SUPERVISORY STRATEGY

2022-2024

SEÐLABANKI ÍSLANDS

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The Central Bank of Iceland, Kalkofnsvegur 1, 101 Reykjavík, Iceland
(+354) 569 9600, sedlabanki@sedlabanki.is, www.sedlabanki.is

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Foreword by the Governor and the Deputy Governor for Financial Supervision

The Central Bank of Iceland has compiled its strategic priorities for supervision of the financial market over the next three years, from 2022 through 2024.

The first section of this report describes the transition currently underway in the financial market and the challenges that this entails for the market and for financial supervision. The second section presents the Bank's four strategic priorities for the period through 2024. These are *cyber- and IT security, anti-money laundering and terrorist financing measures, focus on the customer, and sustainable finance*. This Strategy is intended as a guidepost for development in the Central Bank's financial market supervision and the order of priority the Bank will follow in the years to come. This entails placing greater emphasis on these topics, partly to respond to increased risk, but also to adapt supervisory practices to changes in the regulatory framework and developments in the market. The third and final section describes the underpinnings of financial market supervision and highlights the key priorities for supervision of specific sectors of the financial system in the next several years.

As of this writing, the COVID-19 pandemic has been raging for two and a half years. The pandemic and the public health measures aimed at mitigating its impact on people's lives and health caused a major economic shock in 2020 and have given rise to significant uncertainty. It is gratifying to see that the broad-based changes made in both the regulatory framework and supervisory practice in recent years, with the aim of strengthening the financial system, have withstood this shock. Financial market entities have weathered the storm with room to spare and have carried out their role in intermediating capital. Even so, major tasks related to unwinding with the lingering effects of the pandemic on the economy and financial system still lie ahead, yet there is good reason to expect success if the tasks are approached correctly. In addition, the war in Europe and the sanctions against Russia have created uncertainty in the financial markets and ushered in new challenges for the financial system and the domestic economy.

Financial market legislation has changed radically in the past decade. Nearly all segments of the financial market have been reviewed and revamped with the aim of bolstering companies' resilience and protecting consumer interests, strengthening professional risk management, improving governance, and expanding oversight and supervision. The final chapter in this review remains, however, and substantial changes in the regulatory framework are still foreseeable. By the same token, new legislation has expanded financial market authorities' roles and supervisory tasks, including by according them increased power to intervene and impose penalties. Such power brings with it considerable responsibility and demands thorough and careful work habits in connection with administrative decision-making.

In 2016, before its merger with the Central Bank, the Financial Supervisory Authority published its strategic priorities for 2016-2020 in a report entitled Verðskuldað traust. The title, which translates loosely to *Trust Deserved* in English, was intended to stress that there was every reason to build up trust in the financial market and in the authorities responsible for it. At that time, the settlement of legacy issues from the 2008 financial crisis was largely complete, and the post-crisis financial system had become established. At present, however, the financial market is in transition. Technology is the main catalyst of the shift, although changes in consumer behaviour, the regulatory framework, and increasing globalisation of the domestic financial market are factors as well. The Central Bank of Iceland follows developments closely and considers it necessary to adapt its supervisory activities to these changes. The Bank's Supervisory Strategy 2022-2024 takes account of these changes and the risks that could accompany them. It is important, however, to bear in mind that not only do rapid changes in the financial market bring risks; they also bring opportunities. If implemented successfully, they will strengthen the financial system and enhance its ability to support sustainable economic development for the long term.

