BANKASÝSLA RÍKISINS

The ownership and sale of holdings in Landsbankinn hf.: Status report on the planned sale process

This is an English translation of a report, which was published in Icelandic on January 8, 2016, excluding the appendices contained therein. Should there be any discrepancy between this translation and the Icelandic text in the report, the latter prevails.

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Introduction

The 2016 general budget bill discloses that the Treasury intends to sell up to 30% of its holdings in Landsbankinn hf. in the second half of that year. A similar provision was included in the 2015 general budget where the intention was to sell up to 30% of the Treasury's holdings in Landsbankinn of which 15% would be sold in 2015 and another 15% by the middle of 2016. According to the provisions of Act no. 155/2012 on the sale process of the state's holdings in financial undertakings, the Minister of Finance and Economic Affairs (the Minister) is only authorized to sell the holding in Landsbankinn in excess of 70%. On the basis of the state's current holdings in Landsbankinn, of 98.2% of the share capital of the bank, the Minister is authorized to sell up to 28.2% of the bank's shares.

According to current legislation, the Minister is authorized to sell certain holdings in financial undertakings, subject to two conditions. On one hand, that a proposal to such effect is submitted by Icelandic State Financial Investments (ISFI), and on the other hand that authorization is in the general budget for that year. Such authorization is currently in the general budget for Landsbankinn, as it was in the general budgets of 2014 and 2015, but so far ISFI has not considered it appropriate to submit such a proposal for the sale of holdings in the bank.

According to the cash flow projection for the Treasury in the general budget for the year 2016, cash proceeds of ISK 71,350 million are projected from sale of shares and assets in 2016 and it may be concluded from the introduction by the Minister in the general budget bill that potential proceeds from the sale of the shares in Landsbankinn will equal that amount. The income statement in the general budget bill, however, shows no projection of any profit or loss from the sale. The approach of the ministry is therefore similar to the presentation in the 2015 general budget where it was projected that the sale of a 15% share in Landsbankinn would produce a cash surplus of ISK 35,500 million but neither profit nor loss from the sale on an accrual basis.

On 9th of September 2015 ISFI sent a letter to the Minister where it stated that ISFI had been apprised of the intention to sell a part of the holding in Landsbankinn as set out in the general budget bill.[1] In the letter, ISFI stated that it had already begun necessary preparations and expected to present a formal proposal before 31st of January 2016 to the Minister in accordance with Act no. 155/2012 on the sale process of the state's holdings in financial undertakings. ISFI also stated that before the proposal would be presented to the Minister it would discuss possible alternatives of the sale with Landsbankinn hf., the largest domestic institutional investors (pension funds and investment funds) as well as international investment banks. Furthermore it was noted that in order to ensure transparency in the proposed sale process and facilitate a professional environment in support of the sale process, ISFI would release a report later that year on how ISFI intended to manage the sale process in accordance with applicable law. In the aforementioned letter to the Minister, ISFI explained that it intended to complete the first sale of state holding in the bank in the latter half of 2016 in accordance with the intentions set out in the general budget bill.

In light of the importance of maximizing the Treasury's recovery of its equity contributions to the commercial banks, as well as the financial cost related thereto, ISFI has established four economic criteria regarding the appropriateness of commencing a sale of the state´s holdings. The first three

[1] See http://www.bankasysla.is/fjolmidlar/frettir/nr/331/

criteria relate to external factors, whereas the last one relates to the financial undertakings themselves.

These criteria are:

- Strength and stability of the Icelandic economy.
- Acceptable valuations of shares in financial undertakings.
- Sufficient interest and capacity by markets to invest in the holdings.
- Indications that the operation, profitability, capital structure and corporate governance of the relevant financial undertakings suggest that the financial undertaking can be considered as an attractive investment alternative (or readiness).

Based on the current assessment of Icelandic economy, valuations of financial undertakings, investment capacity as well as the readiness of Landsbankinn, ISFI believes that the sale process of the holdings in the bank should commence. Caution must be taken regarding the fact that the sale of a 28.2% holdings in Landsbankinn corresponds to a large amount in relation to the investment capacity of domestic financial markets. It will therefore be necessary to have close regard to the volume of shares offered for sale compared to possible demand in financial markets. Also, a detailed valuation of the shares is not available at present.

With the publication of this status report, ISFI is fulfilling an important objective on transparency in its operations and publicly sharing its ideas on the proposed sale process of holdings in Landsbankinn. The report is divided into the following chapters:

The government's shareholdings in commercial banks.
The administration and sale process of holdings in financial undertakings.
Possible methods of sale of the government's holdings in Landsbankinn.
Advisors in sale process.
Future developments of ownership of Landsbankinn.

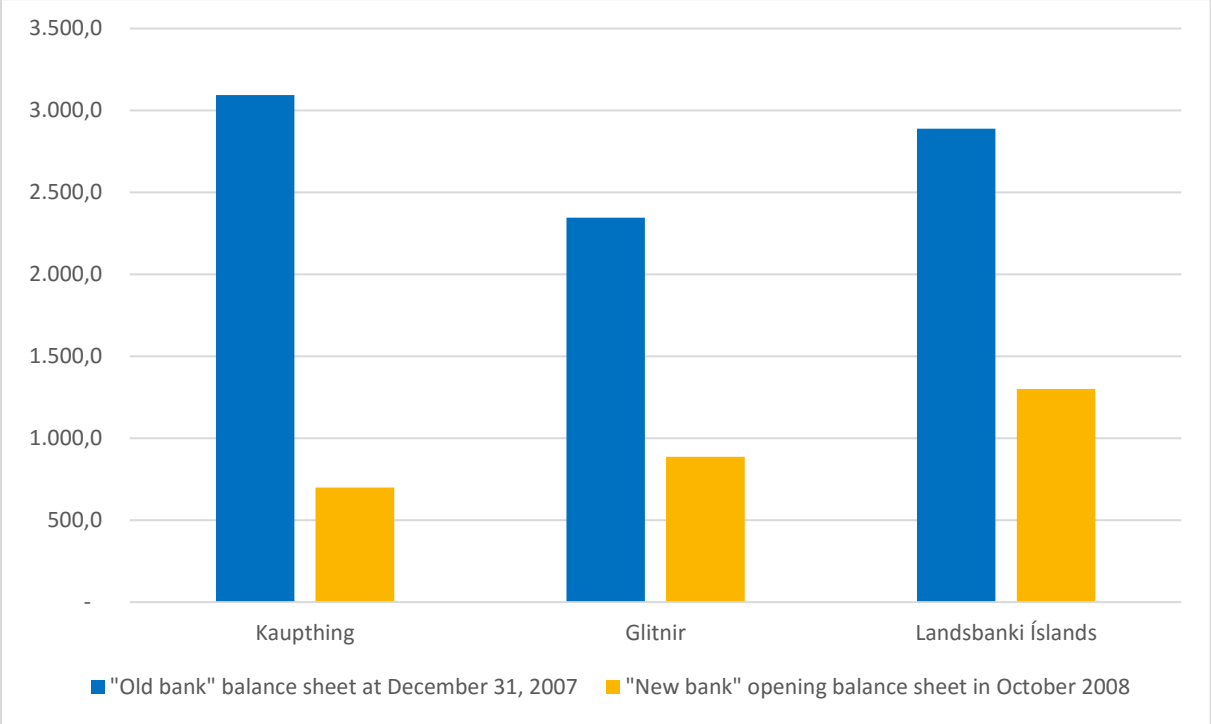
The government's shareholdings in commercial banks

Introduction

The Treasury established three new commercial banks following the decisions of the Financial Supervisory Authority (Fjármálaeftirlitið or FSA) to appoint resolution boards at the beginning of October 2008 over their three predecessors and provided them with share capital on the basis of authority provided in paragraph 1 Article 1 of Act no. 125/2008 on the authority for Treasury disbursements due to unusual financial market circumstance etc., the so-called "Emergency Act".

On 7th of October 2008, the FSA appointed a resolution board for Glitnir banki hf. (Glitnir) and Landsbanki Íslands hf. (Landsbanki Íslands or LBI)[2] and two days later a resolution board for Kaupþing banki hf. (Kaupþing). The Minister of Finance, on behalf of the Treasury, established new banks for the domestic activity of these banks, i.e., New Landsbanki Íslands hf. in an inaugural general meeting on 7th of October 2008, New Glitnir banki hf. in an inaugural general meeting on 8th of October 2008 and New Kaupþing banki hf. in an inaugural general meeting on 18th of October 2008. The Treasury provided each of these banks with minimum share capital, amounting to ISK 775.0 million, equivalent to five million euros at that time. Certain domestic assets and liabilities of Kaupþing, Glitnir and Landsbanki Íslands were transferred by an administrative decision by the FSA on 9th, 14th and 21st of October 2008. With these transfers, the assets of the three largest commercial banks fell from ISK 8,327.4 billion on 31st December 2007 for the old banks down to ISK 2,886.0 billion for the new banks.

Chart 1: Comparison between the "old banks" and the "new banks" (ISK in billions)[3]



[2] The following discussion will refer to Landsbanki Íslands regarding the bank's activity before 7 October 2008 and to LBI after that date.

[3] Source: Bank annual reports 2007 and FSA. Opening balance sheet at October 21, 2008 for New Kaupthing bank, October 15, 2008 for New Glitnir bank and October 8, 2008 for New Landsbanki Íslands.

Landsbankinn

Landsbankinn hf. (Landsbankinn) dates its history to the year 1886 when Landsbanki Íslands began operation.[4] The bank was however established in its present form on 9th of October 2008 following the decision of the FSA on the transfer of assets and liabilities of LBI. The transfer regarded all assets and liabilities associated with the domestic activity of Landsbanki Íslands to Landsbankinn. The fair value of the assets of Landsbankinn amounted to 55.6% of their book value at Landsbanki Íslands, as can be seen from table 1.

Table 1: Landsbankinn opening balance sheet at October 9, 2008 (ISK in billions)[5]

Assets	Carrying amount at LBI	Fair value at Landsbankinn	Ratio
Cash and balances with Central Bank	37,8	37,8	100,0%
Bonds and debt instruments	31,8	24,6	77,3%
Equities and equity instruments	65,7	36,2	55,0%
Loans and advances to customers	1.241,3	655,7	52,8%
Other assets	31,9	28,4	89,1%
Total assets	1.408,6	782,8	55,6%

The share capital of Landsbankinn was ISK 775.0 million at establishment, each share divided into nominal value of one ISK.[6] At a general meeting of the bank on 21st of October 2008 the board of directors received the authorisation to increase the share capital up to ISK 200.0 billion. At a general meeting a year later, on 15th of December 2009, the issuance of share capital to the Treasury with a nominal value of ISK 18,745 million was approved. As consideration for the shares, the bank received government bonds (RIKH 18 1009) amounting to ISK 121,255 million. On the same date, a Framework and Bond Issuance Agreement (FABIA) between the bank, the Minister of Finance and LBI was concluded on the capitalization of the bank, i.e., the issuance of shares and contingent bond to LBI. Later, on 22nd of January 2010, a general meeting approved an increase in the share capital of the bank from 19,520,000,000 shares to 24,000,000,000 shares with the issuance of 4,480,000,000 shares to LBI. The consideration comprised an offset against the claim of LBI against Landsbankinn in the amount of ISK 28.0 billion. With this share capital increase, the state's holdings in the bank fell from 100.0% to 81.3%.

[4] The inaugural general meeting of Landsbanki Íslands hf. was held on 10th of September 1997, and the bank began operation on 1st of January 1998 as it took over the operation and activity of Landsbanki Íslands in accordance with Act no. 50/1997 on the establishment of Landsbanki Íslands and Búnaðarbanki Íslands. In the beginning of 1998 the Treasury assigned to a recently created public limited company wholly owned by the state the assets and debts of older financial undertakings in accordance with the above Act and fulfilled thereby its share capital commitments, amounting to ISK 3.5 billion for Landsbanki Íslands hf.

[5] Reference: Annual account of Landsbankinn for the year 2008. Landsbankinn´s opening balance sheet was dated 9th October 2008, when the FSA determined to transfer certain assets and liabilities of Landsbanki Íslands to the bank, although it had been formed two days earlier.

[6] Landsbankinn was established under the name the New Landsbanki Íslands hf. At a general meeting on 21st of October 2008 the name was changed to NBI hf. and at the annual general meeting on 28th of April 2011 to Landsbankinn hf.

Table 2: Uses and sources funds for Landsbankinn (ISK in billions)[7]

Financial items	Amount
Transferred assets	782,8
Set-off of LBI claims	28,0
Purchase of government bonds	121,2
Cash	0,8
Total uses of funds	**932,8**
Assumed liabilities	507,8
Contingent bonds issued to LBI	274,8
Shares issued in settlement of a payable to LBI	28,0
Shares issued to the Treasury	121,2
The Treasury´s initial capital contribution	0,8
Non-controlling interest	0,2
Total sources of funds	**932,8**

Since the conclusion of the FABIA agreement on 15th of December 2009, the state's holdings in the bank has increased. On 11th of April 2013 Landsbankinn issued a contingent bond to LBI in the amount of ISK 92.0 billion and at the time of issuance LBI transferred its holdings in the bank, on one hand to the Treasury (3,980,000,000 shares) and on the other hand to the employees of the bank (500,000,000 shares).[8] With the issuance of contingent bonds the state's holdings increased from 81.3% to 97.9%. With the merger of Landsbankinn and Sparisjóður Vestmannaeyja ses., following the decision of the FSA on 29th of March 2015, the state's holdings in the bank increased still further. Through the merger, the state received a total of 19,310,892 shares in the bank for its shares in the savings bank – first on 3rd of June 2015 and later on 3rd of July of the same year.[9] Furthermore, following the merger of Sparisjóður Norðurlands ses., approved by the FSA on 8th of September 2015, the state received additional 47,702,886 shares in the bank on 28th of September 2015.

As a result, the government therefore currently holds 98.2% of the shares in Landsbankinn.[10]

[7] Source: Landsbankinn annual report 2008, ISFI.

[8] Following the transfer of shares, the bank withheld part of the shares transferred to its employees and settled their income tax associated with the transfer.

[9] The delivery took place in two parts. First, when a final valuation of the assets of the savings bank was made available and finally when a confirmation was received from the Director of Internal Revenue on the use of accumulated loss of the savings bank.

[10] The development of the state holdings in Arion banki hf. (Arion banki) and Íslandsbanki hf. (Íslandsbanki) differed from that of Landsbankinn. The resolution board of Glitnir decided on 15th of October 2009 to exercise the option to purchase 95% of the share capital of the bank from the Treasury. The transaction closed on 31st of December 2009. A shareholders' meeting of Arion banki decided on 8th of January 2010 to sell its 87% holding in the bank to Kaupskil ehf., a subsidiary of Kaupþing, following an agreement reached by the resolution board of Kaupþing to that effect on 30th of November 2009. In the case of both banks, the Treasury recovered a part of its equity capital contribution but also contributed capital to them in the form of subordinated loans. Since then, the holding of the Treasury in these two banks has remained unchanged, i.e., 5% in Íslandsbanki and 13% in Arion banki.

Table 3: The development of Landsbankinn´s share capital and government ownership[11]

Date	Total number of shares	Shares held by the government	Government ownership
October 7, 2008	775.000.000	775.000.000	100,0%
December 15, 2009	19.520.000.000	19.520.000.000	100,0%
January 22, 2010	24.000.000.000	19.520.000.000	81,3%
April 11, 2013	24.000.000.000	23.500.000.000	97,9%
June 3, 2015	24.000.000.000	23.509.829.938	98,0%
July 3, 2015	24.000.000.000	23.519.310.892	98,0%
September 28, 2015	24.000.000.000	23.567.013.778	98,2%

The financial interest of the Treasury

Central government accounts

When the 2009 central government accounts were released on 19th of July 2010, they reflected the conclusions of the aforementioned agreements on the state's final holdings in the largest commercial banks. The 5% holding in Íslandsbanki was recorded in the government accounts at ISK 6.3 billion, the 13% holding in Arion banki at ISK 8.9 billion and the 81.3% holding in Landsbankinn at ISK 122.2 billion in accordance with the Treasury's equity capital contribution after sale. In the government accounts of 2014 the 97.9% holding in Landsbankinn is valued at ISK 146.9 million. The recorded amount equals the equity capital contribution of the Treasury to the bank of ISK 122.0 billion, plus the 16.6% holding in the bank that was transferred in conjunction with the issuance of the contingent bonds. The state's holdings in Arion banki and Íslandsbanki are recorded at the net capital contribution of the Treasury, following the sale to Kaupþing and Glitnir, but the state held 100% of the share capital of these banks at their establishment, as noted earlier. Other state holdings at the end of 2014 consist of holdings in state enterprises under group B of the Treasury's assets in the balance sheet at the amount of ISK 1.5 billion, in financial undertakings under group C in the amount of ISK 19.5 billion, financial undertakings under group D (Central Bank of Iceland) in the amount of ISK 64.6 billion and other companies in group E where Landsbankinn is included.

Table 4: Central government accounts: (Group) A at December 31, 2014 (ISK in billions)[12]

Assets	Ownership	Amount	As % of assets
Landsbankinn hf.	97,9%	146,9	12,6%
Arion banki hf.	13,0%	9,9	0,8%
Íslandsbanki hf.	5,0%	6,3	0,5%
Investments in banks		163,1	14,0%
Other shareholdings and investments		92,6	7,9%
All other assets		912,2	78,1%
Total assets		**1.167,8**	**100,0%**

The state's holding in Landsbankinn is by far the Treasury's largest asset, whether valued by recorded amount in the government accounts or by the Treasury´s share of the shareholders' equity of the underlying enterprise. The share of the Treasury in shareholders' equity in Landsbankinn is

[11] Source: ISFI

[12] Source: Central Government Accounts 2014.

considerably higher than the recorded value of the holding in the Treasury's accounts and amounted to ISK 245.6 billion at the end of 2014. By comparison, as shown in table 5, Landsvirkjun's (National Power Company of Iceland) book value in the Treasury's 2014 accounts amounted to ISK 60.4 billion and the state's share in its equity amounted to ISK 209.3 million. Other shareholdings are considerably lower valued in comparison to the two companies, irrespective of type of measurement.

Table 5: The state's largest holdings and share of the book value of equity in underlying companies at December 31, 2014 (ISK in billions)[13]

Company	Carrying amount	Owners´ equity	State ownership	State´s share owners' equity
Landsbankinn hf.	146,9	250,8	97,9%	245,6
Landsvirkjun	60,4	209,5	99,9%	209,3
RARIK ohf.	14,6	29,5	100,0%	29,5
Arion banki hf.	9,9	160,7	13,0%	20,9
Íslandsbanki hf.	6,3	183,8	5,0%	9,2
Isavia ohf.	4,9	17,1	100,0%	17,1

If we make comparison to the U.K. government's investments in commercial banks following the financial crisis, we can assess its exposure at the end of the 2013-2014 financial year. At that time, the book value of the government´s holdings in Lloyds Banking Group plc (Lloyds) and in the Royal Bank of Scotland Group plc (RBS) amounted to 3.2% of its assets. These holdings were recorded at market value on 31st of March 2014 and comprise a considerably lower percentage of total assets compared to the Icelandic Treasury.

