to Landsbanki was a 19.8% share in Swedish investment bank D. Carnegie & Co AB, which Landsbanki sold in April 2006 for EUR 235 m, realizing capital gains of approximately EUR 110 m. Other assets allocated to Landsbanki from the Burdaras split were shares in Intrum Justitia AB., Straumur Investment Bank Ltd. and Marel hf. Landsbanki also owned a number of subsidiaries in Iceland, including SP Fjarmognun, an automobile and equipment leasing company.

1.1.3. Growth of Landsbanki London Branch

Landsbanki London Branch received its official branch license in March 2005. At first the branch specialized in leveraged loan financing through participation but subsequently moved also into originating leveraged loans.

In late 2006 the branch also launched an Asset Backed Lending unit, staffed with a core team consisting of experienced bankers out of GMAC Financial Services. The Asset Based Lending unit worked with teams in London, Birmingham, Manchester and Frankfurt. Later Landsbanki also formed a strategic alliance with Wachovia where the bank acted as an agent for Wachovia's clients in Europe.

In 2006 London Branch launched the Icesave product, Internet based savings accounts, while back-office operations were outsourced to the Newcastle Building Society.

In October 2007 the branch launched its Capital Markets Products Unit (CMPU), which was focused on add-ons to Landsbanki's equity brokerage business through securities financing, structured products and equity derivatives. The aim of the CMPU was to offer clients advice and products to meet specific requirements in financing or increasing yield on equity portfolios or to hedge interest and FX exposure. A fixed income unit was launched several months earlier, in June, while a Trade Finance unit was also launched and operated closely with the Hong Kong representative office.

The bank also opened branch offices in Amsterdam, The Netherlands in March 2006; Oslo, Norway in March 2007; Halifax, Canada in June 2007 and Helsinki, Finland in 2007. Out of these offices the Amsterdam office was by far the most important. It was headed by experienced bankers recruited from the Royal Bank of Scotland and started out as a branch for lending, then began taking wholesale deposit and finally initiated a retail deposit operation, under the Icesave brand. The offices in Norway and Canada focused on lending portfolios which had been serviced from Iceland, while the Helsinki office was primarily a brokerage business.

1.2. Investor concerns and Landsbanki's response

In the fall of 2005 and into early 2006 foreign investors and bankers expressed concern with the general economic outlook in Iceland and potential instability. To a certain extent this was a due to lack of accurate information or misinformation. These concerns were addressed publicly and in meetings with analysts by the banks, the bankers association and the government. Valid concerns about fundamentals were also addressed by Landsbanki by more tangible measures.

Although many of the criticisms regarding the banking system were valid, and subsequently addressed, others were based on misconceptions owing to Iceland's relatively recent appearance on international capital markets. Landsbanki and its peers thus started emphasizing information flow regarding Iceland's economic position, and in particular enviable long-term prospects for the domestic economy, based on its rich resource base, consisting of abundant fishing grounds as well as strong hydro-electric and geothermal potential.

The country also sported a favorable demographic profile, with a relatively young labor pool and employment and educational levels well above the average among peer economies. Another source of strength was the fully funded pension system with a ratio of 1.33:1 in terms of pension fund assets to GDP. Moreover, from the turn of the century the economy had been gradually diversifying from being almost totally dependent on the fishing industry and aluminum exports, to a growing importance of services including the financial sector. Milestones along this path were membership of the European Economic Area, achieved in 1992, successful privatization of key state owned enterprises, including the three major banks and increased foreign and domestic investment in export industries.

1.2.1. Warning signs and reaction

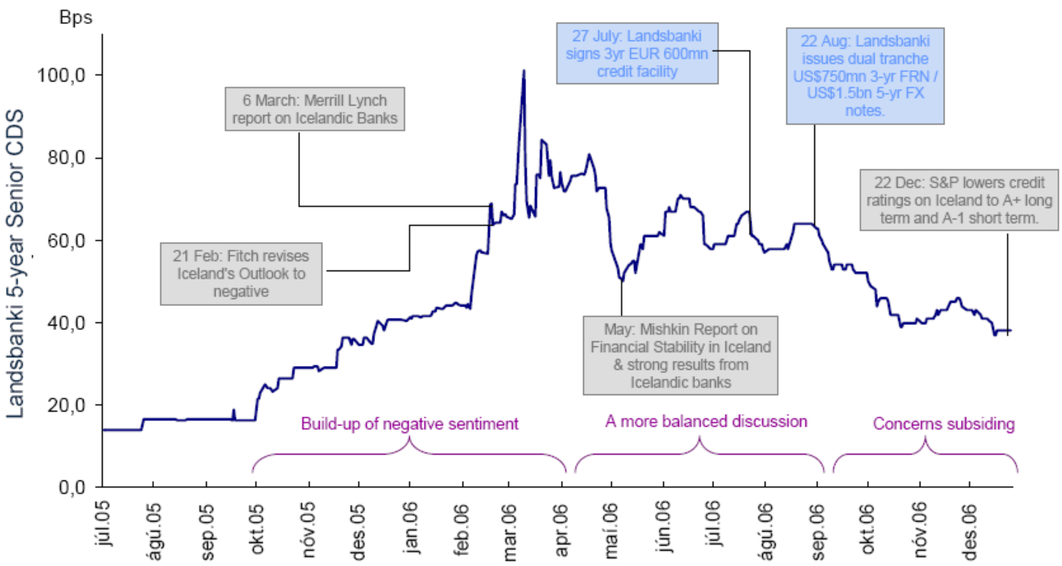
Following the strong expansion by Icelandic banks and other domestic companies abroad internationally in 2004-2005, market analysts and the financial media had begun focusing on perceived weaknesses in the Icelandic economy and its financial sector. Financial analysts thus expressed concern about the domestic economy's ability to adjust to short-term disequilibrium and consequently the banks' ability to cope with the impact of economic fluctuations on funding and operations.

As a measure of increased concerns, in early fall 2005 the Icelandic banks' CDS spreads thus started rising, gradually at first and then sharply in the early months of 2006 from a low of about 15 bp., to almost 100 bp. by March 2006. Another catalyst for increasing risk aversion came on February 21 2006 when Fitch Ratings changed the ratings outlook for Iceland's sovereign debt from positive to negative and on March 6 when Merrill Lynch published an analyst report voicing concerns about the outlook for Icelandic banks.

Some of the criticisms of the banking system were in fact well founded and Landsbanki subsequently addressed them through various strategic measures:

- Reduced reliance on capital market funding with increased geographical diversification and increased deposit base focused on fixed-term international accounts
- Strengthening of liquidity position with more stringent internal guidelines on liquidity and development of deposit initiatives
- Reduced equity exposure and clear division of hedged positions and nominee accounts as well as divestiture of parallel equity holdings with largest shareholders
- Addressing the information gap by a pro-active approach with target audiences to improve information dissemination as well as accessibility, quality and transparency

Following these actions the concerns that had been voiced previously, subsided. Following is a more detailed account of these actions.



Graph: Turning points Jun. '05 – Dec. '06 and Landsbanki's 5-year senior CDS spreads

1.2.1.1. Reduced reliance on capital market funding

One of the points raised by bond analysts and investors, was that the Icelandic banks were relatively dependent on wholesale financing. As we discuss in more detail in the chapter on the history of Icesave, Landsbanki had already in the fall of 2005 started preparations to set up a deposit program in other EEA countries, in order to diversify and reduce risk on its funding side. The objective was to attract longer term retail deposits and reduce the amount of long-term borrowing needed to support the banks funding. The first Icesave program was launched in the UK in October 2006. Year-to-year in 2006 deposits increased by 104% and the deposit-to-loan ratio increased from 34% to 47.5%.

The bank also diversified capital market funding by geography and funding programs, lengthening the maturity profile. In late July of 2006 Landsbanki concluded a three-year EUR 600 m. syndicated lending facility with the participation of the largest players in the banking and bond market, priced at 32 bp. over EUR 3M LIBOR , followed on August 22 by the bank's first US issue. Due to substantial demand the planned USD 1 bn. transaction was increased to USD 2.25 bn. which was seen as strong evidence for the bank's ability to secure ample funding. This transaction, priced at the equivalent of around 80 bp. over USD 3M LIBOR rates, was also instrumental in confirming the downward trend for CDS spreads on the major banks' debt. This was the turning-point in regaining market confidence. The year was then concluded with a EUR 375 m. Tier 1 issue.

Given another successful market issue in Canada in December 2006 the bank had successfully diversified its funding geographically, lengthened its maturity profile and broadened the investor group. These were significant and positive developments, in particular when coupled with the launch of the new Icesave deposit accounts in the UK, which would radically alter the bank's deposit-to-loan ratio and thus the funding profile in 2007-2008.

By end of 2006 the bank had fully funded maturities through 2007 and liquidity was greatly strengthened. Tier I capital had also been strengthened and capital ratios improved from the year before. From this period onwards the bank also followed a modest dividend payment policy in order to maintain a strong equity position and liquidity.

1.2.1.2. Strengthening of liquidity and internal guidelines

In 2006, as a consequence of the crisis, he bank imposed more stringent internal guidelines regarding liquidity aimed at maintaining a liquidity position, net of haircuts, such that it could sustain at least 12 months without access to capital markets, given a modest reduction in business and limited recourse to sales of its portfolio of mortgages and other loans. The stress test thus assumed that all liabilities due would be repaid at maturity and that a significant share of deposits would be taken out.

As a part of the new liquidity guidelines, a number of stress tests were also implemented and routinely applied to the bank's liquidity position. These stress tests assumed that the bank had no access to capital markets, faced zero growth in the loan portfolio and assumed either very limited or moderate fund raising based on the loan portfolio as well as a reduction in deposits. These were conceptually based on the Bank Financial Strength Rating (BFSR) methodology promoted by Moody's.

At a group level the bank had thus implemented several liquidity management guidelines, to meet criteria imposed by management and to requirements set by different jurisdictions in which the bank operated. To whit, these guidelines included the Icelandic/FME liquidity requirements, the BFSR guidelines set by Moody's (implemented in 2006), the UK/FSA requirements (implemented in 2008) and the Dutch liquidity requirements which were continuously met starting in April 2008.

1.2.1.3. Reduced equity exposure and division of hedged positions

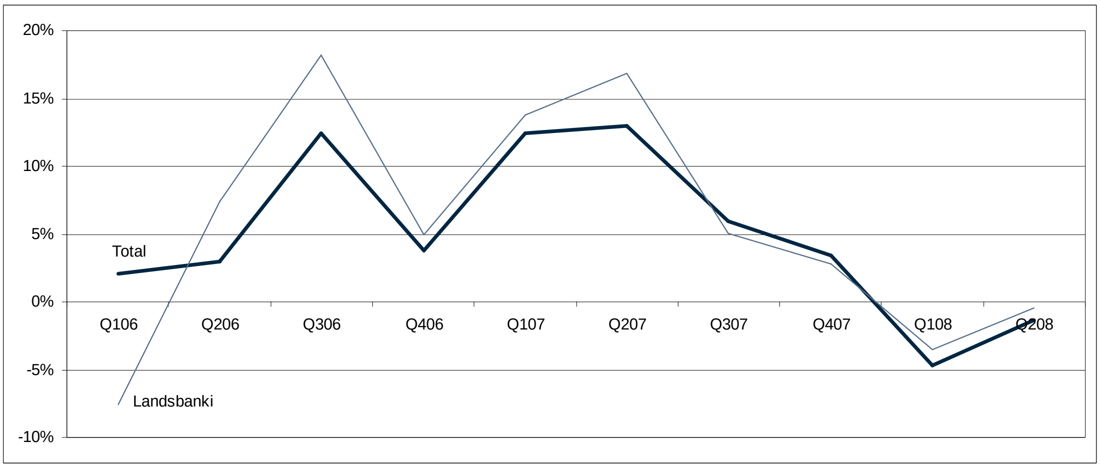
To alleviate some investor concern about risk exposure, in 2006 period Landsbanki reduced its equities exposure from 4-5% of total assets to less than 3% of total assets, by divesting of assets in listed companies as well as in Straumur-Burdaras Investment Bank. This was backed by better information-flow to investors and analysts about the bank's true exposure to market risk and in particular to separate out any equity positions which were held as a hedge against market risk.

1.2.2. Growth of the banking system

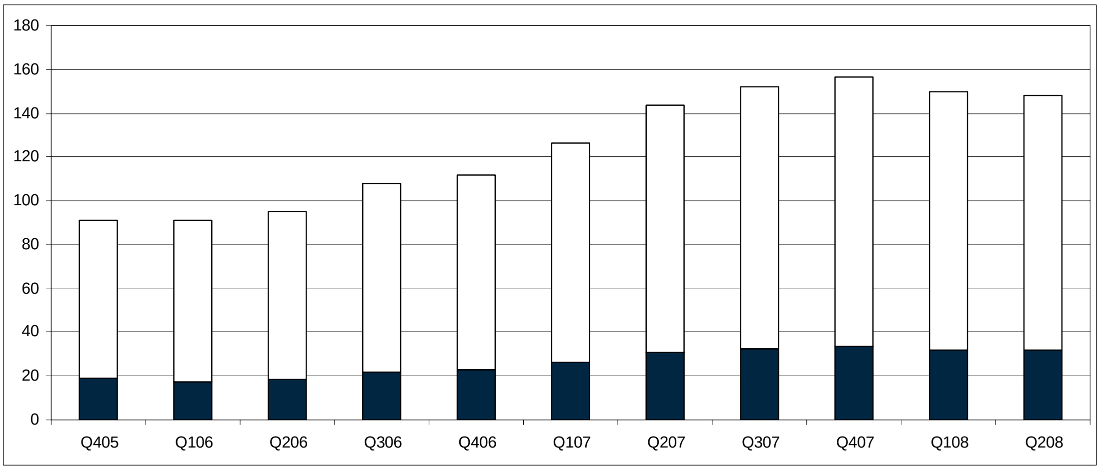
In 2006 the banking system, as measured by assets of the three major banks in EUR, grew by 23%, from EUR 72.4 bn. to EUR 88.8 bn. In the following year total assets grew by 39% in EUR. During the first six months of 2008 total assets increased shrank by 6% in EUR terms.

In 2006 Landsbanki's total assets thus grew in line with the growth of the three major banks which as a whole grew by 23% in EUR. In fact, Landsbanki's share in the total assets of the banking system remained stable through the 30 month period from year end 2005 until end of Q208 - based on total assets in ISK at year end 2005, 2006, 2007 and end of Q208 respectively, Landsbanki's total assets represented 26% - 27% of the total. Towards the last part of this period in EUR terms the ratio of Landsbanki's assets to the total declined as Landsbanki had the largest portfolio of krona denominated assets among the three major banks.

In the first months of 2007, following the crisis of 2006 and successful fund raising later that year, the bank refrained from accessing the market. During this period CDS spreads continued to decline and this provided an opening for the other banks to access the bond market.



Graph: Growth of total assets for the three major banks and Landsbanki, in EUR.



Graph: Total assets Q106 – Q208 for the three major banks and Landsbanki, in EUR billion.

1.2.3. Regulatory framework

Landsbanki was regulated by the Financial Service Authority (FME) on a consolidated basis. The bank's foreign branches in London, Amsterdam, Norway, Finland and Canada were also subject to local reporting requirements, as well as the representation office in Hong Kong which was subject to local regulations. Thus Heritable Bank and Landsbanki Securities UK was regulated by the UK Financial Services Authority; Landsbanki Luxembourg was regulated by the Commission de Surveillance du Secteur Financier (CSSF), Kepler Equities branches in France, Spain, Holland, Italy and Germany was regulated by the French Autorité des Marchés Financiers (AMF), with the branch in Switzerland also being regulated by the Swiss Federal Banking Commission (SFBC) and its USA operations by the Securities Exchange Commission (SEC). Merrion was regulated by the Irish Financial Services

Regulatory Authority, Landsbanki Guernsey was regulated by the Guernsey Financial Services Commission. A framework agreement was in place with each subsidiary regarding reporting on risk management and large exposures on a consolidated basis. Landsbanki placed great emphasis on maintaining good relationships with regulatory agencies. In our experience regulatory pracitices were similar across the different jurisdictions, yet more extensive and comprehensive at the group home regulator level, i.e. by the FME. As recently stated by one of the governors of the Central Bank of Iceland: "The Icelandic Financial Supervisory Authority based its operations on European law, regulations and procedures and was given good marks by rating agencies and the International Monetary Fund…The banks were thoroughly scrutinized by international rating agencies and their favorable credit ratings greatly facilitated the bank's foray into the bond market."[3]

[3] Ingimundur Fridriksson, 'The banking crisis in Iceland in 2008', published on the bank's website in early February 2009. Mr. Fridriksson was a member of the CBI's governing board at the time of the report's publication, but resigned from his post effective on February 9 2009.

2. Period of relative calm in 2006 – 2007

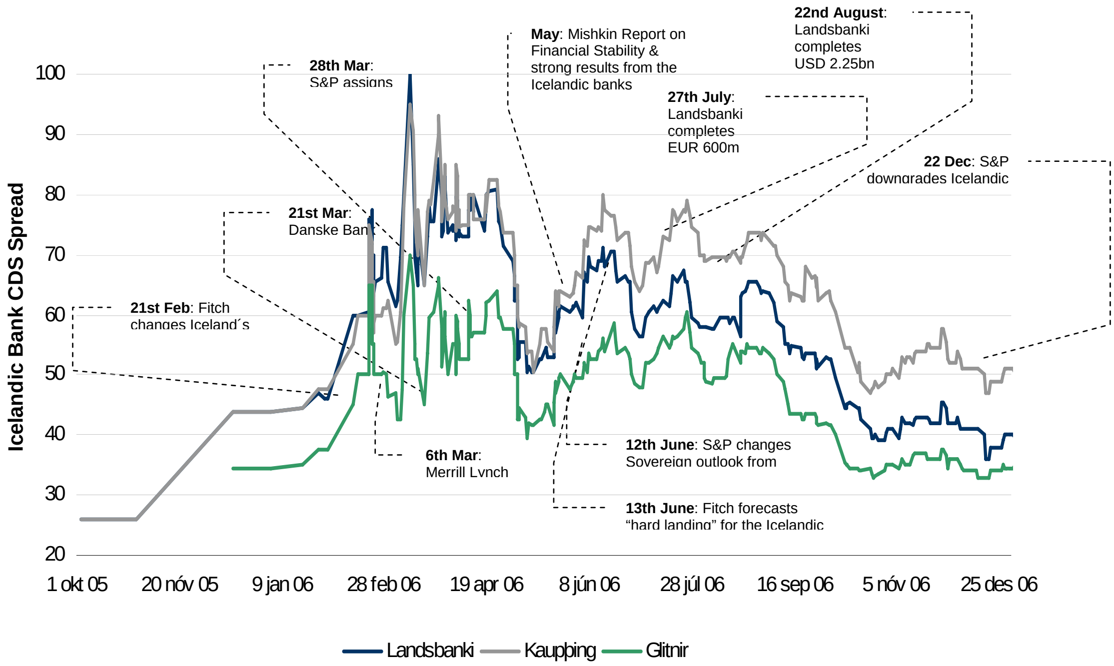
2.1. Strong operating performance

The period from the middle of 2006 until the late summer of 2007 can best be described as a period of relative calm in financial markets and strong performance for Landsbanki. In 2006 net profits rose almost 60% year-on-year, although return-on-equity (ROE) dipped slightly, from 46% in 2005 to 36% - still well above the bank's peer group average within Northern Europe. In terms of core operations, which exclude the effects of financial income and the cost-of-carry for investments, Landsbanki's pretax profits rose 78% in 2006, while ROE dipped from 30% to 26%.

Looking at the first half of 2007 ROE after taxes remained strong at 39% and for core operations the ROE was 26%. As financial income weakened in the second half of the year net profits remained virtually flat in 2007 compared to 2006. Pre-tax profits for core operations rose 20% year-on-year and ROE remained strong at 24% for the full year.

2.2. Economic conditions were benign

The period from late summer 2006 until late summer 2006 also was also marked by a progressive decline in the bank's CDS spreads, which had peaked at 85 pts in February 2006 and fluctuated in the range of 55 – 65 pts during the early summer months. On July 27 Landsbanki completed a placement of EUR 600 m in the market, followed by a USD 2.25 bn placement, finalized on August 22nd. By early September CDS spreads were hovering around 60 pts but shortly afterwards the spreads begun a steady decline which continued unabated until late August 2007. Market sentiment in early fall of 2007 was strongly influenced by the developing crisis in credit markets and Kaupthing's announcement of its pending acquisition of Dutch investment bank NIBC. Kaupthing's CDS spreads rapidly soared to above 100 pts and continued their steady rise through the rest of 2007. Landsbanki's CDS spreads also rose, first to a level of about 80 pts. The spreads did not break the 100 pt barrier until Mid-November.



