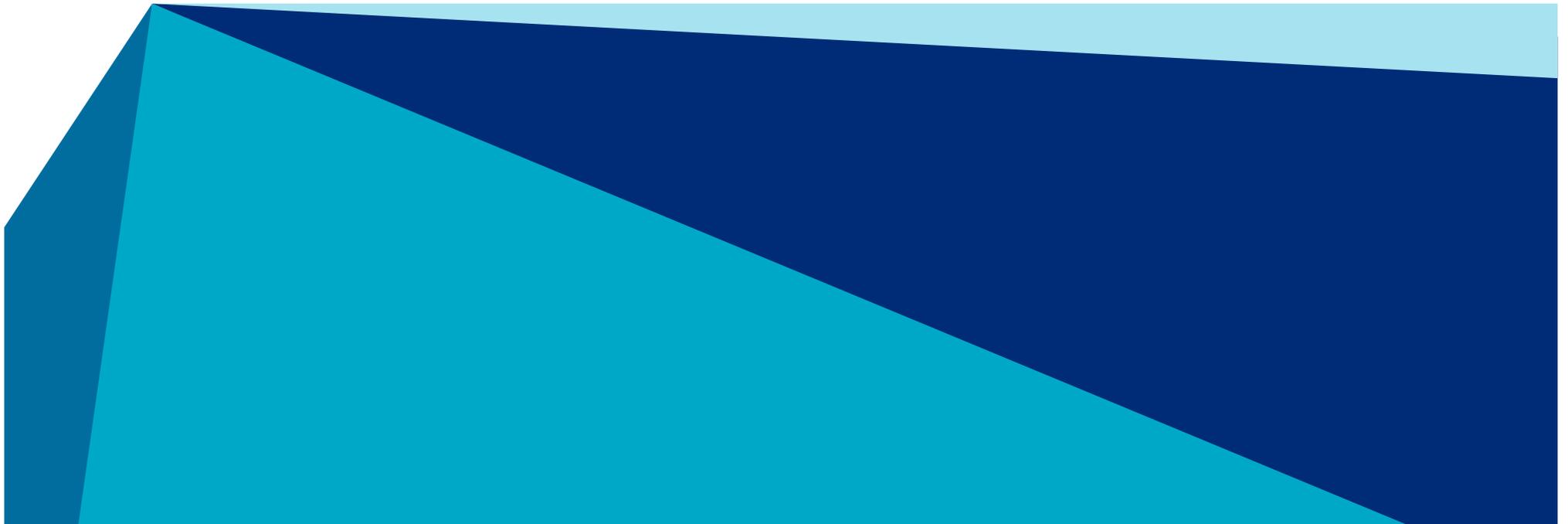


FINANCIAL MARKET COMPETITIVENESS

27 NOVEMBER 2014



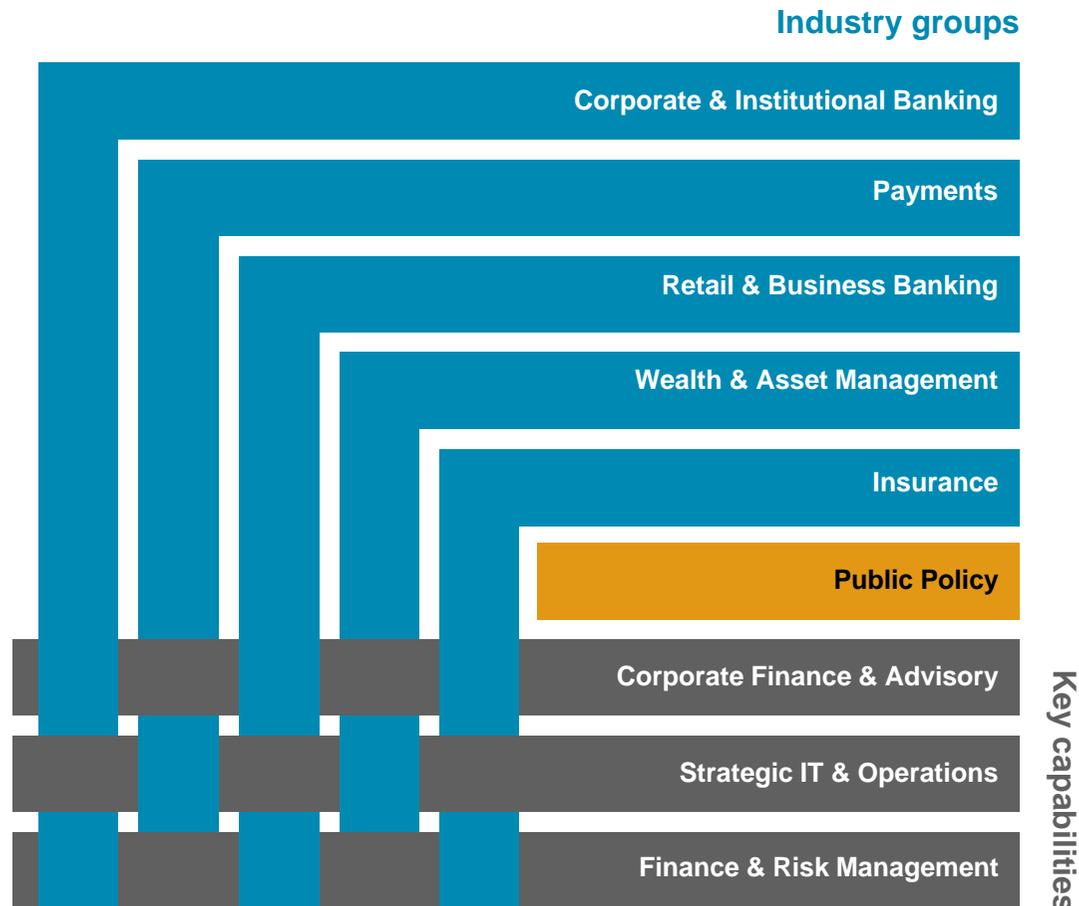
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- 90% of our business is from repeat clients, who include
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Context for today's discussion

- The Icelandic banks continue to resolve many of the direct effects from the financial crisis on their balance sheets and the core operations now need to be scrutinized
- While difficult to benchmark, the industry on a Nordic comparison appears costly and requires radical restructuring for the Icelandic economy to sustain it and for the perception of the financial market to improve
- This requires a number of policy related decisions
 - Allow banks to migrate to more advanced methods for calculating capital requirements and
 - Allowing the banks to reduce their costly equity bases
 - Competition Authority to focus on front end competition and allow back office cooperation
 - Review the bank levy in light of the impact it has on cost of financing in the system
- The banks need to:
 - Increase the use of shared back office utilities to serve the markets more efficiently
 - Refocus cost programs to ensure a sustainable step-change in the cost to serve the market
 - Ensure efficient deployment of capital, based on the insights gained from new models
- This presentation outlines our analysis as well as a few perspectives based on our experience and a number of initiatives for the Icelandic Banking Industry to commence

Post crisis, the Icelandic financial market is in a challenging position

Financial market development ranking (2014)

Out of 144 countries, score scale 1 – 7 (best)¹

Ranking	Country (rank)	Score
	Finland (#5)	5.5
Top 20	Norway (#10)	5.3
	Sweden (#12)	5.2
Top 30	Denmark (#27)	4.7
Top 100	Iceland (#68)	4.0

Comments

- Iceland aims at being a **top 10 country in the financial market competitiveness rankings within ten years**
- A top 10 ranking would entail material improvements compared to today's ranking (#68)
 - Other Nordic countries are relatively well placed on the list and, while very ambitious, this could give some merit to the target
- There are additional studies finding that Iceland is lagging the other Nordic markets in terms of financial market development / competitiveness²
 - All the of the Nordic financial centers have experienced declines in recent quarters; however, Reykjavik had the steepest decline

