

REVIEW REPORT

BANKING CRISIS

**THE FORCED AND PROVISIONAL LIQUIDATION OF THE UK ONSHORE
AND OFFSHORE SUBSIDIARIES OF THE ICELANDIC KAUPTHING BANK hf
BY APPLICATION OF STATUTORY INSTRUMENT NO 2674 ON 8TH
OCTOBER 2008 AND RELATED EFFECTS.**

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SECTION A

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

1.0 Introduction

1.1 Co-incident now with the release of the Treasury Committee Fifth 2009 Session Report entitled 'Banking Crisis: The impact of the failure of the Icelandic banks' this report is an independent attempt to bring together in one place the major known causes and effects to date of the liquidations as embodied in the report's title.

1.2 The opinions and conclusions expressed here are those of the authors alone and do not necessarily represent those of the Kaupthing Singer & Friedlander Isle of Man Depositors Action Group (hereafter referred to as 'action group and 'DAG') as a whole at this time. Although the data herein results from extensive research, the authors do not warrant the accuracy of all of said data since some of it originates from press reports and verbal data.

1.3 The report deals primarily with the effects of the forced liquidation of the onshore company Kaupthing Singer & Friedlander Limited (KSFL) on the offshore company Kaupthing Singer & Friedlander Isle of Man Limited (KSFION) and also considers related effects in Iceland and a parallel situation in Guernsey.

1.4 The report has been reviewed with the DAG Strategy Team and is presented as both a data base and for consideration of the sale alternative for KSFION.

2.0 Summary

2.1 On 8th October 2008, the UK Financial Services Authority (FSA) issued an Administration Order through the High Court of Justice to seize and liquidate KSFL using enabling legislation in Statutory Instrument No 2674, itself based upon enabling legislation in the Banking Special Provisions Act 2008, because the company was considered to be in default for the purposes of the Financial Services Compensation Scheme (FSCS).

2.2 This situation arose due to the difficult market trading conditions which KSFL faced due to the deteriorating world economic situation and substantial outflows of capital, chiefly via its internet based Kaupthing Edge subsidiary, in the period leading up to the seizure. The savings and loan business of Kaupthing Edge, which included deposits of £2.6bn of UK deposits, were transferred to ING in the Netherlands.

2.3 Relevant to this was the downgrading on 30th September of the credit rating of the parent of KSFL in Iceland, Kaupthing hf. and the nationalisation of Iceland's smallest (and most highly leveraged) bank Glitnir. Shortly before the seizure these factors also caused a run on KSFIOM's deposits of up to £40m per day.

2.4 We note in this report that at the time of its seizure KSFL had some £1.3bn of cash in its balance sheet. This figure includes a very substantial cash deposit which was made in early 2008 by KSFIOM (see 2.6 below). The loan to deposit ratio for the bank as calculated here was 1.36 (Appendix 1) which indicates, on general criteria, that the bank was solvent. The ratio is below that of many of its peers. (The Loan to Deposit Ratio or LDR is a measure of the financial solvency of a bank: the lower the ratio, the higher the solvency.)

2.5 The UK Government intent behind the foregoing was to achieve 100% guarantee and/or compensation for UK depositors in KSFL and to recover funds paid by the FSCS to ING, who took over KSFL's deposits under the terms of the Transfer Order.

2.6 In March 2008 the Isle of Man Financial Supervision Commission (FSC) became concerned at the deteriorating banking situation in Iceland and orchestrated the transfer of £700m of funds belonging to KSFIOM which were on deposit with the parent Kaupthing hf in Iceland. Following consultation with the UK Financial Services Authority (FSA) £557m of funds were transferred to the sister onshore company KSFL, a company with which KSFIOM had always had a close business relationship.

2.7 Notwithstanding a Memorandum of Understanding (MOU) between the UK FSA and the Isle of Man Financial Supervision Commission (FSC) dated September 2003, which provided for share of information and co-operation between the FSA and the FSC, no prior warning of the seizure of KSFL and its consequent effect on KSFIOM was given by the FSA. As a result the IOM authorities were forced to withdraw KSFIOM's banking license and put the bank into Provisional Liquidation where it has remained to the present

time. KSFIOM was in a very strong financial position at the time with a very low LDR (Appendix 1)

2.8 During the period from 8th October 2008 to the present the IOM authorities sought repeated contacts with Treasury and other UK Government ministers in attempts to clarify and obtain the position on the frozen KSFIOM assets but with no known result. The FSC, on the specific subject of clarification for the reasons for the seizure of KSFL, failed to get a response from the FSA for over four months until a two page e-mail was received on 30th January 2009.

2.9 During this period the KSFIOM Provisional Liquidator Mike Simpson from Price Waterhouse Coopers was not permitted to sit on the KSFL Creditors Committee. We understand that the reason for this is that the largest initial creditor (circa £2bn.) is the Financial Services Compensation Scheme and HM Treasury, who have made certain unspecified payments/guarantees to ING in Holland to allow the UK deposits of Kaupthing Edge to be transferred to ING. The Statutory Instrument specifies that the KSFL Administrator Ernst and Young shall be concerned for the first six months exclusively with matters pertaining to the ING transfer. However it is also known that liquidation of certain other assets of KSFL has been proceeding in parallel.

2.10 A parallel situation exists in Landsbanki Guernsey (LG) when its parent Landsbanki Islands hf (LI) in Iceland collapsed. LG had £36m of assets with the Heritable Bank, another sibling of LI which was seized under similar legislation, which then forced LG into liquidation.

2.11. There have been various Ministerial statements concerning the modus operandi of the offshore centres of the Isle of Man and Guernsey and the tax position of the depositors. These have been misleading at best. Many are of the view that the statements have exasperated the situation. Key statements are included in Appendix II. The actual position on key points is as follows:

2.11.1 The total assets of the Isle of Man as of 31st March 2008 were £70.9bn. Nearly all of this is “up streamed” mainly to the UK where it is invested in loans, mortgages, and other financial instruments. This is necessary to earn interest on the funds. This massive source of funding is important and beneficial to the UK.

2.11.2 Because the offshore centres are low company taxation regimes, they are able to operate efficiently and with few staff and therefore are able pay competitive interest rates. This has also attracted major UK banks and institutions that operate branches there for commercial and specialist reasons.

2.11.3 Under the EU Savings Directive, the Isle of Man gave EU depositors the option of full declaration or, as of now, the payment of a 20% Withholding Tax annually on earnings. This is due to rise to 35% in 2011. The Withholding Tax is remitted to the UK or to an EU depositor’s country of residence annually. The

balance of taxable income, whether before or after the Withholding Tax, if applicable, must be declared by a depositor in his or her country of residence.

2.11.4. 42% of depositors KSFIOM are overseas resident working or retired UK and other citizens. One reason for the presence of UK citizens is that it is very difficult for non resident UK citizens to open a UK onshore savings account due to the anti-money laundering legislation and 'Know your customer' rules. This was proven by a survey undertaken by the Landsbanki Action Group where 56 out of 58 banks said that they would not take overseas deposits of non resident UK citizens.

2.12. Many depositors have life savings in the KSFIOM and are elderly as well as working people. Many also had their funds there on the advice of experts. These same factors apply to Landsbanki Guernsey.

2.13. Amongst the 700 or more posts on the KSFIOM Depositors Action Group website and on the BBC iPM site 'A Twist in the Expat Tale', there are recorded unprecedented levels of uncertainty, fury, distress, hardship, and even mental illness, which have been caused by the forced Provisional Liquidation of KSFIOM. Almost all express severe indignation at the continued retention of the deposits in KSFL, anger that is compounded by the belief that release should allow a full return of their savings.

2.14 The Isle of Man has in place a Depositors Compensation Scheme (DCS) of £50,000 per depositor and £20,000 for institutions and trusts, which was put in place just before the crisis commenced. It would come into force in the event that a Winding up Order was issued for KSFIOM. It is unfunded in as much as it does not represent a fund accumulated over a period of time and will require levy on other banks in the island and/or payments by the Manx Treasury out of reserves or tax receipts. Mr. Tony Brown Chief Minister has however stated that the commitments will be honoured if necessary.

2.15. Since November 2008, the Isle of Man employed financial consultants AlixPartners to prepare a certain Scheme of Arrangement which will avoid liquidation and, it is claimed will speed payments to depositors. If the scheme is enacted before the release of KSFL funds in their entirety, the Scheme would have to be approved by both English and Isle of Man Courts. It also, like the DCS, will require Manx funds in the form of Top up Funding. This has yet to be approved by Tynwald, the Isle of Man parliament. Indications as to how both schemes will work have now been given. (Michael Simpson Third Affidavit 18th February 2009).

2.16 Evidence presented at the Treasury Select Committee Meeting on the 3rd February 2009 showed that Kaupthing hf, the Icelandic parent to KSFL and KSFIOM was operating with inexperienced personnel at Board level. Mr. Shearer, CEO of Singer and Friedlander Ltd (SFL) which was purchased in late 2007 by Kaupthing, said that dubious practices were observed in as much as loans were used by the directors to buy shares in the company with put options to sell them back to the bank, also that 90% of the banks profits appeared to be from trading rather than more traditional banking activities. Mr.

Shearer said that he advised the FSA that he felt that Kaupthing hf was unsuitable to take over SFL but the FSA took no action whatever on this. Additional evidence is now to hand which indicates corruption – this is a serious allegation. See Section B 6.2 – 6.4.

2.17 Nor did the FSA take any action to warn retail depositors, charities, and local governments of the inherent investment dangers of the impending Icelandic banking crisis notwithstanding the fact that this had been flagged by certain academics and in the press, as noted later in this report, well before the collapse of the investment bank Lehman Brothers in early to mid 2008.

2.18 The evidence shows that all Icelandic banks were under severe pressure to de-gear following the collapse of Lehman Brothers on 15th September 2008 due to the withdrawal of cheap international credit, and to the fact that the Central Bank of Iceland was much too small to be viewed as a lender of last resort. First Glitnir and then Landsbanki collapsed, but at the time of the seizure of KSFL Kaupthing hf was still trading. The seizure of KSFL finally sealed its fate also.

