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<sup>(1)</sup> Texte présentant de l'intérêt pour l'EEE

## II

*(Communications)*COMMUNICATIONS PROVENANT DES INSTITUTIONS, ORGANES ET  
ORGANISMES DE L'UNION EUROPÉENNE

## COMMISSION EUROPÉENNE

**Notes explicatives de la nomenclature combinée des Communautés européennes**

(2011/C 41/01)

Conformément à l'article 9, paragraphe 1, point a), deuxième tiret, du règlement (CEE) n° 2658/87 du Conseil du 23 juillet 1987 relatif à la nomenclature tarifaire et statistique et au tarif douanier commun <sup>(1)</sup>, les notes explicatives de la nomenclature combinée des Communautés européennes <sup>(2)</sup> sont modifiées comme suit:

À la page 354:

**8528 71 11      Récepteurs de**  
**à                signaux vidéo-**  
**8528 71 19      phoniques**  
**(tuners)**

Le texte actuel est remplacé par le texte suivant:

«Ces sous-positions incluent les appareils incorporant un récepteur de signaux vidéophoniques qui convertit les signaux de télévision haute fréquence en signaux utilisables par les appareils d'enregistrement ou de reproduction vidéophoniques ou par les moniteurs.

Ces appareils sont munis de circuits de sélection des canaux ou fréquences porteuses, ainsi que de circuits de démodulation. Ces appareils peuvent également être équipés de circuits de décodage (couleur) ou de circuits de séparation des signaux de synchronisation. Ils sont généralement conçus pour fonctionner sur antenne individuelle ou collective (distribution par câble à haute fréquence).

Le signal obtenu en sortie est tel qu'il peut servir de signal d'entrée pour les moniteurs ou pour les appareils d'enregistrement ou de reproduction vidéophoniques. Il s'agit en fait du signal original de la caméra, lequel est effectué avant modulation au niveau de l'émetteur.

Les récepteurs de signaux vidéophoniques analogiques couverts par ces sous-positions peuvent également prendre la forme de modules contenant, au moins, les circuits de radiofréquence (étage RF), les circuits de fréquence intermédiaire (étage IF) et des circuits de démodulation (étage de démodulation) lorsque le signal de sortie est un signal audio et un signal bande de base composite (CVBS) séparé.

Les récepteurs de signaux vidéophoniques numériques couverts par ces sous-positions peuvent prendre la forme de modules contenant, au moins, l'étage RF, l'étage IF, l'étage de démodulation et un décodeur MPEG pour télévision numérique lorsque le signal de sortie est un signal audio et vidéo numérique séparé.

<sup>(1)</sup> JO L 256 du 7.9.1987, p. 1.

<sup>(2)</sup> JO C 133 du 30.5.2008, p. 1.

Les modules contenant la fois un récepteur de signaux vidéophoniques analogique et un récepteur de signaux vidéophoniques numérique relèvent de ces sous-positions lorsqu'un des composants doit être classé en tant que récepteur de signaux vidéophoniques complet ou fini, conformément à la règle générale d'interprétation 2 a) pour l'interprétation de la nomenclature combinée.

Les modules ne remplissant pas les conditions établies ci-dessus doivent être classés dans la position 8529 en tant que parties.»

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## IV

(Informations)

INFORMATIONS PROVENANT DES INSTITUTIONS, ORGANES ET  
ORGANISMES DE L'UNION EUROPÉENNE

## COMMISSION EUROPÉENNE

Taux de change de l'euro <sup>(1)</sup>

9 février 2011

(2011/C 41/02)

1 euro =

Monnaie			Taux de change		
USD	dollar des États-Unis	1,3647	AUD	dollar australien	1,3510
JPY	yen japonais	112,65	CAD	dollar canadien	1,3573
DKK	couronne danoise	7,4560	HKD	dollar de Hong Kong	10,6275
GBP	livre sterling	0,85000	NZD	dollar néo-zélandais	1,7687
SEK	couronne suédoise	8,7885	SGD	dollar de Singapour	1,7399
CHF	franc suisse	1,3152	KRW	won sud-coréen	1 515,22
ISK	couronne islandaise		ZAR	rand sud-africain	9,8339
NOK	couronne norvégienne	7,8685	CNY	yuan ren-min-bi chinois	8,9930
BGN	lev bulgare	1,9558	HRK	kuna croate	7,4158
CZK	couronne tchèque	24,212	IDR	rupiah indonésien	12 180,12
HUF	forint hongrois	271,61	MYR	ringgit malais	4,1473
LTL	litas lituanien	3,4528	PHP	peso philippin	59,383
LVL	lats letton	0,7035	RUB	rouble russe	40,0022
PLN	zloty polonais	3,8943	THB	baht thaïlandais	41,937
RON	leu roumain	4,2565	BRL	real brésilien	2,2768
TRY	lire turque	2,1650	MXN	peso mexicain	16,4647
			INR	roupie indienne	62,0500

<sup>(1)</sup> Source: taux de change de référence publié par la Banque centrale européenne.

## Communication de la Commission sur la protection du droit d'auteur pour le dessin de la face commune des pièces en euros

(2011/C 41/03)

### INTRODUCTION

Au printemps 1996, les États membres ont décidé que les pièces en euros destinées à la circulation présenteraient une face commune et une face nationale, et ont chargé la Commission d'organiser un concours au niveau européen pour sélectionner le dessin de la face commune des pièces en euros. Les dessins gagnants ont été sélectionnés par les chefs d'État et de gouvernement en juin 1997. Il existe huit sortes de pièces en euros destinées à la circulation: les pièces de 1, 2, 5, 10, 20 et 50 centimes et les pièces de 1 et 2 euros.

Conformément au règlement (CE) n° 974/98 du Conseil concernant l'introduction de l'euro <sup>(1)</sup>, les pièces en euros ont été mises en circulation le 1<sup>er</sup> janvier 2002.

Les valeurs unitaires et les spécifications techniques des pièces en euros destinées à la circulation sont définies dans le règlement (CE) n° 975/98 du Conseil <sup>(2)</sup>.

Le 7 juin 2005, le Conseil a estimé qu'il y avait lieu de modifier les faces communes des pièces de 10, 20 et 50 centimes ainsi que des pièces de 1 et 2 euros, qui représentaient l'Union européenne avant son élargissement de 15 à 25 États membres en 2004, de sorte qu'à l'avenir, tous les États membres de l'Union européenne soient représentés. Les faces communes des plus petites pièces (1, 2 et 5 centimes) n'ont pas été modifiées dès lors qu'il s'agit d'une représentation de l'Europe dans le monde, qu'il n'y a pas lieu de changer à la suite de l'élargissement de l'Union européenne.

Les nouvelles faces communes ont été introduites progressivement à partir de 2007, et toutes les pièces en euros destinées à la circulation des millésimes 2008 et suivants présentent les nouvelles faces communes.

L'artiste qui a remporté le concours européen pour les dessins des faces communes des pièces, sélectionnés par les chefs d'État et de gouvernement en juin 1997, a cédé les droits d'auteur afférents aux dessins des anciennes et des nouvelles faces communes à la Commission.

La communication de la Commission du 22 octobre 2001 sur la protection par le droit d'auteur du dessin de la face commune des pièces en euros <sup>(3)</sup> décrit le dispositif mis en place pour assurer le respect des droits d'auteur et le régime applicable en matière de reproduction des dessins des faces communes.

Compte tenu de l'élargissement de la zone euro postérieurement à l'adoption de la communication et à la cession des droits d'auteur pour les dessins des faces communes aux nouveaux États membres, il convient d'actualiser l'annexe de la communication pour y ajouter les noms des autorités désignées dans les

États membres qui ont adopté l'euro entre-temps (Slovénie en 2007, Chypre et Malte en 2008, Slovaquie en 2009 et Estonie en 2011). Le groupe de travail des directeurs des Monnaies et le sous-comité «pièces en euros» ont également été consultés sur le fonctionnement du régime en matière de reproduction et d'application des règles durant l'automne 2009, et ont estimé que le régime actuel fonctionnait bien et ne devait pas être modifié. La présente communication remplace donc la communication de la Commission du 13 novembre 2001 concernant la protection par le droit d'auteur du dessin des faces communes des pièces en euros. En dehors des modifications éditoriales, les modifications par rapport à la communication de 2001 se limitent donc à des mises à jour des considérants, de la clause de réexamen et de l'annexe.

### 1. Titulaire du droit d'auteur

Les droits d'auteur pour le dessin de la face commune des pièces en euros appartiennent à l'Union européenne représentée par la Commission. La Commission européenne a cédé à chacun des États membres ayant adopté l'euro tous les droits détenus par l'Union pour le territoire de cet État membre. Elle fera de même pour les autres États membres dès qu'ils adopteront l'euro.

### 2. Régime applicable en matière de reproduction

Le régime commun en matière de reproduction décrit ci-après sera appliqué par la Commission et par les États membres participants, conformément au règlement (CE) n° 974/98, sur leur territoire respectif. La reproduction de tout ou partie du dessin de la face commune des pièces en euros est autorisée sans recours à une procédure particulière dans les cas suivants:

- pour les photographies, dessins, peintures, films, images et d'une manière générale les reproductions planes (sans relief) pour autant qu'elles soient fidèles à l'original et ne soient pas utilisées de manière nuisible ou préjudiciable à l'image de l'euro;
- pour la reproduction en relief sur des objets autres que des pièces, médailles et jetons ou autres objets quels qu'ils soient, susceptibles d'être confondus avec des pièces;
- pour la reproduction sur des jetons constitués de substances malléables ou de plastique, pour autant qu'ils soient d'une taille au moins 50 pour cent supérieure ou inférieure à la taille des pièces réelles.

Il est également rappelé que la reproduction sur des médailles ou jetons en métal ou sur tout autre objet métallique pouvant être confondu avec une pièce n'est pas autorisée, conformément au règlement (CE) n° 2182/2004 du Conseil <sup>(4)</sup>.

<sup>(1)</sup> JO L 139 du 11.5.1998, p. 1.

<sup>(2)</sup> JO L 139 du 11.5.1998, p. 6.

<sup>(3)</sup> JO C 318 du 13.11.2001, p. 3.

<sup>(4)</sup> JO L 373 du 21.12.2004, p. 1.

Toute autre reproduction de tout ou partie du dessin de la face commune des pièces en euros doit obtenir l'autorisation expresse de la Commission européenne pour les États membres non participants et les pays tiers, ou de l'autorité désignée de l'État membre auquel les droits d'auteur ont été cédés dans le cas des États membres participants (la liste des autorités désignées des États membres participants est reproduite en annexe).

Les demandes d'autorisation adressées à la Commission européenne doivent être envoyées à la direction générale des affaires économiques et financières.

### **3. Respect effectif du droit d'auteur**

Il appartient aux États membres participants de veiller à ce que le droit d'auteur soit respecté sur leur territoire, conformément à leur législation nationale et au régime applicable en matière de reproduction, tel qu'il est décrit ci-dessus. La Commission entend veiller au respect du droit d'auteur dans les États membres non participants et dans les pays tiers, conformément à la législation nationale applicable.

Si la Commission ou les entités nationales auxquelles le droit d'auteur a été cédé ont connaissance d'un acte de reproduction non autorisé sur le territoire qui les concerne, elles prendront immédiatement des mesures pour y mettre un terme ou pour que les reproductions soient retirées de la circulation. La Commission ou les États membres (dans le cas des États membres participants) peuvent décider d'entamer des poursuites civiles ou pénales à l'encontre de la personne responsable de la reproduction conformément à la législation nationale en vigueur.

La Commission entend œuvrer en coordination avec les États membres pour faire respecter le droit d'auteur. À cet effet, les États membres sont invités à informer la Commission de toute mesure prise pour assurer ce respect ainsi que pour la mise en œuvre des règles de reproduction.

### **4. Évaluation du présent dispositif**

La Commission peut décider de réexaminer la mise en œuvre des règles décrites ci-dessus en vue d'adapter les dispositions actuelles à la lumière de l'expérience acquise.