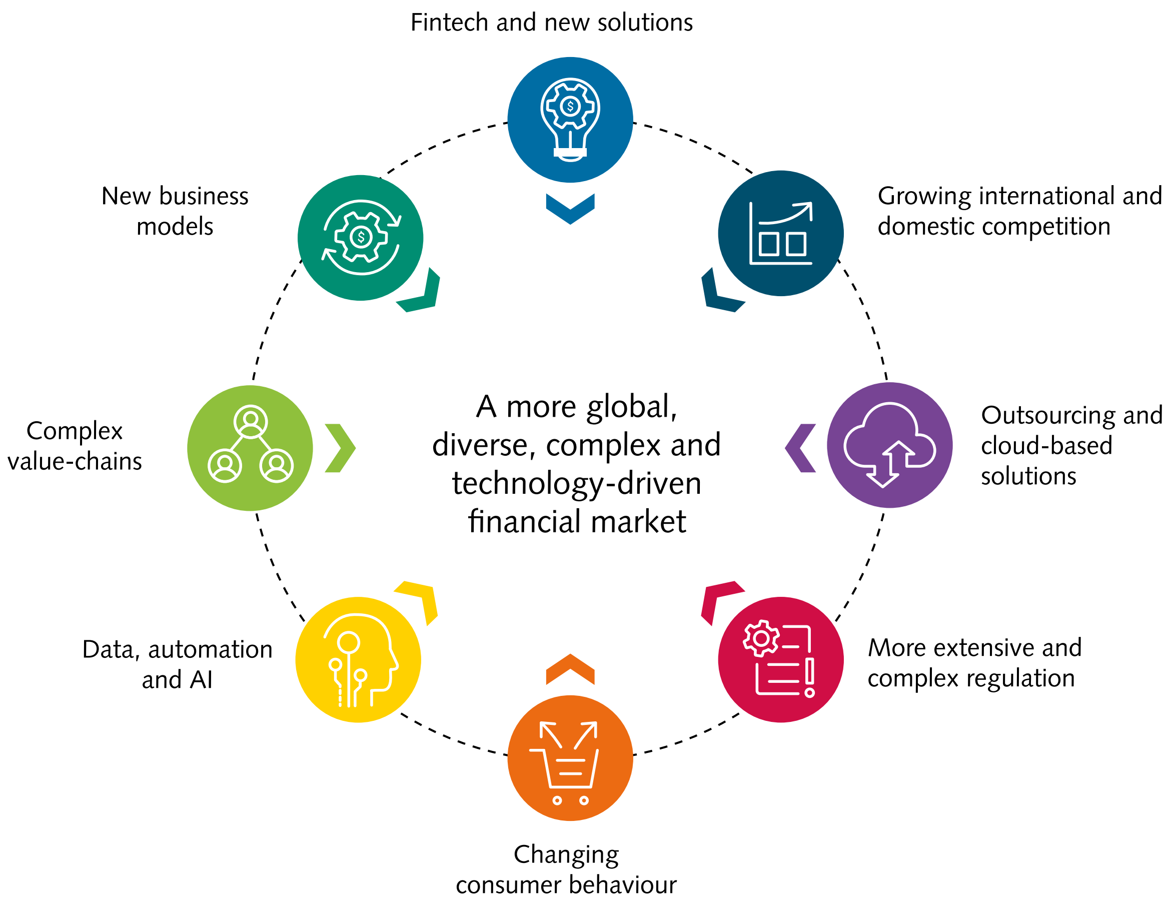
Ásgeir Jónsson
Governor

Unnur Gunnarsdóttir
Deputy Governor for Financial Supervision

I

A FINANCIAL MARKET IN TRANSITION

This section focuses on major changes in the domestic financial market that affect its evolution and characteristics. The financial market is subject to greater and more rapid change than before. Due to a number of factors, the financial domestic market is simultaneously becoming ever more global, diverse, complex, and technology-driven. This shift calls for a change in priorities for the supervision of financial activities. This section focuses on the challenges associated with such changes and describes the preferred supervisory response to these challenges.



A more complex and diverse financial market

New types of entities subject to supervision and registration requirements enter the market on a regular basis, owing to tech innovation, ingenuity, and changes in the regulatory framework. Consumers' expectations and wishes will be a major determinant of how the financial market develops in coming years and how costly it is for new, smaller companies to adhere to current rules and prudential requirements in the market. Furthermore, global tech giants could penetrate the market and cause instrumental changes in coming years.

Technological advances and fintech

A large share of financial market companies are now placing primary emphasis on digital transformation of their activities so as to respond to consumer demands, strengthen their competitive position, and reduce costs in the long run. At the same time, implementing tech solutions can be costly and can entail operational challenges and risks. Many domestic firms are at the forefront in offering digital solutions for their customers, and the Icelandic financial market is well prepared technologically to face the challenges associated with the ongoing digital transformation of the market.

In coming years, technological advances will pose further challenges to previously existing financial business models and open up new paths for services, while simultaneously shifting risks in the financial market and creating new ones. As a consequence, tech advances bring with them a number of opportunities but also various risks that require a response, not least in the area of cyber- and IT security.

Globalisation of the domestic financial market

Foreign companies seek to provide services in Iceland more than ever before, and foreign entities are increasingly involved in the administration and ownership of domestic financial companies. On the basis of reciprocal recognition, entities subject to supervision in the European Economic Area (EEA) are authorised to provide services in Iceland, irrespective of whether they have physical offices in the country or not; i.e., through agents, distributors, or branches. Foreign entities that have operations and provide services in this manner in

Iceland do so within the scope of the authorisations provided for in the operating licence granted in their home state. Governmental authorities in the home state are responsible for supervising the activities of these entities as regards financial requirements, while the Central Bank acts as supervisor in matters including business practices and consumer protection, sound functioning of domestic markets, and anti-money laundering and terrorist financing measures.

The globalisation of the financial market has also increased in other areas; for example, the Nasdaq CSD Iceland securities exchange is now operated as a branch from Latvia after merging with Nasdaq CSD SE. This calls for increased communication and cooperation with foreign supervisory authorities.

Growing competition and changes in consumer behaviour

Competition can be expected to stiffen in certain areas of the financial market, and the consumers of the future will likely be more willing to switch service providers and to do business with multiple companies simultaneously than they have in the past. Conventional long-term business relationships in the financial market are therefore under threat, although they still exist. With increased digitisation, firms' marketing activities and their possibilities to attract international customers have also changed significantly. This can bring with it competitive advantages and risks for consumers, who must, among other things, learn to use new technologies and avoid risks.

New business models

The business models of banks, payment service providers, and other financial market entities are being reviewed. The new Payment Services Directive, PSD2, will presumably usher in further changes, although it is not yet known what the ultimate effect on banks' income and business models will be. Furthermore, financial technology (fintech) will doubtless make its mark on business model development in the insurance market in the years to come.

Tech innovations will continue to lower the costs faced by new players trying to gain a foothold in various areas of the financial services market. On the other hand, the regulatory framework and prudential requirements often create roadblocks for smaller entities. That said, certain technological advances and regulatory changes make it possible to break up older business models, offer limited services in defined areas, and thereby boost competition within specific links in the value chain. Recently, smaller operators often attempt to develop business models centring on limited service offerings and limited risk, while other players in the value chain continue to bear that risk.

There is also a tendency towards increased concentration in the domestic financial market as companies attempt to streamline operations, such as by forming financial conglomerations following mergers of financial and insurance companies.

Sustainable finance and ESG criteria

In coming years, climate action can be expected to be a major force for change in the financial market, both because of companies' and investors' strategies and because of new and growing demands from governmental authorities. These demands will focus, among other things, on directing capital to sustainable economic activities and on addressing risks related to climate catastrophe and other ESG-related aspects of the financial system in an appropriate manner. ESG refers to risks centring on environmental issues, social impact, and governance practices as they pertain to supervised entities' operations and those of their business partners. Significant advancements can be expected in this area, as can statutory amendments that will make more stringent requirements of supervised entities, with the aim of promoting sustainable development while simultaneously increasing information disclosure requirements and boosting transparency so as to prevent greenwashing.