2.19 On 15th March 2009 the Kaupthing hf Resolution Committee issued a statement to the effect that the High Court of England had consented to Kaupthing banks request for a judicial review the transfer of Kaupthing Edge deposits to ING without compensation and the subsequent liquidation of KSFL. Originally proposed then dropped by Iceland, this again raises the possibility that Kaupthing may sue the UK Government over the seizure.

2.20 Unlike the KSFIOM depositors, Landsbanki Guernsey depositors do not have a compensation scheme. Nor is compensation available for local government funds, institutions and charities in the UK branch of Landsbanki Islands hf and in the Heritable Bank. Taken together total funds affected are in excess of £1.6bn.

3.0 Conclusions

3.1 This crisis has caused some of the worst human effects that could ever be experienced by UK and other (EU and non EU) citizens, working and retired, the elderly and the infirm, at home and overseas. Yet the UK Government apparently ignores them.

3.2 If it is the intention of the Government to visibly alter the status of the offshore centres this is not the way to go about it. Change if it comes must come gradually. Otherwise thousands upon thousands of people as well as institutions may be seriously damaged for life.

3.3 This report chronicles a number of errors in several quarters:

3.3.1 The over expansion and risky position of the Icelandic banking system on the back of the low regulation era and cheap credit.

3.3.2 Misstatements by Icelandic ministers as to the true situation with Landsbanki and other entities.

3.3.3 The failure of the FSA to spot the dangers early on when investment in Icelandic banks subsidiaries, particularly Landsbanki, was allowed to continue notwithstanding a deteriorating situation. (See also B 6.12, 6.13) This report does not see similar failures in the FSC's activities (see B 6.14. 6.15)

3.3.4 The angry and inappropriate response of Gordon Brown and others when Landsbanki collapsed and the decision to sue Iceland. (Appendix II) This soured relationships for a long time and hindered and delayed resolution of the problems.

3.3.5 The rapid execution of a plan to seize and liquidate Kaupthing's UK £8bn UK solvent onshore subsidiary KSFL without any warning to affected parties, which finally collapsed the parent Kaupthing hf in Iceland. This meant that Kaupthing hf was no longer able to honour KSFIOM's parental guarantee.

3.3.6 The complete disregard to the present day of the interests of acutely suffering depositors and institutions in the UK offshore subsidiaries of Kaupthing hf and Landsbanki Islands hf (LI); and so far also of the institutions, local government, and charities deposits in the UK branch of LI.. Taken together, these funds partially at risk total in excess of £1.6bn.

3.4 In his address to the US Congress on the 4th March 2009 and again at the G20 summit, Gordon Brown spoke of the need to alleviate hardship for the underprivileged around the world and for help to Africa. Let him first consider and apply these words to his own citizens. For KSFIOM at least, and possibly others, the solution is unlikely to involve a UK taxpayer outlay.

4.0 Recommendations

4.1 The two solutions which have been put forward, immediate liquidation as requested by the DAG, or the Scheme of Arrangement as proposed by the Isle of Man Authorities, both appear to give approximately the same result according to data presented by Mike Simpson in his Third Affidavit on 18th February 2009. Both require the use of Isle of Man resources.

4.2 Common to both is that complete repayment to depositors up to the achievable limit will take a long time, up to two years or more, due to the lengthy administration necessary and to the fact that resources are simply not available to achieve a faster return of depositors funds: unlike the onshore situation where Icesave (but not all Kaupthing Edge) depositors were paid back quickly using HM Treasury funds.

4.3 Common to both also is the large uncertainty caused by the retention of the KSFIOM assets. Assumptions have to be made to arrive at any sort of conclusion as to the result to be obtained from either of the two solutions. It should be remembered that the Transfer Order required that, for the first six months of the administration, Ernst & Young were required to focus on the transfer of funds to ING in the Netherlands. This period will end on 8th April 2009.

4.4 Ernst & Young's activities have been shrouded in secrecy with one publication only, on 14th November 2008. We are aware that there are several contentious issues. The suing over counter claims to some of the Certificates of Deposit and a possible knock on effect from the JJB saga (see also B 6.5), to name but two. KSFIOM was required to keep some of its funds with other financial institutions. Some of these are now not co-operating with the Liquidator Provisional as they are claiming set off, not for funds deposited with KSFIOM but with KSFL.

4.5 Also to note in this respect is that Ian Pearson, Economic Secretary to the Treasury, on 6th November 2008, said he expected that KSFIOM would "*only recover a portion of the £532m*" (Appendix II) and that KSFIOM must rank like any other KSFL creditor.

4.6. However, notwithstanding this, the authors record the possibility that KSFIOM's assets in KSFL may be ring fenced. Certainly Ernst & Young are unlikely to proceed in an unethical manner. So it is possible that the delay and misunderstandings are due to the manner in which the Transfer Order was drawn up.

4.7 There is now political emphasis to find an acceptable solution, following the Treasury Committee's recommendation that the UK authorities and the offshore centres of the Isle of Man and Guernsey work together to that end.

4.8 Assuming 100% frozen assets release, one solution which is quite possible for KSFIOM is the complete sale of KSFIOM as a going concern. Such an outcome is

currently happening in the case of Kaupthing Luxembourg. The advantages of this route are:

- A high probability of bank salvage with 100% of its deposits.
- The use of IOMG funding earmarked for the DCS or Scheme of Arrangement to provide any necessary loans or guarantees required for the sale and operation of the salvaged bank.
- The early restoration of the ability of depositors to use the bank for everyday operations (22% of depositors are Isle of Man residents).
- Provide the ability for depositors to leave funds in the bank to earn interest as before if they wish.
- A relatively rapid complete solution to the problems, faster overall than could be achieved by either liquidation or the Scheme of Arrangement, and therefore at lower cost.

4.9 This approach will allow time for the correct reaction to be taken as information becomes available on the release of assets from KSFL: and it will keep up the pressure on the UK and IOMG Governments for the fairest solution. Immediate actions by the KSFIOM Depositors Action Group should initially include the following:

- Utilise publicity as necessary to illustrate the plight of the depositors and institutions affected by the present situation.
- Investigate further the legal and moral obligations for the release of funds from KSFL due to KSFIOM by the UK Government.
- Avoid calling for liquidation of KSFIOM now.
- Formulate a structured plan which is geared to the progress of Mike Simpson in his negotiations with Ernst and Young for the release of KSFIOM assets, and which will deal with how the IOM authorities would need to be involved. If liquidation is necessary, it could still be enacted at any time.
- Formulate a contingency plan by legal investigation to evaluate whether the group should join with the Kaupthing Resolution Committee in suing HMG for recovery, *including punitive damages*. This should include a study of to what extent the Transfer Order was a true legal expression in every respect of the powers enshrined in the Banking Special Provisions Act 2008.

SECTION B

FACTORS CONTRIBUTING TO THE CRISIS

5.0 The Nature of the Transfer Order

5.1 Statutory Instrument No 2674, Kaupthing Singer & Friedlander Limited Transfer of Certain Rights and Liabilities Order 2008 (herein the Transfer Order) was laid before parliament at 4 pm on 8th October 2008 and enacted at 12.15 pm on the same day (The apparent timing anomaly is correct). It was used by the Treasury to justify in legal terms the seizure, part transfer and then liquidation of Kaupthing Singer and Friedlander Limited (KSFL), a substantial company with a balance sheet of some £8bn.

5.2 The Order was based on Sections 6,8,12, and 13.2 of the Banking and Special Provisions Act 2008 which completed its legal passages through parliament on 21st February 2008.

5.3 On 19th February 2008 Mr. Darling said in parliament:

“As the House knows, the powers in this Bill are necessary to take Northern Rock into a period of temporary public ownership and the Bill is a general one. The reason for its being general is that it contains provisions that could be applicable in other circumstances, but as I made it clear yesterday, and I make it clear today, that it is being introduced now only because there is a need to enable the Government to take Northern Rock into that temporary period of public ownership and it is essential that we proceed quickly”

5.4 This was the key to getting the order passed, even although it was opposed by the Conservatives. They were also specific in their objection to the draconian nature of the Act which allowed for the Order to be enacted, except where compensation payments were due, without the further consent of Parliament.

The shadow chancellor Mr. George Osborne:

“Thirdly, will the Chancellor confirm that he is actually introducing unprecedented, sweeping, draconian powers that will let him nationalise any other bank or deposit-taking institution in Britain by ministerial fiat?”

5.5 Other quotes during the debate on 19th February 2008 register the level of concern about the general provisions of the bill which were later used to formulate the Transfer Order:

Mr. Michael Fallon (Con Sevenoaks)

“We have spent too little time in the Chamber talking about this, because we have had so little time, but nowhere in the Bill are those terms defined. What do we mean by “financial stability”? How do we define a “serious threat to financial stability”?[...].

“It takes general powers, but I am not at all persuaded that hurrying to do that is a good thing. If there is a specific problem that has to be dealt with in an emergency, let us deal with it, rather than taking such sweeping general powers in such a rush.”

5.6 The Order overrode the normal provisions of the Insolvency Act 1986 which requires that the first duty of an administrator is to attempt to rescue a company as a going concern.

5.7 Most of the parliamentary time on the Act was spent discussing the detail of how Northern Rock would be taken in public ownership and later managed. The parts of the bill (in particular clause 12 3 (c), (which were used for the seizure and liquidation of KSFL without compensation and unilaterally), were not specifically debated. **To this extent the powers used for the break up of KSFL were bulldozed through parliament on the back of the Northern Rock crisis.**

6.0 The Icelandic Banking Crisis in a Global Context

6.1 The important chronicle of events leading up to the seizure of KSF is described by reference to an article by Professor Richard Coates, Professor of Economics at the London Business School, published in the Financial Times on 13th October 2008; the salient points of which are as follows:

6.1.1 As known, the global crisis commenced in earnest with the collapse of Lehman Brothers on 15th September 2008 due to the fact that the Bush Administration refused to support it. The knock on effects of this action were catastrophic since banks around the world immediately started withdrawing credit supplies making it difficult for banks (including Iceland's main banks) dependent on wholesale borrowing to maintain their operations.

