Special Investigation Commission

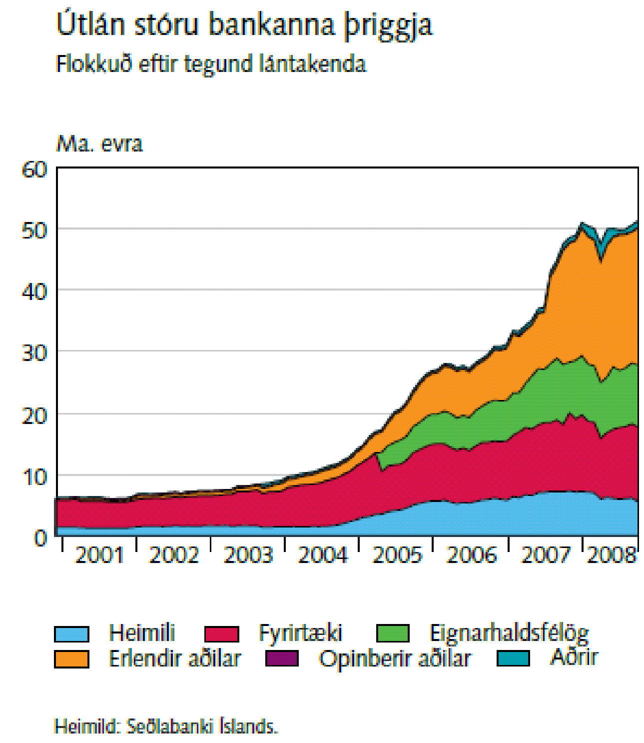
Press Conference

12. April 2010

Growth of the banks

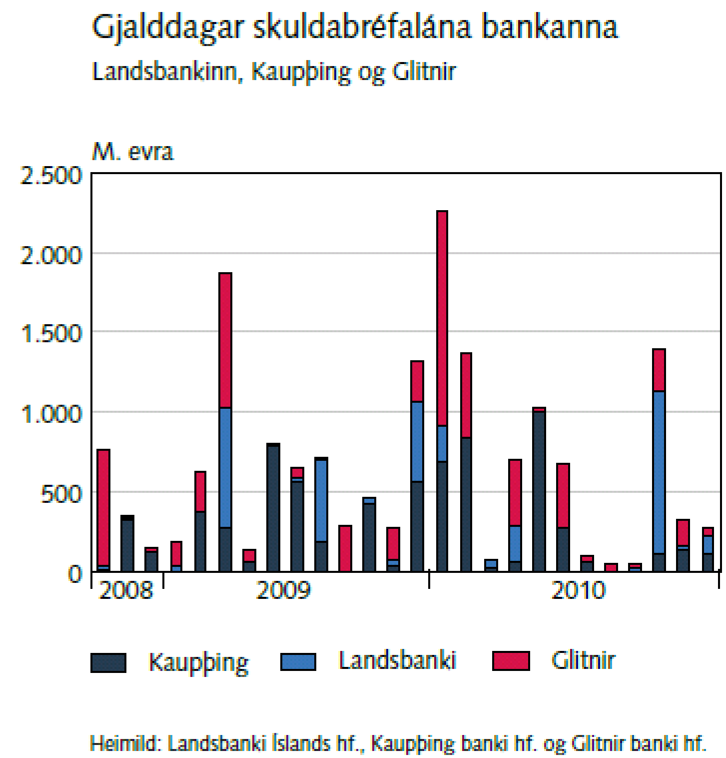
The main cause of the failure of the banks was the rapid growth of the banks and their size at the time of the collapse.

- The big three banks grew 20-fold in size in seven years.
- Such growth is commonly associated with poor underwriting or record-keeping, which can lead to solvency-related difficulties within a few years
- Quality of the Icelandic banks loan portfolios eroded under these circumstances.
  - This rapid growth was not compatible with long-term interests of a strong bank.
  - Strong incentives for growth were within the banks.