## ANNEXE

**Liste des autorités désignées mentionnées au paragraphe 2 de la communication**

BELGIQUE:	Ministère des finances, administration de la trésorerie/Federale Overheidsdienst Financiën, Administratie van de thesaurie/Föderaler öffentlicher Dienst Finanzen, Schatzamt)
ALLEMAGNE:	Bundesministerium der Finanzen (Ministère des finances)
ESTONIE:	Eesti Pank (Banque d'Estonie)
IRLANDE:	Ministère des finances
GRÈCE:	Υπουργείο Οικονομίας και Οικονομικών — Γενικό Λογιστήριο του Κράτους — 825 Διεύθυνση Κινησης Κεφαλαίων, Εγγυήσεων Δάνειων και Αξιών (Ministère de l'économie et des finances — comptabilité générale de l'État — 25 <sup>e</sup> Direction des transferts de capitaux, garantie des prêts et titres)
ESPAGNE:	Dirección General del Tesoro y Política Financiera (Direction générale du Trésor et de la politique financière)
FRANCE:	Ministère de l'économie, des finances et de l'industrie: Direction générale du Trésor
ITALIE:	Ministero dell'economia e delle finanze, (ministère de l'économie et des finances)
CHYPRE:	Banque centrale de Chypre
LUXEMBOURG:	Ministère des finances — Service de la Trésorerie
MALTE:	Banque centrale de Malte
PAYS-BAS:	Ministerie van Financiën — Direktie Binnenlands Geldwezen (Ministère des finances — Direction des affaires monétaires intérieures)
AUTRICHE:	Münze Österreich AG (Monnaie autrichienne)
PORTUGAL:	Imprensa Nacional (Imprimerie nationale). Casa da Moeda (Hôtel des Monnaies)
SLOVÉNIE:	Ministrstvo za finance (Ministère des finances)
SLOVAQUIE:	Národná banka Slovenska (Banque nationale de Slovaquie)
FINLANDE:	Valtiovarainministeriö/Finansministeriet (Ministère des finances)



## INFORMATIONS RELATIVES À L'ESPACE ÉCONOMIQUE EUROPÉEN

## AUTORITÉ DE SURVEILLANCE AELE

**Invitation à présenter des observations, en application de l'article 1<sup>er</sup>, paragraphe 2, de la partie I du protocole 3 de l'accord entre les États de l'AELE relatif à l'institution d'une Autorité de surveillance et d'une Cour de justice, au sujet d'une aide d'État concernant le rétablissement de certaines opérations de (l'ex-) Kaupthing Bank hf et la mise en place et la capitalisation de New Kaupthing Bank (aujourd'hui renommée Arion Bank hf)**

(2011/C 41/04)

Par décision n° 492/10/COL du 15 décembre 2010, reproduite dans la langue faisant foi dans les pages qui suivent le présent résumé, l'Autorité de surveillance AELE a ouvert la procédure prévue à l'article 1<sup>er</sup>, paragraphe 2, de la partie I du protocole 3 de l'accord entre les États de l'AELE relatif à l'institution d'une Autorité de surveillance et d'une Cour de justice. Les autorités islandaises ont reçu copie de la décision.

Par la présente, l'Autorité de surveillance AELE invite les États de l'AELE, les États membres de l'UE et les parties intéressées à soumettre leurs observations sur la mesure en cause dans un délai d'un mois à compter de la publication de la présente communication, à l'adresse suivante:

Autorité de surveillance AELE  
Greffe  
Rue Belliard 35  
1040 Bruxelles  
BELGIQUE

Ces observations seront communiquées aux autorités islandaises. L'identité des parties intéressées qui présentent des observations peut faire l'objet d'un traitement confidentiel sur demande écrite et motivée.

## RÉSUMÉ

**Procédure**

À la suite de discussions approfondies menées entre l'Autorité et les autorités islandaises depuis l'effondrement du système financier islandais en octobre 2008, l'aide d'État concernant le rétablissement de certaines opérations de Kaupthing Bank et la mise en place et la capitalisation de New Kaupthing Bank a été notifiée rétrospectivement par les autorités islandaises le 20 septembre 2010. Les autorités islandaises ont également communiqué d'autres informations lors d'une réunion qui s'est tenue à Reykjavik le 29 septembre 2010 et par lettres datées des 9, 11, 15 et 28 novembre 2010.

**Les faits**

En octobre 2008, les trois principales banques commerciales islandaises, Glitnir, Kaupthing et Landsbanki, ont rencontré des difficultés pour refinancer leur dette à court terme et ont été confrontées à une vague de retraits. Le parlement islandais a voté une loi d'urgence, qui conférait à l'État des droits étendus pour intervenir dans le secteur bancaire. Sur cette base, l'autorité de surveillance financière islandaise a décidé, les 7 et 9 octobre 2008, de prendre le contrôle des activités de ces trois banques et a désigné des comités d'administration provisoires chargés de reprendre les attributions des assemblées générales des actionnaires et des conseils d'administration. Parallèlement, trois nouvelles banques ont été créées, New Glitnir (renommée ensuite Islandsbanki), New Kaupthing (renommée ensuite Arion Bank) et NBI (opérant sous la dénomination Landsbankinn), pour reprendre les actifs nationaux, les opérations et engagements nationaux liés aux dépôts. Au départ, ces nouvelles banques appartenaient entièrement à l'État.

Mesures applicables à Arion Bank:

- 1) En octobre 2008, l'État a octroyé à la banque une somme en numéraire de 775 millions d'ISK (5 millions d'EUR) en tant que capital initial et s'est engagé à capitaliser entièrement la banque.
- 2) Le 14 août 2009, l'État a accepté d'injecter dans Arion Bank un capital de première catégorie de 72 milliards d'ISK sous la forme d'obligations d'État, ce qui a été mis à exécution le mois suivant.
- 3) Suite à un accord conclu le 1<sup>er</sup> décembre 2009 sur des règlements concernant les actifs et les engagements liés aux dépôts transférés de (l'ex-) Kaupthing à Arion Bank, le comité d'administration provisoire de (l'ex-) Kaupthing a acquis 87 % du capital social de Arion Bank, les 13 % restants étant détenus par l'État. Le capital de l'État ne sera rémunéré qu'après sa vente finale.
- 4) Le capital de catégorie II accordé par l'État à la nouvelle banque sous forme d'un emprunt subordonné, libellé dans une devise étrangère, correspond à 29,5 milliards d'ISK. L'échéance des titres est de dix ans à compter du 30 décembre 2009 à un taux d'intérêt annuel pour les cinq premières années de 400 points de base au-dessus de l'EURIBOR, et de 500 points de base au-dessus de l'EURIBOR pour la période entre cinq et dix ans.

(Les mesures ci-dessus sont qualifiées collectivement de «mesures de capitalisation».)

- 5) La déclaration du gouvernement islandais garantissant entièrement les dépôts nationaux dans toutes les banques commerciales et caisses d'épargne islandaises.
- 6) Une garantie de l'État concernant les actifs payables à la banque en échange de son acceptation de la responsabilité pour les dépôts de la banque en faillite Reykjavík Savings Bank (SPRON), et un accord sur une facilité de trésorerie spéciale prévoyant des prêts d'État pouvant être utilisés comme garantie pour les prêts à court terme auprès de la banque centrale d'Islande.

#### Appréciation

La conclusion préliminaire de l'Autorité est que les mesures de capitalisation et l'accord spécial sur les liquidités comportent une aide d'État à Arion Bank au sens de l'article 61, paragraphe 1, de l'accord EEE. L'Autorité ne peut pas non plus exclure qu'une aide supplémentaire ait été octroyée par la déclaration du gouvernement islandais sur la garantie des dépôts et la garantie par l'État des actifs dus à la banque résultant de l'accord SPRON.

L'Autorité appréciera l'aide accordée au titre de l'article 61, paragraphe 3, point b), de l'accord EEE, en se basant sur l'hypothèse selon laquelle cette aide était nécessaire pour remédier à une perturbation grave de l'économie islandaise. Toutefois, les mesures d'aide exigent la présentation d'un plan de restructuration détaillé en ce qui concerne Arion Bank; en l'absence d'un tel plan, l'Autorité a des doutes quant à la compatibilité de ces mesures avec l'accord EEE.

#### Conclusion

À la lumière des considérations qui précèdent, l'Autorité a décidé d'ouvrir la procédure formelle d'examen conformément à l'article 1<sup>er</sup>, paragraphe 2, de la partie I du protocole 3 de l'accord entre les États de l'AELE relatif à l'institution d'une Autorité de surveillance et d'une Cour de justice. Les parties intéressées sont invitées à présenter leurs observations dans un délai d'un mois à compter de la publication de la présente décision au *Journal officiel de l'Union européenne*.

#### EFTA SURVEILLANCE AUTHORITY DECISION

No 492/10/COL

of 15 December 2010

**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)**

**(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 and Protocol 26,

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 and Articles 4(4) and 13(1) of Part II,

Having regard to the temporary rules regarding the financial crisis in Part VIII of the Authority's State Aid Guidelines <sup>(1)</sup>,

Whereas:

## I. FACTS

### 1. Procedure

On 2 October 2008, the Icelandic authorities informed the Authority of their intention to inject EUR 600 million of capital into Glitnir Bank in return for 75 % of its shares. The information was provided by way of a draft notification said to be submitted for legal certainty only as it was contended that the measure did not involve State aid. This proposal was however subsequently abandoned due to a further deterioration in the financial position of Iceland's main commercial banks and on 6 October, the Icelandic Parliament (the *Althingi*) passed 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 State wide-ranging powers to intervene in the banking sector. On 10 October 2008, the President of the Authority wrote to the Icelandic authorities and (among other matters) requested that State aid measures taken under the Emergency Act be notified to the Authority as the Icelandic authorities had previously indicated that they would. On 14 October 2008, the Icelandic authorities submitted a further draft notification, informing the Authority that in their opinion the measures undertaken under the Emergency Act to establish new banks as a result of the failure of the commercial banks did not involve State aid. A letter in response was sent by the Authority on 20 October 2008 indicating that it considered this unlikely and referred to the information that would be required in a notification. The matter was also discussed shortly thereafter in a meeting in Reykjavik on 24 October 2008. 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. On 22 July 2009, the Icelandic authorities informed the Authority that heads of terms had been agreed with resolution committees appointed to administer the estates of the (old) failed banks, which would lead to the new banks being capitalised by the Icelandic State on 14 August 2009. The Icelandic authorities again insisted that no State aid was involved and provided little information beyond what was already publicly available. Correspondence continued and meetings between the respective authorities followed both in August and November 2009, during which the Authority made it clear that from the limited information it had received it believed that the capitalisation of the new banks involved State aid that required notification. Given that the measures had already been implemented, the Authority subsequently sought to assist the Icelandic authorities in producing restructuring plans for the banks with the intention of proceeding directly to assess the measures in one procedure. It transpired, however, that the authorities and the banks were not yet in a position to produce definitive, detailed plans. State aid involved in the restoration of certain operations of (old) Kaupthing Bank and the establishment and capitalisation of New Kaupthing Bank was eventually notified retrospectively by the Icelandic authorities on 20 September 2010, although the process of restructuring the bank in order to ensure its long-term viability remains ongoing. The Icelandic authorities also submitted further information in a meeting held in Reykjavik on 29 September 2010 and by letters of 9, 11, 15 and 28 November 2010.

### 2. Background — the financial crisis and major causes of failure of the Icelandic banks

In their notification of the aid granted to New Kaupthing Bank (later renamed 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 <sup>(2)</sup>, whose remit was to investigate and analyse the processes leading to the collapse of the three main banks. In Sections 2.1 and 2.2 below, the Authority summarises 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.

<sup>(1)</sup> Available at: <http://www.eftasurv.int/state-aid/legal-framework/state-aid-guidelines/>

<sup>(2)</sup> 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/>

## **2.1. Causes of failure linked to the global financial crisis and its impact on underlying problems of Kaupthing and the other main Icelandic banks**

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 dependant 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.

### **2.1.1. Excessive and unsustainable expansion**

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 ISK 1,4 trillion <sup>(1)</sup> in 2003 to ISK 14,4 trillion 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 <sup>(2)</sup>, 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.

### **2.1.2. The reduction in finance available on the international markets**

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 EUR 14 billion 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.

### **2.1.3. The gearing of the banks' owners**

In the case of each major Icelandic bank, the principal owners were among the biggest debtors <sup>(3)</sup>. 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 <sup>(4)</sup> increased steadily from EUR 400-500 million to EUR 1 400-1 700 million and during 2007 and 2008 such lending was nearly equal to the bank's capital base. This increase in 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 <sup>(5)</sup>. 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 ISK 14 billion. 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 EUR 2 billion <sup>(6)</sup>.

### **2.1.4. Concentration of risk**

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.

<sup>(1)</sup> Icelandic *króna*.

<sup>(2)</sup> Lending to foreign parties increased by EUR 11,4 billion from EUR 8,3 billion to EUR 20,7 billion in six months.

<sup>(3)</sup> Chapter 21.2.1.2 of the Report.

<sup>(4)</sup> Exista, Exista Trading, Bakkavör Group, Bakkavor Finance Ltd, Bakkabraedur Holding B.V., Lýsing, Síminn, Skipti and other related companies.

<sup>(5)</sup> More than half of such loans granted from the beginning of 2007 until the collapse of the bank, were granted without collateral.

<sup>(6)</sup> 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.

### 2.1.5. *Weak equity*

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' <sup>(1)</sup>, 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 this 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 ISK 400 billion, 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.

## 2.2. *Causes of failure based on deficient regulation of the banks by the State and the size of the banks in relation to the rest of the Icelandic economy*

### 2.2.1. *The size of the banks*

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 were international and held assets worth nine times Icelandic GDP. The SIC report notes that by 2006, observers were commenting that the banking system had outgrown the capacity of the Central Bank of Iceland ('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, and the foreign deposits of the three banks were 8 times larger, than the foreign exchange reserve. The Depositors and Investors Guarantee Fund held minimal resources in comparison with the bank deposits it was meant to guarantee. These factors, the SIC concludes, made Iceland susceptible to a run on its banks <sup>(2)</sup>.

### 2.2.2. *The sudden growth of the banks in comparison with the regulatory and financial infrastructure*

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 Icelandic Financial Supervisory Authority (the 'FME') and CBI lacked the expertise and experience to regulate the banks in difficult economic times, but could have taken action 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 <sup>(3)</sup>.

### 2.2.3. *Imbalance and overexpansion of the Icelandic economy as a whole*

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' <sup>(4)</sup>. 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 ISK 30 billion in the autumn of 2005 to ISK 500 billion by the beginning of October 2008.

### 2.2.4. *The Icelandic króna, external imbalances and CDS spreads*

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

<sup>(1)</sup> Chapter 21.2.1.4 of the Report.