Graph: CDS development in 2006, and main drivers.

Looking back to late 2006 and early 2007, the outlook in all of Landsbanki's operating markets looked stable and favorable. The large industrial economies appeared to be approaching trend levels in terms of economic growth. Prospects in securities markets appeared good, even though equity prices were expected to rise less in 2007 than in 2006. While some corrections were expected to be due for real estate prices in a number of large markets, Landsbanki's exposure was fairly limited based on conservative lending policies in the past.

It should be noted that Landsbanki developed its strategy of adding diversified international deposit taking as a policy response and started its activities in this field in the midst of very benign market conditions in, when access to capital was good.

The risks associated with the Icelandic economy which had been a focus of attention in early 2006 also seemed to have dissipated. Economic growth was slowing down short-term but still healthy by international standards. Asset prices had shifted down to sustainable levels, without causing any major disruption in the real economy or financial system.

2.3. Icelandic situation improving

The exchange rate of the krona had also stabilized at a more sustainable level. While external imbalances remained problematic, a correction was expected to take place in 2007 – 2008, as major components of domestic demand were declining in real terms. In particular investment demand sould decline rapidly as energy-intensive investments came to a close. All indications were that the economy could adjust to a depreciation of the krona and an adjustment in the current account to a sustainable balance without significant impact on the balance sheet of households or corporates.

Overall benign conditions in both financial and asset markets, coupled with healthy prospects for economic growth in the domestic and global economy were expected to have a favorable impact on Landsbanki's business in all areas of financial services. This has to be taken into account when reflecting on subsequent developments. The mood in early 2007 was also reflected in the then incoming government's emphasis on future growth of the banking system as set out in section 1.1 above.

It is also noteworthy that as growth continued under these benign conditions no bond issues were undertaken in 2007 to strengthen the Central Bank's currency reserves. CDS spreads were low and room for Icelandic issues was ample. Landsbanki's success in deposit taking had reduced its need to issue and market opportunities for Icelandic issues were thus excellent.

3. Deepening liquidity crisis and the authorities' reaction

3.1. Introduction

In late 2007 and increasingly in the early months of 2008, the financial strength and stability of the Icelandic banking system attracted increasing attention in the foreign media. This discussion, which was usually motivated by broader concerns about the global liquidity crisis, often focused on the size of the Icelandic banks in the context of the Icelandic economy, in particular the ability of the Central Bank of Iceland to act as a lender of last resort, given its relatively limited foreign currency reserves.

Landsbanki's management had also during the fall of 2007 been increasingly concerned with a sharp rise in CDS spreads on the debt issued by the three major Icelandic banks, which had risen to higher levels than relevant CDS indices.

It is important to recall that the global liquidity crisis which started in the fall of 2007 was initially projected to last only a few quarters, at worst. This projection was consistent with the history of similar episodes of financial crisis which arose under similar economic conditions and in view of the fundamentals which were the root cause, i.e. increased losses on bonds and derivatives linked to portfolios of subprime mortgage loans in the US.

Early estimates of losses in the value of portfolios of US subprime mortgages were on the order of USD 500 bn. which is a far cry from the amounts now expected to be lost by the financial industry and in the global economy as a whole before this crisis subsides. The global effect is therefore mostly secondary, i.e. no longer linked to the underlying fundamental of distressed mortgage loans in the US.

It was thus not until later, in the early months of 2008 that the more serious nature of the global crisis became clearer, and consequently that expectations about the extent and duration of the effect on financial firms were adjusted, both abroad and domestically. In terms of expectations however, the full blown financial crisis was not factored in fully by most market participants until later, after the fall of Lehman Brothers in Mid-September.

3.2. Missed opportunities

At the end of 2006 the assets of the banking system had already reached more than five times the value of Iceland's GDP. Before the system collapsed in October 2008 it was to increase even further, making it one of the world's largest in relation to GDP.

The IMF notes in its November 2008 Staff Report regarding Iceland's request for a Stand-By Arrangement: "Having allowed its banks to grow to levels that significantly outstrip the [Central Bank of Iceland's] lender-of-last-resort capabilities, Iceland is now faced with its public sector having to take on obligations relating to the restructuring of the collapsed banks on a scale that will dramatically circumscribe the medium-term fiscal outlook. More immediately, the loss of confidence and the attendant sharp fall in the value of the krona will severely compress investments and GDP. A deep recession appears unavoidable"[4].

In light of this an important question remains to be answered, i.e. to which extent if any the government, Central Bank and regulatory institutions actually worried about and thus responded to increased risks due to the growth of the major banks? It is interesting how few changes these institutions made in the implementation of monetary policy and banking regulation in order to reduce leverage and prepare the system to meet the demands of a growing financial sector. Very few tangible measures appear to have been taken to prepare

[4] International Monetary Fund, November 2008, "Iceland: Request for Stand-By Arrangement – Staff Report", p. 22

the monetary system for the effects of potential shocks. The system was however clearly in need of reassessment following the discussions in 2006 and in view of the growth of the foreign liabilities of the banking system and the weak currency on which the economy is based.

It is for example notable that the Central Bank, in spite of its concerns, decided not to heed repeated calls for a strengthening of the currency reserve. It is rather difficult to reconcile this inaction with the now professed sense of urgency on the bank's behalf and deep concern about the level of preparedness in the system. The authorities should have used the favorable situation which evolved in late 2006 and 2007 to strengthen its monitoring of bank liquidity, in particular in foreign currency and to strengthen the currency reserve in order to prepare for potential shocks. During this period the bank had a window of opportunity to counteract the appreciation of the krona due not in least to the carry trade and strengthen the currency reserve by intervening through the exchange market, by buying foreign currency. The strong krona of course contributed to the increasing current account imbalance which in turn set the scene for a massive depreciation of the krona in early 2008 as well as the consequent terminal freeze of the swap market which had a major impact on the banks.

After the government completed a EUR 1 bn. bond issue in November 22 2006 the CBI's net foreign assets doubled from USD 0.9 bn. to USD 2.3 bn. From that time on the CBI did not take out any additional loans and while the assets of the three major banks doubled in USD over the next 18 months, the CBI's foreign assets only grew by 20% during the same period.

In practice the implementation of monetary policy was both contradictory and ineffective over a long period of time, during which inflationary pressures continued to mount. Firstly, hardly anything was done to stem the carry trade which had contributed strongly to the appreciation of the ISK and helped to neutralize the Central Bank's contractionary monetary policy. Secondly, monetary policy was rendered ineffective by the contradictory policy of offering mortgage loans at low real interest rates through the state-sponsored ILS while the Central Bank continued to raise policy rates, although the boom in housing contributed strongly to inflation. Central Bank officials seemed to pay no attention to widespread criticism in the financial community of this policy which according to its critics also contributed to increasing capital inflows and thus had a positive impact on domestic demand, in stark contrast to the intended effect. This was repeatedly pointed out by the IMF, OECD and market analysts.

Apparently, some officials now believe that it should have been clear to managers of the three major banks that they should have independently curbed growth and sold foreign assets in order to reduce systemic risk. This reflects an unreasonable view of how publicly traded companies working in a competitive environment actually operate. The primary responsibility of management is to manage risk while delivering a competitive return on shareholder equity. Each bank had little or no incentive to move unilaterally to curb growth as this would have hurt its prospects and been of direct benefit to its competitors. Authorities on the other hand were in a different situation. They had the means and motive to impose restrictions or controls which could have led to a coordinated deleveraging of the system.

Authorities appeared to be on the sideline and did not use the means at their disposal to reduce the amount of leverage and risk in the banking system. The EEA agreement certainly put certain limits on such actions, in particular by the FME but to a lesser degree the Central Bank. Ways to strengthen collaboration on monetary policy with respect to the banking system should have been pursued, at least starting in late 2006.

In the end the major banks reacted, unilaterally and without government coercion. As the global credit crisis worsened in late 2007, the major banks slowed lending growth, enhanced liquidity buffers, reduced costs and started downsizing non-core operations. The banking systems' ability to decrease leverage was however severely limited by global risk aversion.

Furthermore the Central Bank, which was in the position to take initiative and approach the issue from a more global perspective than any individual financial institution, was conspicuously passive, in particular with respect to the breakdown of the currency market in March 2008 and in providing much needed liquidity in foreign currency during the worst global credit crisis in modern history, as its counterparts in the US and Europe were doing.

In retrospect the period from the mini-crisis of 2006 until the collapse of the financial system is an episode of missed opportunities and lack of proactive policy responses, coupled with changes in the banking system that were not balanced by a change in monetary policy and more effective monitoring. This reflects in many ways the reactionary nature of the Icelandic bureaucracy, which often seems to lack proper incentives to act in a more proactive way towards policy. Collaboration between institutions seemed also often almost non-existent. For example it is surprising to hear from recent statements made by the ex-minister of commerce and banking that there was no contact between the minister and the chairman of the board of governors of the Central Bank through the whole of 2008. The effects of this lack of coordination could been seen in particular with regards to the regulation of bank liquidity where the responsibility was partially shared but the institutions seemed to work independently of each other.

3.3. Liquidity policies strengthened – contingency plans in 2008

Because of the emerging global liquidity crisis, starting towards the end of 2007 Landsbanki's CEOs pursued a strong policy on maintaining and strengthening liquidity. The policy was aimed at these main goals:

- zero growth and reduction in balance sheet activities
- increasing deposit base with emphasis on increased international deposits and term deposits

- strengthening readily available liquidity by creating repo eligible instruments as well as covered bonds
- maintaining a strong positive currency balance to hedge the bank's equity against weakening of the krona
- maintaining a strong net indexation position to hedge the bank's risks from increasing inflation resulting from a weakening of the krona

In order to conserve equity and liquidity the CEOs also sought and gained approval from the board and annual meeting to change the bank's bylaws in order to allow the issue of convertible bonds; also to conserve equity as well as liquidity the annual meeting approved that no dividends were paid out on 2007 earnings.

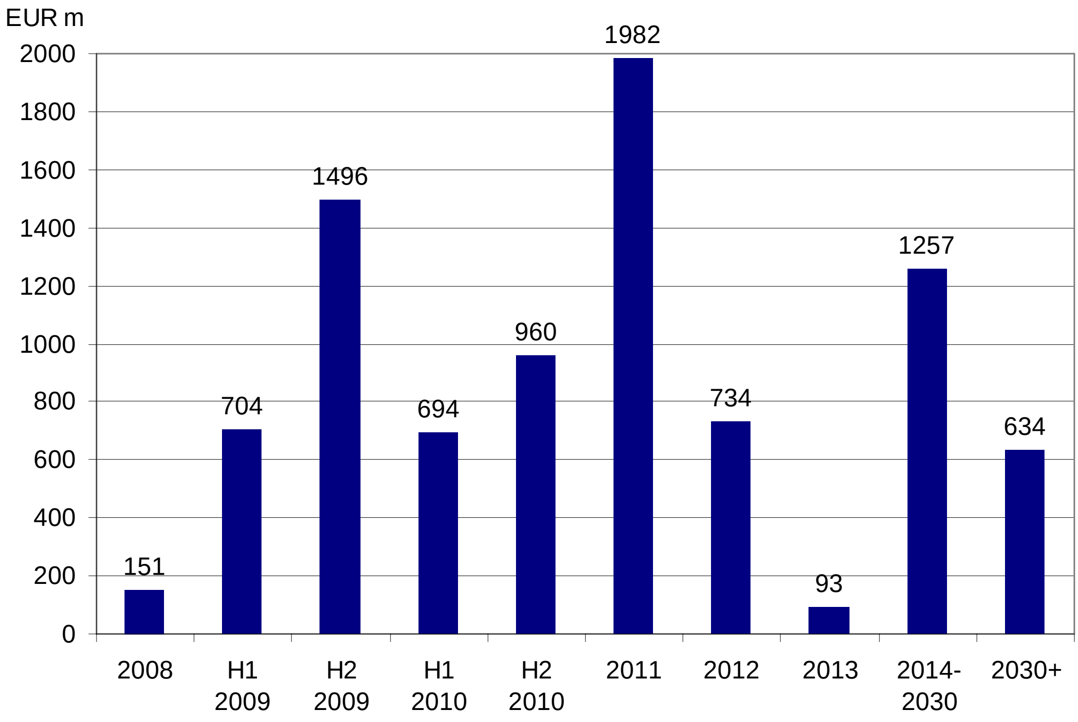
3.4. Unused tactical options – risk mitigation

Management also retained further options for risk mitigation, including a further reduction in number of staff or other cost cutting measures. Further transformation of the bank's illiquid assets to central bank eligible format was one of the options that were developed. Thus asset backed securities of international loans approximating EUR 400 m. were ready to be launched in Q408. Funding could also be pursued against covered bond programs which were under preparation in Iceland and the UK. The Icelandic program was expected to yield approximately EUR 400 m. in Q308 and the covered bond program in the UK approximately EUR 350 m. in Q308.

Other initiatives would have strengthened the bank's capital by actively participating in consolidation in the domestic market. Management also prepared and executed a sale of non-core business lines in the last week before the banking collapse, with the sale of the bank's

Pan-European securities companies to Straumur. The sale of Heritable as a going concern was also considered as a tactical option under certain conditions.

As shown in the following graph Landsbanki's repayment profile in 2008 and H109 was relatively light, while EUR 1.5 bn were maturing in H209 and EUR 1.7 bn in 2010.



Graph: Maturity profile of foreign currency denominated long-term debt 23 July 2008.

3.5. Concerns regarding NIBC acquisition lead to rising CDS spreads

A major catalyst for the abnormal rise in CDS spreads for the Icelandic banks, over and above the rise of CDS spreads for other comparable banks from the beginning of the credit crisis, was most probably the pending acquisition of Dutch investment bank NIBC by Kaupthing, which had been announced on August 15 2007. At a valuation of nearly EUR 3 bn. this would have represented the largest takeover ever attempted by an Icelandic company. It would in fact have added a bank with a balance sheet the size of Landsbanki and thus about 2 times

Icelandic GDP to the Icelandic banking system. NIBC's profile as an originator of structured products based on real estate mortgages also seemed to concern market participants, as well as Kaupthing's challenge to finance the acquisition given deteriorating conditions in international credit markets and a dwindling appetite for leveraged takeovers in global markets.

Criticism about the NIBC acquisition had already emerged when the deal was announced and the discussion became more heated at the end of 2007 as closing of the acquisition was continually delayed. It is interesting to ponder, given recent pronouncements in the media, why during this lengthy period – from August 2007 until late January 2008 – there was never any public reaction by the authorities to the pending acquisition. It was clear to bankers, and presumably policymakers, that a large group of outside observers felt that the Icelandic banking system was ill prepared for such rapid growth. This raises important questions, such as: why did authorities not seize this opportunity and reign in growth? It is however our understanding, although this has not been made public, that the authorities played a major part in halting the merger process in the end, however belatedly.

In the last months of 2007 after the bank presented its Q307 results, Landsbanki’s CEOs met with many analysts which expressed their concerns about the effect of the impending merger on the Icelandic banks.

3.6. January

3.6.1. *The banks’ annual results and ratings agency responses*

Because of conditions in global credit markets and other economic indicators, Landsbanki’s management decided during the annual budget review for 2008 to set a zero limit on the growth of the bank’s balance sheet. Events at the beginning of 2008 only confirmed that the year ahead would be difficult for all of the Icelandic banks.

In January reports indicated that Glitnir had aborted its efforts to secure additional wholesale financing due to a tepid reception to their inquiries abroad.

On January 28 Landsbanki presented its results which showed a healthy profit in Q4 and for the whole year 2007, in spite of the economic slowdown internationally as well as domestically, that was already evident. Two days later, on January 30 Kaupthing announced that it had reached an agreement with NIBC to cancel the pending acquisition at no penalty. Although this decision was favorably reviewed by most commentators it did not seem to sway the Moody's rating agency which later that same day announced that it was placing Landsbanki and Glitnir on review for possible downgrade, while maintaining the review for potential downgrade of Kaupthing.

All three banks were at that time rated Aa3 for long-term debt and C for bank financial strength. Moody's said that the rating review was triggered by a weaker earnings outlook, as the banks' business models were heavily dependent on income from investment banking and corporate banking-related activities.

Moody's announcement therefore seemed to reinforce the perception that the relative size of the Icelandic banks, prospects for the deteriorating economy and the bank's repayment profile, presented disproportionate risks for debt investors. Landsbanki, which had expected to raise additional longtime wholesale bond financing through a new market issue in February, decided to put its debt investor road-show, which was at the planning stages, on hold.

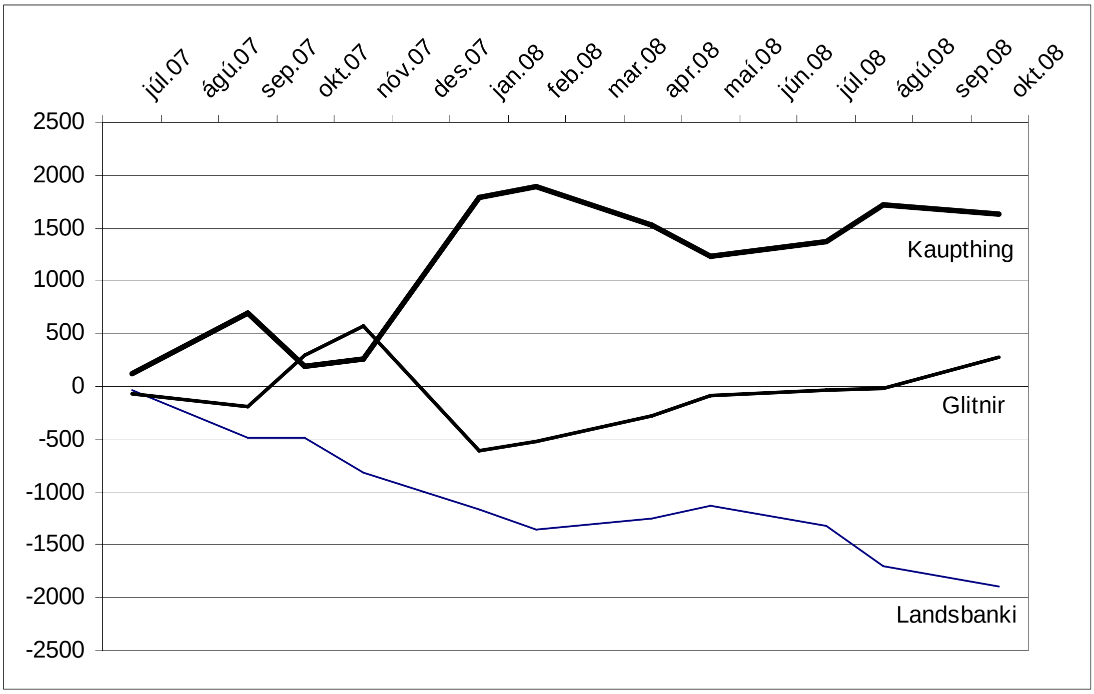
In October and November of 2007 Kaupthing had launched its Edge Internet savings account product in Finland and Sweden. In January 2008, these accounts, which competed directly with Landsbanki's Icesave, were launched in Norway, Belgium and the UK. Kaupthing's interest rates on Edge accounts were the highest on offer in the UK at the time, according to the 'Best-Buy' tables. The launch of the Edge product in the Britain, prompted a number of press reports which focused on the risk-benefit trade-off from high rates of savings accounts and the increasing number of foreign banks offering such products in the UK.

3.6.2. ***Meetings in London and increasing concerns***

In early February there is a marked shift in sentiment in the foreign press and in banking circles towards the Icelandic banks. It is Landsbanki's perception that the introduction of Kaupthing's Edge accounts in the UK, which were launched with some fanfare and at very competitive interest rates, is a certain catalyst for more negative discussion about savings accounts offered by foreign banks in the UK and in particular the situation with respect to Kaupthing and Landsbanki.

The increasingly negative press also coincides with Moody's downgrade of the credit rating for Landsbanki, Kaupthing and Glitnir on February 28, which has a measurable impact on the outflow of Icesave deposits in early March. The downgrade in turn is one of several catalysts impacting the domestic market for currency swaps which collapses at the end of February the same time.

