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2.1 Summary of the Principal Conclusions of the Review

Pension affairs

1. Pension funds are of various types. Both central government pension funds and pension funds under the administration of municipalities enjoy an employer guarantee in addition to accumulated contributions. They may be open to new members, as are the A divisions of LSR and LSS (pension funds of state and municipal employees), or closed, as is the B division of LSR. Occupational pension funds such as Gildi (of the labour union Efling) and Lífeyrissjóður verzlunarmanna (the Pension Fund of Commerce), and independent funds, such as Frjálsi lífeyrissjóðurinn, Íslenski lífeyrissjóðurinn and Almenni lífeyrissjóðurinn, on the other hand are based exclusively on contributions. The difference between the independent and occupational pension funds is that members of the former can choose to which fund their contributions are paid while members of the latter cannot. The demographics of fund membership, its disability pension obligations etc. also vary from one fund to the next, which is reflected to some extent in the risk diversification of their investments. A younger fund member should generally be prepared to accept greater risk in his/her investments than a member approaching retirement age.

- The Review Committee considers it important to bear in mind, in any discussion of pension funds, that they are of various types which, in turn, is reflected in their varying investment needs.

2. There appear to be no substantial arguments for placing all matters concerning pension funds under the jurisdiction of the Ministry of Finance. There are instances where amendments made to Acts concerning regulated entities in general have not included the pension funds, although it would have been appropriate for them to have done so (see Section 4.1.1).

- In the estimation of the Review Committee these matters would more appropriatly belong under the line ministries of economic or social affairs. More limited matters concerning Lífeyrissjóður starfsmanna ríkisins (LSR, the Pension Fund for State Employees) could, however, continue to be the province of the Ministry of Finance due to the links between public servants' pension rights and collective bargaining agreements.

The Pension Funds Act

3. Act No. 129/1997, on Mandatory Pension Insurance and the Activities of Pension Funds (the Pension Funds Act) governs pension funds. Although the pension fund arrangements provided for in the Act appear well-founded in many respects, they are not without their snags. Amendments to the Act on Financial Businesses and Acts on UCITS and Investment Funds, and changes which have taken place in financial markets in general call for changes to the Pension Funds Act as well.

4. Art. 36 of the Pension Funds Act discusses pension funds' investment authorisations. Since the Act was adopted a great number of amendments and additions have been made to this Article, both prior to and after the banks' collapse. Most or all of these amendments expanded the funds' investment authorisations. Most of these amendments were not made with sufficient care and it is questionable how well conceived some of them were, as they comply poorly with the Act's aim of ensuring responsible investments. It could be mentioned, as an example, that the maximum investment authorised in equities was altered in stages from 35% of net assets to 60%, most recently by Act 28/2006. The changes to the Pension Funds Act indicate that up until the banks' collapse Althingi had been responding to requests from interest groups inside and outside the pension funds' Boards for less restrictive investment possibilities. The expansion of the statutory authorisation for investment in equities in 2004 and 2006 should never have been passed without a requirement that a

certain amount of these be foreign equities (see Section 5.1.2).

- Special emphasis must be placed on provisions to encourage responsible risk management. Limiting authorisations to acquire domestic equities would appear to be self-evident, since the Icelandic equity market, because of its limited size and scope, cannot offer the responsible investments needed by pension funds except to a limited extent.

5. The second paragraph of Art. 36 of the Pension Funds Act states that the buying and selling rates of securities in which pension funds may invest, including bonds of commercial banks, savings banks and other credit institutions, must be quoted on a regulated securities market. It appears that in some instances pension funds have not complied with this and invested in securities which did not have a quoted buying and selling rate when acquired. In some instances the securities had not been listed until their date of settlement. Whether or not this is of importance in evaluating the investment in question, it is evident that this is a clear violation of the rules which pension funds are to follow. Even if the banks should have seen to the listing, the lack of listing of such bonds could result in pension fund managers being liable for damages.

- The Review Committee seconds the opinion of the working group appointed by the Icelandic Pension Funds Association (IPFA) to examine what lessons could be learned from the financial setbacks following the banking collapse in 2008, that it is necessary to press for the immediate listing of securities and improved information disclosure on the stock exchange concerning issuers and the scope and nature of transactions. It was also proposed that the provisions of the second paragraph of Art. 36 be altered to state unequivocally that securities are to be listed on a regulated market when acquired and not later.