<sup>(2)</sup> These issues are discussed in more detail in the following paper by Willem H. Buiter and Anne Sibert: <http://www.cepr.org/pubs/PolicyInsights/PolicyInsight26.pdf>

<sup>(3)</sup> 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.

<sup>(4)</sup> Chapter 2, page 5 of the report.



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 on Iceland and the banks rose exponentially.

### 3. Description of the measures

#### 3.1. Background

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 ISK 5,347 billion (EUR 58,3 billion) and it reported net earnings of ISK 71 billion (EUR 799 million) in that year <sup>(1)</sup>. Kaupthing was primarily a northern European bank operating in 13 countries, including all of the Nordic countries, Luxembourg, Belgium, Switzerland, the United Kingdom, the United States, the United Arab Emirates (Dubai) and Qatar. Kaupthing offered integrated financial services to companies, institutional investors and individuals. These services were divided into five business segments: Banking (both Corporate Banking and Retail Banking), Capital Markets, Treasury, Investment Banking as well as 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.

#### 3.2. The collapse of Kaupthing Bank

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. 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 EUR 600 million 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. 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 EUR 500 million 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.

#### 3.3. National legal basis for the aid measures

- 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.

<sup>(1)</sup> Kaupthing Bank Annual Report 2007. The bank's recent annual reports are available at: <http://www.kaupthing.com/Investors/Financial-Reports-and-Data/Annual-Reports>

— Supplementary State Budget Act for 2008 (Article 4)

— State Budget Act for 2009 (Article 6)

### 3.4. *The intervention of the Icelandic State*

The Icelandic authorities' intervention can be categorised into three phases as follows: firstly, restoration of basic banking in October 2008 through the formation of New Kaupthing; secondly, contributions made to properly capitalise the new bank for the first time in the autumn of 2009 (before the majority of the bank was acquired by the creditors of the old bank); and thirdly, the restructuring of the bank, which began when the bank was restored and is ongoing.

#### 3.4.1. *Phase 1: Restoration of certain operations of Kaupthing Bank and the establishment of New Kaupthing Bank*

On 9 October 2008, the FME took control of Kaupthing Bank in order to ensure the continuation of domestic retail banking operations. This was done through the appointment of a Resolution Committee for Kaupthing, which assumed the powers of shareholders' meetings and the board of directors; and subsequently the establishment by the Icelandic Government of New Kaupthing Bank, wholly owned by the State.

On 21 October 2008, the FME transferred the liability for all deposits held in Kaupthing, except for those held in foreign branches, to the new bank. The total amount of liability for domestic deposits transferred was ISK 417,391 million. Certain assets were also transferred to the new bank based on a principle that assets connected to the old bank's domestic operations were to be credited to the new bank with the remainder staying with the old bank. This was, however, subject to certain exceptions <sup>(1)</sup>. The FME also published an internal FME memorandum setting out 'guiding principles' for what was to be transferred not only to New Kaupthing but also to two other new successor banks that were formed following the collapse of Glitnir and Landsbanki <sup>(2)</sup>.

In return for the assets transferred to the new bank, the old bank was to be compensated to the sum of the difference between the value of the assets transferred and the amount of the liabilities (deposits) transferred (if a positive value). In accordance with Article 5 of the Emergency Act and the subsequent decisions of the FME on the disposal of assets and liabilities of the old banks, the FME commissioned a valuation of the net assets transferred from the old banks to the respective new banks. Deloitte LLP was appointed by the FME on 24 December 2008 to prepare the net asset valuations of each of the new banks. The process of valuation was however to prove complex and lengthy.

#### Initial capital

The State provided ISK 775 million <sup>(3)</sup> (EUR 5 million) in cash as initial capital to the new bank and in addition issued a commitment to contribute up to ISK 75 billion in total as Tier I risk capital to the new bank in return for its entire equity. This 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.

#### Deposit guarantee

The initial rescue measures of the Icelandic Government also involved State backing of deposits in domestic commercial and savings banks. An announcement from the Prime Minister's Office of 6 October 2008 on Deposit Guarantee stated that the 'Government of Iceland underlines that deposits in domestic commercial and savings banks and their branches in Iceland will be fully covered' <sup>(4)</sup>. This announcement has since been

<sup>(1)</sup> The decision of the FME of 21 October 2008 on the disposal of assets and liabilities of Kaupthing Bank can be found at <http://www.fme.is/lisalib/getfile.aspx?itemid=5725> The decision was subsequently amended on several occasions. The amendments are available on FME's website: <http://www.fme.is>

<sup>(2)</sup> The document is available at: <http://www.fme.is/lisalib/getfile.aspx?itemid=6021>

<sup>(3)</sup> 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 EUR (as appropriate) where it has been provided by the Icelandic authorities.

<sup>(4)</sup> The English translation of the announcement is available at: <http://eng.forsaetisraduneyti.is/news-and-articles/nr/3033>

repeated by the Office of the current Prime Minister in February and December 2009<sup>(1)</sup>. 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 for Finance, Minister for 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.'<sup>(2)</sup> 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<sup>(3)</sup>.

### 3.4.2. Phase 2: Rescue/Restructuring of Arion Bank (New Kaupthing) through recapitalisation

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 Kaupthing Bank (renamed Arion Bank as from 21 November 2009) and the basis for the compensation payable between the two parties for the transfer of net assets (if any) into the new bank following its creation in October 2008. 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 (old) Kaupthing Bank would not complete the subscription for shares in Arion Bank, the Government would retain full ownership.

On 14 August 2009, the Government announced that it had committed to capitalise Arion Bank with ISK 72 billion of Tier I capital in the form of government bonds, giving the bank a Core Tier I ratio of approximately 12 %<sup>(4)</sup>. The Government capitalisation of Arion Bank was executed on 9 October 2009, involving an injection of ISK 71,225 million into the bank, back-dated to 22 October 2008, in addition to the initial ISK 775 million in cash which the bank had received when it was founded on 22 October 2008. Total Government share capital was therefore ISK 72 billion. In addition, the Government paid to Arion Bank ISK 9,2 billion in accrued interest on the bonds.

On 4 September 2009, the Government announced that definitive agreements with the Resolution Committee of Kaupthing regarding the capitalisation of Arion Bank and the basis for compensation had been signed. The agreement principally contained (alternative) provisions for:

#### 1. Capitalisation under old bank (creditor) ownership (Joint Capitalisation Agreement)

Under this agreement the creditors of (old) Kaupthing had an opportunity to acquire (through the Resolution Committee) control of Arion Bank by subscribing to new share capital. Kaupthing was to pay for the new share capital from the old bank's own assets, as the value of the liabilities transferred to New Kaupthing (Arion Bank) exceeded the value of the assets transferred. 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 ISK 24 billion<sup>(5)</sup>.

<sup>(1)</sup> <http://www.efnahagsraduneyti.is/frettir/frettatilkynningar/nr/2842>

<http://www.efnahagsraduneyti.is/frettir/frettatilkynningar/nr/3001> The Minister for Economic Affairs has also referred to it recently in an interview with Viðskiptablaðið on 2 December 2010, p. 8: '(The declaration) will be withdrawn in due course. We do not intend to maintain unlimited guarantee of deposits indefinitely. The question when it will be withdrawn depends, however, on when an alternative and effective deposit system will come into force and a financial system which will have fully resolved its issues' (the Authority's translation).

<sup>(2)</sup> The relevant paragraph can be found at Section 16 (p. 6) of the letter: [http://www.efnahagsraduneyti.is/media/Acrobat/Letter\\_of\\_Intent\\_2nd\\_review\\_-\\_o.pdf](http://www.efnahagsraduneyti.is/media/Acrobat/Letter_of_Intent_2nd_review_-_o.pdf)

<sup>(3)</sup> [http://hamar.stjr.is/Fjarlagavefur-Hluti-II/Greinargerdir/Raedur/Fjarlagafurvarp/2011/Seinni\\_hluti/Kafli\\_8.htm](http://hamar.stjr.is/Fjarlagavefur-Hluti-II/Greinargerdir/Raedur/Fjarlagafurvarp/2011/Seinni_hluti/Kafli_8.htm)

<sup>(4)</sup> Also in August 2009, the FME imposed a minimum requirement of a 12 % Core Tier I capital ratio and a 16 % CAD ratio as a discretionary minimum capitalisation for Arion (the same as for Islandsbanki and NBI), to be maintained for at least three years. The definition of Core Tier I capital includes only equity, i.e. share capital and retained earnings, but does not include subordinated loans or other types of hybrid capital instruments.

<sup>(5)</sup> This was later revised upwards to ISK 29,5 billion during negotiations, cf. explanation of Tier II capital contribution below.



## 2. Capitalisation under Government ownership (Alternative Capitalisation Agreement)

In the event that Kaupthing's Resolution Committee decided not to acquire control of Arion Bank, the Government would continue to fully own the bank. The compensation would actually come from Kaupthing (the old bank) to Arion Bank (the new bank), as the value of the liabilities transferred to Arion Bank exceeded the value of the assets transferred. The amount of that compensation was calculated at ISK 38 billion, but was to be re-evaluated on a regular basis, based upon future performance of a certain loan portfolio. 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.

### Tier I capital contribution

On 1 December 2009, an agreement was reached between the Government and Arion Bank, on the one hand, and Kaupthing's Resolution Committee on behalf of Kaupthing's creditors, on the other, on settlements concerning assets and liabilities (deposits) transferred from Kaupthing to the new bank established in October 2008. On the same day, the Resolution Committee of Kaupthing decided <sup>(1)</sup> 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.

Kaupthing paid for its acquisition of the majority shareholding in Arion Bank by transferring assets from its estate valued at ISK 66 billion 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 ISK 32,6 billion in government bonds to the Government and issued a subordinated bond in favour of the Government to the sum of ISK 29,5 billion.

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 ISK 66 billion for 87 % of the shares instead of the ISK 62,6 billion that was originally envisaged (i.e. 87 % of ISK 72 billion). The Government paid ISK 12,208 billion for its 13 % share in Arion. To invest in Tier I capital on the same terms as Kaupthing Bank the Government would have paid approximately ISK 2,3 billion less for its 13 % share than was actually the case.

### Tier II capital contribution

The State also provided the new bank with a subordinated loan in order to strengthen its equity and liquidity position, and therefore comply with the capital requirements of the FME. The Tier II instrument provided by the Government is, according to the Icelandic authorities, based on a need to ensure a strong capital structure and is in accordance with the requirements of the FME.

The subordinated loan, denominated in foreign currency, corresponds to an amount of ISK 29,5 billion in the form of a capital instrument providing for Arion Bank to issue unsecured subordinated notes. The term of the notes is ten years as of 30 December 2009. The instrument 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 ten years the interest rate per annum is 500 basis points above EURIBOR.

### Special liquidity facility

The government financing of Arion Bank was carried out by means of an infusion of ISK 72 billion in repo-able government bonds in return for the bank's entire equity. Kaupthing Bank's decision to exercise its

<sup>(1)</sup> Subject to the approval of the FME and the Icelandic Competition Authority. Kaupthing's Resolution Committee currently controls the bank's holding on behalf of its creditors through a special holding company, Kaupskil. On 23 December 2009, the Icelandic Competition Authority cleared Kaupthing's acquisition of 87 % of shares in Arion Bank subject to certain conditions. Following the conclusion of an agreement on the ownership of Arion Bank between Kaupthing Bank and the Ministry of Finance, the FME on 11 January 2010 granted Kaupskil permission to own a qualifying holding in Arion Bank on behalf of Kaupthing Bank.

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 <sup>(1)</sup>. 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 a SPRON swap arrangement which is described in Section 3.5 below.

#### 3.4.3. Phase 3: Restructuring and long-term viability of Arion Bank

According to the Icelandic authorities, the restructuring process, which began by necessity through the collapse of Kaupthing and the transfer of its domestic assets and liabilities for domestic deposits to Arion Bank, remains incomplete. In view of the scale of the systemic collapse in comparison to the resources at the Icelandic government's disposal, and the lack of information available at the time of taking control of the banks, it was not considered prudent to attempt to fully restructure the financial system at that stage. Instead it was decided that a two-staged approach should be adopted. As a first stage, the enforced split would simultaneously achieve the aims of maintaining domestic banking services and significantly scaling down the unsustainably large financial system. The domestic operations transferred were however likely to represent an upper limit for the appropriate size of the Icelandic financial system and further restructuring was likely. In order to continue the process three further steps were required. The first was to settle the claims of international stakeholders (through the Resolution Committees of the old banks), the second was the re-capitalisation of the banks, and the third was to clearly establish their future ownership structure. The Icelandic authorities state that the three conditions were fulfilled in the first quarter of 2010 when new owners took control of the new banks and elected the first Boards of Directors with a mandate to develop a long-term business strategy on behalf of the future owners <sup>(2)</sup>.

A likely consequence of the fact that the rescue approach adopted in Iceland was not predominantly based on a 'good bank/bad bank split' is that extensive loan portfolio restructuring may have to be carried out by the new banks themselves. Despite numerous issues that have caused delays, the new banks have all taken important measures to avert impending losses by transferring impaired assets to specialised subsidiaries or selling them to new owners. They have also developed various programmes intended to resolve debt related issues in the retail and SME portfolios. Achievements have, however, been limited. Based on the ICAAP process <sup>(3)</sup> currently ongoing in all three new banks, the FME expects to be able to systematically enforce and document a definitive return to long-term sustainability by all three banks and conclude the restructuring of the Icelandic financial system.