Table 6: HM Treasury Whole of Government Accounts at March 31, 2014 (GBP bn.)[14]

Asset	Amount	As % of assets
Lloyds Banking Group plc	£ 13,3	1,0%
Royal Bank of Scotland Group plc	29,7	2,2%
Holdings in banks	43,0	3,2%
Other assets	1.294,3	96,8%
Total assets	**1.337,3**	**100,0%**

Historical comparison

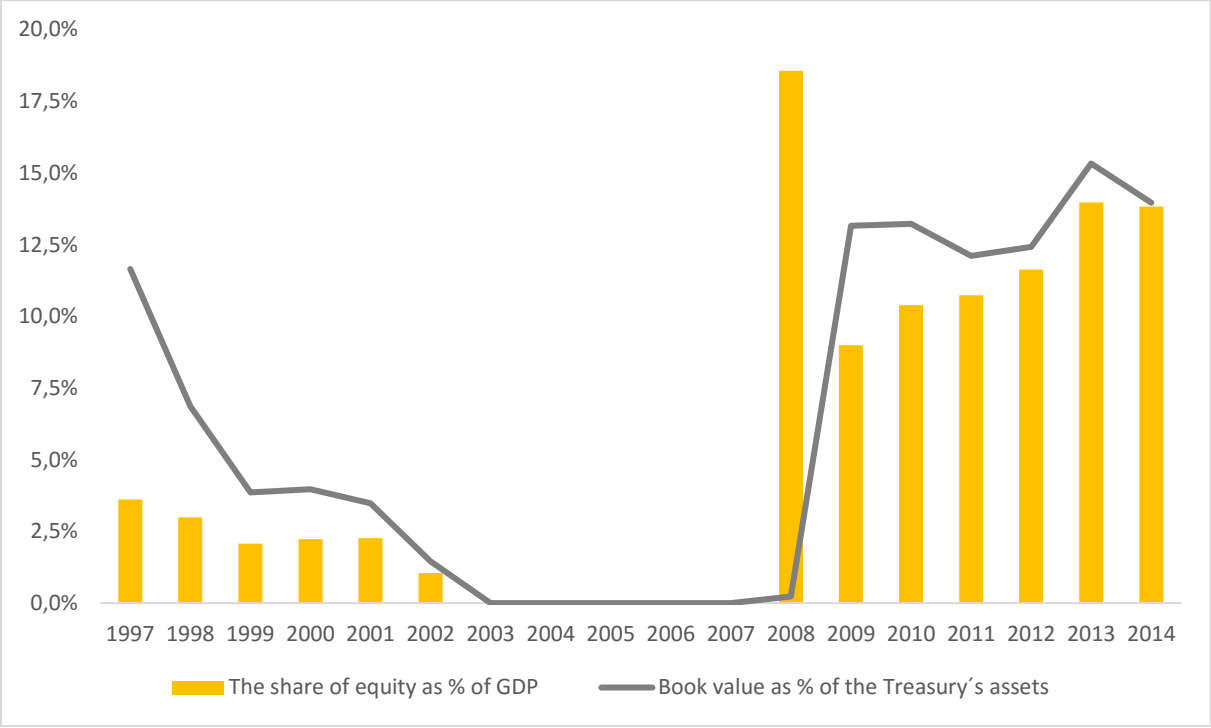
The financial risk of the Icelandic Treasury regarding ownership in commercial banks is not only greater now than in any other European country but also greater than it has ever been historically. Chart 2 illustrates the Treasury's carrying value of shareholdings as a ratio of the Treasury's total assets and the state's share in the book value of the shareholders' equity of the banks compared to gross domestic product (GDP) from 1997 to 2014. At the end of 1997 the Treasury held the entire share capital of

[13] Source: Government Accounts 2014 and annual reports of respective companies.

[14] Source: HM Treasury Whole of Government Accounts year ended 31 March 2014. It should be noted that there is a difference between the United Kingdom and Iceland government accounts in that the assets and liabilities of the Bank of England are included in the former, but the assets and liabilities of the Central Bank of Iceland are not included in the latter.

three commercial and investments banks, i.e., Fjárfestingarbanki atvinnulífsins hf. (FBA), Búnaðarbanki Íslands hf. (Búnaðarbanki Íslands) and Landsbanki Íslands.[15] At that time, the Treasury's book value amounted to 11.7% of government assets, whereas at the end of 2014 it amounted to 14.0%. Moreover, the state's share in the book value of the shareholders' equity was 3.7% of GDP at the end of 1997 but 13.8% at the end of 2014. The comparison of these two points in time is worthy of attention because over a five-year period, starting in 1998, the Treasury sold all of its holdings in these three banks. Although it is still undecided how the sale of the state´s holdings in Arion banki, Íslandsbanki and Landsbankinn will be executed, it is evident since the value of the state's share in the shareholders' equity compared to the GDP at the end of 2014 is four times greater than the state holdings in FBA, Búnaðarbanki Íslands and Landsbanki Íslands at the end of 1997, it is likely that the sale of shareholdings will take a considerably longer time now than before.

Chart 2: The Icelandic state's share in the recorded book value of the shareholder equity of banks and carrying amount of investments in the Treasury accounts 1997-2014[16]



In table 7, a comparison is shown of the size of Landsbanki Íslands' balance sheet at the end of 2002 and Landsbankinn at the end of 2014. Over this period, the total assets of Icelandic credit institutions increased by 10.0% a year or by a factor of 3.1x and the market share of the bank by 5.7 percentage points. The banks' shareholders' equity rose by a factor of more than 15 over the period because the equity ratio, which was 5.9% for Landsbanki Íslands at the end of 2002, had risen to 22.8% for Landsbankinn at the end of 2014.

[15] Búnaðarbanki Íslands and Landsbanki Íslands were licensed as commercial banks but FBA as another credit institution.

[16] Source: Treasury accounts 1997-2014, annual accounts of respective banks, Statistics Iceland and ISFI.

Table 7: Comparison of the size of Landsbanki Íslands in 2002 and Landsbankinn in 2014[17] (amounts in bn. except exchange rate)

	2002	2014	Multiple	Annual growth rate	Volume changes
Total assets of credit instutitons	1.307,5	4.082,1	3,1x	10,0%	2.774,7
The banks‘ share	21,2%	26,9%			5,7% pts
Banks‘ assets	277,8	1.098,4	4,0x	12,1%	820,5
Banks‘ equity ratio	5,9%	22,8%			17,0% pts
Banks‘ shareholders´ equity	16,3	250,8	15,4x	25,6%	234,5
US$ exchange rate	80,8	126,9	1,6x	3,8%	46,1
Shareholders´ equity of the bank	$ 0,2	$ 2,0	9,8x	20,9%	$ 1,8
Consumer Price Index	223,9	422,3	1,9x	5,4%	
GDP for the year	839,8	1.989,3	2,4x	7,5%	

Sale of treasury assets and repayments of debt

In the 2016 general budget bill it is emphasized that the sale of the states' holdings in Landsbankinn is intertwined with plans to reduce Treasury debt levels. In the pre-amble to the bill it is, i.e., stated that "[i]t [will prove] necessary to continue the policy to run the Treasury with a sizeable surplus and liquidate large Treasury assets, such as in Landsbankinn, to repay debt and, as the case may be, meet unfunded pension commitments". It is also stated there that "[t]he fiscal projection is based on various assumptions regarding measures that have the aim of reducing the interest costs of the Treasury for the future … [and the sale] … of the state's holdings in Landsbankinn where the proceeds of the sale would be used to repay bonds that were issued to refinance the banking system following its collapse in the autumn of 2008 … [is a measure] that [would] be [conducive] to reducing the interest costs of the [Treasury]".

Furthermore it is appropriate to place the credit rating of the Treasury for long-term foreign currency obligations into a historical context. The Treasury's credit rating for long-term obligations in foreign currency is currently Baa2 at Moody's Investors Service (Moody's), BBB at Standard & Poor's Ratings Services (S&P) and BBB+ at Fitch Ratings (Fitch). The Treasury was initially publicly rated in January 1994 by Moody's (A2) and S&P (A). The credit rating by Moody's peaked in the period from October 2002 to May 2008, at the highest category of Aaa. For S&P it peaked at AA- in the period from February 2005 to December 2006. The credit rating of Moody's fell thereafter and bottomed at Baa3 in the period from November 2009 to June 2015 when it rose by one notch to Baa2. Similarly, the S&P credit rating fell from AA- from December 2006 to November 2008 when it hit BBB- and stayed there until May 2015. The Treasury's credit rating is currently only one notch above the lowest it has been and three notches below its initial level in 1994.

The sale of the state's holdings in Landsbankinn, as well as other holdings in financial undertakings, could possibly be the most effective means of reducing the Treasury's debt level. Reduction of debt creates headroom for lifting credit ratings, both for obligations in domestic and foreign currency. An upgrade in the sovereign credit rating following debt repayments will probably have a twofold effect.

[17] Source: Annual report of LBI 2002, annual report of Landsbankinn 2014 and FSA.

On one hand, it would reduce the yield (demanded by investors) on government bonds in foreign currency and thereby the government´s future borrowing costs. On the other hand, it would result in an upgrade in the credit rating of Icelandic companies such as the three commercial banks. Since international financial markets base their required rate of return, or yields, on bonds issued by banks and other companies based on government bond yields of the country concerned, these factors could together lead to a reduction in the financing costs for Icelandic borrowers in international markets in the future. The sale of the government´s shareholdings, in which the proceeds are used to pay debt and/or reduce obligations, can therefore have a very positive impact on the entire economy.

The administration and sale process of holdings in financial undertakings

The role of ISFI

According to Act no. 88/2009 ISFI administers the state´s holdings in financial undertakings in accordance with law, good governance and business practice as well as the ownership policy of the government. The Act was passed by the Althingi on 11th of August 2009. The ownership policy was published on 1st of September 2009 and is accessible on ISFI's website.

The responsibilities of ISFI are listed in ten paragraphs according to the provisions of Article 4 of the Act. Amongst those are the following:

- To act as custodian of the state's holdings in financial undertakings.
- To communicate with financial undertakings on behalf of the state on matters that pertain to its ownership role.
- To oversee the implementation of the governments' ownership policy at each time.
- To vote on behalf of the state at shareholder meetings.
- To present proposals to the Minister as to whether and when specific shareholdings in financial undertakings are offered for sale and to prepare proposals on the sale of holdings in financial undertakings.

With Act no. 155/2002 on the sale process of the state's holdings in financial undertakings, the legal framework relating to the sale of shareholdings was further strengthened. According to Article 1 of the Act, the Minister is authorized to sell specific holdings in financial undertakings as follows:

- All shares in Arion banki.
- All shares in Íslandsbanki.
- All shares in savings banks.[18]
- Shares in Landsbankinn in excess of 70% the state holdings of the bank's total share capital.

A more detailed discussion on decision making and rules governing the sale process will follow.

International comparison

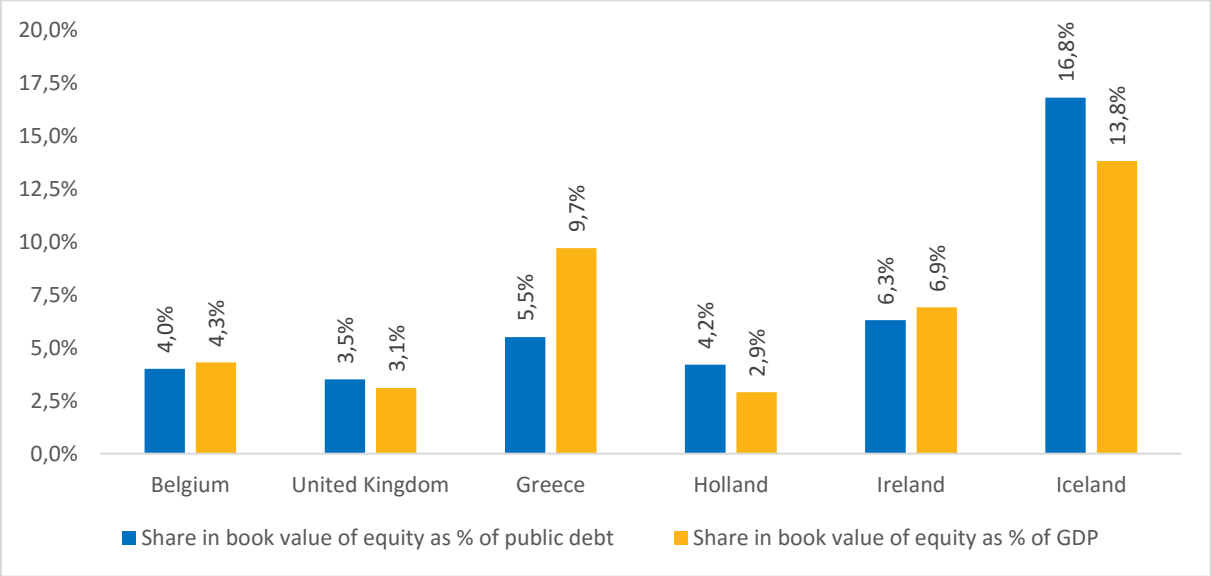
The administration of state holdings in financial undertakings in Iceland is comparable to other European countries that had to recapitalize domestic banks during the financial crisis. State bodies that were established for this purpose have much in common with ISFI. In the United Kingdom, UK Financial Investments Limited (UKFI) was established on 3rd of November 2008, which, i.e., administers the shares of the U.K. government in Lloyds and RBS. In the Netherlands, Stichting administratiekantoor beheer financiële instellingen or Netherlands Financial Investments (NLFI) was established on July 1st 2011. NLFI administers the government's shares in ABN AMRO Group N.V. (ABN AMRO). In Greece, the Hellenic Financial Stability Fund administers the government's holdings in four banks and in Belgium there is a special government holding company, La Société Fédérale de Participations et d'Investissement/De Federale Participatie- en Investeringsmaatschappij (SFPI/FPIM or The Federal

[18] The ISFI currently holds a stake in one savings bank, 49.5% in Sparisjóður Austurlands hf. (previously Sparisjóður Norðfjarðar ses.)

Share and Holding Company) that administers the holdings in the Belgian bank Belfius Bank NV/SA and in the French bank BNP Paribas SA. The largest government shareholding in Ireland is the 99.8% stake in Allied Irish Banks, plc (AIB).

The Icelandic state's holdings in commercial banks appear to be the largest by far amongst European countries, as measured by a ratio to GDP and public debt, as shown in chart 3. The state's holdings at the end of 2014 in the equity of Arion banki, Íslandsbanki and Landsbankinn were equivalent to 16.8% of public debt, compared to 6.3% for Ireland where the ratio was second-highest. At the same time, the state's holdings in the equity of these banks amounted to 13.8% of 2014 GDP, whereas Greece came in second place with 9.7%. The first ratio indicates that the sale of shares in commercial banks or recoveries in another manner can be of great significance in reducing Treasury debt. If one only looks to the government's share in the equity of Landsbankinn, it can be seen that it corresponds to 15,0% of public debt and 12.3% of GDP. For Iceland, the sale of state holdings in Landsbankinn can therefore be of great importance from a fiscal policy point of view.

Chart 3: Share of equity by European governments in the book value of banks' equity as ratio of GDP and public debt at year end 2014[19]



All of the above countries, except Iceland, have commenced the sale of government shareholdings in commercial banks. In October 2011, the first sale by the Irish state in the Governor and Company of the Bank of Ireland was completed, reducing the state´s holdings from 36.1% to 15.1%. The U.K. government completed the sale of Northern Rock plc. in January 2012. From September 2013 to December 2015, the U.K. government sold its 29.5% share in Lloyds in a series of transactions and thereby reduced its holdings in the bank from 38.7% to 9.2%. The sale of the Dutch state of its 23.0% holding in ABN AMRO was completed in November 2015.

[19] Heimild: Annual reports of corresponding financial institution, Eurostat, Statistics Iceland.

Legal framework for the sale process

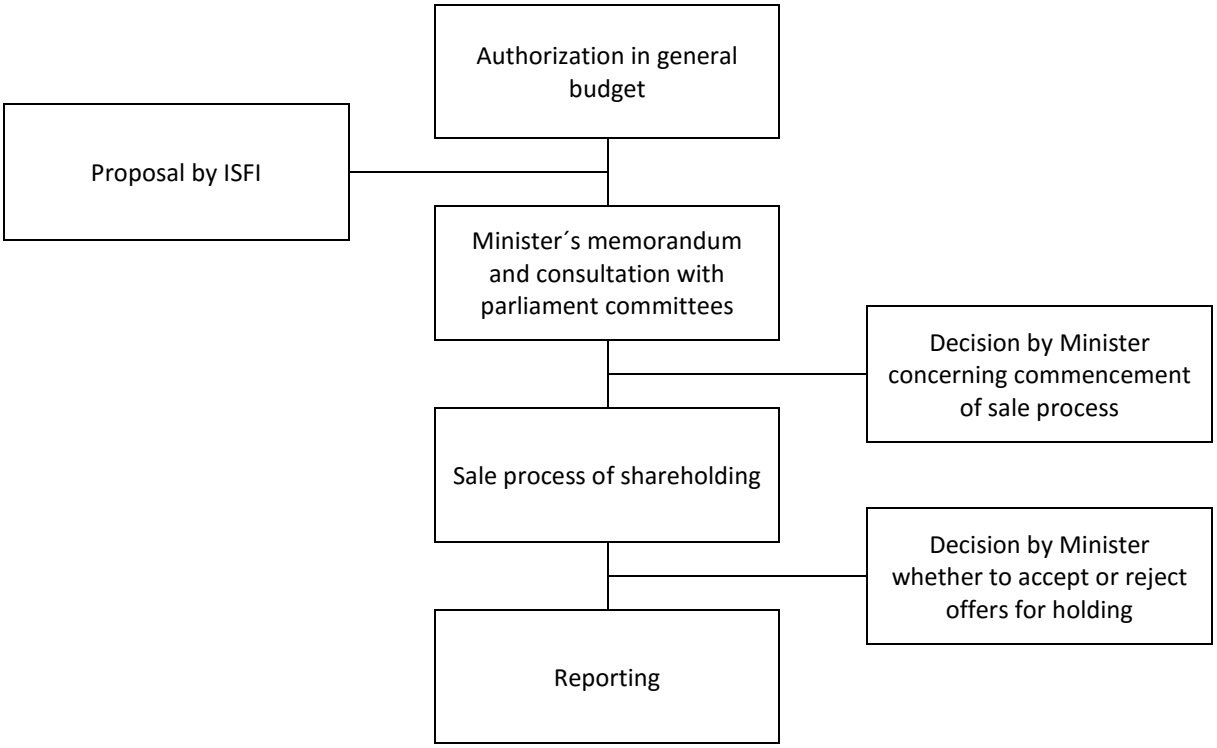
Introduction

The sale process of state holdings in financial undertakings is regulated by the aforementioned Act no. 155/2012 as well as by Act no. 88/2009. ISFI plays a certain role in the sale of the state´s holdings in financial undertakings according to both acts. In determining the roles of all parties during sale, one must therefore be mindful of the provisions of both acts.

This section only discusses the framework governing the sale process by Act no. 88/2009 and Act no. 155/2012. The sale process must also comply with other acts, such as the Public Limited Company Act no. 2/1995, the Act on Financial Undertakings no. 161/2002, the Securities Transaction Act no. 84/2007, the Public Procurement Act no. 84/2007, the Government Financial Reporting Act no. 88/1997 as well as the general budget for each year. It also must be ensured that the sale process will be in accordance with standard market practices in domestic and international financial markets.

According to item i. of Article 4 of Act no. 88/2009, it is the responsibility of ISFI to submit proposals to the Minister of Finance as to whether and when specific state holdings in financial undertakings shall be offered for sale in the general market, having regard to the objective of ISFI and in accordance with law and goals of dispersed ownership. Alongside this, in item j. of Article 4 of the same Act it is stated that ISFI shall prepare proposals on the sale of state holdings in financial undertakings. Also, according to the provisions of Article 1 of Act no. 155/2012 the Minister is only authorized to sell specific shares in financial undertakings, after having been so authorized in the general budget and having received a proposal to that effect from ISFI.

Chart 4: Overview of the sale process of the state´s shareholdings in financial undertakings



Authorization in the general budget

According to paragraph 1 Article 1 of Act no. 155/2012 the Minister is only authorized to sell shares in Landsbankinn in excess of 70% share of the government´s holding in the bank. The Minister is therefore authorized to sell up to 28.2% or 6,767,013,778 shares in the bank according to existing law.

Table 8: State holdings in shares of Landsbankinn and authorization to commence a sale

	Number	Percentage
Issued shares	24.000.000.000	100,0%
Shares of the state before an authorized sale	23.567.013.778	98,2%
Shares which the state is authorized to sell	6.767.013.778	28,2%
Shares by the state after an authorized sale	16.800.000.000	70,0%

The sale process can commence upon authorization in the general budget and other fulfillments, as set out below. Such authorization was approved in the 2014, 2015 and 2016 general budgets.

Proposal to the Minister, memorandum and consultation with committees of Althingi

The Minister shall prepare a memorandum on the proposed sale process, if express authorization for a sale is contained in the general government budget and if ISFI has submitted a sale proposal, which the Minister has approved, cf. Article 2 of Act no. 155/2012.[20] According to the same article, the Minister must present the memorandum both to the Budget Committee and the Economic Affairs and Trade Committee of Althingi and solicit the opinion of the Central Bank of Iceland on the equality of bidders, the possible impact of the sale on the foreign exchange market, the foreign exchange reserves and liquidity in circulation. The memorandum shall provide information on the main objectives of the sale, which method of sale will be deployed and how the sale will be handled in other respects.

Having received the comments from both committees and the Central Bank, the Minister shall decide whether a sale process shall commence. Such a decision can differ from the proposal by ISFI, e.g., by taking into account the commentaries of the two parliamentary committees as well as the Central Bank on the memorandum, cf. paragraph 2 Article 2 of Act no. 155/2012.

Sale process of state holdings and reporting

The provisions of Article 4 of Act no. 155/2012 cover the sale process following the decision by the Minister. The Article has two provisions, one dealing with the role of ISFI in the sale process and the other with the Minister´s position towards offers at the end of the sale process. ISFI's role in the sale process is to organize the sale, seek offers for the holding offered for sale, evaluate offers, administer negotiations with external advisors and prospective investors and conclude requisite contracts. Once offers have been submitted, ISFI shall report to the Minister with a reasoned evaluation and the Minister shall decide whether an offer is accepted or rejected.

[20] The ISFI assumes that its proposal according to Article 2 of Act no. 155/2012 could be the basis for the Minister´s memorandum.