COVID-related challenges

In addition, the COVID-19 pandemic has brought with it a number of changes and challenges in the financial market. Asset quality must be considered during loan portfolio restructuring. Furthermore, demand for residential housing has surged and must be monitored closely. Now that the Government has withdrawn its fiscal support for households and businesses, the impact of the pandemic on the financial system needs to be re-evaluated. Priorities in supervision of financial activities in coming years will inevitably be affected by these challenges.

Keys to appropriate responses by the Central Bank

A more global, diverse, complex, and technology-driven financial market calls for changes in focus, development of new work methods and procedures, and information gathering by the Central Bank of Iceland.

Technological neutrality

The Central Bank must adapt to the demands that tech advances make of its activities at any given time. Supervisory bodies' regulatory framework and activities must not stand in the way of innovation and competition in the financial market, provided that regulated entities' operations and service offerings are in compliance with laws, prudential requirements, and appropriate and sound business practices. The Bank must make sure that it is tech-neutral in this regard and does not impede the natural evolution of the financial market.

Knowledge and international cooperation

Central Bank employees must have the scope and opportunity to add to their expertise, including knowledge of new tech solutions for financial services and the risks associated with them. Connections with market players that lead these developments and with foreign supervisory bodies that face the same challenges need to be fortified. Furthermore, a more global financial market calls for increased cooperation with foreign financial supervisors, although the Central Bank already has a strong network and benefits from participating in cross-border cooperation.

A visible and accessible financial supervisor

The Central Bank considers it important to be visible and accessible to those that offer financial services or plan to offer them, and to participate actively in public discourse on fintech and the evolution of the financial market. In this way, the Bank can prevent new entities from starting up operations without the required permits and can have a positive effect on developments in the market. Furthermore, it is essential to continue fostering transparency in the market and sharing cogent information with market agents and consumers; for example, on whether or not specific service providers are engaged in activities that require supervision. Moreover, the Bank must be accessible to consumers who wish to submit tips and comments on supervised entities' conduct and business practices.

II

SUPERVISORY PRIORITIES 2022-2024

This section describes four priorities for supervision of financial activities over the coming three years. They apply to the financial market as a whole and are intended as a guidepost for further improvement and development of the Bank's financial market supervision through 2024. This entails placing greater emphasis on these topics in coming years, partly in order to respond to growing risk, but also in order to adapt the Bank's supervisory execution to developments in the market and changes in the regulatory framework.

Cyber- and IT security

Cyber- and IT risk is a rapidly growing category of risk in the financial market. The trust placed in use of tech solutions for financial company operations has increased substantially, as has the speed at which new solutions are implemented. As a result, particular attention must be given to cyber/IT risk and measures to mitigate it. Moreover, the risk stemming from cyberattacks has grown significantly in the recent past. It is critical to strengthen resilience against cyberattacks and boost financial market entities' ability to respond to serious incidents.

1

- Supervised entities' boards of directors take active responsibility for protections against cyber-risks and advocate for the adoption of basic protections for cyber- and IT systems.

- Supervised entities shall monitor closely the risks attached to all types of outsourcing, especially outsourcing of IT services, and shall pay particular attention to risks associated with the use of cloud services.

- It must be ensured that important supervised entities' cyberdefences are tested on a regular basis by means of cyberattack contingency exercises and scans for weaknesses based on internationally recognised methodology.

- Resumption of operations after cyberattacks shall be ensured, with minimum damage and disruption to service.

- An effective system will be developed so that supervised entities can notify the Central Bank and, as applicable, other supervisory bodies of serious incidents affecting IT system operation – i.e., cyberattacks and other cyberthreats – so as to learn from them and minimise contagion.

- Formal collaboration will be established among supervised entities, financial institutions in particular, in order to boost protective capacity and increase the chances of detecting cyberattacks in a timely manner. This will be done through monitoring and sharing of information on cyberattacks.

The Central Bank of Iceland's priorities

Growing risk

Surveys among companies and public entities worldwide indicate that increasing risk stems from cyberattacks, data theft, data fraud, and other cyberthreats, which more often than not centre on the efficacy and stability of socially important infrastructure, including in the area of financial services. Furthermore, surveys suggest that the frequency of all types of cybercrime soared in 2020 and 2021, with increased telework, disruption of conventional procedures, and rapid implementation of digital solutions in response to the COVID-19 pandemic. As a consequence, governmental authorities the world over are placing increased emphasis on shoring up their defences and resilience against cyberthreats of all kinds.

In coming years, it will be necessary to focus in particular on the security of cyber/IT systems in the financial market, both because of these threats and because of potential changes in the characteristics and evolution of the financial market itself – in the area of payment services, for example – which could cause risks to shift and thereby open up new avenues for cyberattacks.

The Central Bank of Iceland's role

Rules on cyber/IT system security are based on two main factors: on the one hand, security and defences required of supervised entities, and on the other, required notification of system security malfunctions so as to minimise the risk of contagion and learn from the incidents in question.

The Central Bank is required to ensure that supervised entities monitor the risk stemming from information system operations and minimise it insofar as is possible. A key factor is ensuring that the scope of measures to safeguard the security of information systems is commensurate with the scope of the supervised entity's operations and the risks associated with them.

Cyberattacks

Cyberattacks are a growing threat to companies in the financial market. Most cyberattacks are launched for financial gain, and phishing and e-mail fraud usually target payment information. Surveys show that a large share of companies have suffered phishing attacks and that the number of such attacks rose steeply in 2020. In addition, highly organised large-scale attacks such as distributed denial of service (DDoS) attacks have been made against Icelandic companies in recent years, including financial institutions.