A restructuring plan will therefore need to be submitted to the Authority in order for it to conclude its assessment of the State aid granted to Arion Bank, and its assessment of the new bank's viability, as soon as possible.

#### 3.5. The SPRON swap agreement and special liquidity facility

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 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 ISK 96,7 billion. All assets of SPRON were committed as collateral for the bond, including its shares in Drómi. The parties were unable to reach an agreement on the interest to be paid on the bond and referred the matter to the FME. The FME decided on 5 June 2009 that under the circumstances a rate of REIBOR <sup>(4)</sup> + 1,75 % was an appropriate rate. The FME analysed the deposit rates, the risk of outflow (and other funding cost), cost of handling and other relevant issues in determining the applicable interest rate. The FME will revise its decision bi-annually and is currently in the process of doing so for the first time.

<sup>(1)</sup> The FME second sign-off condition stated that 5 % of on-demand deposits should be in cash or cash-like assets and the bank should be able to withstand a 20 % instantaneous outflow of deposits. The deposits exceeded ISK 417 billion.

<sup>(2)</sup> In the case of Arion Bank this occurred on 25 January 2010.

<sup>(3)</sup> Internal Capital Adequacy Assessment Process, cf. Pillar II of the Basel II recommendation of bank supervisors and central bankers stating that it shall be in the hands of the financial regulator to monitor and assess the ICAAP of regulated banks.

<sup>(4)</sup> REIBOR denotes Reykjavík Interbank Offered Rate, representing the interbank market rate for short-term loans at Icelandic commercial and savings banks. The approach is similar to how many countries use LIBOR as the base rate for variable rate loans, but Icelandic banks use REIBOR (plus a premium) as the basis for supplying variable interest rate loans in the Icelandic currency, the króna.

In heads of terms signed on 17 July 2009 the Government agreed to hold Arion Bank harmless with respect to the value of SPRON bond <sup>(1)</sup>. The parties further agreed to work towards the SPRON bond being made eligible as collateral for funding from the CBI. 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 ISK 75 billion in government bonds if Kaupthing Bank 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.

On 21 September 2010, the Ministry of Finance and Arion Bank formalised the government's undertaking in the letter of 3 September by concluding an agreement on the loan of government bonds to be used as collateral. 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 ISK 75 billion. The 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 ISK 1 billion. The government bonds shall only be used to secure loans against collateral from the CBI for the purpose of acquiring liquidity for Arion Bank. 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 ISK 25 billion, 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 ISK 25 billion 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.

### 3.6. A comparison of the old and new banks: Arion Bank and Kaupthing Bank

The Authority will undertake a full assessment of the business plan of the new bank, including an analysis of the differences between the old and new banks and the potential for the same or similar problems to re-occur, following the submission by the Icelandic authorities of a detailed restructuring plan for the bank. The Icelandic authorities have, however, submitted an overview of the fundamental changes that have already taken place which the Authority considers to be relevant for the purposes of its current assessment.

There is a vast difference in the scope of Arion Bank's operations compared to those of Kaupthing Bank. As previously outlined, Kaupthing was an international bank with operations in various countries. Arion Bank was established by the transfer of mainly the domestic assets and operations of Kaupthing Bank, while other assets and operations of Kaupthing remain under the control of the Resolution Committee and the Winding-up Committee of Kaupthing.

Table 1

Comparison of the balance sheets of Arion Bank and Kaupthing Bank

	Arion Bank 31 December 2009	Kaupthing Bank 30 June 2008	AB as a % of KB
<b>Assets</b>			
Cash and balances with Central Bank	41 906	154 318	27,2 %
Loans and receivables to credit institutions	38 470	529 620	7,3 %
Loans and receivables to customers	357 734	4 169 181	8,6 %
Bonds and debt instruments	173 482	676 316	25,7 %

<sup>(1)</sup> This was later confirmed in a letter sent by the Ministry of Finance to Arion Bank dated 20 August 2009.

	Arion Bank 31 December 2009	Kaupthing Bank 30 June 2008	AB as a % of KB
Shares and equity instruments with variable income	7 078	172 286	4,1 %
Derivatives	6	328 217	0,0 %
Derivatives used for hedging		27 742	0,0 %
Securities used for hedging	2 236	81 207	2,8 %
Compensation instrument	34 371	—	nm.
Intangible assets	—	85 757	0,0 %
Investment property	22 947	37 013	62,0 %
Investment in associates	5 985	107 574	5,6 %
Property and equipment	10 700	39 240	27,3 %
Tangible assets	3 512	—	nm.
Tax assets	1 415	12 027	11,8 %
Non-current assets and disposal groups held for sale	41 527	—	nm.
Other assets	15 975	183 217	8,7 %
<b>Total assets</b>	<b>757 344</b>	<b>6 603 715</b>	<b>11,5 %</b>
<b>Liabilities</b>			
Due to credit institutions and Central Bank	113 647	670 930	16,9 %
Deposits	495 465	1 848 155	26,8 %
Borrowings	11 042	2 883 261	0,4 %
Financial liabilities at fair value	88	230 663	0,0 %
Subordinated loans	—	328 153	0,0 %
Tax liabilities	2 841	18 099	15,7 %
Non-current liabilities and disposal groups held for sale	19 230	—	nm.
Other liabilities	24 997	186 758	13,4 %
<b>Total liabilities</b>	<b>667 310</b>	<b>6 166 019</b>	<b>10,8 %</b>
<b>Equity</b>			
Share capital	12 646	7 187	176,0 %
Share premium	59 354	148 362	40,0 %
Other reserves	1 729	61 196	2,8 %
Retained earnings	16 150	207 461	7,8 %
<b>Total shareholder's equity</b>	<b>89 879</b>	<b>424 206</b>	<b>21,2 %</b>
Non-controlling interest	155	13 490	1,1 %
<b>Total equity</b>	<b>90 034</b>	<b>437 696</b>	<b>20,6 %</b>
<b>Total liabilities and equity</b>	<b>757 344</b>	<b>6 603 715</b>	<b>11,5 %</b>

A comparison of the old and new banks' balance sheets presented in Table 1 reveals a substantial difference in the size of the two operations as the total assets of Arion Bank 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 category. The book value of Kaupthing Bank's loan portfolio at the end of June 2008 was ISK 4,169 billion, whereas the book value of Arion Bank's loan portfolio at the end of 2009 was ISK 358 billion, 8,6 % of that of Kaupthing. The difference is due to the broad geographical scope of Kaupthing Bank compared to Arion Bank's Icelandic operations as well as impairments of the loan portfolio transferred to Arion Bank due to the economic turbulence in Iceland <sup>(1)</sup>. There is also a significant change in securities holdings of Arion Bank compared to Kaupthing Bank. Shares and derivatives are reduced by 96-100 % and bonds held by Arion Bank amount to 25,7 % of Kaupthing Bank's holdings. Furthermore, as can be seen in the income statement analysis in Table 2, activities related to equities, bonds and derivatives have dropped significantly which can be explained by inactive capital markets in Iceland following the introduction of capital controls in the autumn of 2008 and weak equity markets.

Table 2

## Comparison of the income statements of Arion Bank and Kaupthing Bank

	Arion Bank 1 January- 31 December 2009	Kaupthing Bank 1 January- 31 December 2007	AB as a % of KB
Interest income	66 905	304 331	22,0 %
Interest expense	(54 759)	(224 218)	24,4 %
<b>Net interest income</b>	<b>12 146</b>	<b>80 113</b>	<b>15,2 %</b>
Increase in value of loans and receivables	20 199	—	—
FX gain on loans and receivables from ISK income customers	1 535	—	—
Impairment on loans and receivables	(11 474)	—	—
Changes in compensation instrument	(10 556)	—	—
Net interest income less valuation changes on loans and receivables	11 850	80 113	—
Fee and commission income	8 291	64 865	12,8 %
Fee and commission expense	(2 429)	(9 844)	24,7 %
<b>Net fee and commission income</b>	<b>5 862</b>	<b>55 021</b>	<b>10,7 %</b>
Net financial income (expense)	1 638	4 282	38,3 %
Net foreign exchange gain	8 715	10 151	85,9 %
Share of profit or loss of associates	369	3 459	10,7 %
Other operating income	21 201	12 792	165,7 %
<b>Operating income</b>	<b>49 635</b>	<b>165 818</b>	<b>29,9 %</b>
Salaries and related expenses	(10 413)	(46 647)	22,3 %
Administration expense	(5 317)	(24 693)	21,5 %
Depositors' and investors' guarantee fund	(683)	—	—
Depreciation and amortisation	(1 161)	(6 550)	17,7 %
Other operating expense	(16 279)	(841)	1 935,7 %

<sup>(1)</sup> According to the annual report of Kaupthing Bank for the year 2007, the book value of loans to customers in Iceland amounted to ISK 885 billion.

	Arion Bank 1 January- 31 December 2009	Kaupthing Bank 1 January- 31 December 2007	AB as a % of KB
Net loss on non-current assets and disposal groups classified	(375)	—	—
Impairment on loans and other assets	—	(6 180)	0,0 %
<b>Earnings before income tax</b>	<b>15 407</b>	<b>80 907</b>	<b>19,0 %</b>
Income tax expense	(2 536)	(9 716)	26,1 %
<b>Net earnings</b>	<b>12 871</b>	<b>71 191</b>	<b>18,1 %</b>

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 Bank and net fee and commission income of Arion was 10,7 % of that of Kaupthing. Salaries and administration expenses for Arion Bank are just over 20 % of Kaupthing Bank's expenses. However, other operating income and expenses for Arion Bank are substantially higher than for Kaupthing Bank due to the fact that following severe decline in economic activity in Iceland, Arion Bank has foreclosed on a number of companies in various sectors. 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 Bank <sup>(1)</sup>. Comparing the Icelandic operations of both banks, Kaupthing Bank 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.

### 3.7. *The business activities of the new bank*

The operations of Arion Bank differ in important respects from the domestic operations of Kaupthing Bank, underlining the domestic focus of the new bank and different economic conditions. Activities related to Capital Markets have been reduced significantly and the same applies to Risk Management, Finance, Human Resources, IT and Marketing. However, with increased activities related to the restructuring of both companies and individuals, the number of employees in Corporate Finance has increased at Arion Bank compared to Kaupthing Bank.

Arion Bank now operates 26 branches and outlets across Iceland. Kaupthing Bank operated 34 branches and outlets at the end of 2007. Efforts have been made to align the bank's operations to a new economic reality by scaling down various functions such as IT and the branch network. As mentioned above, Arion Bank took over the deposit obligations of Reykjavík Savings Bank (SPRON). Furthermore, the bank acquired the regional Mýrasýsla Savings Bank (SPM), including all its assets and certain liabilities such as deposits. The two acquisitions brought 22 000 new customers to Arion Bank without expanding its existing branch network.

As a result of the economic turbulence in Iceland the debts of many companies and individuals are in need of restructuring. These activities have therefore increased substantially compared to the operations of Kaupthing Bank. The Corporate Finance division of Arion Bank is now focused on Iceland instead of the wide reaching operations of Kaupthing Bank's corporate finance and investment banking divisions. Merger and acquisition activity in Iceland has dropped substantially and the focus has been on the financial restructuring of companies. A special corporate recovery unit was established in 2009 and the position of Customers' Ombudsman was set up. Asset management companies were established for the management of foreclosed assets. The bank introduced a range of customised solutions designed to help households and individual borrowers to cope with their debt.

The asset management arm of Arion Bank has proven to be resilient. The number of employees in asset management has remained the same in Arion Bank as in the Icelandic asset management operations of Kaupthing Bank <sup>(2)</sup>.

<sup>(1)</sup> 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 %.

<sup>(2)</sup> Assets under management in Arion Bank amounted to ISK 581 billion at year-end 2009 compared to ISK 1,630 billion at the end of June 2008 in Kaupthing Bank.



The financial crisis led to a collapse of the activities in capital markets, especially the currency market and equity market. The bonds market has been more resilient as investors have focused their investments towards bonds issued by the Icelandic Government and government agencies. Capital controls were put in place whereby currency trading was only allowed for merchandise and services purposes but all capital account transactions were suspended.

The transition from Kaupthing Bank to Arion Bank was seamless in the sense that customers were able to access their savings throughout the whole process and complete their domestic transactions without disruption. However, the transfer of ownership of the assets from Kaupthing Bank to Arion Bank and the restructuring of assets in a new institution has posed numerous challenges, including the valuation of assets, putting in place a process to deal with the restructuring of the loan book and streamlining other operating activities to reflect the fact that it is now a domestic as opposed to international bank.

#### **4. Position of the Icelandic authorities**

##### **4.1. *State aid nature of the measures and compatibility with the EEA Agreement***

In their notification the Icelandic authorities now accept that measures undertaken in order to establish Arion Bank constitute State aid. They contend however that the measures are compatible with the functioning of the EEA Agreement under Article 61(3)(b), on the basis that they were necessary in order to remedy a serious disturbance in the Icelandic economy.

The Icelandic authorities stress that the situation in Iceland in October 2008 was extreme and required immediate action in order to restore financial stability and confidence in the Icelandic economy. The Icelandic authorities' intentions at this stage of the process were straightforward and basic, ensuring that Icelanders had access to their deposit accounts and that some form of financial system survived. The implications not only for the Icelandic economy but also for Icelandic society were grave.

