Main Emphases and Conclusions

The White Paper highlights a number of factors of significance for the financial system's operations, its users, the government and the regulatory authorities. The following summary outlines the main emphases and conclusions which need to be borne in mind in shaping a future vision of the financial system. Reference is made to specific pages in the White Paper for more detailed discussion.

I. Iceland's Financial System in the Future

Good regulation, efficiency and healthy ownership are the areas focused on in the White Paper

The future vision of the financial system needs to build on three main pillars, which are the principal focus of this White Paper. The first of these is a **good regulatory framework and robust supervision** based on the future development of the financial system. The second pillar is efficiency in banking operations, which is a premise for the **financial system to serve households and corporates effectively**. The third pillar is **solid ownership of financial undertakings**, which contributes to their sound and prudent operation based on long-term perspectives. Changes to the state's ownership of financial institutions will have a significant impact on the future of the financial system. **In the proposed sale by the state of its holdings in financial undertakings these three key aspects need to be safeguarded.**

The financial system is important for society

The financial system is of key importance to society. It transmits capital between savers and borrowers, for example, as well as mediating payments between parties. The infrastructure of the financial system enables it to perform its role in serving society. Financial shocks can result in social costs, especially when banks and financial institutions have become so systemically important that it is too costly to allow them to fail. Access to financial services on fair and affordable terms is an issue of major concern for households and corporates.

Future vision of stability, efficiency and quality

The government should pursue a future vision of a financial system which 1) is stable, ii) is cost-effective and iii) provides good service. **Financial system stability** is based in part on rules which ensure resilience and limit risk-taking. It also relies on sound surveillance to ensure compliance with laws and regulations. Should rules on resilience and limits on risk-taking prove insufficient, processes must exist which provide intervention remedies, to limit the costs which could be incurred by the society. Financial system **efficiency** requires cost-effective operations. This enables financial undertakings to provide households and corporates with financial services on affordable terms. To promote an efficient financial system competition and market competitiveness need to be ensured. The **quality** of a financial system can be measured by how well it provides services which are prompt, secure, transparent, fair and accessible. Increasing efficiency and quality in the financial system is primarily the task of financial undertakings themselves, while the role of the public authorities is to promote a healthy working environment.

Trust is the foundation for proper functioning of the financial system

Trust in the financial system was seriously eroded in the wake of the financial crisis of 2008. The past decade has been spent reconstructing the financial system; today, the financial market situation bears little resemblance to that of the pre-crisis era. A Gallup survey in October 2018 revealed that a decade after the financial setbacks, only 16% of Icelanders have high confidence in the financial system while 57% have scant confidence in it. There are probably two main reasons for the low level of confidence in the banking system in Iceland. Firstly, the shock is still fresh in people's minds, and it is only to be expected that rebuilding trust can take quite some time. In the second place, it is evident that a significant factor in the distrust in the banking system is the fact that the public considers it too expensive. Trust needs to be deserved, and it will take both time and effort for the banking system to regain popular confidence.

The state's role is to ensure a framework that encourages trust where deserved

Due to the societal importance of the financial system, it is in the public interest for the state to reinforce the financial system framework and in so doing reduce immoderate risk and encourage confidence in the system.

The state is responsible for **legislation and supervision** of the financial system with the aim of ensuring stability and sound business practices. Such a regulatory framework ensures the system's resilience and limits risk-taking. It is also important to confirm compliance with laws and regulations through effective supervision - both with regard to risk and business practices and also ownership, competition and consumer protection.

Public authorities can also influence the **efficacy and cost of financial services** directly and indirectly, for example, by levying taxes on financial undertakings. Where the state is the owner of financial undertakings, it is important to provide discipline and oversight, and promote cost-efficiency in their operations to deliver better terms for consumers.

Financial technology - fintech - calls for increased efficacy in banking

Fintech has been defined as a new sector implementing technology to improve or even transform financial services. As it expands increasingly through financial markets it has a major impact on financial services. The impact of fintech in the financial sector could become very profound for banking. In the first place, fintech will lead to the separation of lending activities from payment mediation due to increased availability of payment solutions. Secondly, the consumer surplus will increase. As competition between companies grows the price of financial services will fall, especially in the field of payment mediation and asset management, while at the same time the time and effort involved in banking services will decrease. Thirdly, the risks inherent in the financial system will change, and will shift into the space where transactions take place, with increased risk of network and computer attacks.