6. It is important to give priority to rightholders' interests in reviewing the Pension Funds Act.

- In this connection the Committee is of the opinion that the Act itself must clearly outline the pension funds' role in preserving fund members' assets and ensuring a long-term return on them. Such provisions are important in serving as a continual reminder to pension fund managers and others that the funds' assets belong to others who are depending upon them being available in the future. These funds are therefore not suitable for high-risk investments even though at the time an investment is made it would appear that the rightholders could profit highly if it is successful.

7. Under the current arrangements in the Pension Funds Act, the funds' investment authorisations are listed in the Act itself.

- The Review Committee is of the opinion that the authorisations and limits on them should continue to be part of the Act. Further specifications of these points, however, belong in Regulations and possibly in specific Decisions and explanations from the Financial Supervisory Authority, which could be directed to all pension funds in accordance with a specific statutory provision. In this connection the Committee is of the opinion that a review is necessary of all the authorisations and limits provided for in Art. 36 of the Act. Each authorisation will not be clear and easily comprehensible unless its limits are specifically set out and included under the same point. Limits which apply equally to all items, however, can be placed in separate paragraphs.

8. It is striking how broad the ranges were [for individual investments] in the investment strategies of many pension funds during the years immediately preceding the banking collapse. Pension funds' boards are obliged by law to formulate and adopt an investment strategy for their funds, specifying in detail the funds' objectives in investing in individual categories of securities as a proportion of net assets. In many instances the ranges [for individual investments] in these strategies were so broad that it was actually the maximum limits of Art. 36 of the Pension Funds Act which determined the limits and allocation of investments (see for example Section 13.3.3).

- The Review Committee is of the opinion that a reasonable range may be necessary but that this should not be so broad as to create a risk of exceeding the statutory maximum, in addition to which broad limits clearly reduce the value of the strategy.

9. In the estimation of the Review Committee, it is necessary to undertake an overall review of the Pension Funds Act, in particular of those chapters concerning pension funds' investments and investment strategies.

Investment authorisations following the collapse

10. Following the banks' failure and the complete collapse of the domestic equity market, the pension funds' authorisations to invest in securities which are not listed on a regulated market has been increased, cf. Act No. 171/2008, amending the Pension Funds Act.

- It is important that this authorisation to the pension funds to invest in unlisted securities be reduced again as a proportion of their net assets as the domestic regulated market regains its vigour once more. The pension funds have also placed increased emphasis on private equity investments, such as the Icelandic Enterprise Investment Fund. Closer examination must be made of legal provisions which place limits on such investments (see Section 5.2). This is particularly important with regard to the risk diversification of pension funds' investments and their nature as conservative investors.

11. Other investment authorisations of the pension funds have been expanded and modified following the banks' collapse. With the adoption of Act No. 123/2011, amending the Pension Funds Act, pension funds are now authorised to invest in residential property and to manage such property, e.g. through rentals. Furthermore, pension funds were authorised but not obliged to establish a company for such operations or to conclude an agreement with a private party for the operations. After these changes the pension funds appear to be able to acquire and administer residential housing. It would appear to the Review Committee that this change contradicts Art. 20 of the Pension Funds Act and that it would be very inadvisable for the funds to make this part of their operations. In the Committee's opinion these new provisions show signs of having been scarcely adopted in consultation with the pension funds and are a prime example of the necessity of redrafting the statutory provisions on investment authorisations from scratch following detailed discussions.

- The Committee is of the opinion that the establishment of a special management company (to manage real estate) should be required and pension funds be authorised by law to invest in this a specific limited proportion of their net assets, if the funds are at all interested in being involved in such operations (see further Sections 4.2.11 and 5.1.2).

Auditors' supervision

12. Pension funds' auditors appear in general not to have considered it within their mandate to examine methods for valuation of pension funds' investments in the years of their audits nor the quality of the investments. They point out that up until the banks' collapse in 2008 losses on the assets of the securities portfolios of most pension funds were very low and therefore they had not considered there to be much need for this.