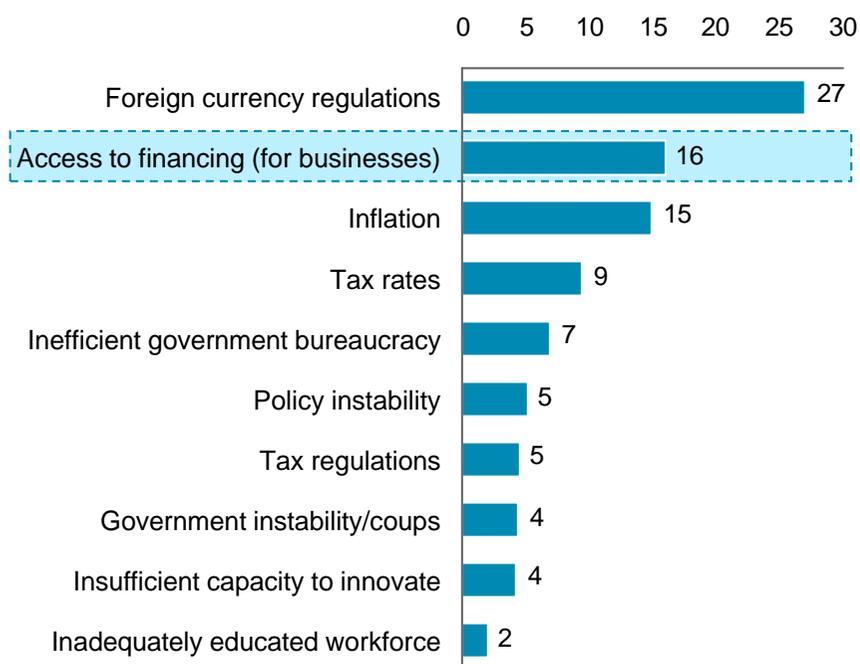
Source: Long Finance, Financial Centre Futures GFCI 16 and World Economic Forum, Global Competitiveness Report 2014 – 2015

1. Score based on a World Economic Forum survey assessing financial market efficiency, trustworthiness and confidence

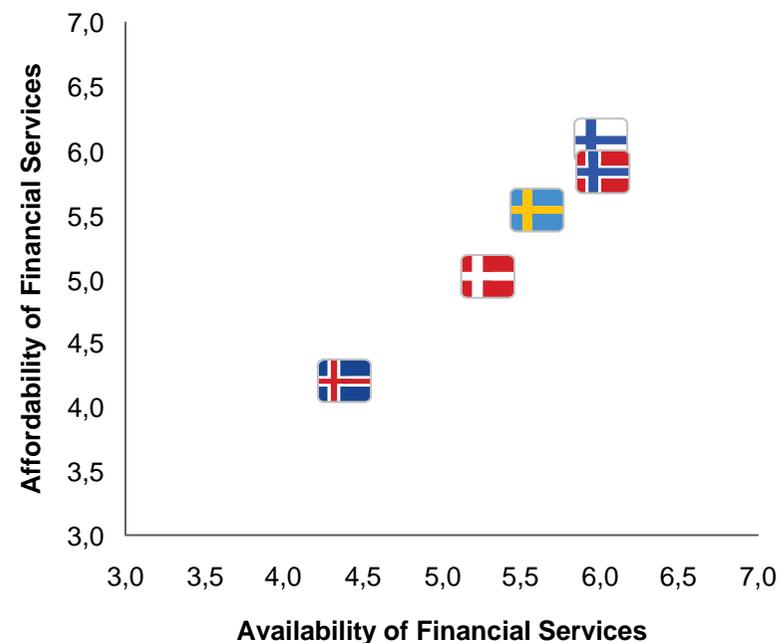
2. Long Finance, Financial Centre Futures: The study focuses on the competitiveness of financial centres

Access to financing is a key perceived problem with the Icelandic market

Most problematic factors for businesses in Iceland
2014 – 2015, % of survey responses



Financial market efficiency scoring
2013, score scale 1-7 (best)



Improving the affordability of financial services will consequently enhance the perceived availability of the services