The Minister then signs agreements on behalf of the Treasury on the sale of shareholdings. ISFI can therefore be viewed as the administrative authority in the sale process, whereas the Minister is the decision-making authority. It should be noted that in the explanatory comments for the bill that was passed as Act no. 155/2012 it was stated that there are various alternatives for selling state holdings in financial undertakings, such as an Initial Public Offering (IPO) or a traditional sale. It follows that an IPO is a process that differs from a traditional sale, in part because an evaluation of individual offers or actual agreement negotiations with specific buyers will not be taking place in the same manner.

Once a sale is completed, the Minister shall present a report to Althingi on the process, cf. Article 5 of the Act. Regardless of whether the block of 6,767,013,778 shares in Landsbankinn that are authorized for sale will be sold wholly or in part, it is clear that the same process needs to be repeated to sell the remaining state holdings earmarked for future sale. Further sales will however always be simpler, since the parties having roles in the sale should have the benefit of experience from the first sale.

Principles in the sale process

The principles governing the process are stipulated in Article 3 of Act no. 155/2012, which states that in the event of a sale of shareholding emphasis shall be placed on an open sale process, transparency, objectivity and efficiency. ISFI shall seek the highest price or the market price for each holding. Caution shall also be taken that conditions for prospective buyers are fair and that they enjoy equality. It shall also be endeavored to promote active and normal competition in the financial market.

In the explanatory comments for the bill that was passed as Act no. 155/2012 it is stated that these main principles apply to the entire sale process. The following text is a quote from the comments:

> "*Among the factors that need to be emphasized are that the conditions for bidders are transparent and that requirements are clear and beyond all doubt. Objectivity needs to be ensured, such as in the evaluation of bids so that a decision on a particular state holding can easily be substantiated. Also it must be ensured that the sale is efficient, i.e., that the highest price or market price is sought for state holdings that the state intends to sell at each instance. Should it be decided to let other consideration than efficiency prevail, they must be grounded on objective reasons and support other objectives of the sale. The intention is to offer state holdings for sale in an open sale process. On the other hand, it is necessary to specifically reason if the intention is not to offer state holdings for sale in this manner. Such an arrangement may in exceptional circumstances be considered, such as for the sale of smaller state holdings or if other special circumstances would call for such an arrangement. It is important to ensure that equality be preserved amongst prospective buyers so that all probable buyers enjoy equal possibility to bid. Equality is best ensured by having few conditions at the time of sale and they be clear for everyone.*"

Furthermore, it should be noted that one of the objectives that ISFI needs to have regard for is dispersed ownership, cf. item i. paragraph 1 of Article 4 of Act no. 88/2009.

With reference to the above it is clear that an IPO and listing of shares fulfills all aforesaid principles. ISFI maintains, on the other hand, that other methods are also suitable. In line with considerations set forth in the explanatory comments quoted above, ISFI will discuss them separately later in this report.

Economic criteria in the sale process

Introduction

ISFI presented its initial thoughts on the sale of holdings in financial undertakings in its strategy statement, which was published on 16th of March 2012.[21] It stated that ISFI's objectives included diversified ownership profiles of financial undertakings following the sale of holdings in them, aiming at different ownership structures across the banks. For example, one commercial bank could have its shares listed, another owned by a foreign financial undertaking and the third being owned by institutional investors. The strategy statement also outlined proposals for direct and indirect exit or monetization alternatives that will be further discussed below. The alternatives included an IPO and listing of shares, a sale to institutional investors, sale to foreign financial undertakings, restructuring, distributions to shareholders and issuance by the government of an exchangeable bond. It was also stated that the sale of state holdings in Landsbankinn would take place in stages.

Ever since the publication of its strategy statement, ISFI has not considered it feasible to commence the first sale of the state´s holdings in Landsbankinn. First, the underlying equity in Landsbankinn was expected to increase, i.e., in light of the fact that the assets of the old banking system were transferred to the opening balance sheets of the new banks at only a fraction of their carrying value on the balance sheets of the old banks before their collapse. Second, the domestic securities market had not recovered to their former levels. Third, the reported profits of the banks were characterized by non-recurring items rather than by regular operating income and it was therefore difficult to evaluate their future profitability from regular operations. Fourth, the valuation of European banks listed on stock markets was low from a historical perspective. For example the market value of shares was under 1.0x book value over a long period of time.

All of these factors suggested that ISFI should not take the initiative in selling the state´s holdings in the banks since their reported profits were high, demand for banking shares was limited, future prospects were uncertain and their valuation was low. For these reasons, ISFI emphasized that the government recover its equity contribution to the banks through both ordinary and extraordinary dividends, rather than an outright sale, since the bank could not utilize rising capital levels in excess of regulatory requirements to support further loan growth due to limited new investments in the economy. The government could thereby, as owner of the bank, recover its investment at book value of equity whilst the market value of banking shares was lower.

Landsbankinn viewed these considerations of its owner favorably. At the annual general meeting of the bank on 17th of April 2013, its board submitted for the first time a proposal of a dividend to shareholders, which was approved. In the years 2012 to 2014 reported profits attributable to owners of the bank amounted to a total of ISK 83.9 billion whereas in the years 2013 to 2015 it paid dividends to shareholders of ISK 54.2 billion. The government´s share of the bank's dividends since its establishment has therefore amounted to ISK 53.1 billion, and the Treasury has thereby recovered 43.5% of its original contribution to the bank of ISK 122.0 billion.[22]

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[21] See http://www.bankasysla.is/um-bankasysluna/framtidarstefna/

[22] The original contribution does not include the financing cost of the Treasury.

Table 9: Historical dividend payments by the commercial banks since their founding (ISK bn.)

	Arion banki	Íslandsbanki	Landsbankinn	Samtals
During the year 2013	-	3,0	10,1	13,1
During the year 2014	7,8	4,0	20,2	32,0
During the year 2015	12,8	9,0	24,0	45,8
Total	**20,6**	**16,0**	**54,2**	**90,9**

The dividend policy of Landsbankinn was presented in the directors´ report at the bank´s annual general meeting on 19th of March 2014. It stated "that the board has established a criterion whereby Landsbankinn aims to pay a regular dividend payment equaling on balance majority of profits from the prior year. In deciding the amount, it must be ensured that the bank maintains its financial strength. Account will thereby be taken of internal and external risk factors, growth prospects and that the bank maintains a strong ongoing capital and liquidity position and meets regulatory requirements at each time." Based on shareholders' profit over the period 2012 to 2014 totaling ISK 83.9 billion and, the aforementioned dividend policy of the bank, regular dividends can be viewed as comprising one-half of profits or ISK 42.0 billion and extraordinary dividends ISK 12.2 billion. It should be noted that non-recurring items had a considerably favorable effect on Landsbankinn's profits over this period.

ISFI´s main objective with the sale of holdings is to ensure the maximization of recovery of the Treasury's equity contribution.[23] On September 30th 2015, its share of the book value of equity in the three banks totaled ISK 280.0 billion. The estimated book value in the Treasury's accounts, taking into account the increase in the stake in Landsbankinn from 97.9% at the end of 2014 to 98.2%, at the end of September 2015, amounted to ISK 163.5 billion. The book value of holdings in the Treasury's accounts, as measured by its share in the book value of the shareholder's equity therefore amounted to 0.58x for the state´s holdings in all the banks and 0.59x for its holdings in Landsbankinn alone. As noted earlier, the state´s holdings are recorded at the original equity contribution.

Table 10: Recorded value of shareholdings in financial undertakings in the Treasury's accounts versus share of underlying book value of shareholders´ equity at September 30, 2015 (ISK bn.)[24]

Commercial bank	Share-holding	Recorded value	Book value of share-holders´ equity	Share in book value of share-holders´ equity	Recorded value in Treasury's accounts vs. share in book value of equity
Arion banki	13,0%	9,9	173,5	22,6	0,44x
Íslandsbanki	5,0%	6,3	191,0	9,5	0,66x
Landsbankinn	98,2%	[25]147,3	252,5	247,9	0,59x
Total		**163,5**	**617,0**	**280,0**	**0,58x**

[23] Such a principal objective is in tandem with the text of the comments accompanied with the bill that later was passed as Act no. 155/2012 where it was stated that it would have to be specially reasoned if other consideration than efficiency (seeking the highest price) were to dictate a sale.

[24] Source: Interim financial statements of respective banks, ISFI.

[25] Estimated recorded amount of 98,2% shareholding, adjusted from recorded amount of ISK 146,9 bn. in the Treasury's accounts for 2014 for 97,9% shareholding at year-end 2014.

As noted earlier in the introduction, ISFI has established four economic criteria establishing the appropriateness of commencing a sale of the state´s holdings in line with its overarching objective to ensure maximum recovery of the Treasury's equity contributions to the banks. The criteria are:

- Strength and stability of the Icelandic economy.
- Acceptable valuations of shares in financial undertakings.
- Sufficient interest and capacity by markets to invest in the holdings.
- The readiness of the financial undertaking.

In light of the current assessment of the state of the Icelandic economy, the valuation of shares in financial undertakings, the interest and financial capacity of investors and the readiness of Landsbankinn, ISFI considers it appropriate to commence the sale process of the government's holdings in the bank. ISFI's considerations are discussed in the following sections.

The strength and stability of the economy

The Icelandic economy is now exhibiting greater strength and stability than when ISFI presented its first ideas on the sale of the government´s holding on March 16th 2012, although certain signs of recovery in the economy were then already evident.

This view is supported by the development of Iceland´s sovereign credit rating in foreign currency. On March 16th 2012 the rating was Baa3 at Moody's with a negative outlook and BBB- with a stable outlook both at S&P and Fitch. S&P upgraded the rating outlook from negative to stable on 23rd of November 2011 and Fitch raised its rating from BB+ to BBB- on 17th of February 2012. By comparison, the rating by each agency is higher at present, i.e., Baa2 at Moody's, BBB at S&P and BBB+ at Fitch. The outlook of all ratings is also stable. It should also be noted that there is greater visibility surrounding the lifting of capital controls and its impact on the banking system, especially after the consultation between the Central Bank of Iceland and the Minister of Finance and Economic Affairs regarding exemptions for the winding-up of the estates of the old banks on 28th of October 2015. Lastly, the Treasury's financial position has strengthened. The Treasury's deficit amounted to ISK 89.4 billion in 2011, whereas in 2014 there was a surplus of ISK 46.4 billion. This favorable development has positively impacted credit spreads on Iceland´s sovereign bonds in US dollars, as measured by the asset swap spreads, which have declined by 2.22 percentage points over the period, compared to only an 0.10 percentage point decline in the yield of comparable US dollar bonds with a BBB credit rating, as shown in table 11.

Table 11: Comparison of asset swap spreads of the Republic of Iceland US$ denominated bonds and comparably rated bonds[26]

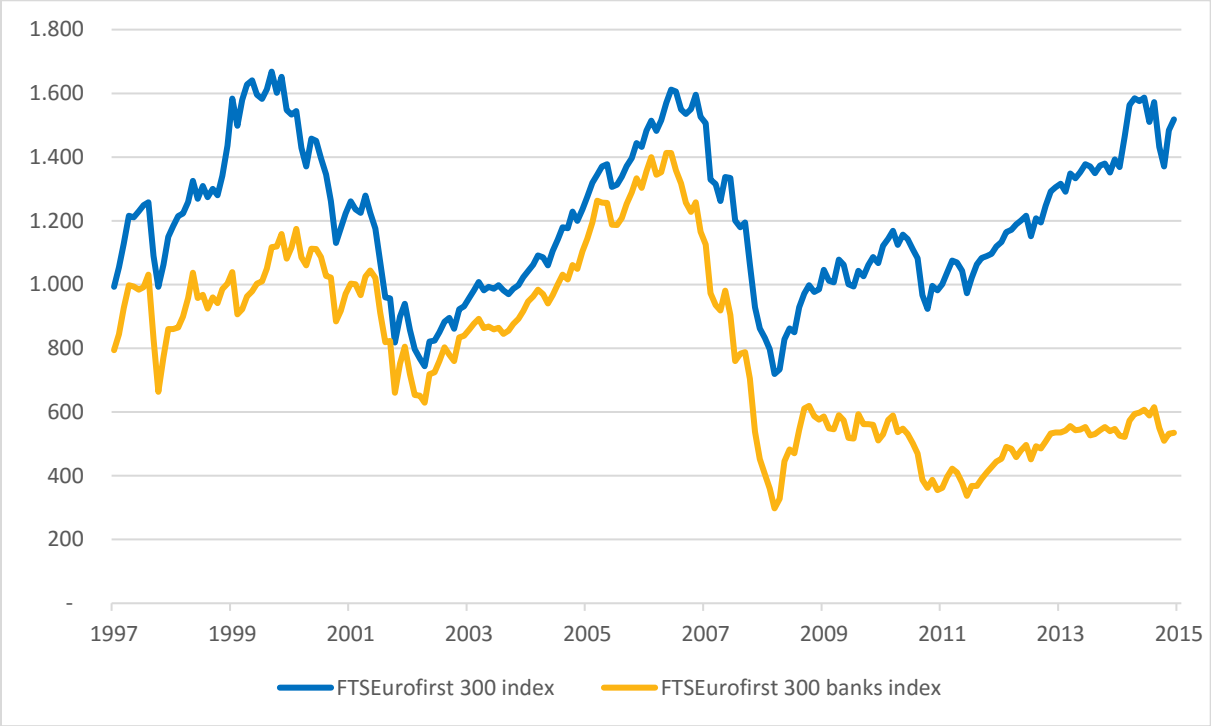
	Yield	Spread	Maturity
February 29, 2012			
U.S.$1,000,000,000 4.875% Notes due 2016	4,89%	3,95%	4,3 years
US$ BBB rated bonds	4,02%	2,47%	11,1 years
November 30, 2015			
U.S.$1,000,000,000 5.875% Notes due 2022	3,44%	1,73%	6,5 years
US$ BBB rated bonds	4,20%	2,37%	11,0 years

[26] Source: ISFI, Bloomberg.

Valuation of shares in financial undertakings

The valuation of shares in financial undertakings, especially banks, has sharply improved in recent years. Since shares in Icelandic commercial banks are not listed on a stock exchange, one must view the development of the valuation of commercial banks in Europe in this context.[27] Both the FTSEurofirst 300 share index and its sub-index for bank shares have increased in value from their lows in the first quarter of 2009, as shown in chart 5. On 30th of November 2015 the FTSEurofirst 300 sub-index for banks stood at 535.1 points, having reached a low of 297.7 points on 28th of February 2009, at the end of that month. The index has therefore risen by 79.7% over this period. By comparison, the FTSEurofirst 300 index rose by 111.0% during the same period, or from 719.4 to 1,518.0 points. With improvement in the share valuation in financial undertakings, the government´s recovery of its capital contributions to the commercial banks should improve.

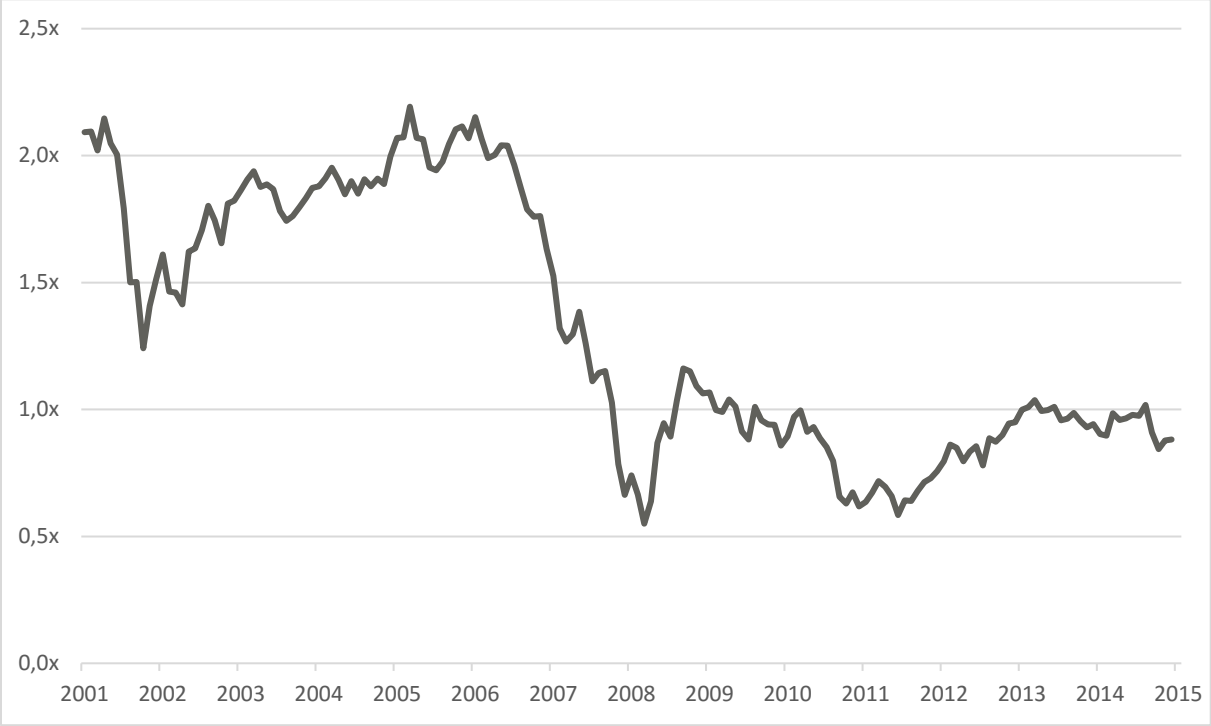
Chart 5: Development of share prices of banks in Europe[28]



[27] It should be noted that the shares in the Faroese bank P/F BankNordik are listed on the Icelandic Stock Exchange as well as on Nasdaq in Copenhagen. At the end of 2014, 17% of the shareholders in the bank were Icelandic. The annual turnover in the shares on the Icelandic Stock Exchange in 2014 was only DKK 8 million compared with DKK 133 million in Copenhagen. On 30 November 2015 the market value of shares in the bank amounted to DKK 1,325.0 million and the equity book value of shareholders on 30 September 2015 was DKK 2,073.3 million.

[28] Source: Bloomberg. From December 31, 1996 to November 30, 2015.

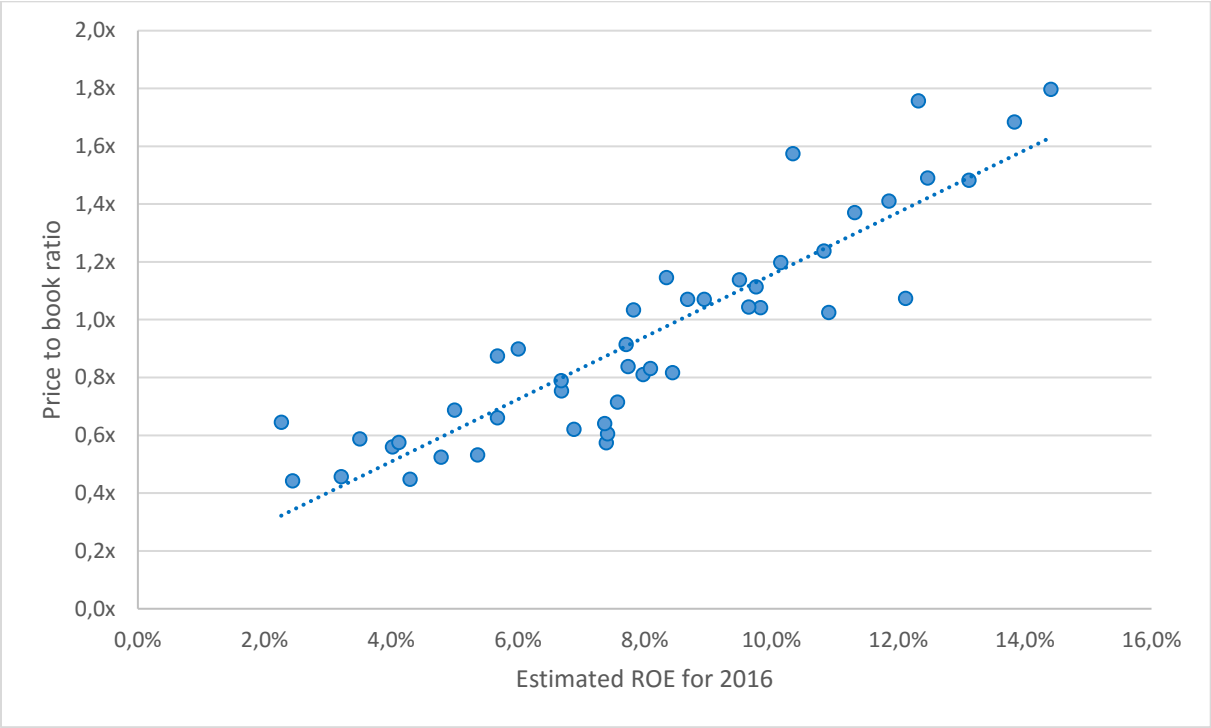
Chart 6: Development of the price to book ratio for bank shares in Europe [29]



On 30th of November 2015, the market value of the FTSEurofirst 300 bank index corresponded to 0.88x of the book value of shareholder equity in the underlying banks in the index, as shown in chart 6. During the period since 31st of December 2001, the price-to-book ratio reached its lowest point in the first quarter of 2009 at 0.55x. Although the ratio was below 1.00x on 30th of November 2015, the price of the underlying European bank shares ranged largely between 0.46x and 1.82x which to a large extent reflected the estimated return on shareholders' equity of each bank for 2016, as shown in chart 7. The chart shows a strong correlation between the price-to-book ratio on one hand and the expected return on shareholder equity for 2016 on the other hand.