6.1.2 Concerning the three Icelandic banks Glitnir, Landsbanki and Kaupthing Coates says *"All posted good first-half results, all had healthy capital adequacy ratios, and their dependence on market funding was no greater than their peers'. None held any toxic securities. These banks had been managed well since their "mini-crisis" in early 2006"*. Banks in the UK and Switzerland had similar ratios.

6.1.3 The first victim of international credit withdrawal was Glitnir. It requested a loan from the Central Bank of Iceland (CBI) but was refused. Rather than taking Glitnir into administration, the CBI Governor David Oddsson forced nationalisation on punitive terms. The author says of this: *"His[David Oddsson's] decision reflected politics, technical incompetence and ignorance of markets, and his comments thereafter were highly destabilising"*

6.1.4 The next section is quoted verbatim:

"This triggered a sovereign debt downgrade and a sharp further fall in the already depreciated[Icelandic] krona. Short-run funding for Glitnir and Landsbanki evaporated, margin calls came from the European Central Bank, loan covenants kicked in because of the downgrade. With the banks unable to meet commitments, Iceland's financial regulators put them into administration.

Kaupthing still seemed viable. But last Tuesday, Mr Oddsson made public remarks that were interpreted to mean that Iceland would not meet its obligations to UK depositors. This was politics for home consumption. So was the UK's retaliation, with an ill-considered invocation of anti-terror [and other] laws to seize the UK assets not only of Landsbanki, but also of Kaupthing. Gordon Brown's highly aggressive statement was not his best moment of the financial crisis.

*Kaupthing was collateral damage. **Britain's seizure of its Singer and Friedlander subsidiary destroyed the larger bank, as covenants on loan agreements were activated.** The UK and Iceland appear now to have agreed on*

dealing with depositors, but too late for Kaupthing. Still, it would be foolish for the UK authorities to impair Kaupthing's assets further".

6.2 In his generous comments about the Icelandic banks however, Professor Coates could not have been aware of revelations that have since emerged. Tony Shearer ex CEO of Singer and Friedlander Limited (SFL) stated at the TSCM (see 5.13 below) that he was not happy with the manner in which Kaupthing carried on its business. In particular the directors had borrowed money to purchase shares and had a put option to put those share back into the company. Profits seemed to relate as to 90% on trading activities and 10% on banking activities. He therefore advised the FSA that he did not consider that Kaupthing was fit and proper to take over SFL but the FSA took no action on his advice. Tony Shearer felt so strongly that he did not want to work for the bank that he turned down a well paid job offer from Kaupthing.

6.3 Kaupthing had loaned roughly 4.4bi US \$ to its main owners in August 2008. The money was transferred from Kaupthing Luxembourg to an account in the British Virgin Islands. In mid September 2008 a Sheikh from Qatar purchased a 5% stake in the bank designed to instill confidence in the bank. However the press release did not mention that the Sheikh actually borrowed money from Kaupthing in order to purchase the stake with out any money from himself. Source: City Wire.

6.4 Both Kaupthing and Landsbanki lent extensively to Baugur who used the funds to buy large stakes in UK and other retailers. Two weeks ago Baugur collapsed so its assets now belong to these banks and ultimately to the Icelandic Government. This could mean that ultimately there could be enough money to repay all depositors but the process will be long, complicated and drawn out. The Resolution Committee has stated that they are very keen to avoid a "fire sale" and are prepared to hold onto assets for as long as it takes to get a good return. Source: Daily Telegraph and Resolution Committee published report.

6.5 An additional complication with regard to KSFIOM and KSF is that KSFL holds 23% of the shares of JJB Sports of which a Mr. Wheeler was a director. This has impacted KSFIOM in as much as institutions holding KSFIOM Certificates of Deposit are not co-operating with Mike Simpson due to cross claims from KSFL with regard to JJB. On the basis of the shares security, KSFL loaned JJB sports £43m. The shares have subsequently declined in value. Mr. Wheeler made a personal application to Mr. Darling with the plea that JJB needed the money to ensure ongoing operations and employment in Wigan. Mr. Darling authorised the FSCS to release the funds to Mr. Wheeler, ahead of release to many businesses and depositors in Kaupthing Edge who have yet to receive their compensation due under the FSCS / Treasury compensation scheme.

6.6 With regard to the Coates statement, David Oddsson, in his own defense later, in a statement to the Icelandic Chamber of Commerce on 18th November, pointed out that he had warned many times for 18 months or so of the gathering global financial storm. Also, he pointed out that the supervisory and regulatory functions of the Central Bank had been split, the latter being delegated to a new Financial Services Authority which implied that

his official intervention powers were limited. But, he said, he had been over-ruled by both government and the management of the banks in the general atmosphere of euphoria which had prevailed.

6.7 Thus, in many ways the situation in Iceland paralleled that in other countries like the UK and the USA. In the UK, the incoming 1997 Labour government took the regulatory powers away from the Bank of England and formed our own FSA. In the USA that did not happen, but the era of lax banking control ushered in was presided over by the former Federal Reserve Chairman, Alan Greenspan, a passionate believer in free markets.

6.8 In this manner, all over the world, financial innovation and free wheeling became the norm. Cheap credit was widely available and was widely used. The toxic asset saga was born and flourished. Iceland took part in this activity at full strength (although without the toxic assets). However with the exception of a few analysts, **no outside regulatory authority, governments or institutions, seriously questioned their actions, at least not in public.** Small wonder that no retail investors did.

6.9 But as far as Iceland was concerned there was a large difference. Because the banks were able to grow very large so quickly, they became many times larger than the island's GDP. Writing in the Financial Times on 1st July 2008, Robert White, professor of political economy at the London School of Economics (and winner of the Leontief Prize in Economics, 2008) said:

“The size of the (Iceland) accumulated macroeconomic imbalances beggars belief. The external deficit was 25 per cent of GDP in 2006 and 17 per cent in 2007. Gross short-term foreign debt amounted to 15 times the value of the central bank's foreign exchange reserves at the end of 2007, or roughly 200 per cent of GDP. Gross long-term foreign debt amounted to another 350 per cent of GDP. Bank assets swelled to 10 times GDP by the end of 2007. These imbalances are the other side of the Icelandic purchases of companies in Britain, Denmark and elsewhere”.

6.10 Reliable City data shows that at end 2007 the Icelandic Banks lead the pack with total assets at 780% of GDP. This was followed by Ireland at 680%, and the UK at 500%. In mid 2008, loan to deposit ratios were: Glitnir 3.59, Kaupthing 2.26, Landsbanki 1.59. At end 2007 Kaupthing had a short term maturity profile (all loans) of Euros 9.7bn 3 months, Euros 4.7bn 3 – 12 months. This indicates that all were unstable.

6.11. In February 2008 Oddsson reported that on a visit to the UK to review matters with our own financial authorities (presumed FSA and/or HM Treasury) he became alarmed at their view of the developing Icelandic situation and the dominance that the Icelandic banks had achieved in the UK and the effect that any default would have.

6.12 We note that about this time the Banking Special Provisions Act (2008) was born. It may have been coincidence it that the timing chimed with the Northern Rock crisis, and/or it may have been a look ahead to allow action in the event that problems

developed with the UK branches of Icelandic banks. However no action was taken by the FSA to warn investors of an impending crisis.

6.13 This is shown up by a comment in the Lex column of the Financial Times 16th October 2008:

“Even if you assume that those assets (many of them secured against the British High Street) are sold for more than that firesale prices, the country still has only some \$4bn of foreign reserves to try to close that gap. Iceland could raise another \$1bn from the IMF.....Raising these funds will take time.....Top of the (blame) list are Icelanders themselves, the heftiest players and largest short sellers in their own market, *The next bogeyman is the UK’s Financial Services Authority. When Icelandic Banks could not fund themselves by borrowing money on the wholesale market at 15% it was absurd that the FSA allowed them to suck up £4.5 bn of UK deposits by offering 6.5% instead.....*”

6.14 As will be shown later, the same necessary reticence was not shown by the Isle of Man FSC. They too foresaw and became concerned at the developing Icelandic situation. As a result, they engineered the transfer of some £700m of funds belonging to KSFIOM which had been up streamed to the parent company Kaupthing hf in Iceland, back to the UK and mainly to KSFIOM’s normal business sister company Kaupthing Singer & Friedlander Limited (KSF) in London. (information source: Treasury Select Committee Meeting The Protection of UK Citizens Investing Funds In Non-UK Jurisdictions 3rd February 2009 (TSCM): statement by John Aspden CEO IOMFSC).

6.15 The FSC has been criticised for this. Criticism of the initiation of the transfer itself is unjustified, in our view. Additionally it must be pointed out that had FSC not arranged for the funds to be up transferred from Iceland to the UK the funds would have been subject to the payment moratorium in Iceland. However, there are certainly those who say that the funds should have been spread around to eliminate the onshore risk. Strictly speaking that is true, with the benefit of hindsight. Indeed, why so much of the funds in Iceland were in the first place is another point. This has to be evaluated in the light of how effective in this regard a supervisory commission, whose role is advisory, could be. Therefore Mr. Pearson’s statement at the Adjournment Debate on 6th November 2008 that “they could have put their money elsewhere” (Appendix II) has to be viewed in the light of how feasible a spread around would have been, and what would have been the parent companies reaction to such a proposal.

7.0 The Seizure of the UK Subsidiaries of the Icelandic Banks.

7.1 On the 7th October 2008 the Icelandic (Fjarmalaeftirlitio/ FME) took control of Landsbanki putting it into administration and freezing all deposits and establishing a Winding up Committee. The deposits included some £4bn in the UK branch mainly with the internet bank Icesave.

7.2 This action caused considerable alarm amongst the UK authorities who, however, reacted with speed, with the following results:

7.2.1 Landsbanki Limited which was the UK branch of Landsbanki islands hf (LI) which contained the Icesave accounts was seized under the anti-terrorist act whilst Heritable Bank, another sibling of LI, which contained some £36m of deposits from Landsbanki Guernsey (LG), was seized under the Banking Special Provisions Act, 2008 as KSFL. This forced LG into liquidation.