As supervised entities provide more digital services and teleworking increases, companies and their customers will become more exposed to cyberattacks. The same can be said of the ever-increasing digital links between financial market entities and their connections with important financial market infrastructure, particularly centralised payment and settlement systems. Because of these links, failure to defend against a serious cyberattack in one part of the system could lead to severe disruption in other parts of it, including the operation of centralised financial market infrastructure, with the associated impact on financial stability. It follows from this that streamlined and targeted responses by individual companies to cyberattacks play a key role in containing the spread to other companies and to centralised financial market infrastructure. Contagion can arise from IT system interconnections, either between multiple financial companies or between financial companies and IT service providers. It can also arise if customers or the general public loses confidence in one or more financial institutions' ability to address imminent threats. For this reason, it is necessary to carry out effective monitoring to ensure that individual firms are sufficiently resilient at any given time.

Outsourcing and cloud services

In the past few years, supervised entities have increasingly chosen to outsource tech services. This applies equally to companies in the banking, insurance, and pension fund markets. This increasing reliance on outsourcing can create, shift, or conceal risks at individual companies and can cause both concentration risk and systemic risk if many supervised entities outsource their activities to the same service provider.

In addition, there has been a significant increase in cloud-based outsourcing by supervised entities. Cloud-based outsourcing requires that the supervised entity possess a higher level of technological expertise; furthermore, data must be protected by encryption, backups must be provided for, and there are stringent requirements for security backups that must be stored in a separate location. In this context, it is also important to consider chain outsourcing, as the Bank stresses that such chains must not be too long.

Chain outsourcing can make it more difficult for supervised entities and the Central Bank to have an overview of the solutions in use, their properties, and the risks they entail. It can also make it more difficult to access data. Supervised entities are responsible for ensuring that the tech solutions they purchase fulfil requirements and play the role intended for them. It is important to ensure that supervised entities are monitoring the risks attached to outsourcing of IT services.

Anti-money laundering and terrorist financing measures

The increasing globalisation of the financial market over the past quarter-century has made fighting money laundering and terrorist financing an ever more complex task. It has proven challenging for both financial companies and supervisors to keep pace with the trend. In coming years, strong emphasis will continue to be placed on ensuring that obliged entities (i.e., those subject to reporting requirements) strengthen their anti-money laundering and terrorist financing defences with robust risk-based measures. Serious or systematic failures in these entities' defences will be met with appropriate action, including the imposition of penalties.

2

- The boards of obliged entities take active responsibility for the entities' defences against money laundering and terrorist financing. Board members' and senior managers' knowledge of this area must be expanded.
- Obliged entities will continue to be subjected to more thorough risk assessment reviews.
- Emphasis will be placed on assessing the risk due to tech solutions that obliged entities use to provide services and carry out their internal monitoring.
- The Central Bank will participate actively in international cooperation in this area, through FATF and through EU financial supervisory institutions. Cooperation with other domestic authorities in this area will also be strengthened and supported.
- Efforts shall be made to increase the use of in-house tech solutions to supervise obliged entities, introduce electronic data submittal by these entities, and automate risk assessment processes.
- The Central Bank shall provide obliged entities with targeted instruction on defences against money laundering and terrorist financing.

Supervision has been strengthened

Supervision of measures to combat money laundering and terrorist financing has been accorded increased importance at the Central Bank in the recent term. A greater number of conventional off-site inspections have been carried out, as have more thorough on-site inspections. Furthermore, supervisory activities extend to a steadily growing number of obliged entities — both domestic entities and foreign entities with operations in Iceland, including cross-border operations and activities through agents, distributors, and branches. The educational material provided by the Bank to these entities has been expanded, and legislation has been updated. Cooperation with other public authorities has also been increased markedly, including cooperation between supervisory entities and the Financial Intelligence Unit of the Icelandic police.

Risk-based supervision

The Central Bank will continue to use a risk-based approach as the basis for its supervision of measures to combat money laundering and terrorist financing. This entails more frequent supervision and more thorough examination where the risk is greatest. Efforts to automate the supervisory process where possible will continue.

Integration with prudential supervision

A lack of measures to combat money laundering and terrorist financing could have a decisive impact on other risks in the activities of obliged entities, including their financial position and the viability of their business model, thereby affecting financial stability. Consequently, the Central Bank plans to emphasise increased integration of prudential supervision and supervision of measures to combat money laundering and terrorist financing.

Governance practices and effective internal controls

It is vital that the boards and senior management of obliged entities enhance their knowledge of this area so as to ensure that appropriate supervision of defences against money laundering and terrorist financing is in place. The boards of directors of these entities should discuss anti-money laundering and terrorist financing measures on a regular basis. Moreover, it is crucial that anti-money laundering officers at these entities receive board and management support so that they can carry out their duties as required.

International cooperation

Extensive changes in the legal framework in the EEA call for effective collaboration and active participation in international cooperation, and there is a need to learn from cases that have arisen in other countries in recent years. Active participation in international cooperation is a prerequisite to Iceland's remaining on a par with countries at the forefront of anti-money laundering and terrorist financing measures.

Governmental authorities in EEA member states are planning to further tighten their defences and shore up their supervision of anti-money laundering and terrorist financing measures. The European Commission's action plan assumes that legislation in this area will be developed further and will change markedly in the next few years.

In the planning stages is the establishment of a centralised EU supervisory body whose role would be to harmonise supervision of anti-money laundering and terrorist financing measures and ensure cooperation between member states' supervisory bodies, as well as ensuring the flow of information between member states' supervisors and EU supervisory bodies. It is also likely that such a centralised supervisory body will to some extent be directly involved with obligated entities within the EEA. Such a fundamental change would probably affect the conduct of supervision in Iceland.

