

Public version of ⁽¹⁾
EFTA SURVEILLANCE AUTHORITY DECISION
No 291/12/COL
of 11 July 2012
on restructuring aid to Arion Bank (Iceland)

The EFTA Surveillance Authority ('the Authority')

HAVING REGARD to the Agreement on the European Economic Area ('the EEA Agreement'), in particular to Article 61(3)(b) and Protocol 26 thereof,

HAVING REGARD to the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice ('the Surveillance and Court Agreement'), in particular to Article 24,

HAVING REGARD to Protocol 3 to the Surveillance and Court Agreement ('Protocol 3'), in particular to Article 1(3) of Part I, Article 7(3) of Part II, and Article 13 of Part II,

Whereas:

I. FACTS

1. PROCEDURE

- (1) Following informal correspondence in October 2008, and the passing on 6 October by the Icelandic Parliament (the Althingi) of Act No 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc. (referred to as the 'Emergency Act'), which gave the Icelandic state wide-ranging powers to intervene in the banking sector, the President of the Authority wrote on 10 October 2008 to the Icelandic authorities and requested that state aid measures taken under the Emergency Act be notified to the Authority. Further contact and correspondence followed periodically including notably a letter sent by the Authority on 18 June 2009 reminding the Icelandic authorities of the need to notify any state aid measures, and of the standstill clause in Article 3 of Protocol 3. Following further correspondence and meetings, state aid involved in the restoration of certain operations of (old) Kaupthing Bank and the establishment and capitalisation of New Kaupthing Bank (renamed Arion Bank as from 21 November 2009) was eventually notified retrospectively by the Icelandic authorities on 20 September 2010.
- (2) By letter dated 15 December 2010 ⁽²⁾ the EFTA Surveillance Authority ('the Authority') informed the Icelandic authorities that it had decided to initiate the procedure laid down in Article 1(2) of Part I of Protocol 3 in respect of the measures undertaken by the Icelandic State to restore certain operations of (old) Kaupthing Bank hf and establish and capitalise New Kaupthing Bank hf, now renamed Arion Bank (the opening decision) ⁽³⁾. The Authority also required that a detailed restructuring plan for Arion Bank be submitted within six months.

⁽¹⁾ This document is made available for information purposes only. In this public version, some information has been omitted so as not to divulge confidential information. This is denoted by [...] or a range in square brackets providing for a non-confidential approximation of the relevant figure.

⁽²⁾ The Authority's Decision No 492/10/COL, opening the formal investigation procedure into state aid granted in the restoration of certain operations of (old) Kaupthing Bank hf and the establishment and capitalisation of New Kaupthing Bank hf (now renamed Arion Bank hf) OJ C 41, 10.2.2011, p. 7 and EEA Supplement to the *Official Journal* No 7, 10.2.2011, p. 1.

⁽³⁾ Further information on the procedure leading up to the Authority's Decision No 492/10/COL, can be found in the procedure part of the decision.

- (3) By letter dated 24 March 2011 ⁽⁴⁾, the Authority received one comment from interested parties, which was forwarded to the Icelandic authorities on 25 May 2011. The Icelandic authorities did not respond to this comment.
- (4) By letter of 31 March 2011, the Icelandic authorities submitted a restructuring plan for Arion Bank. An updated restructuring plan was submitted by e-mail on 30 April 2012.
- (5) The Authority requested information with regards to the restructuring plan on 11 July 2011 and 13 February 2012. Replies to the requests for information were received from the Icelandic Authorities on 26 October 2011, 16 April 2012, 30 April 2012, 21 May 2012 and 6 July 2012. The final versions of the commitments made by the Icelandic authorities and Arion Bank were submitted on 3 July 2012 ⁽⁵⁾.
- (6) In addition, the Authority's representatives met with the Icelandic authorities and representatives of Arion Bank on 7 June 2011 and 27-28 February 2012.

2. BACKGROUND

- (7) The Authority will describe in this section those events, facts and economic, political and regulatory developments relating to the collapse and the reconstruction of the Icelandic financial system from October 2008 to date that appear necessary to set out the context in which the assessment of aid measures at hand is undertaken. Before doing so, it will recall in turn the chronology of Kaupthing Bank's breakdown.

2.1. The collapse of Kaupthing Bank

- (8) In September 2008 a number of major global financial institutions began to experience severe difficulties. In the midst of the turbulence in global financial markets, Iceland's three biggest commercial banks, which had experienced extraordinary growth over the preceding years, encountered difficulties in refinancing their short term debt and a run on their deposits. Lehman Brothers filed for bankruptcy protection on 15 September, and on the same day it was announced that the Bank of America was to take over Merrill Lynch. Elsewhere, one of the United Kingdom's biggest banks, HBOS, had to be taken over by Lloyds TSB.
- (9) The problems in the Icelandic financial sector unfolded more clearly on 29 September 2008, when the Icelandic Government announced that it had reached an agreement with Glitnir Bank whereby it would inject 600 million euros of equity into the bank in return for 75 % of its shareholdings. However, the Government's planned take-over of Glitnir Bank failed to reassure markets and was subsequently abandoned. The share prices of the three commercial banks plummeted and credit ratings were downgraded.
- (10) Withdrawals of deposits from non-domestic branches of Landsbanki and Kaupthing increased dramatically and domestic branches also experienced massive withdrawals of cash. On the first weekend in October it became clear that another one of the three large banks, Landsbanki, was in severe difficulty. Glitnir Bank and Landsbanki were taken over by the FME on 7 October 2008. For a while it was hoped that Kaupthing Bank could escape the same fate and on 6 October 2008, the CBI granted Kaupthing a loan to the amount of 500 million euros against collateral in Kaupthing's Danish subsidiary, FIH Erhvervsbanken. However, the loan agreements and debt securities of Kaupthing Bank generally contained a clause stating that in the event of one of the bank's large subsidiaries defaulting, this would constitute a default by Kaupthing Bank which could lead to the bank's loans becoming due. On 8 October 2008, the UK authorities placed Kaupthing's subsidiary in Britain, Kaupthing Singer & Friedlander (KSF), under cessation of payments. The following day, the FME took control of the bank using powers conferred upon it by the Emergency Act.

⁽⁴⁾ Corrected by the interested parties on 25 May 2012.

⁽⁵⁾ Regarding the competitive situation in the Icelandic banking sector and possible competition remedies, the Authority has cooperated with the Icelandic Competition Authority (ICA).

2.2. The financial crisis and major causes of failure of the Icelandic banks

- (11) In their notification of the aid granted to Arion Bank, the Icelandic authorities explained that the reasons for the collapse of the Icelandic banking sector and their need to intervene were set out in considerable detail in a report prepared by a Special Investigation Commission ('SIC') established by the Icelandic Parliament ⁽⁶⁾, whose remit was to investigate and analyse the processes leading to the collapse of the three main banks. The Authority summarises below the conclusions of the Commission concerning the causes of failure most relevant to the demise of Kaupthing Bank. The information is drawn from Chapters 2 (Executive Summary) and 21 (Causes of the Collapse of the Icelandic Banks — Responsibility, Mistakes and Negligence) of the SIC report.
- (12) The global reduction in liquidity in financial markets that began in 2007 eventually led to the collapse of the three main Icelandic banks, whose business operations had become increasingly dependent on raising funding through international markets. The reasons for the demise of the Icelandic banks were however complex and numerous. The SIC investigated the reasons which led to the collapse of the main banks, and it is notable that the majority of the conclusions applied to all three banks and many are inter-related. Causes of failure related to the banks' activities are briefly summarised below.

Excessive and unsustainable expansion

- (13) The SIC concluded that in the years leading up to the collapse the banks had expanded their balance sheets and lending portfolios beyond their own operational and managerial capacity. The combined assets of the three banks had increased exponentially from 1,4 trillion ISK ⁽⁷⁾ in 2003 to 14,4 trillion ISK at the end of the second quarter of 2008. Significantly, a large proportion of the growth of the three banks was in lending to foreign parties, which increased substantially during 2007 ⁽⁸⁾, most notably after the beginning of the international liquidity crisis. This led the SIC to conclude that much of this increase in lending resulted from loans made to undertakings that had been refused credit elsewhere. The report also concluded that inherently riskier investment banking had become an ever increasing feature of the banks' activities and growth had contributed to the problems.

The reduction in finance available on the international markets

- (14) Much of the banks' growth was facilitated by access to international financial markets, capitalising upon good credit ratings and access to European markets through the EEA Agreement. The Icelandic banks borrowed 14 billion euros on foreign debt securities markets in 2005 on relatively favourable terms. When access to European debt securities markets became more limited, the banks financed their activities on US markets, with Icelandic debt securities packaged into collateralised debt obligations. In the period before the collapse, the banks were increasingly reliant on short-term borrowing, leading to major and, according to the SIC, foreseeable re-financing risks.

The gearing of the banks' owners

- (15) In the case of each major Icelandic bank, the principal owners were among the biggest debtors ⁽⁹⁾. The SIC was of the view that certain shareholders had abnormally easy access to borrowing from the banks in their capacity as owners. The biggest shareholder in Kaupthing Bank was Exista hf., with just over a 20 % share in the bank. Exista was also one of the bank's biggest debtors. During the period from 2005 to 2008, Kaupthing's total lending to Exista and related parties ⁽¹⁰⁾ increased steadily from 400-500 million euros to 1 400-1 700 million euros and during 2007 and 2008 such lending was nearly equal to the bank's capital base. This increase in

⁽⁶⁾ The SIC's members were Supreme Court Judge, Mr Páll Hreinsson; Parliamentary Ombudsman of Iceland, Mr Tryggvi Gunnarsson; and Mrs Sigríður Benediktsdóttir Ph.D., lecturer and associate chair at Yale University, USA. The report is available in full in Icelandic at: <http://rna.althingi.is/> and parts translated into English (including the Executive Summary and the chapter on the causes of the collapse of the banks) are available at: <http://sic.althingi.is/>

⁽⁷⁾ Icelandic *króna*.

⁽⁸⁾ Lending to foreign parties increased by 11,4 billion euros from 9,3 billion euros to 20,7 billion euros in six months.

⁽⁹⁾ Chapter 21.2.1.2 of the Report.

⁽¹⁰⁾ Exista, Exista Trading, Bakkavör Group, Bakkavor Finance Ltd, Bakkabraedur Holding B.V., Lýsing, Síminn, Skipti and other related companies.

lending to major shareholders occurred despite the fact that Kaupthing was starting to face liquidity and refinancing problems. Loans to related parties were also often granted without any specific collateral ⁽¹¹⁾. Kaupthing's Money Market Fund was the biggest fund of the Kaupthing Bank Asset Management Company and in 2007 the fund invested significantly in bonds issued by Exista. At year end it owned securities to the value of around 14 billion ISK. This represented approximately 20 % of the fund's total assets at that time. Robert Tchenguz owned shares in Kaupthing Bank and Exista and also sat on the board of Exista. He also received major loan facilities from Kaupthing Bank in Iceland, Kaupthing Bank Luxembourg and Kaupthing Singer & Friedlander (KSF). In total, the loan facilities Robert Tchenguz and related parties had received from Kaupthing Bank's parent company at the collapse of the bank amounted to around 2 billion euros ⁽¹²⁾.

Concentration of risk

- (16) Related to the issue of the abnormal exposure to major shareholders was the conclusion of the SIC that the banks' portfolios of assets were insufficiently diversified. The SIC was of the view that European rules on large exposure were interpreted in a narrow way, in particular in the case of the shareholders, and that the banks had sought to evade the rules.

Weak equity

- (17) Although the capital ratio of Kaupthing and the other two major Icelandic banks was always reported to be slightly higher than the statutory minimum, the SIC concluded that the capital ratios did not accurately reflect the financial strength of the banks. This was due to risk exposure of the banks' own shares through primary collaterals and forward contracts on the shares. Share capital financed by the companies themselves, referred to by the SIC as 'weak equity' ⁽¹³⁾, represented more than 25 % of the banks' capital bases (or over 50 % when assessed against the core component of the capital, i.e. shareholders' equity less intangible assets). Added to these were problems caused by the risk that the banks were exposed to by holding each other's shares. By the middle of 2008 direct financing by the banks of their own shares, as well as cross-financing of the other two banks' shares, amounted to approximately 400 billion ISK, around 70 % of the core component of the capital. The SIC was of the opinion that the extent of financing of shareholders' equity by borrowing from the system itself was such that the system's stability was threatened. The banks held a substantial amount of their own shares as collateral for their lending and therefore as share prices fell the quality of their loan portfolios declined. This affected the banks' performance and put further downward pressure on their share prices; in response to which (the SIC assumed from the information in their possession), the banks attempted to artificially create abnormal demand for their own shares.

The size of the banks

- (18) In 2001 the balance sheets of the three main banks (collectively) amounted to just over a year of the gross domestic product (GDP) of Iceland. By the end of 2007 the banks had become international and held assets worth nine times the Icelandic GDP. The SIC report notes that by 2006, observers were commenting that the banking system had outgrown the capacity of the CBI and doubted whether it could fulfil the role of lender of last resort. By the end of 2007 Iceland's short-term debts (mainly incurred due to financing of the banks) were 15 times larger than the foreign exchange reserves, and the foreign deposits in the three banks were also 8 times larger than the foreign exchange reserves. The Depositors and Investors Guarantee Fund held minimal resources in comparison with the bank deposits that it was meant to guarantee. These factors, the SIC concludes, made Iceland susceptible to a run on its banks.

The sudden growth of the banks in comparison with the regulatory and financial infrastructure

- (19) The SIC concluded that the relevant supervisory bodies in Iceland lacked the credibility that was necessary in the absence of a sufficiently resourced lender of last resort. The report concludes that the FME and CBI lacked the expertise and experience to regulate the banks in difficult economic times, but that they could have taken action

⁽¹¹⁾ More than half of such loans granted from the beginning of 2007 until the collapse of the bank, were granted without collateral.

⁽¹²⁾ The minutes of the loan committee of Kaupthing Bank's board state, inter alia, that the bank often lent money to Tchenguz in order for him to meet margin calls from other banks as his companies declined.

⁽¹³⁾ Chapter 21.2.1.4 of the Report.

to reduce the level of risk that the banks were incurring. The FME, for example, did not grow in the same proportion as the banks and the regulator's practices did not keep up with the rapid developments in the banks' operations. The report is also critical of the Government, concluding that the authorities should have taken action to reduce the potential impact of the banks on the economy by reducing their size or requiring one or more banks to move their headquarters abroad ⁽¹⁴⁾.

Imbalance and overexpansion of the Icelandic economy as a whole

- (20) The SIC report makes reference to events concerning the wider economy that also impacted upon the banks' rapid growth and contributed to the imbalance in size and influence between the financial services sector and the remainder of the economy. The report concluded that government policies (in particular fiscal policy) most likely contributed to the overexpansion and imbalance and that the CBI's monetary policy was not sufficiently restrictive. The report also refers to relaxing the Icelandic Housing Financing Fund's lending rules as 'one of the biggest mistakes in monetary and fiscal management made in the period leading up to the banks' collapse' ⁽¹⁵⁾. The report is also critical of the ease with which the banks were able to borrow from the CBI, with the stock of CBI short-term collateral loans increasing from 30 billion ISK in the autumn of 2005 to 500 billion ISK by the beginning of October 2008.

The Icelandic króna, external imbalances and CDS spreads

- (21) The report notes that in 2006, the value of the Icelandic króna was unsustainably high, the Icelandic current account deficit was over 16 % of GDP, and liabilities in foreign currencies less assets neared total annual GDP. The prerequisites for a financial crisis were in place. By the end of 2007 the value of the króna was depreciating and credit default swap spreads (CDS) on Iceland and the banks rose exponentially.

2.3. Measures taken to reconstruct the banking sector

- (22) Following the collapse of the three biggest commercial banks in October 2008 (including Kaupthing) the Icelandic authorities were faced with the unprecedented challenge of safeguarding continued banking operations in Iceland ⁽¹⁶⁾. The policy followed by the Icelandic Government is primarily laid down in the Emergency Act ⁽¹⁷⁾ adopted by the Icelandic Parliament on 6 October 2008. The law grants extraordinary powers to the FME to take control of financial undertakings and to dispose of their assets and liabilities as required. The Minister of Finance was authorised, on behalf of the Treasury, to disburse funds in order to establish new financial undertakings. Moreover, in bankruptcy proceedings of financial undertakings, deposits would be given priority over other claims. The Government declared that deposits in domestic commercial and savings banks and their branches in Iceland would be fully protected.
- (23) Policy priorities focused initially on securing the basic functioning of the domestic banking, payment and settlement systems. In the first weeks after the crash, the Icelandic Government also prepared an economic program in collaboration with the International Monetary Fund ('IMF'), leading to the approval on 20 November 2008 of Iceland's request for a two year stand-by-arrangement from the Fund, which included a 2,1 billion USD loan from the IMF aimed at strengthening Iceland's currency reserves. Additional loans of up to 3 billion USD were secured from other Nordic countries as well as certain other trading partners. Of the IMF loan, 827 million USD was made available immediately, while the remaining amount was disbursed in eight equal instalments, subject to quarterly reviews of the program.

⁽¹⁴⁾ It was in fact the then coalition Government's stated policy to encourage more growth and to incentivise the banks to remain headquartered in Iceland.

⁽¹⁵⁾ Chapter 2, page 5 of the report.

⁽¹⁶⁾ For further general details of the measures taken by the Icelandic authorities see the report of the Minister of Finance to the Parliament on the resurrection of the commercial banks of May 2011 (Skýrsla fjármálaráðherra um endurreisn viðskiptabankanna), available at <http://www.althingi.is/altext/139/s/pdf/1213.pdf>

⁽¹⁷⁾ Act No 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc.

- (24) The IMF Program was a broad-based stabilisation program focusing on three key objectives. Firstly, to stabilise and restore confidence in the króna so as to contain the negative impact of the crisis on the economy. The measures included the introduction of capital controls aimed at stemming capital flight. Secondly, the program included a comprehensive bank restructuring strategy, ultimately aimed at rebuilding a viable financial system in Iceland as well as safeguarding the country's international financial relations. Among subsidiary goals was to ensure fair valuation of the banks' assets, maximise asset recovery and strengthen supervisory practices. Thirdly, the program aimed at ensuring sustainable public finances, by limiting the socialisation of losses in the failed banks and implementing a medium-term fiscal consolidation program.
- (25) The Icelandic authorities have underlined that due to the exceptional circumstances linked to the large size of the banking system in relation to the financial capacity of the Treasury, the policy options available to the authorities were limited. The solutions relied upon were therefore in many ways different to the measures taken by the governments of other countries facing threats to financial stability.
- (26) On the basis of the Emergency Act, the three large commercial banks, Glitnir Bank, Landsbanki Íslands and Kaupthing Bank, were split into 'old' and 'new' banks. The Minister of Finance founded three limited liability companies to take over the domestic operations of the old banks and appointed them boards of directors. The FME took control of the old banks, allocated essentially their domestic assets and liabilities (deposits) to the new banks which continued banking operations in Iceland, while the old banks were placed under the supervision of their respective resolution committees⁽¹⁸⁾. Foreign assets and liabilities were in the main placed in the old banks, which were later submitted to winding-up procedures and the eventual closure of all foreign operations⁽¹⁹⁾.
- (27) In the provisional opening balance sheets of the three new banks of 14 November 2008 it was estimated that the banks' combined total assets would amount to 2 886 billion ISK, with an equity to be provided by the State of 385 billion ISK. The total amount of bonds to be issued by the new banks in favour of the old banks as payment for the value of the assets transferred in excess of liabilities was estimated at 1 153 billion ISK. The FME appointed Deloitte LLP to perform assessments of the value of transferred assets and liabilities. In this process it transpired that the independent assessment would not result in fixed values of net assets transferred but valuations within certain ranges. It also emerged that the banks' creditors raised disagreements concerning the valuation process, which they considered not to be impartial, and complained that they were unable to protect their interests. These complications resulted in a change of policy for settling the accounts between the old and the new banks, entailing that instead of relying on valuations by an independent expert, the parties would try through negotiations to reach agreements on the value of the net assets transferred.
- (28) It was clear that it would be difficult for the parties to reach agreements on the valuations as they were evidently subject to numerous assumptions on which the parties were likely to disagree. The state aimed to reach agreements on base evaluations providing a firm foundation for the initial capitalisation of the new banks. Price performance of assets in excess of the base evaluation could be attributed to the creditors in the form of contingent bonds or increases in the value of the banks' share capital, as it had emerged in the negotiations that the resolution committees of Glitnir and Kaupthing and a majority of their creditors could be interested to acquire

⁽¹⁸⁾ See also FME's Annual Report 2009 (July 2008-June 2009), available at <http://en.fme.is/media/utgefid-efni/FME-Annual-Report-2009.pdf>

⁽¹⁹⁾ Further takeovers of financial undertakings were to follow. In March 2009, the FME took control of the operations of three financial undertakings; Straumur-Burðaras, the Reykjavik Savings Bank (SPRON) and Sparisjodabanki Íslands (Icebank), and decided on the disposal of the assets and liabilities of those undertakings. While a composition agreement with Straumur's creditors was later approved, SPRON and Sparisjodabanki were submitted to a winding-up procedure. Other financial undertakings were also severely affected by the collapse of the three main commercial banks and prevailing uncertainties in financial markets, and further financial undertakings were made subject to public administration in 2010. Thus, the FME appointed a provisional board of directors for VBS Investment Bank in March 2010. In April 2010, the FME took control of Keflavík Savings Bank and Byr Savings Bank, determining that their operations would be taken over by new financial undertakings, SpKef Savings Bank and Byr hf, respectively. As the financial conditions of these new undertakings turned out to be worse than initially anticipated, SpKef was later merged with Landsbankinn, by decision of the FME, and Byr hf. was merged with Íslandsbanki, following a tender for the shares in Byr. The Icelandic authorities were furthermore called upon, in 2009, to address the financial difficulties of Saga Capital Investment Bank and, in 2011, the Housing Financing Fund.

holdings in the new banks, and this would allow them to benefit from potential increases in the values of the assets transferred.

