



FIRST SUPERVISORY NOTICE

To: **Landsbanki Islands hf**

Of: **Beaufort House, 15 St Botolph Street, London, EC3A 7QR**

Date: **3 October 2008**

TAKE NOTICE: The Financial Services Authority ("the FSA") of 25 The North Colonnade, Canary Wharf, London E14 5HS has taken the following action:

1. ACTION

1.1 For the reasons listed below and pursuant to sections 194, 196, 197 and 199 of the Financial Services and Markets Act 2000 ("the Act") the FSA has decided to impose the following requirements on you, Landsbanki Islands hf ("Landsbanki") in respect of your branch in the United Kingdom:

- a) You must at all times maintain in a bank account in the United Kingdom cash reserves amounting to not less than 10% of GBP denominated retail instant access deposits held by your group. The cash reserves held in the account must be increased by 6 October 2008 to not less than 20% of GBP denominated retail instant access deposits held in your group. The bank account must be an account with the Bank of England or another account in the United Kingdom approved in writing by the FSA. In this requirement, group has the same meaning as in section 421 of the Act.
- b) You must:
 - i) immediately open a segregated trust account ("the account") with the Bank of England or another account provider in the United Kingdom approved in writing by the FSA on terms set out in paragraphs (iv) and (v) below;

- ii) upon opening the account, credit the account with a cash amount which is at least as great as the aggregate value of the deposits accepted by you from customers of the United Kingdom branch during the course of 2 and 3 October 2008 (the 'initial deposits');
- (iii) thereafter credit the account with a cash amount which is at least as great as the value of any subsequent deposits accepted by the firm from its customers of the United Kingdom branch from time to time (the 'subsequent deposits');
- (iv) hold money standing to the credit of the account on trust for the benefit of the customers referred to in paragraphs (ii) and (iii) according to their respective interests in it (which shall be the amount of their deposit(s) less any sum withdrawn on their account); and
- (v) apply the money standing to the credit of the account solely to repay the initial deposits and the subsequent deposits to those customers.

For the purposes of section 48 and 201 of the Act, the requirement in this paragraph is a requirement of the kind mentioned in section 48(3)(b).

c) This requirement applies to the following assets:

- i) the cash reserves held in the bank account in the United Kingdom referred to in paragraph a) above; and
- ii) any assets held by you which are located in the United Kingdom as at the date and time this requirement takes effect.

You must not in respect of any assets to which this requirement applies take any action or enter into any arrangement in respect of those assets:

- i) which has, or may have, the effect of transferring the assets to a location outside the United Kingdom; or
- ii) which has, or may have, the effect of creating any charge, security interest or other similar economic interest over the assets,

unless you have given the FSA at least 3 days' written notice of the proposed action and the FSA has confirmed, in writing, that it has no objection to those proposals.

The cash reserves that are kept in the bank account in the United Kingdom referred to in paragraph a) must not be used for any purpose other than repaying depositors of the branch.

For the purposes of sections 48 and 201 of the Act, the requirements in this paragraph are requirements of the kind mentioned in section 48(3)(a).

- d) You must revise your interest rate strategy to ensure that:
 - i) the Icesave instant access deposits are not in any Best Buy tables in the United Kingdom; and
 - ii) there is no change to interest rates on the Icesave fixed rate deposit products without providing the FSA with at least two business days notice and demonstrating that any such rate change is merely to maintain current positions in the Best Buy tables.
- e) You must cease all marketing of Icesave instant access deposits in the United Kingdom by no later than 10 October 2008.
- f) You must by the end of 2008 reduce to £1 billion or less the overall level of Icesave instant access deposits.
- g) You must ensure that deposits of all types taken by the United Kingdom branch do not at any time exceed in aggregate £5 billion.
- h) You must submit by 17 October 2008 a plan to ensure the sustained build up of reserves to enable repayment of the Icesave fixed term deposits which mature between now and the end of June 2009.
- i) You must report your total non Icelandic Kronur marketable asset position on a daily basis to the FSA.