II. Good regulatory framework and supervision of financial activities

Risk in banking activities has been reduced

Changes have been made to the regulatory framework of financial undertakings aimed at mitigating risk in their activities and reducing incentives for risk-taking. Examples of this are changes that reduce credit risk and limit currency risk. Loans against collateral in the lender's own shares have been banned; rules have been adopted limiting loans to owners, key employees and related parties; the responsibility of directors of financial institutions has been specified; and rules set on bonuses to reduce immoderate risk appetite.

Banks are better prepared to meet setbacks

Amendments to the legislative and regulatory framework in recent years have aimed at increasing the financial system's resilience to meet setbacks. They include, for instance, increased demands regarding the quantity and quality of their equity. This should mean the banks are already better prepared than before to deal with major shocks in their operations. Rules on leverage ratios have been imposed to limit excessive indebtedness of banks while increased liquidity requirements help ensure banks have sufficient liquidity to meet their payment obligations. Furthermore, in Iceland rules have been adopted on net stable foreign currency funding intended to manage the composition of financial institutions' funding to match their asset portfolios.

Major changes have been made to the supervisory framework and assessment of systemic risk

Modifications to the supervisory environment are intended to improve supervision, increase oversight and clarify responsibility. These changes include, among other things, increased authorisation for timely intervention by supervisors. The Icelandic Financial Supervisory Authority (FME) has been substantially strengthened with increases in its staff, greater co-operation with authorities abroad and focus on risk-based supervision.

A framework has been formulated for co-operation between government authorities that enhances oversight of the system as a whole, and collaboration between parties enshrined in the Act on a Financial Stability Council. Monitoring of the system as a whole and the application of rules and tools to reduce systemic risk, so-called macroprudential surveillance, has through these actions been given increased significance. Integration of the Central Bank and FME is aimed at further enhancing the efficacy of financial supervision and macroprudential measures.

Action plan to minimise the cost of financial shocks to society

Despite regulatory changes and supervision designed to reduce risk and increase resilience, banks may nonetheless encounter difficulties. The provisions of the emergency legislation of 2008 are still in force, giving FME authorisation for wide-reaching interventions in the activities of financial undertakings. Work is underway on transposing an EU Directive formalising an action plan for banks and supervisors on how to react if difficulties arise. The objective is to safeguard the systemically important activities of financial undertakings and reduce the risk to the Treasury in case of operational difficulties or when shocks occur. This involves preparing banks and supervisory bodies for such circumstances, e.g. with pre-arranged contingency plans which are updated on an on-going basis and authorisations for supervisors to intervene in the activities of credit institutions and securities companies if necessary. The new legislation will replace the provisions of the emergency legislation. A deposit guarantee scheme, part of the new framework, is currently under revision. These measures should form a clearer framework than previously existed for government response in the event of setbacks to a financial undertaking's activities.

Proper and timely transposition of EU Directives

It must be borne in mind that an increasing share of the legal and regulatory framework applicable to financial activities in Iceland is based on Directives and Regulations adopted by the European Union. Following the same legal framework as European financial institutions generally makes things simpler for Icelandic financial undertakings. As this legislation is a very extensive the task of transposing it into Icelandic law is time-consuming. Timely transposition is important, but at the same time the acts must be analysed carefully to take advantage of their flexibility or adopt special rules as appropriate. In setting rules, consideration needs to be given not only to their adequacy but also their efficacy, because excessive tightening of regulations can mean that the risk the rules were intended to restrict may be transferred partially or completely to where rules are less stringent. Such rules may also affect the competitiveness of market actors.

Public authorities and supervisory bodies need to take advantage of new technologies

Extremely rapid technological development is reflected in changes to the risk factors in banking. Network security and operational risk now rank among the leading risk factors in the banking system. Financial undertakings will avail themselves increasingly of technical solutions to carry out complex tasks and outsource certain aspects of their activities.