- The Review Committee is of the opinion that auditors should be in a position to examine the funds' investment quality and asset composition in their assessment of the funds. Attention needs to be given to reviewing and modernising Chapter VIII of the Pension Funds Act concerning annual financial statements and auditors. It is urgent to adjust the regulatory framework for pension funds' annual financial statements to fit International Financial Reporting Standards (IFRS/IAS) and to show full consideration for the fact that pension funds are covered by the concept of a public entity, cf. subparagraph b of Point 7 of Art. 1 of Act No. 79/2008 on Auditors (for details, see proposals in the article by Assistant Professor Bjarni Frímann Karlsson, which accompanies the Review Committee's report). The possibility could be considered of having the Ministry of Finance

grant special recognition to those auditors who are considered qualified, in the estimation of the Financial Supervisory Authority following appropriate training, to audit pension funds' annual financial statements and provide them with internal auditing.

Supervision by the Financial Supervisory Authority (FME)

13. There was every need to have more employees working on pension fund supervision during the years reviewed, given the scope of the funds' activities. On average 2-3 FME employees handled this surveillance during the years preceding the banks' collapse.

- It should be pointed out that at least twice as many FME employees handle supervision of the funds today, which is a considerable increase.

14. FME's supervision of pension funds during the years reviewed appears primarily to have involved receiving reports from other regulatory bodies and the pension funds themselves, upon which the Authority depended. No objections appear to have been raised to the broad ranges of the investment strategies of some funds, nor how these were utilised. It is difficult to see any monitoring of individual investments other than as to whether the outermost limits of the investment strategy were complied with. Furthermore, no comments appear to have been made on the terms of those securities invested in, nor was there any monitoring of total investment in groups or connected parties. Nor did FME raise comments as to how the cost of investments was treated (see Sections 5.1.5 and 5.1.6).

- It is proposed that FME express to a greater degree its views on the quality of investment decisions, even if legal provisions in the strictest sense may possibly authorise the investment (see Section 5.1.3).

Actuarial assessment and member's entitlements

15. An actuarial assessment of pension funds' situation can have a considerable effect on their work, as the system is currently structured, based in part on the funds' audited annual financial statements. The actuarial assessment which the funds must undergo each year by law seeks to answer the question of how high an amount is needed to pay obligations based on a specific return (3.5%). Pension fund managing directors and fund managers naturally want the best outcome possible from the assessment, as it determines whether fund members' entitlements should be increased or decreased. The question, however, is whether there is an inherent incentive in this system for excessive risk-taking, which must be determined to some extent by the basis upon which the assessment is based. As an example, in annual financial statements equities are marked to market value at the time of the statements, but equities can fluctuate strongly, as examples demonstrate. The valuation of domestic bonds and equities in the years prior to the collapse did not prove reliable. Actuarial assessment resulted in an increase in entitlement during the years prior to the collapse which subsequently could not be fulfilled. Those funds which took the greatest risks and invested in sizeable equity portfolios and bonds of holding companies and banks lost the most and had to make the greatest cutbacks in entitlements (see Sections 4.3.3 and 5.1.3).

- It appears evident to the Review Committee that the examination procedure underlying the funds' actuarial examination, and especially its basis, should be reviewed. Among other things, the possibility could be considered of specifying more clearly in the Pension Act the discrepancy which may exist between assets and pension obligations before the actuarial assessment must result in changes to entitlement.

Attributability and investment quality

16. Limited demands were made by pension funds concerning documenting procedures for investments during the years prior to the banks' collapse. There were few documented monitoring procedures and assessment of risk factors and monitoring of investments was in many instances inconsistent. The pension funds often appear to have considered it suf-

ficient grounds for individual investments that they could be accommodated within the fund's investment strategy, and the same applied to the pension funds' institutional investors custodians. Reference appears seldom to have been made to the quality of investments or the necessity of providing grounds before a decision was made to undertake individual purchases. It should be pointed out that, following the collapse of the banks, the task of setting up the funds' internal checks and controls and documenting supervision procedures was added to the duties of the funds' Board of Directors, cf. Point 8 of the third paragraph of Art. 29 of Act No. 129/1997 (the Pension Funds Act).

- The Review Committee is of the opinion that pension funds in general should devote greater efforts to assessing each individual investment and need to keep track of documentation in connection with it. This would include, for instance, risk assessment and risk analysis. The funds should work on assessing different risks and rules should be set concerning reassessment of risk factors, to mention some examples. It is only natural to require pension funds to be as meticulous in their preparation of investment decisions as they are in preparations for deciding on mortgages to fund members (see Section 5.2.2). Clear rules also need to be established on the investment decision process and who is responsible for each investment. The Committee, furthermore, points out that it is not sufficient to adopt new and improved rules - it is no less important for pension fund employees to practise them.