Growth of the banks

- A opening of global debt financing markets drove the growth of the banks.
- The Icelandic banks recieved high credit ratings, which was mostly inherited from Iceland's sovereign debt rating.
  - During 2005 the three banks issued around 14 billion EUR in foreign debt securities markets, a little over the GDP of Iceland that year
  - Most of the funding matured in 3 to 5 years – refinancing risk was therefore imminent
- Early 2006 internatinal debt funding dried up temporary.
- Once the liquidity crises started in 2007, foreign deposits and short-term securitised funding became the main source of funding for the three banks
  - Short-term funding which was sensitive to market conditions
- At the time of the collapse repayment schedule of outstanding bond issues was burdensome
  - In the first 6 months after the take-over of Glitnir almost EUR 4 billion were on maturity by the three big banks.
- The repayment schedule of collateralised loans was also steep
  - More than EUR 9 billion was outstanding



Growth of the banks and credibility

Other countries with relatively large financial systems manage to avoid disastrous banking outcomes, since, unlike Iceland, those nations have long experience and proven ability to supervise large, international banks. Their accumulated reputation for careful prudential supervision therefore offsets their inability to provide fully reliable lender of last resort protection, at least to some extent

- FME was in general understaffed and lacked experience.
- FME did not enforce the legal provisions which were at their disposal

- Central Bank of Iceland
  - The CBI's foreign currency reserve was low in terms of both the economies short term liabilities and also in terms of foreign currency deposits at the banks.
    - Short term liabilities of the economy grew to 16-fold the foreign currency reserve, which reduced the credibility of the financial system.
    - Foreign currency deposits grew to be 8 fold the Central banks foreign currency reserve, which increased the risk of a run on the banks.
- Deposit insurance fund
  - Was underfunded, thus decreasing the credibility of the system even further

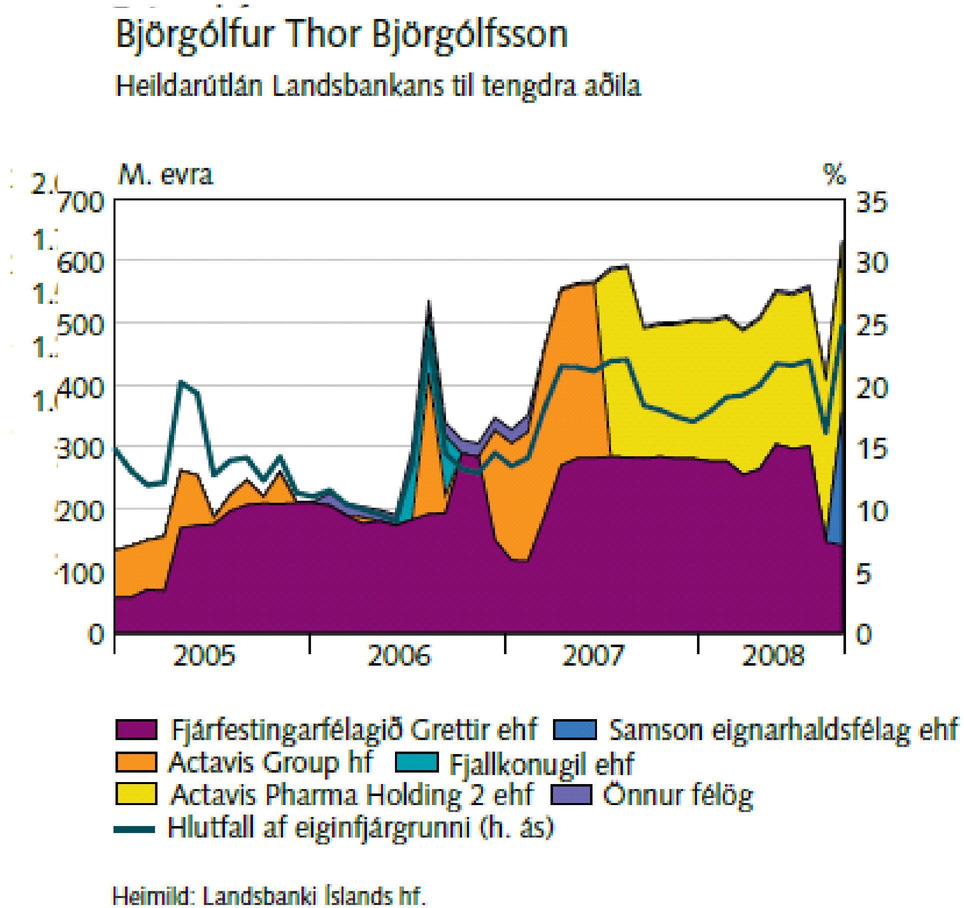
The likelihood of a run increased, both on deposits and other means of funding – a full force run began in March 2008, but at that point the banks prevailed.

