

4th August, 2009.

Mr Nik van Leuven, Director General,
Guernsey Financial Services Commission
La Plaiderie Chambers
La Plaiderie
St Peter Port
Guernsey
GY1 3HQ

Dear Mr van Leuven,

The Landsbanki Guernsey Depositors' Action group would like to take this opportunity to follow up recent communications regarding the GFSC concerns as to the liquidity of Heritable Bank, Landsbanki's sister bank in the UK.

To this end please find appendices containing a number of relevant items which clearly show the level of the GFSC concerns and the information available to it, prior to the placing under administration of Landsbanki Guernsey (LG). I have taken the liberty of summarising the contents of each appendix prior to the actual appendices for ease of reference. I would appreciate your full reply regarding this matter by no later than 11 August, 2009.

With reference to the concerns that the GFSC had regarding Heritable's dependence on LIHF funding in order to continue its operations and the GFSC statements submitted as part of evidence to the TSC, specifically, *'The information provided to us by the FSA in April and July 2008 was a key determinant in our permitting funds to be placed with Heritable, as explicitly stated in Dr Quick's letter of 21 April 2008'*:

- It is clear that although the GFSC had pre-existing concerns as to Heritable's liquidity it ultimately chose to accept the assertions of the FSA with no further documentary proof and allowed funds to be placed by LG with Heritable bank.
- The further assertions made by the GFSC that the FSA was in some way negligent in the information provided to the GFSC of the actual liquidity position of Heritable was firmly denied by the FSA, more specifically, *'Stephen Funnell's letter of 25 April 2008 made it clear that at that time funding was being provided by Landsbanki to Heritable'*.

The LGDAG would therefore seek the following clarifications from the GFSC:

1. Why, if there were concerns over Heritable's dependence on LIHF for funding, was the FSA response accepted without any further due diligence?
2. As there were specific concerns as to Heritable Liquidity why were publicly available documents not used by the GFSC in completing its due diligence prior to any decision being made as to the advisability of placing LG funds with Heritable? These documents included the Fitch Reports of 2007 and 2008 as per Appendix 5 and also LIHF and Heritable Bank's own annual reports of 2007 which state quite clearly the dependence Heritable had on credit lines from LIHF.
3. Significantly, the Fitch report of May 2008, when considering that Heritable liquidity was dependent on LIHF committed credit, warns of the potential of sovereign intervention

should the parent banks fail and highlights the problems of this intervention due to the size of bank liabilities. With this in mind why was no action taken to ensure LG was itself ring-fenced when it was clear that Heritable was not?

Whilst the GFSC has claimed that it has not acted in a negligent manner and has published a redacted copy of the GFSC commissioned Promontory report to justify this claim, it is clear that the GFSC left due diligence to another external regulator which had no legal standing in Guernsey and after LG failed the GFSC has sought to place its own shortcomings on the shoulders of another body.

Documents publicly available to the GFSC and identified by the LGDAG and the Administrators of Heritable Bank (Appendix 6) in a very short time confirmed the reliance placed on LIHF by Heritable and any superficial due diligence on the part of the GFSC should have uncovered this dependence – why was this not the case?

In addition, the LGDAG would like clarification of the situation prior to the failure of LG and notes that the GFSC is currently using the Banking Supervision (Bailiwick of Guernsey) Law 1994 as reason for refusal to comply with requests for information. The LGDAG notes, however, that section 44 of the Law 1994 states
‘ . . . that disclosure of information is not prohibited if it is in the interests of depositors, investors or other customers of the public interest.’

As such the LGDAG believes that the GFSC have an obligation to make available to the creditors and joint Administrators all information relevant to Landsbanki Guernsey, including the GFSC's own efforts to complete a reasonable level of due diligence on the Bank and its affiliated counterparts.

The TSC evidence sessions make it clear that the GFSC believes that the FSA withheld information or did not provide the full information which it had, to the GFSC, notwithstanding the FSA rebuttal of these concerns. Will you please advise why the GFSC did not complete its own due diligence on Heritable prior to authorising LG placement of funds with it and if this due diligence was completed why was the issue of a £400M committed credit line from LIHF not identified?