This terminal freeze in the swap market causes new problems for market participants and has an immediate impact on the banks' management of liquidity in krona and foreign currency. As there is already a significant dearth of liquidity in foreign currency for the system the banks struggle to cope with the progressively worsening effects of this crisis. However, for reasons which are difficult to discern, the government and Central Bank did not react to the crisis in the foreign exchange market.



Graph: Net purchases of foreign currency (in ISK millions), cumulative Jul. '07 – Oct. '08

There is also a growing concern in the market with respect to Glitnir's situation, in particular in light of rumors that the bank had aborted a planned bond issue and that its subsidiary in Norway is having trouble placing covered bonds which have traditionally been the main source of funding for the Norwegian bank. In view of Glitnir's maturity profile in 2008 for long-term debt market participants have justified concerns about the bank's ability to refinance and get through the worsening liquidity crunch.

In January Landsbanki had formally announced that it was in formal discussions with the management of Close Brothers Group plc. about a potential takeover of its banking activities, with the participation of Cenkos Securities, which planned to take over other activities of Close. Landsbanki would not have considered this takeover, if it were not for Close Brothers high liquidity and strong equity position. As Close Brothers was very well financed and highly liquid, the company was a very attractive takeover target. The takeover would have strengthened Landsbanki's liquidity and equity position; only because of this did the bank commit to this transaction.

Landsbanki's management was well aware that success in the Close Brothers talks was far from assured. Discussions with third parties however provided an excellent opening to hear the views of other investors and banks with respect to Landsbanki and the Icelandic financial system. During this period, Landsbanki's CEOs therefore met with about a dozen other banks and thus received good feedback not only on the pending acquisition, but also on the bank's prospects in general. In discussions about the Icelandic banks in general these third parties expressed some concern with the effects of Kaupthing's pending NIBC acquisition and Glitnir's position with respect to maturities in the coming year. There was generally speaking satisfaction with Landsbanki's increased international deposit taking, but some concerns regarding financing in general as most bankers were expecting markets for long term financing to be closed for a longer period than previously assumed.

Based on this input, management was therefore well aware of increasing concerns in the financial community with the viability of the Icelandic banking system. At meetings with the Central Bank governors during this period, the CEOs frequently related the views held by these foreign bankers, regarding their concerns about the state of the Icelandic banking system and the importance of strengthening the lender-of-last-resort capabilities during these difficulties.

3.7. February

3.7.1. Landsbanki's memorandum to the Prime Minister

3.7.1.1. Extraordinary circumstances

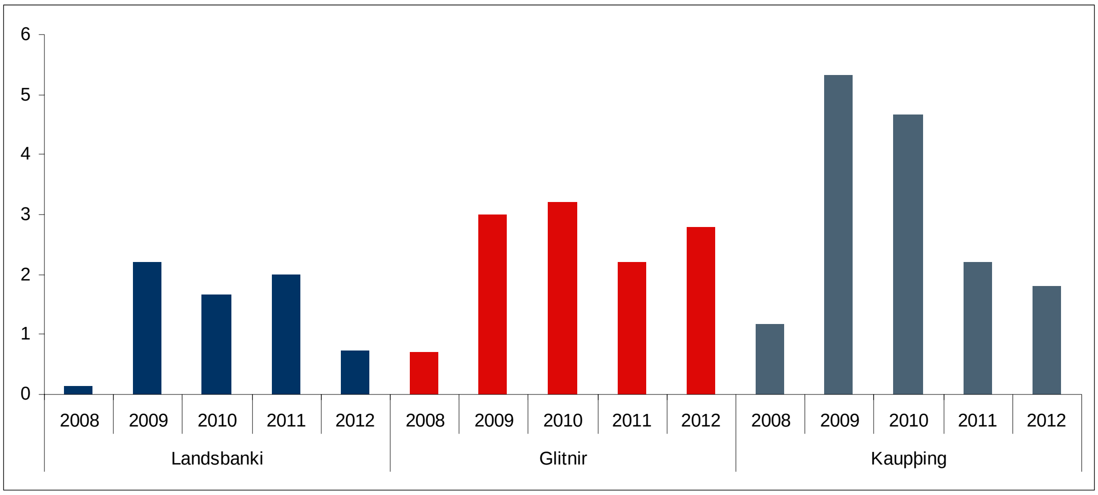
Both Landsbanki's and the Central Bank's upper management attend the Guild of International Bankers banquet in London on February 4. This is an annual event, attended by bankers from around the globe with interests in the City. It is traditional during the days surrounding the banquet, for the Central Bank governors to meet with several foreign banks which have interests in the Icelandic financial system. During the London visit, Landsbanki’s CEOs also met with representatives from other commercial and investment banks and compared notes on views expressed in these discussions with the Central Bank governors. During these discussions both parties expressed concerns about the state of the banking system.

On February 8, Landsbanki’s management delivers, in separate informal meetings, a memorandum to the Prime Minister and the Central Bank governors about the increasingly difficult situation facing the Icelandic banking system. The memo proposes several possible actions that could be taken in order to strengthen the system. The worsening global liquidity crisis has hit Icelandic banks particularly hard, in spite of their strong fundamentals.

The reasons for this are according to the memo mainly twofold: on one hand the banks have only recently started taking deposits outside of Iceland and the Icelandic financial system has grown disproportionately large compared to the domestic economy. On the other hand, due to the global credit crunch, it is now evident that the banks will be unable to access bond markets at reasonable terms in the short or medium term. The memo however highlights that Landsbanki’s need for refinancing because of repayments of long-term debt falling due is modest in the near term, relative to the other two banks.

The memorandum states: “Extraordinary circumstances call for extraordinary measures”. According to the authors, it is therefore reasonable to consider reorganization and strengthening of the banking system as a whole, by a merger between two of the major banks. The authors point out that rising CDS spreads for Iceland’s sovereign debt, which may reflect a generally held view in the market that a turn for the worse for one or more of the three major banks could force the government takeover of the troubled institution or institutions. In order to strengthen the market’s confidence and prevent this scenario from unfolding it may therefore be a prudent course of action for Landsbanki to merge with one of the other banks.

The reason why Landsbanki should be the acquirer in this case is, according to the authors, primarily the bank's strong fundamentals, with regard to a high ratio of deposits to loans and consequently a lower dependency on bond market financing. Also, given the relative size of the three banks, the most logical match for Landsbanki might be Glitnir and the resulting balance sheet would be similar in size to the balance sheet of Kaupthing. The result would be a system with two strong international banking institutions, in addition to the domestic savings banks.



Graph: Maturing foreign long-term funding 2008–12 in EUR bn. (Source: Bank's Q2 reports)

3.7.1.2. Financing of maturing loans over two years needed

To facilitate the merger of Glitnir with Landsbanki it would first be necessary to refinance a large part of long term debt maturing in 2008 and 2009, as well as refinancing of some short term lines. This would require a committed backup of about EUR 4 – 5 bn. in total which corresponds to the amount of maturing long-term debt of the two institutions during the same period, in particular Glitnir. The authors feel that it is necessary to convince the market that the new bank can operate without access to market financing for 1-2 years, as this will help to push CDS spreads down and thus improve financing terms. To raise this amount of money in the tight credit market will however be greatly facilitated with government assistance, both because of general market conditions and also because the merger may effectively cancel out overlapping sources of short term funding.

In practical terms, according to the memo, the government would have to issue a state guarantee of loans to the merged entity which could be used to secure long-term debt financing of 3-5 years maturity in addition to shorter term lending facilities from foreign banks. The memo points out that according to the most recent Moody's ratings report for the sovereign the government should be able to raise EUR 7 – 9 bn. without impairing its debt rating. The authors briefly discuss the negative impact of a state guarantee, but point out that the effect of contingent claims on the sovereign's default risk may already be reflected in CDS spreads for government bonds.

3.7.1.3. Moody's, the bank's growth and sovereign ratings

In this context it is interesting to recall some of the statement made by Moody's in its credit report of January 28, titled "Iceland's Aaa Ratings at a Crossroads":

> "How can such a highly leveraged economy be rated Aaa?
>
> The answer is that Moody's sovereign ratings for Iceland reflect the extremely high probability that the government would repay its debt as well as any contingent liabilities in a timely and orderly fashion. Iceland's current account deficit and high level of debt derive from private sector activity, but this does not mean that the government balance sheet would be fully impervious to the private sector's potential woes. Contingent foreign currency liabilities stemming from Iceland's big commercial banks have risen above comfort levels. Also, the conditions in the global credit markets

> have changed radically, and the balance of risks has worsened for highly leveraged economies and companies alike.
>
> In our view, Iceland's authorities remain able to fend off a liquidity crisis, protect depositors, and avoid disruptions in payments systems. From the current vantage point, we expect that the government would be able to bring onto its balance sheet the additional debt associated with supporting the banking system without permanently taking its debt metrics outside the Aaa rating space. In addition, the Icelandic banks are themselves fundamentally healthy, with strong franchises, ample liquidity, and improved maturity structures for their capital markets funding.
>
> On the other hand, Moody's has become more concerned that the growth of the country's internationalized banking system is stretching the authorities' ability to manage a crisis should one arise. A further material increase in contingent foreign currency liabilities beyond present levels, at least if unaccompanied by increased foreign currency reserves and/or explicit cooperation mechanisms amongst the central banks in which the Icelandic banks operate, would likely weaken the credit standing of the country, in Moody's view."[5]

Moody's also discussed the question about contingent liabilities arising from deposits in foreign currency:

> "First, as in almost any country, and certainly any highly-rated country such as Iceland, the central bank is fully capable of dealing with a liquidity problem that may emerge in its own currency – hence the Aaa local currency deposit ceiling. There is a bigger question mark in Iceland's case regarding foreign currency bank liabilities; the swelling and internationalization of the Icelandic banks' balance sheets has resulted in the

[5] Moody's Global Sovereign, January 2008, "Iceland's Aaa Ratings at a Crossroads", p 1.

accumulation of EUR 40 billion of deposits in the system, of which only about EUR 10 billion are local (mostly ISK) deposits in Iceland. (Note, Icelandic GDP is equivalent to about EUR 13 billion). The remaining EUR 30 billion are foreign currency deposits in overseas branches or subsidiaries. Of this, EUR 16 billion of deposits (foreign currency) are in overseas branches. This EUR 16 billion can be considered a contingent liability of the sovereign in times of extreme stress. (Actually, this measure of contingent liability is exaggerated because branch deposits also fall under local deposit guarantee schemes. However, the ultimate guarantee does come from the home country.)…

While Moody's assigns a very low probability (approaching zero) of a run on all EUR 16 billion of overseas branch deposits, it still is instructive to analyze this worst-case scenario to illustrate the sovereign's ability to handle such a crisis, especially to those alarmed by the headline liability numbers.

The first line of defense to the banks from a run on overseas branch deposits would come from liquid assets of EUR 3.2 billion available to the Icelandic bank parent companies and branches. The banks then have alternative sources of funds available to them such as liquidity portfolios and back-up lines, amounting in aggregate to about EUR 17 billion (including those arranged by their subsidiaries), which could be tapped as the next line of defense. Assuming conservatively that EUR 4-6 billion of this could be mobilized by the parent banks for the overseas branches, the likely gap to be plugged by the sovereign falls, in a truly extreme stress scenario, in the range of EUR 7-9 billion."[6]

[6] Moody's Global Sovereign, January 2008, "Iceland's Aaa Ratings at a Crossroads", p 3-4

3.7.1.4. Landsbanki's view

Landsbanki's memorandum concludes: "It is important to emphasize that the ultimate goal of these ideas is to find a solution to current problems facing the Icelandic banking system and therefore the domestic economy as a whole. Such solutions are a precondition for permanent economic stability and equilibrium in the economy. It is more prudent to face the problem with decisive action before time runs out and the problem becomes too large to solve in a successful manner."

3.7.2. Various options considered

After the ideas for a Landsbanki-Glitnir merger were presented informally to the Prime Minister and Central Bank governors, Landsbanki discusses the matter further with a delegation from the Bank of America. These consultants strongly urge Landsbanki not to consider a possible merger with Glitnir, as such a move might trigger covenants in loan agreements and lead to a worse financing situation for the merged bank than for the two parties independently. It is understood that the particular circumstances in global credit markets, where bond spreads have now increased dramatically, aggravate this risk quite independently of the actual financial situation of the two banks.

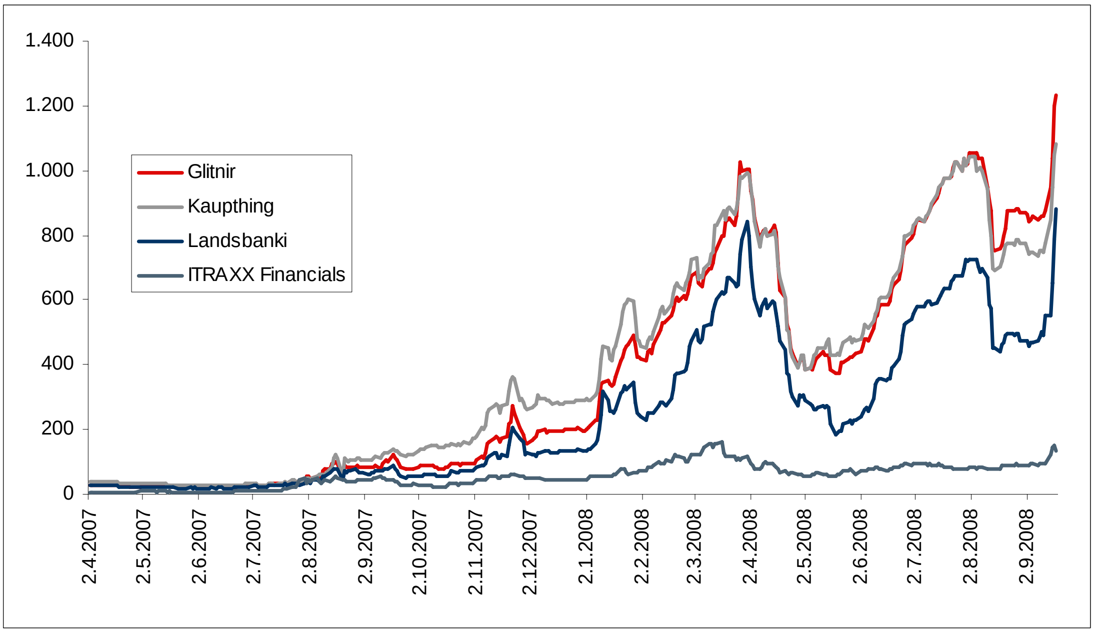
During the spring Landsbanki held talks with various foreign banks and other financial institutions to discuss how to strengthen the bank. One of the options explored by management, with the assistance of consultants from Citibank, is an equity injection by sovereign wealth funds which have been actively investing in European and U.S. banks, in the form of convertible bonds. The option was however considered seriously and in preparation, as a matter of raising preparedness overall, management gains approval from the annual shareholders' meeting for a potential convertible bonds issue of up to EUR 500 m. in par value.

3.7.3. Increasing negative press in the UK

On February 10 the Times of London prints two fairly negative stories about Kaupthing and Landsbanki's Internet savings accounts under the headlines 'Fears over Safety Net' and 'Time to Bale out of Iceland?'. The latter story states: "Advisers are urging British savers to limit their investments in Icelandic savings accounts to £35,000, amid fears that some of the country's biggest banks are headed for strife. The warning comes after Moody's, the credit-rating agency, described Iceland's banks as 'fragile' last month, and said it was reviewing the country's gold-plated triple-A credit rating – the highest possible. This news will worry UK savers who have a growing stake in the Icelandic banks."

The Times article then talks about the growth of Icesave but states: "Admittedly, most of the concern about Iceland centers on Kaupthing, the country's largest bank. It has had a presence in Britain since 2005 through its purchase of investment bank Singer & Friedlander. Earlier this month, Kaupthing Edge, the group's online banking arm, also made an audacious debut into the UK savings market… This aggressive strategy has raised fears that the bank is simply using British savers to plug a funding gap caused by the global credit crunch – and has prompted unflattering comparisons with Northern Rock."

Shortly after returning from the meetings in London around February 4, the Central Bank governor meets with ministers from the government and airs his concerns about the state of the banking system, in view of his recent discussions with foreign bankers. In conversations with Landsbanki's CEOs at the time however the Central Bank governors confirm their view, and the view of bankers with which they have had discussions about the matter, that Landsbanki's situation has given rise to the least concerns in terms of the three major banks, while Kaupthing and Glitnir are believed to be in a more precarious situation. This is reflected in the evolution of CDS spreads where quotes on Landsbanki's spread remain far below the quotes for both Kaupthing and Glitnir.



Graph: CDS spreads for Landsbanki, Glitnir and Kaupthing February 2007 – September 2008

3.7.4. Concerns raised by Central Bank governor about Glitnir

In this time period Mr. Arnason and Mr. Jon Thorsteinn Oddleifsson, head of financing, meet with Central Bank governor Mr. Oddsson and Mr. Sturla Palsson director of the International and Market Department, to discuss the idea that the government issue bonds which the three major banks will acquire in order to use as collateral in a repo action with the European Central Bank. The euro proceeds of this repo action would be deposited with the Icelandic Central Bank, in order to build up a larger reserve of liquidity in foreign currency. This idea is briefly floated but subsequently not implemented as it might raise the ire of the ECB, according to the Central Bank.

At these informal meetings Mr. Oddsson also noted his growing concerns about the maturity profile of the three banks and Glitnir in particular. Should one of the banks experience a liquidity crisis and not be able to meet its maturities, this might require drastic action by the government, including a takeover of one of the banks. In the view of the Central Bank governor an emergency nationalization would of course not involve any compensation for the bank's shareholders. Landsbanki's representatives however pointed out that a considerable weakening of the position of shareholders in one of the banks could have a massive snowballing effect on the rest of the banking system, as well as world perception, as the banks were rightly or wrongly perceived to be tightly connected.

3.7.5. Expression of common concerns by the financial sector

The financial sector had developed its foreign currency activities steadily. The need for more support by the Central Bank has been discussed repeatedly over the last months and years, and for instance in a formal meeting on December 16 2007 the board of the Icelandic Financial Services Association (SFF) pointed to the need for the Central Bank to develop further its capability for being a lender of last resort in foreign currency as more than 2/3 of the banks' lending was already in foreign currency.

The situation is widely discussed within the financial community. In late January, based on discussions at the most recent board meeting of the SFF Mr. Larus Welding, chairman of the board and CEO of Glitnir, had sent a letter to the Prime Minister. The letter, dated January 25, addresses growing concerns about the ongoing international credit crisis and the precipitous fall in price of stocks on the Iceland OMX exchange.

The SFF letter states: "Financial firms in Iceland have already cut back significantly on lending. At the same time more than a full GDP worth of value has been lost by a fall in market value of shares in a few months. Considering these two measures of financial stability…the effects felt domestically are quite severe. The board of SFF therefore believes that it is vital that we take a forward looking view and that the level of tightness in monetary policy reflect the difficult situation that has arisen and the limiting effect on the growth of domestic industry which will result from the situation in international financial markets."

The letter points out that the current level of real interest rates, 8%-10% may be unsustainable and will make it difficult for Iceland to survive the 'ongoing storm' (i.e. credit crunch). The board thus firmly believes that policy rates need to be lowered and that the government must support initiatives to prevent a further slowdown in the economy and encourage initiatives to increase export revenues.

3.7.6. *CEOs send a joint statement to the Prime Minister*

3.7.6.1. *Memorandum on the economy and the financial sector*

Subsequent to the SFF chairman's memo, CEO's from the three major banks, under the umbrella of the Icelandic Financial Services Association (SFF) draft a joint memo to Prime Minister Haarde. The title of this memorandum is: "The economy and the state of the financial sector". The memorandum is signed by Mr. Welding and sent to the authorities in the form of a draft on February 4**.**

The SFF memorandum states that the situation in financial markets has continued to deteriorate, and the financial and economic conditions for Icelandic companies operating abroad have been radically altered. The most recent development which has both impact for the banks and the government is Moody's action to put the three banks' on negative watch for possible downgrade.

The authors also point out that the banks face stiff competition from the government, which has one bank that lends other banks at 14% interest (i.e. the Central Bank) and another bank which lends customers of these same banks at 4.5% real interest (i.e. the Housing Financing Fund). "It is unreasonable to believe that financial services can thrive normally under these conditions," the letter says. "Given these circumstances it is necessary to reiterate the need for a less stringent domestic monetary policy, in order to prepare for an unavoidable period of adjustment, which is already upon us and will become more deeply felt in coming months."