The measures regarding Arion Bank/Kaupthing Bank were considered necessary because if the bank had not been restored, the systemic collapse that Iceland was already suffering would have intensified. The Authority has also been provided with a letter from the Central Bank of Iceland affirming the necessity of the measures taken. The fact that Arion Bank, and other Icelandic and European banks, suffered from lack of liquidity as well as lack of market and investors' confidence meant it was not possible to fund the bank through the financial markets. The intervention of the Icelandic State was necessary to strengthen the bank's equity and liquidity position in order to maintain its viability. The fact that the creditors of Kaupthing opted to acquire 87 % of Arion Bank also greatly decreased the need for a State contribution to the bank.

The part of the capitalisation of Arion Bank borne by the Icelandic State as an owner of 13 % of the bank's shares will be remunerated through the eventual sale of the State's share. According to the Icelandic authorities, it is not possible at this stage to assess whether the State will receive an adequate return on its Tier I investment in Arion Bank, stating that '... the scale of the issues at stake and the potential implications with respect to financial stability and the success of the whole intervention, is such that a discrepancy of approximately ISK 2,3 billion was considered an acceptable upfront cost to the government to achieve the benefits associated with this conclusion of the rescue and restoration process'. Nevertheless the Icelandic authorities argue that as far as applicable, the measures are also in line with the principles set out in the Authority's Recapitalisation Guidelines. The Icelandic authorities argue that the risk profile of the new banks is relatively low and that in consequence the pricing of capital provided should be at the lower end.

According to the Icelandic authorities the Government contribution of Tier II capital to Arion Bank was necessary and essential to restore viability, and an important factor in restoring confidence in the financial market with the aim of reconstructing a bank that would be viable in the long term without State aid. The overall contribution is limited in size to what is absolutely necessary to ensure that Arion Bank meets minimum capital requirements, as defined by the FME. In order to minimise the effect on competition, the same Tier II funding was made available to all of the three main banks, which were in a comparable situation. According to the Icelandic authorities it is currently very difficult to benchmark the interest against the market rates. Using market standards from the past it was customary for Tier II instruments to bear interest a little higher than general unsecured bonds (25-50 basis points). The bond negotiated between Arion Bank and the Kaupthing Resolution Committee on the other hand had a LIBOR plus 300 basis points coupon. By that comparison, the interest negotiated by the Icelandic authorities on the Tier II bond was well above 'market' standard. The Icelandic authorities furthermore argue that built-in incentives for exit are in place, in the form of step-up of interest in five years' time. On this basis the Icelandic authorities consider that the interest coupon is acceptable and that the remuneration is compatible with the EEA Agreement.

The Icelandic authorities also stress that the parties that were shareholders of (old) Kaupthing before the financial crisis have lost their shares in the bank and have received no compensation from the State. In the case of Kaupthing, the agreement acknowledges that in the definitive split more liabilities than assets were transferred to Arion and the net effect of the transfer is to create an obligation of Kaupthing in favour of Arion. The losses stemming from the fall of the old banks have not therefore been mitigated by the Icelandic Government and the costs associated with the re-establishment of the bank must be seen as being borne by the investors in Kaupthing, as the losses stemming from the fall of Kaupthing were largely absorbed by these investors. The measures are therefore consistent with the principle that the bank should use its own resources to finance rescue and restructuring to the extent possible.

As regards competition in the banking market reference is made to decision of the Icelandic Competition Authority No 49/2009 on Kaupthing's take-over of majority shareholding in Arion Bank, where it is indicated that the establishment of the three new banks has not changed the situation as regards competition in the retail banking market in Iceland.

#### 4.2. *Possible alternatives*

The Icelandic authorities are of the view that there were no other realistic alternatives to the actions taken in October 2008. The purpose of the measures undertaken with regard to all three banks was to eliminate the threat to the stability of the Icelandic economy that complete failure of the domestic banking system would have entailed. To do so, the measures had to remedy the identified causes of the banks' problems — mainly their size relative to the size of the Icelandic economy and their reliance on foreign credit facilities. The instruments chosen by the Icelandic Government represent the only credible measures available, given the status of the Icelandic economy, and were therefore both necessary and appropriate means to address these problems. The scope of the measures as regards Kaupthing/Arion Bank is, in the opinion of the Icelandic authorities, limited to the minimum necessary, bearing in mind the serious economic situation of Iceland and the need to rebuild the financial system in the country.

The total revenue in the Icelandic State budget for 2008 was ISK 460 billion and total GDP in 2007 was ISK 1,308 billion <sup>(1)</sup>. The liabilities through deposits alone in the three large Icelandic banks were at the time of their collapse ISK 2,761 billion, of which 1,566 billion was held in foreign currencies in the foreign branches of the banks. The foreign currency reserves of Iceland consisted of ISK 410 billion in October 2008, which amounted to around 25 % of the value of deposits in the non-domestic branches.

The Authority also notes in this context the conclusions of the SIC Report, which refers in Section 4.5.6.2 of Chapter 4 <sup>(2)</sup> to attempts made during the course of 2008, given the concerns about the overblown size of the Icelandic banking sector and limitations of the CBI as a lender of last resort, to strengthen the CBI's currency reserves. Requests were made to other Nordic central banks, the European Central Bank, the Bank of England and the Federal Reserve Bank of New York for currency swap agreements, but despite extensive efforts the CBI managed only to secure agreements with Nordic central banks (Sweden, Denmark and Norway). The Bank of England considered the CBI's request carefully, but eventually declined to participate. A letter from the Bank of England governor, Mervyn King, to his Icelandic counterpart, Davíð Oddson, illustrates the views of the United Kingdom's central bank (letter of 23 April 2008):

'It is clear that the balance sheet of your three banks combined has risen to the level where it would be extremely difficult for you effectively to act as a lender of last resort. International financial markets are becoming more aware of this position and increasingly concerned about it. In my judgement, the only solution to this problem is a programme to be implemented speedily to reduce significantly the size of the Icelandic banking system. It is extremely unusual for such a small country to have such a large banking system. ... I know you will be disappointed. But among friends it is sometimes necessary to be clear about what we think. We have given much consideration to your proposal. In my judgement, only a serious attempt to reduce the size of the banking system would constitute a solution to the current problem. I would like to think that the international central banking community could find a way to offer effective help to enable you more easily to construct a programme to reduce the size of the banking system. I shall be willing to do all in our power to help you achieve that.' <sup>(3)</sup>

<sup>(1)</sup> See: [http://www.statice.is/?PageID=1267&src=/temp\\_en/Dialog/varval.asp?ma=THJ01102%26ti=Gross+domestic+product+and+Gross+national+income+1980%2D2009%26path=/Database/thjodhagsreikningar/landsframleidsla/%26lang=1%26units=Million+ISK](http://www.statice.is/?PageID=1267&src=/temp_en/Dialog/varval.asp?ma=THJ01102%26ti=Gross+domestic+product+and+Gross+national+income+1980%2D2009%26path=/Database/thjodhagsreikningar/landsframleidsla/%26lang=1%26units=Million+ISK)

<sup>(2)</sup> See: <http://rna.althingi.is/pdf/RNABindi1.pdf> (see pp. 167-181).

<sup>(3)</sup> Chapter 4.5.6.2, p. 172-3 of the SIC report.



Later efforts included contacts with Timothy F. Geithner, President and CEO of the Federal Reserve Bank of New York. The request was eventually declined on 3 October 2008. According to the SIC report the main reason given by the Federal Reserve was the size of the Icelandic banking system as for a currency swap agreement to be effective, it would have to be for a bigger amount than the Federal Reserve could accept.

The Icelandic authorities did consider dividing the bank into a 'good bank' and a 'bad bank' by transferring the healthy and valuable assets to a 'good bank' that should generally be able to finance itself on the market and leaving the less valuable assets that are difficult to realise in a 'bad bank' funded by the State. However, it was considered that due to the financial crisis, even 'good' Icelandic banks would probably not have been able to seek sufficient capital to finance their operations despite a potentially healthy financial status. Another problem for Iceland in using the 'good bank/bad bank' solution was that running a 'bad bank' would require substantial equity contributions from the Government. Faced with a situation where aid was needed for three of the nation's biggest banks (over 80 % of the nation's banking system), which had collective liabilities over 10 times Iceland's GDP, it was the conclusion of the Icelandic authorities that such an attempt would almost certainly lead to the state suffering major financial difficulties. In combination therefore it was felt that such a solution would have lacked the credibility necessary in a situation where the immediate problem faced by the banks was the run on their liabilities through the termination of credit facilities and massive deposit withdrawals.

#### 4.3. *Timescales*

In so far as the period of time it has taken to reach this stage is concerned the Icelandic authorities argue that they faced severe and complex circumstances — a division of three commercial banks to save the domestic part of a banking system and through that the economy, had as far as they are aware never been done before. The task required the participation of many parties both domestic and foreign and in their view some aspects of the split proved more difficult than the 'good bank/bad bank' method used in some other countries where banking systems have encountered serious problems.

The first problem encountered was a practical one. The intra-month transfer date for the assets and liabilities (21 October 2008) caused significant technical and audit complexities. The procedure used to split Kaupthing's balance sheet in October 2008 was based on the bank's interim accounts of 30 September 2008. All changes from that date until the date of division were estimated until 21 October 2008. It took until the beginning of 2009 for the division of the bank's systems into the new and old banks to be reconciled. From that time, work was done on each bank separately, and clearing accounts were used for transactions between the two banks. The processing of clearing account transactions entailed substantial risk of error and great complexity, which was only completed by the summer of 2009.

Within a short period of time it became evident that the creditors of the old banks were very unhappy with the asset valuation process that had been established. They considered the process to be one-sided in that their input was not taken into account as a part of the valuation process. As a result the procedure was changed in February 2009 into a formal negotiating process with the participation of domestic and foreign creditors. This process proved time consuming as a large number of international creditors and their advisors needed to participate at the negotiation table <sup>(1)</sup>.

Another factor in the delay of the process was the development of each of the new banks' initial business plans — a necessary element in the negotiations with the creditors. The banks were not ready to present their business plans until they had had the opportunity to go through the valuation of transferred assets prepared by Deloitte, as the opening balance sheet would be the foundation of such business plans. The banks presented five-year year business plans to the creditors in June 2009 following which the negotiations could begin. In their business plans the new banks put forward their own valuation of transferred assets which was not consistent with the Deloitte valuation. As the Deloitte valuation was not an exact number but a wide range, a Deloitte valuation number could not be entered into the opening balance sheet of the new banks. The new banks' valuation of the assets transferred was at the low end or below the low end of the Deloitte valuation, while the creditors' view stood at the high end or above the high end of the Deloitte valuation. A complex negotiation process followed in which both sides were far apart. In the end it became necessary to develop contingent compensation instruments to bridge the gap between the parties.

<sup>(1)</sup> It is also notable that during this period Iceland suffered political upheaval. A new minority government came to power in February 2009, a government which later became a majority government after Parliamentary elections in April the same year. The new government had in some cases different views to the former government and some changes to the process had to be made.

When the split was made between each old and new bank it became evident that there would be a massive currency mismatch in the new banks' balance sheets. The deposits transferred were mainly ISK denominated and the loan assets mainly foreign currency denominated or linked. This created potentially major market risks in the new banks that had to be addressed before the capitalisation could take place. The process of addressing this issue was time consuming and only partially successful.

During the negotiations it became evident that the creditors in two of the banks (Kaupthing and Glitnir) could possibly have an interest in capitalising the banks themselves and become majority owners. To respond to this possibility, two alternative positions had to be formulated during the negotiations. After the creditors had opted for ownership of the bank a due diligence had to be performed by the creditor advisors, which also was time-consuming.

Finally, the Icelandic authorities argue that account should be taken of the fact that from October 2008 until the autumn of 2009 the remainder of the financial sector in Iceland was far from stable, and in fact, during this period almost all financial undertakings in Iceland were taken over by the FME.

The Authority specifically requested information on why full business plans are still not available for the banks and why they have not been fully restructured. The Authority also requested information on why an assessment of the true value of the assets of the banks is yet to be completed. According to the Icelandic authorities, given the circumstances (in particular the impact on international creditors) it was considered important to abide by the principles of good public governance, including moderation. Specifically, it was thought that systematically and deliberately leaving damaged assets behind in the old banks (as would be the case in a 'good bank/bad bank' scenario) would exceed what was strictly necessary to ensure the short to medium-term operability of the new banks. For this reason, insofar as the basic principle of a domestic-foreign split was considered sufficient to ensure operability of the new banks in the short to medium term, 'cherry picking' of good assets was deliberately avoided. Another reason for doing so was that it was considered that successfully valuing the assets (and therefore their degree of impairment) was a highly complex exercise.

The above considerations were borne out by the events. Despite considerable time and resources allocated to the task, the professional firm engaged to assess the true net value of the assets transferred was unable to give a precise estimate. After months of negotiations, supported by some of the world's most renowned professional firms and investment banks, the stakeholders eventually settled on contingent compensation instruments for all three banks due to this uncertainty. The likely implication is that although certain margins can be, and have already been, established regarding the lower limits of asset value, only time can tell with sufficient precision what the true value of the transferred asset portfolios will be. The Icelandic authorities also argue that it is clear that establishing the new banks without performing a 'good bank/bad bank split' — i.e. without ensuring that the level of impairment in their portfolios was kept within very strict boundaries — meant that the entities were not inherently viable. According to the Icelandic authorities the long-term viability of the banks cannot be achieved without first creating banks that are operable and functional in the short to medium-term before undertaking further restructuring. The process of assessing the viability of the Arion Bank is therefore ongoing but the Icelandic authorities have committed to providing a restructuring plan as soon as possible.