Educational information

The Central Bank of Iceland intends to continue providing information and instructions to obliged entities, including by issuing educational materials. Emphasis will be placed on sharing information on best practice in the financial market, including materials based on lessons learned from the Bank's checks and investigations. In addition, the Bank will make an effort to generate public interest in the topic, thereby fostering increased awareness and knowledge of the field.

Focus on the customer

Supervision of business conduct is a necessary element in maintaining trust in the financial market, with the aim of protecting consumers' interests through general supervisory inspections and actions, fostering transparency, and enhancing the credibility of the market as a whole. Recent legislative amendments and developments in the financial market call for a change of emphasis in supervision of business conduct and closer attention to consumer protection in the financial market.

3

- Emphasis will be placed on supervision of product sales and marketing to consumers in the financial market.
- Supervision of product development and distribution to consumers in the financial market, called product oversight and governance (POG), will be strengthened.
- Strong emphasis is placed on investor protection and on ensuring that financial market entities comply with the ground rules in place for the protection of consumers and retail investors.
- Emphasis will be placed on ensuring that supervised entities present information on costs and fees to consumers in a clear and comprehensible way.

The Central Bank of Iceland's priorities

Mis-selling

Sales practices where the customer is deceived or given misleading information on products – for instance, on risks, returns, or insurance protection – are a growing problem in the Icelandic financial market. Dubious or deceptive sales practices of this type, collectively referred to as *mis-selling*, can also entail withholding key information from customers or selling products that unsuitable for the customer's declared needs. The Central Bank places strong emphasis on analysing business practices of this type and taking action vis-à-vis supervised entities that have been found to carry out such practices. Emphasis is placed on analysing and assessing those parties and products that can be considered particularly harmful to consumers.

Stronger investor protection

In recent years, new financial products directed at consumers have entered the Icelandic market. These include insurance-linked investment products with an insurance component and an investment component. According to recent European legislation, consumers must receive comparable protection, irrespective of whether they invest in the securities market, the insurance market, or the banking market, or in composite products. This includes requirements concerning the presentation of costs and other information, product development processes (for instance, defined target groups), and requirements concerning gathering of data from customers for advisory or sales purposes. The Central Bank emphasises strongly that companies in the financial market must follow these ground rules so to prioritise consumers' interests.

Marketing

Supervision of marketing to consumers in the financial market will be strengthened in coming years. Tech advances have already made it very easy for retail investors to invest in highly risky products and financial instruments, such as contracts for differences (CFD), binary options, crypto-assets and related products. At the same time, it has proven ever more difficult for supervisory bodies to have an overview of what is offered to retail investors on the internet and what marketing materials are used, as social media and online advertising systems have opened avenues for highly specialised and targeted marketing that complicates oversight and supervision. The Central Bank relies to a large extent on tips from the public and from financial market entities on dubious marketing and marketing materials.

Sustainable finance

Both climate change and responses to it are already a source of risk in the financial system worldwide. It is necessary to assess and respond to direct risks to which individual entities and the financial system as a whole may be exposed because of climate change, and to indirect risks stemming from the economy's transition in the decades to come as it reduces greenhouse gas emissions. Demands that financial markets contribute to building a sustainable economy for the future will also grow stronger. The financial market regulatory framework and demands made by financial market supervisors will change to reflect this in coming years.

4

- The Bank will place emphasis on assessing how climate change and related risks (including transition risk) affect the financial system and how these risks could conceivably materialise among supervised entities and the financial system as a whole.
- Supervised entities' boards of directors are responsible for ensuring that climate risk is considered in risk assessments and investment decisions.
- The Bank will ensure that the scenarios for stress testing supervised entities take account of climate risk and other related risks.
- Monitoring will be carried out to ensure that supervised entities provide correct information, including in marketing materials and product sales, with the aim of preventing greenwashing.

Risk

Climate risk as it relates to the financial system generally falls into two categories: *physical risk*, which stems from potential loss or damage to any type of valuables, and *transition risk*, which stems from the changes and adaptations that must be made throughout the economy – both the real economy and the financial market – in order to reduce greenhouse gas emissions and prevent the harmful effects of climate change. Supervised entities must assess such risk, and this assessment must be reflected in their in-house stress testing.

Sustainable finance in the spotlight

Financial market supervisors in the EEA do not focus solely on climate risk and the associated transition risk, however. The term *sustainable finance* refers to all measures that entail allocating capital to sustainable economic development projects that reduce strain on the environment and take into account the social impact of the activities in question.

The financial market regulatory framework and the requirements made by supervisory bodies will evolve towards increased emphasis on sustainability and ESG criteria in the years to come. ESG refers to risks centring on environmental issues, social impact, and governance practices as they pertain to supervised entities' operations and those of their business partners. An example of recent regulatory requirements in this area can be found in the Annual Accounts Act, which requires that pension funds, credit institutions, and insurance firms include a discussion of environmental, social, and human resources in their annual reports. These companies must publish a summary of the results of their policies in this area, together with a description of the key risks associated with their activities and their responses to such risks.

The EU and European financial market supervisors are planning to continue working on developing tools, standards, and methods for assessing and managing ESG-related risks. In the next several years, significant advancements can be expected in this area, as can statutory amendments that will make more stringent requirements of supervised entities, with the aim of promoting sustainable development while simultaneously increasing information disclosure requirements and boosting transparency so as to prevent greenwashing. Important steps towards defining the ground rules of sustainable finance have already been taken, including the EU's classification system, or taxonomy, for sustainable finance, which defines sustainable activities, makes greenwashing more difficult, and fosters harmonised procedures for assessments of environmental impact and sustainability.