Supervisors need to be aware of new risk factors and, similarly, that innovations can offer opportunities. Adopting new technology offers two types of advantages for supervisors. On the one hand, they can gain a better understanding of risks in the financial system and the activities of parties they are to supervise. On the other hand, technology can facilitate the work of regulators, e.g. in analysing data, predicting behaviour and improving processes, and by so doing increase efficiency in their operations. Technological developments, therefore, have a major impact on regulators no less than on financial undertakings.

Improved information on indebtedness – Centralised debt database (Section 2.x, pp. x-y)

It is important to establish a centralised debt database to enable the authorities and financial undertakings to obtain better information on indebtedness. A centralised debt database would list the obligations of all individuals and legal entities. The objective of such a database would be to facilitate analysis of debt developments and corporate and household indebtedness and trends and risks linked to the housing market, improving information used in the application of macroprudential tools, enabling better supervision of financial undertakings' credit risk, large exposures and contagion in the financial system and improving risk assessment by financial undertakings. The debt database could also be useful for analysing debt profiles and decisions on macroeconomic management in a non-personally identifiable manner. In so doing, a centralised debt database would contribute to reducing risk and thereby the cost to financial undertakings and consumers in the longer and shorter term.

Line of defence concerning the scope of investment banking activities

It is proposed that FME be required by law to set rules for a line of defence concerning the scope of investment banking activities in line with a proposal of a committee examining the structure of the banking system at the beginning of 2018.Under this proposal if FME's assessment of the capital requirement for direct and indirect positions taken by a systemically important bank reaches 10-15% in any bank, the bank in question has two options: either to cut back these activities or create a separate company for them. If a separate company is established for proprietary trading, it must be operationally, administratively and financially independent from the respective bank.

Despite this proposal for a line of defence, it should be emphasised that diversity of the banking system is a positive factor and it could prove of interest for individual banks to take steps towards increased specialisation.

III. A Financial System that Serves Households and Corporates Efficiently

Efficiency in the financial system is a concern for households and businesses

Access to financial services on **fair and affordable terms** is a major concern for households and corporates. This is evident in the fact that lower interest rates and better terms of borrowing are the factors mentioned most often by the public as likely to increase confidence in the banking system. Efficient banking services are important for the competitiveness of Icelandic companies.

High lending rates reflect the high policy rate

It is important to distinguish between the interest rate level and interest margin. Lending rates in Iceland are higher than in neighbouring countries. This is largely explained by the fact that risk-free interest rates are high in Iceland. The Central Bank's policy rate in effect forms the floor for lending rates and the ceiling for interest rates on deposits. The policy rate is determined by underlying economic conditions, such as the supply of savings, economic growth, demand for credit, nominal wage developments, inflationary pressures and the makeup of the economy. It is therefore part of credit institutions' external environment.

Financial system efficiency is reflected in the interest margin and service charges

The interest margin is actually the banks' mark-up on its services as an intermediary between depositors and borrowers. This margin is necessary to cover the banks' operating costs, with any surplus accruing to the owners as a dividend. Operating costs include e.g. salaries, IT expenses, provisions for loan losses as well as various specific taxes levied on the salaries paid and debts of financial undertakings. A high interest margin can be reflected in lower deposit interest rates, higher lending rates or both. In addition, banks also charge their customers various fees for services. The services charges and interest margin comprise the banks' total revenues from their customers.

The small size of the market, high taxes and high capital requirements result in a mark-up that has been called the "Iceland premium"

The interest margin in Iceland is approximately three times that of large Nordic banks (3% as compared to 1%). A considerable portion of this is due to external factors that the banks cannot influence. In the first place, the small size of the economy means that Icelandic banks cannot achieve the same economies of scale as much larger banks abroad. Secondly, specific taxes imposed in Iceland are much higher than in neighbouring countries, and this expense also increases the interest margin. In the third place, high capital requirements lead to a higher interest margin, as equity bears no interest but must provide an acceptable return to the owners, which is usually higher than the interest on debt. These factors are part of the banks' external environment. They have been referred to as the "Iceland premium" and have nothing to do with the efficacy of the bank's operations.