Yours sincerely,



Matthew Dorman
Director
For and on behalf of
Landsbanki Guernsey Depositors' Action Group
<http://info.landsbankiaction.org.gg>

APPENDIX SUMMARY:

1. **Regulators correspondencePAGE 4**
 - Letters from GFSC to FSA initially dated 21/4/2008 and subsequently 11/7/2008: Stuart Bailey, Senior Analyst for the GFSC writes ‘... ***Heritable Bank seems ring-fenced from Icelandic risk, but I would be grateful if you could confirm that this is still the case...***’
 - FSA Reply dated 18 July 2008: John Brennan of the FSA wrote ‘...***I can confirm that our assessment of Heritable exposure to Icelandic risk as not changed materially...***’
 - The GFSC have stated that this interchange of correspondence was ‘***a key determinant in our permitting funds to be placed with Heritable***’.
 - The FSA have made it clear that they advised the GFSC of funding flows into Heritable from Landsbanki Islands.

2. **Documentation available to GFSC for performance of due diligence prior to Landsbanki Guernsey failure PAGE 5**

3. **Landsbanki Islands Hf Annual Report 2007 PAGE 6**
 - ‘Fitch affirmed Landsbanki Heritable ratings..., these ratings are based on **a guarantee of all its obligations by its parent**’.

4. **Heritable Bank Annual Report 2007 PAGE 7**
 - ‘Liquidity was strengthened by increasing the **committed line of credit from £200M to £400M from Landsbanki**’.
 - ‘as of 31 December 2007 the company had a bilateral committed line of credit of £400M provided by Landsbanki ... and the facility is due for repayment in December 2010. **£178M is outstanding against this facility as at 31 December 2007**’.

5. **Fitch Ratings Report, ‘Heritable Bank Ltd’ 26 September 2007 PAGE 8**
 - ‘Heritable Bank Limited’s (Heritable) Long and short-term IDR’s and Support rating are based on **a guarantee of materially all its obligations from its parent Landsbanki Islands (LB) of Iceland**.’
 - ‘Liquidity is tight with only a small proportion of liquid assets on the balance sheet. Mitigating this, **Heritable has a committed credit line of £200M from its parent**’.
 - ‘.. **liquidity reliant on a committed line from parent**’.
 - ‘**To support liquidity Heritable holds a committed credit line of GBP£200M from Landsbanki , which has been extended to December 2008**. This is needed as the level of liquid assets on the balance sheet is low. . . ‘.

6. **Fitch Ratings: ‘Iceland Special Report’. 22 May 2008. Regarding problems in Icelandic parent banks Liquidity and potential of sovereign support PAGE 9**
 - ‘Given the size of the Icelandic banks relative to GDP (900%) and the lack of foreign parents with deep pockets 6 , it is hard to imagine that the authorities could distance themselves from a systemic crisis, particularly because of banks’ huge net external liabilities (200% of GDP).’

APPENDIX 1: Excerpts from Treasury Select Committee Evidence sessions (EV 740 and subsequently):

In April 2008 the FSA became fully aware (in the context of LGL) of our close interest in matters relating to Heritable, including our concerns in relation to Heritable's links with its parent Landsbanki Islands hf (LIhf). In particular, a letter dated 21 April 2008 from Dr Jeremy Quick to Mr Stephen Funnell explained those concerns and sought FSA confirmation that Heritable was, " . . a UK-orientated, self-standing firm, with only limited Icelandic risk."

The letter also asked questions of the FSA aimed at ensuring, by way of assurances from the FSA, that Heritable's exposure to LIhf, including in respect of dependence on funding lines, would be limited. Specific mention was made of, ". . our concern that LGL might become dependent on liquidity from Heritable."

Mr Funnell responded, in a letter dated 25 April 2008, confirming the FSA's commitment to maintaining dialogue and stating that Heritable met the FSA's capital and liquidity guidelines. The letter also confirmed that Heritable was, "a UK-orientated, self-standing firm, with only limited Icelandic risk".

On 11 July 2008, Mr Stuart Bailey of the Commission wrote to Mr Funnell asking for the FSA's confirmation that Heritable was, "ring-fenced from Icelandic risk." On 16 July Mr John Brennan of the FSA responded in writing stating, "I can confirm that our assessment of Heritable's exposure to Icelandic risk has not changed materially from Stephen's letter of 25 April 2008 to Jeremy Quick".

"The information provided to us by the FSA in April and July 2008 was a key determinant in our permitting funds to be placed with Heritable, as explicitly stated in Dr Quick's letter of 21 April 2008."

4. "Why did the FSA not open a dialogue with the Commission to seek a resolution to its concerns that could have sought to protect depositors in both Heritable and LGL?"

LGL was placed into administration in Guernsey on the night of 6 October 2008 on the application of its directors, before the FSA applied to the Court in Scotland for Heritable to be placed into administration. Therefore, the crucial events in Guernsey preceded our actions.