- (29) The full capitalisation of the three new banks and the basis of agreements with the creditors of the old banks was announced on 20 July 2009. The Government, as the sole owner of the three new banks, reached heads of agreements with the resolution committees of the old banks in relation to how compensation for the transfer of net assets into the new banks would be achieved and paid for. With regard to two of the new banks, Íslandsbanki and Arion Bank, this included conditional agreements for the old banks to subscribe for majority equity interests in the new banks.
- (30) On the basis of the above tentative agreements, the resolution committees of the old banks decided in October 2009 (Glitnir) and December 2009 (Kaupthing Bank and Landsbanki Islands) to exercise the negotiated options and subscribe to shareholding in the new banks. On 18 December 2009 the Government announced that bank reconstruction had been concluded and that agreements had been reached between the Icelandic authorities and the new banks, on the one hand, and the resolution committees of Glitnir Bank, Landsbanki Islands and Kaupthing Bank on behalf of their creditors, on the other hand, on settlements concerning assets which were transferred from the old banks to the new ones, and that the new banks were then fully financed.
- (31) As it turned out, the Treasury's contribution to the new banks' equity was reduced substantially, from 385 billion ISK as originally envisaged to 135 billion ISK in the form of share capital and, in the case of two of the three banks, Íslandsbanki and Arion Bank, approximately 55 billion ISK of Tier II capital in the form of subordinated loans or a total of 190 billion ISK. In addition, the Treasury provided Íslandsbanki and Arion Bank with certain liquidity facilities. The share capital provided by the old banks to the new ones amounted in total to approximately 156 billion ISK. Total capitalisation of the new banks therefore amounted to approximately 346 billion ISK. Thus, instead of maintaining full ownership of the three banks, the agreements implied that the state's holdings would be reduced to approximately 5 % in the case of Íslandsbanki, 13 % in the case of Arion Bank and 81 % in the case of Landsbankinn.
- (32) While this takeover of two of the three banks by the creditors of the old banks resolved major issues in the rebuilding of the financial sector and established firmer capital foundation for the new banks, numerous weaknesses remained which needed to be addressed. Since the autumn of 2009, the banks have concentrated their efforts mostly on internal issues, determining the overall strategy for their operations and in particular restructuring their loan portfolios, which represent the greatest risk factor to their operations and long-term viability. The restructuring process has been complex due to various complicating factors, including Supreme Court rulings on illegality of loans granted in ISK but indexed to foreign currencies. As for Arion Bank, in so far as relevant for its restructuring, these matters are discussed further below.

2.4. Macroeconomic environment

- (33) Major economic turbulence followed the collapse of the banking system in October 2008. The difficulties in Iceland's financial system were coupled with a breakdown of confidence in its currency. The króna depreciated sharply in the first quarter of 2008 and again in the autumn, before and after the failure of the three commercial banks. Despite capital controls imposed in the autumn of 2008, currency volatility prevailed in the course of 2009⁽²⁰⁾. This turmoil resulted in a severe recession in Iceland's economy, with a contraction of GDP by 6,8 % in 2009 and 4 % in 2010.
- (34) Among the implications of the economic crisis was a sudden increase in unemployment from 1,6 % in 2008 to 8 % in 2009, a hike in inflation and a drop in real wages. Moreover, there was a sharp rise in corporate and household debt and of the share of non-performing loans in the banks' loan portfolios as well as a large scale takeover by the new banks of businesses in financial distress. At the same time the high fiscal cost of restructuring the banking system led to a sharp rise in the fiscal deficit and a major surge in public sector debt.

⁽²⁰⁾ As an example of the scale of the sharp depreciation, the monthly average exchange rate of the euro to the Icelandic króna rose from 90,71 ISK in December 2007 to 184,64 ISK November 2009.

- (35) Following the deep recession provisional data from Statistics Iceland indicates a turnaround in the second half of 2011 and for the whole year a growth of GDP of 3,1 % compared to the previous year.
- (36) Economic growth in 2011 was mostly due to an increase in domestic demand, particularly a 4 % rise in private household consumption. This was supported by increases in wages and social benefits as well as certain policy initiatives undertaken to ease the payment burden of household debt, including a temporary interest rate subsidy, the freezing of payments on loans and the early reimbursement of private pension savings. Provisional data for 2011 also indicate a slow increase in investments, however from a particularly low level ⁽²¹⁾. Public consumption has remained at a subdued level during the past three years.
- (37) The general macroeconomic data disguise more significant sectoral differences. In addition to the collapse in the financial sector a major contraction has taken place in construction and many other domestic production and service activities. Growth has on the other hand taken place in certain export sectors. Due to the low exchange rate of the króna and relatively stable prices in foreign currency for both marine and aluminium products, export revenue rose following the onset of the economic crisis, also with respect to tourism and other services exports. At the same time, imports fell sharply, turning the trade balance ⁽²²⁾ temporarily to a surplus of approximately 10 % of GDP in 2010. However, with increased domestic demand in 2011, imports have grown again, leading to an overall smaller trade surplus of 8,2 % of GDP.
- (38) Statistics Iceland forecast for 2012-2017 assumes that gradual economic recovery will continue with 2,6 % growth in 2012. A similar growth rate is expected throughout the forecast period. This forecast is however subject to several uncertainties. Planned large scale industrial investments might be further delayed. Iceland's terms of trade would be negatively affected by a prolonged recession in the main trading countries, implying a lower growth rate in Iceland. Slower progress than anticipated in tackling the debt burden of households and corporations would furthermore restrain domestic demand and the growth prospects of the economy. Growth could also be threatened by continued price instability linked to currency volatility in the context of removal of capital controls.

2.5. Financial supervision and improvements in regulatory framework

- (39) Following the FME's initial work linked to the foundation of the new banks and the assessment of the value of the net assets transferred from the old banks, the FME conducted in the spring of 2009 an audit of the new banks and their business plans, financial strength and capital requirements in a so-called sign-off project. This was done with the assistance of the international management consultant firm Oliver Wyman.
- (40) Having concluded the above process, the FME granted the banks operating licenses subject to various conditions. In view of the quality of the asset portfolios and the anticipated economic uncertainty, it was considered necessary to place higher capital requirements on the three banks than the statutory minimum. The FME therefore set the minimum capital adequacy (CAD) ratio for the three banks at 16 %, thereof a minimum of 12 % for the Tier I capital ratio. The requirements were applicable for at least 3 years unless reviewed by the FME. Liquidity conditions were also specified, requiring that available liquid funds should at any point amount to a minimum of 20 % of deposits and that cash or cash equivalents should amount to at least 5 % of deposits. Furthermore, requirements were made regarding other matters such as restructuring of loan portfolios, risk assessment, corporate governance and ownership. Comparable capital requirements were introduced by the FME regarding other financial undertakings.

⁽²¹⁾ During the years 2009-2011, the share of investments in GDP has been only 13-14 %.

⁽²²⁾ Trade balance refers to the difference in earnings from exports and imports of goods and services. It does not include the balance on primary income from abroad, which has been negative in past years, particularly since 2008. This implies that despite the surplus on the trade balance, Iceland's overall current account has been negative during recent years although declining sharply since 2009.

- (41) The economic stabilisation program established in consultation with the IMF provided for a review of the entire regulatory framework of financial services and supervision to improve defence against future financial crisis. The Government invited the former Director-General of the Finnish Financial Supervisory Authority, Mr Kaarlo Jännäri, to carry out an assessment of the existing regulatory framework and supervisory practices. Among the improvements proposed by Mr Jännäri was the creation of a National Credit Registry at the FME to diminish credit risks in the system. His report also suggested to lay down tougher rules and a stricter practice on large exposures and connected lending as well as to conduct more on-site inspections to verify off-site supervision and reports, particularly on credit risk, liquidity risk and foreign exchange risk. It was also recommended to review and improve the deposit guarantee system, following closely the developments within the EU.
- (42) The Government subsequently proposed a bill of law to the Althingi, based, inter alia, on proposals made by Jännäri as well as amendments made to EEA law on financial activities from 2009 onwards, which was adopted and entered into force on 1 July 2010, as Act No 75/2010. With the new law, extensive amendments were made to the Act on Financial Undertakings. Several other amendments were later introduced to the law on financial undertakings as well as of regulation and supervision of financial services. These regulatory amendments are considered in more detail in the Annex.

2.6. Main challenges ahead ⁽²³⁾

- (43) Despite major achievements in rebuilding a financial sector, Iceland continues to strive with the repercussions of the financial and currency crisis in the autumn of 2008. The financial crisis has revealed various flaws and deficiencies in the financial system, which must be addressed, if public confidence is to be restored. It seems evident that Iceland — as many other countries hard hit by the financial crisis — faces numerous challenges in adapting the legal and operating environment of financial services to support a viable and efficient financial system in the future and reduce as much as possible the risk of further systemic shocks to reoccur.
- (44) The most immediate challenges currently facing Icelandic financial undertakings are linked to the fact that the banks are operating in a sheltered environment with capital controls and a blanket deposit guarantee. The banks now need to prepare themselves to operate in a more exposed environment, when the capital controls are removed and deposit guarantees revert to the arrangement set out in the relevant EU/EEA directives ⁽²⁴⁾. The Icelandic authorities have underlined that extreme caution must be exercised when introducing new rules in this regard.
- (45) Another major challenge is the need to adapt further the legal and regulatory framework to support a solid and efficient financial system which is also consistent with EEA and international law developments ⁽²⁵⁾.

⁽²³⁾ On this subject see for instance the report of the Minister of Economic Affairs to the Althingi of March 2012, *Future Structure of the Icelandic Financial System*. According to the ministry, this report is seen as a catalyst to an informed discussion of this important subject as it does not present fully formed proposals but sets out the main issues and outlook with reference to international developments. The report is available at <http://eng.efnahagsraduneyti.is/media/Acrobat/Future-Structure.pdf>

⁽²⁴⁾ Bringing deposit guarantees back to normal conditions does not only relate to abolishing the state backing of such guarantees, but also to review the provisions in the Emergency Act according to which deposits which enjoy deposit guarantees by law have priority in the winding-up of a financial undertaking. This comprises a considerable advantage for depositors, not least while the 2008 banking collapse is still fresh in people's minds. This provision is on the other hand likely to represent a handicap for the banks to diversify their funding arrangement.

⁽²⁵⁾ See Chapter 9 of the report of the Minister of Economic Affairs referred to in footnote 23. When presenting that report, the Minister of Economic Affairs also appointed a group of banking experts, with participation of foreign experts, to prepare proposals on a comprehensive legal and regulatory framework for the financial market in Iceland as a whole. According to the same report, the Icelandic authorities also foresee to study other future options, including the possible separation of investment and commercial banking activities, the adoption of a financial stability legislation and possible amendment of the division of responsibility of financial services regulatory bodies. It is also clear from the statements of the Icelandic authorities that a review of the monetary policy framework remains on the agenda, with or without the possibility that Iceland will become a member of the European Union, as well as other possible means to improve economic management and ensure that regulators 'see the forest for the trees' and effectively apply the most appropriate macro-prudential tools.

2.7. The state of competition in the Icelandic financial sector

- (46) According to recent information from the Icelandic authorities ⁽²⁶⁾, competition on the financial market has changed radically since the banking collapse. The number of financial undertakings has decreased, as several savings banks, commercial banks and specialised lenders are either being wound up or have been merged with other undertakings ⁽²⁷⁾. The number of financial undertakings is still decreasing, most recently with the mergers of Landsbankinn and SpKef in March 2011, of Íslandsbanki and Byr in December 2011 and the merger of Landsbankinn and Svarfdaelir Savings Bank, approved by the Authority on 20 June 2012. With the reductions in the number of financial undertakings and the larger banks taking over deposits from the banks closing down, concentration in the domestic market has increased. The overall presence of the new banks on the EEA financial markets is on the other hand much smaller than that of their predecessors, as international banking operations have been closed down.
- (47) In addition, the domestic market has shrunk considerably as certain sub-markets have disappeared or are largely subdued. The near disappearance of the stock market and the introduction of capital controls have reduced operations in the stock and currency markets and resulted in limited investment options. With the level of investments in the economy at a historically low level and households and companies generally highly leveraged, demand for credit is low. Since the collapse, the banks have concentrated their efforts on internal issues and restructuring of their loan portfolios as well as the restructuring of some of their major corporate clients.
- (48) Before the financial crisis, the savings banks accounted collectively for a market share of approximately 20-25 % in deposits. This has now collapsed to approximately 2-4 %. The market shares lost by the savings banks and commercial banks exiting the market have been gained by the three major commercial banks, Arion Bank, Íslandsbanki and Landsbanki. Combined the three big banks now account for approximately 90-95 % of the market instead of 60-75 % earlier on, where Landsbankinn's market share is marginally highest. Apart from the 10 regional savings banks, currently accounting for approximately 2-4 % of the market, the only other market player is the restructured MP Bank ⁽²⁸⁾, with a market share of approximately 1-5 %.
- (49) The Icelandic financial market is thus clearly oligopolistic and the three largest companies could collectively achieve a dominant market position. According to the Icelandic Competition Authority (ICA), which the Authority had asked for its views on the state of competition in Iceland and potential remedies, there are significant entry barriers to the Icelandic banking market. This has detrimental effects on competition. There are also certain impediments for consumers to switch banks. The Icelandic authorities furthermore acknowledged that the exchange rate risks associated with Iceland's small and non-traded currency, the Icelandic króna, has further restricted competition and deterred foreign banks and companies from entering the Icelandic market.
- (50) ICA has lately focused on a specific issue regarding IT infrastructure for the banks' operations and their co-operation in that regard. This relates to the financial institutions' jointly owned IT service provider, *Reiknistofa bankanna* (the Icelandic Banks' Data Centre; RB). This matter is of relevance for the assessment of the case at hand and was among the issues discussed by the Authority with the Icelandic authorities and the banks.
- (51) RB is jointly owned by the three main Icelandic banks, two saving banks, the Icelandic Savings Bank Association and the three main payment card processors in Iceland. Landsbankinn owns 36,84 % of the shares in RB, Íslandsbanki holds 29,48 % and Arion Bank 18,7 %. Combined the three commercial banks therefore own 85,02 % of

⁽²⁶⁾ See Chapter 6 of the report by the Minister of Economic Affairs to the Althingi, *The Future Structure of the Icelandic Financial System*, available at <http://eng.efnahagsraduneyti.is/publications/news/nr/3559>

⁽²⁷⁾ Since autumn 2008, several financial undertakings have disappeared from the market (in addition to the 'old' big commercial banks, Glitnir, Kaupthing and Landsbanki): Sparisjóðabanki Íslands (formerly Icebank), the Reykjavik Savings Bank (SPRON), Sparisjóður Mýrasýsla (Myrasýsla Savings Bank, SPM), VBS Investment Bank and Askar Capital Investment Bank. The operations of Straumur-Burðaras Investment Bank and Saga Capital Investment Bank have also diminished significantly.

⁽²⁸⁾ On 11 April 2011, a contract for the sale of (old) MP bank's operations in Iceland and Lithuania was approved at the bank's shareholder meeting, when over 40 new shareholders invested 5,5 billion ISK in new shares in the bank. Other operations of the old bank remained with the previous owners and were transferred to a new legal entity, EA fjárfestingarfélag hf. For further details, see MP bank's press releases of 11 April 2011 available at <https://www.mp.is/um-mp-banka/utgefif-efni/frettir/nr/1511> and <https://www.mp.is/um-mp-banka/utgefif-efni/frettir/nr/1510>

shares in RB. RB's clients are the owners, the Central Bank of Iceland and other financial institutions as well as other public entities. The banks' cooperation in this area is extensive, as RB has developed the clearing and settlement system in Iceland. It also provides a number of core banking solutions which are multi-tenant solutions, used by most of the Icelandic banks. RB furthermore operates an e-invoicing and e-payment system for corporates and consumers.

- (52) According to ICA, the collapse in 2008 has made the smaller banks and savings banks particularly vulnerable. For the smaller financial undertakings, the required IT services were of crucial importance, as they can be viewed as one of the entry barriers for new market participants. The platform for IT services has been provided to a significant extent by RB as regards the bigger financial undertakings and, as regards the savings banks and smaller market players, by Teris. Following the closure of many smaller financial undertakings in recent years, Teris lost a significant share of its income, leading in January 2012 to the sale of some of its IT solutions to RB. According to RB and Teris, this transaction was, *inter alia*, aimed at securing continued provision of IT services to smaller financial undertakings.
- (53) The ICA has been investigating two cases regarding RB. Firstly, whether the joint ownership and cooperation of the banks and other financial undertakings in the RB forum should be considered to be a breach of the ban on restrictive practices under Article 10 of the Icelandic Competition Act. Secondly, the compatibility of RB's purchase of Teris's major assets is being assessed under the merger provisions of the same act. However, in May 2012 these two cases were concluded with a settlement between RB and its owners, on the one hand, and the ICA on the other hand ⁽²⁹⁾.
- (54) Aside from the above concerns that relate directly to the Icelandic financial market, the ICA has in particular pointed to the need for the sale and restructuring of operating companies ⁽³⁰⁾ to be completed without undue delay. Many operating companies have been taken over by the banks (being creditors of those companies) due to over indebtedness following the economic crash in 2008. According to ICA, it may create a conflict of interest when banks provide financial services to companies and own the companies at the same time. The ICA is of the opinion that the banks' direct and indirect ownership ⁽³¹⁾ is the most wide-spread and dangerous competition problem in the aftermath of the financial crisis, as this has an effect on almost every company and industry in Iceland. In ICA's view, faster restructuring of companies would improve competition in the financial market. When the banks' involvement in the restructuring of their corporate clients has been subject to the notification requirements under national merger control, the ICA has in this regard often set conditions regarding the banks' ownership. However, a comprehensive solution to the problem appears to be difficult, as it relates essentially to the high leverage of the Icelandic business sector.
- (55) In their submission to the Authority, the three commercial banks, Arion Bank, Íslandsbanki and Landsbankinn, have all expressed the view that no major changes have taken place in the conditions of competition in the Icelandic financial market since autumn 2008 which should give cause for concerns. Effective competition

⁽²⁹⁾ According to the settlement, RB and its owners have agreed to a number of commitments aimed at preventing distortions of competition resulting from RB's operations and the cooperations of its owners. The commitments require, *inter alia*, that RB shall be operated on general commercial terms independent from its owners and the majority of RB's board shall be composed of specialists independent from the owners, access to the systems and services provided by RB shall be provided on a non-discriminatory basis and the terms of services provided by RB shall be the same irrespective of whether or not the client is a shareholder in RB. Existing owners of RB have committed to offer regularly for sale part of their holdings in RB, with the aim of facilitating non-financial undertakings to acquire ownership in RB. Such invitations shall be made at least every second year, until at least a third of total shareholdings in RB have been sold to parties other than the current shareholders or offered for sale in a shares offering.

⁽³⁰⁾ The ICA uses the term 'operating companies' for the banks' holdings in normally non-financial businesses which the banks have acquired in relation to the restructuring of their loan portfolios through debt to equity swaps or otherwise. Likewise, the Authority uses the term 'operating company' for real economy undertaking, which do not belong to the bank's core business in financial markets.