Increased co-operation on sound and cost-effective financial infrastructure is a way to achieve economies of scale

To partially offset the inefficiency resulting from the small size of the economy, it is important that the banks can co-operate on joint infrastructure, as long as such co-operation does not reduce competition where that is possible. It is therefore suggested that:

A) the possibility be examined of relieving the Competition Authority of the responsibility of granting exemptions for collaboration, and instead making it the task of the undertakings concerned to assess whether the conditions of the Competition Act for collaboration are satisfied, as has been done in many parts of Europe;

B) an assessment be made as to what systemically important infrastructure should operate outside the competitive environment to ensure macroprudential stability and banking system efficacy. The question of how far the authorities should go in attempting to increase the social benefit of infrastructure collaboration could be examined;

C) given that a reduction in the cost of international payment mediation is a growing concern for individuals and corporates, it is important to endeavour to ensure Iceland's access to cross-border infrastructure co-operation, such as Nordic and/or European real-time payment system collaboration.

Reduction of specific taxes is the state's clearest opportunity to reduce the interest margin

Specific taxes on the banking system in Iceland are many times higher than in neighbouring countries and contribute to high costs to consumers. Reducing specific taxes is a step the government can take to reduce the difference between the deposit and lending rates to customers in the short term. The proposal for a review of specific taxes and public levies on financial undertakings is in three parts:

A) Faster reduction of specific taxes than is currently planned: It is important to find a balance in the taxation of the value-added of the financial sector, so that taxation will not be overly burdensome and restrictive to competition.

B) Specific taxes designed to minimise adverse effects on competition: In implementing a reduction of the specific taxes on banks, the focus should be on minimising adverse effects on competition while at the same time choosing the route likely to deliver improved terms to the banks' customers. As an example, it might be desirable to change the tax base of the bank tax so as to distinguish between the banks' long-term and short-term funding, making long-term funding tax-exempt or taxed at a lower rate.

C) Comprehensive review of tax and public levies: The proposed legislative changes and establishment of a special resolution fund offers a unique opportunity to review specific taxes and public levies on the financial market as a whole. It is important to look to the future and emphasise a normal and fair mark-up, designed to build reserves to reinforce the financial system's foundation and respond to future shocks, such as a deposit guarantee fund and resolution fund.

Capital costs increase interest margin

Mandating a high capital ratio can result in more expensive financial services, as equity is general a more expensive form of funding than borrowing. As a rule, banks need to raise their interest margin when capital requirements are increased. Requirements for higher capitalisation of Icelandic banks are understandable in view of the small volatile economy in which the banks operate, as higher capital increases their ability to meet operational shocks and reduces the risk of financial loss to the general public (taxpayers) instead of to their shareholders and lenders in case of financial crisis. Increased equity therefore decreases the banks' profitability, but promotes a more stable financial system.

Possibilities for increasing efficiency lie with the government and the banks themselves

Both the financial undertakings themselves and the government have options to increase the efficacy of the financial system. The Icelandic banks have various opportunities to increase the cost-efficiency of their operations, e.g. by introducing digital solutions, increasing specialisation or outsourcing and collaborating on infrastructure. The government can also contribute by reducing specific taxes on financial undertakings. To give a better idea of the magnitude of these efficiency measures, it could be pointed out that the proposed reduction in the bank tax from 0.376% to 0.145% will reduce operating costs as much as a 15% reduction in the number of bank employees, the equivalent of 400 full-time positions in the three banks.

It is unrealistic to expect that as things stand the interest margin of Icelandic banks will be as low as that of large banks in the Nordic countries, as Nordic banks are among the most efficient in the world.

Active competition and consumer protection increases the likelihood that cost-efficiency gains will benefit consumers

Gains arising from cost efficiencies will either accrue to the banks' owners (as higher profitability) or their customers (in lower interest margins). The split between them depends on how effective competition is in the commercial banking market. Actions that increase competition and strengthen discipline exercised by consumers are conducive to encouraging more favourable terms and creating incentives for cost-cutting by the banks. Active competition and strong customer discipline are key prerequisites for cost efficiencies to benefit consumers and small businesses. These factors are important in order to restore confidence in the Icelandic financial system.

A minimum of three banks in Iceland

Its small size is a key characteristic of the financial market in Iceland. In every business sector there are trade-offs between economies of scale, on the one hand, and competition, on the other. Economies of scale enable fixed costs to be spread over more units in order to lower the average cost.