The memorandum then discusses domestic monetary policy, and argues that it must not only focus on the current rate of inflation, but also be forward looking and take into consideration the rapid depreciation of assets as well as the dire circumstances faced by many firms in need of refinancing. A lowering of interest rates under these circumstances may therefore be not only justified but necessary to facilitate an orderly adjustment.

The memo then proposes that the government shift some of the responsibilities of the Housing Financing Fund (ILS) to the Central Bank, in order to consolidate the financing of government debt in one institution. The letter also proposes changes in the manner in which the government issues bonds to finance the ILS and that actions be taken to align the maturity profile of debts and assets held by the fund, so that it can no longer take advantage of the maturity mismatch in order to hold down interest rates on mortgage loans. The authors also propose that the government abandon reserve requirements at the Central Bank, which would give the banks additional flexibility and might facilitate a lowering of the policy rate without a weakening of the ISK exchange rate. This adjustment would primarily be intended to increase much needed liquidity in the system, but should not lead to any increase in lending by the banks.

The banks state that they will commit to a conservative strategy in lending in order to prevent a rise in private consumption fueled by an excessive increase in leverage. A zero growth in lending should also decrease the threat of overinvestment in sectors of the economy which are most sensitive to a cyclical downturn. The banks and the government should also join hands to stabilize the currency exchange market. The memo also stresses the need for a two year plan to spread more information about the domestic economy and financial market to the foreign press, investors and analysts.

In addition to these points the memorandum also touches on several other issues:

- recent findings by a committee chaired by Mr. Einarsson Chairman of the Board of Kaupthing, with respect to the taxation of expatriates and investment trusts
- Special tax benefits regarding investment in shares should also be reintroduced
- In view of the growth of the Icelandic banks abroad should prompt a comprehensive reevaluation of monetary policy in particular with regard to the currency system
- Pension funds should have more flexibility in investing in individual domestic companies and overall in Icelandic firms
- The government should strengthen its efforts to attract long term foreign investment to Iceland

3.7.6.2. ***Expectations raised about policy initiatives***

On February 7 a senior member of the coalition parliamentary group, shares notes with the general manager of the SFF regarding ongoing discussions within the government prompted by the CEO memorandum. According to this well placed source both coalition parties are hard at work on proposed measures to strengthen the financial system. Heads of both coalition parties, i.e. the Prime Minister and the Minister of Foreign Affairs, agree that any action by the government in this regard must be both tangible, decisive and carried out with the full commitment of the government. In particular, regarding the issue of foreign investment, the government is prepared to support the proposed construction of a new aluminium smelter at Helguvik, which could bring at least ISK 100 bn. into the economy.

Among other measures being discussed in the government are changes to the governing structure of the Central Bank proposed by the Social Democratic Party, whereby the number of bank governors will be reduced to one from three and the governor will no longer be a political appointee. According to the source Mr. Haarde will use his address to the Icelandic

Chamber of Commerce annual meeting on February 13 to announce substantial policy initiatives.

3.7.6.3. *No new initiatives announced during PM's address*

Based on this information Landsbanki's CEOs thus anticipate that major policy initiatives will be announced at the Chamber of Commerce annual meeting. The Prime Minister's address is however rather short on substance regarding new policy initiatives. Instead, the PM emphasizes that in spite of the fact that CDS spreads on bank debt have been rising, both independent analysis by such firms as Credit Sights and Moody's, as well as the most recent reports by the FME confirm that the major banks are fundamentally strong and that in terms of income and earnings from core operations – i.e. disregarding the effects of financial income – the banks compare very favorably with their Nordic counterparts.

"In spite of these positive results, reports by the FME, Moody's, Credit Sights and other parties we are still seeing negative comments from some analysts and media. These comments are often filled with factual errors. Descriptions of the state of the Icelandic financial sector are often quite exaggerated. It is worrying that these parties do not take into consideration the detailed information that is available to everyone and shows the strong fundamental position of both the banks and the sovereign. Often a stronger power seems to be at work than the search for truth," the Prime Minister added.

"It is therefore vital that we join our efforts to react to this. The government is ready to cooperate with all concerned labor and industry associations, with the primary goal to convey accurate information and analysis about the Icelandic economy and industry to foreign analysts, investors and media. Furthermore government ministers will continue to be available to appear at meetings abroad with representatives from industry in order to describe the state of the economy and correct the errors that may be floating around."

As the Chamber of Commerce meeting is dedicated to discussion about the potential adoption of the euro as domestic currency, other parts of the speech quote verbatim from the PM's own comments regarding the EU and the euro at the Central Bank's annual meeting a year earlier. In this speech the minister emphasized that a unilateral move to adopt the euro as domestic currency would be against EU policy. In order to adopt the euro Iceland would have to accede first to the European Union, and the government platform specifically states that this matter is currently off the table. Further discussions about joining the EU or adopting the euro are thus futile and ultimately irrelevant to finding a solution to more pressing economic problems, according to the PM.

Overall the PM's contribution at the Chamber of Commerce meeting is a disappointment to Landsbanki's management, which had been expecting that tangible policy initiatives would be announced. Instead the PM has used this occasion to dispel any doubts about his firm opposition to the adoption of euro as a domestic currency. The PM however announces that he is planning to hold talks with the banks on measures to strengthen the financial system. While this meeting had in fact been planned after the CEO memorandum was sent to the Prime Minister and the meeting agenda has already been set, the CEOs are hopeful that actual policy measures will be discussed at the meeting. As it turns out the government is facing the issues of 2008 with solutions which proved successful in 2006 – i.e. facing this as a problem of perception and PR. The current problems require however more decisive action, for example the breakdown of the currency swap market has already had a tremendous impact on the banks, which the authorities seemed to disregard completely.

3.7.7. Meeting with the PM on pressing issues

The next day, on February 14 CEOs from the three major banks are summoned to a meeting at the Prime Ministers official residence on Tjarnargata. Photographers and journalists are present outside the residence, as a major announcement is expected by the PM following the meeting. On the agenda are the following points:

1. The Central Bank's currency reserve
2. Use of foreign currency as unit of account
3. Issuing foreign currency denominated stock in Icelandic companies
4. Housing Financing Fund
5. Situation of the pension funds
6. Information flow from the government
7. Other matters

On point 1 the CEOs are in full agreement that the currency reserve has to be strengthened by a very significant amount, to the tune of EUR 5 bn. – 10 bn. as a lower amount might be considered to meager by speculators and investors.

On point 2 the CEOs want to know if the PM's statements at the Chamber of Commerce meeting indicate that he disagrees with the position taken by the Central Bank which had recently argued against Kaupthing's application to use the euro as a functional currency, which in the view of Landsbanki's management was meant as Kaupthing's first step towards moving its headquarters out of Iceland.

In its statement on January 11, previously solicited by the Annual Reports Registry, the Central Bank had stated its opinion on this matter as follows: "The Central Bank opposes any move by domestic financial institutions to adopt foreign currency for accounting purposes. If a financial firm is furthermore determined to issue share capital in foreign currency and decrease its use of the domestic currency, it is the Central Bank's position that this matter should give us pause and requires a further consideration of its impact on the nation's monetary system...it is therefore the Central Bank's opinion that preconditions which would allow acceptance of Kaupthing's request to adopt foreign currency as a unit of account have not been satisfied."[7]

The board of the SFF had previously held wide ranging discussions about the matter of foreign currency as a unit of account. On October 17 2007 the PM met with the board for discussions on a wide range of matters. At this occasion the PM stressed his opinion that an accounting currency should correspond to a company's functional currency and that generally speaking he felt that domestic firms should use the krona as functional currency.

Under the rubric of 'other matters' the CEOs agree that the Ministry of Finance and the Central Bank need to use the bond market more effectively to support the current interest rate regime and thus enable the policy rate to have a greater effect on inflation, in order to hasten the time at which the policy rate can be lowered.

Most of the discussion at the Tjarnargata meeting however center on the issue of the government's PR initiatives. It becomes apparent to Landsbanki's representatives at this meeting that the government is less willing to focus on the more tangible issues discussed in the memorandum, or to enforce policy in this regard than previously thought. The ministers seem to be more focused on public relations matters regarding the image of Iceland and its financial industry abroad. Shortly after this meeting the PM announces that he has appointed Mr. Finnur Sveinbjornsson as a special advisor to the government in charge of relations with the financial industry.

3.8. March

3.8.1. Channel 4 report in March and CBI governor's statement

[7] Translated from "Umsögn Seðlabanka Íslands til Ársreikningaskrár" dated January 11 2008 and found at this URL: http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=5622

As February turns into March there are additional stories in the UK press about the security of depositors with Icesave and Kaupthing Edge. In early March, Channel 4 news also broadcasts a prime-time newscast featuring a discussion about both Icesave and Kaupthing Edge. In this report the FSA is quoted saying that 'savers should consider other factors than interest rates, such as what is the compensation arrangement."

The report also includes an interview with Central Bank governor Mr. Oddsson. Mr. Oddsson uses rather careful terms to describe the depositors' guarantee offered by the Icelandic authorities, in particular with respect to the governments backing of the insurance fund which was implied but not stated explicitly: "The economy of this country is quite extraordinarily good. Maybe it is that Iceland is far away in the distance, smaller country and people begin to speculate. But I think that the CDS, that are so much higher on some of these banks than on the average elsewhere, is not fair and should not be so high so I think it takes some explanations and explaining both from the banks and from the state to bring these CDS down to some ordinary things, because no banks can live forever with CDS up to 600, 500, 600," Mr. Oddsson stated in the interview with Channel 4 news.

On the question from the Channel 4 newscaster, whether the Icelandic depositors' guarantee fund could actually shell out the large amounts that it needed to cover for British savers, up to GBP 3 bn., Mr. Oddsson stated that "his country" (sic) could afford to guarantee all deposits. "These banks are so sound that nothing like that is ever likely to happen. If something would happen you would never be talking about the whole amount of money, because it is never like that, but even so the Icelandic economy, the state being debtless, this would not be too much for it to swallow if it would decide to swallow it."[8]

3.8.2. Discussions on providing additional liquidity with the CBI

[8] Channel 4 News online, Business & Money How safe are your savings? http://www.channel4.com/news/articles/business_money/how+safe+are+your+savings/1697147

In early March the UK Financial Services Authority holds a meeting with the bank to discuss the withdrawal of the Global Liquidity Concession waiver which Landsbanki had previously negotiated. In Landsbanki's estimate new liquidity calculations and stress testing scenarios proposed by the FSA would call for additional liquidity provisions at the London Branch.

In order to explore all possible methods to meet additional liquidity requirements, Landsbanki asks the Central Bank governor to consider if the CBI could provide a sizeable committed line to the bank, designated to meet an unexpected run on Icesave deposits. Mr. Oddsson takes this request into consideration and talks to Mr. Mervyn King, governor of the Bank of England (BoE) in order to ask if the BoE would be willing to give the CBI a loan or committed line in order to meet this need. The BoE is not willing to provide a facility for this purpose.

During the CEO's informal talks with the Central Bank, other issues surrounding the Depositors' and Investors' Guarantee Fund, for which the Central Bank acts as a custodian, are also raised. At the time the fund did not have a set policy on how to respond to inquiries about its guarantee for savings accounts in foreign branches of Icelandic banks. In light of recent press in the UK regarding Icesave, Landsbanki stresses that it is necessary to give more clarity to depositors in the UK about the role of the fund and the extent of its guarantee. Following these talks the fund in collaboration with the Central Bank sets a more specific policy on how to deal with questions regarding the guarantee on deposits. The Financial Services Authority (FME) is not party to these discussions.

3.8.3. Graver situation at the end of March

As March wears on the situation both domestically and in international financial markets is becoming graver. The ISK exchange rate keeps worsening as there is a constant and increasing shortage of liquidity, not the least because certain economic actors have taken short position against the krona. While Landsbanki tries to provide foreign liquidity into the market, liquidity in currency is in effect drying up. Due to the worsening sentiment towards Icelandic banks, bad press, soaring CDS spreads and the situation in the domestic economy, Landsbanki and the other major banks experience a significant outflow of wholesale deposits from their foreign branches and subsidiaries.

During this period there is also evidence that foreign hedge funds are trying to spread false rumors to manipulate the market for CDS spreads on the Icelandic banks' debt in order to make speculative profits. In Mid-March the US investment bank Bear Stearns falters and is eventually acquired by the JP Morgan Chase bank, with backing from the Federal Reserve Bank of New York. The potential bankruptcy of this venerable institution, one of the five largest US investment banks, sends shock-waves through the financial community and causes a major crisis in interbank lending across both the US, Europe and Asia.

The Bear Stearns collapse has the effect of focusing attention on weaker links in the financial system, in particular on banks which are believed to be without the backing of a solid lender of last resort. In this regard, the Icelandic banks which have large foreign currency denominated debt and operate with the backing of a Central Bank which only holds a small currency reserve, are a prime example.

3.8.4. Hedge fund rumors and public statements

3.8.4.1. Prime Minister comments on market concerns

The rising CDS spreads for the three banks thus appear to reflect the market's perception that the Icelandic Central Bank will in fact not be able to save the banking system if the threat of a default were to materialize. At the Central Bank's annual meeting on March 28 the Prime Minister addresses these concerns. "Strong economic growth over the last few years in conjunction with successful privatization has led to a good fiscal balance of the government which among other things has been used to pay down debt. Net sovereign debt is therefore virtually nil and few western countries are able to boast of such a position, " the Prime Minister stated. "This means that the state is financially very strong and would be able to borrow large sums if need be. There can be no doubt that the government and Central Bank would be able to come to the assistance if a serious situation came up in the banking system. I have been asked about this repeatedly by foreign parties over the last few weeks, and I have always replied that the Icelandic government would without hesitation follow the same course of action as responsible governments elsewhere. I would like to reemphasize this here."

3.8.4.2. Prime Minister comments on currency reserve

The Prime Minister also emphasized that the Central Bank's currency reserve needed further strengthening: "Over a year ago the government took out a foreign loan and used the proceeds to strengthen the Central Bank's currency reserve. I have said before that it is prudent to continue along this path and I want to reemphasize this now. Also it would be worth considering whether the Central Bank could initiate collaboration with Central Banks in those countries where the Icelandic banks have established large businesses."

The PM was referring to the government's EUR 1 bn. bond issue, completed on November 22 2006, which proceeds were used to strengthen the Central Bank's foreign reserves. While investors bid on EUR 1.7 bn. in bonds, the spread offered on the EUR 1 bn. in accepted bids was 1 bp. below EUR LIBOR rates. Following the bond issue the CBI's net foreign assets more than doubled from USD 0.9 bn. to USD 2.3 bn. At the time of the PM's speech in March 2008 the CBI's net foreign assets were USD 2.8 bn. or 20% larger than in December 2006. Meanwhile total foreign assets in the three major banks had doubled, from approximately USD 64 bn. to USD 122 bn. This shows in perspective how small the reserves were both pre- and post this effort. As a comparison turnover in the interbank currency market in December 2007 amounted to over EUR 1 bn.

It was clear during this period that the country was vulnerable to speculative attacks due to the currency and the size of the banking system relative to the domestic economy. In effect Iceland faced three choices: To move a larger share of the activities of the banks abroad, to adopt a different currency or to join a currency board.

3.8.4.3. Central Bank governor addresses hedge fund rumors

In his speech at the Central Bank meeting, Mr. Oddsson also addresses persistent rumors about the actions of hedge funds which may have been using CDS spreads to short both bonds and shares in Icelandic banks. "We can not ignore the fact that the attacks being made these days against the Icelandic banks and the government, as CDS spreads [for the sovereign] increased today to 400 bp. which is ridiculous, leave us with the impression that shameless traders have decided to make a final attempt to break down the Icelandic financial system. They will not succeed. But an international public investigation into this attempt against a sound financial system must be considered."

Due the persistent rumors and the Central Bank governor's statements the FME asks the FSA to launch a formal investigation into recent actions by hedge funds with respect to the Icelandic banks and the krona. These actions by the FME seem to have an immediate effect on speculative behavior in the market, by hedge funds or other institutions. Another decisive factor is the growing rumor that the government is preparing to take out a sizeable loan to strengthen the currency reserve, which would decreases the expected return from short positions on the krona or the bank's CDS spreads.

3.8.5. Ratings agency action and liquidity squeeze

On March 15 the Fitch ratings agency announces that it has put both Kaupthing and Glitnir on negative watch, but affirmed the ratings of Landsbanki with an issuer default rating of A/Stable and short-term rating of F1. Around this time, Landsbanki's CEOs meet privately with the senior government ministers to discuss the situation. These discussions are primarily informational and not intended to prompt any particular action.

As the first quarter of 2008 draws to a close the three major banks experience a major liquidity squeeze. In order to alleviate the situation the three banks repo bonds with the Central Bank of Luxembourg, which has been their main counterparty for repo transactions with the ECB system. This exchange appears to cause some consternation with the Luxembourg bank, which believes that the Icelandic banks are using the ECB as their lender-of-last-resort rather than the Icelandic Central Bank. Later in the summer the governor of the Luxembourg bank will make his views on this issue better heard.

3.9. Spring

3.9.1. Government delays taking out a loan

Through the spring months the banks have repeatedly made statements about the need for the Central Bank to provide additional liquidity in foreign currency. In May Landsbanki's CEO's learn that representatives from JP Morgan have met with the Central Bank governors to present the idea that the bank may be able to take out a sizeable loan from a consortium of banks led by JP Morgan, in order to build up the domestic currency reserve.

As matters had calmed down significantly in the first weeks of Q2, compared to the situation in March, Landsbanki had at this stage been planning a road show to explore options for refinancing, but these efforts are put on hold. It is the opinion of the bank's management that Landsbanki's efforts could be detrimental for any efforts by the government to raise new financing and that a sizeable loan by the government may positively impact the bank's CDS spreads. The road show was conducted on May 18-19 2008, in the UK, with presentations to 12 likely buyers of Icelandic paper. Responses were mixed, with enough positive feedback that the arrangers recommended that an issue be attempted. However, after it became known that the government might attempt a large bond issue in May, it was decided that Landsbanki should wait until this new benchmark issue had been made. As the government did not act, the Landsbanki issue was thus deferred.

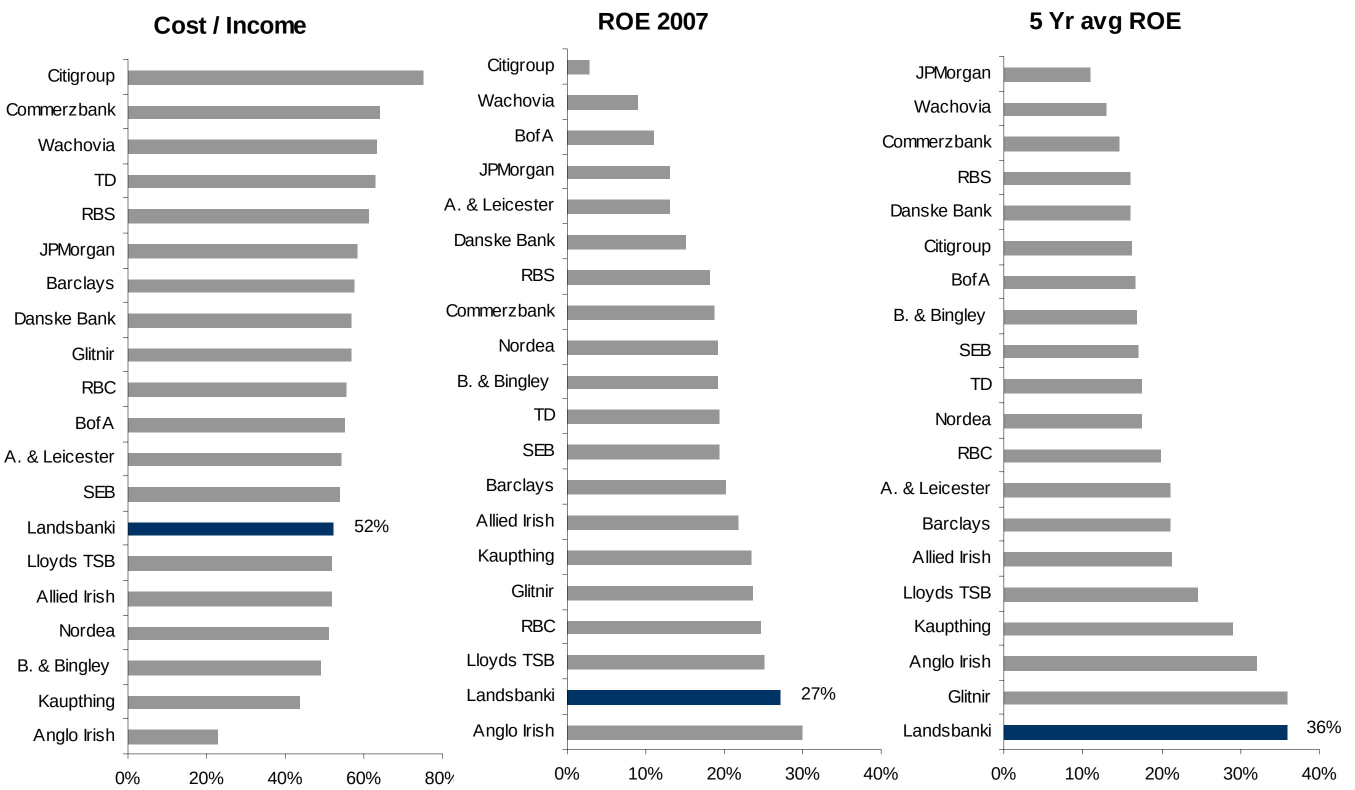
On May 16 the Central Bank announces that it has reached agreements with three Nordic Central Banks on swap facilities. Each bank opens a swap facility of up to EUR 500 m. which the Icelandic Central Bank can use to borrow euros against Icelandic krona. The ISK index strengthens by 4.6% and eventually by about 5.8%, but a week after the announcement the krona starts weakening again and the ISK reaches its value prior to the announcement again by June 5. On June 7, just before the parliamentary recess, the Minister of Finance pushes through new legislation allowing the government to issue up to ISK 500 bn. (EUR 4.2 bn.) in bonds denominated in foreign currency and to lend the proceeds to the Central Bank. The ISK index continues to show a weakening of the krona against a basket of other currencies.