[29] Source: Bloomberg. From 31st of December 2001 til 30th of November 2015.

Chart 7: Price-to-book ratio versus estimated return on equity for 2016 for European banks[30]



In valuing commercial banks on an aggregate basis, one compares the market value of share capital on one hand to the underlying book value of shareholders equity (price to book ratio) and on the other hand to the expected earnings to shareholders (price to expected earnings ratio). A comparison is also made between the expected dividends to the market value of share capital (dividend yield). A valuation can also be established for each individual business segment (sum of the parts valuation) based on the allocated equity to each segment and the expected earnings of each. In such a case, the valuation may depend on the business model of each bank.

Investors´ capacity and interest

ISFI considers that the investment capacity and interest of prospective buyers of holdings in Landsbankinn is sufficient enough to commence the first sale of government's holdings in the bank.

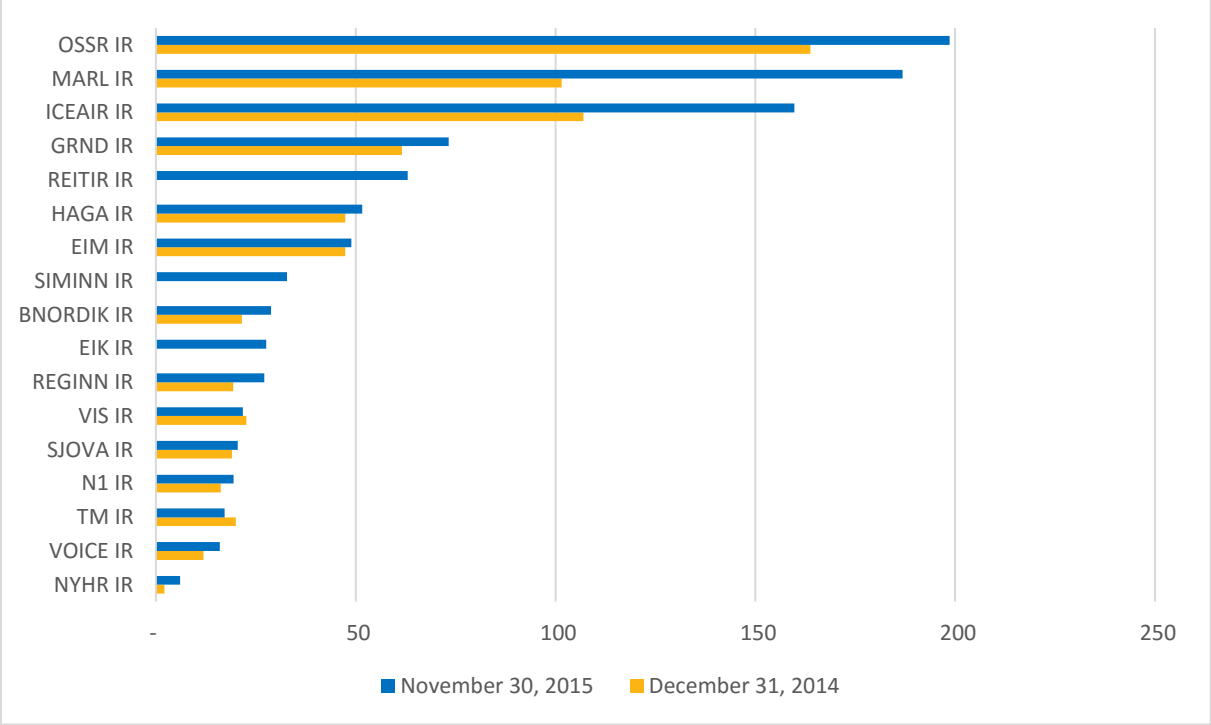
The assessment of ISFI is both based on an objective evaluation of the investment capacity of prospective investors, their investment policy, size and growth of the domestic stock market and the volume of new listings on the Nasdaq OMX Iceland as well as on the subjective evaluation of their interest in investing in shares and Landsbankinn´s position in the Icelandic economy.

On November 30th 2015 the combined market value of companies listed on the Nasdaq OMX Iceland amounted to ISK 999.2 billion compared to ISK 661.6 billion at the end of 2014. The market value of

[30] Source: ISFI. At November 30, 2015. Correlation (*r*) between the two variables was 0,90. Slope of regression line was 10,7 and represents the P/E ratio. According to a survey by ISFI, shares on Nasdaq OMX Iceland main list are traded at a market price corresponding to an average market value of 12.1x expected earnings of the year 2016.

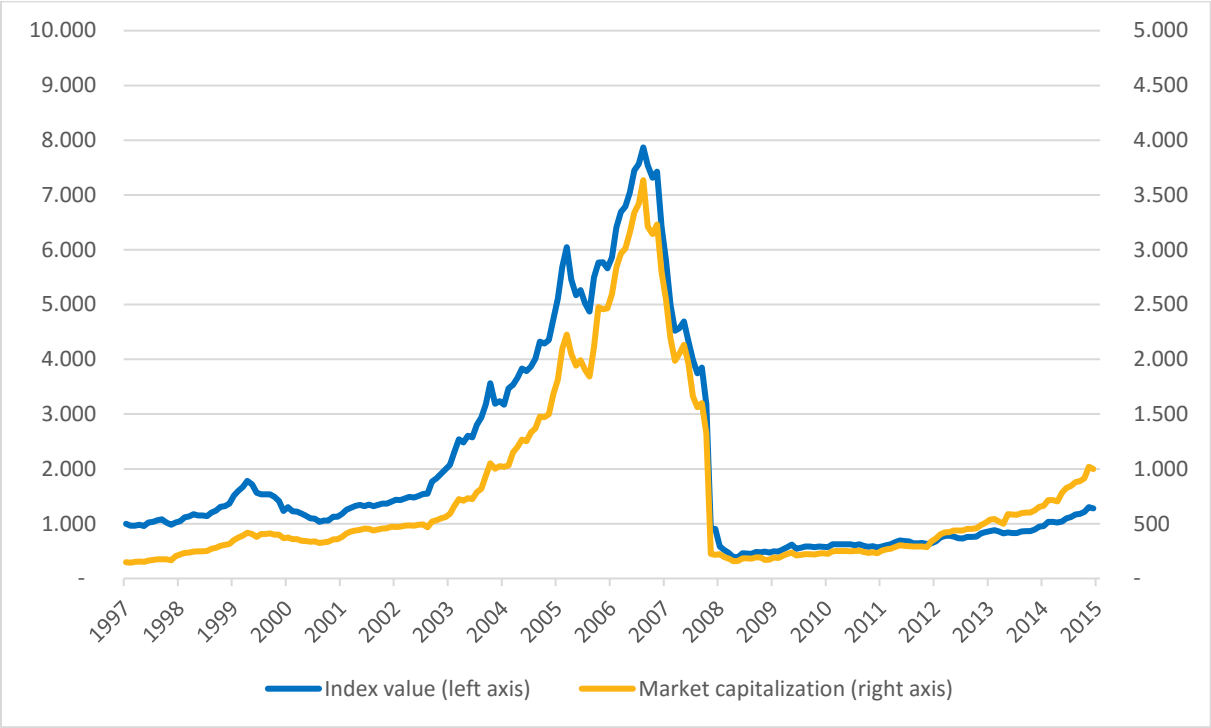
listed companies has therefore increased by ISK 337.7 billion or by 51,0% during this period. Chart 8 illustrates the market value of listed companies on 30th of November 2015 and on 31st of December 2014. On 31st of December 2014 there were 14 companies listed on the Nasdaq OMX Iceland Exchange, of which 13 were Icelandic. During the period from 31st of December 2014 to 30th of November 2015 the market value of these companies increased by a total of ISK 221.9 billion or by 32.3%. Three companies were listed on the exchange during the year. The turnover volume on the Nasdaq OMX Iceland has also increased sharply. Total turnover in the first ten months of 2015 amounted to ISK 320.4 billion compared to ISK 276.7 billion for the same period in 2014, an increase of 15.8%. Daily turnover amounted to an average of ISK 1.5 billion in the first ten months of 2015. The main stock market index stood at 1,281.0 points on 30th of November 2015 compared to 956.4 points at the end of 2014, representing an increase of 33.9% so far this year. The index was trading at similar levels as at the end of 2004 and has risen sharply from the end of 2008, as depicted in chart 9.

Chart 8: Market value of listed companies on the main list of the Icelandic stock exchange at 31st of December 2014 and 30th of November 2015 (ISK bn.)[31]



[31] Source: ISFI, Bloomberg.

Chart 9: Development of the Nasdaq OMX Iceland main index 1997-2015 (ISK bn.)[32]



On 30th of September 2015 the shareholders´ equity of the three largest commercial banks totalled ISK 617.0 billion.[33] The government's share in the equity amounted to ISK 280.0 billion thereof, of which ISK 247.9 billion were in the equity of Landsbankinn. According to Act no. 155/2012, there is authorization to sell up to a 28.2% stake in the bank, equating to to ISK 71.2 billion of the shareholders´ equity in the bank. As noted in the 2016 general budget, it is expected that proceeds from a sale will equal ISK 71.3 billion in the budgeted cash flows for the year. If one looks only at the amount that can possibly be raised by the sale, regardless of the valuation of the underlying shares, ISFI believes that domestic financial markets do not have the capacity to absorb such a large share placement at once. ISFI believes that in order not to cause excess supply in domestic markets the first sale of the state´s holdings in Landsbankinn should therefore comprise a lower amount and share of the bank´s equity. Should the shares be placed in both domestic and foreign securities markets, however, ISFI does not consider the amount being offered as being too high, although it is not clear at this point in time what the initial offering price for each share could be.

It is expected that the largest portion of prospective buyers of shares in Landsbankinn will be domestic investors, institutional investors as well as individuals. On 30th of September 2015 domestic equity instruments held by Icelandic pension funds, both listed and unlisted, amounted to a total of ISK 490.1 billion. At that same time, domestic equities held by mutual funds, investment funds and institutional investment funds in domestic shares amounted to a total of ISK 129.9 billion. In 2014, net cash inflows to pension funds before sale and purchase of securities amounted to ISK 227.7 billion. It is expected that pension funds will participate as investors in shares in Landsbankinn, i.e., because, unlike nearly

[32] Source: Central Bank of Iceland, Bloomberg.
[33] By comparison, the market value of shares on the Nasdaq OMX Iceland main list was ISK 914.9 billion at that same point in time.

all other stock markets in Europe, there is no domestic credit institution represented in the main stock indexes or with shares listed on a stock exchange in Iceland. Moreover, it cannot be ignored that shares in Landsbankinn could become a benchmark instrument in investor portfolios and will carry significant weights in most stock indices if listed on a stock exchange. Indeed, there are few companies that are as representative of the Icelandic economy as Landsbankinn.

It is more difficult to objectively assess the financial capacity of individuals to invest in Landsbankinn shares. In reviewing retail ownership of shares in listed domestic companies, it appears that fewer individuals are shareowners than before. The share of households with financial income from dividends, compared to those receiving interest income from bank deposits, has declined sharply since 2008. This trend indicates that there is some room for converting household savings from bank deposits to equities.

The investment capacity of foreign institutional investors for shares in Landsbankinn is beyond doubt. In analyzing the capitalization and profitability of Icelandic commercial banks in comparison to their European peers, it may be argued that the situation of the Icelandic banks is more favorable in many aspects, as shown in chart 10. The chart illustrates that the tier 1 capital ratio of the Icelandic banks averages 25.3% compared to the top quartile of European banks with a tier 1 capital ratio of 16.1% and higher than the bottom quartile of European banks with a tier 1 capital ratio below 12.2.%. Thus, one half of European banks reported a tier 1 capital ratio between 12.2% and 16.1%. This capital ratio is therefore considerably higher on average for the Icelandic banks than for their European counterparts and appears also to be high compared to the top quartile of European banks. The ratio of non-performing loans (NPLs) using the same comparison is also lower. Moreover, the dividend payments of Icelandic banks have been higher, as a ratio of profits, than amongst European banks. The Icelandic banks therefore exhibit many of the characteristics that equity investors in Europe should consider as being attractive. ISFI's conversations with international investment banks indicate that foreign institutional investors may be interested in participating in an IPO of an Icelandic commercial bank. It should also be noted that international bond investors have already invested EUR 700 million in bonds issued by the three largest commercial banks in 2015, demonstrating that the Icelandic banks have earned certain trust in international markets.

Chart 10: Weighted average financial ratios of Icelandic banks and corresponding interquartile range for European banks[34]

Landsbankinn's readiness

In ISFI's opinion, the financial position of the three largest commercial banks in Iceland is so robust that shares in them can be offered for sale to the public and listed on an exchange. As discussed earlier, Icelandic commercial banks have many of the characteristics that European equity investors may consider attractive.

Landsbankinn is one of the largest companies in Iceland. According to the survey of the business journal *Frjáls verslun*, the reported earnings of the bank in 2014 as well as its shareholders´ equity at the end of the year was higher than that of any other Icelandic company. Since its foundation on 7th of October 2008 and until 30th of September 2015, the bank's shareholders´ equity has increased from ISK 149.9 billion to ISK 252.5 billion, and in addition Landsbankinn has paid dividends to its shareholders totalling ISK 54.2 billion over this period.

Ever since the establishment of Landsbankinn, its financial strength has steadily improved. Few other banks in Europe exhibit such a high equity ratio as Landsbankinn, or 29.2% at 30th of September 2015 on a risk weighted asset basis and 21.5% on a reported total asset basis. Landsbankinn has established

[34] Source: Interim financial statements of the commercial banks for the first six months of 2015, European Banking Authority. Tier 1 ratio and NPL ratio at 30th of June 2015 and return on equity for the twelve month period ended that date. The ceiling of the interquartile range indicates a number, above which one quarter of banks report a certain ratio, while the lower limit indicates a number, below which one quarter of reporting banks report that ratio. The interquartile range therefore indicates the range within which one-half of the sample falls.

a dividend policy and its board of directors has proposed dividend payments in accordance with the policy at the bank´s annual general meeting in each of the past three years.

Additionally, uncertainty in the bank's operations has fallen considerably since its establishment, such as regarding the legality and the re-evaluation of foreign exchange linked loans and indexed loans as well as the impact of non-recurring items on the bank's earnings. The ratio of non-performing loans has therefore declined sharply since its establishment, falling to 3.7% on 30th of September 2015. Moreover, the number of retail branches and staff have both declined, despite the fact that the bank has since its founding taken over the operations of three other deposit money banks.

At the same time Landsbankinn's capitalization has improved. The bank repaid outstanding amounts under the LBI bonds more rapidly than scheduled amortizations required, and termed out the remaining balance with refinancing. Landsbankinn´s S&P credit rating has also improved from BB+ to BBB- with a positive outlook on 21st of July 2015 and confirmed on 19th of November 2015. With a bond issue of EUR 300 million on 15th of October 2015 the bank further strengthened its balance sheet as well as its reputation with investors in international markets.[35]

Finally, an important prerequisite for offering shares in a company is that potential investors are able to assess its operations, financial strength and future prospects to determine their required rate of return for their investment. The disclosures provided by Landsbankinn in its financial accounts and supplementary results presentations is fully comparable to those demanded by investors in listed shares of banks. Landsbankinn fully discloses the total capital requirements and buffers required by the FSA as well as the calculation underlying its liquidity coverage ratio, that are important information for shareholders who want to assess the ability of the bank to pay dividends. Landsbankinn also has bonds listed on stock exchanges in Iceland and Ireland and complies with rules related thereto, such as disclosure.

Other issues for consideration

Costs associated with the sale process

It is not apparent at this point in time what the costs to ISFI associated with the sale process will be. Outlays in connection with financial and/or equity capital markets advisors can consist of fixed monthly retainers as well as sales commissions proportional to sales proceeds. In addition, there will be legal expenses and other fees relating to advisory services. It is also expected that operating expenses of ISFI may rise due to increased activity. In reviewing comparable situations, we note NLFI's analysis of investment banking fees paid by European governments in placing shares in government enterprises since 2006 showing fees ranging between 1.3% and 1.7% for the initial tranche sold. According to the reply by Iceland´s Minister of Finance at the time in response to a parliamentary question during the 123rd session of Althingi in 1998-99, the total cost "of the conversion of state enterprises into limited liability companies and the sale of shares owned by the government" amounted to 1.42% of the total proceeds from the sale over the term.[36] Also a report on the sale of the government's holdings in

[35] Landsbankinn's bond issues are included in recognised bond indices in euros.
[36] http://www.althingi.is/altext/123/s/0435.html.

Landssími Íslands hf. (Iceland Telecom) in 2005 showed that the sales commissions amounted to 1.2% of the proceeds, of which 1.0% went to the coordinating investment bank.[37]

Currently ISFI has not incurred any direct costs in connection with the proposed sale process. Furthermore, no information will be available on estimated costs until the decision by the Minister has been made and the amount of sale proceeds is available. For this reason, ISFI does not deem it appropriate to request a special appropriation from Althingi in the 2016 general budget to meet such costs but intends to do so in the supplementary fiscal budget for the same year.[38]

Capital controls and their liberalization

After the announcement of consultation between the Ministry of Finance and Economic Affairs and the Central Bank on the exemptions of the winding-up of the bank estates on October 28th 2015, the impact of the liberalization of capital controls has become clearer. It is expected that the impact of liberalization will be positive on the economy and activities of credit institutions. S&P therefore confirmed its credit ratings and outlook for the country's three largest commercial banks following the announcement. On the other hand, the withdrawal of deposits by the estates in winding-up proceedings from the commercial banks and their refinancing could have an impact on their liquidity and profitability. Furthermore, the timing and arrangements of the expected auctions of the Central Bank of off-shore ISK are not at hand.

ISFI believes that the process of the liberalization of capital controls will not have an impact on the sale process of the state´s holdings in Landsbankinn. ISFI believes that the interest of foreign investors in shares in Icelandic banks will increase after the lifting of capital controls and therefore important to keep informed about developments in this process.

Considerations regarding the timing of a sale

Ever since the aforementioned consultation was announced, there has been a public debate about the expected sale of Arion banki, Íslandsbanki and Landsbankinn over the next years. As noted earlier, the book value of the share capital of these banks amounted to a total of ISK 617.0 billion on 30th of September 2015, or specifically ISK 173.5 billion at Arion banki, ISK 191.0 billion at Íslandsbanki and ISK 252.5 billion at Landsbankinn. It is therefore evident that a large volume of bank shares might be offered for sale over the next several years, and initial price expectations by prospective buyers of shares being offered for sale in each instance will likely reflect the anticipated supply of other holdings.

ISFI informed the Minister by a letter on 9th of September 2015 that ISFI wishes to commence a formal sale process of the state's holdings in Landsbankinn. The intentions of shareholders of other banks will not influence the submission by ISFI of a proposal to the Minister. Although Icelandic pension funds do in theory have the investment capacity to purchase all the share capital of the commercial banks, it may prove necessary, so as not to disturb equilibrium in domestic markets, to sell a certain part of the shares in one of the commercial banks to foreign entities.

[37] http://www.forsaetisraduneyti.is/raduneyti/verkefni/Einkavaeding/nr/1987.

[38] The general budget for 2015 was presented on 9th of September 2014, whereas the supplementary general budget for the same year was presented on 31st of October 2015, i.e., more than a year later.

It is important to bear in mind, in spite of IFSI's assessment to commence a sale process at the current time, that there are other arguments in support of holding back with an initial sale. First, the valuation of shares in European banks is still below their historical average.[39] Second, domestic investors have not faced the task of having to value shares of banks for a long time. One might therefore argue that the first sellers of holdings in a commercial bank will receive a lower price than would be considered to be fair compared to comparable issuers.[40] Third, the commercial banks may still have room to pay special dividends or buy back their own shares which could be a more effective way of recovering the equity contribution by their owners. Fourth, Landsbankinn is implementing a long term strategic plan until the year 2020, as announced at the bank's annual general meeting on March 18th 2015. The management of the bank expects that the implementation of the plan can have a positive impact on profitability of its core operations over a period of several years. In connection therewith, the management of Landsbankinn has highlighted that the construction of new headquarters could increase the operating efficiency of the bank.