1.2 These requirements take effect immediately.

2. REASONS FOR THE ACTION

Summary

2.1 The FSA has concluded, on the basis of the facts and matters described below, that in respect of your UK branch:

- a) you have contravened, or are likely to contravene, the liquidity requirement in GENPRU 1.2.26R and the requirement to maintain adequate financial resources in principle 4 both of which are imposed on you under the Act; and
- b) it is desirable to exercise its power of intervention to protect the interests of actual or potential consumers.

2.2 The FSA has decided it should exercise its power of intervention as a matter of urgency in order to protect the interests of consumers. Accordingly, that it is necessary for the requirements to take immediate effect. The FSA will, at the earliest possible opportunity, inform the home state regulator and the Commission of its decision.

Relevant Statutory Provisions

2.3 The FSA's regulatory objectives, established in section 2(2) of the Act, include the protection of consumers.

2.4 The statutory and regulatory provisions set out below are consistent with and give effect to the Directive of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (2006/48/EC) ("BCD").

2.5 Article 30(1) of the BCD provides as follows:

"Where the competent authorities of a host Member State ascertain that a credit institution having a branch or providing services within its territory is not complying with the legal provisions adopted in that State pursuant to the provisions of this Directive involving powers of the host Member State's competent authorities, those authorities shall require the credit institution concerned to put an end to that irregular situation."

2.6 Article 33 of the BCD provides as follows:

"Before following the procedure provided for in Article 30 the competent authorities of the host Member State may, in emergencies, take any precautionary measures necessary to protect the interest of depositors, investors and others to whom services are provided. The Commission and the competent authorities of the other Member States concerned shall be informed of such measures at the earliest opportunity."

2.7 Article 41 of the BCD provides as follows:

"Host Member States shall, pending further coordination, retain responsibility in cooperation with the competent authorities of the home Member State for the supervision of the liquidity of the branches of credit institutions."

2.8 By section 194 of the Act, the FSA may exercise its power of intervention against an incoming EEA firm where it appears to it that

- (a) the firm has contravened, or is likely to contravene, a requirement which is imposed on it by or under this Act (in a case where the FSA is responsible for enforcing compliance in the United Kingdom); [...] or
- (b) it is desirable to exercise the power in order to protect the interests of actual or potential consumers.

2.9 By section 196 the FSA may impose any requirement in relation to the firm which it could impose if the firm's permission was a Part IV permission and the FSA was entitled to exercise its power under that Part to vary that permission.

2.10 Pursuant to section 45(4) and section 43 of the Act the FSA's power to vary a Part IV permission extends to imposing such requirements as it consider appropriate. Section 48 applies if the FSA imposes an assets requirement on an authorised person.

- 2.11 By section 197(2) of the Act a requirement may be expressed to take effect immediately, or on a specified date, only if the FSA, having regard to the ground on which it is exercising its power of intervention, considers that it is necessary for the variation to take effect immediately, or on a particular date.
- 2.12 Section 199 of the Act gives effect to the requirements of Articles 30 and 33 of the BCD. By section 199(6) of the Act the FSA may exercise its power of intervention as a matter of urgency in order to protect the interests of consumers. If it does so it must at the earliest opportunity inform the firm's home State regulator and the Commission.

Relevant Regulatory Provisions

Relevant Rules

- 2.13 GENPRU 1.2.26R provides that a firm must at all times maintain overall financial resources including liquidity resources which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due.
- 2.14 GENPRU 1.2.3R provides that an incoming EEA firm which is a full BCD credit institution and has a branch in the UK is subject to GENPRU 1.2 in relation to liquidity risk with respect to the branch. So the systems, processes and resources required by GENPRU 1.2 are only those that are required in relation to liquidity risk with respect to the branch.

Relevant Principle

- 2.15 Principle 4 of the FSA's Principles for Businesses (Financial prudence) provides that a firm must maintain adequate financial resources.
- 2.16 PRIN 3.1.1R(2) provides that for an incoming EEA firm which is a BCD credit institution without a top-up permission, Principle 4 applies only in relation to the liquidity of a branch established in the UK.