As many weeks go by without any tangible action by the government or Central Bank, it becomes apparent that the Central Bank has decided not to accept the offer by JP Morgan, presumably because of the high interest rate offered. By raising expectations in May and June, and later delaying or postponing any action, the government has thus lent further ammunition to those who believe that the banking system is operating without a sufficiently strong lender of last resort.

3.9.2. Markets show improvement

In April the global credit crunch was entering its second semester. Effects of the fall of Bear Stearns,, were still reverberating through the investment banking world and global markets. In spite of this, credit markets were actually showing signs of improvement. Financial institutions were temporarily able to issue securities without government guarantee. This window closed by mid summer and has not been opened again at the time of this writing.
It is now apparent that in late spring and early summer the Icelandic government lost a golden opportunity to strengthen the currency reserve. Questions linger about the reasons why a sizeable bond issue never materialized. Publicly senior ministers had signaled that they were planning to do so. In fact the government sought and received approval by the Althingi, with a considerable sense of urgency right before summer recess, to issue up to ISK 500 bn. (EUR 4.2 bn.) in new bonds. Was the government not willing to issue these bonds or could reasonable terms not be obtained?

Although Landsbanki's CEOs were still vary of the difficult situation in terms of credit and liquidity, in May consortium of banks, led by Barclay's and Citibank, suggested that Landsbanki road show for the UK sterling market. Representatives from these banks argued that there had been a shift in market sentiment and there might in fact be a good possibility for Landsbanki to place paper in the sterling market at this point in time. The road show was held on May 20 by Landsbanki's CEOs.



Graph: Cost/income ratio and ROE for Landsbanki and its peer group

In international comparison, Landsbanki's long term performance had been very good, as shown on the accompanying graphs of the cost/income ratio and ROE for a select number of banks within Landsbanki's peer-group.

In retrospect it seems clear that the relative quiet experienced by the banks in April and May, when CDS spreads were getting lower, foreign deposit gathering progressing at a rapid rate and the general outlook on the banks' fundamental seemed to be improving gave many market participants a sense that markets were improving. On May 20 for example Moody's affirmed Kaupthing, Glitnir's and Landsbanki's debt ratings with stable outlook, in spite of a downgrade on the Housing Financing Fund to Aa1 from Aaa. On May 9 Fitch downgraded Glitnir and Kaupthing to A- from A, but affirmed Landsbanki at A, noting that Landsbanki's funding position benefited from the rapid build-up of large overseas retail deposits. In May Landsbanki's attention was focused on reaching an agreement with the FSA on Icesave, and by the end of the month the parties had reached a conclusive result, which was confirmed in a letter signed on May 29.

3.9.3. ECB strengthens requirements and FSA reinitiates discussions

In late June Landsbanki receives a message from the Central Bank of Luxembourg requiring the bank to repurchase EUR 700 m in bonds which had previously been placed with the central bank in a repo action. The bank's rationale for this action is that it is no longer willing to accept bonds issued by Icelandic banks as collateral, as this constitutes to high a concentration of risk. Landsbanki has no trouble meeting this margin call. The governor of the Luxembourg bank also makes his opinion clear that the Central Bank of Iceland should be the preferred counterparty in repo transactions with the Icelandic banks and the proper lender of last resort.

Landsbanki also learns that the ECB is planning to impose restrictions on assets accepted for repo and will increase the 'haircut' used in these transactions. An immediate impact on Landsbanki is to complicate matters regarding covered bond issues that are being prepared, as currency swaps involved from ISK or GDP to EUR will have to involve a foreign third party – as swap agreements between banks within the same group will no longer allowed by the new ECB rules. The bank has already started work on preparing several portfolios of assets which would be eligible for repo under ECB rules, with the assistance of the Bank of America and JP Morgan. The new ECB rules were formally announced on September 4 under the heading "Biennial review of the risk control measures in Eurosystem credit operations."[9] The rules were to come into effect on February 1 2009.

On July 2 the UK FSA also initiates new discussions with Landsbanki regarding its concerns, which is in stark contrast with the result already reached in May. Dealings with the FSA are

[9] Found under this URL: http://www.ecb.int/press/pr/date/2008/html/pr080904_2.en.html.

discussed in more detail in the chapter on the history of the Icesave accounts. In the context of the present discussion it is however important to note that up to this point the FME had been a passive observer to the discussions that Landsbanki had held with the FSA, regarding the Global Liquidity Concession and the transfer of the Icesave accounts to a subsidiary.

At this point Landsbanki however calls upon the FME to take on a more active role in these discussions, as the dealings with the FSA were not only having an impact on the UK subsidiary and branch, but more importantly for the liquidity management of the wholebank, which was under the jurisdiction of the FME and the Icelandic Central Bank. During August Landsbanki's CEOs also approach the Minister of Commerce and Banking, Mr. Bjorgvin G. Sigurdsson, and ask for his help to discuss the matters of Icesave with the UK Minister of Finance, Mr. Alistair Darling, which is in charge of the FSA. In particular Landsbanki would like Mr. Sigurdsson's assistance to argue that Landsbanki should be allowed to transfer assets to a proposed subsidiary or merger with Heritable bank in stages, in order not to trigger any covenants in Landsbanki's loan agreements.

During the same period the Dutch National Bank also starts discussing matters over the Icesave accounts in Holland, which have been growing rapidly. As is discussed in more detail in the chapter on Icesave the DNB wants to impose a firm cap on deposits held by Icesave.

The sum net of these events is that authorities in the UK, Holland and within the ECB system have started making new demands on Landsbanki, while outwardly matters with Icesave are progressing quite well.

On September 2 Mr. Sigurdsson meets with Mr. Darling in London and discusses the matter of the Icesave accounts and a potential subsidiarization. No agreement is however reached at this meeting on the handling of this matter.

As summer turns in to fall, events start to unfold which will eventually lead to the collapse of the Icelandic financial system.

4. The last stages of the banking crisis

As set out above, during the last part of summer 2008 and in early September the global credit crisis suddenly took a turn for the worse, as intrabank lending markets started cooling down progressively and eventually froze over. These events culminated in the downfall and bankruptcy of Lehman Brothers on September 15, which had a major detrimental effect on global markets and financial firms world-wide.

In its Quarterly Review in December 2008 the Bank for International Settlements stated that after the fall of Lehman Brothers, global financial markets "seized up and entered a new and deeper state of crisis…With credit and money markets essentially frozen and equity prices plummeting, banks and other financial firms saw their access to funding eroded and their capital shrink owing to accumulating mark-to-market losses."

In the report prepared by the Mr. Fridriksson the former CBI director, it is noted that the Lehman Brothers collapse played an important role in the difficulties faced by Glitnir in Mid-September 2008: "Among other repercussions of the Lehman Brothers collapse, the above-mentioned virtually completed sale of Glitnir assets did not materialize. This kicked off the well-known chain of events. Glitnir turned to the Central Bank for assistance. Not only was the bank unsuccessful in its attempt to sell assets, it was unable to renew a bank loan that it had expected to extend without difficulty. Ultimately, the Government decided that the Treasury should acquire a majority holding in Glitnir, but before that could be finalized the bank collapsed."[10]

The estimated exposure by the Icelandic banking system to Lehman Brothers was relatively modest, at EUR 183 m of which half was due to various contracts between Straumur

[10] Ingimundur Fridriksson, 'The banking crisis in Iceland in 2008', published on the bank's website in early February 2009.

Investment bank and Lehman. But the effects of the bankruptcy on interbank trading worldwide were felt very strongly at Landsbanki as well as the other major banks in Iceland. Lending and trading facilities were curtailed or pre-settlement demanded in transactions were a line of credit was previously given. The market seemed to perceive a greater risk of bank default, as a key institution of Lehman's stature was evidently no longer 'too large to fail'. The Icelandic banks were again seen as particularly vulnerable to a severe liquidity squeeze as they did not have the backing of a strong lender of last resort.

From Mid-September 2008 governments throughout the world were engaged in a rescue of financial systems, including actions to prevent bank runs through retail deposit guarantees or direct capital injections and asset purchases. Staggering amounts have been committed to this task, for example the US Troubled Asset Relief Program (TARP) alone is projected to cost tax payers USD 700 billion. The table summarizes bank rescue programs in economies around the world.

Elements of banking system rescue plans in developed economies[1]

Country	Expansion of retail deposit insurance	Guarantee of wholesale liabilities[2]		Capital injections[3]	Asset purchases
		New debt	Existing debt		
Australia	✓	✓	✓		✓
Austria	✓	✓		✓	
Belgium	✓	✓			
Canada		✓			✓
Denmark	✓	✓	✓		
Finland	✓				
France		✓		✓	
Germany	✓	✓		✓	✓
Greece	✓	✓		✓	
Ireland	✓	✓	✓		
Italy		✓		✓	
Netherlands	✓	✓		✓	
New Zealand	✓				
Norway					✓
Portugal	✓	✓			
Spain	✓	✓		✓	✓
Sweden	✓	✓		✓	
Switzerland				✓	✓
United Kingdom	✓	✓		✓	
United States	✓	✓		✓	✓

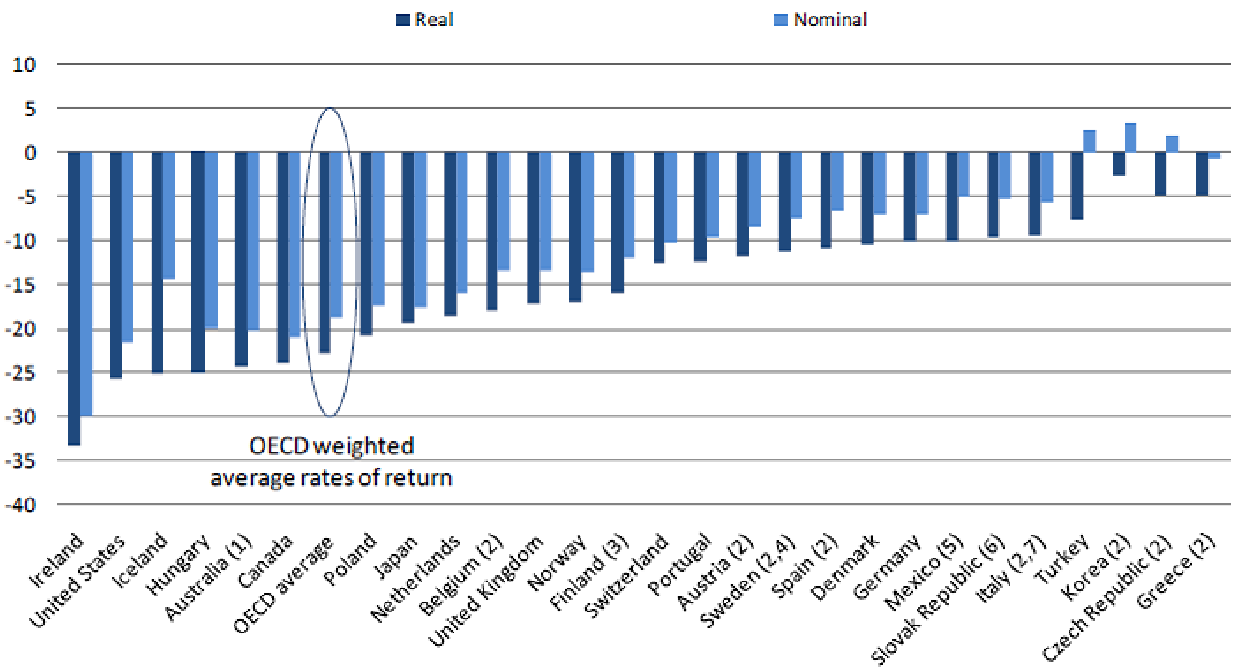
[1] As of mid-November 2008. [2] Includes bond issuance, interbank lending and other wholesale liabilities. Coverage of the guarantee on these items varies across countries. [3] Refers to announced programmes only (excluding standalone actions).

Source: BIS.

Table: **Elements of banking system rescue plans in developed and some developing economies. Source: BIS Quarterly Review, December 2008**

4.1. Deepest recession ever

The depth of the world wide crisis which took another turn for the worse in Mid-September is in most respects unprecedented and the speed by which it has spread around the world has taken many experts by surprise. Clearly the global crisis is key to understanding the situation which unfolded in Iceland in late September and early October and to explaining the events which eventually lead to the drastic government action in the week of October 6. The actions of all participants in these events also must be viewed in this light.



Graph: Nominal and real pension fund returns in selected OECD countries Jan.-Oct. 2008

The seriousness of the world wide crisis is for example evidenced by the actions taken by governments and central banks in support of financial systems; in Mid-February it was estimated that governments had used over USD 1 trillion (tn) to recapitalize banks, while bond guarantees extended by governments and central banks were approaching USD 7 tn. To put this into perspective the GDP of the UK is approximately USD 2 bn. Accordingly, a wast number of prominent and less prominent banks and financial institutions both in the US and Europe have been in the need of an outright rescue to prevent these institutions from failing. As these financial woes have deepened, share prices of banks around the world have plummeted. This has led to significant losses in the value of money market funds and pension funds around the world.

Due to the massive commitments that central banks and governments are taking on as a consequence of the financial crisis, CDS spreads on sovereign debt has soared, not to mention the CDS spreads on financial institutions and corporates in general. All of these issues need to be mentioned and analyzed to understand the context in which the events in Iceland took place.

4.2. Merger ideas floated with the government

On September 25 or September 26 Landsbanki's management learned that Glitnir had asked for the assistance of the Central Bank of Iceland, to meet a sudden demand for additional liquidity. It had been well known up to this point that Glitnir had to meet several significant payments for maturing long term debt in the Fall, notably a USD 750 m repayment on October 15. In view of the maturity profile and the worsening liquidity crisis world-wide, Glitnir's liquidity crunch was therefore not entirely unexpected although the sudden urgency of the matter almost three weeks prior to the payment deadline had not been evident from publicly available information. Glitnir apparently had been hit worse by the fall of Lehman than anybody expected and this took Landsbanki's management by surprise. It turned out that not only did this affect Glitnir indirectly, but also directly as Lehman had been working with them on several projects in order to create liquidity out of illiquid assets.

As the Central Bank seemed to be reluctant to accept Glitnir's offer of collateral for a foreign denominated repo loan, Landsbanki made two separate offers to the Prime Minister and Central Bank to merge Landsbanki, Straumur and Glitnir with an equity injection and significant stake by the government.

The goal for a potential merger was to create a stronger banking institution which would have been roughly equal to Kaupthing in size, and would have created cost synergies and achieved further economics of scale. This would have preserved and increased financial stability in Iceland. Increased efficiency combined with financial strength would have created the proper basis for additional restructuring, asset sell-off and refinancing.

Landsbanki also stressed to the government and central bank that a systematic problem had emerged and the best way to combat this problem would be to merge two of the three major banks in order to create a stronger entity, combined with a significant equity injection in order to provide sustainable financing and strengthen the bank's competitive situation with respect to foreign deposits, including the Icesave accounts. With this action, potential problems with Glitnir's liquidity position could be avoided, and thus the collateral damage that could ensue from any problems that could befall Glitnir. A transfer of assets and liabilities to match in the UK operation would also have facilitated the merger of Landsbanki's and Glitnir's into Heritable, and hence the transfer of Icesave into the UK jurisdiction.

4.2.1. First proposal for merger with Glitnir

At about 3 PM on Sunday September 28 Landsbanki sent the first offer by letter to the PM and Central Bank governors. This offer would have given the government a 19% stake in the combined bank, after an ISK 100 bn. capital injection into Glitnir, which would subsequently have merged with the combined entity of Landsbanki and Straumur. The merged bank would have operated under the Landsbanki name. Glitnir's shareholders would have held 18% share in the merged bank, Landsbanki's shareholders a 40% share and Straumur's shareholders a 23% share. The valuation of Glitnir in this merger would have been ISK 229 bn. and Landsbanki (combined with Straumur) ISK 390 bn.

Furthermore, according to this plan, the Central Bank would have opened a temporary EUR 2–3 bn. facility for Landsbanki to meet Glitnir's liquidity requirements. In order to finance the repayment of this facility, the government would have accepted a large loan portfolio from the combined bank as collateral for a loan which would have been used to repay the Central Bank.

According to the offer the bank would have made best efforts to sell assets in order to shrink the merged bank's balance sheet. Ongoing merger talks between Glitnir and Byr savings and loans would have been subsumed by Landsbanki.

At around 6 PM on September 28 the idea proposed by Landsbanki was turned down during a telephone conversation with representatives from the Central Bank.

4.2.2. Second merger proposal floated

On Sunday evening, at around 8 PM, after having learned that the first merger proposal was rejected, Landsbanki presented a second set of ideas for a potential merger with Glitnir to the PM and governor. According to this idea the equity injection needed from the government was ISK 200 bn. This would have increased the government's effective stake in Glitnir to 100%. After a merger with Landsbanki and Straumur, the government would have held a 40% stake in the combined bank, while Glitnir's shareholders would have held zero. Landsbanki's shareholders would have held 40% and Straumur's shareholders the remaining 20%.

Other terms in the proposal were similar, with the additional caveat that Landsbanki would subsidiarize the Icesave deposit accounts in the UK as soon as possible, which would have ensured that these accounts were covered by the British deposit insurance scheme. Landsbanki would also make best efforts to assist the government in selling its share in the bank to foreign investors within 12 – 24 months; potential synergies realized through the merger should lead to a good return on the government's investment.

The second proposal also assumed that the Central Bank would open a temporary ISK 300 – 450 bn. facility for Landsbanki to facilitate the repayment of maturing loans by Glitnir.

No further discussions were held with the PM or Central Bank governor on the basis of this proposal.

4.3. The government acquires significant stake in Glitnir

On the morning of Monday September 29 the government announced that it had decided to acquire a 75% stake in Glitnir. Landsbanki's attempts to convince the government that a merger between Glitnir and Landsbanki with a minority stake held by the state were therefore to no avail.

The government's announcement was met very negatively by market participants in general and the three major ratings agencies cut ratings both for the sovereign and the major banks.

There main reason for this strong reaction was quite predictable: Glitnir's liquidity position was still weak and in spite of the equity injection the bank would have to write off a considerable amount of equity as a large amount of loans to holding companies which had exposure to Glitnir would have to be impaired. The government's equity injection might in fact not match the loss realized in equity from loan impairments.

At noon on September 29 the board of Landsbanki met to discuss the situation. The bank's assessment was that the massive write-off of Glitnir shares held as collateral for loans by Landsbanki would have a significant negative impact on the bank.