⁽³¹⁾ In this context, the Authority understands that indirect ownership refers to the banks' possible influence and control over companies due to their high indebtedness to the bank.

prevailed in the market, without any evidence of collusive behaviour of the three biggest players. When examining the conditions of competition in the market, the ICA had overlooked certain key factors. Foreign banks, although without presence in Iceland, have for long and still are actively competing with Icelandic banks for the provision of corporate loans and other financial services to the biggest clients, such as undertakings in export-based activity (fisheries, power-intensive industry, etc.) as well as state and municipal activity.

- (56) However, this view is contrary to the view expressed in the submission of the Icelandic authorities, as set out in the report referred to above by the Minister of Economic Affairs to the Althingi and to the views of ICA. Moreover, as will be outlined below, Arion Bank has, despite certain reservations regarding analysis of competition conditions, decided to provide certain commitments aimed at limiting distortion of competition linked to the aid measures concerned. Those commitments are reported in the Annex.

3. DESCRIPTION OF THE MEASURES

3.1. The beneficiary

- (57) As described above, Kaupthing Bank collapsed in 2008, as did the two other large Icelandic commercial banks. So as to ensure the continuing operation of the domestic banking sector, the Icelandic authorities undertook certain measures to restore certain operations of (old) Kaupthing Bank hf, including the establishment and capitalisation of New Kaupthing Bank hf (now renamed Arion Bank).

3.1.1. *Kaupthing Bank*

- (58) Prior to the financial crisis of 2008, Kaupthing Bank was the largest bank in Iceland. At the end of 2007 its balance sheet amounted to 5 347 billion ISK (58,3 billion Euros). Kaupthing was primarily a northern European bank operating in 13 countries. Kaupthing offered integrated financial services to companies, institutional investors and individuals, divided into five business segments: Corporate and Retail Banking, Capital Markets, Treasury, Investment Banking and Asset Management & Private Banking. In addition, the bank operated a retail branch network in Iceland, where it was headquartered, and to a lesser extent in Norway and Sweden. Kaupthing had banking licences through subsidiaries in Denmark, Sweden, Luxembourg and the UK and branches in Finland, Norway and the Isle of Man. Kaupthing's principal subsidiaries were Kaupthing Singer & Friedlander (UK) and FIH Erhvervsbank (Denmark), but the bank operated 16 other subsidiaries and branches in various countries in Europe, North America, Asia and the Middle East. At the end of 2007 the bank employed 3 334 people. Shares in the bank were listed on the OMX Nordic Exchange in Reykjavík and in Stockholm.

3.1.2. *Arion Bank*

- (59) Kaupthing's successor, Arion Bank, is an Icelandic bank offering universal financial services to companies, institutional investors and individuals. The Bank aims to be a relationship bank with a focus on larger corporations and individuals seeking a broad range of financial solutions.
- (60) The Arion Bank Group consists of the parent company and eight core subsidiaries which are an integral part of the Bank's operations ⁽³²⁾.

⁽³²⁾ The core subsidiaries are (main operation and the Bank's holdings are indicated in brackets): AFL-sparisjóður (savings bank; 94,45 %), Verdis hf. (securities custodian; 100 %), KB ráðgjöf ehf. (sells insurance and pension products; 100 %), Gen hf. (holding in international enterprise funds; 100 %), Okkar Líftryggingar hf. (insurance company — individual and life insurance; 100 %), Sparisjóður Ólafsfjarðar (savings bank; 99,99 %), Stefnir hf. (management company for UCITS; 100 %) and Valitor Holding hf. (payment service company; 52,94 %).

- (61) In relation to the recent and ongoing restructuring of its loan book, the Bank has taken over assets that are categorised as held for sale or if the recovery work is not finished, temporary operations. According to the Bank, it nevertheless endeavours to sell such assets without undue delay ⁽³³⁾.
- (62) Other key shareholdings are in Auðkenni (a holding company managing security keys for online banking; 20 %) and Reiknistofa bankanna (the Icelandic Banks' Data Centre, RB; 18,05 %). Arion Bank has closed down or is in the process of closing down a total of 15 companies, where the Bank has held equity interests. These companies are either in liquidation or have no assets or no operations.
- (63) The main banking products fall into four categories: Asset Management, Investment Banking, Corporate Banking and Retail Banking, as further outlined below.

A s s e t M a n a g e m e n t

- (64) This division consists of Sales and Services, Private Banking, and Institutional Asset Management. The Bank's subsidiary, *Stefnir* Asset Management Company, operates the fund management business and Arion Bank Asset Management is the main fund distributor. Asset Management is a leading participant in the Icelandic market with assets under management at Arion Bank and subsidiaries in excess of 659 billion ISK at the end 2011.
- (65) Asset Management is responsible for managing assets on behalf of its clients, including institutional investors, corporations, high net worth clients and retail investors. It serves clients with differing investment objectives, offering a broad range of services. In addition to a variety of mutual funds, alternative investment vehicles and pension plan schemes, the division offers customised asset allocation strategies and managed accounts. The division also offers funds from other leading global fund management companies.

I n v e s t m e n t B a n k i n g

- (66) Investment Banking provides various services to corporate clients through its four main product areas:
- M&A advisory
 - Capital market transactions
 - Acquisition and leverage finance
 - Principal investments.
- (67) The division aims to combine advisory with the Bank's financing capabilities, creating an integrated solution for clients, in close cooperation with other divisions of the Bank, in particular Capital Markets and Corporate Banking.

⁽³³⁾ In this regard, the Bank distinguishes between three types of assets. Firstly, the Bank's asset management company Eignabjarg ehf., which manages shares in viable operating companies that the Bank has taken over. This comprises shareholdings in the following companies (main operation and the Bank's shareholding indicated in brackets): Hagar hf. (a commercial enterprise operating in Iceland; 5,98 %), Penninn á Íslandi ehf. (a retail company specialising in stationery and office supplies; 100 %), Reitir fasteignafélag hf. (associate company of Eignabjarg hf. specialising in real estate; 42,65 %) and Fram Foods ehf. (food industry; 100 %). Secondly, other assets held for sale, comprising shareholdings in the following companies: Langalína 2 ehf. (holding company; 100 %), Umtak fasteignafélag ehf. (real estate; 100 %), EAB 2 ehf. (food industry; 100 %), Farice ehf. (operation of submarine data cable to neighbouring countries; 43,47 %), Sementsverksmiðjan ehf. (produce and import of cement; 33 %), HB Grandi hf. (fishing company; 33 %) and GO fjárfestingar ehf. (mushroom production; 30 %). Thirdly, assets are held as temporary operations as shareholdings in the following companies: Landey (holding company dealing with non-revenue generating properties; 100 %), Landfestar (operating company around commercial real estate acquired by Arion Bank from financially distressed clients; 100 %), Rekstrarfélagið Braut ehf. (pork farm; 100 %), NS 1 ehf. (owns land and leases out lots for holiday homes; 100 %), Módelhús ehf. (property and real estate; 100 %), EAB 1 ehf. (land and properties; 100 %), Andvaka ehf. (business and management consulting; 50,11 %), Klakki ehf. (former Exista — holding company; 44,9 %), Ölgerðin Egill Skallagrímsson ehf. (production, distribution and sale of soft drinks and some other drinks; 20 %) and SMI ehf. (property and real estate; 39,1 %).

Corporate Banking

- (68) Corporate Banking is organized into 7 departments: Corporate Lending; Specialised Lending; Legal & Documentation; Portfolio Management; Corporate Services; Recovery; and Factoring. Corporate Banking offers a range of financing services and products for its corporate clients, from medium-sized businesses to large corporations. The prime focus of the division is to maintain long-term relationships with its clients as well as deliver tailor-made solutions and personalised services.
- (69) Arion Bank considers that it is at the forefront in resolving corporate debt issues and has made considerable progress with the restructuring of companies. The Recovery unit within Corporate Banking is responsible for the Bank's debt recovery, i.e. the restructuring of companies which are experiencing payment difficulties. The work has progressed well and is close to completion.

Retail Banking

- (70) Retail Banking has a 30 % market share in Iceland. There are 24 branches throughout Iceland and over 100 000 customers. The branches provide a comprehensive range of services, including advice on deposits and loans, payment cards, pension savings, insurance, funds and securities.
- (71) The branch network is divided into seven clusters, each with its own business manager. Smaller branches capitalise on the strength of larger units within each cluster. More executive authority and responsibility is transferred to the branches and therefore closer to the customers. According to the Bank, this arrangement helps coordinate procedures and fully harness the expertise within the branches. Four of these business managers work in the greater Reykjavik area and three in larger urban areas. This structure is designed to reinforce the links between branches in the same part of the country.

Indications of market shares

- (72) According to Arion Bank's calculations, its market share in deposits, based on the annual reports of Icelandic banks and savings banks, is [> 30] % or marginally lower than the shares of Landsbankinn ([> 30 %]) and Íslandsbanki ([> 30 %]). Other market players with only minor significance are MP Bank ([< 5 %]) and savings banks (collectively [< 5 %]).
- (73) Arion Bank's share in loans to customers is approximately [15-25] % or similar to that of Íslandsbanki and slightly lower than Landsbankinn. The Housing Financing Fund has the biggest share in this market, [> 25] %. When counted collectively, pension funds also have a significant share in this market or [5-10] %, while the shares of other market players are insignificant.
- (74) Arion Bank's market share in trade on the Icelandic Stock Exchange measured by turnover in the first 14 weeks in 2012 was [10-20] %, but the shares of each of the other commercial banks, Íslandsbanki, Landsbankinn and MP Bank, were [20-25] %.

3.2. Comparing the old and the new bank

- (75) An indicative comparison of key financials in the old and new banks' balance sheets presented in Table 1 reveals a vast difference in the size and scope of the two operations⁽³⁴⁾. Arion Bank's total assets at the end of 2009 were only 11,5 % of those of Kaupthing Bank at mid-year 2008. The loan portfolio is the largest single asset

⁽³⁴⁾ Significant changes have occurred in Arion Bank's key financial indicators since its inception, but it is nevertheless appropriate to compare the two banks with reference to data close in time. It is recalled that Kaupthing was an international bank with operations in various countries, but Arion Bank was established to take over certain domestic operations and assets of Kaupthing Bank.

category. The book value of Kaupthing Bank's loan portfolio at the end of June 2008 was 4 169 billion ISK compared to Arion Bank's loan portfolio of 358 billion ISK at the end of 2009, 8,6 % of that of Kaupthing. There is also a significant change in securities holdings of Arion Bank compared to Kaupthing Bank. Shares and derivatives are reduced by 96-100 %. The reduction is smaller as regards bonds, as bonds held by Arion Bank amounted to 25,7 % of Kaupthing Bank's holdings.

Table 1

Comparison of Arion Bank and Kaupthing Bank balance sheets, amounts in billion ISK

	Kaupthing 30.6.2008	Arion 31.12.2009	Arion as % of Kaupthing
Total assets	6 603	757	11,5
— Loans and receivables to customers	4 169	358	8,6
— Bonds and debt instruments	676	173	25,7
— Shares and equity instruments	172	7	4,1
Total liabilities	6 166	667	10,8
— Deposits	1 848	495	26,8
Total equity	438	90	20,6

- (76) The income statements of the two entities display a similar difference in size and scope. Comparing Arion Bank in 2009 and Kaupthing Bank in 2007, net interest income of Arion Bank amounts to 15,2 % of Kaupthing and net fee and commission income of Arion was 10,7 % of that of Kaupthing. Arion Bank employed 1 057 people at the end of 2009 (including employees of subsidiaries) compared to Kaupthing Bank's 3 334 employees at the end of 2007. The total number of employees at Arion was therefore 32 % of the corresponding total for Kaupthing⁽³⁵⁾. Comparing the Icelandic operations of both banks, Kaupthing employed 1 133 people for the Icelandic operations (excluding employees of subsidiaries) at the end of June 2008, whereas in Arion Bank, there were 952 employees (excluding subsidiaries) at the end of 2009.

Table 2

Comparison of Arion Bank and Kaupthing Bank income statements, amounts in billion ISK

	Kaupthing 2007	Arion 2009	Arion as % of Kaupthing
Net interest income	80	12	15,2
Net fee and commission income	55	6	10,7
Operating income	166	50	29,9
Earnings before income tax	81	15	19,0

⁽³⁵⁾ Changes differ between business segments and in certain areas the reduction is up to 90 %. A significant scale-down took place in the CEO's office, where 6 % of Kaupthing's staff in Iceland were employed, whereas in the case of Arion Bank the corresponding number is 1 %.

3.3. National legal basis

(77) The national legal basis for the aid measures is as follows:

— *Act No 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc., commonly referred to as the Emergency Act*

The Emergency Act gave the FME authority to intervene 'in extreme circumstances' and assume powers of financial institutions' shareholders meetings and board meetings, and decide on the disposal of their assets and liabilities. The FME was also granted power to appoint resolution committees to financial undertakings that it had taken over, which held the powers of shareholders' meetings. In winding up the institutions, the Act gives priority status to claims by deposit holders and deposit guarantee schemes. The Act also authorised the Icelandic Ministry of Finance to establish new banks. The Emergency Act includes amendments of the Act on Financial Undertakings, No 161/2002, the Act on Official Supervision of Financial Activities, No 87/1998, the Act on Deposit Guarantees and Investor-Compensation Scheme, No 98/1999, and the Act on Housing Affairs, No 44/1998.

— *Supplementary State Budget Act for 2008 (Article 4)*

— *State Budget Act for 2009 (Article 6)*

3.4. The aid measures

(78) The Icelandic authorities' intervention following the failure of Kaupthing Bank has been described above, and was set out in more detail in the opening decision. The essence of the interventions can be summarised as follows: The FME took control of Kaupthing on 9 October 2008, and domestic liabilities and (most) domestic assets were transferred to New Kaupthing. The old bank's estate was to be compensated for this transfer by receiving the sum of the difference between assets and liabilities. As determining this difference proved to be difficult and time-consuming, the State provided some initial capital and a commitment to contribute further capital if need be. It then capitalised the bank, before finally an agreement was reached between the State and the old bank on 1 December 2009, which led to the State's stake in the bank being reduced from 100 % to 13 %⁽³⁶⁾. The Authority considers this date — 1 December 2009 — to mark the beginning of the 5 year restructuring period, which will consequently last until 1 December 2014.

(79) The following section is limited to describing those aspects of the State's intervention that constitute measures relevant for assessment under Article 61 of the EEA Agreement.

3.4.1. Tier I capital

(80) The State provided Tier I capital twice — once, when New Kaupthing was created, and then again when it capitalised the bank fully (and retroactively); followed by an agreement with the old bank on behalf of its creditors according to which the State retained a 13 % stake in the bank.

3.4.1.1. Initial capital

(81) Following the establishment of New Kaupthing Bank in October 2008, the State provided 775 million ISK⁽³⁷⁾ (5 million Euros) in cash as initial capital to the new bank and in addition issued a commitment to contribute

⁽³⁶⁾ However, it was only on 8 January 2010 that the agreements were formalised, when Kaupthing, on behalf of its creditors, through its subsidiary Kaupskil ehf. took ownership of Arion Bank, following approval by the FME and the Icelandic Competition Authority. Kaupskil holds 87 % of common equity and the Icelandic State Financial Investments (the ISFI) 13 %. Kaupskil has a call option to buy the government's stake at a later point.

⁽³⁷⁾ Monetary figures are referred to in this section first in the currency in which the capital was provided, followed by a reference in brackets to the corresponding amount in ISK or euros (as appropriate) where it has been provided by the Icelandic authorities.

up to 75 billion ISK in total as Tier I risk capital to the new bank in return for its entire equity. The former figure corresponds to the minimum capital required under Icelandic law for the foundation of a bank. The latter figure was calculated as 10 % of an initial assessment of the likely size of the bank's total risk weighted assets. Appropriation to this amount was formally included in the state budget for the year 2009 as an allocation of government funds to address the extraordinary circumstances in financial markets. This allocation of capital was intended to provide an adequate guarantee for the operability of the bank until issues relating to its definite re-capitalisation could be resolved, including the size of its opening balances and a valuation of compensation payable to the old bank for assets transferred.

3.4.1.2. Capital injection and retention of a 13 % stake as a part of the settlement with the creditors of the old bank

- (82) On 20 July 2009 the Icelandic Government announced that it had reached heads of agreement with the Resolution Committee of Kaupthing in respect of the initial capitalisation of New Kaupthing Bank (renamed Arion Bank as from 21 November 2009) and the basis for the compensation payable between the two parties. The Government conditionally agreed with the Resolution Committee of Kaupthing that the creditors should, through the Committee, be granted the option of acquiring majority shareholding in Arion Bank in order to facilitate the bank's independent development. This would in effect involve the old bank providing the majority of the capital in Arion Bank, as a part of the compensation agreement. In the event that Kaupthing Bank would not complete the subscription for shares in Arion Bank, the Government would retain full ownership.
- (83) On 14 August 2009 the Government announced that it had committed to capitalise Arion Bank with 72 billion ISK of Tier I capital in the form of government bonds, giving the bank a Core Tier I ratio of approximately 12 %. The Government capitalisation of Arion Bank was executed on 9 October 2009, involving an injection of 71 225 million ISK into the bank, back-dated to 22 October 2008, in addition to the initial 775 million ISK in cash. Total Government share capital was therefore 72 billion ISK. In addition, the accrued interest on the government bond amounted to 9,2 billion ISK.
- (84) On 4 September 2009 the Government announced that definitive agreements had been reached regarding the capitalisation of Arion Bank and the basis for compensation. In line with the heads of agreement of 20 July 2009, the agreement principally contained provisions for two alternative agreements: capitalisation under old bank (creditor) ownership (Joint Capitalisation Agreement) or capitalisation under Government ownership (Alternative Capitalisation Agreement) ⁽³⁸⁾. Under the former agreement, the creditors of Kaupthing had an opportunity to acquire (through the Resolution Committee) control of Arion Bank by subscribing to new share capital. As the value of the liabilities transferred to Arion Bank exceeded the value of the assets transferred, Kaupthing was to pay for the new share capital from the old bank's own assets. The amount of that compensation was calculated at 38 billion ISK, but was to be re-evaluated on a regular basis, based upon future performance of a certain loan portfolio. The Government would hold minority ordinary share capital, amounting to 13 % of Arion Bank. In order to comply with the supervisory sign-off requirement of the FME for an additional 4 % of Tier II capital, the Government would also contribute to the capital of Arion Bank in the form of a subordinated loan amounting to 24 billion ISK.
- (85) On 1 December 2009 an agreement was reached between the Government and Arion Bank, on the one hand, and Kaupthing's Resolution Committee, on the other, on settlements concerning assets and liabilities transferred from Kaupthing to the new bank. On the same day the Resolution Committee of Kaupthing decided to exercise the option provided for in the Joint Capitalisation Agreement to take over 87 % of the share capital in Arion Bank. The Government would retain the remaining 13 % of Tier I capital.

⁽³⁸⁾ Under the Government ownership agreement — which did not materialise — the Government would continue to fully own the bank, in the event that Kaupthing's Resolution Committee decided not to acquire control of Arion Bank. The compensation would also in this case come from Kaupthing to Arion Bank and in the same form as under the Joint Capitalisation Agreement, i.e. a compensation instrument calculated at 38 billion ISK. Kaupthing would also be granted an option to acquire the Government's shareholding exercisable between 2011 and 2015, at a price which provided the Government with an appropriate level of return on its investment.

- (86) Kaupthing paid for the acquisition by transferring assets from its estate valued at 66 billion ISK to Arion Bank. For this purpose Kaupthing used a combination of cash, Icelandic related corporate loans and a portfolio of mortgages and loans to Icelandic Government related entities. The Government capitalisation from 9 October 2009 was subsequently reversed and Arion Bank returned 32,6 billion ISK in government bonds to the Government and issued a subordinated bond in favour of the Government to the sum of 29,5 billion ISK.
- (87) Complexities arose in respect of the 12 % Tier I and 4 % additional Tier II capital adequacy requirement as the transfer of non-risk free assets to Arion Bank implied an increase in the Bank's risk-weighted asset base. Since Arion Bank was re-capitalised by a transaction that involved a significant increase in risk-weighted assets, more capital was needed under the Joint Capitalisation Agreement than under the Government capitalisation, which was financed exclusively by government bonds. A greater portion of the funds returned to the Government had to take the form of a Tier II obligation than would otherwise have been the case. For the same reason, Kaupthing paid 66 billion ISK for 87 % of the shares instead of the 62,6 billion ISK that was originally envisaged (i.e. 87 % of 72 billion ISK). The Government paid 12,2 billion ISK for its 13 % share in Arion.