7.2.2 The Chancellor, Alistair Darling spoke on the telephone with the then Icelandic Finance Minister Arnie Mathiesen. The next day he made a statement that the Icelandic authorities “had no intention” (Appendix II) of honouring their obligations here, referring to their equivalent FSCS obligations. Mathiesen never said that. However it is clear from the transcript that Iceland were probably not able to meet their obligations. Nor was it to be inferred from a letter which the Icelandic Business Ministry sent to HM Treasury on 5th October 2008. (Appendix II)

7.2.3 Also on 8th October 2008, the Chancellor issued a statement to the effect that all UK retail depositors (but not the institutions) in Icesave and onshore Heritable would be fully compensated. Later this was effected by making substantial loans to the Iceland authorities, thus allowing them to meet their obligations. No such guarantees were offered to offshore depositors.

7.2.4 The then Icelandic Prime Minister Gier Haarde issued a conciliatory statement in response to the Chancellor to the effect that they were willing to negotiate over Landsbanki to find a mutually beneficial solution but Gordon Brown countered with an aggressive statement saying that he would pursue Iceland through the courts to recover the money owed.

7.2.5 At about noon on 8th October 2008, HM Treasury issued the Transfer Order which allowed the seizure and break up of KSFL, the substantial UK subsidiary of Kaupthing Hf in Iceland with a balance sheet of some £8bn. Of note is the fact that the Transfer Order was very detailed being designed specifically for KSFL and draconian in its powers. Therefore, this represented the springing of a contingency plan which must have been several months in the making.

7.2.6 In the afternoon of the 8th October, Aidan Doherty Managing Director of KSFIOM telephoned the KSFL Administrators and established that there was no

prospect of release of funds. He explained that the KSFIOM board had received no prior warning of the seizure and was in need of liquidity since there had been on run on the bank with outgoings approaching £40m per day, and that they had always relied on funds in London for managing their day to day business. With no prospect of funding from there, he then telephoned the parent Kaupthing hf in Iceland requesting a transfer of about £300m of funds under their parental guarantee. The board director was initially sympathetic but then called back much later in the evening to say that Kaupthing hf was in default. The next day the entire board of Kaupthing hf was dismissed and the company nationalised. A court order was issued in the Isle of Man withdrawing the banking license of KSFIOM and the bank was put into provisional liquidation by appointment of Mike Simpson of PricewaterhouseCoopers as a Liquidator Provisionally.

7.3 It is quite clear from the foregoing that the act of seizing of KSFL, which was followed by the transfer of some £2.6bn of deposits to ING under Treasury Guarantee, along with the later transfer of (unknown) assets, together with the commencement of liquidation of the balance of the company's assets, was certainly responsible for the final downfall of Kaupthing hf. Many commentators agree with this. It is not sufficient to trivialize the issue by the statement that the bank would have fallen anyway. Reference to Kaupthing hf's short term maturity profile referred to in 5.6 above suggests that is very likely that this would have been the case, although we will never know for sure.

7.4 Following the above events there has been a number of Ministerial statements from the Government in defense of their actions. Regrettably some of these have been both inaccurate and misleading. They are detailed in Appendix II.

7.5 In summary of this and Section 6, the approaching financial storm was evidently apparent to the FSC and to the FSA and to the UK Government late in the day. Then the action taken was rapid and severe and had dire and, in human terms, unacceptable knock on effects, as shown in the next sections.

8.0 The Effect on the Offshore Subsidiaries of Landsbanki hf and Kaupthing hf

8.1 Tables 2 and 3 of Appendix I summarise the unaudited balance sheets of KSFL as of 7th October 2008 and KSFIOM as of 30th September 2008 respectively. It can be seen that both companies were relatively to very cash rich respectively. KSFL had some £1.3bn of cash in its balance sheet. KSFL was geared to a degree, although we do not at present have details of the loans maturity profile. That of KSFIOM is short, with a maximum of six years in a roughly bell shaped curve. This gives rise to relatively healthy to robust preliminary Loan to Deposit Ratios for the two entities of 1.37 and 0.36 respectively.

8.2 In the KSFL Administrators Statement of Proposals, on the reasons for administration, for KSFL dated 14th November 2008 states that:

“These decisions were based on the FSA’s assessment of the financial position of the firm particularly having regard to its liquidity”

The Ernst & Young administrator also states that there was a run on the bank in the days leading up to the seizure. This also happened offshore with KSFIOM which briefly experienced withdrawals at the rate of up to some £40m per day. However, as noted above, it would appear that superficially, taken together, both banks were in good financial state at the time of the seizure.

8.3 The unusual effect of the Transfer Order in relation to normal liquidation procedures of paragraph 49 of Schedule B1 of the Insolvency Act 1986 and Rule 2.33 of the Insolvency Rules 1986 is highlighted by the administrator’s initial statement of the effect that the purpose of Administration on this occasion was to:

*“realise Kaupthing’s (KSFL’s) business and assets in a manner which would be achieved in a more advantageous realisation than would be achieved on a winding up (a formal liquidation as defined in the Act) However, for the **first six months** of the Administration the Administrators have been directed by the Transfer Order to achieve the **Overriding Objectives**”*

8.4 The Overriding Objectives concern mainly transfer of the Kaupthing Edge business to ING and the associated administration and, “ensuring that KSFL performs the other obligations imposed on it by the Transfer Order” The 1986 Rules were made secondary to this.

8.5 Ominously we see from this document that the transfer of 170,000 Edge deposits worth some £2.6bn triggers liabilities from the FSCS and HM Treasury which in turn are passed to KSFL. To the extent that these liabilities cannot be covered by the relevant assets later transferred to ING there could be cross claims on other assets, specifically those belonging to KSFIOM (see below).

8.6 Of relevance to KSFIOM is Article 27 of the Transfer Order which says:

“Kaupthing (KSFL) shall not make any payment, dispose of any property, or modify or release any liability to or for the benefit of a related party without the prior consent of the Treasury, and any such purported payment, disposal, modification or release shall be void”

Aimed specifically at Iceland, this effectively also enabled the Treasury to retain some £557m of cash assets (see below) belonging to KSFIOM. Furthermore, KSFIOM Liquidator Provisionally Mike Simpson understands that KSFIOM must stand in line behind other creditors and as yet is to receive no preferential treatment. Worse, we also understand from the Memorandum from the Isle of Man Government (Appendix III) that the FSA has even denied the FSC or its nominee representation on the KSF creditor committee, even although the KSFIOM is the largest creditor.

8.7 The Business Relationship between KSFL and KSFIOM

8.7.1 As noted in 6.2.6 above, there was always a close business relationship with regard to everyday matters. Aidan Doherty’s affidavit on the 8th October records: 13.(iv): *“the freezing of the companies assets held by KSFL caused a serious liquidity problem for the company. In the normal course of its business the Company maintained liquidity by managing from day to day its deposits held with KSFL in London”*

8.7.2 Also it can be noted in this regard from Tables 2 and 3 of Appendix 1 that KSFIOM had a sub-participation agreement in its loan book (risk sharing) with KSFL of £164.3m.

8.8 The Business Relationship Between Kaupthing hf, KSFIOM and KSFL

8.8.1 It is normal practice for offshore companies to upstream funds for investment to parent companies in the country of origin. It is quite apparent that this must happen to manage funds if one considers the magnitude of total funds invested through the Isle of Man. See Appendix 1 Table 1. Generally speaking this causes very large fund flows into London which are put to a variety of uses for mortgages and other financial instruments. **Since the funds have variable origin from around the world, this can and should be thought of as a benefit to the UK.**

8.8.2. But, in the case of KSFIOM about £700m of funds (see 5.8 above) were up streamed to Kaupthing hf. In early January 2008 the FSC became concerned at the developing situation in Iceland and stated in their submission to the TSCM (Appendix III 1.8.11):

“At the end of March 2008, when the FSC became sufficiently concerned at the deteriorating situation in Iceland it initiated discussions with the board of K&SF (IOM) L. The priority was to eliminate K&SF (IOM) L’s exposure to Iceland”.

8.8.3 In 1.8.12 of the Memorandum the board of KSFIOM agreed to; *“substitute the banks exposure to its parent in Iceland by re-directing those deposits to KSF”*. A short term liquidity facility of £185m was left in place. (It appears that this facility was drawn upon later since on 30th September 2008 the net cash in Iceland was £10m – Table 2 Appendix 1)

8.8.4 Before permitting the transfer to go ahead the FSC consulted with the FSA regarding the permitted amount which KSFL could accept in terms of exposure to non legislation assets and it was determined that the regulatory limits could be met. We do not have a written record of when the assets were transferred to KSFL. It would appear to have been in the second quarter of 2008.

8.8.5 In the context of 7.8.1 above and Section 7.7, this transfer was not unusual or unreasonable. There was no reasonable way at the time that the FSC or the management of KSFIOM could have foreseen the issuance and effects of the Transfer Order. Indeed, in the general context of what happened subsequently to Iceland, the elimination of the Icelandic country risk was timely, although unfortunately the destination of the funds proved to be inappropriate.

8.9 In general terms however subsequent to this there was a complete lack of co-operation shown by the FSA. This volte face on normal co-operation between the FSA and the FSC, according to the Memorandum of Understanding with the FSA in September 2003, commenced immediately after the Transfer Order had been issued. Other examples of this lack of co-operation follow:

8.10 In the first place, the IOM authorities repeatedly attempted to obtain clarification from the HM Treasury and others as to the status of the KSFIOM assets and the reasons for the seizure of KSFL but obtained no information or a rebuff. For the FSC’s part they received in early December a communication from the FSA requesting clarification as to what was wanted. It was not until 30th January 2009 that some clarification was obtained via a short e-mail (Source TSCM John Aspden)

8.11 In the second place at a meeting of Creditors of KSFL held in London on 1st December 2008 it is evident that the Financial Services Authority Compensation Committee Ltd did not vote for the Liquidator Provisionally for KSFIOM to join the committee, even although he represented some 10,000 depositors and KSFIOM, with some £600m of claims against KSFL was the largest external creditor. We now understand that this position arises from the fact that the FSCS and the Treasury are, or were, the largest creditor (circa £2bn) due to the fact that initially money was lent to ING to enable them to payout under the compensation scheme. However the FSA also refers on its website to the transfer of other assets in addition to the liabilities to ING, such as

would be expected if the whole business was transferred. If this has happened it is possible that the large State creditors may have been now discharged.