Probably greater economies of scale could be achieved by merging two of the systemically important banks. However, strong arguments advise against this. The banks' customers enjoy optimal terms where competition prevails. In order to ensure competition and the efficient functioning of the interbank market, there must be at least three substantial deposit institutions in this country Of significance here is the fact that, in a country with its own currency and monetary policy, the interbank market - where financial institution trade with each other - plays a key role in determining short-term interest rates and currency rates, and as such serves as a platform for transmission of monetary policy, both in terms of the policy rate and FX market interventions. The interbank market can only function reasonably efficiently if two large counterparties are potentially available for each purchase and sale on the market initiated by a third large bank. A merger of two of the three existing systemically important banks would increase still further the hitches currently afflicting the interbank market for FX and liquidity.

Need for a comprehensive and improved framework for future consumer protection

Strong consumer protection is one requirement for trust in the financial system: consumers must be able to rely on a determined response to violations of their rights in the financial market.

It must be clear where consumers can turn should a dispute arise. This needs improvement. Consumers need to be provided with a one-stop public service to pursue their disputes with financial market undertakings. It is also important that consumers are aware of the remedies available to them, as few seem to know about them, according to Gallup's survey for the White Paper working group.

It is urgent that consumer issues are not overshadowed by other important tasks of those bodies which are responsible for supervision of consumer protection. In view of the proposed integration of FME and the Central Bank, it has become even more pressing to examine comprehensive future arrangements for consumer protection in the financial market.

Competition concerns taken into account in financial supervision

The Icelandic Act on Official Supervision of Financial Activities states: "The Financial Supervisory Authority shall monitor the compliance of the activities of supervised entities with laws, regulations, rules or resolutions governing such activities, and their consistency in other respects with sound and proper business practices." More emphasis could be placed here on competition in the market, for example, as has been done in the UK. In view of the importance of competition in a small market such as in Iceland, there is still more reason to consider competition concerns in tandem with supervision.

Such a legislative amendment would further strengthen FME's statutory authority to take decisions and pursue those aspects of its activities that concern competition issues, such as a fintech service desk or examining the feasibility of establishing a "sandbox". However, it is clear that these goals will always be subordinate to other main objectives of supervision.

Changes in the pipeline could increase the mobility of financial institutions' customers

Major steps have been taken in recent quarters to reduce the cost of changing banks and facilitate customers in making such a change. This trend has a positive impact on competition and should increase the interest of new actors in entering the market and offering their services. Many actions in this direction have recently been implemented while others are in the pipeline, e.g. not all banks have fulfilled their obligation to publicly disclose information on their charges, terms and conditions through an open information portal, i.e. an API. Increasing interest in fintech and new legislation on payment services (Payment Service Directive, PSD 2) will further boost active competition in financial services in the coming years. It is important that public authorities encourage this trend.

Implementation of housing policy and the legacy problem of the Housing Financing Fund

The current activities of the Housing Financing Fund (HFF) and traditional commercial banking operations overlap to a very limited extent. HFF has changed from being primarily a credit institution to an institution which is responsible for the implementation of housing policy. However, HFF is still struggling with legacy problems in connection with its older loan portfolio. A working group of the Ministry of Welfare is attempting to resolve HFF's difficult situation and the state's risk arising from it. It is important that the solution to this problem ensure increased efficiency, effective competition and minimum distortion of securities market functioning.

Transfer of risk capital from credit institutions to markets

In light of the experience gained, increased emphasis is placed on limiting the risk appetite of deposit institutions and by so doing prevent excessive risk to customers and the public. For future financial services this has two implications: Firstly, capital markets will probably assume greater risks through direct financial intermediation. In other words, owners of capital and borrowers will transact directly without the involvement of third parties.

Secondly, the focus of corporate financing will have to be shifted towards equity investments, which is a desirable channel for risk capital, as the principal is not guaranteed and both the risk as well as the potential gains are therefore greater.

Ways to improve the functioning of the securities market

An efficient securities market represents an important option for corporate funding and for savers to invest their money. It therefore provides competition for the banks. As the efficiency of Icelandic securities markets has been far from acceptable in recent years, it is necessary to examine from an overall perspective means of encouraging greater efficiency. These include both actions aimed at increasing turnover and liquidity on financial markets and at boosting the significance of independent investment funds in the Icelandic capital market. One of the most effective steps could be to open the way for new independent parties - i.e. funds with different investment strategies - to undertake the investment of private pension savings, which up until now has been solely the province of pension funds.