## II. ASSESSMENT

### 1. The presence of State aid

State aid within the meaning of Article 61(1) EEA Agreement.

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.'

The Authority will assess the following measures 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')

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

### 1.1. *Presence of State resources*

It is clear that the capitalisation measures are financed through State resources provided by the Icelandic Treasury. State resources are also present in the provision of liquidity to the bank as part of the compensation for taking over the deposit liabilities of SPRON and otherwise.

The primary intention of the statement made by the Icelandic authorities safeguarding domestic deposits was to reassure deposit holders and to stop widespread run on deposits in the (old) banks. The deposit guarantee was implemented in practice through the use of powers under the Emergency Act to change the priority of deposit holders in bankruptcy proceedings and by transferring the liabilities for deposits to the newly established banks, which were initially fully capitalised by the State. According to statements made by the Icelandic authorities, however, a full guarantee of all deposits in Icelandic banks remains in place. The Authority wishes to further investigate whether the notice issued (and subsequent references to it) was a precise, firm, unconditional and legally binding statement such as to involve a commitment of State resources <sup>(1)</sup>.

### 1.2. *Favouring certain undertakings or the production of certain goods*

Firstly, the aid measure must confer on the new bank advantages that relieve it of charges that are normally borne from its budget. The Authority is again of the view that each of the capitalisation measures confers an advantage on the new bank as the capital provided would not have been available to the bank without State intervention. The approach taken both by the European Commission (in numerous cases since the financial crisis began <sup>(2)</sup>) and by the Authority <sup>(3)</sup> in assessing whether State intervention to recapitalise banks amounts to State aid assumes that, given the difficulties faced by the financial markets, the State is investing because no market economy investor would be willing to invest on the same terms. The market economy investor principle is considered not to apply in cases involving the capitalisation of financial institutions affected by the crisis that are in difficulty. The Authority considers this to be the case notwithstanding the eventual transfer of 83 % of the capital of the new bank to the (largely private sector) creditors. The private investor involvement in the capitalisation of the new Icelandic banks is made up entirely of creditors of the old banks who are not therefore investors acting freely in an open market but rather are seeking to minimise their losses in the most efficient manner <sup>(4)</sup>.

Secondly, the aid measure must be selective in that it favours 'certain undertakings or the production of certain goods'. The capitalisation measures are selective as they only benefit Arion Bank. Similar measures were also implemented in the cases of the other two failed banks, and several other Icelandic financial institutions have required assistance from the government. However, not all Icelandic banks have received State aid, and State support can in any event be selective in situations where one or more sectors of the economy benefit and others do not. This principle applies also to the State guarantee on deposits which benefits the Icelandic banking sector as a whole.

<sup>(1)</sup> 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, not yet reported, paragraph 283 (on appeal).

<sup>(2)</sup> See for example Commission Decision of 10 October 2008 in Case NN 51/08 *Guarantee scheme for banks in Denmark*, at paragraph 32, and Commission Decision of 21 October 2008 in Case C 10/08 *IKB*, at paragraph 74.

<sup>(3)</sup> 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>

<sup>(4)</sup> 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).

In so far as the liquidity facility is concerned, paragraph 51 of the Authority's temporary rules on the 'application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis' provides that, following the Commission's decision-making practice <sup>(1)</sup>, the Authority considers that the provision of a central bank's funds to financial institutions will not constitute aid when the following conditions are met:

- the financial institution is solvent at the moment of the liquidity provision and the latter is not part of a larger aid package,
- the facility is fully secured by collateral, to which haircuts are applied, in function of its quality and market value,
- the central bank charges a penal interest rate to the beneficiary,
- the measure is taken at the central bank's own initiative, and in particular is not backed by any counter-guarantee of the State.

The Authority concludes that, given that the liquidity facility 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 failed bank, the above conditions are not fulfilled.

From the information provided to the Authority to date, the Authority cannot exclude that Arion Bank has also received a selective advantage through the transfer of assets and liabilities of SPRON savings bank. An advantage is *prima facie* present to the extent that the revenue (interest) it receives through partially State guaranteed assets exceeds the cost (interest) of holding the deposits, and to the extent that the transfer of deposit holders enhances goodwill and increases market share.

The Authority also considers that it is possible that the bank has benefitted (indirectly) from the statements made by the Government safeguarding all domestic deposits, as in the absence of the guarantee the new bank could have suffered from a run on its deposits like its predecessor <sup>(2)</sup>. Accordingly, the Authority has doubts as to whether the guarantee entailed an advantage for the bank.

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

The measures strengthen the position of the new bank in comparison to competitors (or potential competitors) in Iceland and other EEA States and must therefore be regarded as distorting competition and affecting trade between the Contracting Parties to the EEA Agreement <sup>(3)</sup>.

### 1.4. *Conclusion*

The Authority's preliminary conclusion, therefore, is that the measures taken by the Icelandic State to capitalise the new bank, as well as the liquidity facility, involve State aid within the meaning of Article 61(1) of the EEA Agreement. It also cannot exclude that aid to Arion Bank may be present in the transfer to it of SPRON's assets and liabilities and as a result of the government's notice safeguarding deposits.

## 2. *Procedural requirements*

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'.

<sup>(1)</sup> See for instance Northern Rock (OJ C 43, 16.2.2008, p. 1).

<sup>(2)</sup> 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.sedlabanki.is/lisalib/getfile.aspx?itemid=8260> p. 5. See also Commission Decisions NN 48/08 Guarantee Scheme for Banks in Ireland, paragraphs 46 and 47: [http://ec.europa.eu/community\\_law/state\\_aids/comp-2008/nn048-08.pdf](http://ec.europa.eu/community_law/state_aids/comp-2008/nn048-08.pdf) and NN 51/08 Guarantee Scheme for Banks in Denmark: [http://ec.europa.eu/community\\_law/state\\_aids/comp-2008/nn051-08.pdf](http://ec.europa.eu/community_law/state_aids/comp-2008/nn051-08.pdf)

<sup>(3)</sup> See in this respect Case 730/79 *Phillip Morris v Commission* [1980] ECR 2671.

The Icelandic authorities did not notify the aid measures 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 aid was therefore unlawful.

### 3. Compatibility of the aid

Assessment of the aid measures under Article 61(3) of the EEA Agreement is set out below.

#### 3.1. *The necessity, proportionality and appropriateness of the aid*

In the Authority's view it is beyond dispute that Iceland faced, and still faces, a serious disturbance in its economy and that Kaupthing Bank was of structural importance. In consequence the Authority will assess the potential compatibility of the aid under Article 61(3)(b) of the EEA Agreement and the guidelines based upon that sub-paragraph.

The Authority considers that this case, although not necessarily unique, is difficult to assess using the traditional and commonly understood notions of on the one hand 'rescue' aid and the other 'restructuring' aid. For instance the restoration of the bank as an emergency measure in October 2008 involved both rescue aid and immediately enforced restructuring. Through this decision the Authority intends to assess, retrospectively, the measures undertaken to restore the bank both through its initial creation and subsequent capitalisation as rescue measures. Such aid can only, however, be approved on a temporary and conditional basis. In the absence of a restructuring plan, the Authority is unable to fully assess the case and reach a conclusion and in consequence the measures will be assessed once again — on this occasion as structural measures, upon receipt of the restructuring plan <sup>(1)</sup>. The Authority will at that stage assess the viability of the bank and the requirement that the aid provided was the minimum necessary to ensure its viability. The restructuring plan should include a full comparison of the old and new banks (for the purposes of demonstrating that previous problems should not re-occur), as well as an assessment of how ongoing restructuring should secure the long-term viability of the bank.

In line with the general principles underlying the State aid rules of the EEA Agreement, which require that the aid granted does not exceed what is strictly necessary to achieve its legitimate purpose and that distortions of competition are avoided or minimised as far as possible, and taking due account of the current circumstances, support measures must be:

- well targeted in order to be able to achieve effectively the objective of remedying a serious disturbance in the economy,
- proportionate to the challenge faced, not going beyond what is required to attain this objective, and
- designed in such a way as to minimise negative spill over effects on competitors, other sectors and other EEA States.

In assessing the rescue measures undertaken to date, therefore, the Authority takes into account the following.

#### 3.1.1. *The necessity of the measures*

Again the Authority accepts the argumentation of the Icelandic authorities, and believes that it is largely self-evident, that the State had to intervene in order to restore certain operations of Kaupthing Bank as well as the other two banks and guarantee deposits and avoid a systemic failure of the Icelandic financial system. The Authority also notes the views of the CBI in this respect. It also accepts, given the run on the banks and the instability of the financial system, that a State guarantee of deposits was required <sup>(2)</sup>.

<sup>(1)</sup> This approach is similar to the one taken by the European Commission in the case of emergency aid for Ethias — Belgium — case NN 57/08.

<sup>(2)</sup> See paragraph 19 of the Authority's temporary rules on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis: <http://www.eftasurv.int/?1=1&showLinkId=16604&1=1>



### 3.1.2. *The method of restoring the bank — the appropriateness of the means employed to achieve the objective*

The Authority accepts in principle the views of the Icelandic authorities that given the circumstances, the approach taken of restoring domestic operations of the banks and guaranteeing domestic deposits was likely to be the only credible and effective means of safeguarding an Icelandic banking sector and the interests of the wider economy <sup>(1)</sup>. Bank rescue measures of the kind adopted elsewhere in the EEA; recapitalisation, restructuring, relief for impaired assets, or a combination of each were unlikely to succeed. The scale of the problem and the sums of public money that would have been necessary to remedy it, the disproportionate size of the three main Icelandic banks, and the realistic threat that the entire system could collapse meant that the State's options were limited.

The measures however involved wide-ranging restructuring of the bank's operations through the effective divestiture of foreign operations, and potential further restructuring of domestic operations. The measures can only therefore finally be considered to be appropriate if it can be demonstrated through the means of a detailed restructuring plan that the bank is viable in the medium to long term.

### 3.1.3. *The proportionality of the measures — limiting aid and distortions of competition to the minimum necessary*

The Authority is conscious in this context that in light of the foreign operations of the Icelandic banks remaining in the old banks, which are under administration; and in light of the Icelandic authorities adopting similar measures to restore each of the three main banks in Iceland which make up over 80 % of the domestic market <sup>(2)</sup>, the impact on competition and trade across the EEA is minimal. The Authority is also of the view that the State intervention in the case of Arion Bank is *prima facie* proportionate as the process of ensuring that the creditors of the old bank became the majority shareholders of the new bank meant that the Icelandic authorities were able to ensure:

- firstly, that the aid payable was kept to the minimum necessary to ensure private sector involvement in the bank — something that may not otherwise have been achievable for many years, and
- secondly, that the amount of aid paid by the State was reduced substantially through private involvement in the recapitalisation.

Although, due to the circumstances involved, this was not achieved through a tendering procedure, the Authority is of the view that it would not have been realistic to expect any private sector investors to have invested other than those already involved as creditors of the collapsed bank.

The amount of the capital provided is the minimum necessary in order to enable Arion Bank to comply with the minimum capital adequacy ratio set by the FME of 12 % Tier I capital and 4 % Tier II capital. The liquidity facility is also considered to be necessary by the regulator.

In so far as the remuneration of the capital is concerned, paragraphs 26 to 30 of the Authority's rules on the recapitalisation of financial institutions specifies a method of calculating an 'entry level' price for capitalising fundamentally sound banks. Capitalisation of banks that are not fundamentally sound are subject to stricter requirements and in principle the remuneration paid by such banks should exceed the entry level. Although the remuneration payable in the case of Arion Bank most likely does not comply with these requirements it is clear that (as envisaged by paragraph 44 of the rules) the bank has experienced far-reaching restructuring including a change in management and corporate governance.

The Authority will further assess the aid granted through the remuneration payable for the capital and the terms of the liquidity facility, as well as any aid paid through the transfer of liabilities and guaranteed assets of SPRON savings bank, as part of its full assessment of the restructuring of the bank. It will also assess the duration of the State guarantee in this context.

<sup>(1)</sup> This decision does not relate to any aspects of the internal market rules of the EEA Agreement that may apply in so far as the division of foreign and domestic assets and liabilities is concerned.

<sup>(2)</sup> A number of other financial institutions have also required State assistance. On 22 April 2010, the FME decided to take control of BYR Savings Bank, to establish on its foundation a new limited liability company BYR hf. and to transfer to BYR hf. assets and liabilities of the failed savings bank. At the same time FME decided to take control of Keflavik Savings Bank and establish on its foundation SpKef Savings Bank to take over assets and liabilities of the failed Keflavik Savings Bank. Measures for recapitalisation of these two savings banks are under way and the Authority awaits notification from the Icelandic authorities. On 21 June 2010, the Authority approved for a period of six months a rescue scheme in support of five smaller savings banks in Iceland through settlement of claims owned by the Central Bank of Iceland on the savings banks concerned.