8.12 The Isle of Man Government Memorandum to the TSCM (Appendix III) sums up the above situation as follows:

“In conclusion, the Isle of Man contends that a solvent bank in the Isle of Man has been made insolvent by the actions of the UK authorities, when the UK was attempting to protect its own interests against Iceland. Had the existing regimes and protocols been adhered to then the situation, of not avoided, could have been managed with significantly less impact on the Isle of Man”

8.13 One is forced reluctantly to the conclusion that the behavior of the FSA with respect to this situation goes well beyond the normal and professional response that is to be expected from a controlling body and that, therefore, there must be an entrenched political constraint in operation, by default or by design, which to date has prevented such communication from taking place due to the offshore status of KSFIOM.

8.14. The same attitude is quite apparent with regard to Landsbanki Guernsey. Here some £36m of deposits are frozen onshore UK in the seized Heritable Bank.

8.15 If we take all Icelandic UK funds in the UK branches of Icelandic banks, including offshore, not subject to the FSCS, i.e. to include those funds invested by institutions, pension funds, retail depositors, local governments, and charities, the total funds affected by the Governments actions are in excess of £1.6bn, of which the Isle of Man deposits represent about half this figure. This disgraceful situation must be given the highest possible public and political exposure.

8.16 Without exception around the world, since the large majority of depositors are non resident UK citizens many with life savings and pensions at stake, this has caused hardship, distress, and even attempted suicide.

9.0 Solutions Proposed For the Isle of Man Problems

9.1 On 24th October 2008, the Financial Times reported that:

“The Isle of Man has decided to spend up to £150m – half its disposable reserves – and 7.5% of its gross domestic product – to raise the maximum payable under the depositor’s compensation scheme from £15,000 to £50,000”. (the Depositors Compensation Scheme – DCS)

Guernsey had no plans to follow the Isle of Man’s lead in offering public funds to help bail out savers in subsidiaries of collapsed Icelandic banks.....”

9.2 Following that Tynwald approved relief payments first of £1000 per depositor, then, recently, a further £10,000 per depositor. The total interim cost of this to the Isle of Man will be £94m.

9.3 In approximately November 2008, the Isle of Man Government, hired AlixPartners, Financial Consultants, to work up a certain Scheme of Arrangement. The aim of this was to speed up and possibly improve compensation payments to depositors and would avoid liquidation. The Isle of Man would still contribute funding by means of a top up scheme, with claw backs under certain conditions. However many details of this are unavailable and the DAG is currently working with the IOMG to clarify certain areas.

9.4 Mike Simpson in his Third Affidavit published on 18th February 2009, estimated that the relative benefits of Liquidation now versus the SoA now were £226m and £212m respectively. This is to be compared with the total value of the deposits of £840m. Simpson identified legal hurdles for the SoA which would require action both in the Isle of Man and English Courts. The Court once more adjourned consideration of either scheme, this time until the 9th April 2009.

9.5 Understandably, many depositors, particularly those with larger savings in the bank, are not in favour of either solution at present. However, in conjunction with KSFL assets or partial assets relief, the SoA might provide accelerated payments for depositors.

9.6 On 15th March 2009 the High Court of England consented to a request by the Kaupthing hf nationalized bank to investigate the legitimacy of a decision by the UK Authorities to transfer KSFL Kaupthing Edge deposits to ING in the Netherlands without compensation: this was the precursor to the placement of KSFL into administration and the freezing of the KSFIOM assets. This once again raises the possibility that KSFIOM may consider suing HMG alongside Kaupthing in the event that the release of assets from KSFL is considerably less than expected.

9.7 Whilst the provisions of the Transfer Order are clear enough, legally challenging it would appear to rest on the correlation between the Transfer Order and the Banking Special Provisions Act 2008, including the timing aspects of the enactment. The possibility of punitive damages also arises.

9.8 It is concluded that the only viable and fair solution for the KSFIOM retail depositors and institutions is the release by HM Treasury of the £600m or so of assets belonging to KSFIOM and held in KSFL under the Transfer Order. According to Mike Simpson this could, even at this stage result in a sale of the bank as a going and viable concern, thereby relieving pressure in every direction.

9.9 This solution will also solve the problem of non retail depositors and trusts where are at present not eligible for compensation under the DCS. We know of at least one depositor in KSFIOM, a family, who, because their funds, life savings of circa £350,000, were managed by Friends Provident Association, are deemed to be institutional and therefore not eligible for the £50,000 Depositors Compensation Scheme. The anxiety and pressures felt by this family are exceptionally severe, but match also those of the Guernsey depositors.

10.0 Taxation and Expatriate Issues

10.1 There is a great deal of misunderstanding concerning the tax and expatriate status of depositors in the Isle of Man and Guernsey. These must be rectified, as follows:

10.2 In the interests of international co-operation against tax evasion the Isle of Man and other Crown Dependencies such as Jersey Guernsey and the Cayman Islands together with Switzerland and Monaco, voluntarily adopted the European Union Tax Directive 2005. This gave EU depositors the choice of full disclosure and exchange of information with the host country or payment of a Withholding Tax with declaration of the balance of income in the country of residence. Currently the Withholding Tax is 20%. It is due to rise to 35% in 2011. In the EU, Withholding Tax is remitted to the host country. For remaining expatriate depositors outside the EU, full declaration on income must be made in the country or residence.

10.3 The other area of misunderstanding concerns the status of expatriates. The Landsbanki Guernsey Depositors Action Group undertook a survey of 58 UK banks with regard to their position on the acceptance of expatriate deposits. All bar two said that an expatriate resident overseas could not open a UK saving bank account due to the antiterrorist laws. The two who said that it was possible required the person opening the account to be present when the account was opened. This situation has been encountered many times by Isle of Man depositors, 42% of whom are resident outside the EU overseas.

11. The Plight of the Depositors In KSFIOM and Landsbanki Guernsey

11.1. For Landsbanki Guernsey (LG) the liquidation recovery is currently around 30%. More is promised but there is great uncertainty as to how much. Payouts to them to date have been accomplished by liquidating quick assets, but the balance will take a long time and involves redemptions of medium to long term property loans, some in the buy to let market. There is no depositor's protection scheme in Guernsey.

11.2 The position of KSFIOM depositors is little better in reality due to the enormous uncertainty and stress and anger which abounds everywhere. This stems not only from the delays but also from the extreme frustration caused by the knowledge (almost universally shared) that the UK Government is holding the £600m of funds which are due to them, and that these funds, if released would enable near 100% funds recovery.

11.3 Many savers in both locations have placed their life savings there on financial advice and in good faith. Many overseas UK citizens are still working. Many are retired. Amongst the elderly retired there are reports of forced sales of retirement property being built, forced change of plans when moving overseas, broken marriages, and mental illness. LG report some elderly considering returning to the UK to live with the help of state aid: and two attempted suicides.

11.4 Recent statistics released for KSFIOM show that 22% of the depositors are island based, 22% UK based, 14% EU and 42% overseas. Many of the island depositors used the bank for everyday purposes. In all including the LG, more than 10,000 mainly UK citizens are affected.

11.5 If one considers the all UK funds affected by the Icelandic Banking Crisis which are either partially covered by compensation schemes or, in the case of local government funds and LG funds not covered at all, the total of funds partially or wholly at risk is in excess of £1.6bn. This figure includes local government and charitable funds in the UK branch of Landsbanki Islands hf and in the Heritable Bank.

4th April 2009

APPENDICES

APPENDIX I: FINANCIAL DATA

1. ISLE OF MAN FINANCIAL SECTOR BALANCE SHEETS

Source: Financial Services Commission Annual Report March 2008

	£bn 31 Mar	
	2008	2007
<u>Assets</u>		
<i>Money market assets due from banks and building societies</i>	59	51.4
Loans, advances & Assets Leased	10.7	9.5
Investments	0.2	0.2
Other Assets	1.0	0.8
Total	<u>70.9</u>	<u>61.9</u>
<u>Liabilities</u>		
Deposits due to banks and building societies	11.2	7.4
<i>Deposits Due to Customers</i>	54.4	50.1
Other deposits (held as security and interest payable inc deposits due to public sector bodies	1.8	1.7
Loans, advances & Assets Leased	10.7	9.5
Other Liabilities	1.0	0.8
Capital & Reserves	2.5	1.9
Total	<u>70.9</u>	<u>61.9</u>

2. KSFIOM AND KSFUK BALANCE SHEETS

Source: Provisional Liquidator and Liquidator Reports

A. Kaupthing Singer & Friedlander (IOM) Ltd

As of 30th September 2008

<u>ASSETS</u>	£,000
Cash with External Banks and Certificates of Deposit	182,300
Cash with Kaupthing Singer & Friedlander Ltd	557,154
Cash with Kaupthing Hf	195,085
Advances to Customers	410,464
Other Assets	1,744
Total	<u>1,346,547</u>

LIABILITIES

Customer Deposits	927,544
Deposits from SFIM(IOM) ltd	15,336
Deposit from Kaupthing Hf	185,156
Sub-participation deposits from KSF Ltd	164,331
Other Creditors	10,926
Share Capital	5,000
Revenue Reserve	38,254
Total	<u>1,346,547</u>

LOANS TO DEPOSIT RATIO (PROVISIONAL)= Advances+assets net of CD's and reserve/total deposits and creditors. Khf assets and liabilities and cash with KSF Ltd ignored.