It is important to minimise the detrimental effects of reserve requirements on FX inflows

The reserve requirements for currency inflows are a management instrument of the Central Bank, intended to prevent excessive short-term capital inflows. They have negative side effects, as they restrict competition in the financial market by limiting participation of non-residents and can thus reduce the efficiency of securities markets. This is particularly true when Iceland's largest investors, its pension funds, are investing abroad to an increasing extent. Such a situation can create difficulties in funding the Icelandic banks on the domestic bond market, as it makes trading more intermittent than otherwise. In the short term, it should be possible to grant an exemption for investment in corporate bonds and/or bonds over a certain duration without reducing the effectiveness of the management tool. In the longer term, it is important to make the conditions clear so that it will be evident under what circumstances restrictions on inflows can be imposed.

Pension funds' involvement in housing mortgages in the future

Pension funds currently provide direct real estate mortgages to their members, and in recent quarters the majority of these are new real estate mortgages. This trend has had a very positive impact on mortgage lending rates. One of the main drawbacks of this arrangement is that it causes discrimination on the basis of union membership, residence or education, and also reduces competition among pension funds.

It is suggested that the possibility be examined of requiring pension funds to offer direct mortgages to all persons who meet a credit assessment, regardless of whether they are a fund member or not. Loans on market terms should not be less desirable from the pension funds' perspective than their current arrangements. Doing so would ensure that loans were granted with a view to earning an optimal return on fund members' savings.

In addition, a reduction to and/or modification of the application of specific taxes on commercial banks and savings banks, which also provide mortgages, would reduce the inequality in their position and thereby increase competition in housing mortgage lending for the future. As an example, taxes could be levied primarily on short-term financing. Such a change would benefit borrowers, especially young people and others for whom the LTV ratio offered by pension funds is not sufficient.

IV. Banking System Ownership

Sound ownership is a key prerequisite for well-deserved trust

Sound ownership is an important prerequisite for the banking system to remain stable in the long term. This implies that bank owners must be trustworthy, have extensive experience and knowledge of banking activities and the financial strength to provide support for the bank in times of adversity. It is important for owners to be guided by long-term perspectives.

Strict rules apply concerning the requirements made of parties who seek to exercise a qualifying holding. As EU legislation assumes maximum harmonisation, these may not exceed what it prescribes. It is important, however, that FME continue to enjoy in full the scope it has to interpret the eligibility criteria in its assessment.

The possibilities of owners to use their influence to their own advantage have also been limited substantially by new, stricter rules adopted since the last financial crisis. These include new rules limiting credit provided to related parties, rules restricting lending against collateral in the lender's own shares and tighter rules on governance and large exposures.

Transparency is a good thing but only if it can be put into practice

Increased demands for transparency are understandable given recent history, in order to instil confidence. In 2013, a provision was added to the Act on Financial Undertakings obliging financial undertakings to specify on their website the names and proportional ownership of all parties currently holding more than 1% of their share capital or guarantee capital. It is proposed that the provision in the Act be revised, both regarding time limits and scope, to take into account on what undertakings are capable of doing. The change would naturally not affect the authorisation of supervisory bodies to closely monitor the ownership of Icelandic financial undertakings.

Diversified ownership tends to increase acceptance and reduce risk

Diversified and broad ownership can encourage general acceptance of a bank's policy and reduce the risk of overly close direct and indirect links between large owners and managers of banks. This could mean both different groups of investors and domestic and foreign ownership.
The direct involvement of a foreign bank in one Icelandic bank is likely to have a positive impact on the banks' competitive environment in the future, increase stability and reduce systemic risk with diversified ownership of the banking system, thereby reducing the risk of cross-ownership links. If a foreign bank were to acquire an Icelandic bank completely, this would probably result in the Icelandic bank being converted to a branch, which would then be partly under the surveillance of a foreign supervisory body. In the case of a bank under highly competent supervision, e.g. in the European Economic Area, such should further reduce risk and costs and boost competition.