This approach was perhaps misguided or at least unconventional. The nationalization of Glitnir was contrary to the methods practiced by most governments, where the bank in question first received adequate liquidity support and an agreement on a debt guarantee was attempted only if liquidity support was not adequate to remedy the situation. Banks in need of liquidity support are usually given an injection of equity. If equity support is deemed necessary, hybrid instruments are first applied and a direct injection of equity avoided in order not to set the stage for an explicit government guarantee, where all outstanding obligations of the institution in effect become a responsibility of the treasury.

The recent interventions by the Danish and Irish governments are good examples of this practice. The equity support offered by the Danish government is always in the form of hybrid instruments. The attempt by the Irish government to recapitalize Allied Irish Banks and the Bank of Ireland are also based on hybrid instruments.

4.4. Landsbanki's presentation to the Prime Minister

Late on Monday evening, Landsbanki's representatives gave a slide presentation to the Prime Minister, where Landsbanki reiterated its view that a merger between Landsbanki and Glitnir would be the best method to strengthen the banking system and international bond financing. Given the current situation the government would have to secure a considerable additional injection of liquidity and equity for Glitnir. The underlying systematic risk would however still be in place.

4.5. Meetings with Pension Funds and Kaupthing

On Tuesday September 30 Landsbanki's management met with management of the largest pension funds to discuss the effects of the Glitnir takeover on the major banks. The pension fund representatives queried about rumors regarding Landsbanki's situation and whether the bank could be taken over by the government as soon as the next weekend. These questions took Landsbanki's management by surprise.

On Thursday Landsbanki's management met again with representatives from the large pension funds in order to discuss a plan of action which would be completed the following weekend. This plan called for the pension funds to assist in increasing liquidity in foreign currency, by repatriating foreign assets. Labor unions and trade associations would be included in the joint action plan and urged to reach an accord on wage increases in order to curb inflation.

It was the view of Landsbanki's representatives following these meetings that the pension funds large interests in Kaupthing were no small influence on their view towards potential cooperation between these parties and proposals for policy initiatives.

Following the meetings with the pension funds, Landsbanki also met with the management of Kaupthing to discuss potential measures to avert the deepening of the banking crisis. At this meeting the idea that Landsbanki and Kaupthing would jointly take over the assets of Glitnir was floated for the first time.

On the same day Landsbanki's CEOs also met with representatives from the Confederation of Icelandic Employers (Samtok Atvinnulifisins) and the Icelandic Confederation of Labor (ASI) about a joint plan of action to be discussed the following weekend. It was the common view of these parties that wide-ranging measures would need to be taken in order to counter the negative effects from the Glitnir takeover by the government and in order to reestablish trust in the Icelandic financial system. The board of the Confederation of Employers met again on Friday October 3 in order to prepare at the government's request proposals for discussions to be held over the weekend. Mr. Kristjansson represented the Icelandic Financial Services Association at the board meeting. All parties present were determined to use the time over the weekend to prepare a plan for decisive action in preparation for the market opening on Monday October 6.

4.6. Sale of Landsbanki's investment banking arm

Landsbanki's management realized that the bank would suffer a considerable loss from the de facto nationalization of Glitnir which was about to be carried out. The bank could meet this loss by a quick sell-off of three foreign subsidiaries. On Wednesday October 1 Landsbanki thus announced that on the previous day an agreement had been signed with Straumur Burdaras Investment bank on Straumur's acquisition of Landsbanki's investment bank subsidiaries in Europe. Landsbanki's board had already approved the transaction. The acquisition was valued at EUR 380 m. and would strengthen Landsbanki's equity ratios considerably.

On October 10, a few days after FME had assumed the power of Landsbanki's shareholder meeting and UK authorities had taken steps to freeze Landsbanki's assets in the UK, it became clear that the agreement had to be cancelled.

4.7. Harsh reaction by ratings agencies and the market

Both Standard & Poor's, Fitch Ratings and R&I lowered the sovereign's debt ratings on September 29, with negative outlook. Standard & Poor's for one said in its announcement that the government's action validated the ratings agency's concerns over the financial system's large foreign debt and the contingent claims on the Icelandic treasury. Fitch ratings also lowered the bank's ratings by two to three notches, based on a deteriorating business environment which was unlikely to improve in the near term. Fitch also reached the conclusion that the government would have a difficult time selling its stake in Glitnir, the financial system was already under a great deal of stress and the state might have to provide a significant amount of liquidity based on the how the market was developing.

The Icelandic stock market also took a dive, partially because the value of companies directly exposed to Glitnir fell drastically. The OMX15 stock market index fell by 16,6% on September 30 which was its largest decrease to date. By the end of the week the stock market index had lost 50% from January 1st. The ISK index depreciated by 12,6% during the week and had by then lost 42% from the beginning of the year. CDS spreads continued to spike and on October 3 CDS spreads for Landsbanki had reached 2825 bp.

4.8. Negative developments following the nationalization of Glitnir

Immediately after the proposed Glitnir takeover, ratings for sovereign and bank debt were downgraded by the major ratings agencies. Another significant effect was a steep depreciation of the krona, which fell by 13% against the EUR from Friday September 26 to market close on Friday October 3.

Because of the effect of the ratings downgrade and krona depreciation, krona denominated government bonds which had been 'repoed' with the ECB are now subject to significantly greater restrictions. Late on Friday October 3 the European Central Bank announced to Landsbanki that instead of being able to repo an additional EUR 400 m. in bonds on October 6 Landsbanki would be required to reduce its repo with the ECB by EUR 400 m. creating an effective margin call. The effect on Landsbanki from these changes was therefore EUR 800 m. and this would put a significant pressure on Landsbanki's liquidity at a difficult time.

The bank had already seen some outflow from Icesave accounts following the announcement about Glitnir, as would have been expected. From the announcement on September 28 until Friday October 5 the total balance on Icesave accounts fell from GBP 4.7 bn. to GBP 4.2 bn. The outflow from Icesave in Holland was much smaller, or around EUR 27 m. as the news did not appear to have the same impact there as in the UK. More significantly however several other actions, including reduction in wholesale deposits and general liquidity lines led to liquidity problems for the bank, more swiftly than was ever envisaged.

After close of markets on Friday October 3 the UK FSA sent a letter to Landsbanki where new demands were made for collateral, i.e. Landsbanki was required to deposit GPB 400 m. with the Bank of England, and furthermore the FSA demanded a freeze on Icesave deposits which would have put additional stress on Landsbanki's liquidity. This came as a surprise to Landsbanki, as it had the day before transferred, at the request of the FSA, GBP 200 m. from its account with the Central Bank of Iceland to Barclay's in preparation for possible outflows from Icesave over the weekend. At the close of markets Friday October 3, at the end of the most difficult week that Landsbanki had ever experienced with respect to liquidity, after the Glitnir nationalization and the global effect of the fall of Lehman, creating extremely difficult situation on the interbank market, Landsbanki thus found itself in the difficult situation of having to meet additional demands on its liquidity due actions by British authorities and the ECB, consisting of EUR 800 m. and GBP 400 m. or roughly EUR 1.3 bn. equivalent.

4.9. Attempts to find a comprehensive solution over the October 4/5 weekend

The events of September 29 and the subsequent reaction by ratings agencies, the stock market and the foreign exchange market had already roiled politicians, financeers and the general public. As the week drew to a close it became apparent that the government was preparing to hold emergency talks on a wide range of issues in order to explore all options to strengthen the financial system. Labor associations, industry associations, pension funds, independent economic advisors and bankers were among those who were asked to join the talks which were held at the Prime Ministers official residence in Tjarnargata.

On Sunday October 5 Landsbanki's management board sent the Central Bank and FME a memorandum which described a drastic change in the bank's position in the few days which had passed since the Glitnir announcement. The memo also listed some of the major initiatives which could help the bank in its current circumstances.

At noon on Sunday the bank's CEOs held a meeting with the board of governors of the Central Bank, where Landsbanki's CEOs described the problems faced by the bank. Directly after this meeting key government ministers were briefed on the same issues. At the meeting with the government ministers Landsbanki also presented a proposal whereby the government would sponsor new legislation giving the Depositors Insurance Fund powers to seize assets from depositor institutions which were in or close to insolvency. The fund would then have the power to assume responsibility for depositor's claims and an equivalent amount of assets to cover these claims, for deposit banks registered in Iceland which were on the verge of insolvency. This authority would be similar to the authority vested in the FDIC in the US which had recently been used to insure depositors during the bankruptcy of Washington Mutual.

4.9.1. The major banks float joint proposals

Based on brief discussions on Sunday afternoon, Landsbanki and Kaupthing float a joint proposal with government representatives. According to this proposal Kaupthing would assume all of Glitnir's domestic deposits and assets, but would then sell some of these assets to Landsbanki. Based on this exchange both bank's equity position would be solid. In addition the government would sponsor a liquidity facility of EUR 500 m. for Kaupthing and

EUR 1,000 m. for Landsbanki. Kaupthing's representatives had suggested to Landsbanki that the two parties would make this proposal jointly to the authorities, as they believed that a joint proposal of this sort would be received favorably.

The proposal was discussed in a meeting with the Prime Minister and other key ministers (treasury, industry and business) in a meeting around 6 pm on Sunday evening. Landsbanki's CEOs indicated that their participation was contingent on reaching an agreement later that evening with UK authorities on the issue of additional liquidity reserves. Representatives from Landsbanki and Kaupthing continued these discussions immediately following the meeting with government officials.

At around 8 pm on Sunday night Landsbanki got word from the ECB that the margin call which was to come into effect on Monday morning would be postponed for the time being. Furthermore, the FSA lowered its demand for additional collateral from GBP 400 m. to GBP 200 m. Therefore Landsbanki's need for additional liquidity was not as large as had been described in the meeting with government ministers at 6 pm. The need was closer to EUR 500 m. than the EUR 1,000 m. previously mentioned.

4.9.2. Discussions with the FSA

At 8 pm on Sunday night Landsbanki's CEOs held a teleconference with Hector Sants, director of the UK FSA, and his staff about the FSA's request for an additional GBP 200 m. payment into an account at Barclay's bank or the Bank of England to meet potential further outflows from Icesave accounts. The teleconference was another event in a series of discussions which had taken place between Landsbanki and the FSA on the similar topics in the days and weeks leading up to this weekend.

During the teleconference between Landsbanki and FSA, Mr. Sants made a new offer to Landsbanki, under which the bank would be given a 'fast-track' solution in order to shift Icesave deposits from the London Branch into a proper subsidiary of Landsbanki. The transfer could take place quite rapidly, within the business week. The bank would however also have to transfer assets to the subsidiary in order to create a balance between assets and liabilities in the new company.

Landsbanki was aware that the FSA and FME had also held a teleconference earlier on Sunday afternoon. Following this meeting the FME had briefed Landsbanki that the British authorities might now be open to discussing a fast-track solution and the FME representatives had in fact urged Landsbanki's management to push for this solution during its teleconference with the FSA. Landsbanki does however not have any information about the topic of discussion between the FSA and the FME, or between other authorities of the two states or the reason for written communications, such as the letter issued on Sunday October 5 by the permanent secretary of the Ministry of Commerce to the UK Treasury, stating that Icelandic authorities would honor their obligations regarding deposit insurance for foreign accounts of Icelandic banks.

Landsbanki explained to the FSA representatives that a merger between a part of Glitnir and Landsbanki had been discussed earlier, which would give Landsbanki additional assets in order to meet demands for a transfer of assets into the new subsidiary without breaking loan covenants.

Following the teleconference with Mr. Sants, Landsbanki gave the Central Bank an update about the proposed 'fast-track' solution and new ideas presented during the FSA teleconference regarding asset transfer to the proposed subsidiary.

Following the teleconference Landsbanki's CEOs met at the Tjarnargata residence with the Chairman of the Board of FME and the Special Economic Advisor to the Prime Minister and briefed them on the discussions with Hector Sants, in particular his offer of a fast-track solution for subsidiarizing the UK Icesave accounts, by which the UK Deposit Insurance scheme would have guaranteed all deposits in these accounts. Landsbanki's CEOs stressed that FSA's had provided an new opening which might facilitate greatly reaching an agreement.

The Special Political Advisor to the Minister for Business Affairs was also briefed on the same matters and he stated that these latest developments regarding Icesave and the fast-track solution were so favorable that the minister was strongly considering briefing the media on the matter. Mr. Kristjansson however urged the advisor to hold of on any public announcements pending approval by the UK authorities.

The CEOs also requested a meeting with the Prime Minister and the Minister for Business Affairs, which had been leading the discussions this weekend on behalf of the minority party in the government coalition. A meeting was thus planned with the Prime Minister at around 10 pm on Sunday evening, but the Prime Minister did not see fit to meet with Landsbanki at this point. The Prime Minister left the Tjarnargata residence shortly before midnight after giving a brief statement to the press in which he said that an agreement had been reached with the major banks to decrease their foreign holdings, that tensions were lower than before the weekend and that it was his conclusion after talks over the weekend that major government action was not needed at this point. He indicated that a formal announcement on government action regarding the crisis was therefore no to be expected before markets opened on Monday morning.

At around midnight Landsbanki's CEO reached the Prime Minister by phone and described that the following morning could prove very fateful for the bank, unless the Central Bank would agree to lend the bank GBP 200 m. against over EUR 2.8 bn. in collateral which had been offered earlier. If the loan facility would not be granted the bank could probably not prevent additional outflows from Icesave.

From the various discussions that took place with government representatives, i.e. from the Central Bank, FME, office of the Prime Minister and the Ministry of Business and Commerce on Sunday night, it should be clear that the proposed fast-track solution offered by the FSA during the 8 pm teleconference was well known at the highest levels of government.

We would also like to draw attention to the letter sent by the Ministry of Business and Commerce on Sunday October 5, following discussion between authorities from the UK and Iceland, regarding depositors insurance. This letter clearly states that the Icelandic government is prepared to back the Icelandic Depositors Guarantee Fund with respect to the guarantee on deposits with Icelandic banks in the UK.

At 1:45 am on Monday morning Mr. Oddleifsson sent an e-mail to Michael Ainly of the FSA, according to the FSA's whishes, stating that the bank is aware that a transfer of GBP 200 m. in favor of LILB is required the following morning and that a further transfer of GBP 53 m. is needed by end of business in favor of Heritable bank. "We have been working on arrangements, including a repo transaction with the Central Bank and have submitted to them our pool of assets for those purposes. We understand that the Central Bank will deal with this tomorrow. As soon as the repo transaction has been completed we will transfer the required funds as discussed. I trust this meets the requirements discussed earlier tonight with you and Mr. Hector Sants."

Early on Monday October 6 and again around noon the same day, Landsbanki sent another letter to the Board of Governors of the Central Bank reiterating its request for a repurchase agreement in order to meet the required payment of GBP 200 m. to the BoE. The request was formally rejected at a meeting with the Central Bank governors late in the afternoon.

The bank was owed approximately EUR 600 m. in foreign currency by pensions funds in the form of currency swaps which the bank attempted to settled, to no avail. These funds would have been very helpful in achieving the fast-track solution. It appears also that bilateral discussions with other central banks and governments were uncoordinated during this period.

At 4 pm on Monday the Prime Minister addressed the public on the state television channel where he stated that the government was preparing to introduce an emergency law in parliament. The Prime Minister said:

> "This weekend we held near continuous meetings about the state of the financial system. I can assert that everyone who participated in these discussions was adamant to find solutions in order to insure that banks and other financial institutions could continue operating today and based on what was achieved this weekend we fully expected that the banks would be able to continue to operate for the time being. Because of this I stated last night that it was my assessment and that of my government that there was no need for special actions on our behalf at this time. No responsible government would introduce drastic action regarding the national banking and financial system unless all other avenues were already closed.
>
> The situation has now taken a turn for the worse. Large lending facilities to the banks have been curtailed and this morning the stock exchange halted all trading in bank shares.
>
> It is now vital to act responsibly and without hesitation. I will later today introduce a bill in parliament which will allow the treasury to react to the situation now at hand in

> the financial markets. I have discussed this with opposition leaders today and they have given me a good indication that the bill will be able to pass today. I am grateful to them for their cooperation in this regard.
>
> Through these changes in our laws we will be able to better adjust the banking system to Icelandic situations and rebuild the confidence and trust that foreign parties have in the operation of banks and financial institutions in Iceland. If the bill is passed into law today it is to be expected that the authority so granted becomes active immediately."

The bill was passed into law shortly before midnight on Monday as Act 125/2008. Based on this law the management board and the board of Landsbanki agreed to make a formal request to the FME based on paragraph 5 of the law, by which a specially appointed receiver committee would replace the bank's board and take necessary action.

At around 8:30 pm the bank's board met to discuss the situation regarding the mandatory GBP 200 m. transfer to the BoE which the bank could not meet and the impending emergency law. The Central Bank had declined the bank's request for a EUR 500 m. repurchase agreement based on collateral in bonds valued at EUR 2.8 bn. At the board meeting two motions were introduced and passed, on one hand to initiate discussions with the FME in order to put Landsbanki into receivership and on the other hand to initiate discussions with chairman and CEO of Glitnir on a possible merger.

During the last few days before submitting the bank for receivership under the new law, Landsbanki's management had attempted to execute measures to provide additional time to deal with the liquidity issues, such as to effect the sale of Heritable bank as a going concern and invoke a clause in the Icesave customer agreements to trigger a 60 day halt in payments in order to conserve funds.

4.10. Landsbanki enters into receivership

On October 7 2008 the FME took control of Landsbanki and appointed a receivership committee. The management board wrote a memorandum to the committee dated October 8 where matters regarding the bank are explained in some detail. On the same day British authorities took control of Heritable bank as well as Landsbanki London Branch, freezing all of Landsbanki's assets in the UK under authority granted by the UK terrorism act. The assets frozen were not only Landsbanki's assets, but also assets which were under the control of our in custody of the Central Bank, the FME, Landsbanki's receivership committee and the government of Iceland.

Following the UK governments action under the terrorism act, Landsbanki was placed on the Treasury's list of current regimes subject to financial sanctions, which included Al Qaida, the Taliban and North Korea. These actions by the British government, which are without parallel, were destined to cause incredible damage to the interests of Landsbanki in the UK. A sale of Heritable bank as a going concern was thus prevented and damages to Landsbanki from this act alone are estimated at GBP 200 – 250 m. In addition the operations of Landsbanki London Branch suffered irreversible damage as well as the collateral damage suffered by institutions which were doing business with Landsbanki. As a whole these actions by the British government came as a shock and total surprise to Landsbanki's management which was acting under the assumption that solutions to problems regarding the bank were being sought by all parties in an amicable manner.

The British law which was enforced in order to freeze Landsbanki's assets states that it can only be used if there is reason to believe that acts have been committed or are about to be committed which may cause significant damage to Britain's economy. There is serious doubt about the legality of the British authorities' actions and there is reason to believe that they may have stepped outside legal bounds when these powers were used to move against

Landsbanki's interests in the UK. It is for example obvious that Landsbanki's assets in the UK only amounted to 0.5% of total deposits in the UK, i.e. GBP 4 bn. of more than GBP 800 bn. in total deposits and as such could not be considered as vital to Britain's economic stability. These actions are even less understandable in light of the letter issued by the Ministry of Business affairs on October 5, regarding the governments backing of the Depositors' Insurance Fund.

Furthermore Landsbanki was not planning to move any assets offshore from the UK, nor could any transfers by the bank have reached the magnitude that they could endanger the stability of the UK financial system. In fact Landsbanki had prior to the fateful weekend transferred considerable assets to the London Branch and members of government were well aware that Landsbanki was doing its utmost to raise the GBP 200 m. necessary in order to meet outflows from Icesave accounts.

4.11. Media reports and official letter to the British authorities

Because of discussion in the UK media which was based on reports that a transfer of assets had taken place between the UK subsidiary and parent of an Icelandic bank immediately before Landsbanki entered into receivership, the bank issued a statement on October 10 to the effect that no such transfers had taken place from the UK. In fact on the contrary the bank had transferred funds into UK prior to the events of October 7.

Statements made by British government officials and discussions about possible acts by Landsbanki thus had no basis in fact. It now appears that the statements made by the British government were in fact prompted by actions taken by Kaupthing, as the Central Bank issued a statement on October 27 which shows that there was a direct link between transfers made by Kaupthing during the week of September 29 and the loan granted by the Central Bank of Iceland on October 6. The Central Bank's statement said: "It had also been decided based on consultation with the Prime Minister to lend EUR 500 m. to Kaupthing for a few days in order to assist the bank in meeting the demands of the FSA and other British authorities due to the situation of the bank's subsidiary in London."