Future ownership and the relationship between first sale and subsequent sale of shares

When a shareholder like the Icelandic government in the case of Landsbankinn, holding nearly all the underlying share capital, embarks on the first sale of shares, two questions may be raised by prospective investors. First, what percentage of the share capital does the owner intend to retain permanently and, second, over what period of time does the owner plan to dispose of its holdings that it does not plan to retain. The investors´ concerns are therefore twofold, first, whether they will become minority shareholders in the bank with the government as a controlling shareholder and, second, what the expected supply of Landsbankinn shares into the market would be in the near future. If no clear policy exists for the future holdings of the government in Landsbankinn at the time of the first sale, there is a risk that the valuation of the shares by prospective investors will be lower than of comparable companies that either have all of their shares listed on a stock exchange or whose owners have a clear policy of future ownership.[41] In light of the high proportion of Landsbankinn´s share capital that is held by the government relative to GDP, ISFI considers it very difficult at this point in time to present a time plan for future sales, as sales by the government of its shareholdings in the bank are expected to take many years. ISFI, however, considers it to be very positive for the entire sale process if a clear policy is laid down concerning what percentage ownership the government wants to retain permanently in Landsbankinn.

Although it is difficult at this time to present plans for future sales, it is still important to bear in mind the relationship between the first and subsequent sales of holdings. The sellers of large holdings are faced with a certain trade-off, whether to sell a significant stake in the beginning and a smaller stake later, or a small stake at first and significant stake later. If a significant stake is sold at the outset, the IPO discount, as compared to the valuation of comparable companies, could be larger than if a smaller

[39] On 30 November 2015 the FTSEurofirst 300 sub-index for banks stood at 535.1, with a price-to-book value ratio of 0.88x. During the period from 31st of December 2001 to 30th of November 2015 that ratio averaged 1.32x.
[40] This difference in price is often referred to as IPO discount.
[41] There are actual examples of listed government-owned companies where experts refer to the difference between the fair value price and the actual market price of shares as government ownership discount.

stake is sold.[42] Subsequent sales of holdings could, on the other hand, prove to be an easier task since a more active market would exist relative to any share overhang. On the other hand, if a small holding is initially sold, the IPO discount could be smaller but future sales could prove to be more difficult because anticipated future supply is high compared to the turnover of the shares already sold. The main argument for a larger initial offering is that the company attracts the greatest interest from prospective investors during the initial sale. The main argument for the initial sale of a small stake is that later sales would be expected to fetch a higher price than the first sale.

Legal restrictions pertaining to holdings

The provisions of Article 40 of Act no. 161/2002 on Financial Undertakings stipulate that a party which intends to acquire, alone or in cooperation with others, a qualifying holding in a financial undertaking shall give notice to the FSA in advance. A qualifying holding, whether direct or indirect, is defined as 10% or more of the company's equity or voting rights or other holding which enables significant influence over the management of the company concerned. The same applies if an entity, alone or in cooperation with others, intends to increase its holdings so that it exceeds 20%, 33% or 50% or if a holdings increases to the point where the financial undertaking becomes its subsidiary. The voting rights of such a holding will not take effect until time limits have elapsed or the FSA has deemed the party in concern as qualified. If the FSA does not view a party as a qualified owner, FSA must notify the said party. If a party acquires or increases a qualifying holding in spite of the disqualification of the FSA, the voting rights of the party in excess of the minimum holding constituting a qualifying holding shall be suspended, cf. Article 46 of said Act. The party concerned becomes subsequently obligated to sell the holding in excess of what it previously owned. The FSA sets time limits for this purpose and with a deadline not less than two months.

The assessment of the qualifications shall take account of all of the following factors:

- The reputation of the party intending to acquire or increase a qualifying holding.
- The reputation and experience of any person who will direct the business of the financial undertaking as a result of the proposed acquisition or increase in holdings.
- The financial soundness of the party intending to acquire or increase a qualifying holding in the financial undertaking.
- Whether the ownership by the party intending to acquire or increase a qualifying holding could be expected to impede supervision of the financial undertaking in question or influence whether the undertaking will comply with the laws and rules applicable to its business activities.
- Whether there are grounds to suspect that the proposed acquisition of or increase in qualifying holding could lead to money laundering or terrorist financing or that the proposed acquisition or increase could increase the risk of such activities.

It can be discerned from the preceding paragraphs that there are detailed rules on the qualification of owners with qualifying holdings in financial undertakings that place strict requirements upon them. The FSA also, in addition to the above authority, has the right to deprive the party concerned of its

[42] It should be noted that at the time of the first sale of shareholdings in a commercial bank in the Icelandic market there will be no comparable domestic company on which a valuation can be referenced to at the time of sale.

voting rights as well as to impose an obligation to sell. These rules are imposed due to the importance of financial undertakings for the economy as well as reducing the risk that an undesirable ownership could emerge.

One of the objectives that ISFI must bear in mind regarding the sale of holdings in financial undertakings is dispersed ownership, cf. Article 4 of Act no. 88/2009. It is clear, however, that ownership may become concentrated over time. In order to ensure dispersed ownership for the future, it is possible to enact legislation to the effect that parties will not be able to own more than a certain percentage in a financial undertaking. In establishing such limits, regard must be had to the basic property rights as well as to the commitments of Iceland according to the EEA Agreement. At the same time, it is clear that such rules, if imposed before a sale, could hamper the efficiency of the sale, i.e., reduce the value of the state's holdings to some extent. It should also be noted that aforementioned rules on qualified holdings constitute limits on ownership and should therefore have an effect on maintaining dispersed ownership. It must furthermore be taken into account that investors will carefully consider whether they have an interest in maintaining a qualified holding given the conditions that would be attached thereto, rather than holding a stake below the aforesaid limits.

Minority interests

As noted earlier, the state's holding in Landsbankinn is now 98.2% and the minority's share is 1.8%, divided among 1,800 shareholders. Other shareholders are mostly current and former employees that obtained shares in connection with the issuance of the contingent bond to LBI in accordance with the FABIA Agreement. The former equity owners of Sparisjóður Vestmannaeyja and Sparisjóður Norðurlands are also among the shareholders as they received shares in Landsbankinn following the merger of these savings banks with Landsbankinn in 2015.

All of these shareholders have agreed to a lock-up period until the 1st of September 2016 unless the shares are listed on a stock exchange. Likewise, the same shareholders have waived the provisions of Article 26 of Act no. 2/1995 on Public Limited Companies regarding the redemption rights of minority shareholder up to that time.

Possible methods of sale of the government's holdings in Landsbankinn

Introduction

ISFI classifies the possible methods of sale, which it considers employing in recovering the equity contributions by the Treasury to the commercial banks, into direct and indirect sale options (or monetization or exit alternatives), as shown in table 12.

Table 12: Possible monetization alternatives of ISFI´s investment in Landsbankinn

Direct sale options

□ IPO
- Single: Domestically
- Dual: Domestically and internationally

□ Sale to institutional investors
- Domestic pension and investment funds
- International specialized funds

□ Sale to foreign financial institutions (trade sale)

Indirect sale options

□ Distributions to shareholders
- Special dividends
- Buy back of own shares

□ Issuance of government financial instruments
- Issuance of exchangeable bonds
- Sale with a conditional put option

□ Asset swaps
- Exchange of shares for government bonds
- Contribution by government to LSR (The Pension Fund for State Employees)

□ Restructuring
- Separation or spin-off
- Sale of assets

□ Direct distribution of shares to the public

Main principles and criteria

Before reviewing the advantages and disadvantages of each method of sale, it is appropriate to review the main provisions of Acts no. 155/2012 and 88/2009 as they establish the legal framework for the sale process of the state´s shareholdings. First, one must consider how the method fulfils the principle of efficiency for the sale process, cf. Article 3 of Act no. 155/2012 and the accompanied commentary to the bill that was passed into law. Regard must thereby be had whether the method (a) ensures the highest price for the state's holding, (b) that it maximizes demand, (c) minimizes cost and administration, (d) facilitates further future sales of the shareholdings and (e) minimizes execution risk.

Second, whether the method fulfils other main principles of the sale process must be considered. In Article 3 of Act no. 155/2012, emphasizes is placed on openness, transparency, objectivity, fairness and equality of conditions, and that it promotes active and normal competition in the financial markets. Also item i. of Article 4 of Act no. 88/2009 states that the proposal to the Minister on the sale of shareholdings shall be in accordance with the goal of dispersed ownership.

Third, it must be assessed how the method conforms to ISFI's principles, cf. paragraph 3 Article 1 of Act no. 88/2009 such as the reconstruction of a strong domestic financial market, transparency in all decision-making and an active disclosure of information to the public.

Fourth, it must be assessed how the sale method aligns with the government's policy at each time, such as on the repayment of interest-bearing Treasury debt, reduction in unfunded pension

commitments and the state's holdings in financial undertakings in the future. In the introductory section to the general budget bill, it is stated that "… it will be necessary to continue pursuing the policy of generating a sizeable Treasury surplus, to liquidate large state owned assets such as Landsbankinn hf. in order to repay debt and, as the case may be, address unfunded pension commitments". ISFI considers it necessary to take account of these views at the time of sale.

Direct sale options

Introduction

ISFI sees mainly two alternatives for the direct monetization of equity contributions to Landsbankinn. First, an IPO followed with a listing of shares. The listing could either be only in the domestic market (single) or in both domestic and international markets (dual). Second, a sale to institutional investors through an open process. In such a sale, it may be assumed that two kinds of investors would be interested, i.e., both domestic pension funds and institutional investors as well as international investment funds that specialize in bank investments. In this context, ISFI considers it very unlikely that a sale of the state's holdings to another domestic financial undertaking, or a merger with it, would be approved by the Icelandic Competition Authority.

If ISFI submits a proposal to the Minister on the sale of state holdings in Landsbankinn through an IPO, followed by a listing of shares, ISFI will probably propose that a certain part will be offered for an outright sale and at the same time another part will be allocated to the book runner to secure secondary market support (green-shoe or over-allotment option). Such an arrangement is considered market standard internationally. For example, in the sale of the Dutch state´s holdings in ABN AMRO of 20% of the total share capital of the bank, the green shoe amounted to 3%, i.e., 15% of shares sold.[43]

An IPO and domestic exchange listing

By selling the state's holdings through an IPO and a listing in Iceland, the Treasury would offer shares in Landsbankinn for sale after which Landsbankinn would apply for a listing of the bank's shares on a stock exchange. An IPO is a method of sale often employed when only a part of a company's share capital is offered for sale rather than its entire share capital.

The advantages of an IPO, followed by a listing of the shares on an exchange in the domestic market, are beyond doubt. First, an IPO and a listing on a domestic exchange adheres to all the principles of a sale of the state´s holdings such as dispersed ownership, equality of bidders, openness of sale process, transparency and fairness. Second, this method could also be efficient, since it will ensure that shares in the bank will be offered to as many investors as possible and that a market price will be obtained for the shares. Third, such a sale would be convenient for the whole sale process of Landsbankinn, since it is anticipated that a further sale of the state's holdings in the bank will be easier if the shares are already listed on a stock exchange. Fourth, an IPO followed by a listing of shares, offers the

[43] If the same method were applied in a general share offer followed by the listing of Landsbankinn's shares on a stock exchange, such an offer would cover 24.5% of shares and in addition cover 3.7% of shares, equivalent to 15% of 24.5%.

possibility for the participation of cornerstone investors that often occurs in IPOs and listings on stock exchanges in the Nordic countries.[44]

Fifth, an IPO and listing has certain advantages for Landsbankinn itself. A listing would bring greater discipline to the management of the bank from the financial markets and the bank would obtain form of financing which it can use in the acquisitions of other financial undertakings. Sixth, the minority shareholders would be holding far more liquid shares following a listing.

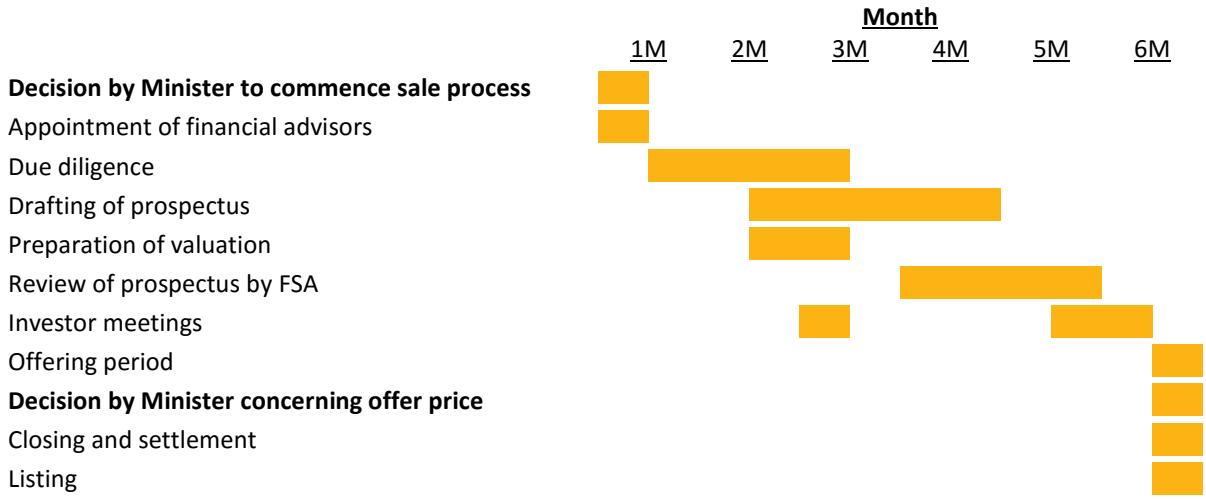
There are three main disadvantages to an IPO and a unilateral listing. First, there are costs associated with an initial listing on an exchange. Second, there could be greater uncertainty of the final price for the state's holding than if it were sold directly to investors. Third, it is possible that foreign investors would show less interest if there was only a single listing following an IPO.[45]

Table 13 shows a timeline of the process of an IPO and listing on an exchange. The sale process begins following a formal decision by the Minister to that effect. As can be seen from the table, there are many steps that must be taken before a final decision is made by the Minister whether offers are accepted (or rejected) for a state holding that is being sold. These steps are both in accordance with Act no. 108/2007 on Securities Transactions as well as accepted business practices in the stock market. Before an IPO can commence, a prospectus must be prepared by the issuer and confirmed by the FSA. The information in the prospectus must, i.e., reflect the conclusions of due diligence. Alongside the legal process, the issuer must be marketed to investors, i.e., to assess potential demand and develop preliminary valuation. Such a process is generally believed to take up to six months.

[44] The difference between a cornerstone investor and an anchor investor is that the former invests at the time of a public listing, whereas the anchor investor is invited to participate in a private placement prior to an IPO. The cornerstone investor thus purchases the shares at the same price as other investors in an IPO but does not negotiate a special price like an anchor investor. A cornerstone investor generally invests in a smaller stake than an anchor investor. With the participation of a cornerstone investor in an IPO, equality of buyers is ensured.

[45] It should be pointed out that there is a condition for listing on the Main List of the Icelandic Stock Exchange that 25% of the shares are in the hands of general shareholders. A general shareholder in this context is one who is not an insider, a party related to an insider, a parent company or subsidiary or a party owning more than 10% of outstanding shares. This is the condition for listing. It is not ruled out that a sale of up to 28.2% will be implemented in such a manner that this condition will not be satisfied but the Nasdaq OMX Iceland has the authority to grant exemptions from this condition, i.e., if the goal of sufficient liquidity is not being compromised or that it can be achieved by other means, cf. the rules for issuers of financial instruments of 17th of December 2013.

Table 13: Timetable for an IPO[46]



An IPO and dual listing on a domestic and foreign exchange

With an IPO and a dual listing, the Treasury would sell shares in the bank followed by a simultaneous listing on a domestic and a foreign exchange. This method carries the same advantages and disadvantages as a single listing. In addition, there are several advantages of a dual listing. First, access is possibly gained to a larger group of investors than with a single listing. By marketing shares to a larger group of investors it could prove possible to place a larger block of shares in the initial phase. The demand from a broader group of investors could lead to a higher sale price than otherwise that would greatly facilitate later sales of holdings. At the same time it mitigates the risk that a sale of the state's holdings in the bank now, or in the foreseeable future, will lead to an excess supply and distortion in the domestic stock market. Second, liquidity in secondary trading should be greater than in the case of a single listing.[47] More coverage would also be expected from research departments of investment banks on Landsbankinn's shares than otherwise. Third, a certain recognition could be gained for Landsbankinn by fulfilling listing rules in international equity markets.

In addition to the disadvantages of a single listing, five disadvantages of dual listing could be highlighted. First, costs would be higher, as reflected in listing fees, disclosure standards imposed on the issuer, presentation of annual accounts and governance standards. It should, on the other hand, be pointed out that Landsbankinn, as well as other commercial banks, issues quarterly accounts, adheres to international financial reporting standards (IFRS) and publishes quarterly and annual accounts in English. Landsbankinn should therefore be able to meet such demands. Second, there is the danger that liquidity will be higher in one market than in the other. Third, it is not known currently which market should be the secondary home of shares in Landsbankinn, e.g., Nordic markets, London

[46] Source: ISFI. Shows number of months expiring from the date that the Minister has decided to commence the sale process, cf. article 2. of Act no. 155/2012, until the Minister has decided wither to accept or reject offer for shareholding based on a reasoned opinion of ISFI at that time.

[47] At a later sale of a shareholding, reference is often made to the size of an offering in relation to turnover in the shares or the market concerned. It may be noted in this context that the daily turnover of shares on the Icelandic Stock Exchange main list in 2015 was ISK 1.5 billion.

or New York, since the bank has no operations abroad. It should be pointed out in this context that the initial sale of the shareholdings of the Dutch government in ABN AMRO took place with an IPO and a single listing on the Euronext Amsterdam exchange, even though the largest part of investors in the shares were investors outside the Netherlands. In other words, the demand by investors in listed shares in a company need not necessarily be dictated by the location of the stock exchange where the shares are listed. Fourth, there always remains a doubt whether a sale of up to a 28.2% shareholding on two stock exchanges will fulfil the minimum float condition of the stock exchanges concerned and whether an exemption from such rules may be granted.[48] Fifth, volatility in foreign stock markets could increase uncertainty during the sale process.

A sale to institutional investors

With a sale to institutional investors, the Treasury would solicit offers for the state's holdings in the bank. Both domestic and foreign institutional investors would be expected to indicate their interest in such a sale. Domestically, it may be expected that the investment capacity and interest would be the greatest from the pension funds, whereas outside Iceland it would come from private equity funds, hedge funds and sovereign wealth funds. With a sale to institutional investors, it would also be possible that investors would form a consortium that would make a joint bid for an entire undertaking.

There are several advantages to a sale to institutional investors. First, the final sales price could be more foreseeable earlier in the process, since in an auction process the group of potential investors would be narrowed in the later stages once their price indications become clearer. Second, such a sale method could be more suitable than an IPO and a listing if the entire company is sold. Third, this could be favorable if there is need for detailed due diligence on behalf of the investors. Fourth, if the objective of the sale is to ensure the participation of anchor investors this method could be advantageous.

There are also many disadvantages to a sale to institutional investors. First, the costs that the seller would incur could be higher than with other methods, since it might need to pay for due diligence work. Second, this method is seldom used when the intention is to sell a minority share in a company as is in this case, not a majority share or the whole company. Third, such commitment of financial resources for domestic institutional investors could constitute too large a share of assets until the shares are listed on a stock exchange. Fourth, it is uncertain whether such a method would secure sufficiently dispersed ownership in accordance with Act no. 88/2009.

Sale to foreign financial undertakings

The sale of Icelandic commercial banks to foreign financial undertakings is an option worth considering. Should a foreign financial undertaking express interest in the state's holdings in an Icelandic commercial bank, it would probably wish to acquire the entire share capital of the bank or at least a majority share. ISFI considers it unlikely at this point in time that a sale of the state's holdings in Landsbankinn will be considered if such conditions by a prospective purchaser are to be met.

[48] It should be noted that the listing of shares in a domestic company on a foreign stock exchange as well as corresponding trading will need an exemption from capital controls in accordance with presently applicable law Act no. 874/1992 on Foreign Exchange, cf. Regulation 565/2014 on Foreign Exchange.

First, it should be noted that there is no authorization contained in Act no. 155/2012 for a sale of a holding in Landsbankinn in excess of 28.2%. It must be considered unlikely that another financial undertaking will wish to acquire such a small holding in the bank unless it had in place an agreement with the Treasury of a right to acquire the remaining government holdings in the bank. It is also worth pointing out that in recent years, cross border mergers and acquisition activity in the banking sector has been lower than in other industries. This may be explained by the fact that European banks have been implementing extensive changes to the regulatory framework which have resulted in higher capital requirements following the introduction of Directive 2013/36/EC (the CRD IV Directive) and Regulation (EU) no. 575/2013 (the CRR Directive) in addition to the increased cost of operations outside their home country following the introduction of Directive 2014/59/EU (on the resolution and winding-up of financial undertakings). Furthermore, European stock markets apply higher valuation multiples to commercial banks that concentrate on operations in their local markets than on those with operations across borders.