3.4.2. Tier II capital contribution

- (88) The state also provided the new bank with two subordinated loans in order to strengthen its equity and liquidity position. Instrument A, denominated in foreign currency, corresponded at the time to an amount of 29,5 billion ISK. The loan was in the form of a capital instrument providing for Arion Bank to issue unsecured subordinated notes. Instrument B was in the amount of 6,5 billion ISK, and was used by Arion Bank for payment to the State of retained earnings (dividends) over the period until the Joint Capitalisation Agreement took effect. The Tier II instruments provided by the Government were based on a need to ensure a strong capital structure and were in accordance with the requirements of the FME.
- (89) The term of instrument A is 10 years as of 30 December 2009. It has built-in incentives for exit in the form of a step-up of interest in five years. The interest rate per annum for the first five years is 400 basis points above EURIBOR, but in the period from five to 10 years the interest rate is 500 basis points above EURIBOR. The terms of instrument B are the same, except that for the first three years, the interest rate is 300 basis points above EURIBOR.

3.4.3. Deposit guarantee

- (90) In order to comply with Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes ⁽³⁹⁾ and Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit guarantee schemes ⁽⁴⁰⁾, Iceland adopted Act No 98/1999 on deposit guarantees and investor-compensation scheme and thereby set up the so-called Depositors' and Investors' Guarantee Fund ('TIF'), which has been funded by annual contributions from the banks, calculated in relation to the total deposits of that bank.
- (91) According to the Icelandic authorities, and so as to provide further assurance and comfort to the general public on the safety of their deposits when the crisis struck, the bank rescue measures of the Icelandic Government of autumn 2008 also entailed an additional state backing of deposits in domestic commercial and savings banks, outside the scope of Act No 98/1999 implementing the deposit guarantee Directive 94/19/EC and the investor-compensation Directive 97/9/EC.
- (92) An announcement from the Prime Minister's Office of 6 October 2008 stated that the 'Government of Iceland underlines that deposits in domestic commercial and savings banks and their branches in Iceland will be fully covered'. This announcement has since been repeated by the Office of the current Prime Minister in February and

⁽³⁹⁾ OJL 84, 26.3.1997, p. 22.

⁽⁴⁰⁾ OJL 135, 31.5.1994, p. 5.

December 2009. Moreover, reference was made to it in a letter of intent sent by the Icelandic Government to the International Monetary Fund (and published on the website of the Ministry of Economic Affairs and of the IMF) on 7 April 2010 (and repeated in a further letter of intent dated 13 September 2010). The letter (which was signed by the Icelandic Prime Minister, Minister of Finance, Minister of Economic Affairs and Governor of the CBI) states that 'At the present time, we remain committed to protect depositors in full, but when financial stability is secured we will plan for the gradual lifting of this blanket guarantee.' Furthermore, in the section of the bill for the Budget Act 2011 concerning state guarantees, reference is made in a footnote to the Icelandic Government's declaration that deposits in Icelandic banks enjoy a state guarantee ⁽⁴¹⁾.

- (93) A recent statement of the current Minister of Economic Affairs and former Minister of Finance (2009-2011), Steingrímur Sigfússon in a debate in the Icelandic Parliament regarding the Government's cost related to Landsbankinn's taking over the savings bank SpKef, illustrates the above further. According to the Minister, one must keep in mind regarding this matter the State's declaration in the autumn of 2008 that all deposits in savings banks and commercial banks would be safe and protected. 'Work has since in all instances been based on this (i.e. the declaration) and it is unfortunately correct that this (i.e. payments due to SpKef) will be one of the bigger bills footed directly by the state as costs for securing the deposits of all inhabitants of Suðurnes ... and all SpKef's clients in the West Fjords and the West and North-West area ... I do not expect that anyone has thought that deposit holders in those areas would be treated differently from other inhabitants, so the state did not have much of a choice in this matter' ⁽⁴²⁾.
- (94) According to the Icelandic Government, the additional deposit guarantee will be lifted before the capital controls are fully abolished, which according to the Icelandic authorities is currently foreseen for the end of 2013.

3.4.4. *Special Liquidity Facility*

- (95) The government financing of Arion Bank was carried out by means of an infusion of 72 billion ISK in repo-able government bonds in return for the bank's entire equity. Kaupthing Bank's decision to exercise its option to acquire 87 % of shares in the Bank, however, meant that the majority of these bonds were returned to the Government. Kaupthing Bank transferred assets from its estate to Arion Bank in return for the equity, significantly reducing the bank's holding of repo-able assets and threatening its capability to comply with supervisory requirements regarding liquidity reserves. In view of this and in the context of Kaupthing exercising the option referred to above, the Government agreed to provide an additional liquidity facility for Arion Bank. The liquidity facility was formulated as an extension to the SPRON swap arrangement described below.

3.4.5. *The SPRON swap agreement*

- (96) On 21 March 2009, using its powers under the Emergency Act, the FME took control of Reykjavík Savings Bank (SPRON) and transferred most of its deposits to Arion Bank. A limited liability company to be owned by SPRON was established to take over SPRON's assets and also all collateral rights, including all mortgages, guarantees and

⁽⁴¹⁾ See the relevant section of the bill for the Budget Act 2011 available at: http://hamar.stjr.is/Fjarlagavefur-Hluti-II/Greinargerdir/Raedur/Fjarlagafurvarp/2011/Seinni_hluti/Kafli_8.htm

⁽⁴²⁾ Unofficial translation by the Authority of a statement reported in Morgunblaðið (www.mbl.is) on 10 June 2012.

other similar rights connected to SPRON's claims. The subsidiary, named Drómi hf, took over SPRON's obligations to Arion Bank for the deposits transferred and issued a bond to Arion Bank on 22 June 2009 for the amount of 96,7 billion ISK. All assets of SPRON were committed as collateral for the bond, including its shares in Drómi. However, the parties have so far been unable to reach an agreement on the interest to be paid on the bond ⁽⁴³⁾.

- (97) In heads of terms signed on 17 July 2009 the Government agreed to hold Arion Bank harmless with respect to the value of the SPRON bond. The parties further agreed to work towards the SPRON bond being made eligible as collateral for funding from the CBI.
- (98) In a letter to Arion Bank on 3 September 2009, the Government extended the terms of the SPRON swap arrangement to cover not only potential outflow of the SPRON deposits, indemnifying the bank for taking over of the deposits, but also the liquidity required in order to comply with the FME's conditions. In the letter, the Government pledged to provide up to 75 billion ISK in government bonds if Kaupthing decided to exercise its option to become the majority owner of Arion bank. The amended facility envisages that other assets than the SPRON bond can serve as collateral on less favourable terms. This commitment by the Government was later formalised in an agreement dated 21 September 2010 on the loan of government bonds to Arion Bank to be used as collateral ⁽⁴⁴⁾. This facility terminates on 31 December 2014, which coincides with the maturity of the SPRON bond. The amount of each drawdown on the facility shall be a minimum of one billion ISK. The government bonds shall only be used to secure loans against collateral from the CBI for the purpose of acquiring liquidity for Arion Bank ⁽⁴⁵⁾.

3.5. The restructuring plan

- (99) The Icelandic authorities submitted a restructuring plan for Arion Bank on 31 March 2011 and an amendment of that plan on 26 October 2011. An updated restructuring plan was submitted on 30 April 2012 together with a 5 year business plan and an Internal Capital Adequacy Assessment Process (ICAAP) report dated April 2012. The ICAAP report was submitted to the FME in April 2012.

⁽⁴³⁾ The disagreement between the parties regarding the interest rate on the bond was initially referred to the FME. The FME decided on 5 June 2009 that under the circumstances a rate of REIBOR + 1,75 % was an appropriate rate. In its decision, the FME declared that it would review its decision every six months at the request of the parties. However, the dispute was later brought to court and is unsettled at the time of writing. According to Arion Bank's annual report 2011, Drómi requested, in a letter dated 2 December 2009, that the FME review its former interest rate decision. On 4 February 2011 the FME decided that the debt should bear annual interest rate which should be the original given interest rate plus the original given interest premium from the takeover date until 30 June 2010, but without an interest premium from that time until the debt has been paid in full. The Arion Bank has brought legal action against the FME and Drómi in an attempt to annul the FME's decision of 4 February 2011. On 4 May 2011, Drómi brought legal action against the FME and Arion Bank, demanding principally the annulment of all decisions by the FME on interest rates and secondly demanding a different interest rate from the outset.

⁽⁴⁴⁾ The Ministry of Finance agreed to lend to Arion Bank government bonds eligible for obtaining liquidity facilities through repo transactions with the CBI, in accordance with the CBI's existing rules. The market value of the government bonds is a maximum of 75 billion ISK.

⁽⁴⁵⁾ Arion Bank is not permitted to sell the bonds or use them for any other purpose than that stated in the agreement. If Arion Bank uses the SPRON bond as counter-collateral to secure its loan of government bonds, Arion pays no fee for draw-down up to 25 billion ISK, but for the remainder of the facility, it shall pay a consideration of 1,75 % for permission to pledge the government bonds. However, Arion pays no consideration if it can clearly demonstrate that more than 25 billion ISK of the loan relates to withdrawals of SPRON deposits. If Arion uses assets other than the SPRON bond as counter-collateral to secure its loan, the consideration rises to 3 % of the loan amount which was granted in relation to that collateral only. In such cases, Arion shall furthermore pay a special fee amounting to 0,5 % of the loan amount on each occasion government bonds are utilised.

- (100) The restructuring plan addresses the substantive issues of viability, burden-sharing and limitation of distortions of competition. According to the restructuring plan, Arion Bank has solely operations in Iceland and aims to focus on traditional universal banking services.

3.5.1. Description of the restructuring plan

- (101) The Icelandic authorities and the Bank consider that the restructuring of Arion Bank will ensure its return to being a solid, well-funded bank with sound capital ratios so that it can maintain its role as a supplier of credit to the real economy. Based on the information in the restructuring plan and the answers to questions from the Authority, this will be achieved through the following steps:
- (i) Setting the long-term strategic direction, scaling down the operations and limiting risk exposure
 - (ii) Achieving and maintaining a strong capital position and satisfactory profitability
 - (iii) Maintaining a solid liquidity position and improving the funding structure
 - (iv) Restructuring of household and corporate loan portfolios
 - (v) Limiting foreign exchange imbalances
 - (vi) Rationalising the branch network and achieving cost efficiency
- (102) Before describing the restructuring plan in more detail, it is appropriate to set out briefly the Bank's view on how the flaws that contributed to Kaupthing's demise are being addressed in the restructuring plan for Arion Bank. In this regard, it has been underlined that while Arion Bank's operations are based on the domestic operations and assets of Kaupthing Bank, it is nevertheless a new bank, with different commercial objectives and ownership, board of directors and management different from that of Kaupthing. The current management of Arion Bank has in fact stated that it considers itself not to be in a position to speculate on the specific weaknesses or the collapse of Kaupthing. Otherwise, Arion Bank refers firstly to the SIC report discussed above regarding the causes for the collapse of Kaupthing Bank. Secondly, it is pointed out that following the collapse of Kaupthing, actions has been taken to strengthen the infrastructure after an assessment of risk management and governance made by the FME.
- (103) According to Arion Bank, two projects are particularly relevant regarding actions taken at the Bank in response to the above assessment. Firstly, regarding large and connected exposures. It has been alleged that Kaupthing held a 'legalistic' view of the treatment of connected exposures, allowing it to engage in lending to connected or related parties in excess of the legal limit of 25 % of risk capital. Through this project Arion Bank has extended its definitions of connected parties, and applies stricter processes in this regard, where Arion Bank's Risk Management has the ultimate authority if disputes arise. Large exposures are rigorously monitored and reported and as part of the credit granting process, a special report is given when the granting of credit would result in a large exposure. Changes to Icelandic legislation on financial institutions made following the crisis have significantly curtailed the ability of banks to lend to related parties. Lending to owners or key employees can no longer exceed 1 % of risk capital and can only be made against quality collateral.
- (104) Secondly, more scrutiny is applied to cross-ownership and indirect exposures. Kaupthing Bank allegedly engaged in lending against its own shares which was certainly risky and possibly beyond the limits set by the Icelandic companies act. Changes to Icelandic legislation now make it impossible to engage in any lending against own shares or to engage in contracts where own shares are the underlying risk.

Assumptions of the restructuring plan

(105) The restructuring plan is prepared for the parent company as a part of the ICAAP process and also takes into account the effects of the subsidiaries. It is based on a set of general and economic assumptions, constituting the economic underpinning of the base case and stress case scenarios set out below.

(106) The assumptions include the following:

- Economic, legal, political and regulatory uncertainties are still considerable in the Bank's operating environment and do affect its long-term forecast. For these reasons, no major changes are assumed in the Bank's operating activities.
- Macroeconomic assumptions are based on a forecast prepared by Arion Bank's Research division, which includes the following key variables:

Table 3

From Arion Bank Research Division economic forecast

Percentage change from previous year	2012	2013	2014
GDP growth	3,0	3,9	3,5
Unemployment	6,2	5,3	4,9
Inflation	5,5	6,1	5,9
Reibor (*)	4,9	5,8	5,6
Libor	0,5	0,5	0,5
Euribor	1,0	1,0	1,0
Wages	9,2	9,7	8,4
ISK exchange rate index (TWI) (**)	4,9	5,0	5,0

(*) REIBOR (Reykjavik interbank offered rate) is the interbank rate used by commercial and savings banks in Iceland and is applied to short term loans.

(**) Trade-weighted exchange rate index of the Icelandic króna.

- The Bank also makes assumptions in relation to for instance its market position, opportunities and threats, internal data and market development, including so-called key beliefs ⁽⁴⁶⁾.
- On-going growth is expected, driven mainly by consumption ⁽⁴⁷⁾.
- Consumption will continue to be driven by special measures (pension withdrawals and recalculations of foreign exchange loans, etc.). In addition, increasing housing prices will contribute to household wealth. A decrease in unemployment will also help to boost consumption.
- During the financial crisis since 2008, investment as a percentage of GDP has been below past 50 years' minimum, but is expected to gradually pick up for the remainder of the restructuring period.
- In line with the forecast increase in investment activity, the Bank expects demand for new loans to increase and its loan book to grow in the restructuring period.
- Imports will increase more than exports but will reach a balanced level at the end of the forecast period.
- Inflation and interest rates play a key role in the Bank's business and restructuring plan ⁽⁴⁸⁾. It is assumed that inflation will remain high throughout the forecast period.
- A 5 % weakening of the króna is expected, on average, throughout the forecast.
- Arion Bank expresses doubts about the strategy related to the lifting of the capital controls and assumes that they will remain in place during the forecast period ⁽⁴⁹⁾.

(i) Setting the long-term strategic direction, scaling down the operations and limiting risk exposure

- (107) With a swift transformation from a Northern European bank with operations in 13 countries to a bank that has solely operation in Iceland, Arion Bank was faced with countless challenges, both internal and external, that needed to be addressed and overcome. The revaluation of transferred assets from Kaupthing to Arion Bank was

⁽⁴⁶⁾ Among the Bank's key beliefs is that [...].

⁽⁴⁷⁾ Despite various difficult issues remaining unresolved, the Icelandic economy has, according to Arion Bank, shown clear signs of recovery in the past year, with the economy growing for the first time since the start of the financial crisis and the unemployment rate dropping.

⁽⁴⁸⁾ The Bank notes that in 2011 the depreciation of the ISK, high global commodities prices in the first half of the year and contractual wage increases all contributed to an annual rate of inflation of 5,3 % at the end of the year. The inflation outlook for the next few years is not promising and inflation is likely to exceed the CBI's target of 2,5 %. In response to increasing economic activity and the deteriorating inflation outlook the CBI raised interest rates twice during 2011 by a total of 50 basis points and by a total of 75 basis points in the first half of 2012. The business plan assumes this development to continue in 2012-2014.

⁽⁴⁹⁾ In this regard, Arion Bank states that although there are signs of a recovery in the Icelandic economy, there are a number of problems still to be resolved; one of the problems being the lifting of the capital controls. The lifting of capital controls has progressed slowly although the CBI announced a liberalization schedule in March 2011 which listed a number of measures aimed at lifting controls over the next four years. However, later in the year the Icelandic parliament decided merely to extend the laws on foreign currency (and thus the capital controls) until 2013. The CBI has therefore been given little room for manoeuvre by the parliament if the controls are to be lifted over the next two years. As a matter of fact, the capital controls were tightened in March 2012, with amendments to the Foreign Exchange Act. The strategy related to the lifting of the capital control is not clear and therefore it is assumed that the capital controls will remain in place during the forecast period.

one of them. Additionally the Bank's infrastructure had to be scaled down, and the Bank had to adjust to the new economic reality where many corporations, individuals and households found themselves with a severely diminished ability to service their debt.

(108) Many of the numerous challenges faced by the new bank were thus directly related to the circumstances surrounding its establishment. The transfer of domestic assets and liabilities from the estate of Kaupthing to Arion Bank created some unfavourable risk exposures for the Bank. However, in the broad efforts made to aligning the Bank's operations to a new economic reality, considerable success has been achieved in bringing the Bank's risk exposure down to a controllable level. The focus has been on:

— Debt recovery of distressed loans ⁽⁵⁰⁾.

— Reducing the currency imbalance ⁽⁵¹⁾.

— Reducing the credit concentration towards large and connected clients ⁽⁵²⁾.

— Increasing the capital level ⁽⁵³⁾.

— Increasing term deposits and securing alternative funding sources ⁽⁵⁴⁾.

— Reducing the inflation risk due to the Consumer Price Index (CPI) imbalance ⁽⁵⁵⁾.

(109) During 2010, the long-term strategic direction for the Bank was set. According to Arion Bank, its customer portfolio is already leaning towards its goal of becoming a relationship bank and it is believed that this kind of banking model can be fully achieved.

(110) The organizational structure of the Bank has been simplified since its establishment ⁽⁵⁶⁾ and corporate governance standards have been introduced, ensuring disclosure and transparency and increased accountability. The role and functions of support divisions, in particular the Risk Management division, have been enhanced. The division is independent and centralised and reports directly to the CEO. The CEO and the Board of Directors are responsible for defining and articulating a risk appetite for the Bank's operations. Risk appetite is translated into exposure limits and targets that are monitored by Risk Management, which reports its findings regularly to the CEO and the Board of Directors.

(111) The FME chose Arion Bank to take over all of the deposit obligations of Reykjavík Savings Bank (SPRON). In April 2009, the Bank acquired the regional Mýrasýsla Savings Bank (SPM), including all its assets and certain

⁽⁵⁰⁾ Efforts regarding the restructuring of the loan book have resulted in a reduction of the non-performing ratio from 37 % at the end of 2010 to 13 % at the end of 2011. This progress made in the resolution of distressed borrowers, decreases substantially the uncertainty linked to the assessment of the loan book's carrying value.

⁽⁵¹⁾ The currency imbalance has decreased from 300 % of the Bank's capital base at the end of 2008, to 30 % of the capital base at the end of 2011.

⁽⁵²⁾ The Bank had [...] groups exceeding 10 % of capital base end of year 2009. These groups summed up to 175 % of the capital base. At the end of year 2011 the Bank had [...] groups exceeding 10 % of the capital base totalling 87 % of capital base.

⁽⁵³⁾ The total capital base has increased by 20,7 billion ISK from 2009 to 2011.

⁽⁵⁴⁾ Term deposits have increased from 10 % to 23 % from the end of year 2009 to end of year 2011.

⁽⁵⁵⁾ The CPI balance has been reverted from minus 17 % of the Bank's capital base at the end of 2009 to plus 9 % of capital base at the end of 2011.

⁽⁵⁶⁾ After the intervention of the FME in October 2008, structural changes were made. Internal audit and Compliance were strengthened and Private Banking was merged with Asset Management and Treasury with Capital Markets. Following the new strategic direction and with new management joining the Bank in the fall of 2011 further substantial changes were made to the organizational structure to ensure that it better reflects and supports the Bank's new strategy, simplifies operations and increase synergies between divisions.

liabilities such as deposits ⁽⁵⁷⁾. These actions brought 22 000 new customers to the Bank without expanding its existing branch network.

(112) On 22 December 2011 Arion Bank acquired the former Kaupthing Mortgages Institutional Investor Fund, KMIIF (now named Arion Bank Mortgages Institutional Investor Fund, AMIIF) ⁽⁵⁸⁾.

(113) In 2012, the securities custodian Verdis, a fully owned subsidiary of the Bank, will be merged with the Bank. [...].

(ii) Achieving and maintaining a strong capital position and satisfactory profitability

(114) As can be seen in Table 4, Arion Bank has been profitable since establishment, with return on equity (ROE) ranging between 10,5 and 16,7 %.