The letter issued by the Ministry of Business Affairs to the British Treasury Department on October 5 defines the amount guaranteed by the Depositor's Insurance Fund with respect to Icesave deposits. The letter lends further credence to the statement that the government had made a promise to British authorities to insure deposits on Icesave accounts in the UK. Landsbanki made further statements regarding the discussion about international deposits on October 14.

5. History of Icesave and plans for subsidiarization

Operations of Landsbanki London Branch (LILB) were started in early 2005. The bank's business model in the UK (and globally) was based on the understanding that a Global Liquidity Concession (GLC) issued by the UK Financial Services Authority (FSA) on February 13 2007 would stay in force until January 5 2011 as granted. By this concession the FSA agreed to waive rule 1.2.2R (1) of the FSA's General Prudential Source Book (GENPRU) and rule 11.1.1R (3) of the FSA's Senior Management Arrangements, Systems and Controls (SYSC).

In March 2008 the FSA initiated discussion with Landsbanki focused on liquidity management within the Landsbanki Group and its branch in London and the removal of the GLC. Through lengthy discussions, explained in more detail below, an agreement was reached under which Landsbanki issued a letter to the FSA on May 27 requesting the formal withdrawal of the GLC and start working according to the UK liquidity rules.

On May 29 2008 an agreement was reached between the bank and the FSA establishing a basis for whole bank monitoring of group liquidity, by which the FSA rules on liquidity management were effectively extended to the whole bank. Under this regime Landsbanki was required to deposit 5% of the wholebank GBP denominated instant access deposits into an account with the Bank of England (BoE) although the FSA later agreed to have the reserve deposited in GBP with the Central Bank of Iceland (CBI).

5.1. Icesave and the decision to operate through London branch

In late 2005 and early 2006, Landsbanki started developing blueprints for the Icesave Internet accounts. The main reason for this initiative was to add a new stable funding pillar for the bank, given shifting sentiment in Europe towards the Icelandic banks. In particular reports issued by ratings agencies and bond analysts in early 2006 shifted the focus to concerns about the Icelandic banks' reliance on wholesale funding for growth and diversification. Ratings agencies in particular started emphasizing the need for an increase in deposit based funding as a percentage of lending vis-a-vis wholesale funding and a more balanced approach to funding from more diverse sources.

On the point of international deposit taking Mr. Fridriksson, ex-director of the CBI, remarked: "Because they took this action, the Icelandic banks were perhaps better prepared than they would otherwise have been for the sudden changes that took place in the global financial markets in mid-2007."[11]

The launch of Icesave took place in October 2006. Prior to the launch, the decision was made to operate the accounts through the London Branch office, instead of a UK subsidiary. The main reason was that a branch office method would facilitate the use of the deposits in the overall operation of the bank, i.e. upstreaming of funds for use in other parts of the group, due to the manner in which UK authorities have chosen to implement EEA regulations.

Contrary to recent statements by some commentators, Icesave was not launched because other sources of funding were lacking. In fact the market for long term issues was wide open at this time. The primary purpose of the bank's entry into international retail deposits was to diversify funding sources.

Operating the Icesave deposit accounts through a branch office however meant that deposits were insured under two different deposit insurance schemes. Approximately EUR 20,000 of each deposit account was insured under the home country insurance scheme (by the Icelandic Deposit Insurance Fund) while the difference between this amount and the GBP 35,000

[11] Ingimundur Fridriksson, 'The banking crisis in Iceland in 2008', published on the bank's website in early February 2009.

mandated by UK law were insured under the UK insurance scheme (a.k.a. a top-up). In August the UK insured amount was increased to GBP 50,000. These arrangements for the division of responsibility for deposit insurance between the Icelandic fund and its British counterpart were formally agreed upon in a contract between the two funds signed in 2006, prior to the launch of Icesave in the UK. At that time the fund management was provided by the Central Bank of Iceland.

5.2. Icesave success and stress test in periods of difficulty

From early on, Icesave met with great success in the UK market. By Mid-January 2007 the amount deposited in Icesave accounts had reached GBP 1 bn. and in the first half of the year deposits grew by GBP 500 m on average per month. After the introduction of fixed term accounts in October 2007 an increasing amount of deposits were fixed for one year or more, which had a stabilizing effect on the total amount of deposits. By the end of 2007 10% of Icesave deposits were fixed term, but this proportion was to grow rapidly in the new year. In January 2008 the bank introduced fixed term ISA accounts which provide certain tax benefits; these accounts soon became a highly popular product and provided additional stability to the deposit base.

In August 2007 Northern Rock suffered a bank run, becoming the first British bank in 141 years to suffer this fate. The bank was subsequently nationalized by the UK government, a highly irregular view without precedent in recent banking history. This put other banks which were thought to be vulnerable in the spotlight, including the Icelandic banks. The Northern Rock episode however did not result in a substantial outflow of funds from the Icesave accounts as only GBP 100 – 200 m were withdrawn, followed by a fairly swift correction as funds started flowing in again.

In early 2008 the amount of bad press about Icelandic banks in the UK media started increasing. CDS spreads on Icelandic bank debt also started soaring, potentially due to an attack by short sellers on the Icelandic system during this period. During Q1, from January 1 to April 1, CDS spreads on Landsbanki debt, as reported by Markit, thus went from 133 bp. to 799 bp., while CDS spreads for Kaupthing bonds went from 292 bp. to 986 bp. The global financial system was also under increased stress at this time, culminating in the liquidity crisis and takeover of Bear Stearns in late March. The Icelandic krona had also started weakening around the middle of January and progressive and accelerated weakening started taking place as Q1 drew to a close.

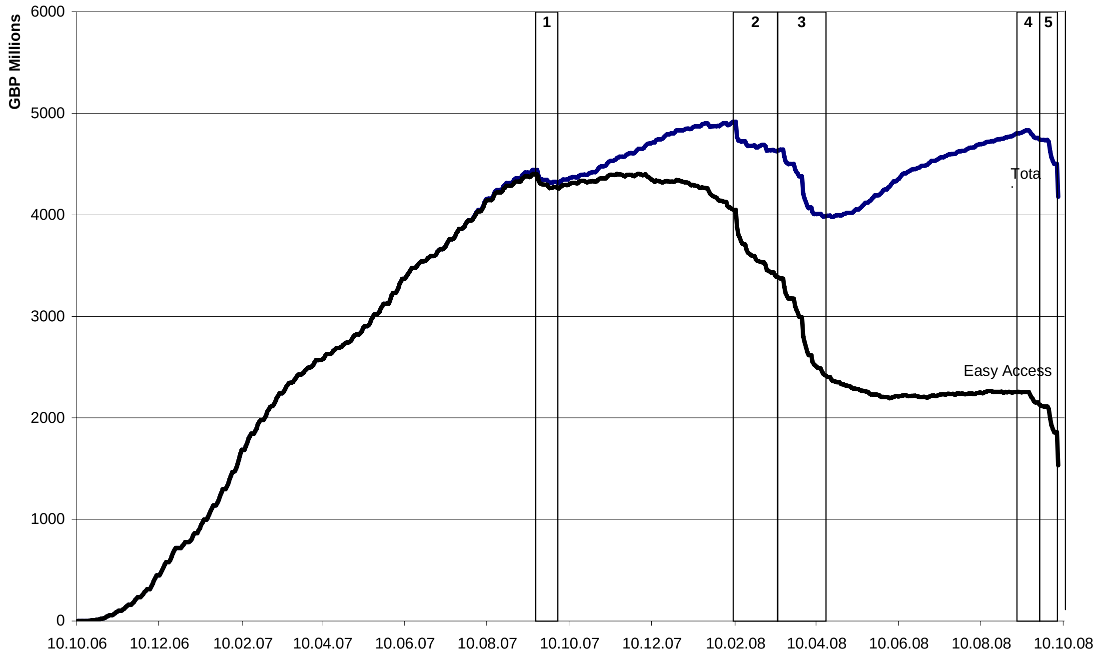
These developments, combined with general pessimism about the domestic economic outlook drew the attention of the foreign press, in particular in the UK. As a result of the bad press and general financial turmoil, Icesave experienced a mild form of a bank run during which the net outflow of funds amounted to nearly GBP 1 bn. (20%), taking the total amount of deposits down from GBP 4.9 bn. on February 10 to GBP 4.0 bn. on April 22. During this period the percentage of fixed term deposits shifted from being 17% of total deposits to 41%.

Following this episode matters calmed down and deposits into Icesave started rising again. The ratio of fixed term accounts was also rising markedly during this period, further stabilizing the amount of deposits. By July 2 the total amount of deposits had reached GBP 4.5 bn., and the deposits peaked again on September 14 at GBP 4.8 bn., when fixed term deposits were over 53% of the total amount deposited.

	Dates	Total deposits	Net inflows			New accounts, daily ave.
			Total	Easy Access	Term deposits	
	11.10 - 31.12.06	774.528.209	774.528.209	774.528.209	0	404
	31.12 - 13.09.07	4.443.446.260	3.668.918.051	3.627.009.841	41.908.210	287
1	13.09 - 02.10.07	4.312.644.741	-130.801.519	-141.802.306	11.000.787	122
	02.10 - 10.02.08	4.917.163.282	604.518.541	-210.968.320	746.320.847	411

	11.02 -14.02.08	4.721.039.470	-196.123.812	-313.148.426	117.024.614	1293
2	14.02 -16.03.08	4.640.701.150	-80.338.320	-343.071.598	262.733.278	849
3	17.03 - 22.04.08	4.045.057.463	-595.643.687	-922.849.118	327.205.431	646
	22.04 -14.09.08	4.891.393.894	846.336.431	-105.142.072	951.478.503	783
4	15.09 - 28.09.08	4.809.035.384	-82.358.510	-120.253.720	37.895.210	147
5	29.09 - 06.10.08	4.264.816.760	-544.218.624	-556.737.084	12.518.460	772

Table: Episodes in the development of Icesave deposit accounts 11.10.06 – 06.10.08. Numbers in first column refer to periods highlighted in Graph 1.



Graph: Total balance in Icesave deposit accounts 11.10.06 – 06.10.08. Numbered periods refer to periods defined in the previous table.

5.3. Discussion about the withdrawal of the GLC

As indicated before, in Mid-March the FSA requested discussions with Landsbanki on withdrawal of the GLC waiver. The reasons for this were FSA concerns regarding the rapid growth of retail deposits in the Icesave accounts, as Landsbanki had been primarily engaged in wholesale deposit gathering when the terms of the GLC waiver were negotiated. Landsbanki had also earlier indicated its intention to move the deposits into a UK subsidiary of the bank. Discussions centered in particular on reserve requirements and the 'stress test scenarios', i.e. the amount of outflows of deposits of varying maturity that the bank should reasonably be able to meet. The bank always met these requirements from the signing of the agreement and onwards, although a significant grace period had in fact been granted.

5.3.1. Discussions initiated on subsidiarization

During the phase of discussions which were initiated in March and culminated at the end of May, Landsbanki also proposed a plan for transferring all Icesave deposits from the London Branch into a subsidiary (a.k.a. subsidiarization).

In the initial proposal, submitted to the FSA on April 4 2008, Landsbanki suggested transferring assets and Icesave deposits from LILB to Heritable Bank, the London based subsidiary of Landsbanki. It was envisioned that this transfer would be carried out under section VII of the Financial Services and Markets Act (FSMA). It was argued that this could constitute the most viable approach to the problem as it would entail the least amount of disruption for the regular operations of the deposit accounts, the branch and the group as a whole. As a consequence Heritable would, in stages, transform into a UK financial institution with assets of GBP 5.5 bn. and deposits of GBP 5.0 bn.

Following the May 29 agreement, the operation progressed as expected under the agreement. Weekly reports were submitted confirming that the bank complied with all requirements; however on July 8 the FSA initiated a new line of discussion with Landsbanki, in order to set a timetable for the subsidiarization of the Icesave deposit accounts. The FSA however also announced its intent to set strict limits on the growth of the Icesave book and to restrict the marketing of the Icesave products, in particular to ensure that rates on Icesave Instant Access accounts would not appear in the so-called 'Best Buy' tables, which are prominently featured in many UK newspapers and play a significant role in determining consumer behavior. Furthermore, the FSA requested additional clarity about the Icelandic compensation agreement, due to growing concerns about the Icelandic government's ability to support the deposit insurance fund in a time of crisis.

5.3.2. UK FSA introduces additional requirements

In the course of discussions between the FSA and Landsbanki over the next few weeks the regulator then introduced additional burdensome requirements and restrictions.

During this period, difficulties with the subsidiarization plan also became apparent, as the FSA was not willing to waive certain restrictions on connected lending or large exposures. Landsbanki argued that it would not be able to comply with the FSA strict limits as it would require the transfer of assets from the parent to the subsidiary in one go which would in all likelihood lead to the breach of covenants in Landsbanki's funding agreements.

In Mid-August the bank submitted a step-wise plan for the transfer of assets into a subsidiary. Under this plan Icesave deposits would be transferred to Heritable Bank by the end of 2008 and Landsbanki would strengthen the capital base of the bank by GBP 500 m. Lending operations of LILB would then be transferred into Heritable in early 2009, creating a further balance between the liabilities (i.e. Icesave deposits) and third party assets. The complete transfer of asses into Heritable would then be completed before the end of 2010, using a gradual method in order not to violate covenants in lending agreements.
During this period Landsbanki had initiated work on a detailed plan for the transfer of assets into a proposed subsidiary. The head of treasury and chief loan officer led this project, which was focused on identifying assets which would be most appropriate for the new entity and constitute a portfolio fit to be regulated by the UK authorities.

Under a version of the plan presented on September 8, in a letter to the Chief Executive of the FSA, Landsbanki proposed a pro-forma balance sheet. According to this balance sheet the total amount of assets and liabilities held by Heritable would be GBP 5.4 bn. On the liabilities side, GBP 4.8 bn. in Icesave deposits would be transferred from LILB and GBP 600 m in equity from the parent. On the asset side a loan portfolio of GBP 1.3 bn. would be transferred from LILB, and GBP 150 m would be held in reserve with the CBI or BoE, with an equal amount deposited with other financial institutions. GBP 1 bn. would be upstreamed to the parent collateralized with bonds and equities, and GBP 2.4 bn. would be upstreamed and collateralized gradually during 2009. The remainder of the assets, GBP 400 m would be lent to the parent under the 75% limit on large exposures, subject to FSA permission.

5.3.3. FSA invokes legal powers

Before the end of August however the tone of the discussion between the FSA and Landsbanki had shifted, as the regulator threatened to invoke its legal powers to enforce the mandated reduction in Icesave deposits and other measures. Landsbanki continued to argue that meeting these demands would have a profound effect on the bank as a whole and could threaten its overall liquidity. In a letter from the bank’s management board to the FSA on September 8 the joint CEOs argued that the FSA's demands had in fact exceeded the regulators authority and could constitute a breach of the fundamental rights of Landsbanki under European law.

At this stage the FSA announced that it did not accept Landsbanki’s plan for subsidiarization of the Icesave deposits due to the amount of uncollateralized exposure (GBP 2.4 bn.) which the subsidiary would have to the parent company for a significant period of time.

5.4. Last days prior to the nationalization of Glitnir bank

On September 25 the FSA sent a further notice to Landsbanki to announce that it deemed that the bank was not fulfilling its liquidity requirements and requested that the bank remedy the situation immediately. The bank did not agree with this statement as it fulfilled the conditions agreed upon on May 29. The regulator stated that it had grave concerns about shorter term risks, and believed that a run on Icesave deposits could take place at any time.

Following the governments decision on September 29 to inject equity into Glitnir and take control of a 75% share of the bank, on October 2 the FSA issued a mandate to Landsbanki for the immediate transfer (before end of business that day) of 10% of group GBP denominated instant access deposits (approximately GBP 200 m) to an account in the UK. In view of the heightened risk to the Icelandic banking system and Landsbanki in particular the FSA was also considering to take formal emergency and precautionary action pursuant to article 33 of the Banking Consolidation Directive (BCD) and section 199(6) of the FSMA. This mandate was followed by a formal First Supervisory Note on October 3, which also stated that by October 6 the amount held by Landsbanki in reserve at the BoE should be no less than 20% of GBP instant access deposits.

On October 5 the BoE formally opened an account on behalf of Landsbanki. Later that night during a teleconference between the FSA Chief Executive and Landsbanki's CEOs it was agreed that if the bank could transfer GBP 200 m into the BoE account as soon as possible the following morning and the FSA would agree to fast track the subsidiarization of the Icesave deposits according to Landsbanki's plan. Following this Landsbanki requested a repurchase agreement with the CBI in order to obtain the necessary GBP 200 m for transfer to the BoE account.

Shortly after midnight on October 6 Landsbanki thus sent a message to the FSA indicating that it was in the process of obtaining the necessary funds, potentially through a transaction with the CBI and would have them transferred as soon the central bank repo transaction was completed. A reply was sent back from the FSA in early morning on October 6 indicating that the funds were required instantly. Later that day Landsbanki was told that it had one hour to comply with the request. The bank then issued a new request for a repo transaction to the CBI by letter but was not granted access to the funds.

Later that evening the Althingi passed a bill giving the government emergency powers to seize control and assets of Icelandic financial institutions. By October 7 control of Landsbanki's assets had been formally transferred to the state.

5.5. Dutch Icesave accounts – part of a wider strategy

Since the introduction of the Icesave product in the UK market, Landsbanki planned to introduce similar savings accounts in other countries in order diversify Landsbanki's deposit base. The Dutch market was viewed as a prime candidate, given relatively weak local competition and low interest rates on savings accounts. Notably one of the pioneering Internet savings banks in Europe, ING Direct had elected not to compete in its own home market, and instead offered regular savings rates through its brick-and-mortar subsidiary, Postbank.

During the spring of 2008 Landsbanki went ahead with plans to enter the Dutch market. These preparations were completed when Landsbanki formally entered into the Dutch deposit guarantee scheme on May 23. Subsequently Dutch Icesave accounts were launched on May 29, which coincides with the signing of Landsbanki's agreement with the UK FSA. It is important to note that the agreement with the British authorities meant that Landsbanki had resolved all pending issues with the FSA.

Landsbanki's plan for the Dutch Icesave accounts was to move the accounts from the Amsterdam branch to a subsidiary as soon as possible. The Dutch loan book at the time amounted to approximately EUR 700 m and Landsbanki projected that the total amount of

Icesave deposits in the Dutch branch would reach EUR 400 – 500 by year end 2008. The product however met with considerably more success than initially projected, presumably due to a strong brand, competitive interest rates and luck of timing. By Mid-July deposits had reached EUR 500 m, and between July 15 and September 15 (which marks the date when Lehman Brothers went bankrupt) net deposits grew by EUR 174 on average per week. In the last two weeks of operation net deposits still grew by EUR 104 m and eventually Icesave deposits in the Dutch branch reached close to EUR 1,700 m. The development of Icesave in the Netherlands was part of a Pan-European strategy.

5.6. Dutch Central Bank demands a freeze

On August 12 2008 the Dutch Central Bank (DNB) requested a meeting with Landsbanki, to be held two days later. A specific purpose or agenda was not provided. During the August 14 meeting the DNB expressed its concerns about the state of the Icelandic economy and the funding of the Icelandic deposit guarantee scheme, in relation to Landsbanki's Icesave deposits. The DNB also requested that Landsbanki halt further growth of deposits in the Icesave accounts, meaning that effective immediately no new deposits should be accepted. The DNB however did not provide proper commercial reasons for this action and Landsbanki argued that without a sensible explanation to the public, this would have a wide detrimental effect.

On August 15 Allen & Overy, legal counsel retained by Landsbanki, provide a memorandum to management about potential scenarios leading to the use of legal powers by the DNB to enforce the freeze of Icesave deposits. The legal team concluded that if the Dutch branch would show that it was in compliance with applicable liquidity requirements, the DNB would not be able to enforce Landsbanki ceasing taking Icesave deposits. Furthermore the DNB would only be able to take legal action in respect of the branch if there were signs of a development which might jeopardize the liquidity of the branch. In this matter, the DNB would however be afforded a rather wide degree of discretion.

On August 19 Landsbanki sent a letter to the DNB describing the bank's liquidity policy and an overview of the Icesave customer portfolio. Deposits at that time had reached EUR 1.2 bn. Two days later the DNB submitted a number of questions regarding to the documents submitted. The DNB requested clarification a number of points relating to indicators of potential liquidity problems. The central bank also requested further information about the bank's Contingency Funding Plan (CFP) and whether it had been activated, which tactical options the bank had considered or used due to the CFP coming into effect, as well as details about liquidity stress tests and the liquidity buffer. Information on the use of repo markets was also requested, with details about the central bank facilities used in each instance and frequency of such use. Landsbanki replied to these questions within the set deadline, which was August 23.