Arguments for reducing the state's extensive ownership of financial institutions

In Western countries, extensive state ownership of commercial banks is rare. State involvement is generally through the regulatory and supervisory system, aimed at promoting a sound financial system and ensuring equal treatment for all market actors. The Icelandic state owns two of the country's three systemically important banks, which is unique in the Western world.

Significant changes have occurred to the banks' profits from those of the years following the financial collapse when their profitability was very high, primarily due to the fact that recoveries on loan portfolios taken over at a discount proved to be better than the assumptions of the write-downs. The major share of the resulting profits has now been recognised with the result that the relatively low profitability of the banks' core operations is becoming more evident.

The following are among the principal arguments in support of a reduction of such extensive state ownership:

1. Risk to the state of ownership: The Treasury currently has some ISK 300 billion tied up in its holdings in the banking system. Financial market shocks or an altered environment resulting from new technologies could significantly reduce the value of the state's holdings.

2. Opportunity cost to the state of large holdings in banks: The Treasury is subject to a certain opportunity cost from its holdings in the banking system. These funds could be used to lower Treasury debt or for other responsible purpose. In addition, the outlook is for changes to the dividends, which have been very significant in recent years but are likely to be considerably lower in the coming years.

3. Impact on competition: In the long term, the state's joint control of a major share of the financial market is likely to distort competition and create conditions that can lead to stagnation.

Government policy for ownership of similar magnitude as in Norway

Given the shock suffered by the Icelandic financial system, the political will in favour of the state retaining a core holding in a systemically important bank, at least to begin with, is only natural. In view of the objectives pursued under the state's ownership strategy, i.e. to promote stability in the financial system and ensure its necessary infrastructure, and what this requires, everything would indicate that there is no need for ownership as extensive as the state currently has.

The current strategy of the Icelandic state is to retain a 34% stake in Landsbanki indefinitely in order to contribute to the stability of the financial system and to ensure its necessary infrastructure. Such investment is equivalent to around 3% of GDP. The Norwegian state's holding in DNB, Norway's largest bank, is proportionally of a similar size, amounting to around one-third of the bank and 3% of the country's GDP.

A clear and transparent strategy needs to be set out for the state's long-term ownership plans

The Norwegian state's holding is intended primarily to ensure that the bank's headquarters are not transferred out of the country. Given the country's extensive state assets, very stringent rules have been set by the state regarding ownership. In DNB's case, the Norwegian state does not play an active ownership role unless this is necessary to clearly oppose any move of its headquarters abroad.

The Norwegians' have considered security perspectives and aim at holding a sufficiently large stake to be able to veto major decisions contrary to the public interest. It is important for Iceland to follow the Norwegian example and define clearly in advance in what instances such a veto would be used.

Transparency regarding the state's long-term intentions is a prerequisite for the sale of its holdings in the banks.

Once a large part of the state's existing holdings in the banks has been sold, as provided for in the state's ownership strategy, it may be appropriate to reassess the situation with regard to the objectives, costs and benefits of continuing ownership. A specific solution could prove to be both more successful and cost-effective from the public's perspective in achieving the prescribed goals.

A strong correlation exists between a bank's value and its profitability

The value depends on the underlying profitability, which underlines the importance of lowering levies and increasing the efficiency of the banks' operations. The ratio of market value to book value for Arion Bank has fluctuated between 70% and 80% since the bank was publicly listed. This ratio indicates that the value of Íslandsbanki and Landsbanki is somewhere between ISK 290-330 billion. The upper limit of this range is equivalent to five new university hospitals or around thirty Hvalfjörður tunnels.

Considerable uncertainty currently exists regarding the future price tag for the banks in light of stiffening competition and developments in fintech which greatly reduce the cost of outside parties in providing financial services online.

A clearer framework for the sales process of state holdings in financial undertakings

The current framework for the sale of the state's holdings in the banks is very different from what it was when the banks were sold in the previous decade. It is now enshrined in statute, cf. the Act on the Sales Process for the State's Holdings in Financial Undertakings, the Act on Icelandic State Financial Investments, and statutory provisions on eligibility to exercise a qualifying holding in financial undertakings. In addition, the sale must be carried out in accordance with the State's ownership strategy. By this means the principles which are to serve as guidelines in the preparation and implementation of the sales process have been laid down: **an open sales process, transparency, objectivity and cost-efficiency**

Social perspectives in banking operations

The emphasis on social and environmental responsibility is steadily increasing in financial markets. Depositors want to ensure that their funds are used responsibly, e.g. based on environmental perspectives, regional considerations etc. These trends have already had a significant impact on the activities of traditional banks.