Source: World Economic Forum, Global Competitiveness Report 2014 – 2015

Note: Nordic peers include Sweden, Norway, Denmark and Finland

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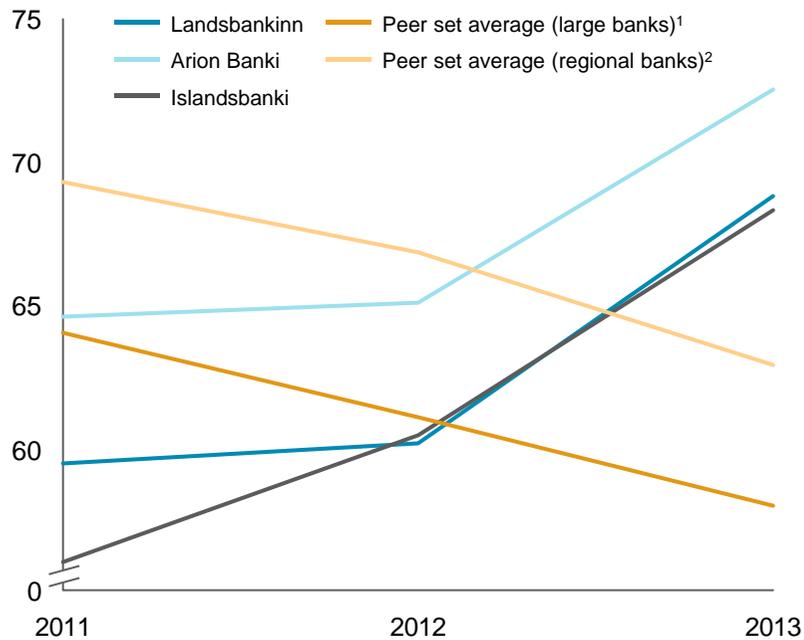
Affordability is directly linked to banks' costs, and we see room for improvement through both bank and policy driven initiatives

Cost drivers and potential initiatives

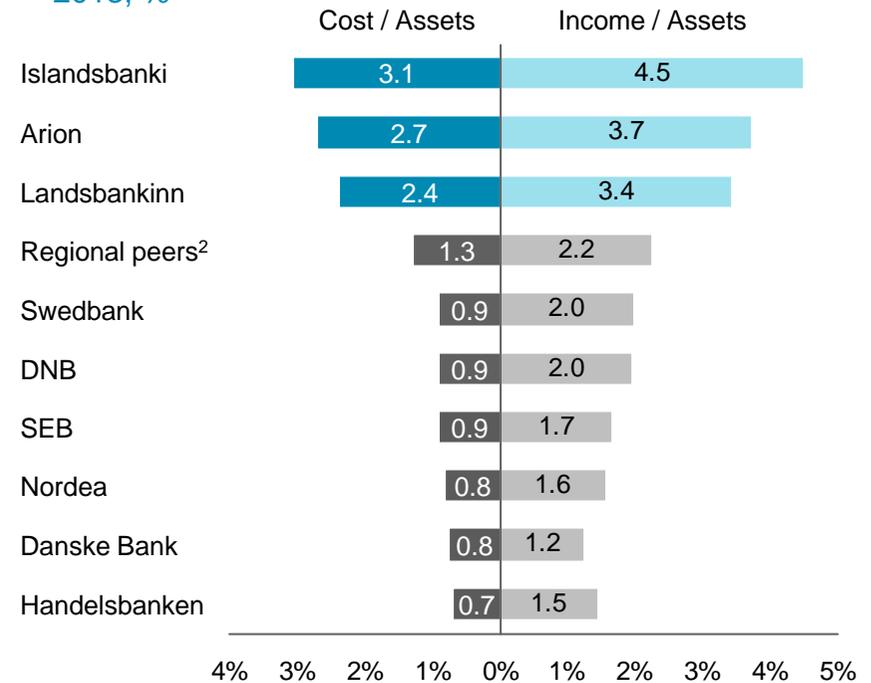
Cost driver	Observations for Icelandic banks	Bank initiatives	Policy initiatives
1 Operating costs	<ul style="list-style-type: none"> High cost-income ratios relative to peers Large number of employees and branches relative to size of banks 	Shared infrastructure between banks Cost reduction programmes	Refocus competition authority on FO competition
2 Cost of funding	<ul style="list-style-type: none"> High CT1 ratios relative to Nordic peers 	IRB migration	Expedite applications Allow for new underwriting standards to be factored in Review capital requirements
3 Other costs	<ul style="list-style-type: none"> High bank levy 	Focus for today's discussion	Review bank levy