On August 27 Landsbanki's CEOs met in Amsterdam with Mr. Nout Wellink, President of DNB. Among the ideas proposed at the meeting by Landsbanki was that the bank would increase specific liquidity in the Netherlands significantly, by diverting any growth in easy access deposits into a special account to strengthen liquidity. Other options, such as a complete freezing of deposit operations, were argued against as they would pose a significant operational and reputational risk to Landsbanki, while undermining the bank's deposit strategy across its European platform. Furthermore, the bank's plan to introduce a fixed-term deposit product in the Netherlands would be thwarted, as the bank's infrastructure requires each fixed term client to have an easy access account as well.

Landsbanki also described its plans to subsidiarize its Dutch operations, which had been previously introduced to DNB and FME. As the Dutch activities had now expanded from leveraged finance and real estate finance to a retail product and were of growing importance for the operations of Landsbanki, management believed it appropriate to perform these activities within a licensed bank in the Netherlands. A decision to proceed with the application submitted to the DNB would be made in late September 2008.

5.7. Questions about legal authority

Over the next few days Landsbanki and its legal counsel studied the question whether the DNB had any legal authority to take action against Landsbanki, in view of the fact that Landsbanki had demonstrated that the group met all Dutch Liquidity requirements with a very comfortable margin.

Allen and Overy determined that the DNB if the DNB were to invoke article 1:75(2) of the Dutch Financial Supervisions Act (FSA) it would first have to determine that Landsbanki was not acting in compliance with the FSA, in particular due to the liquidity situation as FSA requirements regarding own funds and solvency do not apply to branches. The DNB should provide an opportunity to Landsbanki to express its views, unless one of the following conditions would apply: the need for expedition precluded this, the bank had already been given an opportunity to explain its point of view or the objective of the decision could only be achieved if the party concerned had not already been notified. The lawyers however concluded that the DNB had a legitimate possibility to take such an action without giving Landsbanki the opportunity to explain its point of view, and filing an objection would not have suspensory effect.

During this period the Icelandic Financial Services Authority (FME) initiates discussions with its Dutch counterpart.

5.8. Actions of DNB following Lehman collapse

On September 18 the DNB sends an e-mail to Landsbanki, requesting information about the potential exposure of Landsbanki or its Amsterdam branch to several American and British firms that had recently been under duress (Lehman Brothers, Merrill Lynch, AIG, and HBOS). Landsbanki responds that the estimated losses due to the bankruptcy of Lehman Brothers were EUR 12.3 m – 4.4 m, based on a recovery rate in the range of 40-60%. The exposure to Merrill Lynch was EUR 42.6 m, to AIG EUR 12.5 m and to HBOS EUR 3.5 m. The bank concluded that these positions had no impact on Landsbanki's liquidity and solvency.

On October 1, two days after the government's announcement about Glitnir, the DNB replies with follow-up questions to Landsbanki. The DNB thus inquires whether the bank's conclusion about solvency and liquidity has changed in some way; whether the Lehman recovery rate can be determined with more accuracy and about the probability of losses related to the other three companies named earlier. The central bank also asks for an update on Landsbanki's liquidity and ability to raise funding, the implication of the recent S&P downgrade and whether the bank is exposed to any other financial companies which have come into trouble recently.

On October 2 Landsbanki replies to the DNB. Regarding changes in the liquidity and solvency position the bank points out that in recent days there had been minor withdrawals of deposits and a tendency by other financial institutions to firm up credit lines, with tighter intraday settlement limits, re-negotiation of CSA agreements by counterparties etc. The best source of new liquidity remains the bank's deposit schemes, as capital markets are as good as closed. Repurchase transactions with central banks are presented as another option and the bank is setting up a covered bond program. Landsbanki states that the S&P downgrade has not hit any direct triggers, although wholesale funding may be affected (presumably in the future, although this is not stated in the document).

Regarding exposures to other financial firms which have been under stress, Landsbanki names Fortis, Glitnir, Wachovia and Royal Bank of Scotland, where the situation has affected a number of customers and the continuing weakening of the ISK has put further pressure on a part of the loan portfolio. The bank also states that recent developments concerning Glitnir have impacted a limited number of customers who have pledged shares in Glitnir.

5.9. Closing of the Dutch Icesave accounts

On October 6 the DNB visits Landsbanki and freezes all deposits to Icesave. On October 7 the DNB issues an instruction and appoints a receiver to Landsbanki and its Amsterdam branch under section 1:75 (1) and (29 of the FSA. The letter from the DNB informing the CEOs about the central bank's decision states that given "the extremely serious financial economic situation in Iceland, reflected in part in the measures taken today by the authorities in Iceland and the United Kingdom, the vast amount in solicited savings that increased from EUR 1 billion to EUR 1.7 billion in six weeks, [Landsbanki's Amsterdam Branch] efforts to double this amount, it is essential from a prudential perspective...to terminate further soliciting of savings with immediate effect. The Icelandic deposit guarantee fund does not offer adequate means to sufficiently repay the savers should [Landsbanki] enter into involuntary liquidation."

The DNB instruction to Landsbanki's Amsterdam Branch were to (1) immediately terminate the soliciting of funds from retail customers and suspend all marketing activities (2) immediately transfer all amounts received from retail savers in the Netherlands to the DNB and maintain a cash reserve at the DNB of EUR 20 m plus 10% of the Icesave total, approximately EUR 170 m (3) place additional collateral as security with the DNB of an amount to be specified (4) repatriate adequate liquidity to the branch and terminate outflow of funds to accounts outside of the Netherlands. In view of the urgency the appointment of a receiver was effective immediately and the view of Landsbanki would not have any effect on the implementation of the instruction.

In a second letter sent to the Board of Directors of Landsbanki on October 7 the DNB states, after consultation with the Dutch Minister of Finance, that it has become apparent that there is a major threat that the DNB will in the future have to pay out a considerable amounts to account holders of Landsbanki's Amsterdam Branch, should the Icelandic deposit guarantee scheme not be complied with.

The letter further states: "If payment under the Dutch deposit guarantee scheme were to become applicable or DNB needs to make payment pursuant to other reasons, DNB becomes subrogated to the rights of the parties claiming payments from [Landsbanki] and these rights will be transferred to DNB...DNB hereby now and for then holds [Landsbanki] liable for any failure to comply with [Landsbanki's] obligations vis-a-vis DNB in any case those under aforementioned subrogation and transfer of rights...After all in various discussions with [Landsbanki] DNB expressed its concerns to [Landsbanki] with respect to the strong and rapid increase in deposits accepted at the Amsterdam branch of [Landsbanki]...After initial opposition [Landsbanki] also indicated that actual measures would be taken to prevent further growth. It has now become apparent that [Landsbanki] has not taken sufficient measures. Additionally, at various times [Landsbanki] demonstrably informed DNB incorrectly and incompletely on the situation that had arisen. These matters are not only wrongful vis-a-vis DNB but are furthermore in breach of the contractual obligations of [Landsbanki] under, inter alia, the Agreement with DNB of 23 May 2008. Accordingly, DNB holds [Landsbanki] liable in full (whether under the power of attorney or other representation of interest such as representation based on section 6:201 of the Dutch Civil Code or otherwise) for all damage that DNB, the customers of [Landsbanki] and/or Dutch banks suffer as a result for the actions or inactions by [Landsbanki]."

On the same day, Landsbanki's Management Board sends a reply to DNB regarding the instruction and appointment of a receiver, wherein the bank acknowledges receipt of the instructions and its intention to comply with the instructions given to it. However the bank wishes to note that it does so under protest, as it is the opinion of the bank that the interests of the creditors of the Amsterdam branch are adequately preserved by the public administration [i.e. FSA receivership] to which the bank is currently subject.

The bank notes that the purpose of the DNB receivership is to liquidate bank assets for the purpose of honoring commitments of the branch. By these actions the DNB will most likely cause inequality among Landsbanki creditors by seemingly favoring the interests of Dutch creditors to the detriment of other creditors. Landsbanki thus reserves every possible right to take a course of action in relation to this. Furthermore the bank's management stated that it would not be able to comply with instructions regarding the transfer of funds to the DNB and additional collateral, as the bank was currently under instructions from its receivers and the FSA not to transfer any funds outside of Iceland. Any payment instructions due at the Amsterdam branch would therefore not be cleared due to insufficient funds available at the branch.

6. Concluding remarks and observations

6.1. Nature of the banking crisis

Iceland is currently experiencing twin crisis, liquidity and currency crisis, affecting both the banking sector and the domestic currency. This results in a combination of a least five major shocks, depreciation of the exchange rate, soaring inflation, rapid deflation in the housing market, increasing unemployment and massive cut in real wages. The effects of these shocks will be felt very strongly in 2009-2010 but will undoubtedly reverberate through the economy for years to come. The bank was also affected by the falling value of all banking assets domestically and world wide.

Could the crisis have been averted? As the crisis was caused by a combination of factors, many of which – such as the collapse of Lehman Brothers in Mid-September – were out of the control of local authorities or the banks, we may never know the answer to this question. It is however relatively easy to list a number of measures which if implemented would have made a significant difference in the development of the domestic monetary and banking system.

6.2. Measures that could have been implemented

We can first point towards the developments in 2006, where the banking system dealt successfully with the effects of a more moderate and localized crisis, as we have already explained. During this period and after crisis was averted, authorities could have used the opportunity to review the regulatory framework and monitoring, in particular to strengthen the currency reserve to the extent needed.

One set of measures concerns the regulation of bank liquidity, which was of course one of the elements contributing to the current crisis. We believe that the Central Bank should have taken the initiative in 2006 to strengthen rules on bank liquidity and started to monitor more closely overall systemic changes in liquidity, in particular on shorter timescales. Furthermore the bank should have made a distinction between liquidity in domestic currency and foreign currency, and treated these two as separate issues. Lack of liquidity in foreign currency was of course at the core of the critical problems that the banks faced in 2008, but throughout the Central Bank made little progress in monitoring or strengthening liquidity in foreign currency remained lagging behind. This did not affect Landsbanki since it applied stricter internal rules on liquidity adopted following the mini crisis in 2006. The lack of oversight and detailed individual information on each institution's liquidity was however a clear weakness'. As the perception of the market was interlinked no matter how strong other institutions would be, Landsbanki was open for negative consequence of failure within the system.

In 2006-2007 the Central Bank also had a golden opportunity to strengthen the currency reserve and counteract the appreciation of the krona, which was in part due to the continuing inflow of funds from carry trade. The Central Bank should have used the increased demand for krona to buy foreign currency and strengthen the currency reserve. By not doing so the bank allowed the real exchange rate to continue to strengthen well beyond a sustainable range. The strong currency in effect hid the underlying inflationary pressure, creating a false sense of security for consumers and investors. The strong krona of course contributed to the increasing current account imbalance, which in turn set the scene for a massive depreciation of the krona which then started in early 2008 and sharpened as the global liquidity crunch became more severe in the third quarter of the year.

Finally, as the global liquidity crunch took shape the opportunity was lost to deleverage the system or to strengthen the Central Bank's currency reserve and thus potential to provide liquidity to the banks in times of crisis. In effect the level of preparation in the system was to low and lessons learned during the 2006 crisis were not put to proper use. Among issues to be considered are: Ineffectiveness of the monetary policy that is, the lack of coordination between the Central Bank and government (regarding the HFF, tax changes, etc). The high real interest rates, supported carry trade and an unrealistically strong currency. Therefore the purchasing power of the public was inflated, creating a substantial current account deficit.

With hindsight it is easy to criticize previous actions. During this debate it has to be kept in mind that the depth of the current world-wide financial and economic crisis is unprecedented and it is at the root of the events leading to the actions taken by the Icelandic government towards the banks in early October. The actions of all other participants which are now under scrutiny and in some cases harshly criticized, should also be viewed in light of the fact that abrupt changes in the external environment have created a situation which is abnormal and unprecedented

6.3. As the crisis deepened all banks needed support

As the world-wide financial crisis progressed and turned into a prolonged global economic recession governments in all developed economies have implemented wide-ranging measures to support their financial systems. Most major banks would probably have collapsed if such wide-spread measures had not been implemented and many governments are still prepared for the worst.

The liquidity problems experienced by the Icelandic banks in early October have to be considered in the light of the global situation, in particular following the fall of Lehman Brothers, which was a tipping factor in the development of the global crisis. In these turbulent times no bank could function in the absence of a lender of last resort in international currencies. Strong government guarantees for bond issues and inter-bank operations has also been a necessary condition for uninterrupted operation of commercial banks in the economies affected by the crisis.

In Mid-January the Secretary General of the OECD remarked about the drastic measures undertaken by many member governments in order to shore up their financial systems:

> "These measures have helped to prevent a systemic financial collapse in European financial markets, though markets remain strained. There is also doubt about whether the funds set aside for recapitalization are sufficient or being used quickly enough. It is essential that national differences in implementation, do not lead to distortions in competition and that consideration be given to how governments exit from their commitments when the turmoil eventually dissipates. In addressing financial markets' vulnerabilities, governments must be careful not to sow the seeds of future problems."[12]

As the banking crisis in Iceland took place in the absence of any liquidity or recapitalization support by the government or central bank, the depth and impact of the crisis should be adequately weighed and measured.

6.4. International causes

When Landsbanki sought administration on October 6, it had not borrowed any money from the central bank and was in fact owed EUR 600 m. in foreign currency by the country's pension fund system. Furthermore, the bank's repayment profile was very light for the next year. The bank had not been able to raise liquidity with regards to two covered bond programmes which were in the final stages of preparation. This included close to GBP 300 m. in GBP denominated mortgage assets.

In response to the international crisis, multinational bodies such as the OECD and European Commission (EC) are already debating the pertinent problems which need to be addressed,

[12] Remarks by Angel Gurría, OECD Secretary-General, January 14 2009 found at: http://www.oecd.org/document/10/0,3343,en_2649_34569_41987466_1_1_1_1,00.html

such as liquidity and risk management, transparency and valuation, strengthening the responsiveness of authorities to risk and improving arrangements to deal with stress in financial systems.

The EC is working on all of these issues, while the OECD will focus on longer-term structural reforms, based on a more comprehensive strategic response to the crisis, which will complement global efforts in fora such as the G-20. The authors believe that policy responses in Iceland should be based on the international work set out above.

Other factors which have undoubtedly contributed to the financial crisis include the overreliance by the Bank of International Settlements (BIS) on capital adequacy rules and the reduction in equity ratios that this brought about, as banks' leverage was increased through internal modeling. The BIS on the other hand did not focus adequately on regulations regarding liquidity or the standardization of rules and measurements for liquidity management. The International Financial Reporting Standards (IFRS) also caused excessive fluctuations in the value of assets and eventually led to a downward spiral in asset prices.

We must also mention the detrimental shift in banking systems, but in particular US banks, away from the 'originate and distribute' model of banking where lenders and debtors were tightly linked, towards a decoupling of banks and borrowers. Another factor which has led to more risk taking and a riskier system overall is the naked short selling of shares and the explosive growth in the secondary market for Credit Default Swaps, which rather than providing insurance against risk has proven to be highly destabilizing for the financial system.

Under the extreme conditions now experienced by financial systems world-wide the importance of governmental backing has also become evident, as the state now plays the role of the actual lender of last resort, rather than central banks. Hence the size discrepancy between the banks and GDP took on a new dimension.

6.5. Issues of specific relevance to Iceland

Focusing on the issues specific to the situation in Iceland, the most often mentioned problems tend to be connected lending, exposure to connected parties and large exposures overall. These problems however appear to exist in all small economies. As the smallest developed economy with an independent currency, Iceland was however particularly vulnerable to these problems. The lack of foreign investment in bank share capital also led to owner concentration, which in turn probably contributed to the lack of interest by foreign parties in taking equity or providing outside equity research. Overall the currency and other technical aspects made it more difficult for foreign investors to access this market.

It should be noted that it became increasingly clear to all of the Icelandic banks that the krona presented a fundamental weakness for the whole financial system. One of the initiatives taken by Landsbanki in order to convey this message to the authorities was the commissioning of William Buiter's and Anne Sieberts' report in the winter of 2007. Buiter's and Siebert's conclusions, delivered to public officials at a meeting in Reykjavik in the summer of 2008, were clear. The authors concluded that the country was vulnerable to speculative attack because of weaknesses in the currency regime. The banks could be saved, although the necessary steps would neither be politically palatable nor cheap.

The authors also pointed out that only areas with adequate reserve currency (US and Euroland) were suited to having large banking systems and by this measure even the UK and Switzerland were not ideally positioned. As a consequence Iceland faced a stark choice, either to retain the krona and relocate the internationally active part of the banking system to the eurozone or to keep the internationally active part of the system in Iceland and join the EU/EMU. It should be pointed out that all of the Icelandic banks were pursuing such alternatives in one form or other.

6.6. Asset deterioration is fast in times of crisis

When banks run out of liquidity the quality of assets deteriorates at a very fast pace. Iceland was hit not only by the world wide financial crisis, with its accompanying drastic fall in all asset values, but also by a currency crisis which had an even worse negative effect on asset quality. On top of this the whole banking system collapsed as a result of liquidity shortage.

It is the estimate of Landsbanki's management that the drop in asset value was close to ISK 1,000 bn. in the first week after the collapse of the banking system. This rapid deterioration is a vivid reminder of the link between bank liquidity and asset value on its balance sheet.

To compare the situation in Iceland we can note that troubled assets in the US are now estimated at 1/3 to ½ of US lending overall. According to Barclay's capital between USD 828 bn. and USD 1,104 bn. of the estimated USD 1,864 bn. of first lien mortgages are 'troubled'. Counting other types of mortgages and consumer credit the total assets held by all banks are estimated at USD 6,534, but between USD 1,896 bn. – USD 2,819 bn. are believed to be currently 'troubled'.

6.7. Effect of the economic crisis on net government debt

It is a common misconception that the Icelandic government has in the wake of the banking collapse shouldered a debt burden which far outweighs the debt burden of any other developed country. In fact, various commentators have emphasized that this debt burden is not only far greater than the current debt burden of any developed country but far larger than any debt burden ever experienced by a comparable country at any point in time. Icelandic taxpayers are therefore thought to be in a virtual debtors prison, suffering massive welfare costs and unable to reach previous living standards ever again. The fact of the matter is that net government debt at the end of 2009 will be well within the average among OECD countries and in fact comparable to the debt held by the Icelandic government as recently as 2002.

Prior to the banking collapse net government debt in Iceland was close to zero. Since the events in early October the government has taken on approximately ISK 563 bn. in new debt, according to a recent newspaper interview with Mr. Thorhallur Arason, Permanent Secretary in the Finance Ministry. According to the ministry's own forecast, 2009 GDP will be approximately ISK 1.530 bn. Thus net government debt will be about 37% of GDP by the end of this year.

This estimate includes all of the government guarantees given following the banking collapse, with the largest share of the debt related to the Central Bank's losses from repurchase agreements where bonds issued by the banks were given as collateral by third parties, amounting to ISK 220 bn. In comparison the maximum net loss due to depositors' guarantees for Icesave accounts is estimated at ISK 150 bn.

In comparison the UK government's net debt position at the end of March 2009 is forecast at 48.2% of GDP according to the UK treasury's own estimate. The UK government's recent intervention in support of the UK banking system is not factored into this number, but as seen by recent news reports the level of these commitments is staggering. The bottom line is however than even before we factor in the effect of the banking crisis on the state of the UK treasury, the British government is in fact more indebted relative to GDP than the Icelandic government when the effect of the Icelandic banking crisis is taken into account.

According to the latest figures released by the OECD the average net government debt in member countries is 45% of GDP, while the average for the eurozone is 44% of GDP. Iceland will therefore be well within average, in spite of the effects of the banking crisis.

It appears that the misunderstanding about the level of government debt is related to double counting and that the value of assets has not been factored when deriving the net debt figure. For example, loans from the IMF and foreign governments, which will be granted under terms of the IMF program should not be counted as part of net government debt as these funds will presumably be used as currency reserve and invested in interest bearing assets. Only the net interest burden on these funds should therefore be counted. Also, new equity which the treasury will have to issue to recapitalize the new banks should not be counted as part of government debt, as the government will receive an equivalent asset in return and this capital will presumably generate a flow of dividends or profit from any potential privatizations of banks in the future.