LGL, was only one of a number of unsecured creditors of Heritable. Our decision to apply for an administration order in relation to Heritable on the morning of 7 October was designed to ensure an equal treatment of all depositors and other unsecured creditors. The chief executive of Heritable indicated his support for this application.

The arrangements that were put in place in the UK to transfer certain deposits with Heritable to ING Direct depended on the application of the UK Financial Services Compensation Scheme, the provision of significant funding by the UK Government and the use of UK legislation.

5. "Why did the FSA not advise the Commission that Heritable was substantially dependant on LIhf for its liquidity despite its assurances to the contrary?"

I cannot accept your implication that the FSA misled the GFSC as to the level of dependence of Heritable on the provision of liquidity by Landsbanki. Indeed, as you note, Stephen Funnell's letter of 25 April 2008 made it clear that at that time funding was being provided by Landsbanki to Heritable. It stated that: " ... we have historically seen funding flows in both directions. At present, however, any movements are from Landsbanki to [Heritable], and we do not expect this to change."

This letter also made it clear that while we were not aware of any material exposures to Iceland in the course of Heritable's normal lending activities, Heritable was exposed to reputational Icelandic risk by virtue of its parentage. As events unfolded, this reputational risk crystallised. The collapse of confidence in the Icelandic banking system caused Heritable to lose wholesale funding. This, in turn, increased its dependence on its parent for funding.

You refer to our general guidance on liquidity. This makes it clear that a firm can rely on committed facilities from group companies where appropriate [see paragraph 21(d) of Section 7 of Chapter LM of our Interim Prudential Source Book for Banks]. At no time did we indicate to you that we had restricted the firm's ability to rely on intra-group funding lines.

APPENDIX 2: Related Correspondence between GFSC and FSA



APPENDIX 2: Related Correspondence between GFSC and FSA *continued* . . .

Mr. Stuart Bailey
Guernsey Financial Services Commission
PO Box 128,
La Plaiderie Chambers,
La Plaiderie,
St Peter Port
Guernsey
GY1 3HQ

16 July 2008

Our Ref:

Your Ref:

Dear Mr. Bailey

Landsbanki Guernsey Ltd and Heritable Bank Limited

Thank you for your letter to Stephen Funnell dated 11 July 2008. I can confirm that our assessment of Heritable's exposure to Icelandic risk has not changed materially from Stephen's letter of 25 April 2008 to Jeremy Quick.

Yours sincerely

John Brennan
Wholesale Banks and li

APPENDIX 3: Landsbanki Islands 2007 Annual report – excerpt:

5.1 2007 Annual Report – page 28.

Landsbanki Heritable Bank

On 25 September, Fitch affirmed Landsbanki Heritable's ratings at A / F1 / C and support 1. According to Fitch, these ratings are based on a guarantee of all its obligations by its parent.

APPENDIX 4: Heritable Bank: Annual report and financial statements for the year ended 31 December 2007:

This document clearly states that Heritable has committed a line of credit of £400M from LIhF. Furthermore, the accounts show that the full £50M subordinated credit agreement had been taken up by Heritable.

Capital, Funding and Liquidity

The Bank's capital base remains healthy, and was further enhanced during the year by the issue of a further £10m of Tier 2 subordinated loan capital. The actual regulatory individual capital ratio was 14% at the year end and was significantly in excess of minimum capital requirements of 8%. This ratio is expected to improve in 2008 due to lower risk weighting applicable for residential mortgages under the revised capital adequacy rules. Customer deposits increased strongly during the year by 27% to £902m (2006 £712m). The strategy of being a balance sheet lender with a conservative funding bias towards deposits proved to be very beneficial at a time of tightening credit generally. The Bank achieved significant media profile for its consistently competitive range of variable and fixed rate accounts. The ratio of customer deposits to loans stood at 82.8% at year end (2006 95%).

Liquidity was strengthened by increasing the committed line of credit from £200m (in 2006) to £400m from Landsbanki and extending the maturity date to December 2010.

(e) Liquidity Risk

This is the risk that the Company is unable to meet future liabilities as they fall due. The principal funding requirement arises to meet commitments to lend. The most significant element in assessing this risk is the ability to raise customer deposits and committed funding from the parent company.

The Company has been successful in raising the majority of its funding from customer deposits and has increased the level and maturity of additional funding available from the parent company. The susceptibility to liquidity risk is assessed both over the short term but also over the three year time horizon of the business plan.