1 While benchmarking should be used with care, there is a marked cost difference between Icelandic banks and Nordic peers

Operating expenses / (NII + Net fees & commissions)
2010 – 2013, %



Operating expenses and NII+ Net fees & commissions to total assets
2013, %



Source: Bankscope, Annual Reports, Oliver Wyman analysis

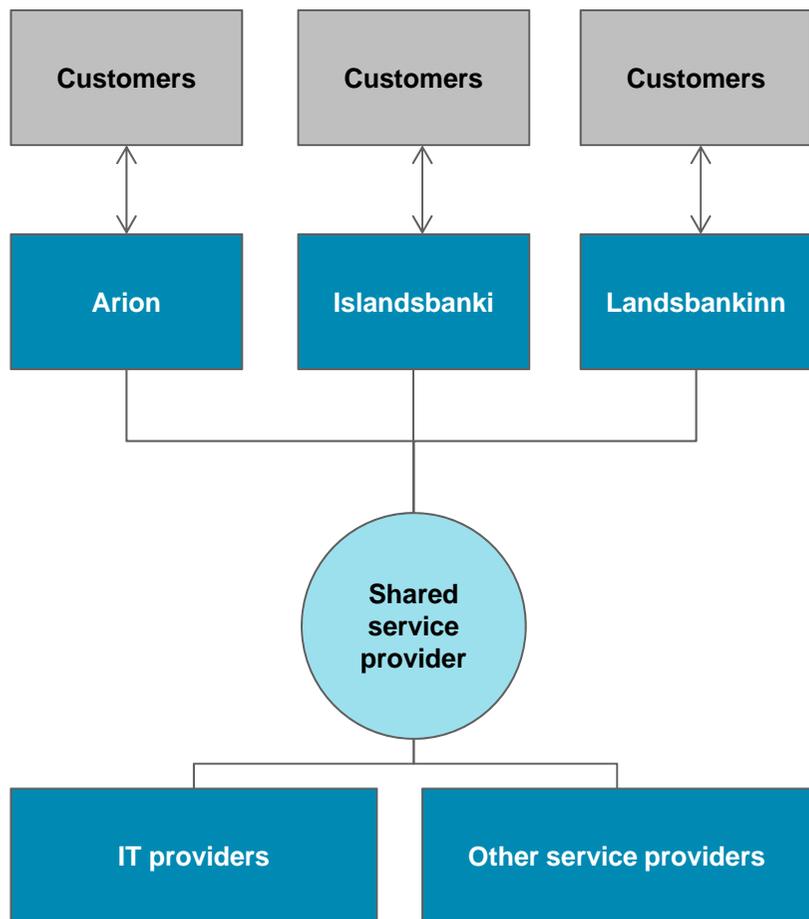
1. Peer set includes Nordea, SEB, Swedbank, Handelsbanken, DNB, Danske Bank

2. Regional peers consist of: Aktia (FI), SBAB (SE), LF Bank (SE), Skandiabanken (SE), Fars&Frosta Sparbank (SE), Jyske Bank (DK), Spar Nord Bank (DK), SB 1 SR-Bank / SMN (NO)

1 One potential solution to achieve economies of scale and thereby reducing operating costs would be to expand the role of shared infrastructure

Shared service provider overview

Illustrative



- Shared service provider serving all Icelandic banks
 - State owned or
 - Jointly owned by the banks
- Potential services in scope
 - IT, e.g.
 - Core banking engine
 - Online banking platform
 - Trading / custody platform
 - Finance and risk systems
 - Manual processing (e.g. document scanning, statements)
 - Customer support
- Systems need not necessarily be developed in-house; however, the joint structure provides increased purchasing power
- All banking decisions, such as product range and pricing, would still remain with individual banks to stimulate competition
- An independent shared services provider would also lower barriers to entry for potential smaller competitors