0.37

B. Kaupthing Singer & Friedlander Limited (in Administration)

Consolidated Draft Unaudited Balance Sheet as of 7 October 2008

<u>ASSETS</u>		£,000
Credit Institutions	3,061,300	
Customers	3,273,100	
Total Loans		6,334,500
Cash with Central Banks	425,300	
Bank Accounts – Other	366,600	
Bank Accounts – Group	550,700	
Total Cash and Bank Accounts		1,342,600
Trading	235,600	
Fair Value	200	
Available for Sale	9,500	
Total Financial Assets		245,100
Derivatives Used for Hedging		600
Investments		62,600
Intangible Assets		11,100
Property & Equipment		26,600
Tax Assets		6,500
Other Assets		69,700
Total Assets		<u>8,099,200</u>
<u>LIABILITIES</u>		£,000
Demand	3,318,100	
Time	1,670,000	
Consolidated Companies	286,600	
Total Deposits		5,274,700
Money Market Borrowing Group	1,232,400	
Money Market Borrowing – Other	110,000	
Overdraft Group	499,700	
Total Borrowings		1,842,200
Due to Banks/Central Bank		569,800
Repurchase Agreements	793,300	
Derivatives	3,000	
Total Trading Liabilities		796,300

<u>LIABILITIES (Cont)</u>	£,000
Subordinated Loans	202,200
Provisions	2,600
Tax Liabilities	Nil
Other Liabilities	(981,300)
Equity	392,500
Total Liabilities	<u>8,099,200</u>

LOANS TO DEPOSIT RATIO (PROVISIONAL) = Asset loans plus money market and other borrowing and liabilities net of cash / total deposits

1.36

RATIO WITHOUT KSFIOM CASH

1.46

Notes

1. This draft unaudited balance sheet is preliminary in nature and continues to be under review.

2. Loans – credit institutions. These sums include funds deposited at Khf and other institutions where these institutions may also have claims against KSF, in respect of which there is risk that set off may be asserted. If such set off claims were successful, the gross assets and gross liabilities will reduce accordingly.

3, Cash and Bank accounts. These sums include funds deposited at institutions where these institutions may also have claims against KSF in respect of which there is a risk that set off may be asserted. If such claims were successful, the gross assets and gross liabilities will reduce accordingly.

APPENDIX II

Letter From Iceland to HM Treasury & Ministerial Statements



Mr. Clive Maxwell
HM Treasury
1 Horse Guards Road
London SW1A 2HQ
United Kingdom

VIÐSKIPTARÁÐUNEYTIÐ
Ministry of Business Affairs

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Reykjavik October 5, 2008
Reference: VRN08080014/51.020

Dear Mr. Maxwell.

Reference is made to the discussions you have had with the Ministry this weekend.

If needed the Icelandic Government will support the Depositors' and Investors' Guarantee Fund in raising the necessary funds, so that the Fund would be able to meet the minimum compensation limits in the event of a failure of Landsbanki and its UK branch.

On behalf of the Minister

Jónína S. Lárusdóttir

MINISTERIAL STATEMENTS

8th October 2008

On the 8th October following Mr. Darling's statement on BBC radio that the "*Icelandic Government, believe it or not, have told me yesterday that **they have no intention of honouring their obligations here***" Gier Haarde the Icelandic Prime minister issues a statement responding to Darlings accusations "*The governments of the two countries will immediately review the matter in detail through official channels with a view to finding a mutually satisfactory solution. It should be highlighted that on Monday evening changes were made to the Act on Depositors and Investors Guarantee Fund strengthening the position of depositors by giving them priority when allocating assets. There is a good probability that the total assets of Landsbanki will be sufficient to cover the deposits in Icesave. The Icelandic government re-iterates that if needed it will support the Depositors and Investment Guarantee Fund in raising necessary funds*"

Later that day Gordon Brown tells members of the press that he and his colleagues "*are taking legal action to recover money lost to people who deposited in UK branches of its banks*"

9th October 2008

Gordon Brown repeatedly claims that Iceland's government has taken "illegal action". In an interview with Sky News he says "*The issue is basically this. The Icelandic banks have collapsed, the Icelandic authorities have to take some responsibility for it. They cannot just default and say that they're going to take on none of the responsibility for what has happened. And we have therefore taken action to seize the assets of the Icelandic banks*"

15th October 2008

The Times Letter

Browns Action Was Cowardice Not Courage

Daniel Hannan Con MEP South East England

"To seize the assets of a friendly state was bad enough; to use anti terrorist legislation was unforgivable. When the Crime and Security Act was passed in 2001, we were repeatedly told that it would be used only in cases of imminent danger....."

"Gordon Brown claims that the expropriation was necessary because Iceland planned to default on British Icesave accounts. How he got this impression was a mystery.

Brown's response? To seize the assets, not of the bank which ran Icesave, but of a wholly unrelated bank Kaupthing, thereby collapsing it. Icelanders, who had been expecting to guarantee British depositors.... were stunned. They could not bring themselves to believe that the leader of a country they admired would destroy their last solvent bank simply to give himself what Labour MP's have since called his "Falklands moment".....To pick a country with half the population of Wiltshire was cowardice, not courage".

3rd November 2008

Subject: Understanding of the Isle of Man Economy and Tax Status

UK Chancellor has IOM 'tax haven' in his sights

Manx Herald Editor

The Rt Hon Alistair Darling, MP, the UK Chancellor of the Exchequer, has given a firm warning to the Isle of Man authorities that he will be gunning for them once the current financial crisis has calmed down.

Appearing this afternoon, before a UK House of Commons Treasury Committee - after responding to a question, from Mr. Graham Brady, Conservative member for Altrincham and Sale West, about any responsibility the UK Government may have in seeing that money, deposited in the UK division of Kaupthing Singer & Friedlander, is returned to KSF (IOM) – he (Mr. Darling) made the following comment:

"I would just add another thing, I actually think having looked at what has happened over the last few months we really do need to have a long hard look about the relationship between this country and the Isle of Man - a 'tax haven' sitting in the Irish Sea (clapping in background) -where you know, where we really, (stutters) where it is leading to, perhaps, people not really being clear to what the different rights and responsibilities are. But we can't have the situation where sitting there, with all sorts of tax advantages accruing to being in the Isle of Man, but when things go wrong people saying 'what about the British compensation scheme?' So it is important that we take this opportunity, not rushing in to it, not a knee jerk reaction, but I think we do need to have a look at it, and indeed it is something that your own committee may want to look at as well."

Mr. Darling and Chairman of the UK Financial Services Authority, Lord Turner, also comprehensively rejected any suggestion that the UK authorities were responsible for the situation in which the IOM part of Kaupthing Bank finds itself.

Mr. Darling seemed to take exception to reports that the problem had originated in the UK....., by the action of the FSA, and that people had to look to the Icelandic authorities passing legislation to takeover their banks as the trigger He said the UK

authorities had only taken action to protect British depositors' interests; which he said are the people he owes a responsibility and not those in any other jurisdiction - i.e. the IOM who have their own regulatory authority.

Mr. Ian Pearson Economic secretary to the Treasury
Adjournment Debate 6th November 2008 Hansard

“My understanding is that KSF Isle of Man had some £532 million of deposits in KSF UK, and can be expected to recover a proportion of this from the insolvency process. It is my view that, given the lack of clarity that remains about the winding up of KSF in Iceland, depositors of KSF Isle of Man are likely to be better off than if those sums had been deposited with the parent company. However, under UK insolvency law, KSF Isle of Man ranks like any other creditor of KSF. KSF Isle of Man will have been fully aware of this. It could have chosen to put its money elsewhere.”

Indeed, KSF Isle of Man was only one of a number of depositors with KSF UK that was not protected by the UK Financial Services Compensation Scheme. Other depositors included local authorities, building societies and charities. The FSA could not have given KSF Isle of Man advance warning of events, any more than it could have done so for other parties, as to have done so would have been highly inappropriate.

On the question whether depositors in the Isle of Man or Guernsey had any choice in the matter of opening offshore accounts, or whether non-UK residents are forced to open accounts offshore, I can confirm that this is not the case. There is no legal bar under financial services regulation that would prevent a non-UK resident from opening a new bank account here. When an account is opened remotely, more onerous anti-money laundering checks are, quite properly, required because of the increased risks involved. This might well be a factor in the willingness of some UK banks to offer new accounts to non-residents. However, this would not be a burden for customers who move offshore but wish to retain existing accounts”.

APPENDIX III

**Memorandum from the Isle of Man Government for the Treasury Select Committee
Meeting 3rd February 2009**

January 2009

Memorandum from Isle of Man Government

The UK Treasury Committee is seeking to identify lessons that can be learned from the banking crisis. To that end, it has invited written evidence on four key areas. The Evidence from the Isle of Man Government which focuses on Sections 1.8 and 3.5 of the Committee's examinations is set out below.

Executive Summary

The Isle of Man Government:

- asserts that it is a well regulated economy and applies international standards to the highest level.
- contends that the usual communication channels between the Isle of Man Financial Supervision Commission and the UK's FSA were not followed in advance of or during the Kaupthing insolvency.
- has in place a deposit protection scheme in line with affordable best practice.
- is keen to contribute to a debate as to how international consumer protection may be strengthened recognising that expectations may have changed.
- welcomes the opportunity to provide evidence, both in writing and orally, to demonstrate that the Isle of Man promotes transparency in the provision of financial services and plays an active part in combating international crime.

About the Isle of Man Government

Background to the Isle of Man, its Economy and Political System

1. The Island is a self-governing British Crown Dependency with its own parliament, government and laws. The UK government, on behalf of the Crown, is ultimately responsible for its international relations and the Queen, as 'Lord of Mann', is the Head of State and is represented on the Island by the Lieutenant Governor. The Island has a special and limited relationship with the EU, under an agreement ('Protocol 3') negotiated when the UK joined Europe in 1972, allowing free trade in agricultural and manufactured products between the Isle of Man and EU members. Apart from matters relating to this agreement, including Customs, the Island is not bound by EU legislation and it pays nothing to, and receives nothing from, EU funds.
2. The Isle of Man has had one of Europe's fastest growing economies in recent years, led by the international financial services industry. Over the last 25 years, the Island has developed into a flourishing and internationally respected offshore business centre providing significant business introduction into the UK and, in particular, the City of London. Business is attracted by professional expertise, supportive government, world-class telecoms infrastructure and sound financial regulation, as well as by a competitive tax regime. New growth areas include e-commerce, film industry, international shipping, aircraft registry and space and satellite business, while traditional sectors like tourism are still important.