### 3.2. *Timescales*

While the Authority regrets that the normal timescales for the duration of rescue measures have been exceeded, a need for longer periods to restructure financial institutions was envisaged by the European Commission and Authority when adopting guidelines for the assessment of rescue and restructuring aid granted as a result of the financial crisis <sup>(1)</sup>. The Authority accepts in particular that for the various reasons put forward by the Icelandic authorities, delays were inevitable at least until the assets of the bank could be valued and its ownership and capitalisation could be resolved. The Authority is also aware of domestic litigation in Iceland concerning loans linked to foreign currencies which has had the potential to have a major impact on the value of each bank's assets, and led to considerable uncertainty for many months <sup>(2)</sup>. It also notes the content of the CBI's financial stability report for 2010/2 <sup>(3)</sup> which refers among other matters to the fact that non-performing loans (90 days or more in default) of the Icelandic commercial banks now total 39 % of all loans — a major political and economic issue given that many loans have already been written down. The Authority is therefore willing to accept that given the exceptional circumstances the rescue measures could be authorised and remain in place for a longer period than is normally allowed. However, whilst the Authority accepts that there are also justifiable reasons for further delay since the recapitalisation of the banks, the Authority is concerned at the lack of progress since the summer of 2009 in concluding a detailed restructuring plan. In the absence of the restructuring plan, therefore, the Authority has doubts concerning the compatibility of the measures with the EEA Agreement.

### 4. Conclusion

On the basis of the foregoing assessment, had the Icelandic authorities notified the capitalisation measures and deposit guarantee involved in Phase 1 and Phase 2 of the process of restoring and restructuring Arion Bank in advance, the Authority would in all probability have temporarily approved the measures as aid compatible with the functioning of the EEA Agreement. The aid granted could, however, only have been considered compatible on a temporary basis, conditional upon the submission of a detailed restructuring plan for the bank and a satisfactory assessment by the Authority of its future viability. Although the Icelandic authorities have committed to submit a restructuring plan for the Authority's assessment, in view of the time period that has elapsed since the aid was granted, the Authority is required to open a formal investigation procedure into the measures adopted. The decision to open a formal investigation procedure is without prejudice to the final decision of the Authority, which may conclude that the measures in question do not constitute State aid or are compatible with the functioning of the EEA Agreement.

The Authority also regrets that the Icelandic authorities did not respect their obligations pursuant to Article 1(3) of Part I of Protocol 3. The Icelandic authorities are therefore reminded that any plans to grant further restructuring or other aid to the bank must be notified to the Authority and approved in advance,

HAS ADOPTED THIS DECISION:

#### *Article 1*

The formal investigation procedure provided for in Article 1(2) of Part I of Protocol 3 to the Surveillance and Court Agreement is opened into 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).

#### *Article 2*

The Authority requires that a detailed restructuring plan for Arion Bank be submitted as soon as possible and in any event no later than 31 March 2011.

#### *Article 3*

The measures involve 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 aid in accordance with Article 1(3) of Part I of Protocol 3.

<sup>(1)</sup> See paragraphs 10 and 24, and footnote 13, of the Authority's guidelines: <http://www.eftasurv.int/?1=1&showLinkId=16604&l=1>

<sup>(2)</sup> The issue is referred to in the CBI's Financial Stability Report for the second half of 2010 (pp. 18-21), <http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=8260> and the Annual Report of the FME for 2010 (currently only available in Icelandic, pp. 31-32): <http://www.fme.is/lisalib/getfile.aspx?itemid=7604> See also the following news reports: <http://www.businessweek.com/news/2010-07-29/iceland-debt-outlook-cut-to-negative-at-moody-s-on-bank-ruling.html> <http://www.businessweek.com/news/2010-09-17/iceland-ruling-may-save-banks-4-billion-in-losses.html>

<sup>(3)</sup> <http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=8260>

*Article 4*

The Icelandic authorities are requested to provide within one month from notification of this Decision, all documents, information and data needed for assessment of the compatibility of the aid measure.

*Article 5*

This Decision is addressed to the Republic of Iceland.

*Article 6*

Only the English language version of this Decision is authentic.

Done at Brussels, 15 December 2010.

*For the EFTA Surveillance Authority*

Per SANDERUD  
*President*

Sverrir Haukur GUNNLAUGSSON  
*College Member*

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**Invitation à présenter des observations, en application de l'article 1<sup>er</sup>, paragraphe 2, de la partie I du protocole 3 de l'accord entre les États de l'AELE relatif à l'institution d'une Autorité de surveillance et d'une Cour de justice, sur des éléments d'aides d'État concernant le rétablissement de certaines opérations de (l'ex-) Landsbanki Islands hf et la mise en place et la capitalisation de New Landsbanki Islands (NBI hf)**

(2011/C 41/05)

Par décision n° 493/10/COL du 15 décembre 2010, reproduite dans la langue faisant foi dans les pages qui suivent le présent résumé, l'Autorité de surveillance AELE a ouvert la procédure prévue à l'article 1<sup>er</sup>, paragraphe 2, de la partie I du protocole 3 de l'accord entre les États de l'AELE relatif à l'institution d'une Autorité de surveillance et d'une Cour de justice. Les autorités islandaises ont reçu copie de la décision.

Par la présente, l'Autorité de surveillance AELE invite les États de l'AELE, les États membres de l'UE et les parties intéressées à soumettre leurs observations sur la mesure en cause dans un délai d'un mois à compter de la publication de la présente communication, à l'adresse suivante:

Autorité de surveillance AELE  
Greffé  
Rue Belliard 35  
1040 Bruxelles  
BELGIQUE

Ces observations seront communiquées aux autorités islandaises. L'identité des parties intéressées qui présentent des observations peut faire l'objet d'un traitement confidentiel sur demande écrite et motivée.

RÉSUMÉ

**Procédure**

À la suite de discussions approfondies menées entre l'Autorité et les autorités islandaises depuis l'effondrement du système financier islandais en octobre 2008, l'aide d'État concernant le rétablissement de certaines opérations de Landsbanki et la mise en place et la capitalisation de New Landsbanki (NBI) a été notifiée rétrospectivement par les autorités islandaises le 15 septembre 2010. Les autorités islandaises ont également communiqué d'autres informations lors d'une réunion qui s'est tenue à Reykjavik le 29 septembre 2010 et par lettres datées des 9, 11, 15 et 28 novembre 2010.

**Les faits**

En octobre 2008, les trois principales banques commerciales islandaises, Glitnir, Kaupthing et Landsbanki, ont rencontré des difficultés pour refinancer leur dette à court terme et ont été confrontées à une vague de retraits. Le parlement islandais a voté une loi d'urgence, qui conférait à l'État des droits étendus pour intervenir dans le secteur bancaire. Sur cette base, l'autorité de surveillance financière islandaise a décidé, les 7 et 9 octobre 2008, de prendre le contrôle des activités de ces trois banques et a désigné des comités d'administration provisoires chargés de reprendre les attributions des assemblées générales des actionnaires et des conseils d'administration. Parallèlement, trois nouvelles banques ont été créées, New Glitnir (renommée ensuite Islandsbanki), New Kaupthing (renommée ensuite Arion Bank) et NBI (opérant sous la dénomination Landsbankinn), pour reprendre les actifs nationaux, les opérations et engagements nationaux liés aux dépôts. Au départ, ces nouvelles banques appartenaient entièrement à l'État.

Mesures applicables à NBI:

- 1) En octobre 2008, l'État a octroyé à la banque une somme en numéraire de 775 millions d'ISK (5 millions d'EUR) en tant que capital initial et s'est engagé à capitaliser entièrement la banque.
- 2) Un accord final sur la capitalisation de NBI a été conclu le 15 décembre 2009 lorsqu'il a été convenu que la banque serait capitalisée à hauteur de 150 milliards d'ISK, dont 121 225 milliards d'ISK en provenance de l'État. (L'ex-) Landsbanki détient une quote-part de 18,67 % des actifs éventuels de la banque à titre de compensation pour les actifs nets transférés de l'ancienne banque vers la nouvelle banque. Cette somme sera reversée à l'État (en tout ou en partie) dans le cas du versement intégral d'une compensation au moyen d'une obligation convenue entre les parties. Le capital de l'État ne sera rémunéré qu'après sa vente finale.

(Les mesures ci-dessus sont qualifiées collectivement de «mesures de capitalisation».)

- 3) La déclaration du gouvernement islandais garantissant entièrement les dépôts nationaux dans toutes les banques commerciales et caisses d'épargne islandaises.

### Appréciation

La conclusion préliminaire de l'Autorité est que les mesures de capitalisation et l'accord spécial sur les liquidités comportent une aide d'État à NBI au sens de l'article 61, paragraphe 1, de l'accord EEE. L'Autorité ne peut pas non plus exclure qu'une aide supplémentaire ait été octroyée indirectement à la banque par la déclaration concernant les dépôts.

L'Autorité appréciera l'aide accordée au titre de l'article 61, paragraphe 3, point b), de l'accord EEE, en se basant sur l'hypothèse selon laquelle cette aide était nécessaire pour remédier à une perturbation grave de l'économie islandaise. Toutefois, les mesures d'aide exigent la présentation d'un plan de restructuration détaillé en ce qui concerne NBI; en l'absence d'un tel plan, l'Autorité a des doutes quant à la compatibilité de ces mesures avec l'accord EEE.

### Conclusion

À la lumière des considérations qui précèdent, l'Autorité a décidé d'ouvrir la procédure formelle d'examen conformément à l'article 1<sup>er</sup>, paragraphe 2, de la partie I du protocole 3 de l'accord entre les États de l'AELE relatif à l'institution d'une Autorité de surveillance et d'une Cour de justice. Les parties intéressées sont invitées à présenter leurs observations dans un délai d'un mois à compter de la publication de la présente décision au *Journal officiel de l'Union européenne*.

## EFTA SURVEILLANCE AUTHORITY DECISION

No 493/10/COL

of 15 December 2010

**opening the formal investigation procedure into State aid granted in the restoration of certain operations of (old) Landsbanki Islands hf and the establishment and capitalisation of New Landsbanki Islands (NBI hf)**

**(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 and Protocol 26,

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 and Articles 4(4) and 13(1) of Part II,

Having regard to the temporary rules regarding the financial crisis in Part VIII of the Authority's State Aid Guidelines <sup>(1)</sup>,

Whereas:

### I. FACTS

#### 1. Procedure

On 2 October 2008, the Icelandic authorities informed the Authority of their intention to inject EUR 600 million of capital into Glitnir bank in return for 75 % of its shares. The information was provided by way of a draft notification said to be submitted for legal certainty only as it was contended that the measure did not involve State aid. This proposal was however subsequently abandoned due to a further deterioration in the financial position of the bank (and that of the other two main Icelandic commercial banks Landsbanki Islands <sup>(2)</sup> and Kaupthing) and on 6 October, the Icelandic Parliament (the *Althingi*) passed 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 State wide-ranging powers to intervene in

<sup>(1)</sup> Available at: <http://www.eftasurv.int/state-aid/legal-framework/state-aid-guidelines/>

<sup>(2)</sup> Referred to in this Decision as 'Landsbanki'.

the banking sector. On 10 October 2008, the President of the Authority wrote to the Icelandic authorities and (among other matters) requested that State aid measures taken under the Emergency Act be notified to the Authority, as the Icelandic authorities had previously indicated that they would. On 14 October 2008, the Icelandic authorities submitted a further draft notification, informing the Authority that in their opinion measures taken under the Emergency Act to establish new banks as a result of the failure of the commercial banks did not involve State aid. A letter in response was sent by the Authority on 20 October 2008 indicating that it considered this unlikely and referred to the information that would be required in a notification. The matter was also discussed shortly thereafter in a meeting in Reykjavik on 24 October 2008. 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. On 22 July 2009, the Icelandic authorities informed the Authority that heads of terms had been agreed with resolution committees appointed to administer the estate of the (old) failed banks, which would lead to each of the new banks being capitalised by the Icelandic State on 14 August 2009. The Icelandic authorities again insisted that no State aid was involved and provided little information beyond what was already publicly available. Correspondence continued and meetings between the respective authorities followed both in August and November 2009, during which the Authority made it clear that from the limited information it had received it believed that the capitalisation of the new banks was State aid that required notification. Given that the measures had already been implemented, the Authority subsequently sought to assist the Icelandic authorities in producing restructuring plans for the banks with the intention of proceeding directly to assess the measures in one procedure. It transpired, however, that the authorities and the banks were not yet in a position to produce definitive, detailed plans. State aid involved in the restoration of certain operations of Landsbanki and the establishment and capitalisation of a new Landsbanki Bank ('NBI') was eventually notified retrospectively by the Icelandic authorities on 15 September 2010, although the process of restructuring the bank in order to ensure its long-term viability remains ongoing. The Icelandic authorities also submitted further information by letters of 9, 11, 15 and 28 November 2010 and in a meeting held in Reykjavik on 29 September 2010.

## **2. Background — the financial crisis and major causes of failure of the Icelandic banks**

In their notification of the aid granted to New Glitnir/Íslandsbanki, the Icelandic authorities explained that the reasons for the collapse of the Icelandic banking sector and their need to intervene in the banking sector were set out in considerable detail in a report prepared by a Special Investigation Commission ('SIC') established by the Icelandic Parliament<sup>(1)</sup>, whose remit was to investigate and analyse the processes leading to the collapse of the three main banks. In Sections 2.1 and 2.2 below, the Authority summarises the conclusions of the Commission concerning the causes of failure most relevant to the demise of Landsbanki. 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.

### **2.1. Causes of failure based on the 2008 financial crisis and its impact on underlying problems of Landsbanki and the other main Icelandic banks**

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 dependant 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 banks, and it is notable that the majority of the conclusions applied to each bank and many are inter-related. Causes of failure related to the banks' activities are briefly summarised below.