17. The Review Committee has not noticed connections of the sort during the years under review where directors were tempted to influence investments so that they were directed towards companies for whom they worked or had holdings in or companies connected to them. Directors with interests at stake in a decision generally withdrew from meetings where such items were on the agenda.

- The Review Committee is of the opinion that it should be the rule that a director in such a situation should not attend a meeting where he/she has interests at stake but should be replaced by an alternate. This would ensure that discussion by the fund's Board of Directors is objective and critical (see Section 5.2.2).

18. All of the large commercial banks had, during the years under review, and still have, a special department in their asset management divisions which undertook to manage investment for pension funds and other institutional investors. The banks also undertook to manage complete pension funds. In each of the large banks private pension savings funds also existed which, upon the entry into force of the Pension Funds Act in 1997, also began to offer mandatory pension schemes in accordance with specific provisions of the Act. These pension funds are Almenni lífeyrissjóðurinn, which was managed by Glitnir, Frjálsi lífeyrissjóðurinn, managed by Kaupthing Bank and Íslenski lífeyrissjóðurinn, managed by Landsbanki. Most of the pension funds which were controlled fully by the banks were, according to their management agreements with the banks, to invest in the funds of the management company of the bank in question. This could also apply to funds which had a specific portfolio with a bank's asset management. These agreements had a considerable impact on the performance of these funds. After the collapse of the three banks they have all sought to establish a more independent existence, although by varying routes (see the discussion of individual funds in Sections 6 (Almenni lífeyrissjóðurinn), 11 (Frjálsi lífeyrissjóðurinn) and 13 (Íslenski lífeyrissjóðurinn).

- The Review Committee is of the opinion that this is the proper direction to follow. It has been demonstrated that the more independence shown by the management departments overall or in managing individual types of investment, the better they survived the collapse. It was also evident that the better the opportunities offered for supervision of investments by the funds of the banks' management companies, the better was their management outcome. This is

because within at least some of the banks' management companies there was a tendency for the fund managers of their funds, after mid-2007, to invest incautiously in assets linked to the banks' owners and their leading customers, without regard for the interests of pension funds and other investors.

Boards of Directors and working practices

19. It does not appear appropriate that the owners of pension funds (the fund members) generally do not have representatives on their Boards and have no influence on who sit on these Boards (see Section 5.2.2).

- The Review Committee proposes that private and public sector pension funds adopt a policy providing for one or more directors to be directly elected at the pension fund's AGM. In five years' time the experience of such arrangements would be assessed and a decision taken as to whether further steps should be taken.

20. The ordinary operations of pension funds are the province of the funds' managing directors, although their Boards bear the ultimate responsibility for their operations and decisions by law. According to the Pension Funds Act, the Board is to perform supervisory duties, shape the investment strategy and take decisions on major or unusual matters. The Act offers no indications, however, as to what should be considered major or unusual, placing it in the hands of the funds' Boards of Directors to assess this and decide on investment references.

- The Review Committee's examination revealed that interpretations as to what should be considered major or unusual vary greatly and few pension funds have set references in this regard. It is important that the funds adopt clear rules in this connection which deal with the scope and different types of investments which the funds' employees, who handle investments, and managers may conclude without the Board's involvement (see Section 5.2.3).

21. It is important to have some turnover in pension fund directors, in part to reduce the risk of agency problem(Principal-Agent Theory). It is clear, however, that new directors must be allowed some latitude to get a proper grasp of the responsibility which they have undertaken as pension fund directors. Similarly, continuity must be ensured in the work of each pension fund's Board (see Section 5.2.3).

- The Review Committee considers it proper for pension funds' Boards of Directors to prescribe in the funds' Articles of Association a maximum length of time for each pension fund director's service. A period of 8-12 years would not be inappropriate.

22. According to the Pension Funds Act, the Boards of pension funds are to lay down working procedures on securities transactions for the fund, its directors and employees. According to the Review Committee's examination, pension funds have not in all cases sufficiently supervised that the rules are complied with in all instances. There were examples of rules which did not in all instances cover directors' securities assets (see Section 5.2.4).