3. Growth in the Island's economy has been matched by investment in the Island's public services, funded by direct and indirect taxation. The Island is self-financing.
4. Economic sectors include: financial services (36% of GDP), construction (7%), manufacturing (7%), professional and scientific services (21%), tourism (5%), and farming/fishing (1%). The Island has a working population of 44,000 and an unemployment rate of 1.5%. Inflation is currently 4.7%. The Isle of Man produces its own notes and coins with the same value as UK Sterling, for local use only.
5. For the 2007-2008 taxation year overall Government net spending was £543 million. This funding was used to provide a variety of services to Isle of Man residents, many in excess of those provided in jurisdictions such as the UK. For example:-
 - the basic pension plus supplements for a married couple, with the wife qualifying on her husband's contribution, is £217.58, some £72.53 per week higher than the basic pensions of £145.05 per week in the UK.
 - free eyesight tests and dental examinations are provided under the Health Service.
 - all tuition fees for Island students accepted into Higher Education courses at UK universities are paid by the Isle of Man Government without any required student contribution, while UK students are responsible for their own tuition fees.
 - free public transportation is provided for those over 60 years and pupils travelling to and from state schools.
 - during the past decade significant investment has been made in new infrastructure throughout the Isle of Man. In recent years over £500 million have been committed for such projects as a new acute care hospital, an energy-from-waste facility, new sewerage treatment works, improved schools, a new prison and two new water treatment plants.
 - the provision of affordable housing for Island residents has been a high priority and some £200 million has been made available for housing schemes that will see more than 1,000 additional homes built before 2010. A further £85 million has been allotted to repair and refurbish public sector housing and £44 million in grants and loans has been provided to construct homes for first-time buyers.
6. The provision of extensive public services and infrastructure within a legislative framework that does not permit a budget deficit, has earned the Isle of Man a coveted AAA credit rating from both Standard and Poor's and Moody's credit rating agencies for the past 8 years.
7. The Isle of Man is an international financial centre but because of its relatively low levels of income taxation, it has on occasions, been described as a "tax haven." Such labels are misleading, and may suggest to some a stereotype of secrecy and weak financial regulation. In recent years the Isle of Man has proved to the world that it does not conform to this stereotype.

8. The Island is not a secret or closed jurisdiction; it has no bank secrecy laws. A number of external and independent assessments of financial regulation have confirmed that the Island co-operates fully in the pursuit of international financial crime, and that its defences against money laundering comply with the highest global standards.
9. The Manx government's policy is to be both internationally responsible and economically competitive. At the heart of its taxation strategy is a determination to comply with current international standards on information exchange whilst endeavouring to promote good quality business in a low tax environment.
10. A number of international organisations have assessed the Isle of Man's practices against global standards to ensure that the Isle of Man does not present a weak link in the financial system generally.
11. The International Monetary Fund ("IMF") has endorsed the Isle of Man's compliance with international standards in such areas as banking, insurance, securities, anti-money laundering and combating the financing of terrorism. The IMF's Report in 2003, stated that the regulatory and supervisory system of the Isle of Man complied well with the assessed international standards and commended the Isle of Man for the attention it had given to upgrading the financial, regulatory and supervisory system to meet international supervisory and regulation standards.
12. A further inspection was undertaken by the IMF in September 2008 and early indications confirm positive findings.
13. The Island is a member of the International Organisation of Securities Commissions (IOSCO), the main body responsible for the setting of international standards in the securities sector. It is also a member of the Offshore Group of Banking Supervisors.
14. The Financial Action Task Force ("FATF") has carried out its own review of the Island's defences against money-laundering. Its positive report concluded that the Island is a co-operating jurisdiction with measures in place which are close to full adherence with FATF recommendations.
15. The Financial Stability Forum ("FSF") also considered the effect which offshore centres generally can have on global financial stability. The Isle of Man was placed in the top group of centres reviewed.

The Isle of Man Government's comments on specific areas of the Committee's inquiry

Turning now to the Isle of Man Government's comments on specific areas of the Committee's inquiry.

Securing financial stability

1.8 Possible improvements to the architecture of international financial regulation and maintenance of global financial stability.

- 1.8.1 It is the contention of the Isle of Man Government that the financial regulations in the Isle of Man and the protocols that exist between the Island and the UK regulatory authorities are appropriate to manage financial stability, if applied consistently. These are well documented and have been subject to scrutiny by numerous national and international bodies e.g. Treasury Select Committee, IMF, OECD, etc.
- 1.8.2 It is the contention of the Isle of Man Government that there was a significant shortfall in communication between the regulatory authorities in respect of the action which the UK was planning to take in relation to Kaupthing Singer & Friedlander Limited ("KS&FL") a UK incorporated company authorised by the FSA to take deposits. This meant that the Island had no opportunity to make or join in contingency arrangements for the safety of retail depositors' funds held locally.
- 1.8.3 This has had a significant detrimental impact on the reputation of the Isle of Man, a Dependency of the British Crown, because as a consequence of the actions of the UK, Kaupthing Singer & Friedlander (Isle of Man) Limited ("KS&F(IOM)L"), a licensed banking institution in the Isle of Man could not meet the repayment demands made on it by its depositors. Many of these depositors are UK expatriates or people living in the UK who are retail depositors and for legitimate reasons found themselves banking in the Isle of Man with what had until recently been a UK banking group i.e. Singer & Friedlander.
- 1.8.4 Apart from being licensed by the Isle of Man Government's Financial Supervision Commission ("FSC"), KS&F(IOM)L was also authorised by the FSA to conduct certain activities in relation to UK Regulated Mortgage Contracts – including administering, advising, arranging and lending.

Why does the Isle of Man contend this?

- 1.8.5 The FSC signed a Memorandum of Understanding ("MOU") with the FSA in September 2003. Such memoranda, while not having any legal or contractual standing, are designed to facilitate assistance and co-operation between regulators. The regulatory relationship between the FSC and the FSA (and its predecessor for banking supervision in the UK, the Bank of England) has functioned effectively for over 25 years (when the Isle of Man was one of the first smaller jurisdictions to establish a dedicated body responsible for the regulation of its financial services industry).
- 1.8.6 Except for the recent events relating to the Kaupthing case, the FSC has had a good working relationship with the FSA particularly in relation to all banks and other credit

institutions that are domiciled in the UK and that represent significant liquidity and /or credit exposures for Isle of Man banks. This is especially the case where the UK and Isle of Man banks are both part of the same banking or financial services group. It is accepted that in the majority of these cases, but not all, the FSA is responsible for the consolidated supervision of the whole group because it is the Home Regulator. A good recent example of a case where regulatory cooperation between the FSC and FSA worked effectively is in relation to the situation experienced by Bradford & Bingley plc.

- 1.8.7 The FSC sought to discharge its functions responsibly in relation to Kaupthing Bank hf and these circumstances are set out in the information which follows.. The presence of this banking group in the Isle of Man goes back almost 38 years when in April 1971 the Singer & Friedlander Group, a banking group in the UK, incorporated the existing bank (KS&F(IOM)L) under the name Singer & Friedlander (Isle of Man) Limited. In August 2005 the FSA had permitted the Singer & Friedlander Group to be acquired by Kaupthing Bank hf. This parent / subsidiary relationship existed until January 2007 when ownership of KS&F(IOM)L changed from it being a subsidiary of KS&FL to a sister of KS&FL and owned directly by Kaupthing Bank hf; the word "Kaupthing" being introduced into the company name, with the London bank, at that stage. During 2007, Kaupthing Group commenced to upstream deposits taken by KS&F(IOM)L to Iceland where previously it had been to KS&FL in the UK.
- 1.8.8 In December 2007, the FSA and the FSC permitted the Derbyshire Building Society to sell its Isle of Man banking subsidiary to KS&F(IOM)L.
- 1.8.9 During 2008, the two Icelandic banks (Landsbanki and Kaupthing), marketed aggressively, by offering high interest rates in the UK for retail deposits from UK consumers, via their internet product offerings ("Icesave" and "Kaupthing Edge", respectively).
- 1.8.10 The business relationship between KS&F(IOM)L and KS&FL was not removed because of the change in upstreaming by KS&F(IOM)L to Kaupthing Bank hf. KS&FL continued to participate in some significant lending opportunities together with KS&F(IOM)L as well as the latter using KS&FL for certain settlement transactions. In February 2008, the FSC visited the FSA to discuss regulatory issues concerning the market conditions and a specific session related to Kaupthing. It was evident therefore that both the FSA and the FSC believed there were common issues to discuss.
- 1.8.11 At the end of March 2008, when the FSC became sufficiently concerned with the deteriorating economic situation in Iceland, it initiated discussions with the Board of KS&F(IOM)L. The priority was to eliminate KS&F(IOM)L's exposure to Iceland.
- 1.8.12 The Board of KS&F(IOM)L offered to substitute the bank's exposure to its parent in Iceland by withdrawing deposits from Kaupthing Bank hf and redirecting those deposits to KS&FL in the UK. A liquidity facility of £185 million was left in place between KS&F(IOM)L and Kaupthing Bank hf which gave KS&F(IOM)L the opportunity to call for short term liquidity if it was needed.
- 1.8.13 Before permitting KS&F(IOM)L to place a significant amount (48% as at 30 September 2008 - after netting off the "liquidity" exposure to Kaupthing Bank hf) of

its total assets with KS&FL, the FSC believed it prudent to discuss this and confirm two important matters with the FSA:

- The maximum exposure that it permitted KS&FL to have to related parties (including Kaupthing Bank hf); and,
- The liquidity requirements placed upon it in relation to deposits made with it that had a maturity date of up to one month.

1.8.14 The FSA informed the FSC that the maximum exposure that the FSA permitted KS&FL to have with all related parties was 25% of Large Exposure Capital Base in aggregate. The FSA confirmed that this included interbank placings with a maturity of less than 12 months (which is noteworthy because such exposures, which can be significant, are sometimes exempted.) Within this limit the FSC was given to understand that there was to be no net exposure between KS&FL and Kaupthing Bank hf. The FSA also stated that most of the related party exposures comprised exposures to related parties situated within the UK. This was supported by the fact that when the FSC spoke to KS&F(IOM)L and the FSA regarding the margin on £185 million of additional collateral (that was being put in place between KS&F(IOM)L and KS&FL to give some independent security for a placing by KS&F(IOM)L with KS&FL), some difficulty was experienced because the margin was regarded as part of the 25% related party limit.