Policy actions for coming years

With the advent of the new regulatory framework, supervisory bodies will formulate strategies and procedures on how supervision is to be conducted in accordance with growing demands for the incorporation of environmental and social factors, as well as improved governance, into supervised entities' investment decisions and risk assessments. The Bank will keep abreast of international developments in this area and will design procedures for different types of supervised entities. In this work, emphasis will be placed on integrating the assessment of ESG criteria into investment strategies, risk management, and information disclosure to all stakeholders. Both accountability and the participation of supervised entities' boards of directors are vital to ensuring that satisfactory oversight and a defined risk appetite are in place for ESG-related risks.

III

FOUNDATIONS OF FINANCIAL SUPERVISION

and priorities in specific sectors

A sound and secure financial system is based on a strong foundation of dependable regulation and effective supervision. This section describes the underpinnings of financial market supervision and highlights the key priorities for supervision of specific sectors of the financial system in the next several years.

Strong foundations

The Central Bank of Iceland will continue to build on the risk-oriented supervisory model and methodology that has been developed in the past decade, concurrent with the rapid evolution of the regulatory framework. The approach to financial supervision is forward-looking and consistent with international best practice at all times. Forward-looking supervision takes account not only of current risk but also of potential future risk. The Bank directs its attention to ensuring that the ongoing transformation of the financial market does not jeopardise financial stability and does not pose a threat to the progress that has been made in building up a sound financial system that can withstand shocks.

Prudential supervision

The financial market must be trusted if it is to carry out its macroeconomic role effectively. This trust is based in part on robust prudential supervision that ensures that financial market entities comply with regulatory provisions and do not take excessive risk. Prudential supervision centres mainly on financial requirements that ensure financial undertakings' solvency and their capacity to withstand shocks.

However, modern prudential supervision of the financial market is based not only on capital and liquidity requirements made of supervised entities, but also on requirements that supervised entities carry out a comprehensive assessment of risk in their operations and that they have in place the organisational structure, processes, and internal control mechanisms needed to ensure sound and secure operations. Emphasis is placed on thorough policy formulation, good governance, and professional work habits by supervised entities.

The Central Bank's emphasis on supervised entities' comprehensive risk management, sound governance practices, healthy culture, and effective internal controls is intertwined with the Bank's fundamental obligation to enforce prudential requirements in the financial market, thereby contributing to a sound, stable, and effective financial system.

Conduct supervision

Financial market entities bear the obligation and responsibility of considering their customers' interests and the integrity of the market as a whole when they sell their services. This responsibility is enshrined in law with provisions requiring that supervised entities conduct sound and appropriate business practices, as the vast majority of such entities meet the criteria for and are defined as *public interest entities*. The Central Bank does not rule in matters involving disputes between supervised entities and their customers. However, it does carry out general supervision of sound and appropriate business practices by supervised entities, thereby fostering better financial market functioning and protecting consumers from misconduct. The Central Bank's supervision of business conduct will not always be clearly separated from its prudential supervision, nor from its supervision of supervised entities' governance practices. In this context, the various supervisory functions complement one another in identifying failures or violations that could jeopardise the interests of customers or the financial market as a whole.

Information disclosure to the public

The Central Bank takes the view that its role in protecting the interests of consumers in the financial market and safeguarding the integrity and credibility of the market is carried out, among other things, through direct disclosure of information to the public. This refers not only to transparency concerning the Bank's decisions but also to proactive sharing of information by means of public warnings and other information that the Bank considers applicable to consumers at any given time. In providing such information, the Bank uses the media outlets and platforms it considers most appropriate in each case.

Tips from consumers

The Central Bank will continue to accept tips and queries from consumers about their interactions with supervised entities. Such communications are an important element in the Bank's activities. The information received in this manner makes it easier for the Bank to have an overview of the market and is useful for monitoring and assessing risk.

Prudential supervision

Prudential supervision entails supervision conducted to ensure that financial market entities comply with regulatory instruments and do not take excessive risks in their operations, thereby ensuring that they are solvent, able to honour their obligations to their customers, and able to withstand shocks. This reduces the probability the supervised entities will experience operational difficulties that have a detrimental effect on the financial system, the domestic economy, their customers, and the general public.

Prudential supervision emphasises that supervised entities must conduct a comprehensive assessment of risk in their operations, comply with prudential requirements, define their risk appetite and take measures to handle risk, maintain sound governance practices, and ensure that their operations are healthy.

Conduct supervision

The term *business conduct* covers, among other things, all forms of communication between those who sell goods and services and the customers who buy them. These forms of communication include information provided to customers, advisory services, pricing transparency, marketing and marketing materials, and responses to customer complaints. Business conduct therefore cover sellers' integrity in communicating with customers, providing advisory services, and engaging in sales and marketing.

Supervising business conduct involves ensuring that information provided to consumers is correct and honest, that advisory services are provided in customers' interests, that pricing is transparent, and that marketing materials and sales practices are neither misleading nor deceptive.

Banking

- Banks and savings banks maintain strong capital and liquidity so as to ensure their resilience against unexpected shocks.
- Banks and savings banks maintain sound governance practices, comprehensive risk management, and effective internal controls.
- The viability and sustainability of banks' and savings banks' business models will be closely monitored, and the banks' success in adapting to changed external conditions.
- Banks and savings banks shall systematically address the impact that the COVID-19-related economic crisis has had on their customers.

Financial strength

The primary focus of banking market supervision is to ensure continued sound operation of banks and savings banks. This is best done if banks and savings banks have enough financial strength and liquidity to withstand unexpected shocks and address the challenges they face.