1 Smaller banks in e.g. Sweden and Denmark have use this model to reduce their operating costs to be able to compete with the larger banks

Case study A: BEC (Denmark)

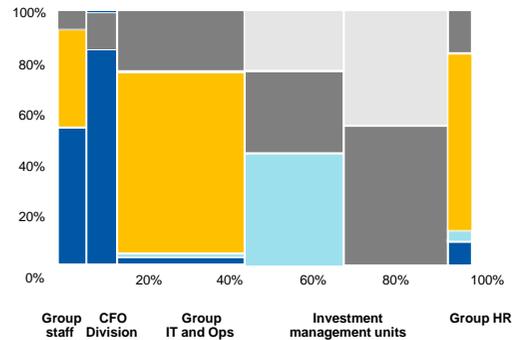
- Danish provider of full service IT solutions for financial institutions
- Turnover (2013): DKK 1.1 BN
- Ownership: jointly owned by a subset of its customers
- Examples of customers (50 in total):
 - Smaller banks, e.g. Spar Nord, Arbejdernes Landsbank, Fynske Bank, Lollands Bank
 - Also larger, e.g. Nykredit, Swedbank, SEB, Citi, RBS
- Examples of IT services:
 - Administration of accounts, loans and customers
 - National and international payments including SWIFT
 - Online and mobile banking
 - Securities trading
 - Capital markets platform
 - Risk and credit management
 - Statutory reporting and compliance

Case study B: Cerdo (Sweden)

- Swedish provider of IT and process solutions for financial institutions
- Turnover (2013): SEK 0.3 BN
- Ownership: Sparbanken Öresund and Sparbanken Syd
- Examples of customers (13 in total):
 - Smaller banks, e.g. Sparbanken Syd, Sparbanken Öresund, ICA Banken, IKANO Bank, Marginalen Bank
 - Consumer finance: Nordax Finans, Bluestep, Collector
- Examples of services:
 - Full service banking platform (savings and lending)
 - Card platform
 - Trading platform
 - Customer services
 - Back office
 - Payroll services

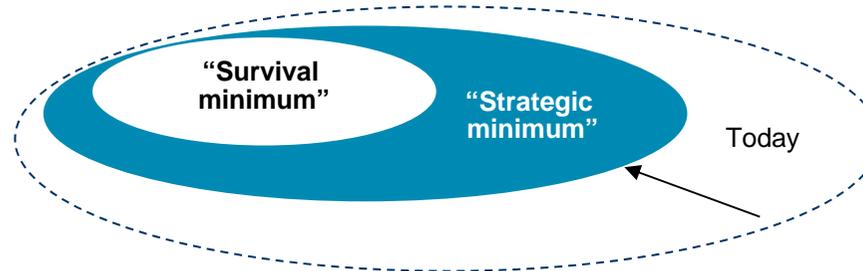
1 Shared infrastructure alone will not fully achieve C:I-ratios in line with peers, but will require broader cost management programmes

Illustrative overview OW approach



- Corporate Centre
- True shared services
- Region services
- Single BU services
- 3rd party service