Relevant Guidance

- 2.17 In deciding to take the action described above, the FSA has had regard to guidance published in the Enforcement Guide ("EG"), in particular EG 8.26 and EG 8.1-8.12.
- 2.18 EG 8.26 provides that where exercising its power of intervention the FSA adopts a similar approach as it does to its own-initiative powers to vary Part IV permission, but with suitable modification for the differences in statutory grounds for exercising the powers.
- 2.19 EG 8.1 provides that the FSA will have regard to its regulatory objectives and the range of regulatory tools that are available to it when it considers how it should deal with a concern about a firm. It will also have regard to:
- (1) the responsibilities of a firm's management to deal with concerns about the firm or about the way its business is being or has been run; and

- (2) the principle that a restriction imposed on a firm should be proportionate to the objectives the FSA is seeking to achieve.
- 2.20 EG 8.2 provides that the FSA will take formal action affecting the conduct of a firm's commercial business if that business is being conducted in such a way that the FSA judges it necessary to act in order to address the consequences of non-compliance with the Act, the Principles and other rules.
- 2.21 EG 8.5 provides that the circumstances in which the FSA will consider exercising its power include where the FSA has serious concerns about the firm, or about the way its business is being or has been conducted.
- 2.22 EG 8.7 provides that the FSA will consider exercising its own-initiative power as a matter of urgency where the information available to it indicates serious concerns about the firm or its business that need to be addressed immediately, and circumstances indicate that it is appropriate to use statutory powers immediately to ensure the firm addresses these concerns.
- 2.23 EG 8.9 includes, among the factors which will determine whether the urgent exercise of the FSA's power is an appropriate response to serious concerns, the extent of any loss or risk of loss or other adverse effect on consumers and the extent to which customer assets appear to be at risk.

Facts and matters relied upon

- 2.24 You are a company incorporated in Iceland that is authorised by the Icelandic regulator ("the FME") to accept deposits. As a credit institution under the BCD you are exercising your passport rights as an incoming firm to operate a branch in the UK, which operates under the brand name 'Icesave'. You do not have any top up permissions in the UK.
- 2.25 You have a number of wholly owned subsidiaries that operate in the UK, although only one of those subsidiaries, Heritable Bank Limited ("Heritable") also accepts deposits. The other subsidiaries operate different businesses.
- 2.26 In relation to your UK branch and for the purposes of the BCD the Icelandic FME is your home state regulator and the FSA your host state regulator.
- 2.27 Your Icesave branch in the UK currently has deposits of approximately £4.5 billion consisting of approximately £1.92 billion in instant access accounts and £1.93 billion in fixed term deposits and £0.7 billion in ISAs. This is made up of approximately 300,000 depositors in the UK.
- 2.28 There are a number of issues relating to the Icelandic economy, its banks and your UK business that have developed since early in the year that could have a potentially adverse effect on the liquidity position of your branch in the UK. These include:
- a more rapid deterioration in the macroeconomic environment facing Icelandic banks;

- risks to the Icelandic economy and banking sector identified in the Concluding Statement by the International Monetary Fund issued in July 2008;
- concerns about the ability of the Icelandic Central Bank to provide support to the banking sector considering the sector's size relative to the rest of the economy and also the low levels of foreign exchange reserves compared to the size of the banking sector;
- concerns about the ability of the Icelandic Deposit Guarantee scheme to provide the levels of compensation to depositors required in a crisis;
- ongoing negative publicity which may provoke investors to withdraw their funds; and
- the high volatility of high interest internet based savings products such as Icesave and therefore the potentially severe impact of a liquidity stress on your branch in the UK.

2.29 Throughout the year the FSA has been closely monitoring the situation so far as it affects your UK branch. There have been frequent discussions and correspondence between the FSA and the firm about the position in relation to the UK branch. This led to the liquidity framework set out in our letter to you of 29 May 2008.