Leveraging of the banks' owners

The Special Investigation Commission is of the opinion the owners of all three big banks had an abnormally easy access to loans in these banks, apparently in their capacity as owners.

- The largest exposures of Glitnir, Kaupthing Bank and Landsbanki were the banks' principal owners.
  - This raises questions as to whether the lending is done at arms length
  - The operations of the banks were in many ways characterised by their maximising the benefit of majority shareholders, who held the reins in the banks, rather than by running reliable banks with the interests of all shareholders in mind and to show due responsibility towards creditors.
- In late 2007 and in 2008 the banks began to experience funding problems. It seems that the boundaries between the interests of the banks and the interests of the shareholders were often blurry and that the banks put more emphasis on backing up their owners than can be considered acceptable.
- Examination of the investments made by money market funds operated by the management companies of the three banks reveals that their prime investments included securities and deposits connected the bank's largest owners. These investment decisions cannot have been determined by coincidence alone.

Baugur Group hf., Exista hf. and Björgólfur Thor Björgólfsson



Weak equity

- The banks risks exposure due to funding of own shares was excessive
  - Direct loans with collaterals in own shares
  - Forward contracts in their own shares
- The banks capital ratios, therefore did not reflect the real ability of the banks nor of the financial system as a whole to withstand losses.
- The three banks themselves had financed a total of 300 billion IKR of their own shares in mid-2008. In the report this is called “weak equity”.
- At the same time, the capital base of the banks was about 1,186 billion ISK in total. Weak equity, therefore, represented more than 25% of the banks' capital base in mid-2008.
- If cross-financing is figured in, this amounted to 400 billion ISK or nearly 70% of core capital.

ISK billion	**Direct own financing**						**Cross-financing**	**Total**	
	Glitnir	**Kaupthing**	**Landsbanki**	**Total**	**Total equity**	**% Equity**			**% Equity**
31.12.2006	24	44	47	**115**	922	**12%**	88	**203**	**22%**
31.12.2007	44	102	84	**230**	982	**23%**	119	**350**	**36%**
30.6.2008	63	159	81	**303**	1186	**26%**	92	**395**	**33%**

Weak equity

- The Special Investigation Commission is of the opinion that the financing of owners' equity in the Icelandic bank ing system had in such a large portion been based on borrowing from the system itself that its stability was threatened.

- An overestimation of equity in a bank increases its capacity to grow. The bank's capacity to deal with setbacks decreases at the same time, thereby increasing the risk of bankruptcy.

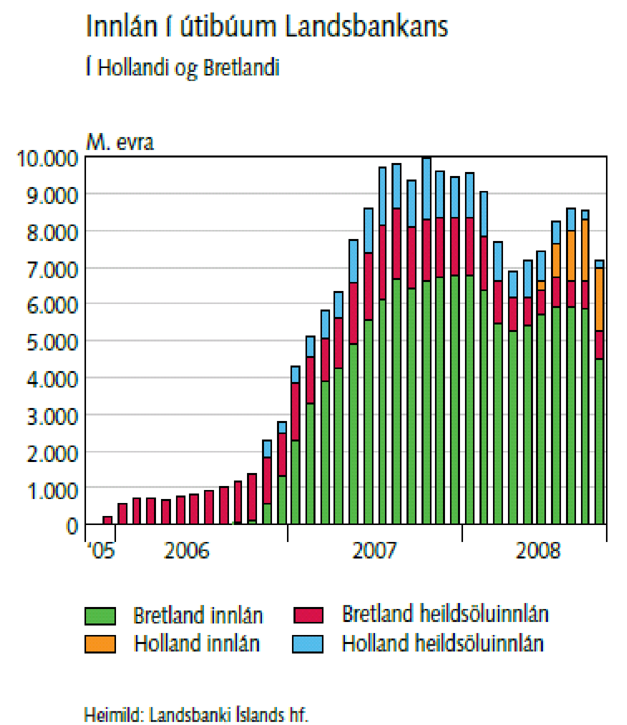
- The loss to depositors and other creditors will be greater than it would otherwise have been in a bankruptcy under these circumstances.