1.8.15 Secondly, the FSA informed the FSC that KS&FL had to have liquidity available within 30 days equivalent to 95% of liabilities maturing within 30 days (a mismatch of no more than 5% out to 30 days). In the maturity band sight to 8 days, no mismatch was permitted. The FSA stated that certain behavioural adjustments were permitted to the retail deposit book (except at the time for deposits accepted via the Kaupthing Edge internet product offering). No behavioural adjustments were permitted to the contractual maturity date for wholesale / interbank deposits taken by KS&FL.

1.8.16 The FSC had therefore satisfied itself that:

- The exposure to the parent bank would be eliminated (except that a line of liquidity was available to draw upon from the parent if needed and which netted off in the event of insolvency);
- The 60% of total assets of KS&F(IOM)L that were represented by claims on Kaupthing Group in October 2008 (after netting off the "liquidity" exposure to Kaupthing Bank hf) were due from KS&FL, a UK bank where all related party exposures were limited to 25% of Large Exposure Capital Base and where there was no net exposure to Kaupthing Bank hf; and,
- KS&FL would have liquid assets to meet all maturing liabilities out to 8 days and were only permitted to have a maximum mismatch of 5% out to one month.

1.8.17 As explained above, the FSA would have been aware of the business model adopted by KS&F(IOM)L and of the importance which the Isle of Man regulator attached to these prudential limits for the containment of risk.

Up until the demise of KS&F(IOM)L the FSC had no major concern about the way in which the local bank was managed or about its asset quality.

- 1.8.18 On 8 October 2008 KS&FL was placed into administration on application by the FSA. The relevant Order of Court provides that the Court file shall not be available for public inspection without the Court's leave. The UK Tripartite Committee / UK authorities made arrangements for a number of UK accounts (badged "Kaupthing Edge" accounts) to be transferred to ING Bank. The FSC has been informed that the funds backing the transfer of these deposits came directly from HM Treasury and/or the UK Financial Services Compensation Scheme.
- 1.8.19 Whilst the Isle of Man has been unable to verify matters because of a lack of information as can be seen later, if the limits referred to above were being properly observed it is unclear why KS&FL needed to be placed into administration without prior regulatory dialogue, given the disastrous effect which such a move was bound to have on asset values.
- 1.8.20 The UK Government has agreed to represent the Isle of Man's interests in ongoing discussions with Iceland, including on the enforcement of a guarantee given by Kaupthing Bank hf. However, it has been pointed out that under the terms of international loans granted or to be granted to Iceland, the country will be bound to treat all creditors *pari passu* and the UK Treasury has subsequently informed the Isle of Man Government that the parental guarantee is a "creditors issue" which should be pursued directly with the Resolution Committee of Kaupthing hf.
- 1.8.21 As mentioned above, a high degree of co-operation normally exists between the FSA and the FSC, supported by a MOU. This notwithstanding there was no prior indication to the FSC by the FSA that KS&FL was to be placed into administration and that KS&F(IOM)L's claim on KS&FL would be affected. Such regulatory co-operation and dialogue is to be expected situations, and as had happened in dealing with other situations previously. In the Isle of Man's view there was a breakdown of regulatory co-operation in this instance.
- 1.8.22 Prior to the placing into administration of KS&FL, arrangements (backed by UK Treasury and Bank of England/ UK Financial Services Compensation Scheme Ltd funding) were apparently made in advance to ensure that retail depositors with KS&FL (that is in effect all UK situs accounts belonging to individuals) would receive back 100% of their deposits. No opportunity was given to the Isle of Man to see whether KS&F(IOM)L's retail depositors could participate in these or other safety arrangements, even though the FSA knew of KS&F(IOM)L's high reliance on KS&FL.
- 1.8.23 The basis on which the application was made for the UK administration Order for KS&FL was not explained at the time though some details have come to light in subsequent Select Committee reporting. The underlying Court documents cannot be disclosed without the Court's leave. The FSC has requested access to them from the FSA but this has not yet been granted.
- 1.8.24 At the meeting of Creditors of KS&FL held in London on 1 December 2008, it is evident from the votes cast, that the UK authorities (in the form of the UK Financial Services Compensation Scheme Ltd) did not vote for the Liquidator Provisionally of KS&F(IOM)L to join the Creditors Committee – despite the fact that he is in effect representing the interests of the over 10,000 depositors who banked with the group through KS&F(IOM)L and has an indicative claim of £600 million against KS&FL. The FSC understand that this makes the Liquidator Provisionally of KS&F(IOM)L the

largest creditor of KS&FL apart from the UK Financial Services Compensation Scheme Ltd.

1.8.25 The Statutory Instrument, The Kaupthing Singer & Friedlander Ltd Transfer of Certain Rights and Liabilities Order 2008 (the "SI"), made by HM Treasury under emergency powers created by the Banking (Special Provisions) Act 2008 effectively provides for the immediate transfer of retail depositors to ING Direct N.V. It also imposes an overriding objective on the administrator to effect ING transfers as a priority over all other administrative actions.

Paragraph 27 of the SI, under the heading of "Moratorium on payment to related companies" states that:

1. "Kaupthing (KS&FL) shall not make any payment, dispose of any property or modify or release any right or liability to or for the benefit of a related party without the prior consent of the Treasury, and any such purported payment, disposal, modification or release shall be void.
2. No related party shall exercise any right of set-off or combination of accounts in respect of any debt owing by Kaupthing (KS&FL) without the consent of the Treasury, and any such purported exercise shall be void."

1.8.26 KS&F(IOM)L is a related party as defined. It will be seen that the effect of the paragraph in this SI creates an exceptional variance to the usual process of administration.

1.8.27 During December 2008, the FSC had sight of the Estimated and Redacted Summary of Statement of Affairs for Kaupthing Singer & Friedlander Limited (KS&FL) (in Administration) as at 8 October 2008. This indicates some £3,025 million of loans and advances are due from "Intercompany" (related) parties, including £2,300 million from Kaupthing Bank hf. It appears from a note to that Statement that there is a net amount due from Kaupthing Bank hf of £900 million. This net amount would be 150% of what the FSC calculate may have been KS&FL's Large Exposure Capital Base. The Statement is less helpful than one would expect because it does not quantify the sums due to related parties. The aggregate for related party exposures reported on the Statement are also significantly greater than the £531million (before netting off amounts due to group) reported in Note 41 to KS&FL's audited financial statements for the year ended 31 December 2007.

1.8.28 Moreover, as explained above, KS&F(IOM)L funds were placed with KS&FL on the understanding that any exposure of KS&FL to the remainder of the Kaupthing Bank hf Group would be contained within the prescribed UK regulatory policies / restrictions applying to it in relation to related party lending and liquidity mismatches. It would appear from the Estimated and Redacted Summary Statement of Affairs that these policies / restrictions were either not applied or were subsequently relaxed significantly or were breached in a significant manner.

1.8.29 Furthermore, the UK freezing Order made by HM Treasury against Landsbanki assets (Landsbanki Freezing Order 2008) was publicly construed by many as a freeze of Icelandic assets generally. This perception, even though the generality was wrong, exacerbated an already tight liquidity position for Kaupthing Bank hf Group as a whole.

1.8.30 **In conclusion the Isle of Man contends that a solvent bank in the Isle of Man has been made insolvent by the actions of the UK authorities, when the UK was attempting to protect its own position against Iceland. Had the existing regimes and protocols been adhered to then the situation, if not avoided, could have been managed with significantly less impact on the Isle of Man.**

3.0 Protecting the Consumer

3.5 The protection of UK citizens investing funds in non-UK jurisdictions.

3.5.1 The Isle of Man Government and its regulatory authorities have designed and implemented comprehensive consumer protection regimes, based on international good practice, over many years. However, the IOM appreciates that the international financial community now wants to understand how the current market conditions have occurred and is happy to co-operate in that exercise.

3.5.2 The Isle of Man has a Financial Services Ombudsman Scheme which is a free, independent dispute resolution service for customers with a complaint against an Isle of Man financial firm such as a bank, insurance company or financial adviser which the firm has been unable to resolve. It became fully operational in January 2002. The role and powers of the Scheme are set down by law and the Ombudsmen are appointed by the Isle of Man Office of Fair Trading. It has powers to order payments up to £100,000 for cases where a consumer complaint is upheld.

3.5.3 The Isle of Man has a depositors' compensation scheme (DCS). The DCS partially compensates depositors (wherever resident) if a bank in which they have deposited money fails. To pay compensation, a DCS fund is created (when needed) from contributions made by other banks in the Isle of Man and the Isle of Man Government. The DCS compensates people who have money in current and deposit accounts in the Isle of Man up to a limit of £50,000 per individual depositor and up to £20,000 for most other categories of depositor (companies, trusts etc). There is no "standing fund" of compensation (i.e. money is not collected in advance).

3.5.4 The Isle of Man also has a scheme to compensate investors in authorised collective investment schemes: Isle of Man's Authorised Collective Investment Schemes' Compensation Scheme ("ACISCS"). The ACISCS partially compensates an investor if an authorised collective investment scheme in which they have invested fails to pay when money is due. Compensation may be due if a manager or trustee of an authorised collective investment scheme fails to repay an investor when required by the terms of the scheme. Compensation payable is calculated as 100% of the first £ 30,000 and 90% of the next £ 20,000 with a maximum compensation of £48,000. Compensation is paid out of levies collected from other authorised scheme managers and trustees ("authorised persons") in the Isle of Man. There is no "standing fund" of compensation (i.e. money is not collected in advance).

- 3.5.5 For life assurance companies, the Isle of Man's Life Assurance (Compensation of Policyholders) Regulations 1991 ensure that, in the event of a life assurance company being unable to meet its liabilities to its policyholders, up to 90% of the liability to the protected policyholder will be met. Unlike many other policyholder protection schemes, the Island's scheme operates globally, providing protection to policyholders no matter where they reside. The scheme would be funded by a levy on the funds of the other life assurance companies.
- 3.5.6 All authorised institutions are required to provide details of the various compensations schemes within their literature to ensure that depositors / investors are familiar and cognisant of the protection regimes in place. The Isle of Government prides itself both on its quality of financial regulation and on the responsible stance it takes to consumer protection. It contends that UK citizens can invest in the Isle of Man with confidence.

January 2009