Table 4

Financial overview 2009-2011 and forecast 2012-2014

(The data is for the parent company. Effects of subsidiaries are taken through other income. Amounts in million ISK)

	2009	2010	2011	2012	2013	2014
Net interest income	14 258	24 440	25 480	[...]	[...]	[...]
Valuation change in loans	9 642	29 722	20 037	[...]	[...]	[...]
Commission income	3 914	3 379	4 454	[...]	[...]	[...]
Net financial income	13 460	- 5 681	1 223	[...]	[...]	[...]
Other income	1 713	1 047	4 364	[...]	[...]	[...]
Total income	42 988	52 908	55 559	[...]	[...]	[...]
Operating expenses	- 13 133	- 14 226	- 15 791	[...]	[...]	[...]

⁽⁵⁷⁾ SPM had been experiencing financial distress for several months, seeking composition agreements with its creditors under the bankruptcy law, as its CAD ratio was below legal requirements. These efforts failed, however, and on 3 April 2009, an agreement was concluded between SPM and New Kaupthing, according to which New Kaupthing bought all assets of SPM, including the branch in Borgarnes, Iceland, as well as SPM's subsidiaries, including two savings banks in Northern Iceland, Afl Savings Bank and Ólafsfjörður Savings Bank (SPÓL). At the same time, New Kaupthing took over certain liabilities of SPM, including deposits and borrowings, as set out in the agreement. On the same day the FME took a decision on the disposal of assets and liabilities of SPM. The FME decision does not indicate any government intervention in the form of capital injection, commitments or declarations provided. It has furthermore been confirmed to the Authority by the Bank and the Icelandic authorities that no financial commitments were made by the state in this context. See the FME's decision of 3 April 2009, available at <http://www.fme.is/media/akvardanir/3.-april-2009.pdf>

⁽⁵⁸⁾ The background to this transaction is that Kaupthing issued four series of covered bonds in 2006-2008, guaranteed by the Kaupthing's subsidiary KMIIF. Through KMIIF, Kaupthing owned a portfolio of Icelandic residential mortgages in excess of 120 billion ISK. The purpose of the covered bond was to fund a large part of Kaupthing's mortgage portfolio. According to the agreement of 22 December 2011, Arion Bank has acquired this mortgage portfolio. The deal was funded mostly by the acquisition of covered bonds in the amount of 117,7 billion ISK, as Arion Bank has assumed Kaupthing's liabilities under the covered bond programme. In the Arion Bank's opinion, the acquisition of AMIIF can neither be categorised as a 'normal' acquisition nor as an acquisition related to the restructuring work. The acquisition was related to the setup of the Bank where AMIIF was not transferred to Arion Bank when it was established. Before the transfer Arion Bank provided services to borrowers without having control over the loans. In addition, the borrowers with mortgages in the fund believed they were customers of Arion Bank. After the transfer the loans are owned by Arion Bank. As stated, the agreement on the above transaction was concluded between Kaupthing and Arion Bank and was without any involvement or commitment made by the Icelandic state.

	2009	2010	2011	2012	2013	2014
Impairment	- 14 470	- 23 067	- 26 582	[...]	[...]	[...]
Net earnings before taxes	15 384	15 614	13 186	[...]	[...]	[...]
Taxes and bank levy	- 2 414	- 2 897	- 2 692	[...]	[...]	[...]
Net earnings	12 971	12 717	10 494	[...]	[...]	[...]
Return on equity (ROE)	16,7 %	13,4 %	10,5 %	[10-20] %	[5-15] %	[5-15] %
Net interest margin	3,6 %	[...] %	[...] %	[...] %
Cost-to-income ratio	44,8 %	[...] %	[...] %	[...] %

- (115) During 2009-2011, irregular items have had a major impact on the profit and loss account, in particular as concerns valuation change in loans. The Icelandic authorities have provided information on the total loans and discounts obtained from the old bank ⁽⁵⁹⁾. The total face value of the loans transferred was 1 230 billion ISK and the book value 459 billion ISK. The total discount was thus approximately ISK 771 billion. When conditions have permitted, the loans have been re-valued, leading to a valuation change in loans, as indicated in Table 4 ⁽⁶⁰⁾. However, for the remainder of the restructuring period, valuation change in loans are forecasted to be unsubstancial. The Bank's profitability will therefore not any longer depend on this irregular item.
- (116) The capital requirements set by the FME as a condition for granting an operating license to Arion Bank was 12 % for the Tier 1 capital and 16 % for the total capital (CAD ratio). The Bank's capital policy is to maintain a strong capital base to support business development and to meet regulatory capital requirements, even in times of stress. Long-term capital planning at the Bank is currently based on a benchmark minimum of [...] % for Tier 1 capital and a total CAD ratio of [...] %. The capital position of the Bank has been strengthening gradually during 2009-2011 and has exceeded both the FME capital requirements and the Bank's internal targets. At the end of 2011, the Bank's CAD ratio was 20,5 %, with a Tier 1 ratio of 15,7 %.

Table 5

Capital ratios year-end 2009-2011 and forecast 2012-2014

(The data is for the parent company. Effects of subsidiaries are taken through other income. Amounts in million ISK)

	2009	2010	2011	2012	2013	2014
Tier 1 capital	88 302	98 715	106 459	[...]	[...]	[...]
Tier 2 capital	29 543	26 257	32 105	[...]	[...]	[...]
Total capital	117 845	124 972	138 564	[...]	[...]	[...]

⁽⁵⁹⁾ These loans are grouped into mortgage loans and other loans from individuals and loans to corporate. The discounts differed depending on the types of loans as well as whether they were denominated in króna or foreign currency.

⁽⁶⁰⁾ The increase in valuation of loans was, however, bigger in 2009-2011 than indicated in Table 4, as part of it was allocated to the compensation instrument, a total of 38 billion ISK. The compensation instrument was closed in the first quarter of 2011, as the valuation gap between assets and liabilities transferred from Kaupthing to Arion Bank was paid up in full.

	2009	2010	2011	2012	2013	2014
Risk-weighted assets	685 702	678 563	675 998	[...]	[...]	[...]
Tier 1 ratio	12,9 %	14,5 %	15,7 %	[15-20] %	[15-20] %	[15-20] %
CAD ratio	17,2 %	18,4 %	20,5 %	[20-25] %	[20-25] %	[20-25] %

- (117) The Bank's assessment, according to the ICAAP report of April 2012, is that a capital of [...] billion ISK is needed to cover its risk exposure. The Bank has a capital base of [...] billion ISK and thus holds a capital buffer of [...] billion ISK. Based on the current Risk Weighted Amount this translates to a capital ratio of [...] %.
- (118) It has been the policy of Arion Bank to refrain from paying dividends until 2013. This policy will only be altered in cooperation with the FME and only if Arion Bank and the FME jointly determine that a sustainable turnaround of the Icelandic economy has been achieved.

(iii) Maintaining a solid liquidity position and improving the funding structure

- (119) Regarding liquidity, the FME requires that the bank must hold secured liquidity reserves of at least 20 % of deposits and cash reserves of 5 % of on-demand deposits. In addition, the Central Bank of Iceland sets rules on credit institutions' liquidity ⁽⁶¹⁾ according to which credit institutions' liquid assets and liabilities are classified by type and maturity and assigned weights according to risk. Credit institutions must have liquid assets in excess of liabilities within one month and after one month and up to three months. The rules also entail a certain stress test where a discount is applied to various equity items, but where it is assumed, on the one hand, that all obligations must be paid upon maturity, and on the other, that a portions of other obligations, such as deposits, must be paid at short notice or none at all.
- (120) The Bank's liquidity ratios during 2011-2012 are set out in the graph below. It is apparent that the Bank has maintained a solid liquidity position, surpassing the requirements of the FME both with respect to the cash ratio requirement and the broader requirement of secured liquidity. According to the Bank's plans for 2012-2014, it will maintain a cash ratio between [...] — [...] % and a liquidity ratio of [...] — [...] %. The Bank has also complied with the CBI liquidity rules as its liquidity ratios (more than 1 and up to 3 months) at year end 2009-2011 have been in the range of 1,5-2,1.

Chart 1

Arion Bank's liquidity ratios 2011-2012

[Graph on Arion Bank's liquidity ratios under FME rules

Values not disclosed for reasons of professional secrecy]

- (121) While the Basel III liquidity requirements are not yet mandatory, Arion Bank has begun voluntary monitoring of the Liquidity Coverage Ratio (LCR) ⁽⁶²⁾ according to those rules, and at year end 2011 its LCR was [...] %.
- (122) Arion Bank is to a large degree deposit-funded, but steps have been taken to diversify the funding by issuing covered bonds. In November 2011, Arion Bank was granted a license by the FME to issue statutory covered bonds. In February 2012, a EUR 1 billion covered bond program was completed. The funds will be used to finance Arion Bank's mortgage lending. It is recalled that at the end of 2011, Arion Bank bought the KMIIF mortgage fund, taking over the outstanding amount 127 billion ISK in covered bonds and continued as the issuer of covered bonds. The Bank deems that issuance of covered bonds in the domestic markets will meet the refinancing needs of the Bank and funding of new loans in the period 2012-2016.

⁽⁶¹⁾ See the CBI's Rules on Liquidity Ratios No 317 of 25 April 2006, available at <http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=4713>

⁽⁶²⁾ The LCR requires banks to maintain a stock of high quality liquid assets that is sufficient to cover net cash outflows for a 30-day period under a stress scenario. The LCR benchmark is thus 100 %.

(iv) Restructuring of household and corporate loan portfolios

- (123) One of the most important tasks facing the Icelandic financial sector was the restructuring of household and corporate debt. This is a complex and sensitive issue with a number of financial, economic and ethical considerations.
- (124) According to Arion Bank's submission, restructuring of the loan book has been a high priority and the Bank considers that it has been at the forefront in resolving corporate and household's debt issues and achieved good progress in that regard. A corporate recovery unit was set up at the Bank in 2009 and asset management companies were established for the management of foreclosed assets. The Bank has introduced a range of customized solutions designed to help households and individual borrowers tackle their debts.
- (125) Corporate clients who have been unable to meet their obligations have entered the Bank's debt recovery process. The objective is to turn insolvent companies into solvent companies with a healthy balance sheet, thus enabling them to take on future business and contribute to the development of the economy. At the end of 2011, 986 companies had entered the Bank's corporate recovery programs, and conclusion was reached in 871 instances. In the Bank's view, the corporate debt restructuring is expected to be largely completed by the end of 2012.
- (126) As for the restructuring of household debt, more than 14 000 personal customers have taken advantage of the Bank's debt solution packages, including the special debt relief programme. At the end of 2010, the Bank has also set up a dedicated debt advisory service for personal customers. In the Bank's view, this arrangement was important, given the high number of difficult debt recovery cases to be dealt with. The Bank aims to complete its household debt restructuring in 2012.
- (127) The goal of the debt recovery programs is to improve asset quality. The share of non-performing loans has fallen from 37 % at the end of 2010 to 13 % at the end of 2011. At the end of 2011, 56 % of the loans in the loan book were categorised as performing, 18 % were 'on watch', 13 % sub-performing and 13 % non-performing.

(v) Measures to limit foreign exchange imbalances

- (128) Foreign exchange (FX) loans in the loan portfolio are divided into FX/FX loans and FX/ISK loans. FX/FX loans are loans where the customers generate FX income but the FX/ISK loans are loans in FX where the customers generate ISK income. The Bank's FX imbalance is mainly due to the FX/ISK part. During 2010 and 2011 the Bank has made progress toward lowering its FX imbalance. The imbalance will continue to decrease during 2012 with redenomination of foreign currency loans to individuals into ISK as well as actions taken to encourage companies with limited foreign currency income to re-denominate their loans into ISK. There is still a legal uncertainty regarding the FX loans, but the Bank aims to reduce the FX/ISK imbalance so that by the end of 2012 the imbalance will be within CBI requirements.

(vi) Rationalization of the branch network and achieving cost efficiency

- (129) In Arion Bank's view, the Icelandic market is 'over banked' in comparison with comparable economies. Banks will be forced to reduce cost to remain competitive. Arion Bank has focused on controlling its cost levels and considers that it has been at the forefront of the much needed rationalization within the financial sector.
- (130) Arion Bank has streamlined the business by reducing the number of employees and rationalising the branch network. In March 2011 the rationalisation of the branch network was completed when three branches in the Reykjavík area were merged into one. A total of 15 branches have been closed and the remaining network of

24 branches is, according to the Bank, cost efficient while maintaining a high level of attention to customer needs. In relation to the above changes the Bank has reduced its workforce by approximately 10 % during 2011. Cost levels have been kept under firm control and the cost-to-income ratio is already down to 45 % at parent company level in 2011 and will be improved slightly further in 2012-2014, down to [...] %.

3.5.2. Ability to reach viability under a base and stress scenario

- (131) In the restructuring plan, with reference made to the ICAAP report, a stress scenario has been submitted for Arion Bank examining the Bank's ability to achieve long-term viability under different scenarios and risk exposures.

3.5.2.1. The base scenario

- (132) The restructuring plan as described above including the assumptions on which it is based constitutes the base case.

3.5.2.2. The stress case scenario

- (133) The restructuring plan includes a stress case scenario where the base case is run under the 'Prolonged Deep Recession' (PDR) assumptions, which are based on guidelines from FME. The objective of the stress test is to examine how earnings, credit losses, capital requirements, available capital/capital buffers and liquidity positions of the Bank would evolve under stressed economic conditions. The difference is that assumptions in the PDR scenario for 2009 are now assumptions for the year 2012 and so on. The assumptions are summarised in Table 6 below.

Table 6

Main assumptions in Prolonged Deep Recession scenario (*)

	2012	2013	2014
GDP growth	- 16,0	- 3,9	- 2,8
Unemployment rate	10,6	16,6	16,9
Inflation	9,7	0,1	0,3
REIBOR	10,0	7,0	8,0

(*) This scenario is also based on further adverse assumptions. Housing prices are presumed to fall by 10 % in 2012, 18 % in 2013 and 16 % in 2014. An outflow of retail deposit of 30 % is assumed in 2012, 20 % of corporate deposits and 80 % of deposit from credit institutions. Commission income is assumed to be reduced by 50 % from the base case in 2012-2014. Lending impairment rate is assumed to be reduced by 1-3 % and lending spread by 0,5-1 %, but deposit spread will increase by 0,5-1 %. Operating expenditure is assumed to be 10 % higher than in the base case. The exchange rate of the króna is assumed to depreciate, with an increase of the trade-weighted index (TWI) of 4 % in 2013 and 11 % in 2014.

- (134) The stress scenario is designed against the background of unlikely but potentially plausible changes in the economic environment in which the Bank operates. The Bank's profitability is certainly adversely affected by the severe conditions of the prolonged deep recession scenario, as its return on equity will be significantly reduced ⁽⁶³⁾. It will nevertheless make small profits and as the Bank's loan book and risk-weighted assets will shrink at the same time, its capital position will not be adversely affected ⁽⁶⁴⁾. The Bank's liquidity position would also remain well above the minimum requirements.

- (135) The ICAAP report is based on financial figures from 31 December 2011. Its main result is that it is the Bank's assessment that a capital of [...] billion ISK is needed to cover the Bank's risk exposure, based on Pillar I and II.

⁽⁶³⁾ ROE would drop down to [0-5] % in 2012, [0-5] % in 2013 and [5-10] % in 2014.

⁽⁶⁴⁾ The Bank's CAD-ratio will be [20-25] % in 2012, [20-25] % in 2013 and [25-30] % in 2014.

16 % of risk-weighted assets (RWA) amounts to [...] billion ISK. The Bank has a capital base of [...] billion ISK and therefore holds a capital buffer of [...] billion ISK. The capital assessment takes into consideration stress related factors, including the impact on the Bank's loan book. According to the ICAAP report, the Bank's Risk Management focuses on identifying, assessing and measuring all material risks faced by the Bank, where the risks are grouped into four classes: credit risk (including concentration risk), market risk, operational risk and other risks (including liquidity risk, business risk and political and legal risk). Table 7 displays the various risk factors taken into account in the capital assessment.

Table 7

ICAAP results regarding capital assessment, amounts in billion ISK

	ICAAP 31.12.2011
Capital Requirement (Pillar I)	[...]
Single name concentration	[...]
Sector concentration	[...]
Interest rate risk in the banking book	[...]
Foreign exchange risk class C,D,E	[...]
Tax authorities	[...]
Valuation risk — unlisted equities	[...]
Valuation risk — loan book	[...]
Pillar II Capital Assessment	[...]
Total capital adequacy assessment (Pillar I+II)	[...]
16 % of RWA	[...]
Total Capital Base	[...]
Capital Buffer	[...]

- (136) The ICAAP report states that although much progress has been made in curtailing the large imbalance between foreign currency denominated loans to customers and Icelandic currency denominated deposits, work remains in order to eliminate the remaining imbalance in 2012. At the end of 2011, the imbalances still exceeded the legal limit and dispensation from the CBI was necessary. The Bank's strategy for reducing its currency imbalance is on the one hand the systemic ISK redenomination of currency loans to customers who have income in ISK, and on the other hand the hedging of currency imbalances through agreements with the CBI and through currency swaps with Icelandic customers.

(137) Liquidity risk is one of the Bank's most important risk factors. This stems from the fact that the maturity of loans exceeds the maturity of deposits. It is the Bank's strategy to closely monitor its liquidity position and to lengthen the maturity on the liability side, through careful analysis of the stickiness of deposits ⁽⁶⁵⁾ and diversification of its funding. According to the Bank's internal requirements, the secured liquidity ratio should not go under [...] % of deposits and the minimum cash ratio should be [...] % or slightly above the FME requirements, which are 20 % for the secured liquidity ratio and 5 % for the cash ratio. As can be seen on Chart 1 above, the Bank has remained well above the FME and internal benchmarks. Through an analysis of its deposit base, where deposits are rated into seven groups according to stickiness, the Bank has stress tested its liquidity. Assuming that the capital controls would be lifted immediately, the Bank's secured liquidity ratio would [...]. The cash ratio would [...]. However, the Bank has formulated contingency plans to address a potential funding crisis, and would among other things [...].

3.5.3. Exit strategy/repayment of the State

(138) As already described above, the Tier II capital contribution has 10 year duration from 30 December 2009. As for the remuneration, there is a built in step-up clause after 5 years (i.e. 2014), from 400bp to 500bp over EURIBOR. According to the Icelandic authorities, this step-up should act as an incentive for the bank to pay back this capital as from this time.

(139) As for the 13 % equity stake that the State retains in Arion Bank, the Government's holdings in financial undertakings are managed by the Icelandic State Financial Investments (the ISFI) ⁽⁶⁶⁾. According to the State Budget for 2012, the Government has been authorised to sell the stakes that it currently holds in savings banks, but no decision has yet been made regarding sale of state holdings in the three major commercial banks. A working group has however been established by the responsible ministers to explore possible ways of disposing of shareholdings in the commercial banks. The Government has indicated that while it has no intention of reducing its holdings in Landsbankinn below two-thirds of the bank's share capital, the stakes in Arion Bank and Íslandsbanki could soon be offered for sale or sold with the banks in their entirety if their majority owners decide to sell, subject to certain prerequisites being resolved.

(140) The special liquidity facility is only available until 31 December 2014, which coincides with the maturity of the SPRON bond.

4. GROUNDS FOR INITIATING THE FORMAL INVESTIGATION PROCEDURE

(141) In the opening decision, the Authority preliminarily concluded that the measures by the Icelandic State to capitalise Arion Bank, as well as the liquidity facility, entail state aid pursuant to Article 61 EEA. Furthermore it could not exclude that state aid was present in the deposit guarantee. The Authority will take a final view on these measures, which continue to have a bearing on the assessment at hand, in the present decision.

(142) As for the compatibility of the measures assessed in the opening decision, the Authority considered that a final view could only be taken on the basis of a restructuring plan, which had not been submitted when the Authority opened the formal investigation procedure on 15 December 2010. It was in particular due to the absence of a restructuring plan more than one year after the establishment of Arion Bank that the Authority expressed doubts about the compatibility of the aid.

⁽⁶⁵⁾ The term 'stickiness of deposits' refers to the past stability of deposits and the projected behaviour over time.

⁽⁶⁶⁾ The ISFI is a state body with an independent Board of Directors, reporting to the Minister of Finance, which was established with Act No 88/2009. The ISFI shall have completed its duties no later than 5 years after its foundation. The ISFI manages the State's holdings in financial undertakings in accordance with the law, good governance and business practices and the state's ownership policy. It aims to restore and reconstruct a dynamic domestic financial market, while at the same time promoting effective competition in the market as well as guaranteeing transparency in all decisions regarding the state's participation in financial activities.