Indirect sale options

Introduction

ISFI has drawn up five indirect monetization alternatives of the government´s capital contribution to Landsbankinn. First, distributions to shareholders by Landsbankinn itself. Such distributions could either be effected with special dividends or a share buyback by the bank. Second, through issuance of government instruments, such as exchangeable bonds into underlying shares in Landsbankinn. Third, through asset swaps under which the Treasury would swap shareholdings in Landsbankinn for governments bonds held by Landsbankinn or other investors. The swap alternative could also cover contribution of the state's holdings in the bank to cover guarantees extended to the State Employees' Pension Fund (LSR). Fourth, through reorganization, i.e., by asset sales. Fifth and last, by a direct distribution of shares in Landsbankinn to the public by the Treasury.

Distributions to shareholders by Landsbankinn

Distributions by Landsbankinn to its shareholders could either take place via a special dividend or a share buyback by Landsbankinn. Although both methods produce the same material results, the difference is that a share buyback would constitute a sale of shares by the government and thus fall within the ambit of Act no. 155/2012, but not dividend payments. Distributions could be financed by Landsbankinn through three different means: (1) liquid funds, (2) sale of assets and (3) the issuance of bonds.[49]

There are considerable advantages to dividend payments or share buybacks. First, such monetization is effected at book value of equity. This is advantageous in view of the fact that the market value of shares in European banks has been lower than the underlying book value. On the 30th of November 2015 the ratio was, for example, 0.88x, as shown in chart 6 above. Second, there are little or no costs associated with such monetization which would be incurred in the case of other indirect sale methods.

[49] Landsbankinn could also hand over RIKH 18 bonds corresponding to the amount of dividends or purchases of own shares. The bonds are classified as liquid funds according to the rules of the Central Bank of Iceland on liquidity coverage ratio et al. no. 1031/2014. This method is discussed under the asset swap alternative.

Shareholders might though have to incur costs relating to the assessment of the adequacy of the bank´s offer and for documentation. Third, it is foreseeable that the bank's return on equity would improve following the payout. The impact of an ISK 18.9 billion dividend payment is illustrated in table 14 on the basis of Landsbankinn's interim account for the first six months of 2015. For the period, the annualized return on equity, based on average shareholders´ equity, was 10.3%, but would have been 10.8% *pro forma* for such a dividend. If the equity of the bank had been reduced by the amount of the dividend as well as its profit corresponding to the interest income of the bank after tax, its return on equity would have improved since the actual return on equity (10.3%) was higher than the interest rate on the RIKH 18 bonds (4.25%) over the period. Fourth, such distribution reduces the book value of the shares offered for sale, with the total amount becoming more manageable for domestic investors.

Table 14. *Pro forma* impact of a dividend on Landsbankinn´s profit and return on equity for the six month period ended June 30, 2015 (ISK in billions)[50]

	Actual results	Adjustment for dividend	*Pro forma* adjusted for dividend
Pretax profit	16,8	(0,4)	16,4
Income tax	(2,7)	[51]0,1	(2,7)
Tax on liabilities of financial institutions	(1,7)	-	(1,7)
Proft after tax	**12,4**	**(0,3)**	**12,1**
Average shareholders´ equity during period	241,5	(18,9)	222,6
Annualized return on equity	**10,3%**		**10,8%**

There are three main disadvantages to distributions to shareholders. First, such distributions are subject to laws and regulation, especially in the case of financial undertakings. Public limited liability companies are, pursuant to Article 55 of the Public Limited Company Act no. 2/1995, prohibited from holding more than 10% of own shares. There are also special provisions in Act no. 161/2002 on Financial Undertakings and in the rules of the Central Bank of Iceland that limit their scope for the distribution of equity, as is discussed below. Second, any distributions to shareholders by Landsbankinn that are too large could have an adverse impact upon its S&P credit rating. The bank currently has a rating of BBB- with a positive outlook, whereas Arion banki and Íslandsbanki have the same rating with a stable outlook. Third, the distribution of equity will not change the ownership of the bank.

As other banks, Landsbankinn must meet three kinds of ratios relating to equity, liquidity and foreign currency balance. The main ratios are (1) the ratio of regulatory capital to risk weighted assets, (2) the ratio of liquid assets to short term outlays and (3) the ratio of foreign currency balance to regulatory capital base. Since all these ratios will be influenced by distributions to shareholders with liquid funds, it must be verified that the bank meets all ratios immediately thereafter. In the interim accounts for the first nine months of 2015 Landsbankinn disclosed that the FSA currently imposes a 14.3% capital

[50] Source: Landsbankinn condensed consolidated interim financial statements for the six months ended June 30, 2015, ISFI.
[51] Source: ISFI calculations. Based on 16.2% effective tax rate during the first six months of the year 2015.

requirement on the bank plus a 7.5% capital buffer, or a total of 21.8% capital requirement, partly based on its Supervisory Review and Evaluation Process (SREP) dated on 31st of December 2014. Capital requirements consist of the minimum capital requirement of 8.0% under pillar one of the Basel III rules, a 6.3% capital requirement under pillar two of the Basel III rules along with an addition of 7.5% due to four capital buffers introduced with the amendments to Act no. 161/2002 that took effect on 9 July 2015. With these amendments, the CRD IV Directive and the CRR Regulation were partly incorporated into Icelandic law.[52]

The results of an analysis of Landsbankinn's capacity to distribute funds to shareholders are shown in table 15. In the table, the capacity for Landsbankinn is evaluated, based on the minimum liquidity coverage ratio being not lower than 100% and the capital ratio not being lower than 21.8%. It is also established that the foreign currency balance ratio should not be lower than 15%, based on the bank's balance sheet on the 30th of September 2015. The analysis shows that the capacity to pay dividends or repurchase shares is ISK 18.9 billion if such distribution is financed with liquid funds or government bonds. If the bank were to finance such payments by other means, e.g., with the sale of assets or issuance of bonds, the headroom could amount to ISK 63.3 billion. It should be noted that this analysis does not take account of recent refinancing by Landsbankinn, the possible effect of the composition of LBI on the bank and of the recent change in the reserve requirement of the Central Bank of Iceland.[53]

Table 15: Analysis of Landsbankinn´s dividend capacity at September 30, 2015 (ISK in billions)[54]

	Actual	Regulatory ratios	Estimated capacity
Weighted liquid assets	223,1	204,2	18,9
Weighted outflows, net of inflows	204,2		
Liquidity coverage ratio	**109,3%**	**100,0%**	
Capital base	250,8	187,5	63,3
Risk weighted assets	860,1		
Total capital ratio	**29,2%**	**21,8%**	
Foreign exchange balance	22,8		
Capital base	250,8	152,3	98,5
Foreign exchange balance ratio	**9,1%**	**15,0%**	

According to the above analysis, Landsbankinn´s capacity to distribute funds to shareholders is ISK 18.9 billion based on its liquidity position but ISK 63.3 billion based on its capital position. For that reason, the bank would have to finance distributions to shareholders in excess of ISK 18.9 billion with issuance of bonds or the sale of assets that would not impact its liquidity position. ISFI believes it is important

[52] The supplemental requirements of these four capital buffers are as follows: (1) 3.0% systemic risk buffer, (2) 2.0% capital buffer for systematically important institutions, (3) 0,0% countercyclical capital buffer and (4) 2.5% capital conservation buffer.
[53] Regulation of the Central Bank of Iceland on reserve requirements no. 870, dated 30 September 2015.
[54] Source: ISFI´s analysis based on Landsbankinn´s condensed consolidated interim financial statements for the nine months ended 30th of September 2015. Analysis does not distinguish between regulatory ratios of the bank or the consolidated group.

that the bank explores such financing options of distributions to shareholders before a sale of the state's holdings. In this context, it should be pointed out that it could be appropriate for the bank to issue senior unsecured bonds following the issuance of covered bonds and prior to the listing of its shares, if listing would materialize, to further strengthen its place in domestic financial markets. As an example, the bank could with the issuance of indexed bonds meet the demand of pension funds for such financial instruments and at the same time reduce the imbalance of ISK 165.9 billion between indexed assets and indexed liabilities of the bank on 30th of September 2015.

Issuance of government financial instruments

The recovery of the equity contribution to Landsbankinn with the issuance of financial instruments by the Treasury could take two forms. On one hand, by issuing exchangeable bonds that after a certain period would be exchangeable into shares of Landsbankinn. Although both types can be converted into shares, they differ since the issuer of exchangeable bonds would always be the owner of the shares, i.e., the Treasury, whereas the issuer of convertible bonds would be the issuer of the shares, i.e., the bank itself. On the other hand, with the sale of shareholdings with a conditional put option, i.e., in the case that the shares would not be listed on a stock exchange the investor would have the right to put them back at a predetermined price back to the seller (the Treasury).

Turning first to the issuance of exchangeable bonds, there are four advantages. First, it could meet the demand of investors for bonds.[55] Second, the method could be applied at any time in the overall sale process of shareholdings in Landsbankinn, e.g., before the shares were listed or at a later stage following listing. Third, the Treasury would declare certain commitments on its future intentions regarding sale of holdings with the issuance of exchangeable bonds, for example following a listing where holdings in Landsbankinn would be reduced with the conversion of the bonds into shares, when such time comes. Fourth, it would broaden the product spectrum in domestic financial markets. Following the listing of shares and the issuance of such bonds, an option market could develop.

There are three main disadvantages with the issuance of exchangeable bonds. First, they would be a novelty and difficult to price for prospective buyers, especially before the underlying shares have been listed. Second, this method is quite costly because of negotiations of terms and investor education. Third, it would not be possible to sell the government´s entire holdings in Landsbankinn in this manner.

Turning to the sale of the state's holdings with a conditional put option, there are two advantages. On one hand, it would be possible to secure the participation of investors with strong reputation into Landsbankinn´s group of shareholders alongside the Treasury that would support further sale of the bank. On the other hand, the Treasury would with the sale give certain promises on future listing. The disadvantages of this method are mainly four. First, this method can only be applied in the initial sale. Second, it would only apply to a limited amount of the state's holdings, since only few investors would probably participate in such a purchase due to their special position. Third, such a sale could be costly, since it may prove difficult to reach an agreement with buyers on the terms of the transaction and the underlying value of holdings. Fourth, it may be possible that the buyers of the holdings in this manner would request a special shareholder's agreement.

[55] Here, the condition must be attached to the terms of the bonds that they would be classified as such according to the classification of financial instruments under accounting standards.

Asset swaps

Any asset swaps would consist of the Treasury swapping shares in Landsbankinn for consideration other than cash, such as the extinguishment of debt or guarantees. The asset swap alternative may be further divided into two. On one hand, the Treasury could swap its holdings in government bonds. Such a swap could take place between Landsbankinn and other owners of government bonds, such as pension funds. If such a swap agreement would be made with Landsbankinn it could entail a swap of shares owned by the Treasury in exchange for RIKH 18 bonds owned by the bank that the Treasury contributed to the bank as initial share capital. It would therefore be necessary to ensure that the bank complies with all regulatory ratios following the reduction in share capital. On the other hand, the Treasury could deliver shares in Landsbankinn to the State Employees' Pension Fund to cover future obligations by the Treasury to the pension fund.

The advantages of an asset swap are many. First, it would be guaranteed, along with the sale of the state's holdings, that Treasury debt would be reduced, whether within or outside the government accounts. This is an important point in light of the fact that governments bonds are non-callable, whereas otherwise the Treasury would have to tender for outstanding bonds with unforeseen consequences for the bond market. Second, it would be possible to employ the swap alternative together with other monetization options, such as an IPO and listing or a sale to institutional investors. Some assurances could thus be realized that shares in Landsbankinn would be sold, for example if some pension fund would like to acquire shares at market price in exchange for governments bonds it held. Third, it would be possible to apply the method at any time during the sale process of the state's holdings in Landsbankinn. Fourth, the cost of the sale could be held at a minimum if negotiations are only with few counterparties.

There are three main disadvantages to swap arrangements. First, there are limits to the size of the state's holdings that could be swapped in each instance. The limits placed upon Landsbankinn in case of a swap with the bank have already been discussed. Pension funds are not permitted to hold more than 10% of their assets in securities issued by the same entity, together with the restriction that if a pension fund acquires more than a 10% shareholding in a financial undertaking it is viewed as a qualified holding and imposes considerable duties that pension funds have up to now, as far as known, not been willing to undertake, cf. for example Chapter VI, of Act no. 161/2002 on Financial Undertakings. Second, the transaction costs could be higher in case of many negotiators. Third, dispersed ownership in Landsbankinn would at first not be secured.

If such swaps would be executed alongside an IPO and a listing of shares, it would be appropriate to arrange that the parties concerned would hold the shares for a certain period (6-12 months) to ensure stability in the secondary market (lock-up agreement).

Restructuring: Separation or sale of assets

As discussed above, the balance sheet of Landsbankinn is quite robust and shareholders' equity high. By reorganizing the bank, either through a sale of assets or a separation of business segments, it would be possible to better prepare the bank, or its remaining operations, for the sale of the state's holdings. It would thereby be possible that such a restructuring would reduce the capital requirement of the

bank and would facilitate distribution to shareholders or the reduction in the amount of equity offered for sale. Separation could consist of separation of investment banking from the commercial banking activity or a separation of corporate banking from retail banking. It should be pointed out that a proposal for a parliamentary resolution on the separation between investment banks and commercial banks is currently before Althingi.

Table 16: Financial performance of Landsbankinn´s operating segments in 2014 (ISK in billions)[56]

	Assets	Liabilities	Allocated capital	Profit (loss) before tax
Personal banking	348,0	290,1	57,9	15,6
Corporate banking	453,1	339,6	113,5	19,9
Markets	19,4	10,2	9,1	0,9
Treasury	455,1	384,8	70,3	4,4
Support functions	31,0	31,0	-	(1,1)
Reconciliation	(208,2)	(208,2)	-	(0,1)
Total	**1.098,4**	**847,6**	**250,8**	**39,5**

The main advantages of a restructuring are threefold. First, equity could be released to pay dividends to shareholders. Second, it would be easier to sell shares in the bank since the amount being offered for sale would be lower. Third, such restructuring could strengthen competition in the financial markets. There are four main disadvantages. First, a restructuring could be very costly and time-consuming. Second, it could reduce the synergies in the provision of diversified financial services by the same legal entity. Third, the possibility exists that it would delay the sale of the state's holdings in the bank. Fourth, separation could in fact create two banks that needed to be sold and would not have the operational history required for listing.

Distribution of shares to the public

With a dividend payment to the public on behalf of the Treasury in the form of shares in Landsbankinn, a certain volume of shares in the bank would be distributed to the public (individuals, not legal entities). In order to facilitate the development of an active secondary market, the shares in Landsbankinn would have to be simultaneously listed.[57]

There are many advantages to this monetization option. First, it would guarantee that ownership in Landsbankinn would be dispersed. Second, the market would determine the price of the shares through secondary transactions before the next sale would take place. It would therefore be difficult to criticize that state holdings had been sold at a price that was too low or too high at the time of a direct sale by the Treasury of additional holdings in Landsbankinn. Third, the public would enjoy the direct financial benefits that the Treasury seems to have reaped by providing the bank with initial

[56] Source Landsbankinn annual report for 2014.

[57] It should be mentioned that such ideas have been floated in Britain on the distribution of shares of the government in Lloyds and RBS. See the report *Privatising the Banks: Creating a new generation of shareholders.* Policy Exchange. 2013: http://www.policyexchange.org.uk/publications/category/itme/privatising-the-banks-creating-a-new-generation-of-shareholders.

capital. Fourth, such a distribution of shares would increase share ownership by the public and strengthen domestic financial markets.

At the same time, there can be several disadvantages. First, the Treasury would not receive the proceeds of such a distribution that otherwise could be applied to debt reduction. Second, there are limits to the size of state holdings in the bank that could be handed over to the public in this manner, since it is foreseen that the Treasury needs to raise funds for repayments of debt, including debt incurred to finance the equity contribution to the bank. Third, the method could be associated with higher costs, both for the recipients of the shares and for Landsbankinn. The recipients of shares in Landsbankinn would have to open special custody accounts and pay custody fees, since the shares are electronically registered. Furthermore, the bank´s costs in fulfilling its legal obligations to shareholders could increase if the number of shareholders would increase. Fourth, the method could be complicated to execute, concerning the volume of shares, selection methods of recipients, etc. There are also risks that if the number of shares distributed in this manner would be too low, a normal market price on the shares would not be established by the secondary market. There is also the danger that if the number of shares would be too large that the Treasury would miss out on further sale proceeds in the future. There is equally the possibility that, if the ownership by other shareholders than the Treasury would be below 10%, a redemption obligation could arise for the Treasury, cf. Article 26 of Act no. 2/1995 on Public Limited Companies. This method would call for a widespread consensus on fairness of pay-out rules and selection of recipients. Furthermore, in the opinion of ISFI, regard must be had for provisions in tax law related to such distributions, such as the possibility that the initial transfer of shares would be exempt from income tax purposes. In addition there to, it may be necessary to impose sales restrictions on the shares, i.e., to limit the accumulation of subscription rights and to minimize possible sales pressure immediately upon their distribution. Such restrictions could be lifted in stages in order to minimize disruptions in the secondary market.

Finally, it should be pointed out that it is possible to implement this method in another manner. In order to limit the cost to the Treasury, it would be possible to effect distributions to shareholders by Landsbankinn up to the volume that would be acceptable to the bank's capacity before such a dividend payment to the public would take place. It would also be possible to give the public the right to purchase the 28.2% stake in Landsbankinn at the Treasury ´s costs (or in-price), i.e., ISK 42.3 billion or a price corresponding to 0.58x of the book value of the equity of Landsbankinn on 30th of September 2015. If such an approach would be used, it would be desirable that the amount sold to each individual would be limited in order to mitigate the risk of accumulation of subscription rights.

Tafla 17: Calculations of the share by individuals in shares of Landsbankinn relative to shares which are authorized for sale [58]

	Total	Shares per individual	Share of book value of shareholders´ equity	Share in recorded amount in government accounts
Landsbankinn´s share capital		24.000.000.000	252,5 bn.kr.	150,0 bn.kr.
Of which authorized for sale		6.767.013.778	71,2 bn.kr.	42,3 bn.kr.
Individuals filing tax returns	236.197	28.650	301.366 kr.	179.062 kr.
Financially competent individuals	249.094	27.167	285.762 kr.	169.791 kr.
All Icelanders	329.100	20.562	216.292 kr.	128.514 kr.

If the main objective with distribution of shares is to promote increased share ownership, it would also be possible to encourage the public to participate in IPOs through tax incentives, similarly to those introduced with Act no. 9/1984 that was terminated with Act no. 154/1998. Scholars have indicated that these tax incentives had significant impact on developments in the domestic equity market in the last two decades of the 20th century.[59] It is possible to some extent to conclude that the broad participation of the public in the IPOs of FBA, Búnaðarbanki Íslands and Landsbanki Íslands in the 1998 to 1999 period may in part be attributed to these incentives. Possible implementation would have to be assessed, in part with regard to state aid rules.

[58] Source: ISFI, Landsbankinn, Statistics Iceland, Directorate of Internal Revenue. Based on population at 1st of January 2015 and number of individuals or families filing tax returns for 2014.

[59] A detailed account of these tax incentives and the development of equity markets can be found in Appendix V to the report of Althingi´s Special Investigation Commission (which investigated and analysed the collapse of the three main banks).

Advisors in sale process

Introduction

ISFI considers it important that competent and experienced advisors be engaged in the proposed sale process. The engagement of advisors will result in increased costs, which ISFI considers as normal and unavoidable, especially in light of the significant financial interests at stake. In appointing such advisors, the appropriate provisions in Act no. 88/2009, Act no. 84/2007 on Public Procurement and Act no. 155/2012 must be considered. In said Act, it is stipulated in Article 4 that ISFI shall administer negotiations with outside advisors.

It is necessary to mention that the procurement by ISFI of financial and legal advice in connection with the sale of shares in financial undertakings is exempted from Act no. 84/2007, cf. Article 4 and 6 of said Act. The provisions on equality and transparency apply, however, to all public procurement as well as the main principles of Article 3 of Act no. 155/2012.

Looking to the preparation by ISFI´s sister agencies or those bodies that administer the holdings by European governments in commercial banks, it may be possible to classify advisors with roles in the preparation and execution of such a sale into three groups.