- The Review Committee is of the opinion that in fact part of drafting such rules should be having the funds appoint a compliance officer, an employee who keeps track of information on the board membership and securities transactions of the fund's directors and employees and makes sure that this information is updated and current. Furthermore, in the opinion of the Review Committee, pension fund directors should, in all instances, disclose information on all their securities transactions.

23. Some of the pension funds have adopted guidelines such as the UN Principles for Responsible Investment. The main idea of rules such as the UN Principles is to have investors consider other factors in addition to short-term gain in assessing investments. They should consider long-term gain and, in this connection factors such as good corporate government, environmental responsibility and social aspects should influence investments. Two illustrative examples of aspects which the funds could consider

are companies' gender equality and wage equality performance (see Section 5.2.6).

- In the Review Committee's estimation, the pension funds have made too little attempt to use such guidelines systematically in laying down rules and drafting investment strategies and policies as to what sort of shareholder a pension fund should be. It would be appropriate for the funds to devote efforts towards formulating and implementing policies concerning these factors.

24. Most pension funds have adopted codes of ethics concerning, for instance, their relations with financial market actors, including regarding invitational trips and gifts. It is, however, striking that only a few pension funds had adopted such rules prior to the banking collapse in October 2008 and devoted considerable work to this end (see Section 5.2.7).

- The Review Committee would like to point out that adopting a code of ethics and relationship guidelines is only the first step in a longer process, and that the rules need to be reviewed regularly to keep the Board of Directors and employees always conscious of the demands made of them by such rules. It is also appropriate to point out that it is not a matter of course that a pension fund's managing director or Board of Directors determine the limits and substance of such rules, since possible infringements could involve these parties. The Review Committee urges pension funds to find a solution to this problem.

Currency hedges

25. Opinion is divided as to whether pension funds as long-term investors should hedge their foreign assets against exchange rate fluctuations. The funds are authorised to do so in Point 10 of the first paragraph of Art. 36 of the Pension Funds Act, but this authorisation is subject to the condition that concluding the currency contract must be conducive to reducing the fund's risk. To what extent it is advisable to hedge foreign assets in this manner is a matter for consideration. Such an assessment has to consider the fund's payments to its members and its long-term investment strategy. The hedged proportion of pension funds' foreign assets varied during the quarters preceding the banks' collapse and was in some cases very high, up to 90%. It is evident that some pension funds assumed that the ISK exchange rate would strengthen during the latter half of 2008.

26. There was also a painful shortage of settlement provisions in the contracts concluded by the pension funds with the banks on management or purchase of currency hedges. International contracts on currency hedges usually have so-called ISDA terms and conditions, which describe in detail how they are to be dealt with in the case of flawed assumptions on the part of the contracting parties.

- The Review Committee is of the opinion that some of the pension funds proceeded very incautiously. They do not appear to have realised how close the banks were to failing. With the benefit of hindsight, it is clear that after mid-2007 it was very risky to increase currency hedges and the funds should have sought advice on this point. In addition, in view of the master agreements on currency hedging which were in effect between themselves and the funds, the banks should have warned the pension funds (see Section 5.1.4). The pension funds will also have to co-operate on inserting in currency hedging transactions, if and when they are introduced once more, terms on their settlement.

Terms and conditions and types of bonds

27. There were major flaws in corporate bond issuance in Iceland prior to the banks' collapse which have caused the pension funds, like other investors, enormous losses. For instance, most often the bonds had no covenants to the effect that, if companies' operating premises or equity ratio changed materially, the bonds would be accelerated.

- The Review Committee is of the opinion that due to the characteristics of pension funds' investments and the caution which their leaders must show with regard to the custody and investment of fund members' assets, it was reprehensible of them as institutional investors not to ensure that the bonds included

covenants on acceleration in the case of changes in ownership, equity ratios or operating premises. Such covenants could have been priced into the bonds, even if this had meant slightly lower yields (see Section 5.1.5).

28. After the beginning of this century, it began to be common, on the initiative of financial businesses, for market bonds to be issued to a considerable extent as bullet bonds, rather than the previous amortised bonds. These bonds, with only a single due date for payment of the principal, had foreign models. The pension funds, as well as other investors, invested in these bonds, whose issuer could not be said to be in default as long as interest was paid on the due dates. Upon the banks' collapse many bullet bond investments were lost completely.