Viability and sustainability of business models

The Icelandic banking market is highly concentrated, with three systemically important commercial banks offering comprehensive services to firms and individuals. A fourth commercial bank and five smaller savings banks compete with them. The three systemically important banks are financially strong; they are influential in the domestic market, and they have ready access to customers. They are also at the forefront in terms of developing and offering digital solutions to consumers. On the other hand, it is possible that some of their income sources may dry up in response to growing competition and changes in the market environment in the coming years. A number of factors lie behind this: not only growing competition in the banking market and changes in consumer behaviour, but also the ultimate impact of the implementation and entry into force of the second Payment Services Directive, PSD II, via the Payment Services Act, no. 114/2021. It is not unlikely that the banks will respond to these challenges in differing ways. This could cause the homogeneity of the banking market to subside and the unique characteristics of individual banks to emerge. Supervision of such banks must take account of this increased heterogeneity and evolve appropriately. The sustainability of the banks' business models will be in the spotlight in coming years as they adapt to changes in their environment.

Risks due to the COVID-19 pandemic

The banks face large-scale tasks due to the impact of COVID-19 on the economy, and it will be necessary to write off and restructure debt for some borrowers. This will be one of the banking system's biggest challenges in the next few years, although the banks do have the financial strength to resolve the issue. Furthermore, demand for housing has grown significantly, calling for action on the part of the Central Bank. It will be important to keep monitoring this trend closely.

The Central Bank's role is to oversee the progress made with these tasks and ensure that the banks work systematically towards resolving them. Experience shows that not handling lending problems in a structured and targeted way can have severe economic repercussions and can stand in the way of needed investment and development for the future. In this context, it is also important to avoid moving too quickly and aggressively on restructuring, as this could cause a negative chain reaction in the real economy. Handling this effectively will therefore be a balancing act. As a result, the Bank will give priority attention to the banks' credit risk, asset quality, collateral values, and loan portfolio restructuring in coming years.

EBA Strategic priorities

At least every three years, the European Banking Authority (EBA) publishes up to two Union-wide Strategic Supervisory Priorities that supervisory authorities in member states must take into account in their planning and supervisory activities during the period concerned.

In 2020, EBA specified the following Union-wide Strategic Supervisory Priorities:

- **Business model sustainability**
- **Adequate governance structures**

In addition, EBA regularly issues a single programming document that the Central Bank uses as a reference.

For the period 2021-2023, EBA emphasises the following:

- Advanced efforts in implementing the proportionality principle
- Enhancing consumer protection
- Developing the regulatory framework to ensure finance is used for climate change mitigation and adaptation and providing the tools for understanding and managing ESG risks

In addition, the Central Bank takes account of EBA's annual work programmes.

Pension funds

- Maintaining sound governance practices, comprehensive risk management, and effective internal controls is a priority for pension funds. They shall also place strong emphasis on the independence of their boards of directors.
- The Bank will continue to monitor the boards of pension funds that have outsourced a majority of their operations, such as asset management and risk management, so as to ensure that the boards exercise sufficient oversight of subcontractors.
- The execution of and framework for actuarial assessments will be monitored.
- The Central Bank will contribute to the review of the pension system framework.
- Emphasis on disseminating cogent information on the status and evolution of the pension system, thereby promoting transparency and constructive discourse on the system's future.

Scope of pension funds' activities

One of the main characteristics of the Icelandic financial market is the size and growth of the pension funds, which are major players in the market.

Despite the pension funds' strong growth and increased activity in the past decade, legislation governing their activities has not been updated to accord with their position in the financial market. With their growing size and importance in the Icelandic economy and financial market, the need for strategic decisions on the pension funds' size, activities, future, and desirable evolution has become more pressing.

For a number of years, the Central Bank has called for legislation on mandatory pension rights and pension funds' activities to be reviewed and updated to reflect the size and position of the pension funds, and aligned with the requirements made of other financial market entities, including requirements concerning governance, business conduct, and consumer protection. There is a pressing need for this review.

Governance practices and board independence

There must be no doubt that members of pension fund boards are independent in their work and that they do not allow views other than the interests of fund members to determine their perspectives and decisions.

The pension funds' widespread activity in the Icelandic economy and their importance for the domestic financial market give cause for continued focus on their governance practices. The funds' share in the distribution of pension income increases year by year, and the weight of the social security system is declining at the same time. This exacerbates political risk, as does possible interference by private interest groups in the decisions made by pension fund executives and board members. Other aspects of the pension funds' governance and management systems should also be under scrutiny. This includes the need to continue developing the pension funds' risk management activities and to emphasise a healthy risk culture in their operations.

Furthermore, the Bank will continue to ensure that the boards of those pension funds that have outsourced a majority of their operations, such as asset management and risk management, oversee their subcontractors. The Central Bank has called for the passage of clearer statutory provisions on conflicts of interest and outsourcing of pension fund operations..

Finally, it can be assumed that growing interest in sustainability and climate action will come to affect the pension funds in the years ahead, and that the funds themselves will require increased emphasis on sustainability and ESG criteria in their investments.

Actuarial assessments: execution and framework

Each year, pension fund boards must have an actuarial assessment carried out of the funds' finances. The actuarial assessments are carried out on the basis of experience rather than forecasts. Forward-looking assumptions foster pension system sustainability and moderate risk-taking in accordance with the interests and age demographics of pension fund members. They form the basis for fairer distribution when the time comes to pay invested premiums back to fund members in the form of pension income.

The Central Bank stresses that pension funds' and actuaries' responsibilities and roles must be clearly defined. It is important that pension funds examine closely the underlying assumptions and results of actuarial assessments and respond in a timely manner if the assumptions do not hold. It must be guaranteed that the funds' pension entitlement systems, without employer liability, are sustainable, so that the funds can fulfil their pledge to provide insurance protection.