- If the bank in question is important to the system, as was the case with all the banks in Iceland, the costs to society will also be significant, as history has shown.

- The SIC concludes that loans, exclusively secured with collaterals in the institution's own shares, should be subtracted from the equity of the institution. The same should apply to shares, formally registered as owned by a third party and "for own account" of the respective financial institution.

Foreign deposits

- Foreign deposits in the Icelandic banks increased considerably from the end of 2006 and that was, inter alia, the banks' response to the criticism at the beginning of that year of the one-sided financing of the banks through foreign debt securities markets.
- The foreign deposits of the three banks had become eight times larger than the CBI's monetary reserves at the end of 2007.
  - Affecting the credibility of the financial system
- From the end of the third quarter of 2006 until mid year 2007, deposits in the Landsbanki's foreign branches in London and the Netherlands increased by €9 billion. The largest proportion of this growth was at the Landsbanki branch in the UK.
  - Lending growth was considerable in Landsbanki during this period, or €5 billion. Lending to holding companies and foreign parties grew the most.
  - The Landsbanki also decreased the issue of debt securities during this period. The decrease in outstanding debt securities was approximately €1.5 billion.
- The outflow of wholesale deposits in the UK and Dutch branches in the year leading up to the collapse of the banks was more than the inflow of retail deposits in the bank's Icesave accounts.



Debt repatriation

- The largest Icelandic investment companies had, in addition to borrowing in Iceland, been doing business with foreign banks and borrowed from them as well. Several of these loans were secured by pledging the Icelandic banks securities.
  - As share prices fell the quality of the collateral for the Icelandic companies declined.
  - The foreign conducted margin calls or closed credit lines.
- **Glitnir, Kaupthing and Landsbanki reacted by taking over the financing so that loans to the foreign banks could be paid up.**
- Thus the Icelandic banks loaned out high amounts at the same time they were suffering from a considerable shortage of liquid assets. Why?
  - The performance of the banks was too tied to the performance of the concerned company, so the only way out was to lend the money for this. Bet for life.
  - These investment companies had an an abnormally easy access to loans in the banks in the capacity of their ownership and influence within them.
  - These loans were largely made in order to finance the purchase of shares in the banks themselves. To prevent sales of the shares the banks overtook the financing in an effort to maintain the value of the shares.
  - To prevent negative publicity.

Risks

- In light of the prevailing market conditions from the autumn of 2007 it was difficult for the banks to unwind the risks that had formed within the system.
- A large part of the problems that the banks tried to react to in the prelude to their collapse was due to risks that were already in place within the system when the liquidity crisis hit.
  - The banks had taken risks with their operations when the going was better.
  - It should be pointed out that the risks formed when they were taken and not when stock prices and the exchange rate of the IKR began to fall.
- Increased loans to the owners, the taking-over of foreign financing, losses due to the buying and selling of own stock and other comparable behaviours of the banks, to the extent that is described in the report,can, however, hardly be considered a legitimate reaction to such problems or in bearing with healthy and normal business practices.

Depreciation of loans

- When the banks collapsed there was an inevitable and significant reduction in the value of their assets. It is however the Commission's finding that the quality of loan portfolios had started to erode at least 12 months before the collapse and continued to erode until the collapse, even though this was not reported in the banks' financial statements.
- The investigation by the Commission into the finances of the banks strongly suggest that the worth of loans and related liabilities was exaggerated in the banks' financial statements for the year-end 2007 and the semi-annual statements for 2008.
- The values of the assets of the three big banks were adjusted in November 2008.
  - Before they were IKR 11,764 billion
  - After the adjustment they were IKR 4,427 billion
  - A write-down of IKR 7,337 billion or about 60%.
  - The write-down at the end of June 2008 was IKR 67 billion or 0.7% of the companies' total assets at that time.
- For comparison, the GDP of Iceland in 2008 was approx. IKR 1,476 billion, meaning that the write-down of the assets of the financial companies corresponds to the five year GDP.

Amounts in billion IKR	Assets before value adjustment	Adjusted value	Weite-downs	Write-downs as a percentage of assets (%)
Landsbanki Íslands hf.	4.353	1.994	2.359	54%
Kaupthing banki hf.	3.505	1.073	2.432	69%
Glitnir banki hf.	3.906	1.360	2.546	65%
Total	11.764	4.427	7.337	62%