- Careful attention must be given to the substance of covenants before purchasing bonds and, where large amounts are involved, quick decisions must not be taken relying on the fact that these are financial instruments "which everyone is buying and accepting". The Board of Directors of the Icelandic Pension Funds Association should establish a group of attorneys to draft several basic types of terms and conditions, and a checklist for what should be included in the covenants of bonds which pension funds intend to purchase (see Section 5.1.5).

Commissions

29. Commissions paid to banks or foreign businesses handling investments for the funds abroad cannot be determined from the pension funds' annual financial statements. These commissions have only been included in aggregate figures.

- The Review Committee agrees with views expressed by the National Audit Bureau, that this expense should be indicated specifically, and is of the opinion that FME should see to it that the funds show without exception all commissions as a special expense item, rather than hiding much of the commissions in the difference between the buying and selling rate of securities. FME should also see to it that Icelandic financial businesses disclose this expense. It should not be subject to confidentiality.

Connected parties

30. The risk which could result from excessive investment in groups and connected companies does not appear to have been sufficiently clear to the pension funds during the years preceding the banking collapse. It should be pointed out that the pension funds' authorisations for investments in groups and connected parties were restricted still further after the collapse and are now based on the definition of connected parties in the Act on Financial Undertakings. Pension funds are not covered by the Act on Financial Undertakings. The Review Committee is of the opinion, however, that as institutional investors pension fund managers should have been cognizant of provisions applicable to financial undertakings at that time and should have taken them into some consideration in their investments and the custody of the funds' asset portfolios. On the other hand, it now appears that the financial undertakings kept their own situation and that of connected companies to themselves, concealing on grounds of bank secrecy their real prospects and those of connected parties and the extensive credit which the banks' owners had obtained from them. It is therefore somewhat understandable that it was difficult for the pension funds to tread safely on the financial market during the period leading up to the banks' collapse.

Equity

31. The pension funds based their decisions on investments to a considerable extent on assessment of companies' equity. It is clear from information in the Report of the parliamentary Special Investigation Commission on the equity of Icelandic financial undertakings that a substantial share of the domestic investments made after mid-2007 was based on data which would not have withstood closer examination, if this had been possible. There were admit-

tedly rumours during the period leading up to the banks' collapse that the banks had made loans for purchases of their own shares.

32. It could not be said, however, that in general investors should have realised the details of the funding of financial undertakings and holding companies at this time. On the other hand, questions could be asked as to whether the Boards of Directors and managing directors of the pension funds could have done a better job if they had used formal risk assessment and set up effective monitoring procedures. It should be completely clear to the pension funds that mistakes were made and that in some cases they should have done better (see Section 5.1.8).

Individual investments

33. Apart from traditional investments such as government-backed papers, equities, units in UCITS funds and corporate bonds, the pension funds invested to a significant extent in more specialised types of bonds and debt structures during the years preceding the banking collapse. In the opinion of the Review Committee, they did not in all instances show the caution they should have in choosing such investments.

34. Among the pension funds' investments were so-called credit-linked notes (CLNs). Payments on these bonds during the contract period are generally linked in some way to the CDS spreads of the underlying company. Payment of the principal is also generally subject to certain conditions. One example of such a security was a note of the Jersey Branch of the Union Bank of Switzerland (UBS), which was sold by Landsbanki as intermediary in the spring of 2008. The total amount of the notes issue was ISK 3.1 billion and the main buyers were pension funds. The said note was linked to the credit ratings of Glitnir and Kaupthing; it could be accelerated under certain specified circumstances, for instance, if the banks became insolvent. This investment was lost upon the banks' collapse (see Section 5.1.9).

- The Review Committee considers it highly questionable for pension funds to invest at all in financial instruments such as this, since they imply a bet on the future of certain companies which is outside the obligation itself. The Review Committee points out that the parliamentary Special Investigation Commission was of the opinion that in the spring of 2008 it should have been evident on this market that a default by the banks was considered to be quite probable.

35. The share of subordinated long-term debt in the Icelandic banks' operations and accounts also grew. The objective of issuing such bonds would have been to improve the capital ratios of commercial banks and savings banks. These bonds are ranked after all other obligations than equities in an insolvency. Many of the pension funds invested in such bonds of the banks.

- The Review Committee considers it scarcely compatible with the role of pension funds and legal provisions on conservative investment for them to participate in such funding. There is hardly the same secondary market for subordinated bonds as for equities if the funds need to dispose of them. The pension funds cannot acquire these bonds as if they were normal bonds. They should rather be considered as equities because of their debt ranking.