Discussion of social priorities has also included state-owned community banks. A community bank may operate with the primary objective of benefiting the community. This can mean that it lends in particular to small and medium-sized businesses in the local community, that the return required by the owner does not encourage greater risk-taking and that service to the community is a strategic aspect of the bank's policy. Historically, community banks have arisen independently rather than being established on the state's initiative. The State's Ownership Strategy for Financial Undertakings of 2016 lays down the principle that "the company is to work towards those social objectives set out by the owner in its Ownership Strategy". The government needs to decide what these social objectives of the state as owner involve, especially if it plans to sell part of its bank assets.

What changes in the external environment need to be considered in connection with sale of the banks?

In anticipation of sale of the banks the following proposals should be given priority (see further Sections II and III of the White Paper). They concern the banks' efficiency and external environment and may be of significance to investors and affect the value of the holdings.

1. The reduction of specific taxes and/or public levies (see Section III) prior to the sale of the state's holdings would most likely have a positive impact on the value of these assets - it would therefore be beneficial to complete such a review before a sale takes place.

2. A decision needs to be available on legislation regarding a line of defence for the riskier types of investment banking activities of systemically important banks (see Section II). While it is difficult to state definitively the impact of such a change on the selling price of the state's holdings, it should be borne in mind that political uncertainty on this point is likely to adversely affect the selling price.

The preparation and actual sale of state holdings in the banks will take time. The afore-mentioned actions should not delay a decision to commence the sales process, but emphasis is placed on completing them before the actual sale. It would also be advisable to amend those provisions of the Act on the Sales Process for the State's Holdings in Financial Undertakings concerning the restrictions on sale of shares in Landsbanki so that an IPO with the bank's shares can be sufficiently large to attract larger investors and ensure an active secondary market in the shares.

Cost-efficiency measures need to continue, but no specific actions are required prior to sale

t is not advisable to undertake a merger or divide up the banks' operations prior to the state's sale of its holdings. However, there is scope for increased efficiency at the commercial banks, and cost-cutting measures could increase the value of the state's holdings. Both domestic and foreign banks have been working on such operating improvements practically continuously during the past decade. Stiffer competition, in part resulting from new technologies, will continue to force banks to further cost-cutting regardless of ownership. This makes it necessary to continue operational improvements in anticipation of the sale of the state's holdings, as cost-efficiency measures are likely to increase their value. Investors' expectations as to how effectively operating costs can be reduced are the most important factor here.

It is important that the government consider possibilities for reducing its ownership in a cohesive manner

The government needs a comprehensive vision of its long-term ownership. Steps taken towards sale must aim at achieving the objective of diversified, broad and solid ownership, to encourage active competition in the banking market of the future. As mentioned, distributed ownership by various types of active investors, including a foreign bank, together with public participation in line with developments abroad, is the most desirable arrangement for the future.

Therefore, the possibility of selling part or all of Íslandsbanki to a foreign bank should be examined. Despite the fact that foreign banks have shown little interest in such a purchase, the entry of a foreign bank would be very positive for the Icelandic financial market, and it is therefore important to test this possibility.

In tandem with this, preparation for the listing and sale of part of the state's holding in Landsbankinn should commence. It is important that the stakes sold in a public offering are sufficiently large to attract the interest of larger foreign investors. Statutory authorisations in the Act on the Sales Process for the State's Holdings in Financial Undertakings need to be expanded to give the minister the scope necessary to achieve this objective.

Following the government's stated policy, it is important to begin the sales process as soon as a decision has been taken

The timing of the offering and pricing is of major importance in the sale of state holdings in financial undertakings. However, the preparation time for an IPO is very lengthy. It is therefore important to commence preparations as soon as possible to follow the government's strategy of reducing its ownership of the commercial banks. The decision to initiate a sales process should not be overly influenced by the market situation at the point in time when it is decided to commence the preparatory work, as market circumstances can change at short notice. When the time for the sale itself arrives, the situation needs to be reassessed.