At 31st December 2007 the Company had a bilateral committed line of credit of £400 million (2006 £200 million) provided by Landsbanki. Interest is payable on the drawn balance at a margin over sterling LIBOR and the facility is due for repayment in December 2010. £178 million is outstanding against this facility as at 31st December 2007 (2006 £1m).

APPENDIX 5: Fitch Reports:

Report: 26 September 2007: 'Heritable Bank Ltd.'

The report outlines the status of Heritable Bank and identifies that it relies on a committed line of credit from its parent LIHF.

- *Page 1 Point 1 Rating Rationale:*
'Heritable Bank Limited's (Heritable) long and short-term IDR's and Support rating are based on a guarantee of materially all its obligations from its parent Landsbanki Islands (LB) of Iceland.'
- *Page 1 Point 7 Rating Rationale:*
'Liquidity is tight with only a small proportion of liquid assets on the balance sheet. Mitigating this, Heritable has a committed credit line of £200M from its parent.'
- *Page 5 Point 1 Funding and Capital:*
'... liquidity reliant on a committed line from parent'
- *Page 5 Para 3 Funding:*
'To support liquidity Heritable holds a committed credit line of GBP£200M from Landsbanki , which has been extended to December 2008. This is needed as the level of liquid assets on the balance sheet is low, although it improved in 2006, and together with the high level of funding concentration, this results in poor on-balance sheet liquidity.'

Report: 22 May 2008: 'Iceland and the Banks – Questions and Answers':

The report highlights the state of the Icelandic Banking industry and discusses the potential of sovereign intervention in the event of a liquidity crisis. Selected extracts are:

- 'In a worst-case scenario, where banks continue to encounter limited access to external funding beyond 2008, against a backdrop of domestic recession and global slowdown, sovereign support could become necessary.'
- 'The authorities have stated that they will support the banks if necessary. However, the sheer size of the potential funding challenge relative to the limited resources of the sovereign raises concerns about the extent to which any deterioration in the banks' credit ratings would ultimately tarnish the superior creditworthiness of the sovereign.'
- 'Given the size of the Icelandic banks relative to GDP (900%) and the lack of foreign parents with deep pockets, it is hard to imagine that the authorities could distance themselves from a systemic crisis, particularly because of banks' huge net external liabilities (200% of GDP).'
- 'While there is no denying the authorities' willingness to support the banks, there has been a question mark over their ability to deliver foreign-currency support. International reserves amount to just 13% of GDP and would be ill-matched to the task of supporting the banking system through an external funding crisis.'

APPENDIX 6: Ernst And Young Reports:

4.1: Excerpt from E&Y report Heritable Bank Plc (In Administration), update report to all creditors dated 17 April 2009.

The report highlights the information the administrators have amassed since the bank was placed under administration in October 2008.

‘10.4.1 Intercompany liabilities:

LlhF is owed a sum of c. £86m (made up of £81m and €6m) under a £400m facility agreement with LlhF. It is also owed an additional £50m which was drawn down under a subordinated loan agreement of 13 August 2001. This latter amount is subordinated to all other liabilities of Heritable. We have received a claim from LlhF for the above amounts. LlhF has also submitted a contingent claim of £1,011,817,245 in respect of their liabilities under the 2004 guarantee mentioned above. To the extent that LlhF has a right of indemnity from Heritable in respect of such liabilities, this claim is contingent upon all potential creditors of Heritable claiming against LlhF under the guarantee and, pursuant to the terms of the 2004 guarantee, all such liabilities having been paid and discharged in full.’

4.2: Excerpts from Ernst and Young Report to Creditors 5th December 2008.

4.2.1 Page 4: Penultimate Paragraph:

‘The Icelandic economy, in particular, suffered a number of difficulties which adversely affected Heritable’s ultimate parent, LlhF. Heritable as an entity was dependent upon the ongoing support of LlhF. In the period immediately prior to the Administration, there was a loss of confidence and certainty in the Icelandic banking system including LIHF’

4.2.2. Section 2.3.3

Para 3: ‘It is believed that these parental loans comprise the balance drawn down as at 30 September 2008 under a £400m facility agreement granted to Heritable by LlhF’

Para 5: In addition to the above, ‘Heritable also entered into a subordinated loan agreement with UHF on 13 August 2001 for the provision of a £40m facility. This facility was most recently increased to £60m on 19 December 2006 and is reflected in the Management and Audited accounts at that full facility level.’