Target setting using high-level benchmarks for each function



Agreed targets by function

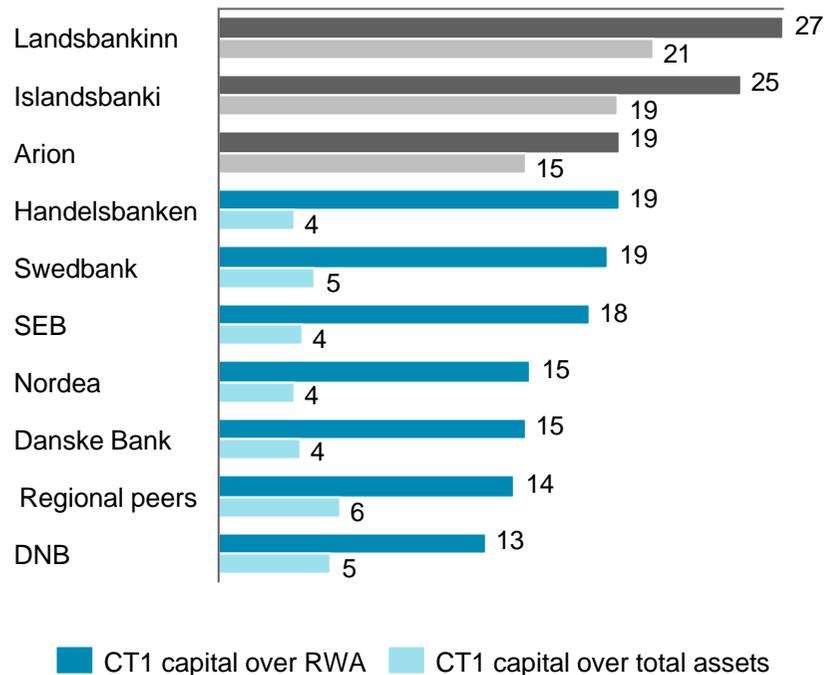
- “What is necessary to ensure the survival of the business?”
- Survival defined as ongoing business in line with markets
- No comfort zones, no break-outs
- “What in addition is critical to implement our strategic objectives?”
- No frills, but targeted investments in levers for strategic impact

25-40% cost reduction possible (depending on life cycle stage and aspiration)

Source: Oliver Wyman

2 With limited ability to dividend out capital Icelandic banks are funding very large portions of the balance sheet with costly capital bases
With RWA intensity similar to peers, CT1 capital reduction by up to €1.5

CT1 ratios (CT1 capital over RWA and Total assets)¹
 2013, %



Hypothetical CT1 capital reduction from IRB migration
 Benchmarked to Nordic regional peers

	Current		Potential	
	Nordic peer avg.	Icelandic banks total ⁴	Icelandic banks total ⁴	Implicit reduction
RWA (€BN)	7.5	14.3	8.0	-6.3
RWA / TA	43%	77%	43%	-34 pp.
CT1 Capital (€MM)	1,046	3,440	1,922	-1,519
CT1 ratio	14%	24%	24%	-

Assuming €1.5 BN of equity could be replaced with debt, this could have the potential to reduce prices to customers by up ~10% while keeping ROE constant³

While risk weights in line with Nordic peers are unrealistic given recent Icelandic credit history, models should be allowed to factor in post-crisis changes in underwriting standards and product offerings

1) CT1 capital and RWA numbers are based on Basel II, excluding the transitional rules
 2) Regional peers consist of: Aktia (FI), SBAB (SE), LF Bank (SE), Skandiabanken (SE), Jyske Bank (DK), Spar Nord Bank (DK), SB 1 SR-Bank / SMN (NO)
 3) Assumes cost of debt at 5%, leading to a €1.5BN decrease in equity, but a ~€80m increase in interest expense. Keeping ROE constant, it allows for a ~€100m decrease in interest income
 4) Arion, Islandsbanki, Landsbankinn

Note: If the transitional rules would be taken into account in Sweden and Norway, the RWAs would increase materially (in effect, reducing the CT1 ratios)