First, an investment bank is generally in a leading role. Its role is the most extensive of all the advisors participating in the project. Investment banks can undertake two kinds of roles in the proposed process. At the beginning, a financial advisor could be hired to assist ISFI in preparing a proposal to the Minister before he decides to commence the sale process. Later, an advisor on the sale (or an equity capital markets advisor) could be hired that assisted ISFI in the execution of the sale process following the decision by the Minister.[60] It is possible that the same investment bank will perform the role of financial advisor and equity capital market advisor, i.e. such an investment bank would first be hired as financial advisor and later on hired as equity capital market advisor that would assist in execution of the sale itself. Further, financial advisor could continue to work alongside ISFI, i.e., to review the work of the equity capital market advisor.[61] It is also conceivable that only an equity capital market advisor be hired, once the Minister has decided to commence the sale process, as is being assumed in Article 4 of Act no. 155/2012.

Second, there will be a need for a legal advisor that would assist ISFI in negotiations of agreements, such as with other advisors on the procurement of their services.

Third, an accounting firm, public relations agency and other experts may be necessary for the sale process.

The above discussion mentions advisor in a singular form, but it is also possible that more than one advisor be appointed each role. It is thereby likely that both foreign parties, such as internationally recognized investment banks as well as domestic parties, all with the appropriate operating licenses,

[60] The general terms in English for an advisor of this kind is *underwriter* but, since in the sale of shares a number of advisors are used, they receive a number of sub-titles for their roles, such as *global coordinator, book runner* and *lead manager,* to name but a few examples.

[61] Such financial advisors or advisors on the sale of shares are generally referred to as *equity capital markets advisors.*

will be hired as advisors. It is also possible that more than one investment bank will act as an equity capital market advisor. It may also be expected that Landsbankinn will hire the same kind of advisors as ISFI, in part because the bank is responsible for the preparation of a prospectus if shares will be sold, and then listed. Similarly, it is possible that ISFI and the bank join forces in hiring advisors.

Finally, it is important to note that, since ISFI will act in a project management capacity during the sale process of the government´s holdings in Landsbankinn on behalf of the Minister, ISFI will oversee the work of the advisors, the work of Landsbankinn and the bank's advisors and be responsible to the Minister as the competent government agency that shall oversee and administer the sale process according to law. The importance of the government possessing expertize in the sale of the holdings it owns was especially emphasized in a report issued in connection with the sale and listing of shares by the U.K. government through a public offering.[62]

Investment banks

Role

In light of the size of this project and the financial interests concerned, ISFI considers it necessary and inevitable that ISFI and Landsbankinn appoint an internationally recognized investment bank as advisor. Such an appointment is important in the opinion of ISFI to establish credibility of the sale process and to increase the likelihood of material monetization of the capital contributions of the Treasury. ISFI´s sister agencies in other countries appear to have utilized two kinds of advisors for the sale process of state holdings. On one hand, there is a financial advisor who works with the agency in preparing and executing a comprehensive plan for the sale of state holdings as well as the proposal to the Minister on the arrangement of the sale. On the other hand, there is an equity capital market advisor that works with the agency in carrying out the sale of individual state holdings, such as managing an IPO and listing or a sale to institutional investors or other financial undertakings. In such instances, the fee paid to the financial advisor could be a fixed monthly retainer and the fee paid to the equity capital market advisor could be performance based as a percentage of the sale proceeds. In case of a listing of shares, the issuer would assume the cost associated with the preparation of a prospectus whereas all other fees would in general be borne by the seller. It is also understood that the government owned financial undertaking concerned would also procure the service of its own financial advisor.

Financial advisor

In Article 4 of Act no. 155/2012 on the sale process of the state's holdings in financial undertakings, it appears to be assumed that external advisors for the sale process will be appointed once the decision of the Minister to commence a sale process has been taken. In light of the large financial interests at stake, ISFI may consider it necessary to hire as advisor an internationally recognized investment bank in the preparatory phase of the sale process that concludes with a proposal to the Minister, cf. the Articles 1 and 2 of said Act.

If such a financial advisor would be hired, ISFI envisions multiple roles for it. First, to review the proposals developed by ISFI on the recovery of capital contributions of the Treasury to Landsbankinn

[62] An Independent Review for the Secretary of State for Business, Innovation & Skills: IPOs and Bookbuilding in Future HM Government Primary Share Disposals. 16th December 2014.

as outlined in this report. Second, to develop recommendations with ISFI on the arrangement of the sale of up to a 28.2% of the government´s holdings in Landsbankinn as well as future sales. Recommendations would concern such issues as timing, appropriate monetization alternative, the initial volume of shares to be offered for sale as well as the advantages and disadvantages of the government holding a majority share in the bank in the future. Third, to perform a detailed review of the financial structure of Landsbankinn, prepare proposals on how it can be improved prior to a sale and assist with their implementation. Fourth, to perform a provisional valuation of the state's holdings. Fifth, to confirm the assessment by ISFI and Landsbankinn itself concerning the IPO readiness of the bank.

The mandate of a financial advisor by ISFI could formally end as soon as an equity capital markets advisor would be engaged. On the other hand, it is possible that such an advisor would continue to work on the execution of proposals for the restructuring of the bank's balance sheet and could then possibly be engaged jointly by ISFI and Landsbankinn. There are examples from other European countries where a financial advisor is specifically hired before a decision is made on the sale of a state holding in preparation of re-entry into equity markets. For example, the U.K. Treasury hired BlackRock Solutions as an advisor in the middle of 2013 to investigate whether a separate bank should be created for the troubled assets of RBS.[63] The first sale of the U.K. government´s holdings in RBS was not completed until at the beginning of August 2015. Moreover the Irish Treasury hired Goldman Sachs International in January 2015 as financial advisor in connection with the possible financial restructuring of AIB, aimed at maximizing the recovery of Ireland's Treasury from the sale of the state's holdings in the bank, although no decision was at hand on to commence a sale process.[64] NLFI also hired N M Rothschild & Sons (Rothschild) as an advisor for selection of equity capital markets advisors and for planning of a sale process of ABN AMRO.

Equity capital markets advisor

ISFI fully expects that an equity capital markets advisor will be hired, once the decision of the Minister of commencing a sale process is at hand, cf. Article 4 of Act no. 155/2002. It is also possible that an equity capital markets advisor will be hired before the decision of the Minister takes place, provided that a special financial advisor has not been hired. ISFI considers that the role and appointment of an equity capital markets advisor can depend on which method of sale will be chosen.[65]

ISFI expects that the role of an equity capital markets advisor will cover many functions, irrespective of the choice of a sale method. It should be noted, however, that in this discussion it will be assumed that the sale of shareholdings will take place through an IPO, followed by listing of shares. First, the role of an equity capital markets advisor will be to assist ISFI in the overall management of the sale of the state´s holdings in accordance with the decision of the Minister. Second, to conduct due diligence on Landsbankinn and coordinate the work of other advisors. Third, to provide advice regarding marketing of the state's holdings in the bank to potential investors, including formulation of the equity story of the bank, development of ideas on which investor groups should be targeted for the offering (domestic and foreign, individuals and investors) as well as assessment of the advantages and

[63]https://www.gov.uk/government/news/hm-treasury-appoints-blackrock-solutions-as-asset-specialist-advisor-to-the-rbs-bad-bank-review.

[64]http://www.finance.gov.ie/news-centre/press-releases/goldman-sachs-international-appointed-financial-advisors-capital.

[65] The participation of other advisors, such as accounting firms and law firms, will differ depending on the method of sale as well as fee arrangements for them.

disadvantages for the participation of cornerstone investors. Fourth, to prepare valuation which will be used in connection with the sale. Fifth, to assist in preparation of investor roadshow presentation[66] Sixth, to supervise communication with potential investors, assist in preparing introductory material for investors and research departments and prepare the management of Landsbankinn for such meetings. Finally, the overall supervision of the execution of the sale of the state's holdings, analysis of investors´ feedback, evaluation of their bids and preparation of assessment thereof.

No decision has been made as to whether one or more equity capital markets advisors will be hired. ISFI strongly emphasizes that an internationally recognized investment bank will be hired for the sale of the state's holdings in Landsbankinn. It is also evident that if the sale of shares is largely in the domestic market, it is important that a security firm with knowledge of the domestic equity market will be included in the process. It is equally clear that ISFI and Landsbankinn will consider cooperation regarding the hiring of advisors.

Selection criteria

ISFI considers it important to establish certain criteria to use in its selection of a financial advisor and/or an equity capital markets advisor. ISFI considers it both important to have regard to the experience of the investment bank concerned as well as those individuals that will be involved in the project. The criteria are as follows:

- Experience in the sale of shares in financial undertakings.
- Experience in direct and indirect methods of sale that ISFI considers appropriate and apply to the state's shareholdings in Landsbankinn, such as an IPO and listing, sale to institutional investors, sale to foreign financial undertakings, distributions to shareholders, issuance of government financial instruments and restructuring.
- Depth and breadth of trading, sales, distribution and research capabilities, especially in relation to shares of commercial banks.
- Ability to provide secondary market support in trading of Landsbankinn's shares and research coverage in the future.
- Experience in advising governments in sale of shareholdings.
- Expertise in Icelandic companies which have issued financial instruments in international markets.
- Corporate social responsibility and management of potential conflict of interests.
- Satisfactory terms.

At this time, ISFI has not given the above criteria any particular weight.

Selection process

ISFI also considers it appropriate to outline the proposed selection process for investment banks. It may also be anticipated that ISFI and Landsbankinn will to some extent cooperate in hiring an advisor, as noted earlier. The selection process that ISFI´s sister agencies have embarked upon in their selection of investment banks have been considerably more extensive than ISFI envisions it will undertake. This is to some extent explained by the fact that the estimated sales proceeds from foreign banks is significantly higher, as shown in table 18.

[66] It should be noted here that since Landsbankinn is responsible for the preparation of such a prospectus it is also possible that the sale advisor of the ISFI be hired to assist the bank in preparing the prospectus.

Table 18: Capital Investment and sale of shareholdings in banks by European governments (amounts in billions)[67]

	RBS	Lloyds	ABN AMRO	AIB	Landsbankinn
Country	U.K.	U.K.	Holland	Ireland	Iceland
Total Investment					
In domestic currency	£ 45,5	£ 20,3	€ 21,7	€ 19,2	122,0
In Euros	€ 63,5	€ 28,3	€ 21,7	€ 19,2	€ 0,9
Inaugural sale					
In domestic currency	£ 2,1	£ 3,2	[68]€ 3,3		71,4
In Euros	€ 2,9	€ 4,5	€ 3,3		€ 0,5
Date	4.8.2015	17.9.2013	20.11.2015	Pending	Pending

ISFI considers the process for choosing an investment bank to be for the main part threefold.

First, expressions of interest to act as financial advisor and/or an equity capital markets advisor. Following the review of expressions received, ISFI will then contact potential advisors that are considered most qualified to participate in the next step of the selection process.

In that stage, ISFI expects to ask the parties concerned to submit to it (1) detailed information on their qualification to perform the role of financial advisor and/or an equity capital markets advisor and (2) provisional proposals as to how best to structure the sale process of the government´s holdings in Landsbankinn, i.e., with regard to the direct and indirect methods of sale advanced by ISFI in this report.[69] ISFI will carefully review submitted information and proposals in accordance with the selection criteria. A decision will then be made concerning those parties that will continue in the process.

In the third and final phase, ISFI expects to enter into further discussions with three to five parties on their proposals, qualification and costs. ISFI expects to choose at least one internationally recognized investment bank to take on the role of advisor. Thereafter, it is possible that an equity capital markets advisor will be selected, irrespective of whether that advisor is domestic or foreign. It is then possible that a financial advisor will assume the role of an equity capital markets advisor since with such an arrangement it would be possible to proceed with a sale immediately after the decision by the Minister to commence the process. Finally, it is evident that in the case of a dual listing, more investment banks will participate in the process.

It is assumed that the selection process for other advisors will be considerably less extensive but a similar selection process will be used to some extent.

In recent years, many international investment banks and domestic securities companies have expressed informal interest in becoming advisors to ISFI during the sale process of shareholdings. One of the aims of this status report is to provide information on how ISFI envisions the selection process ahead. The parties concerned can therefore now make some preparation. It should be noted that ISFI has not decided to hire any advisors at this stage.

[67] Source: NLFI, UKFI, ISFI. Investment in shares of underlying banks. Amounts in Euros at October 30, 2015.
[68] Sales proceeds in offering. Sales proceeds in addition to green shoe totalled €3,8 billion.
[69] It should be noted that it is not excluded that parties that submit expressions of interest may participate in sale of other state holdings in financial undertakings when the agency considers it appropriate.

ISFI will issue a notice following the publication of this report, amongst other on its website, with invitations for expressions of interest. The process will commence with the formal issue of such a notice.

Cooperation and competition considerations

In light of the common interests of ISFI and Landsbankinn, it is possible that these two parties will cooperate in hiring a joint financial advisor before the proposal on the sale of shareholdings will be presented to the Minister as well an equity capital markets advisor following the decision by the Minister. If it is possible to improve the capitalization of the bank prior to its sale, all shareholders will benefit therefrom. It is also possible that Landsbankinn will embark upon such a review independent of the sale of the state's holdings. In all likelihood costs associated with such advisory work will therefore be divided between Landsbankinn and ISFI. By the same token, if an IPO and listing of shares will be employed as an exit alternative, Landsbankinn must procure its own equity capital markets advisor for the project, since the bank is the issuer of the underlying shares and bears responsibility for the preparation of the prospectus for the listing of shares.

As noted earlier, it is possible that the same internationally recognized investment bank will both act as financial advisor and as an equity capital markets advisor, if a financial advisor will be hired. The advantage of such an arrangement is greater continuity in the sale process from preparation to execution if the same party would advise from the beginning, to the advantage of all parties in the process. It is also foreseeable that the total cost of the process would be lower if the same party would both act as a financial advisor as well as an equity capital markets advisor on the sale. The other option, i.e., where the equity capital markets advisor would not be the same as the financial advisor, also has advantages. There are precedents from other countries that the financial advisor reviews the work of the equity capital markets advisor on behalf of the seller. It is also possible that more than one equity capital markets advisor would be hired for the task if stakes in Landsbankinn were offered for sale in an IPO followed by a listing of the shares, especially in regard to the participation of retail investors in the sale of the state's holdings.

In this context, it is also important to discuss the role, participation and cooperation between an internationally recognized investment bank, Landsbankinn and the domestic competitors of the bank. If a prospectus is to be prepared in Icelandic and shares are only to be sold to domestic buyers it will be difficult at first to see what kind of a role an international investment bank would assume in the sale, whether in the preparation of a prospectus or the marketing of the shares. On the other hand, it is important that a financial advisor and/or an equity capital markets advisor with no conflict of interest towards the issuer, competitors or possible buyers participates in the sale, such as in the initial valuation, the development of the bank's equity story as well as communication with potential investors. It is important that an investment bank which enjoys reputation in Iceland and in international financial markets can defend its own valuation on the state's holdings and the bank's equity story to prospective buyers in an objective manner. It is also possible that such a party could find international cornerstone investors prepared to purchase a certain stake in the bank at the offering price, but such an arrangement could broaden the group of prospective buyers and contribute to a more favorable valuation for the Treasury.

Since Landsbankinn will be responsible for the preparation of a prospectus, the corporate advisory department of the bank will be expected to participate in it.[70] On the other hand, it may be expected that domestic investors would call for the participation of other equity capital market advisors other than Landsbankinn. Since due diligence is performed prior to the preparation of prospectus and sale, it may be expected that the managers of the IPO may request access to their conclusions.[71] It would have to be ascertained that such information disclosure would be in accordance with the requirements of the Competition Act and rules of bank secrecy. It should be noted here that when the Treasury offered for sale 49.0% in FBA in October 1998, 15.0% in Búnaðarbanki Íslands in December 1999 and 15.0% in Landsbanki Íslands in the same month, the managers of the IPO in each instance were the banks themselves. On the other hand, ISFI is obliged to promote competition in the domestic financial market according to the provisions of Article 1 of Act no. 88/2009 as well as strengthen competition in the financial market, cf. the provisions of Article 5 of the same Act. A comparable provision is to be found in Article 3 of Act no. 155/2012 where it is stated that at the time of sale an effort shall be made to promote active and normal competition in financial markets. It is therefore important to bear the above in mind to facilitate the participation of more financial undertakings, especially smaller securities firms.

Legal and other advisors

ISFI expects to hire legal advisors for the sale process. It will be important to hire legal advisors to oversee negotiations of engagement letters with financial advisors and equity capital market advisors. It is also likely that legal issues will emerge where ISFI will wish to seek relevant advice. If the sale of shares in Landsbankinn takes place outside of Iceland, ISFI would need to hire appropriate foreign counsel with the necessary knowledge of securities law in the country concerned.

Example of the involvement of advisors: NLFI´s sale of shares in ABN AMRO

As an example of an engagement of advisors in the sale process by another government of its shareholding in a financial undertaking, we look to the initial sale process by the Dutch state of its shareholdings in ABN AMRO, where both NLFI (as seller) and ABN AMRO (as issuer) hired investment banks in connection therewith. NLFI first hired Rothschild as a financial advisor, after a procurement process, as NLFI´s report from 22nd of May 2015 and the letter by the Dutch Minister of Finance to Parliament of the same date. At the same time, an announcement was made about a decision to offer shares in the bank for sale followed by a listing. On 24th of July 2015, NLFI announced it had selected three investment banks (ABN AMRO Bank N.V., Deutsche Bank AG, London Branch and Morgan Stanley & Co. International plc) as global coordinators. Other investment banks were engaged thereafter. The selection process of these investment banks as equity capital markets advisors to NLFI began with an invitation to tender for advisory services on the 19th of December 2014. It can be concluded from reports and news releases that the number of equity capital market advisors had in part been influenced by the fact that a significant stake in ABN AMRO would be sold to international investors outside the Netherlands, in other countries of Europe, the US and Asia. It also appears that NLFI was interested in having advisors with strength in as many areas as possible, such as the ability to market shares in certain sub-markets, so that as a group the equity capital market advisors would make up a strong team. The hiring of internationally recognized U.S. investment banks appears to be aimed at

[70] In this connection is may be mentioned that Landsbanki Íslands was the manager and Landsbankinn-Landsbréf prepared the prospectus for the sale of 20.0% of the share capital in Landsbanki Íslands in June 2002.

[71] Sellers will also need to rely on the conclusions of such due diligence in order to make appropriate declarations in the prospectus.

placement to institutional investors in international markets, whereas ABN AMRO Bank N.V. was hired for placement into the domestic retail market.

Table 19: NLFI´s process in selection of advisors in connection with sale of holding in ABN AMRO

Date	Event
December 19, 2014	NLFI publishes invitation to tender for equity capital markets services for three panels of advisers: (1) global coordinator panel, (2) bookrunner panel and (3) co-lead manager panel.[72]
January 6, 2015	Closing date for submission of an expression of interest and clarification questions.
January 15, 2015	Closing date for submission of tenders by prospective service providers.
February 2, 2015	NLFI publishes a longlist of 26 possible service providers to enter into a framework agreement. Of these 26 possible service providers, 14 qualified as global coordinator, 20 as bookrunnner and 14 as co-lead manager. Of these 26, three qualified for all panels, including, ABN AMRO Bank N.V.
June 25, 2015	NLFI announces that it has granted ABN AMRO the right to appoint one investment bank to assist NLFI with the proposed IPO of ABN AMRO, which then announces that it appoints ABN AMRO Bank N.V. NLFI also announces that further appointment of investments banks will not take place until the House of Representatives has approved the proposed IPO.[73]
July 24, 2015	NLFI announces the appointment of three investment banks as global coordinators, i.e., ABN AMRO Bank N.V., Deutsche Bank AG, London Branch and Morgan Stanley & Co. International plc.
August 26, 2015	NLFI announces the further appointment of eight investment banks as advisors. Of these, two Dutch banks are appointed as local bookrunners, four appointed as international bookrunners and two as co-lead managers.
November 10, 2015	ABN AMRO publishes a prospectus which includes a list of eight underwriters in three categories.[74]

As shown in table 19, ABN AMRO Bank N.V. was one of the equity capital market advisors of NLFI. However, ABN AMRO Group N.V., as issuer, hired Lazard & Co. Limited as financial advisor for the sale process.

NLFI also hired Allen & Overy LLP as legal advisor for the sale process. In addition, ABN AMRO hired two law firms as advisors, De Brauw Blackstone Westbroek N.V. in connection with Dutch law and Davis Polk & Wardwell London LLP in connection with U.S. law. The underwriters also hired law firms as advisors, Stibbe N.V. for Dutch law and Shearman & Sterling (London) LLP for U.S. law. The large number of advisors indicates how extensive this process was. No information is available on the appointment of other advisors, but NLFI indicated that the agency would consult with public relations advisors in connection with the sale process. Although NLFI greatly emphasized containing the total

[72] NLFI manages the state holdings of the Dutch state in five financial undertakings where it has been the only shareholder: ABN AMRO Group N.V., ASR Nederland N.V., SNS Holding B.V., Propertize B.V. and SRH N.V. It would be possible to utilize NLFI´s arrangement if ISFI would planned to enter into a framework agreement with investment banks for the sale of state´s holdings in financial undertakings, rather than specifically for the purpose of sale of up to 28.2% stake in Landsbankinn.