2.30 On 25 September 2008 the FSA sent a letter to you requiring you pursuant to article 30(1) of the BCD and s199(3) of the Act to remedy an irregular situation, namely your ongoing non-compliance with the FSA's general liquidity requirement set out in the financial adequacy rule at GENPRU 1.2.26R. The FSA issued this requirement because it considered there was a significant risk that you would suffer a liquidity stress that would exceed the liquidity reserves available to your UK branch and that your liabilities would consequently not be met as they fell due. The letter suggested a package of measures that in the FSA's view were necessary and appropriate to remedy the situation. The measures included the steps set out in paragraph 1.1 (a)(d)(e)(f)(g) and (h) of this draft notice. The letter asked you to put an end to this irregular situation and stated that the FSA would review compliance with these requirements in liaison with you and the FME at the end of October 2008.

2.31 Since that letter there have been a number of significant developments relating to the Icelandic banking sector that have forced the FSA to consider whether any further measures are necessary and the necessity of imposing requirements immediately.

2.32 On 29 September 2008 the Icelandic government took control of Iceland's third largest bank, Glitnir, after the bank faced short term funding problems. The Icelandic Central Bank governor was quoted as saying that without this intervention Glitnir would have ceased to exist within the next few weeks.

2.33 On 30 September 2008 the rating agency Fitch downgraded your long term issuer default rating ("IDR") to 'BBB' from 'A,' your short term IDR to 'F3'

- from 'F1' and put your ratings on negative watch. Standard and Poors also cut Iceland's long term foreign currency sovereign credit rating to A- from A.
- 2.34 On 30 September 2008 the Icelandic Kronur fell to a record low against the Euro dropping to Ikr 150.15. Icelandic Central Bank interest rates are currently 15.5%. On 1 October Credit Default Swaps (CDS) on Iceland's sovereign debt rose by 45 basis points to 635 basis points and for your bank to 1593 basis points.
- 2.35 On 1 October 2008 it was announced that you had entered into an agreement with Straumur-Burdaras Investment Bank (Straumur) to sell the majority of your corporate finance and brokerage platforms for €380 million. Of this amount €50 million was cash.
- 2.36 On 2 October 2008 Barclays Bank plc required you to pre fund your Icesave clearing account.
- 2.37 You currently have the following assets located in the UK:
- (a) approximately £2.3 billion in illiquid assets;
 - (b) over £200 million in cash reserves (being 10% of the GBP instant access retail accounts) which you have agreed on 2 October 2008 to transfer from an account with the Icelandic Central Bank to an account with the Bank of England.
- 2.38 Your group cash and marketable non-Icelandic Kronur foreign currency liquidity on 25 September 2008 was euros 1.5 billion.
- 2.39 The recent publicity relating to the financial markets, Icelandic Banks and the Icelandic economy has resulted in a significant number of new withdrawals from your UK branches. From 29 September to 2 October 2008 you received withdrawal requests amounting to £207.3 million.
- 2.40 On 1 October 2008 you received in respect of your branch;
- (a) 1800 calls to the call centre (double normal volumes) some of which were requests to break fixed rate deposits;
 - (b) 260 emails compared to a normal number of around 140; and
 - (c) higher than normal hits on the 'Icesave' website.
- 2.41 In current circumstances in financial markets where it is already difficult to obtain funding, these recent developments in Iceland are likely to make it even more difficult for you to retain or obtain funding.
- 2.42 These developments have in the FSA's opinion further increased the risk of a run on the branch and of you not being able to meet your liabilities in such an event.

- 2.43 You are continuing to accept new deposits.
- 2.44 Any transfer of your assets outside the UK could further reduce the liquidity available to your UK branch.