4.1. Comments from interested parties

- (143) The Authority received a statement on behalf of the creditors of the old bank, in which they emphasised that they were to be considered as interested parties, and indicated to possibly submit further comments at a later stage.

4.2. Comments from the Icelandic authorities

- (144) The Icelandic authorities accept that measures undertaken in establishing New Kaupthing Bank, now Arion Bank, constitute state aid. In the view of the Icelandic authorities, the measures are however compatible with the functioning of the EEA Agreement on the basis of Article 61(3)(b) of the Agreement, as they are necessary, proportionate and appropriate to remedy a serious disturbance in the Icelandic economy. In the view of the Icelandic authorities the measures taken are in all aspects in line with the principles set out in the Authority's state aid guidelines. They also submit that the aid is necessary and limited to the minimum amount necessary.
- (145) Moreover, the Icelandic authorities emphasise that the former shareholders of Kaupthing Bank have lost all their shares and received no compensation from the state, that the aid is well designed to minimize negative spill-over effect on competitors and that the terms of the loans (the Tier II capital) are comparable to market rates.
- (146) The Icelandic authorities do not regard the deposit guarantee as entailing state aid.

4.3. Commitments by the Icelandic authorities

- (147) The Icelandic authorities have submitted a number of commitments, most of which related to the distortions of competition caused by the aid under assessment. The commitments are set out in the Annex.

II. ASSESSMENT

1. THE PRESENCE OF STATE AID

- (148) Article 61(1) of the EEA Agreement reads as follows:

'Save as otherwise provided in this Agreement, any aid granted by EC Member States, EFTA States or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Contracting Parties, be incompatible with the functioning of this Agreement.'

- (149) The Authority will assess the following measures ⁽⁶⁷⁾ below:

- The initial operating capital provided by the Icelandic State to the new bank;
- The (temporary) full state capitalisation of the new bank;
- The retention by the State of the 13 % share capital remaining after 87 % of the share capital in the new bank was transferred to the creditors of Kaupthing; and
- The provision by the State of Tier-II capital to the new bank by way of subordinated debt.

The above measures are referred to collectively below as 'the capitalisation measures'. In addition, the Authority will assess:

- The special liquidity facility agreement;
- The SPRON swap agreement;
- The Icelandic Government's statement to guarantee domestic deposits in all Icelandic banks in full.

⁽⁶⁷⁾ Described in detail in Chapter 3 of the present decision.

1.1. Presence of state resources

- (150) As the Authority already preliminarily concluded in the opening decision, it is clear that the capitalisation measures are financed through state resources provided by the Icelandic Treasury. State resources are also evidently present in the liquidity facility available to Arion Bank. As for the SPRON swap agreement, the State assumed the risk that the assets of SPRON/Drómi would be insufficient to cover the transferred liabilities (deposits) of SPRON. In essence it guaranteed to make up for the shortfall, which entails a (potential) transfer of state resources.
- (151) Regarding the deposit guarantee, the Authority emphasises at the outset that its assessment is limited to the additional deposit guarantee described above, consisting in essence of the statements made by the Icelandic Government that deposits in domestic commercial and savings banks and their branches in Iceland will be fully covered.
- (152) This assessment is without prejudice to the Authority's view on the compatibility of Act No 98/1999 and the actions of the Icelandic Government and the TIF during the financial crisis with EEA law, in particular Directive 94/19/EC. As regards the implementation of Directives 97/9/EC and 94/19/EC, the Authority is of the view that to the extent such measures constitute state aid, the use of state resources to comply with obligations under EEA law would generally not raise concerns under Article 61 EEA. The present decision is therefore not concerned with those measures.
- (153) The Authority stated in the opening decision that it would investigate further whether the statements by the Icelandic State described above are sufficiently precise, firm, unconditional and legally binding such as to involve a commitment of state resources ⁽⁶⁸⁾. In assessing whether these criteria are met, the Authority notes that the declarations entailed an irrevocable commitment of public resources as shown by the fact that the Icelandic state has done its utmost to protect depositors: Not only has it changed the priority of deposit holders in insolvent estates (which would not entail the use of state resources), but it has also made it clear that it would not allow depositors to suffer any losses. The Government's blanket guarantee of all deposits in domestic commercial and savings banks is furthermore distinct from any deposit guarantee scheme based on EEA acts due to the fact that the protection is unlimited in amount and no financial contribution is made by the banks benefitting from the measure.
- (154) The Icelandic Government's understanding of its declaration is illustrated by the state interventions in the financial sector that have occurred since October 2008 which have been motivated by the intention to honour this declaration. Those interventions have included measures to cover deposits of financial undertakings, such as the foundation of the three commercial banks, the transfer of SPRON deposits to Arion Bank, the transfer of Straumur deposits to Íslandsbanki, the CBI takeover of the deposits of 5 savings banks in Sparisjóðabanki Íslands, the transfer of deposits in Byr Savings Bank to Byr hf, the transfer of deposits from Keflavík Savings Bank to SpKef and the State's responsibility for deposits in SpKef following forced merger with Landsbankinn.
- (155) In fact, the Icelandic authorities have argued in several state aid cases that the Authority is currently investigating, some of which were mentioned above, that the respective chosen measure was the financially least burdensome option for the Icelandic state to comply with its pledge to protect depositors in full.
- (156) In the light of the above the Authority considers that there is a legally binding, precise, unconditional and firm measure in place. On this basis, the Authority therefore concludes that the statements by the Icelandic state according to which deposits are fully guaranteed entail a commitment of state resources in the meaning of Article 61 EEA.

⁽⁶⁸⁾ See in this respect the judgment of the General Court in joined Cases T-425/04, T-444/04, T-450/04 and T-456/04, *France and others v Commission*, judgment of 21 May 2010, ECR [2010] II-02099, paragraph 283 (on appeal) as well as the Opinion delivered by AG Mengozzi in the appeal case, i.e. Case C-399/10, *Bouygues*, paragraph 47, considering these conditions as too restrictive for the finding of state aid.

1.2. Favouring certain undertakings or the production of certain goods

1.2.1. Advantage

- (157) First, the aid measures must confer on the new bank advantages that relieve it of charges that are normally borne from its budget. In line with the preliminary conclusion it reached in the opening decision, the Authority remains of the view that each of the capitalisation measures confer an advantage on the new bank as the capital provided would not have been available to the bank without state intervention.
- (158) In determining whether an investment in an undertaking, for example by means of a capital injection, entails an advantage, the Authority applies the market economy investor principle, and assesses whether a private investor of a comparable size to that of the public body operating in normal market conditions would have made such an investment ⁽⁶⁹⁾. As regards capitalisation measures for the benefit of banks in difficulties, since the onset of the financial crisis, the approach taken both by the European Commission (in numerous cases since the financial crisis began ⁽⁷⁰⁾) and by the Authority ⁽⁷¹⁾ has been in general that state recapitalisations of banks amount to state aid given the turmoil and uncertainty that have characterised financial markets since the autumn of 2008. This general consideration applies in particular to the Icelandic financial markets in 2008 and 2009, when the entire system collapsed. Thus the Authority considers the capitalisation measures to confer an advantage on Arion Bank notwithstanding the eventual transfer of 87 % of the capital of the new bank to the (largely private sector) creditors. The private sector involvement in the capitalisation of Arion Bank was made up entirely of creditors of the old bank who were solely seeking to minimise their losses ⁽⁷²⁾.
- (159) Similar consideration apply in so far as the special liquidity facility is concerned, which was negotiated as part of a package of state assistance measures aiming to restore operations of a failed bank in a newly formed bank and to encourage equity participation in the new bank by the creditors of the failed bank. It is evident that the State stepped in as it was not clear if sufficient liquidity could be obtained by Arion Bank on the market. Thus, rather than acting as a private investor, the State replaced the role of private market participants who shied away from lending to financial undertakings. Therefore the Authority confirms the preliminary conclusion that it reached in the opening decision and considers the special liquidity facility as conferring an advantage on Arion Bank.
- (160) Regarding the transfer of deposits from SPRON and the payment by the bond issued by Drómi — the SPRON swap agreement, the Authority notes positively that the overall transaction aims at providing Arion Bank with compensation equalling solely the amount of the transferred liabilities. However, the entire risk of the Drómi bond being of less value than the transferred deposits, and the obligation to make up for any potential shortfall, is allocated to the State. It thus seems that Arion Bank, aside from receiving revenue through interest payments on the bond, is able to acquire goodwill and additional market shares, without taking on any risk. The Authority concludes that this constitutes an advantage ⁽⁷³⁾.
- (161) Finally, the Authority also needs to assess whether the additional deposit guarantee conveys an advantage on Arion Bank and Icelandic banks in general. In this regard, the Authority notes that when the statement that deposits would be guaranteed were first made by the Icelandic authorities, it was not entirely clear how this guarantee would work in practice, in particular what effect such intervention would have on the bank that could not

⁽⁶⁹⁾ See for example T-228/99 *WestLB* [2003] ECR II-435.

⁽⁷⁰⁾ See for example Commission Decision of 10 October 2008 in case NN 51/2008 *Guarantee scheme for banks in Denmark*, at paragraph 32, and Commission Decision of 21 October 2008 in case C 10/2008 *IKB*, at paragraph 74.

⁽⁷¹⁾ See the Authority's decision of 8 May 2009 on a scheme for temporary recapitalisation of fundamentally sound banks in order to foster financial stability and lending to the real economy in Norway (205/09/COL) available at: <http://www.eftasurv.int/?1=1&showLinkID=16694&1=1>

⁽⁷²⁾ See in this context similar reasoning adopted by the European Commission in respect of investments made by suppliers of a firm in difficulty in Commission Decision C 4/10 (ex NN 64/09) — *Aid in favour of Trèves (France)*.

⁽⁷³⁾ This conclusion is not affected by the disagreement and legal dispute between the parties to the Drómi bond regarding the interest rate on the bond.

live up to its financial obligations vis-à-vis its depositors anymore. In the meanwhile, it appears that such a bank would be allowed to fail, but that the Icelandic State would ensure — for example by transferring deposits to another bank and making up for the shortfall in assets — that deposits could be paid in full, and the depositors would never lose access to the full amount of their deposits.

- (162) The Authority considers that it is of secondary importance how exactly the State would act in complying with the unlimited guarantee on domestic deposits. What matters is that it has assumed the obligation to step in if a bank would fail to pay out deposits, to an unlimited extent.
- (163) This unlimited guarantee has, in the Authority's view, favoured Arion Bank: First, as it provides a valuable competitive advantage — an unlimited state guarantee, and hence a significant safety net — over alternative investment options and providers. This is illustrated for example by a recent report of the Minister of Economic Affairs which states that: 'Icelandic financial undertakings are currently operating in a sheltered environment with capital controls and a blanket deposit guarantee. Under such conditions, bank deposits are practically the only secure option for Icelandic savers' ⁽⁷⁴⁾.
- (164) Second, it seems clear that in the absence of the guarantee, Arion Bank could have more easily suffered from a run on its deposits like its predecessor ⁽⁷⁵⁾. Thus the bank would likely have had to pay higher interest rates (to compensate for the risk) in order to attract or even simply retain the same amount of deposits, were it not for the additional unlimited deposit guarantee that the Icelandic state has taken upon itself. Accordingly, the Authority concludes that the deposit guarantee entails an advantage for the bank.

1.2.2. Selectivity

- (165) Second, the aid measure must be selective in that it favours '*certain undertakings or the production of certain goods*'. The capitalisation measures, the liquidity facility and the SPRON swap agreement are selective as they only benefit Arion Bank.
- (166) Moreover, as state support can be selective even in situations where one or more sectors of the economy benefit and others do not, the Authority also considers the state guarantee on deposits which benefits the Icelandic banking sector as a whole as selective. This conclusion also follows from the considerations set out above according to which banks are favoured over other undertakings that offer possibilities to save and invest money.

1.3. Distortion of competition and effect on trade between Contracting Parties

- (167) The measures strengthen the position of Arion Bank in comparison to competitors (or potential competitors) in Iceland and other EEA States. Arion Bank is an undertaking which is active, as described above, on financial markets, which are open for international competition in the EEA. Whilst the Icelandic financial markets are currently rather isolated, particularly due to the capital controls, cross-border trade and potential for it still exist, and trade will likely increase as soon as the capital controls are lifted. All measures under assessment must therefore be regarded as distorting competition and affecting trade between the Contracting Parties to the EEA Agreement ⁽⁷⁶⁾.

⁽⁷⁴⁾ Report of the Minister of Economic Affairs to the Althingi (March 2012), 'The Future Structure of the Icelandic Financial System', Ch. 9.6, available at: <http://eng.atvinnuvegaraduneyti.is/media/ Acrobat/Future-Structure.pdf>

⁽⁷⁵⁾ The Authority notes in this respect comments of the Governor of the CBI, who states in the foreword to the bank's Financial Stability report for the second half of 2010 that the '*financial institutions' capitalisation is currently protected by the capital controls and the Government's declaration of deposit guarantee*'. See <http://www.seclabanki.is/lisalib/getfile.aspx?itemid=8260>, p. 5. See also Commission Decisions NN48/2008 Guarantee Scheme for Banks in Ireland, paragraphs 46 and 47: http://ec.europa.eu/community_law/state_aids/comp-2008/nn048-08.pdf; and NN51/2008 Guarantee Scheme for Banks in Denmark: http://ec.europa.eu/community_law/state_aids/comp-2008/nn051-08.pdf

⁽⁷⁶⁾ See in this respect Case 730/79 *Phillip Morris v Commission* [1980] ECR 2671.

1.4. Conclusion

- (168) The Authority, therefore, comes to the conclusion that the measures taken by the Icelandic State to capitalise the new bank, as well as the liquidity facility, the deposit guarantee and the SPRON swap agreement involve state aid within the meaning of Article 61(1) of the EEA Agreement.

2. PROCEDURAL REQUIREMENTS

- (169) Pursuant to Article 1(3) of Part I of Protocol 3, 'the EFTA Surveillance Authority shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid (...). The State concerned shall not put its proposed measures into effect until the procedure has resulted in a final decision'.
- (170) The Icelandic authorities did not notify the aid measures covered by the opening decision to the Authority in advance of their implementation. The Authority therefore concludes that the Icelandic authorities have not respected their obligations pursuant to Article 1(3) of Part I of Protocol 3. The granting of those aid measures was therefore unlawful. With respect to the acquisition of SPM savings Bank by Arion Bank, which the Authority has not found to involve state aid, it is nevertheless noted that according to paragraph 41 of the Authority's restructuring guidelines, and in order to avoid anti-competitive use of state aid, acquisitions by a bank of competing business can only be made in exceptional circumstances and upon notification to the Authority.

3. COMPATIBILITY OF THE AID

- (171) As a preliminary remark, the Authority notes that whilst Arion Bank is a new legal entity that was established in 2008, it is — as regards domestic operations — evidently the economic successor of Kaupthing Bank, in the sense that there is an economic continuity between those two entities. As those economic operations that were carried out by Arion Bank from the autumn of 2008 onwards could not have continued in the absence of the aid, the Authority considers the Bank as an undertaking in difficulties.
- (172) Moreover, the measures under assessment are at the same time rescue and restructuring measures. As stated in the opening decision, the Authority would probably have temporarily approved the measures as compatible rescue aid, had they been notified before their implementation, before then taking a final view on them on the basis of a restructuring plan. However, in the absence of a timely notification, the Authority initiated the formal investigation procedure and requested the submission of a restructuring plan. As indicated above, the final compatibility of these measures depends on whether the restructuring plan meets the criteria of the Authority's applicable state aid guidelines for undertakings in difficulties.

3.1. Legal basis for assessment of compatibility: Article 61(3) of the EEA Agreement and the Authority's Restructuring Guidelines

- (173) While state aid to undertakings in difficulties is normally assessed under Article 61(3)(c) of the EEA Agreement, the Authority may, under Article 61(3)(b) of the Agreement allow state aid to remedy a serious disturbance in the economy of an EC Member State or an EFTA State'. As is stated in paragraph 8 of the Banking Guidelines ⁽⁷⁾, the Authority reaffirms that, in line with the case law and the European Commission's decision making practice, Article 61(3)(b) of the EEA Agreement necessitates a restrictive interpretation of what can be considered a serious disturbance of an EFTA State's economy.

⁽⁷⁾ See Part VIII of the Authority's State Aid Guidelines. Temporary rules regarding financial crisis. The application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, available at <http://www.eftasurv.int/?1=1&showLinkID=16604&1=1>

- (174) The Icelandic authorities have explained, as described in detail above, that Iceland's financial system entered into a state of systemic crisis in October 2008, leading to the collapse of its major banks as well as major savings banks within a time span of a few days. The combined market share of the collapsed financial institutions exceeded 90 % in most segments of the Icelandic financial market. The difficulties were coupled with a breakdown of confidence in the country's currency. Iceland's real economy has been severely hit by the financial crisis. Although more than three years have passed since the onset of the crisis, vulnerability still remains in the Icelandic financial system. Even if the situation has eased significantly since 2008, it is evident that at the time that the measures were taken, they were intended to remedy a serious disturbance in the Icelandic economy.
- (175) Consequently, Article 61(3)(b) of the EEA Agreement is considered to apply in this case.

The application of the Restructuring Guidelines

- (176) The Authority's State Aid Guidelines on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules ⁽⁷⁸⁾ ('the Restructuring Guidelines') sets out the State aid rules applicable to the restructuring of financial institutions in the current crisis. According to the Restructuring Guidelines, in order to be compatible with Article 61(3)(b) EEA, the restructuring of a financial institution in the context of the current financial crisis has to:
- (i) Lead to a restoration of the viability of the bank;
 - (ii) Include sufficient own contribution by the beneficiary (burden-sharing);
 - (iii) Contain sufficient measures limiting the distortion of competition.
- (177) The Authority will thus assess below, based on the restructuring plan submitted for Arion Bank, whether these criteria are met, and if therefore the aid measures described above constitute compatible restructuring aid.

3.2. Restoration of viability

- (178) Restoring the long-term viability of a beneficiary in receipt of restructuring aid is the main objective of such aid, and the assessment of whether restructuring aid will attain this, is an important aspect in determining its compatibility.
- (179) As indicated above, the turmoil in the Icelandic economy in the wake of autumn 2008, the presence of extraordinary measures such as the capital controls, an evolving regulatory environment and a macroeconomic outlook that, in spite of some recent stabilisation, remains somewhat uncertain, given in particular the ongoing economic woes of the euro zone, make it challenging to operate a bank profitably and ensure its long-term viability. The Authority emphasises at the outset that this consideration needs to be borne in mind in the below assessment.

⁽⁷⁸⁾ Return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, adopted by the Authority on 25.11. 2009 under chapter VII: Temporary Rules regarding the Financial Crisis, as extended by the Financial Crisis Guidelines 2012. Available on the Authority's website at: <http://www.eftasurv.int/media/state-aid-guidelines/Part-VIII—Return-to-viability-and-the-assessment-of-restructuring-measures-in-the-financial-sector.pdf>

- (180) Section 2 of the Restructuring Guidelines sets out that the EEA State should provide a comprehensive and detailed restructuring plan which provides complete information on the business model and which restores the bank's long-term viability. Paragraph 10 of the Restructuring Guidelines requires that the restructuring plan identifies the causes of the bank's difficulties and the bank's own weaknesses, and outlines how the proposed restructuring measures remedy the bank's underlying problems.
- (181) The causes of Arion Bank's difficulties are, as described above, spelt out both in the restructuring plan, but also in the SIC report, related to the circumstances surrounding the establishment of the Bank and the problems of its predecessor. Among the main causes identified in the latter at the level of the predecessor bank were the excessive and unsustainable expansion, the gearing of the bank's owners, the concentration of risk, weak equity and the size of the banks as compared to the Icelandic economy. Kaupthing Bank had large single exposures and took on major risk by lending to its owners. It also relied predominately on short-term wholesale funding.