[73] In comparison, Act no. 155/2012 appears to provide for the appointment of advisors once the Minister´s decision whether to proceed with a sale process has been made.

[74] In alphabetical order: ABN AMRO Bank N.V., Deutsche Bank AG, London Branch and Morgan Stanley & Co. International plc (joint global coordinators), Barclays Bank PLC, Citigroup Global Markets Limited, Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A., ING Bank N.V., J.P. Morgan Securities plc and Merrill Lynch International (joint book runners) and RBC Europe Limited and Stifel Nicolaus Europe Limited (co-lead managers).

cost of the sale to a minimum and achieved exactly that, it is clear that the selection process of equity capital market advisors that began on 19th of December 2014 and was completed more than nine months later was quite extensive. The sale process employed by NLFI of shareholdings in ABN AMRO could in many respects be similar to ISFI's sale process of shareholdings in Landsbankinn since NLFI was the sole shareholder of the bank, and shares in the bank were not listed on a market before the sale.

Future developments of ownership of Landsbankinn

Introduction

In the course of ISFI's meetings with domestic institutional investors between the 30th of September and 13th of October 2015, several issues emerged relating to the state´s management of its shareholdings in Landsbankinn and assurances towards investors on the clarity of the future development of ownership of Landsbankinn. These issues first relate to how a further sale of the state's holdings in the bank would be carried out, second, how the Treasury would conduct itself as a shareholder in the bank once it has sold shares to other owners and third, how large a stake the government would be expected to hold in Landsbankinn in the foreseeable future. Although these issues had been highlighted to ISFI by domestic investors, it is likely that foreign investors would similarly call for clarity on them before they invest.[75]

ISFI is not in a position to respond to these questions since the final decision making power on further sales, the legal framework on the management and sale of the Treasury's holdings in financial undertakings and the ownership policy lies with the Minister and Althingi. In this part, ISFI on the other hand outlines the viewpoints that it has regard to in its work in accordance with present law in effect.

Possible steps in the monetization of the state's holdings in Landsbankinn

In the previous chapter, the advantages and disadvantages of various methods of sale were discussed with a special emphasis on applying them to the initial sale of shareholdings in Landsbankinn, i.e., the sale of up to 28.2% share in accordance with intentions of the government as expressed in the 2016 general budget. In this chapter, the relationship between the various methods of sale which could be employed in the first three sales of holdings in Landsbankinn will be discussed. The tracks (or sequences of steps) discussed here are five, marked A to E. The goal of this discussion is to share the ideas that ISFI has developed concerning the future sale of holdings in Landsbankinn, in part to increase visibility to all parties, as it is desirable that the path chosen for the first step improves the possibilities of the Treasury for further sales and does not preclude the utilization of any other methods of sale.

Since ISFI considers it unlikely that a sale of Landsbankinn to a foreign financial undertaking will take place, it is not covered by this analysis. The restructuring of Landsbankinn is also not being considered, since it could be too time consuming in light of the intention to conduct the sale during 2016. A sale to institutional investors is also not being discussed, since other methods, in the opinion of ISFI, would better fulfill the main principles which apply to the sale process of equality, transparency and dispersed ownership. Nonetheless, ISFI has not excluded any of the above methods of sale in the future.

[75] It should be noted that when the Treasury offered a 49% share in FBA for sale in October 1998, the prospectus stated the clear policy of the government regarding the future intentions on further sales and future ownership of the bank as follows: "The decision is also at hand that authority will be sought to sell all the share of the Treasury in FBA before the middle of 1999 if circumstances permit." It was also stated in the prospectus for the 15% share in Landsbanki Íslands that "… the goal of selling the shares is to continue moving the ownership of the commercial banks out of the hands of the Treasury to private owners". This same goal was also clearly stated in the prospectus of Landsbanki Íslands in June 2002 in connection with the sale of the 20% share of the Treasury in the bank, whereby the share of the Treasury was reduced to 48.29%.

Table 20 summarizes the sequences of steps in tracks A through E. The first column shows the various sales methods and the following columns shows the different tracks. The table shows three steps comprising each track, marked with the appropriate number.

Table 20: Monetization of the government´s capital contributions to Landsbankinn: Possible initial steps

Monetization or exit alternative	Track A	Track B	Track C	Track D	Track E
IPO and listing	② ③	① ② ③	② ③	① ③	③
Distribution to shareholders	①				①
Government financial instruments				②	
Asset swap			①		
Distribution of shares to the public					②

If track A would be chosen for the sale of holdings, the goal would be to first effect distributions to shareholders by Landsbankinn before an IPO, followed by a listing. The goal would be to reduce the equity of the bank before the sale, thus facilitating a further sale. Following a listing, the Treasury could, as a third step, sell further holdings in the bank on the market.

By choosing track B, shareholdings would only be sold through a public offer and listing (initial and then secondary). The goal would be to establish a market price as early as possible for shares in Landsbankinn and sell shareholdings into the stock market. In an analysis of the investment capacity of potential investors discussed above, the capacity for participation in the first sale was assessed on the basis of the present equity level of commercial banks, the present state of investments of pension funds and the current equity market valuations. Subsequent placements will then be benchmarked against the daily turnover in the stock market (on Landsbankinn shares).[76]

With track C, the Treasury would first swap share holdings in Landsbankinn for government bonds or contribute shareholdings to LSR followed by an IPO and a listing. The goal of choosing this track would be to ensure that a large part of the bank was sold in the first two steps and ensure thereby the liquidity in the secondary market for the third step in the sale of the state's holdings.

With track D, the Treasury would first embark upon an IPO and listing. Later on, a sale would be made through the issuance of a government financial instrument such as exchangeable bonds that could be priced with reference to government bond yields, market price (of Landsbankinn shares) and implied equity volatility in Landsbankinn shares. It might thereby be possible to maximize demand for the sale of the holdings. The third step would be to sell further holdings on the stock market.

With track E, the share capital in Landsbankinn would first be reduced through a distribution (dividends and buybacks). Next, a stake would be distributed to the public. By initially reducing outstanding share capital it would be guaranteed that the largest ownership percentage in the bank would be distributed to the public. Thus, two simultaneous goals of reducing government debt and dispersed ownership in the bank could be met. Since it may be assumed that by distributing shares to the public, Landsbankinn would at the same time apply for a listing, subsequent sales by the government of stakes in the bank would be into the market. At the time of such a sale, it would be assured that a market price for shares in the bank had been developed with an active secondary market.

[76] Such a sale could take place through investor roadshows and fully marketed offerings, sales of block trades or a dribbled-out sales.

As indicated in table 20 above, each of the tracks discussed assumes that shares in the bank will be listed on a stock exchange, since an IPO and listing reflect well the main principles that ISFI must honor during the sale process of the state´s shareholdings. On the other hand, several tracks assume that preparatory measures will be undertaken, such as a distribution to shareholders before the sale.

ISFI's policy as a shareholder

According to Act no. 88/2009, ISFI manages the government´s holdings in financial undertakings. ISFI therefore understands that potential investors wish to have some certainty in how the shareholdings will be managed as it is foreseeable that the Treasury will continue to be the largest shareholder in the bank in the near future.

ISFI will continue its policy of maximizing the value of shareholdings in Landsbankinn in accordance with Act no. 155/2012, ensure that qualified individuals will be elected to the board of directors in each instance and that the bank will be operated on market principles. As noted earlier, the state's holdings in Landsbankinn amounted to 12.6% of the assets (group A) of the Treasury on the 31st of December 2014. If the pension funds in the country acquire holdings in Landsbankinn in accordance with their policy of investing in individual companies, it is also foreseeable that in the near future the Treasury´s holdings in the bank will always remain a higher proportion of its assets than at any pension funds. The Treasury thereby has a large financial incentive in ensuring that Landsbankinn will be managed to maximize shareholder value, adjusted for risk.

ISFI will also ensure that new shareholders can participate in the election of directors in the bank. The current articles of association that were adopted at the annual general meeting on the 18th of March 2015 state in Article 18 that the chairman of the board of directors shall be elected separately. ISFI assumes that this provision will continue to be kept in the articles of the bank to ensure that the largest shareholder in the bank, i.e., the Treasury in the foreseeable future, elects the chairman. This is also done to prevent a shareholder with a small underlying stake from controlling a chairman in opposition to other owners. The election of directors in Landsbankinn is currently undertaken through majority elections in accordance with the main principle of paragraph 5 Article 63 of Act no. 2/1995 on Public Limited Companies. Nonetheless, said Act contains minority shareholder protection provision so that (1) shareholders having at least one-fifth of share capital can always request proportional elections or multiplication elections or (2) where shareholders are more than 200, those shareholders controlling at least one-tenth of share capital can make such a request. The current articles of association do not specify a particular election arrangement. ISFI believes it is desirable that new shareholders in the bank will enjoy the right to vote in proportion to their holdings. ISFI believes it is appropriate that at each sale it will be ensured that the right of others to nominate directors will be in proportion to their holdings or it will be ensured in another manner with each sale of a 15% state holdings that the Treasury will reduce its nominations to the board of the bank by one individual.

ISFI has discussed the possibility with Landsbankinn to introduce quarterly payments of dividends rather than annual. No provisions in Act no. 2/1995 on Public Limited Companies or in other laws applying to the bank would prevent such an arrangement. It would in such case be assumed that the annual general meeting of the bank would approve a total dividend payment to shareholders on account of the profit of the previous year, but instead of a single payment, the dividend would be paid with four equal quarterly payments until the next general meeting. There are many advantages to such an arrangement. First, the bank would thereby carve out a niche position amongst dividend paying, listed companies in the domestic market if dividend payments (regardless of amount) are paid four

times a year instead of once, as is common in Iceland. Second, the liquidity management of the bank could improve with this arrangement. Third, this arrangement would align well with the changes in emphasis that have taken place with Act no. 161/2002 on Financial Undertakings regarding equity buffers and the protection of financial undertakings' equity.

At the time of the first sale, ISFI will propose to the Minister that no further sale of the state's holdings in Landsbankinn will take place until 180 days will have passed from the first sale. ISFI will also endeavor to make subsequent sales of stakes in the future as foreseeable as possible within provisions in Act no. 88/2009 and 155/2012. ISFI believes it is advisable that the Minister seek authority for subsequent sales of the state's holdings with the submission of the budget bill for each year, which is presented to Althingi nearly four months before the beginning of the fiscal year.[77] If a sale were to take place in the middle of the fiscal year, it may be expected that such a sale will be foreseeable with a nine month period. In light of the substantial financial interests at stake and the importance of maximizing the sale proceeds of the state's holdings in the bank, it may be assumed that ISFI will annually present a proposal to the Minister for a sale of a modest stake in each instance, within the authority provided in the general budget, bearing in mind that the investment capacity of the stock market will not be overloaded.

The possible development of the state's holdings in the future

The biggest question by potential investors in Landsbankinn will probably be how large a holding in the bank the state will own permanently. On the 30th of June 2015, the book value of the share capital of Landsbankinn amounted to ISK 252.5 billion. The ownership of the state in the equity of the bank currently amounts to 98.2% after the merger with Sparisjóður Vestmannaeyja and Sparisjóður Norðurlands, with others therefore holding 1.8%. Currently, there is authorization to sell a 28.2% stake in the bank, corresponding to a book value of equity in the bank of ISK 71.2 billion as at 30th of June 2015. At this point, there is no further authority at hand for a sale of shareholdings in Landsbankinn. It is likely that potential investors in Landsbankinn will wish to see a sale of more than 28.2% in the bank in the near future, in part to guarantee the liquidity of the shares in the secondary market. Subsequent sales of state holdings in the bank could be necessary to further reduce the Treasury's debt levels, which in turn could lead to an upgrade of the sovereign credit rating as well as other Icelandic entities, as pointed out earlier.

A decision regarding future or permanent ownership level of the government in Landsbankinn rests with Althingi. For this reason, ISFI cannot say with certainty at this time how large a part of Landsbankinn the state will wish to permanently own. ISFI considers, however, it would support the proposed sale process of the state's holdings in Landsbankinn, if a clear policy was available regarding the future ownership by the government in the bank.

ISFI believes it is appropriate to discuss various perspectives regarding the state ownership of Landsbankinn. There are change of control provisions in the bonds issued by Landsbankinn to LBI with a final maturity date in October 2026 which permit LBI to declare an event of default on the bonds if the government ownership falls below 34%. Although the bonds are callable at any time, these provisions place limits on the Treasury concerning further sales. It should also be pointed out that provisions in Act no. 2/1995 on Public Limited Companies require the affirmative vote of two-thirds at

[77] The 2015 fiscal budget was presented to the Althingi on 9th of September 2014 and the 2016 fiscal budget was presented on 8th of September 2015.

a shareholders' meeting to effect amendments to the articles of association, e.g., an increase or a reduction in shareholder capital, changes in the company's purpose or its name. With a 34% stake, the Treasury can prevent such changes, whereas with a 67% stake it could make such amendments. Chart 11 shows the possible development of the government´s holdings in Landsbankinn assuming the aforementioned change of control provisions (in the bonds issued to LBI) will be the limiting factor to subsequent sales. On the 30th of June 2015 the shareholders´ equity in the bank amounted to ISK 252.5 billion, of which the 98.2% stake of the Treasury equated ISK 248.0 billion. The authorized sale of a 28.2% stake therefore corresponds to ISK 71.2 billion, and the minimum 34% contractual binding ownership level according to the change of control provision of the bonds is therefore ISK 85.8 billion. If Althingi authorizes a further sale in excess of the 28.2% share, the government can up to the year 2026 sell a 36% share in the bank, corresponding to ISK 90.9 billion, based on equity at the 30th of September 2015

Chart 11. Possible development of the government´s shareholding in Landsbankinn (ISK in billions)

ISFI also wishes to point out criteria used by treasuries of other European countries. The Norwegian government retained a one-third ownership share in DnB after having acquired all the shares in the bank in 1994 and more than 20 years later the Norwegian government still retains that share. The Norwegian government held about one-third in Christiania Bank & Kreditkasse up to the year 2001 when it was sold to Nordea Bank, but disposed all its holdings in Fokus bank at once in an IPO in 1995. ISFI views it as important that the Treasury closely monitors the development of ownership in commercial banks in other countries in a similar position as Iceland, such as the U.K., the Netherlands and Ireland with large investments in commercial banks such as RBS, ABN AMRO and AIB as well as the intentions of government in these countries concerning future ownership in commercial banks. ISFI considers it important to point out that there are no indications of anything other than that the governments of Britain, the Netherlands and Ireland aim at selling their entire holdings in banks.

It should also be noted that there are several encumbering provisions in law that apply to companies majority-owned by the government and that can hurt their competitive ability. Furthermore any policy by the Treasury to own a certain share in a commercial bank can become an obstacle for the bank itself, such as when the bank wishes to raise additional capital. In such cases, if the Treasury would have to contribute additional capital to the bank, the relevant approval of the EFTA Surveillance Authority would be needed as well that of parliament. This process could take too long a time in the case of a financial undertaking and could force it to cut dividend payments to shareholders in order to strengthen its equity base, whereas a cut in dividends could lead to a decrease in the market value of underlying shares and thus place the bank in a worse position than before. It should also be noted that the government can safeguard the interests of the public with legislation and special supervisory authorities for the operation of financial undertakings. On the other hand, it should not be disregarded that governments in Western countries have considered it important that banks should be partly government-owned during a period of restructuring and reconstruction of financial markets. Governments can thereby apply their efforts as owners as well as supervisors of important economic agents.

Finally, it should not be overlooked that the opportunity cost of the Treasury holding shares in the three largest commercial banks is also significant due to the interest costs of those government bond issued to finance the equity contribution to the commercial banks. Since the interest decision of the monetary policy committee of the 4th of November 2015, the interest rate on the current accounts of deposit institutions has been 5.5%, but it determines the interest rate on the RIKH 18 bonds. It is possible to assess the annual opportunity cost, either on the basis of the original share capital contribution to the commercial banks of ISK 138.2 billion, or on the basis of the Treasury's share in the shareholders´ equity of the banks on the 30th of September 2015, which amounted to ISK 280.0 billion. According to the former measurement, showing the financial cost of the Treasury on account of the state holdings, the annual opportunity cost is ISK 7.6 billion, whereas on the basis of the latter measurement the opportunity cost is ISK 15.4 billion. The actual interest costs of the Treasury over the six-year period 2010 to 2015 arising from its equity contribution to the commercial banks has amounted to ISK 39.9 billion. On the other hand, the Treasury has received higher amounts in dividend payments from the banks, or ISK 56.6 billion over the same period.

Summary and conclusions

The Icelandic government founded Landsbankinn and capitalized it with an initial equity contribution based authorization in the so-called "Emergency Act" passed by Althingi on the 6th of October 2008. In the 2015 and 2016 general budgets, the government´s disclosed its intention to commence the sale of up to a 30% share in Landsbankinn. According to Article 1 of Act no. 155/2012, the Minister is authorized to sell the government's holdings in Landsbankinn in excess of 70% subject to two conditions: (1) an authorization in the general budget for the sale and (2) a proposal from ISFI regarding the sale. Since the government now holds a 98.2% stake in Landsbankinn, the Minister is presently authorized to a 28.2% share in the bank, subject to the above conditions, and ISFI informed the Minister by a letter dated the 9th of September 2015 that it would submit a proposal to that effect. In spite of the fact that no sale of the government's investment in Landsbankinn has so far taken place, it has already recouped 43.5% of its original equity contribution of ISK 122.0 billion through dividends.

The government's investment in Landsbankinn is the single largest asset of the Treasury, whether it is measured by recorded amount in the central government accounts or the government´s share of owner´s equity in the bank. The government´s investment in the shareholder´s equity of the bank at year-end 2014 corresponds to a significantly higher ratio of GDP than the government´s investment in the shareholder´s equity of FBA, Búnaðarbanki Íslands and Landsbanki Íslands combined at the end of 1997, as well as holdings by other European governments in the shareholders´ equity of banks at present.

The main objective of ISFI with the sale of the government's holdings in financial undertakings, such as Landsbankinn, is to ensure that the recovery of equity contributions will be maximized. So far, ISFI has not considered it appropriate to commence a sale of the state´s holdings in Landsbankinn but rather to recover its equity contributions through ordinary and special dividends from the bank. However, at present ISFI considers, following an assessment of four economic criteria, i.e., economic and financial stability, valuation of shares in financial undertakings, the investment capacity of possible buyers and the readiness of Landsbankinn, that it is appropriate to commence the sale process of the state's holdings in the bank.

ISFI will submit a proposal to the Minister in accordance with the provisions of Article 1 of Act no. 155/2012 in the first quarter of 2016. ISFI has evaluated many methods of monetizing the government´s equity contribution to the bank. ISFI believes that the likeliest proposal to the Minister will encompass a sale of up to 28.2% of the holdings with an IPO and a subsequent listing of the shares. Further, ISFI considers it desirable that an appropriate amount of share capital will be distributed by Landsbankinn prior to such a sale. ISFI considers an IPO and a subsequent listing of the shares meets all the main principles that apply to the sale of the state's holdings in financial undertakings, cf. Acts no. 88/2009 and 155/2012.

In the projected cash flow statement in the government´s general budget for 2016, it is assumed that sale proceeds of the state's holdings of up to 30% will generate ISK 71.3 billion. By comparison, the 28.2% share in the book value of the shareholders´ equity in Landsbankinn on the 30th of September 2015 amounted to ISK 71.2 billion. If account is only taken of that amount, without regard to the valuation of the underlying shares, ISFI believes that domestic financial markets do not have the capacity to absorb such a large offering. In order not to disturb new supply into domestic financial markets, ISFI deems it appropriate to aim at a lower amount and share in the capital of the bank in the first sale of the state´s holdings in the bank. If the shares, however, will be offered for sale both in

domestic and international financial markets, ISFI believes that the above amount is not too high. These considerations are also important to keep in mind in subsequent sales of shares.

Prior to the first sale, ISFI believes it will be of paramount importance that the government indicate how large of a stake it intends to hold in Landsbankinn in the future to reduce the uncertainty that investors face at the time of their investment decision regarding shares in Landsbankinn. Concerns by potential investors could revolve around whether they would end up as being minority shareholders in a company against a controlling shareholder and how large the supply of new shares into the market is likely to be in the future. A clear policy on the future ownership can have a positive impact on the valuation and demand by prospective buyers.

Following the publication of this report, ISFI will solicit expressions of interest by parties that are interested in working as advisors with ISFI in the proposed sale process and take the first steps in the appointment of appropriate advisors. ISFI is also ready to present the report to the Budget Committee and Economic Affairs and Trade Committee of Althingi at the earliest opportunity as well as to representatives of all parliamentary parties, should they so request. If the decision by the Minister on the sale process has been made by the spring of 2016, ISFI believes that it will be possible to complete the sale in the latter part of the year in accordance with the Minister´s supporting statements in the 2016 general government budget.