36. One example of an extremely unfavourable subordinated debt investment by the pension funds was an issue by Glitnir in March 2008 of so-called subordinated and convertible bonds, in a total amount of ISK 15 billion. The pension funds were the main buyers. This issue was special in that the bonds had no due date and Glitnir was not expected to repay the bonds in cash, but rather they would be repaid in 2013 with shares in Glitnir. Two of the country's three largest pension funds invested significant amounts in the issue; in one of the funds the matter was presented to the Board in advance while in the other it was presented

after the fact. This investment was lost immediately upon the bank's collapse (see Section 5.1.9).

- The Review Committee is of the opinion that the pension funds should not invest in such instruments unless specifically authorised by law. In all instances, special investments of this sort should be referred to the Board for approval in advance.

37. During the years under review, several pension funds invested in foreign collateralised debt obligations (CDOs) or structured debt. Such structures are of various types and each issue is specifically tailored depending upon the underlying assets and other premises. In most instances these apparently were synthetic CDOs (see Section 5.1.9). It should be pointed out that the interest rates on these securities were high, which made them attractive to the pension funds' management.

38. An example of such investments in structured credit were bonds acquired from the French bank Société Générale, which were sold by Landsbanki as intermediary in 2005. The bonds were denominated in EUR. These were so-called covered bonds, linked to bond portfolios of the 100 largest companies in Europe at the time. The underlying asset pool admittedly included names such as the US investment bank Lehman Brothers and other companies which did not survive the 2008 financial crisis. In an interview with the Review Committee, one pension fund managing director stated that in hindsight, the terms of the notes had been too weak.

- The Review Committee questions whether there is a statutory basis for pension funds to buy such issues. They are complex in nature and difficult to comprehend, and experience has shown that they involve a high risk. It must be assumed that in the future legislation will state specifically if these investments are to be lawful and that pension funds should only risk very limited amounts in an otherwise well-diversified portfolio.

Pension funds' losses

39. Pension funds' net assets for payment of pensions and the NPV of the funds' obligations are calculated annually. The pension funds' losses in this report are therefore based on their annual financial statements, as the funds' actuarial assessments are based primarily on the final figures of their annual financial statements, together with a variety of actuarial assumptions. The funds' accounting performance is highly dependent upon the exchange rates of the currencies in which they hold foreign assets and the market value of domestic equities, if they have substantial investments in such. Both can fluctuate strongly over the course of the year. During the period preceding the banks' collapse the value of equities in the pension funds' asset portfolios had shrunk considerably from mid-2007 onwards, as is reflected in their annual financial statements for 2007. Equities continued to fall in price right up until 30 September 2008, and were subsequently lost for the most part upon the banks' collapse, as is shown in annual financial statements for 2008.

- The Review Committee considers it appropriate to point out that because equities were marked to market value in the annual financial statements, the accounting losses are only part of the story, as the investment could in many cases have been made long before 2007, and as a result the actual loss could be much lower, as has been pointed out by the pension funds. Similarly, the return since the time of investment must be taken into consideration for the investment to be properly assessed. Section 5.3 discusses the total losses of pension funds in individual categories of securities and from individual issuers. Losses of individual funds are discussed in the sections on the funds concerned.

40. Although the preceding discussion has raised various objections to the pension funds' investment practices and investment strategies, there are also various positive aspects which could be mentioned. Nor did all the funds follow the same practices. Those who took risks

appeared to have gained the most in 2005 and 2006, but they also subsequently had the largest write-offs. Others which had lower gains those years and invested more conservatively suffered smaller losses in the collapse and came out better off on the whole. Consideration must also be given to the mood which prevailed in Icelandic financial circles at this time, which were dominated by the influence of the investment banks and commercial banks, the views of leading politicians, the feebleness of regulatory institutions and the Central Bank's policy of maintaining a high ISK exchange rate as long as possible without ensuring that other economic forces were in step with this. In this connection it could be mentioned that the mood was much more conducive to boosting the Icelandic banks' expansion abroad than to restraining it. It is sufficient to mention the fact that in the years preceding the collapse the government appointed a committee chaired by the then Chairman of the Board of KB Bank, whose task it was to map out Iceland's possibilities of becoming an international financial centre.