Insurance market

- Insurance companies shall maintain financial strength and resilience against unexpected shocks.
- Insurance companies shall maintain sound governance practices, comprehensive risk management, and effective internal controls.
- The impact of fintech and digitisation of the insurance market will be analysed.

Financial strength and business practices

The key priorities for supervision of insurance companies centre on ensuring that their operations remain sound and that they have the financial strength to withstand unexpected shocks. Important changes have been made to legislation and supervision in the insurance market in recent years. With the entry into force of a new comprehensive Act on Insurance Activities (Solvency II) in 2016 and amendments to the Act on Insurance Contracts and the Act on Insurance Distribution (IDD), the regulatory framework has been harmonised throughout the EEA, risk-based solvency requirements for insurance companies have been codified, consumers' position improved, and further support provided for the financial stability of the insurance market. These reforms are now used as a benchmark, but in coming years, particular consideration must be given to rapid technological advances, conduct and business practices, and the position of consumers in the insurance market.

Impact of digitisation

The insurance market has not been excluded from the digital revolution now sweeping the financial market. In the short run, however, the outlook is not for fintech to cause fundamental changes in currently operating insurance companies' conventional revenue streams. That said, fintech solutions and the digital transformation of services have already begun to have a major impact on operations, operational structure, and communications with customers. Furthermore, the possibility cannot be excluded that capitalising on tech solutions will cause further disruption in the insurance market in the future, including with the entry of new market players at the front of the service chain that could handle customer relations and recruitment of new customers. The homogeneity of the domestic insurance market could then recede and new tech solutions and business models could emerge. It is vital to monitor this trend closely and assess its impact.

EIOPA Strategic Priorities

At least every three years, the European Insurance and Occupational Pensions Authority (EIOPA) publishes up to two Union-wide Strategic Supervisory Priorities that supervisory authorities in member states must take into account in their planning and supervisory activities during the period concerned.

In 2022, EIOPA specified the following Union-wide Strategic Supervisory Priorities:

- **Business model sustainability**
- **Adequate product design, including via a close monitoring of product oversight and governance (POG)**

At regular intervals, EIOPA issues a single programming document that the Bank uses as a reference.

For the period 2021-2023, EIOPA emphasises the following, among other priorities:

- Digitalisation
- Sustainable Finance

In addition, the Bank takes account of EIOPA's annual work programmes.

Securities market

- Promoting a safe and effective securities market through strong supervision.
- Continued emphasis will be placed on reliable information disclosure from issuers, as this is a prerequisite for an effective securities market.
- Proactive and preventive supervision shall be accorded increased importance in the securities market.
- Proactive checks will be directed at the quality of data submitted by securities market entities.
- Focus will be on the security of important financial market infrastructure. More detailed statutory requirements are made of central securities depositories and securities exchanges than before.
- The Central Bank will continue to work systematically towards increased automation of supervision and more efficient and effective supervision of data submittal by supervised entities.

Broad-based statutory amendments

Strong supervision and a sound regulatory framework are the prerequisites for a secure and effective securities market. Major changes have already taken place and are foreseeable in the securities market because of legislation that has entered into force recently or will do so in the near future. These statutory amendments place greater obligations on market entities and increase the number of supervisory tasks undertaken by the Central Bank, both temporarily – while new legislation is being implemented – and for the long term – in the development and execution of securities market supervision. In the same manner, supervised entities will have to shoulder the burden in coming years of adapting their activities to the new legislation, which imposes more stringent data submittal and information disclosure requirements on securities issuers and market participants.

Market supervision

In recent years, the Central Bank has placed strong emphasis on inspections relating to treatment of insider information and securities issuers' information disclosure, as well as monitoring all types of market misconduct, including insider misconduct and market abuse. The Bank now has improved technology for monitoring market activity to carry out this supervision and gathers more data for this purpose than it did previously. Monitoring of this type will continue to be the mainstay of securities market supervision.

Proactive and preventive supervision

In view of recent statutory amendments and more stringent requirements made of securities market entities, the Bank intends to undertake more proactive and preventive supervision so as to monitor compliance with specific aspects of the regulatory framework. These proactive checks will focus on issues including data submittal, organisational structure requirements, and operation of financial infrastructure such as central securities depositories and securities exchanges.

Management companies and funds

The Central Bank supervises collective investment fund (undertakings for collective investment in transferable securities, UCITS) management companies, UCITS funds, and alternative investment fund (AIF) managers (i.e., managers of alternative investment funds for retail investors and other special-purpose funds). Such supervision revolves mainly around whether or not the funds in question invest in accordance with statutory authorisations and their own internal rules. The Bank will place increased emphasis on monitoring funds' risk management, conflicts of interest, and liquidity management, as well as the obligations of custodians.

ESMA Strategic Priorities

At least every three years, the European Securities and Markets Authority (ESMA) publishes up to two Union Strategic Supervisory Priorities that supervisory authorities in member states must take into account in their planning and supervisory activities during the period concerned.

In 2020, ESMA specified the following Union Strategic Supervisory Priorities:

- **Cost and performance for retail investment products**
- **Market data quality**

On a regular basis, ESMA also issues its Strategic Orientation document, which the Central Bank must take into account in its supervision of the securities market.

For the period 2020-2022, ESMA emphasises the following:

- Supporting the development of the European securities market and capital markets, including with the aim of increasing the number of direct market participants and expanding financing options for small and medium-sized enterprises (SME)
- Promote sustainable finance and long-term orientated capital markets
- Digitalisation as an opportunity for market participants and regulators
- Ensure effective supervision of cross-border firms in a more fragmented market
- Consider the principle of proportionality in the development of the regulatory framework for the European securities market

In addition, the Bank takes account of ESMA's annual work programmes.