Conclusions

- 2.45 The facts and matters described above lead the FSA, having regard to its regulatory objectives, to the following conclusions:
- (a) acute, adverse market conditions and recent developments in relation to the Icelandic banking sector mean that there is a high risk that you may experience material liquidity difficulties in respect of your UK branch and that your liquidity position will deteriorate rapidly and to such an extent that you will be unable to pay your liabilities in respect of your UK branch as they fall due;
 - (b) further increasing numbers of withdrawals mean there is a significant risk that the liquidity available to you will not be of sufficient amount and quality to enable you to meet the liabilities relating to your UK branch as they fall due; and
 - (c) there is a significant risk that assets in the UK or cash reserves that are held to ensure liquidity in respect of UK depositors will be dissipated or will not be available if there is any further deterioration in your position.
- 2.46 It therefore appears to the FSA that you have contravened, or are likely to contravene, GENPRU 1.2.26R and Principle 4.
- 2.47 Due to adverse events since 25 September 2008 the FSA believes that the exercise of its power of intervention is necessary as a matter of urgency to protect the interests of actual or potential depositors with your UK branch.
- 2.48 The FSA believes that the proposed requirements are an appropriate and proportionate means to improve the liquidity position of your UK branch and hence to protect the risks posed to actual and potential depositors with your UK branch.

3. PUBLICATION AND CONFIDENTIALITY

- 3.1. The FSA is required by section 391(5)-(6) of the Act to publish such information about the matter to which this notice relates as it considers appropriate, unless such publication would in its opinion be unfair to the firm to which the requirement applies or prejudicial to the interest of consumers.
- 3.2. In the FSA's opinion, publication of such information would be prejudicial to the interests of consumers, since it would be likely to provoke a further crisis of confidence in Landsbanki and make it more difficult to protect the interests of depositors. The FSA has therefore decided not to publish any information about the matter to which this notice relates.

- 3.3. You should note that this Notice may contain confidential information and the Notice or any details concerning it should not be disclosed to a third party (except for the purpose of obtaining advice on its contents).
- 3.4. The FSA will inform your home state regulator and the European Commission of the requirements imposed under this notice pursuant to our obligations under Article 33 of the BCD and section 199(7) of the Act.

4. DECISION MAKER

- 4.1. This decision was taken by the Chairman of the Regulatory Decisions Committee.

5. IMPORTANT

- 5.1. This Supervisory Notice is given to you in accordance with section 197(3) of the Act. The following statutory rights are important.

The Tribunal

- 5.2. You may refer this matter to the Financial Services and Markets Tribunal ("the Tribunal"). Under section 133 of the Act, you have 28 days from the date this Supervisory Notice was given to refer the matter to the Tribunal or such other period as specified in the Tribunal Rules or as the Tribunal may allow. A reference to the Tribunal is made by way of a written notice signed by you and filed with a copy of this notice. The Tribunal's address is: 15-19 Bedford Avenue, London WC1B 3AS (telephone 020 7612 9700). The detailed procedures for making a reference to the Tribunal are contained in section 133 of the Act and the Tribunal Rules.
- 5.3. You should note that the Tribunal Rules provide that at the same time as filing a reference notice with the Tribunal, you must send a copy of the notice to the FSA. Any copy notice should be sent to Melanie Beaman at the FSA, 25 The North Colonnade, Canary Wharf, London, E14 5HS.

Representations

- 5.4. You have the right to make written and oral representations to the FSA (whether or not you refer this matter to the Tribunal). If you wish to make written representations you must do so by 6 November 2008 or such later date as may be permitted by the FSA. Written representations should be made to the Regulatory Decisions Committee and sent to Lynn Cheesman, Regulatory Decisions Committee Professional Support Services, at the above address. If you wish to make oral representations, you should inform Lynn Cheesman by 14 October 2008.

FSA contacts

- 5.5. If you have any questions regarding the procedures of the Regulatory Decisions Committee, you should contact either Lynn Cheesman (direct line: 020 7066 3192 /fax: 020 7066 3193) or Jackie Noonan, Team Leader of RDC Professional Support Services (direct line: 020 7066 3074 /fax: 020 7066 1015).

5.6. For more information concerning this matter generally, you should contact Melanie Beaman at the FSA (direct line: 020 7066 0592/fax: 020 7066 0593).

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Tim Herrington
Chairman of the Regulatory Decisions Committee