Regulatory viability measures

- (182) Whilst the Arion Bank's restructuring plan addresses many of the bank's weaknesses as identified above, the Authority considers that the failure of Kaupthing, and the collapse of the Icelandic financial industry, was also caused by a number of factors specific to Iceland, relating to its small size and the regulatory and supervisory shortcomings highlighted by the Special Investigation Commission. The long-term viability of Arion Bank, such as that of any other Icelandic bank, thus does not depend solely on the measures taken at the bank's level, but also on whether those supervisory and regulatory shortcomings have been remedied.
- (183) In this regard the Authority notes positively the amendments to the regulatory and supervisory framework that the Icelandic authorities have made, as explained in the Annex.
- (184) First, the powers and competences of the FME have been enhanced, inter alia, with new responsibilities regarding large single exposures and the risks related thereto, which in the Authority's view addresses one of the factors that led to the financial collapse.
- (185) Second, the temporary high CAD ratio requirements, and a number of provisions relating to collateralisation, in particular the prohibition of extending credit against pledges of own shares, aim at ensuring that Icelandic banks cannot once again build up a weak capital position. The Authority considers that these measures will contribute to the resilience of the Icelandic banks.
- (186) Third, a range of measures have been implemented relating to the eligibility of directors and board members, as well as their remuneration. Moreover, lending to related parties (such as owners) has been subjected to stricter rules, and the FME can now prohibit a bank from performing specific activities, if it sees reason to do so. External and internal accounting rules have also been amended, for example the duration for which an external accountant can work for the same bank has been shortened. The Authority notes positively that these measures are aimed at preventing a repetition of events in so far as the owners and high executives are concerned, and the measures also increase external risk monitoring, both of which reduce threats to the banks' viability.
- (187) Fourth, according to the Icelandic authorities, the already mentioned possibility for the FME to limit a bank's activities, is also prompted by the large-scale deposit taking by Icelandic commercial banks before the crisis, which seems to at least have accelerated their demise. Moreover, the new rules on liquidity and foreign exchange

balance ⁽⁷⁹⁾ also appear, in the Authority's understanding, to entail certain restrictions as regards the banks' possibility to attract disproportionately large amounts of foreign deposits if that were to make the banks' business more fragile and vulnerable to foreign currency exchange and liquidity risks. The Authority welcomes that the Icelandic authorities have responded to this aspect of regulatory failure.

Arion Bank's restructuring plan

- (188) As for the restructuring plan and the measures at the bank's level, Arion Bank has in essence reverted to a more traditional banking model, focusing on relationship banking for the Icelandic market. The Bank will be predominately funded through customer deposits and equity, with a gradual increase in borrowing mostly through covered bonds.
- (189) Moreover, as indicated above, Arion Bank was — if compared to Kaupthing — from the moment of its establishment substantially less leveraged, and as most wholesale debt remained in the estate of Kaupthing, it will, according to the restructuring plan, have to rely on refinancing on international markets for unsecured debt only to a very limited extent. For the same reason, the issue of deleveraging the balance sheet of the Bank was in essence resolved already in October 2008. Nevertheless, the Authority concurs with the assessment of Arion Bank and the Icelandic authorities of the need for the various measures outlined in the restructuring plan as regards the scaling down of the Bank's operations to a new economic reality and limiting risk exposure. The deficiencies addressed by those measures (such as concentration of large and connected exposures, severe currency imbalances, etc.) are mostly inherited from the old bank. For Arion Bank's future viability it is of paramount importance that these deficiencies are adequately addressed in the restructuring plan.
- (190) The reliance on wholesale markets for refinancing turned out to be one of the main reasons for Kaupthing's demise. Arion Bank's funding has so far been largely based on deposits and equity, but the restructuring plan foresees a slight reduction in the significance of deposits from 68 % to 61 % of total liabilities, based, inter alia, on the Bank's analysis of its deposits base. Arion Bank intends to make up for this by means of issuing covered bonds on the domestic market. It is recalled that Arion Bank has been granted a license to issue covered bonds and subsequently completed a EUR 1 billion covered bond program. In February 2012 Arion Bank completed its first covered bond offering, issuing 2,5 billion ISK worth of bonds, and in May 2012, the Bank completed its first non-indexed fixed rate covered bond offering, to the value of 1,2 billion ISK ⁽⁸⁰⁾. For the remainder of the restructuring period, the bank intends to issue bonds in various formats, including covered bonds and senior unsecured bonds.
- (191) The Authority considers that, based on the facts submitted by the Icelandic authorities, the Bank's funding situation appears to be sound until the end of the restructuring period. Given the uncertainties surrounding the deposit guarantee and the capital controls, as well as the ambiguous future developments of (sovereign) debt

⁽⁷⁹⁾ New Rules on Foreign Exchange Balance adopted by the CBI entered into force on 1 January 2011. The purpose of the rules is to limit foreign exchange risk by preventing foreign exchange balances from exceeding defined limits. One of the most important changes from previous versions of the Rules is that the permissible open foreign exchange position in individual currencies has been reduced from 20 % to 15 % of equity, and the permissible total foreign exchange balance has been lowered from 30 % to 15 %. Foreign exchange balance reporting is also more detailed than before, as foreign-denominated assets and liabilities are classified by type: loans, bonds, equity securities, shares in mutual funds, deposits, interest-bearing agreements, debts to the Central Bank, and so on. Should the foreign exchange balance deviate from the limits set forth in the rules, the financial undertaking concerned must take action so as to eliminate the difference within a maximum of three business days. If a financial undertaking's measures fail to achieve this, the CBI may calculate periodic penalties. The CBI has also taken other steps to limit foreign exchange imbalances, for instance by concluding a currency swap agreement with one of the commercial banks as well as purchasing foreign currency. According to the CBI, these measures promote increased financial stability and bolster the CBI's non-borrowed foreign exchange reserves.

⁽⁸⁰⁾ In the context of the Bank's acquisition at the end of 2011 of the former Kaupthing Mortgage Institutional Investor Fund, the Bank also took on responsibility for covered bonds in the amount of 117,7 billion ISK.

markets, it cannot conclude on whether Arion Bank's funding strategy will materialise as foreseen in the long run. However, given the strong reliance on deposits and covered bonds during the restructuring period, and the large share of those types of debt on the balance sheet, the Authority concedes that slight variations to the funding strategy that might subsequently be necessary would not threaten the Bank's viability.

- (192) As regards the assets side of the balance sheet, the international assets remain in Kaupthing's estate. As a result, the balance sheet has shrunk by 88 %. A main weakness of Kaupthing's business model — the reliance on risky international assets without appropriate risk assessment — has thus been remedied. The Authority welcomes that pursuant to the restructuring plan, the Bank will not engage in similar business in the future, but rather focus on its traditional core business.
- (193) A considerable challenge for the Bank as regards its asset portfolio remains the restructuring of the loans that were transferred from Kaupthing. In this regard the Authority notes positively that this restructuring process has been and remains a key priority for the Bank, as illustrated by the many generic and tailor-made proposals that the Bank has made to its overleveraged customers. While work still remains to finalise the restructuring progress, information from the Bank appears to confirm that good progress has been made, particularly as from 2011, as is demonstrated by the fact that of the 986 companies which had entered recovery programs at the Bank, conclusion was reached at the end of 2011 in 871 cases, whereas conclusions had only been reached for 416 companies at the end of the first quarter in 2011. Good progress has also lately been achieved with regard to restructuring of household debt, and the Bank aims to complete its corporate and individual debt recovery projects by the end of 2012.
- (194) The Authority considers the above to be an indicator of the soundness of Arion Bank's restructuring methods. Moreover, based on the data submitted by Arion Bank, it appears realistic that the bank can meet its target of completing the restructuring of its corporate and household loan portfolios by year-end 2012. Overall, barring unexpected developments in the macroeconomic environment in Iceland or abroad, this would mean that at the latest at the end of the restructuring period, Arion Bank will, in the Authority's view, have a relatively healthy balance sheet and well-performing loan portfolios.
- (195) As indicated above, the weak capitalisation of Kaupthing was one of the factors that led to its downfall. Arion Bank's restructuring plan predicts that the bank will stay well above the minimum CAD ratio of 16 % required by the FME throughout the restructuring period. This ratio is well above the future Basel III minimum of 10,5 %. Even pursuant to the stress case, which Arion Bank has submitted, the CAD ratio will continue to remain significantly above this high benchmark, at > 20 %. As for the capital assessment of this year's ICAAP report which Arion Bank has submitted in conjunction with the restructuring plan, the Authority considers it prudent and comforting that having taken into account the various risk factors, the Bank holds a capital buffer of [...] billion ISK, which, in an operating environment as described above, provides Arion Bank with a significant capacity to deal with unexpected adversities.
- (196) As for the bank's liquidity position, the Authority notes that the current situation, pursuant to the restructuring plan, appears sufficiently robust, and that there are no indications that the situation could deteriorate substantially during the restructuring period. Moreover, the Authority considers that stress testing the bank's liquidity ratio in the context of the ICAAP report, suggests that while the Bank is exposed to liquidity risks which could materialise in the case of abrupt lifting of capital controls, its liquidity situation is monitored closely, measures are under way to limit the risk and contingency plans have been made to prepare the Bank for unexpected and adverse events. This is also of high significance, given the fact that it was necessary for the state in 2010 to provide the Bank with a special liquidity facility in order for it to comply with the FME's liquidity requirements and that this liquidity facility terminates at the end of 2014.
- (197) The Authority also welcomes the changes to Arion Bank's organisational structure and risk management, as described above, which address a weakness in Kaupthing's business and will contribute to a more objective and professional risk assessment in the Bank's operation.

- (198) As regards profitability, the Restructuring Guidelines also provide that the restructuring plan should demonstrate how the bank will restore its long-term viability without state aid as soon as possible. In particular, the bank should be able to generate an appropriate return on equity, while covering all costs of its normal operation and complying with the relevant regulatory requirements. In particular, point 13 of the Restructuring Guidelines indicates that long-term viability is achieved when a bank is able to cover all its costs including depreciation and financial charges and provide an appropriate return on equity, taking account of the risk profile of the bank.
- (199) At this point, the Authority recalls what was already mentioned above, namely that the economic environment in which Arion Bank operates would be challenging for any bank. With this in mind, the Authority is satisfied with the restructuring plan's forecast profitability, which, in spite of the high capital ratio, will be adequate throughout most of the restructuring period and beyond. The return on equity, which was particularly high in 2009-2010, will vary between [> 10] % and [< 15] %. Irregular items in the profit and loss account, in particular substantial valuation gains from the loan portfolios transferred from Kaupthing and the write-downs caused by the recent Supreme Court ruling on FX-loans, which have had major impact on the Bank's financial results in past three years, are expected to recede. According to the restructuring plan, such irregular events are foreseen to have only a minor impact in 2012-2013 and not foreseen to occur beyond 2013.
- (200) An important driver of future profitability according to the restructuring plan is greater fee and commission income, which is forecast to [...] over the planning period. Commission fee yielding business such as stock market related transactions and foreign currency trade virtually came to a standstill after the collapse and as a result of the capital controls. However, once the restructuring of the corporate sector nears completion and capital controls will be lifted, it appears realistic to expect a substantial increase in stock exchange activity and currency trade. Hence, the Authority does not question the plausibility of these figures.
- (201) The Bank has taken a number of initiatives, as described above, to achieve cost efficiency, amongst others to rationalise its branch network and has closed a total of 15 branches. According to the Bank's commitments, [...]. A reduction of staff by approximately 10 % took place in 2011. The Authority welcomes these efforts as they imply that the Bank has already managed to contain its costs and maintain its cost-to-income ratio at 45 % in 2011. According to the restructuring plan, the Bank intends to ensure that this ratio will be reduced slightly further to [...] % for the remainder of the restructuring period.
- (202) In addition to the above, it is evident that the restructuring plan is based on a large number of other assumptions. The Authority has aimed to scrutinise those that seem most pertinent and of greatest influence to the future viability of Arion Bank. As regards the macroeconomic assumptions, they appear broadly in line with the forecasts of Statistics Iceland and the CBI, although the Bank predicts slightly stronger growth and higher inflation. Overall the assumptions on which the restructuring plan is based appear to be sufficiently prudent to allow, in conjunction with the considerations set out by the Authority above, the conclusion that the restructuring measures undertaken by the Bank are sufficient to ensure its long-term viability, barring unexpected adverse events of unforeseen scale and consequences.
- (203) Taking into account the above elements, the Authority considers that the restructuring plan comprises sufficient elements contributing to the restoration of the long-term viability of the bank for the Authority to conclude that the provisions of section 2 of the Restructuring Guidelines are complied with.

3.3. Own contribution/burden-sharing

- (204) Paragraph 22 of the Restructuring Guidelines reads as follows: 'In order to limit distortions of competition and address moral hazard, aid should be limited to the minimum necessary and an appropriate own contribution to restructuring costs should be provided by the aid beneficiary. The bank and its capital holders should contribute to the restructuring as much as possible with their own resources. This is necessary to ensure that rescued banks bear adequate responsibility for the consequences of their past behaviour and to create appropriate incentives for their future behaviour'.

- (205) The Authority recalls in this regard a decisive aspect of the case at hand. When Arion Bank was established on the basis of the domestic operations of Kaupthing, the investments of shareholders in Kaupthing Bank were fully wiped out and have thus contributed the maximum possible to the restructuring of Arion Bank. Moreover, the creditors of Kaupthing had to take considerable losses ⁽⁸¹⁾, or at least had to take on the risk of their investment depending on the profitability of Arion Bank. Therefore, as far as the owners and creditors of Kaupthing are concerned, the criterion of burden-sharing is optimally satisfied and the issue of moral hazard addressed.
- (206) In addition to the above, the Authority needs to assess whether the state aid that Arion Bank has received was limited to the minimum necessary.
- (207) As regards the capitalisation measures, the initial capitalisation of Arion Bank, until the agreement with the creditors of Kaupthing reduced the State's stake to 13 %, was just sufficient to meet the FME's capital requirements. In 2009, after the agreement on Kaupthing's acquisition of Arion Bank had been reached, and the Tier-II capital had been granted to Arion Bank, the CAD ratio reached approximately 18 %, 2 percentage point more than the minimum ratio set forth by the FME. In this context, the Authority notes that the capital ratio depended mainly on whether valuation of the assets that had been transferred from Kaupthing to Arion Bank had been done accurately. Moreover, it has to be borne in mind that at the time the economic outlook for Iceland was cast in uncertainty. In view of the foregoing, the Authority considers that the amount of capital provided by the Icelandic state to Arion Bank was limited to the minimum necessary, as it amounted to nothing more than the regulatory minimum plus a reasonable buffer.
- (208) This conclusion is not undone by the fact that Arion Bank's CAD ratio has subsequently grown somewhat, to 19 % in 2010 and 21 % in 2011. The increase of the CAD ratio was to a significant extent due to the writing up of the book value of the assets that had been transferred from Kaupthing to Arion Bank. It could not have been predicted with any certainty that this would happen, and the fact that the CAD ratio developed so favourably later is in the Authority's view no reason to consider that Arion Bank was overcapitalised by the State at the outset ⁽⁸²⁾.
- (209) Paragraph 26 of the Restructuring Guidelines provides that banks in receipt of restructuring aid 'should be able to remunerate capital, including in the form of dividends and coupons on outstanding subordinated debt, out of profits generated by their activities'.
- (210) In this context, it is worth recalling that at the time when agreements were concluded on the takeover of Kaupskil of 87 % of shareholdings in Arion Bank, it was agreed that the Government would be paid a fair share of the bank's returned earnings over the period until the new agreement on ownership took effect. The amount agreed upon was 6,5 billion ISK ⁽⁸³⁾, corresponding to an annualised return for the State of almost 9 % on the capital which was redeemed already in the autumn of 2009. It is clear that this amount falls 2,3 billion ISK short of the accrued interest on the government bond for this time and is also significantly below the ECB benchmark interest of 15,3 % for this period as set out in the Authority's Recapitalisation Guidelines. ⁽⁸⁴⁾ However, as for the 13 % stake that the State retained in Arion Bank, the prospect of a satisfactory return appears promising, given the overall good performance of Arion Bank since its establishment.

⁽⁸¹⁾ As Kaupthing is still in a winding-up procedure, the precise losses are not yet known. According to information presented at the Kaupthing creditors' meeting on 31 May 2012, Kaupthing's total assets at year end 2011 were 874 billion ISK (5,2 billion EUR), and the current accepted claims under Article 113 of the Icelandic bankruptcy act (non-priority claims) amounted to 2 873 billion ISK (17 billion EUR). For further information see <http://www.kaupthing.com/lisalib/getfile.aspx?itemid=21204>.

⁽⁸²⁾ In fact, the state capitalisation of Arion Bank was based directly on the difference between the initial valuation of assets and liabilities transferred, and the capital requirement of the FME.

⁽⁸³⁾ The Icelandic authorities have explained that a fixed sum of 6,5 billion ISK was agreed upon as remuneration for the state in this context, as financial information was changing over the time when the negotiations took place and the true profitability of the bank in this period was difficult to determine.

⁽⁸⁴⁾ The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition ('the Recapitalisation Guidelines'), OJ L 17, 20.1.2011 and EEA Supplement No 3. The guidelines are also available on the Authority's website at: <http://www.eftasurv.int/state-aid/legal-framework/state-aid-guidelines/>.

- (211) However, it also should be stressed that the remuneration for the Tier-II capital deviates from the Authority's Recapitalisation Guidelines. As correctly submitted by the Icelandic authorities, the required remuneration pursuant to the Recapitalisation Guidelines consists of the government's funding cost of 8 %, Kaupthing's pre-crisis CDS-spread and an add-on fee of 2 %. Given Kaupthing's high pre-crisis CDS-spreads, the remuneration that Arion Bank pays, EURIBOR plus 4 % add-on, would appear to fall significantly short of this benchmark.
- (212) According to paragraph 25 of the Restructuring Guidelines, derogation from adequate *ex-ante* burden-sharing (i.e. appropriate remuneration) can, inter alia, be justified by farther-reaching restructuring, including measures to limit distortions of competition. As will be shown below, the Authority considers that the restructuring of Arion Bank is sufficiently far-reaching for this condition to be met.
- (213) Whilst the SPRON swap agreement, as described above, entails elements of state aid, the Authority considers that it is constructed in a manner that aims at limiting if not excluding a direct financial advantage for Arion Bank. The agreement constitutes in essence a negotiated compensation for Arion Bank in exchange for taking on the deposit liabilities of SPRON, and it is likely that Arion Bank obtains matching assets for the transferred liabilities. The Authority does not consider that this aid is of great significance for its burden-sharing assessment.
- (214) Finally, as regards the deposit guarantee, the Authority has already indicated in the opening decision that — in light of the extraordinary circumstances at the time — it might constitute a proportionate means to safeguard financial stability in Iceland. It is evident however that such aid cannot be approved indefinitely.
- (215) Thus, in order for this state aid to be considered as limited to the minimum necessary, the Authority is of the view that it needs to be terminated as soon as possible. The Authority therefore welcomes the intention of the Icelandic authorities to introduce a different deposit guarantee system, which is currently envisaged to be set up before the capital controls are lifted, thus no later than the end of 2013.
- (216) In addition, the Authority is of the view that a viable bank should be able to compete on the market without the protection of such a blanket guarantee on deposits, and will therefore authorise the deposit guarantee only until the end of 2014 ⁽⁸⁵⁾. After that time, protection of deposits should be governed only by the applicable EEA legislation regarding deposit guarantees.
- (217) On the basis of the above elements, the Authority concludes that the restructuring plan of Arion Bank ensures that the aid is limited to the minimum necessary and that the beneficiary, the shareholders and debt holders of its predecessor bank have participated significantly in the burden-sharing. The restructuring aid thus complies with section 3 of the Restructuring Guidelines.

3.4. Limiting distortions of competition

- (218) The Restructuring Guidelines provide in section 4, paragraphs 29-32:

'Financial stability remains the overriding objective of aid to the financial sector in a systemic crisis, but safeguarding systemic stability in the short-term should not result in longer-term damage to the level playing field and competitive markets. In this context, measures to limit distortions of competition due to state aid play an important role. [...] Measures to limit the distortion of competition should be tailor-made to address the distortions identified on the markets where the beneficiary bank operates following its return to viability post restructuring, while at the same time adhering to a common policy and principles. The Authority takes as a starting point for its assessment of the need for such measures, the size, scale and scope of the activities that the bank in question would have upon implementation of a credible restructuring plan as foreseen in Section 2 of this Chapter. [...] The nature and form of such measures will depend on two criteria: first, the amount of the aid and the conditions and circumstances under which it was granted and, second, the characteristics of the market or markets on which the beneficiary bank will operate.

⁽⁸⁵⁾ At the end of 2014, the restructuring periods of all Icelandic banks for which a formal investigation has been initiated will have come to an end.

As regards the first criterion, measures limiting distortions will vary significantly according to the amount of the aid as well as the degree of burden sharing and the level of pricing. Generally speaking, where there is greater burden sharing and the own contribution is higher, there are fewer negative consequences resulting from moral hazard.