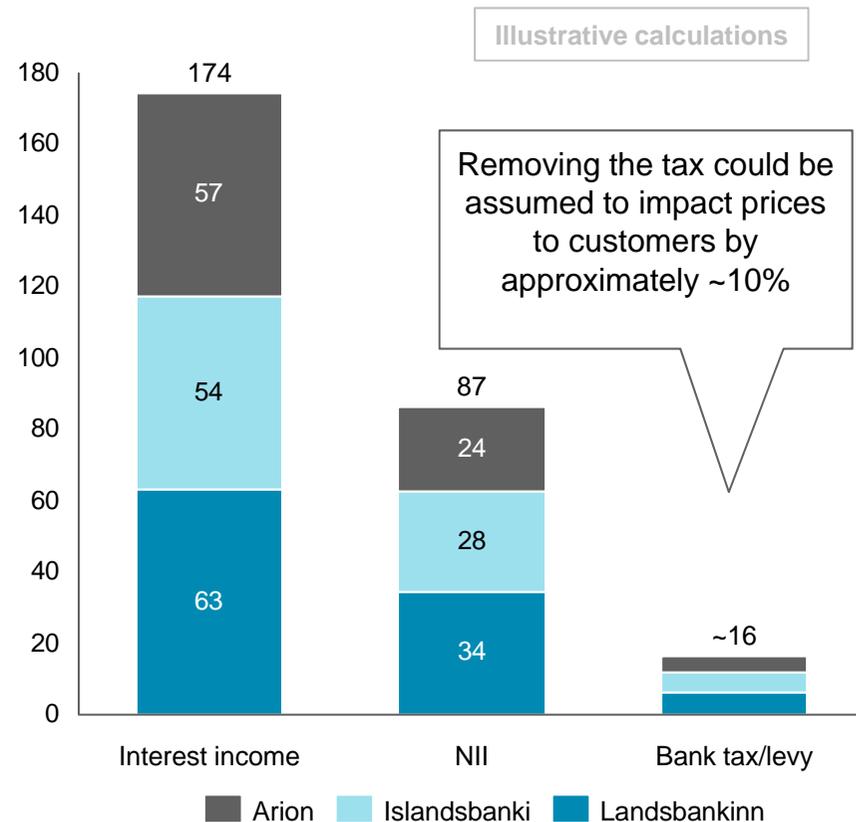
Source: Bankscope, Annual Reports, Sedlabanki, Oliver Wyman analysis

3 The high bank taxes in Iceland has a direct effect on the accessibility and affordability of the financial market

Comparison of bank levies by country

Country	Tax rate	Tax base	Corp. tax rate
Cyprus	0.11%	Deposits	10%
Finland	0.13%	RWA	20%
France	0.50%	Minimum equity requirement	33.33%
Germany	0.02-0.06%	Balance sheet (with certain adjustments)	29.58%
Iceland	0.376%	Liabilities (>ISK 50bn)	20%
	+6%	Corporate income tax base >ISK 1bn (20% → 26%)	
	5.5 %	Total remuneration to employees	
Netherlands	0.022-0.044%	Non-secured liabilities	25%
Sweden	0.04%	Debt (with certain adjustments)	22%
UK	0.07-0.14%	Balance sheet (with certain adjustments)	21%
US	0.17%	'Covered liabilities' (broadly equal to RWA less equity and insured deposits)	40%

Bank tax/levies relative to interest income¹ 2013, ISK MM



1) The impact of financial services taxation was indicatively estimated based on the 2013YE balances, taking into account the following: Bank tax 0.376% on total liabilities (>ISK 50BN); levy on remuneration paid to employees (5.5% on total staff-related expenses; assuming the wage tax is a deductible expense against the income tax base; and special income tax on the corporate income tax base (26% on profits exceeding ISK 1BN)

Source: PwC, KPMG, Bankscope, Eurostat

The discussed initiatives can have significant impact and should be part of strategy formation for getting closer to the competitiveness target

Estimated impact of initiatives (illustrative)

	Initiative	Assumed impact on costs	Total impact on pricing
1 Operating costs	Shared infrastructure between banks	Assume 50% of reduction from current levels to regional peer level is achievable	Potential reduction in operational and interest expenses would make a 25% reduction in interest income possible (keeping ROE constant)
	Cost reduction programmes		
2 Cost of funding	IRB migration	Assume 60% of risk weight reductions (relative to Nordic peers) is achievable	
	Review capital requirements	Assume average CT1-ratio could be reduced from 24% to 19% resulting in additional reduction of €0.5BN in CT1 capital	
3 Other costs	Review bank levy	Assume current levy rate reduced by 50%	

■ Policy driven initiative
■ Bank driven initiative

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