As regards the second criterion, the Authority will analyse the likely effects of the aid on the markets where the beneficiary bank operates after the restructuring. First of all, the size and the relative importance of the bank on its market or markets, once it is made viable, will be examined. The measures will be tailored to market characteristics to make sure that effective competition is preserved. [...] Measures limiting distortions of competition should not compromise the prospects of the bank's return to viability.'

- (219) It follows from the above that the size of the aid, particularly in relative terms, and the market characteristics are decisive in the Authority's assessment of the appropriateness of measures to limit distortions of competition. At the same time, it is evident that such measures must not jeopardise the viability of the beneficiary of restructuring aid, and competition concerns must be addressed with a view to the overriding goal of financial stability in the present crisis.
- (220) Against the background of the above legal framework, the Authority will set out below the considerations that it deems essential for its assessment of the measures limiting distortions of competition.
- (221) First and foremost the Authority considers that given the particular situation on the Icelandic financial markets and the economic conditions, as described in previous chapters, a careful assessment of the market conditions and the competitive environment is necessary. The measures limiting the distortion of competition should reflect the currently difficult circumstances, while ensuring that the distortions of competition are limited to a minimum both in the short-term and the long-term.
- (222) Second, as set out above in the section on burden-sharing, the greatest possible contribution from the former owners of Kaupthing, and to some extent, of Kaupthing's creditors has been addressed. Consequently, the need for additional competition measures has been limited.
- (223) Third, as regards the characteristics of the relevant market and as described above, the collapse of the financial system in Iceland, followed by the interventions of the Icelandic authorities, including the establishment of Arion Bank on the basis of Kaupthing's domestic operations, led to a greater concentration in the Icelandic market for financial services, and substantially increased the market share by the three major banks — Landsbankinn, Íslandsbanki and Arion Bank. Beside these, only a few small market players remain, and the immediate prospect of a new entry is extremely slim, not only due to the already mentioned barriers to entry and the small size of the market, but in particular also due to the prevailing capital controls. Arion Bank enjoys a very significant position on this concentrated market, with a market share of 30 % or over in the most relevant and economically important segments.
- (224) Fourth, the crisis led to a number of very specific problems, such as the extremely high degree of direct and indirect ownership of the large banks in the real economy. A further competition concern is the existence of a de-facto monopoly for banking IT-services (RB), majority owned by the three major banks.
- (225) Fifth, the relative size of aid that Arion Bank has received is significant. In this regard, the Authority notes that at the outset the entire capital of the bank was provided by the State. In addition, the bank has benefited from a variety of aid measures — the special liquidity facility, the SPRON swap agreement and the blanket deposit guarantee. At the same time, Arion Bank remains a small bank, at least by international standards.

(226) Against this background, the Authority notes that a number of measures have been or will be taken that limit the distortions of competition resulting from the state aid granted to Arion Bank.

(i) Measures and regulatory developments undertaken or committed to by the Icelandic authorities

(227) The Icelandic Government has specifically made two commitments (see Annex) which in the Authority's view can contribute to creating a regulatory environment that favours competition in financial markets:

(228) First, by appointing a working group that will review Act No 36/1978 on Stamp Duty, and by examining in particular whether to abolish stamp duties for bonds issued by individuals when transferred between creditors (e.g. when individuals transfer their loans from one loan institution to another). The Authority considers that the current law — which, inter alia, obliges customers to pay stamp duty on the amount of the respective bond ⁽⁸⁶⁾ when switching lenders — may be capable of constituting an impediment to competition, as it may lock customers to existing contracts on long term loans. The Authority thus welcomes the commitment for this law to be reviewed.

(229) Second, the Authority takes note of that, in accordance with a resolution passed by the Icelandic parliament on 21 March 2012, a committee will be appointed by the Government with the mandate to review consumer protection in the financial market. This will include a specific mandate for the review of switching facilitation and switching costs reduction, and for the committee to work closely with the Icelandic Competition Authority (the ICA) as regards that issue. The Committee shall present its report no later than 15 January 2013. The Authority is of the opinion that a closer assessment could be of benefit for competition in the long-run. In the meantime the bank-specific commitment by Arion Bank discussed below should contribute to making switching easier, and thereby will increase competition.

(230) As for the competition concerns identified by the Authority regarding RB, the Authority welcomes the settlement that ICA and the owners of RB, including the three major banks, have reached on this issue. This endeavours to ensure access to essential IT-infrastructure on a non-discriminatory basis and at reasonable cost for small competitors and potential new market entrants. The Authority is of the view that its concerns have been addressed in a satisfactory manner by this settlement, and that there is no need for the Authority to further address this issue in the current decision.

(231) Finally, the Authority takes note of the regulatory amendments that have been made since 2008, as discussed in the Annex. As regards competition concerns, the introduction of Article 22 in the Act on financial undertakings No 161/2002 is of particular relevance in this regard. It includes provisions which limit the participation of financial undertakings in activities falling outside the scope of their operating licenses. According to this new rule, such activities may only be pursued on a temporary basis and for the purpose of concluding transactions or reorganising the activities of customers. A reasoned notification to this effect must be sent to the FME, and time limits have been introduced for financial undertakings to complete reorganisation of their customers and dispose of appropriated assets.

(232) The Authority regards this change as an appropriate regulatory response to the issue of the disproportionately large ownership by financial institutions in the real economy. This provision appears to at least mitigate this situation — which is a direct result of debt-to-equity-swaps (and similar transactions) involving over-indebted companies in the wake of the crisis — from becoming a permanent one. As it addresses one of the most pressing competition issues that is linked to the state aid to the three banks, the Authority takes it duly into account in its assessment.

⁽⁸⁶⁾ The stamp duty varies depending on the type of legal document concerned, but is normally 15 ISK for each started thousand ISK (i.e. approximately 1,5 %) on the amount of interest-bearing bonds secured by a mortgage or other security.

(ii) Measures specific to Arion Bank

- (233) The Authority emphasises that Arion Bank's market presence and size is only a fraction of that of Kaupthing — as total assets have been reduced by 88 %, as described above. Unlike Kaupthing, Arion Bank is only active in the Icelandic market. Whilst most of this reduction is evidently a result of the winding up of Kaupthing's international operations, the Authority is of a view that this process is of particular relevance as regards the distortions of competition, as it was in particular Kaupthing's risky overseas strategy that led to its collapse and caused distortions in the EEA financial markets in the past ⁽⁸⁷⁾.
- (234) The Authority takes note of Arion Bank's commitments set out in the Annex, according to which Arion Bank will not acquire financial institutions until 1 December 2014, except if it obtains the Authority's approval beforehand. This means, unless further mergers would be necessitated by financial stability considerations, that further concentration of the Icelandic financial market through acquisitions by Arion Bank can be prevented. This commitment also ensures that the aid that has been granted to Arion Bank is used for restoring its viability rather than it being used to consolidate and further expand its market presence in Iceland. Arion Bank's commitment to [...] is also to be welcomed as it [...] and supports the policy to achieve necessary cost reductions. The same is true for Arion Bank's commitment pursuant to which it will, until 1 December 2014, neither enforce contract clauses in housing mortgage agreements for individuals ⁽⁸⁸⁾ nor introduce new contract clauses which make special terms on interest rates contingent upon maintaining a minimum range of business with the bank.
- (235) As described above, the Icelandic financial market currently represents a challenging operating environment for any bank, which is reflected also by the almost complete absence of interest from abroad to enter this market at the present time. The Authority thus welcomes the commitments by Arion Bank relating to facilitating the switching between banks and providing basic payment processing services. The Authority is of the view that those measures, in conjunction with the agreement between the three major banks and ICA on RB mentioned above ensure that smaller market participants can access the most essential infrastructure and services at reasonable prices without the larger players being able to block their access. The Authority is of the view that this will reduce the barriers to entry for future (potential) market participants, and could allow existing smaller players to expand their market shares if they are able to offer better services than their larger competitors. Moreover, all the measures aimed at facilitating switching will contribute to fiercer competition between the existing large players, and could contribute to prevent or dissolve a situation of potential collective dominance.
- (236) Lastly, Arion Bank commits to sell, as soon as possible, shareholdings in operating companies which have been taken over due to restructuring in line with Article 22 of the Act on financial undertakings No 161/2002, commits to follow the procedure and time-limits which are set out in this provision and as interpreted by the FME, and will maintain up-to-date information on its website or of a subsidiary on subsidiaries and shareholdings that are held for sale. The Authority welcomes Arion Bank's commitment to divest as soon as possible all companies and shareholdings that are not related to its core business, not at least because of viability concerns. Whilst the Authority is of the view that it is self-evident that the Bank needs to respect domestic legal obligations such as Article 22 of the Act on financial undertaking, it takes note of this commitment and draws the Icelandic authorities' and beneficiaries' attention to the fact that in this regard a breach of national law might also entail a misuse of aid. The Authority moreover considers that by having to include information about foreseen divestments and sales on its website, more transparency about the current ownership situation in the Icelandic economy is introduced. This remedies, at least to some extent, this particular competition concern that currently characterises Iceland's markets.

⁽⁸⁷⁾ Cf. for example Commission Decision in Case SA.28264, Restructuring aid for Hypo Real Estate, in which the Commission accepted the separation of a large part of the Hypo Real Estate's overseas business as a measure to limit distortions of competition for the bank's successor PBB.

⁽⁸⁸⁾ The Bank has confirmed that it is not aware of any clauses in any other types of lending agreements that allow the Bank to raise the interest rate if the customer does not maintain a minimum range of business with the Bank. If such clauses can be found within the Bank, the Bank will not enforce them until December 2014.

(237) On the basis of all of the above, given in particular the specific situation in Iceland and the fact that the Authority considers that the above measures address the main competition issues that the Authority has identified in collaboration with the ICA, and taking into account the overriding objective of financial stability, the Authority concludes that the commitments limit distortions of competition to a satisfactory degree. The restructuring aid therefore complies with section 4 of the Restructuring Guidelines.

III. CONCLUSION

(238) On the basis of the foregoing assessment and in the light of the restructuring plan submitted by the Icelandic authorities for Arion Bank, the Authority's doubts expressed in the opening decision as regards the nature and the compatibility of the aid measures for Arion Bank are allayed. The Authority therefore approves the aid measures as restructuring aid compatible with the functioning of the EEA Agreement pursuant to Article 61(3)(b) EEA subject to Iceland and Arion Bank adhering to the commitments as set out in the Annex,

HAS ADOPTED THIS DECISION:

Article 1

The initial operating capital, the (temporary) full state capitalisation, the retention by the State of the 13 % share capital and the Tier-II capital granted to Arion Bank as well as the special liquidity facility, the SPRON swap agreement and the unlimited deposit guarantee constitute state aid within the meaning of Article 61(1) of the EEA Agreement.

Article 2

The measures enumerated in Article 1 constitute unlawful state aid from the dates of their implementation to the date of this decision in view of the failure by the Icelandic authorities to comply with the requirement to notify the Authority before implementing the aid in accordance with Article 1(3) of Part I of Protocol 3.

Article 3

The measures enumerated in Article 1 are compatible with the functioning of the EEA agreement pursuant to Article 61(3)(b) EEA subject to adhering to the commitments as set out in the Annex. The authorisation for the unlimited deposit guarantee expires at the end of 2014.

Article 4

This Decision is addressed to the Republic of Iceland.

Article 5

Only the English language version of this decision is authentic.

Done at Brussels, 11 July 2012.

For the EFTA Surveillance Authority

Oda Helen SLETNES

President

Sverrir Haukur GUNNLAUGSSON

College Member

ANNEX

COMMITMENTS AND RELEVANT CHANGES TO THE LEGAL FRAMEWORK FOR BANKING

1. COMMITMENTS BY THE ICELANDIC AUTHORITIES

The Icelandic authorities have made two commitments which are enumerated below.

Amendment of stamp duty to preclude state aid and reduce switching costs

The Ministry of Finance will appoint a working group with the mandate to review Act No 36/1978 on Stamp Duty. The working group is to submit a report to the Minister of Finance by October 2012, along with a draft bill. The assignment of the working group will be, in particular, to examine the abolishment of stamp duties for bonds issued by individuals, when transferred between creditors (i.e. when individuals transfer their loans from one loan institution to another). The group shall furthermore examine how the provision of stamp duty may be amended in order to simplify procedures and promote competition.

Measures to facilitate switching and reduce switching costs

In accordance with a resolution passed by the Icelandic parliament on 21 March 2012, a committee will be appointed by the Government with the mandate to review consumer protection in the financial market and present proposals as to how the position of individuals and households can be strengthened vis-à-vis loan institutions. The appointment of the committee will include a specific mandate for the review of switching facilitation and switching costs reduction, and for the committee to work closely with the ICA as regards that issue. The Committee shall present its report no later than 15 January 2013.

Moreover, the Icelandic authorities have endorsed the following commitments by Arion Bank:

Limitation on acquisition

Arion Bank commits itself not to acquire financial institutions until 1 December 2014. Notwithstanding this commitment, Arion Bank may, after obtaining the Authority's approval, acquire such undertakings, in particular if this is necessary in order to safeguard financial stability.

[...]

Arion Bank commits itself to [...].

Divestment of shares in companies under restructuring

Arion Bank commits itself, to sell, as soon as possible, shareholdings in operating companies, which have been taken over due to restructuring, cf. Article 22 of the Act on Financial Undertakings No 161/2002. Furthermore, the bank commits itself to follow the procedure and time-limits, in the above-mentioned legal provision as interpreted by the FME. Finally, the bank will maintain up-to-date information on its website (or website of a relevant subsidiary) on such shareholdings that are held for sale.

Measures benefitting new and small competitors

Arion Bank commits itself to enact the following measures for the benefit of new and small competitors, until 1 December 2014:

- (a) Arion Bank will not enforce contract clauses, nor introduce new contract clauses, on interest rates in housing mortgage agreements for individuals that make special terms on interest rates contingent upon maintaining a minimum range of business with the bank.
- (b) Arion Bank will provide for easily accessible information, at the bank's website, on the process of switching banking services to another financial institution. Furthermore, the website will make easily accessible the necessary documents to switch between financial institutions. The same information and business-transfer forms will be available at the branches of the bank.
- (c) Arion Bank will execute all requests for transfer of banking services in a swift manner.
- (d) Arion Bank will not invoke state involvement as a source of competitive advantage when marketing.

- (e) Provided that competitive service offers are not available, Arion Bank is willing to offer the following services at a price that will be based on cost plus a reasonable margin, as decided by the Bank at any given time:
- (i) Payment processing services for ISK.
 - (ii) Payment processing services for FX.

2. RELEVANT ADAPTATIONS AND CHANGES TO THE REGULATORY AND SUPERVISORY FRAMEWORK FOR FINANCIAL MARKETS IN ICELAND ADOPTED AFTER THE CRISIS

The Icelandic authorities have submitted the following overview of amendments made to the legislation which was in effect in the autumn of 2008:

- FME's (The Icelandic Financial Supervisory Authority) authorisations to intervene (to take over the powers of shareholders' meetings and dispose of assets, cf. the emergency legislation) have been increased; FME has been given expanded supervisory authorisations; additional provisions have been adopted enabling FME to evaluate the operations or behaviour of individual supervised parties. These include both decision-making authorisations, such as on the closing of establishments or termination of specific activities without actual revocation of operating licences, as well as a more detailed definition of concepts whose interpretation has been disputed by FME and supervised entities or appellate bodies.
- Rules on individual large exposures have been clarified and made more specific; both the role and responsibility of risk management have been increased and FME authorised to accord risk management higher status in the organisation of financial undertakings; provisions on the application of stress tests have been tightened.
- Provisions for a special registry of larger borrowers have been legalised, in order to provide better overview of large, individual exposures to two or more financial undertakings. The registry is important for linking exposures together and assessing their systemic impact if difficulties should arise in the borrowers' operations. Entities not subject to FME supervision, but which are listed in the registries of financial undertakings, must provide FME with information on all their obligations. FME can prohibit the provision of services to such parties should they refuse to provide the information requested.
- Provisions on sound business practices have been reinforced and the existence of the Complaints Committee on Transactions with Financial Undertakings enshrined in law; detailed information must be disclosed on all major owners of financial undertakings.
- The time limits allowing financial undertakings to dispose of appropriated assets have been shortened.
- Provisions on financial undertakings' holdings in own shares have been tightened and defined in more detail. Holdings of subsidiaries are now considered own shares, as are off-balance-sheet contracts concerning own shares.
- Financial undertakings have been prohibited from extending credit against pledges of their own shares or guarantee capital certificates.
- FME is now to lay down rules as to how loans secured by a mortgage on the shares of other financial undertakings are to be calculated in the risk base and capital base.
- Both the responsibility and role of internal auditing section has been increased. There are detailed rules concerning the balance between the size and diversity of the activities of the financial undertaking concerned and the scope of its internal auditing section.
- Five-year limits have been placed on the period for which an auditing firm may carry out the audit of the same financial undertaking; financial undertakings' ability to dismiss a 'difficult' auditor is reduced.
- All provisions on calculation of equity and various other technical aspects have been reviewed.

- Rules on exercising qualifying holdings, i.e. 10 % or more of voting rights, have been reviewed. FME is authorised to reverse the onus of proof in assessing parties intending on acquiring or adding to qualifying holdings, e.g. when it is uncertain who is/are the beneficial owner/-s of a holding company with a qualifying holding.
- Additional demands on eligibility have now been made of directors, their responsibility for supervision or operations have been increased and executive chairmen of the Board are prohibited; FME has been assigned a greater supervisory role for Boards of Directors; personally identifiable information must be disclosed on remuneration to senior management.
- Rules have been set concerning credit transactions of financial undertakings with directors, managing directors, key employees and owners of qualifying holdings in the financial undertaking concerned. Similar rules apply to parties closely connected with the above-mentioned. FME has adopted rules as to what is considered satisfactory collateral for such transactions.
- Rules concerning arrangements for incentive schemes and bonuses to management and employees and on termination contracts have been adopted.
- Provisions on the reorganisation and winding-up of financial undertakings have been tightened.
- An overall revision of special rules on savings banks has been carried out. The status and rights of guarantee capital owners of savings banks have been clarified, restrictions set on dividends, clear rules have been adopted on guarantee capital transactions, rules have been set on write-downs of guarantee capital and rules on savings banks' authorisations for formal cooperation have been clarified. Savings banks have been prohibited from altering their legal form.

According to the Icelandic authorities, Icelandic rules in some respects go beyond the pan-European framework. The main deviations from rules adopted by the EU which have been taken up in the EEA Agreement are the following:

- FME is authorised to restrict the activities of individual establishments of financial undertakings, if it sees reason to do so. Furthermore, it is authorised to set special requirements for individual establishments of financial undertakings to continue their activities. FME may also limit provisionally the activities which a financial undertaking may pursue, in full or in part, whether subject to license or not, if the Authority sees reason to do so. This is naturally prompted not least by the activities of branches and deposit accounts established by them in other European states until 2008 (Icesave, Edge and Save-and-Save).
- Considerably more detailed provisions are set concerning the role of internal audit in Icelandic law than in the EU directives.
- Considerably more detailed provisions are set on how stress tests are to be carried out than in the EU directives.
- Financial undertakings must keep a special registry (a credit registry) of all parties to whom they extend credit and submit an updated list to FME at the end of each month. Furthermore, a similar list shall be sent on parties closely connected with financial undertakings, their Boards of Directors and managers and groups of connected clients, to the extent that these parties are not on the above-mentioned list. This list will provide a better opportunity to monitor inter-linkages between financial undertakings, their directors and management.
- If FME is of the opinion that the borrowing of a single party on the credit registry, which is not subject to official supervision of financial activities, could have a systemic impact, it may demand information from the party concerned on its obligations.
- Should a party not subject to official supervision listed on the credit registry refuse to disclose information to FME, the Authority may order supervised entities to refrain from providing the said party with further service. The same applies if the information disclosure of the party concerned is unsatisfactory. The provisions on a credit registry and extensive authorisations to supervisors concerning parties not subject to official supervision are not in EU/EEA rules.

- There are considerably more detailed and restrictive provisions on related party lending and collateral than in EU/EEA rules.
- FME must refuse the owner of a qualifying holding the right to exercise the holding if there is doubt as to who is or will be its beneficial owner.
- The maximum length of time external auditors can work for the same financial undertaking is shorter than in EU/EEA rules.
- There are considerably more detailed provisions on the eligibility of directors in financial undertaking than in the EU directives.
- Provisions are adopted on arrangements for bonus schemes and termination contracts.
- Recently formal rules have been set on remuneration policies in EU directives, but rules on termination contracts have not yet been adopted in this forum.

On 23 March 2012, the Minister of Economic Affairs introduced a report on the future structure of the Icelandic financial system. The Minister has further appointed an expert group to prepare a legislative frame for all financial activities in Iceland.