#### **2.1.1. Excessive and unsustainable expansion**

The SIC concluded that in the years leading up to the collapse each of the banks had expanded their balance sheets and lending portfolios beyond their operational and managerial capacity. The combined assets of the three banks had increased exponentially from ISK 1,4 trillion<sup>(2)</sup> in 2003 to ISK 14,4 trillion at the end of the second quarter of 2008. Significantly, a large proportion of the growth of the banks was in lending to foreign parties, which increased substantially during 2007<sup>(3)</sup>, 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.

<sup>(1)</sup> 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/>

<sup>(2)</sup> Icelandic króna.

<sup>(3)</sup> Lending to foreign parties increased by EUR 11,4 billion from EUR 8,3 billion to EUR 20,7 billion in six months.

### *2.1.2. The reduction in finance available on the international markets*

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 EUR 14 billion 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, using 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.

### *2.1.3. The gearing of the banks' owners*

In the case of each major Icelandic bank, the principal owners were among the biggest debtors <sup>(1)</sup>. Samson Holding Company ('Samson') was the biggest shareholder in the Landsbanki since its privatisation. When Landsbanki collapsed Samson's co-owner Björgólfur Thor Björgólfsson and companies affiliated to him were the bank's largest debtors, while his father and co-owner of Samson, Björgólfur Guðmundsson was the bank's third largest debtor. In total their obligations to the bank exceeded ISK 200 billion, which was greater than the bank's equity. The SIC was of the view that certain shareholders had abnormally easy access to borrowing from the banks in their capacity as owners. This was notable in the case of Landsbanki from the fact that as late as 30 September 2008, when it was clear that Landsbanki did not have sufficient foreign currency to honour its obligations abroad, the bank provided a loan of EUR 153 million to a company owned by Björgólfur Thor Björgólfsson. It also concluded that there were strong indications that in the case of each bank the boundaries between the interests of the largest shareholders and the interest of the bank were blurred. The emphasis on the major shareholders was therefore to the detriment of other shareholders and creditors.

### *2.1.4. Concentration of risk*

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.

### *2.1.5. Weak equity*

Although the capital ratio of Landsbanki (and the other two major 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 the risk exposure of the bank's own shares through primary collaterals and forward contracts on the shares. Share capital financed by the company itself, referred to by the SIC as 'weak equity' <sup>(2)</sup> represented more than 25 % of the banks' capital bases (or over 50 % when assessed against the core component of the capital, shareholders' equity less intangible assets). Added to this were problems caused by the risk 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 ISK 400 billion, around 70 % of the core component of 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 portfolio 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.

## **2.2. Causes of failure based on deficient regulation of the banks by the State and the size of the banks in relation to the rest of the Icelandic economy and currency**

### *2.2.1. The size of the banks*

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 were international and held assets worth nine times Icelandic GDP. The SIC report notes that by 2006, observers were commenting that the banking system had outgrown the capacity of the Icelandic Central Bank ('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 financing

<sup>(1)</sup> Chapter 21.2.1.2 (page 6) of the Report.

<sup>(2)</sup> Chapter 21.2.1.4 (page 15) of the Report.

the banks) were 15 times larger, and the foreign deposits of the three banks were 8 times larger, than the foreign exchange reserve. The Depositors and Investors Guarantee Fund also held minimal resources in comparison with the bank deposits it was meant to guarantee. These factors, the SIC concludes, made Iceland susceptible to a run on its banks <sup>(1)</sup>.

#### 2.2.2. *The sudden growth of the banks in comparison with the regulatory and financial infrastructure*

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 Icelandic Financial Supervisory Authority (the 'FME') and CBI lacked the expertise and experience to regulate the banks in difficult economic times, and could have taken action to reduce the level or risk that the bank were incurring. The FME for example did not grow in the same proportion as the banks and their 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 bank to move their headquarters abroad <sup>(2)</sup>.

#### 2.2.3. *Imbalance and overexpansion of the Icelandic economy as a whole*

The SIC report also 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' <sup>(3)</sup>. The report is also critical of the ease in which the banks were able to borrow from the CBI, with the stock of CBI loans increasing from ISK 30 billion in the autumn of 2005 to ISK 500 billion by the beginning of October 2008.

#### 2.2.4. *The Icelandic króna (ISK), external imbalances and CDS spreads*

The report notes that in 2006, the value of the Icelandic króna was unsustainably high, the Icelandic current account deficit amounted to 16 % and rising, 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 on Iceland and the banks rose exponentially.

### 2.3. *The global financial crisis and collapse of Glitnir Bank*

In September 2008, a number of major global financial institutions began to experience severe difficulties. Lehman Brothers filed for bankruptcy protection on 15 September, and on the same day it was announced that the Bank of America was to takeover Merrill Lynch. Elsewhere, one of the United Kingdom's biggest banks, HBOS, had to be taken over by Lloyds TSB. In Iceland meanwhile, Glitnir Bank was experiencing major difficulties in financing its activities. A bond issue had had to be cancelled as a result of a lack of interest, an asset sale did not complete, and a German bank refused to extend two loans estimated at EUR 150 million. Market conditions also worsened dramatically after the fall of Lehman Brothers. On 24 September 2008, the Chairman of Glitnir's Board contacted the CBI to inform them that as a result of loans that had to be repaid in October, the bank had an immediate shortfall of EUR 600 million. On 29 September, it was announced that the Icelandic Government would provide Glitnir with EUR 600 million in return for 75 % of its equity. The fact that EUR 600 million amounted to nearly a quarter of Iceland's foreign currency reserves, and that Glitnir had experienced refinancing problems for some time and had debt estimated at EUR 1,4 billion to repay over the following six months (information that was publically available) suggested, however, that the proposal was not credible <sup>(4)</sup>. The effect was a reduction on the value of issued Glitnir shares from over ISK 200 billion to ISK 26 billion in one day. The Icelandic banks experienced massive withdrawals of deposits not only abroad but also within Iceland. Domestic withdrawals became so large that at one stage the Icelandic banks and the CBI were close to experiencing a shortage of cash. On 30 September 2008, the credit agency Moody's lowered Glitnir's credit rating, triggering repayment obligations for further loans. Margin calls of over a billion euro also followed and eventually on 7 October 2008 Glitnir's Board decided that it had no alternative but to submit the bank to the FME for actions to be taken under the newly passed Emergency Act. Within days the other two Icelandic commercial banks also failed and were taken over by the FME.

<sup>(1)</sup> These issues are discussed in more detail in the following paper by Willem H. Buiter and Anne Sibert: <http://www.cepr.org/pubs/PolicyInsights/PolicyInsight26.pdf>

<sup>(2)</sup> 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.

<sup>(3)</sup> Chapter 2, page 5 of the report.

<sup>(4)</sup> Page 13 of the Executive Summary to the Report (Chapter 2), fourth bullet point.



### 3. Description of the measures

#### 3.1. Background

Prior to the financial crisis of 2008 Landsbanki was the second largest bank in Iceland. At the end of the second quarter of 2008 its balance sheet amounted to ISK 3,970 billion (EUR 43,5 billion) and it made a pre-tax profit during the first half of that year of ISK 31 billion, around EUR 341 million. The published business strategy <sup>(1)</sup> of the bank was to transform the bank from a local commercial bank, operating exclusively in Iceland, 'into a highly profitable corporate and investment banking operation stretching eastward from Iceland across Europe and westward over the Atlantic'. In 2000, Landsbanki began its activities abroad by acquiring a 70 % holding in the Heritable Bank in London and over the following years the bank grew substantially both through acquisitions and the establishment of foreign branches. Prior to its collapse the bank held seven main subsidiaries in the UK, Ireland, Luxembourg, France/Germany and Iceland itself. It also had branches in the UK (which in turn had offices in the Netherlands, Germany and the United States), Canada, Norway and Finland; and a sales office in Hong Kong.

#### 3.2. The collapse of Landsbanki

Access to foreign debt securities markets had been the main source of the Icelandic banks' growth, in particular between 2003 and 2006. This source of financing however began to diminish, and foreign credit-rating agencies also expressed concern that the ratio of the banks' lending to deposits was low in comparison to other (foreign) banks. The banks (in particular Landsbanki) responded by strengthening their deposits by accumulating custom abroad. From the end of the third quarter of 2006 to the middle of 2007, customer deposits in Landsbanki tripled — an increase of almost EUR 10 billion. The largest proportion of this was 'Icesave' accounts opened in the Landsbanki UK branch, in which retail deposits had grown from nothing to EUR 6,6 billion, while wholesale deposits (in branches in the UK and the Netherlands) had grown to EUR 2,5 billion. To put the figures in context, the increase in (foreign currency denominated) deposits over a period of merely nine months amounted to nearly five times the monetary reserves of the CBI (which stood at just under EUR 2 billion). The SIC report concludes that on that basis it should have been clear that the Central Bank could no longer act as a lender of last resort if Landsbanki experienced a run on foreign deposit accounts. Despite this Landsbanki continued to choose to accumulate deposits in branches instead of subsidiaries, a decision that the SIC report concludes was 'highly risky' <sup>(2)</sup>. The report also notes that there is no indication that any evaluation was undertaken by the Icelandic regulatory authorities of the stability of Icesave accounts as a means of financing Landsbanki's activities, noting that accumulating deposits abroad entailed new risks. On 3 October 2008, the European Central Bank issued a margin call to Landsbanki to the amount of EUR 400 million and although this was later withdrawn the bank's UK branch had begun to experience a run on its deposits, meaning that it had to make available large amounts in pounds sterling. Landsbanki's request for the assistance of the Icelandic Central Bank was turned down on 6 October and when the bank failed to make the funds demanded by the UK Financial Services Authority available the UK authorities closed the branch. The following day the Dutch Central Bank requested that an insolvency practitioner be appointed for Landsbanki's Amsterdam branch. Also that day the FME suspended the board of directors of Landsbanki, took over the power of shareholders' meetings and appointed a Resolution Committee in its place using its powers under the Emergency Act <sup>(3)</sup>.

#### 3.3. National legal basis for the aid measure

- 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

<sup>(1)</sup> Annual Report 2007, p. 10. Available here: [http://www.lbi.is/library/Opin-gogn/pdf/landsbanki\\_annual\\_report\\_2007.pdf?bcsi\\_scan\\_A7E1E556D7B2F94D=aB9LkrKRu+y0xx3fjm/jyUDnRB0bAAAAANp6SAg==&bcsi\\_scan\\_filename=landsbanki\\_annual\\_report\\_2007.pdf](http://www.lbi.is/library/Opin-gogn/pdf/landsbanki_annual_report_2007.pdf?bcsi_scan_A7E1E556D7B2F94D=aB9LkrKRu+y0xx3fjm/jyUDnRB0bAAAAANp6SAg==&bcsi_scan_filename=landsbanki_annual_report_2007.pdf)

<sup>(2)</sup> Page 85 of Chapter 21 of the report. Operating as a subsidiary could have avoided currency risk. Subsidiaries would also be subject to local deposit guarantee scheme provisions.

<sup>(3)</sup> Glitnir Bank was also placed in receivership on the same day and Kaupthing Bank followed two days later on 9 October 2008. The SIC report concluded (at page 86 of Chapter 21) that a key issue was that notwithstanding Landsbanki's liquidity in ISK, the bank had insufficient foreign currency at its disposal to honour its foreign obligations. The report also considered it noteworthy that the loan of EUR 153 million to its principal owner (referred to above) had taken place only days earlier, stating that it was therefore 'apparent that the principal owners of Landsbanki were not interested in or capable of helping the bank out of the difficult position that had arisen'.

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 intervention of the Icelandic State*

The Icelandic authorities' intervention can be categorised into three phases as follows: firstly, restoration of NBI in October 2008 through the formation of the new bank, the transfer of assets and liabilities, and the provision of initial capital and a commitment to fully capitalise; secondly, the completion of the capitalisation (primarily by the State) in the autumn/winter of 2009; and thirdly, the restructuring of the bank, which began when the banks were restored and is ongoing.

#### 3.4.1. *Phase 1: Restoration of certain operations of Landsbanki and the establishment of NBI*

On 7 October 2008, the FME took control of Landsbanki in order to ensure the continuation of domestic retail banking operations. This was done through the appointment of a Resolution Committee for Landsbanki, which assumed the authority of its board of directors; and the establishment by the Icelandic Government, on 8 October 2008, of New Landsbanki (or NBI), wholly owned by the State. On 9 October 2008, the FME transferred the liabilities for deposits held in Landsbanki, except for those held in foreign branches, to the new bank <sup>(1)</sup>. The total amount of liability for domestic deposits transferred was ISK 462 069 454 174. Certain assets were also transferred to the new bank based on a principle (that was subject to certain exceptions) that assets connected to the old bank's domestic operations were to be credited to the new bank with the remainder staying with the old bank. The FME also published an internal memorandum setting out 'guiding principles' for what was to be transferred not only to NBI but also to new successor banks that were formed following the collapse of Glitnir and Kaupthing <sup>(2)</sup>.

In return for the assets transferred to the new bank, the old bank was to be compensated to the sum of the difference between the value of the assets transferred and the amount of the liabilities (deposits) transferred. In accordance with Article 5 of the Emergency Act and the subsequent decisions of the FME on the disposal of assets and liabilities of the old banks, the FME commissioned a valuation of the net assets transferred from the old banks to the respective new banks. Deloitte LLP was appointed by the FME on 24 December 2008 to prepare the net asset valuations of each of the new banks. The process of valuation was however to prove complex and lengthy.

#### Initial Capital

The State provided ISK 775 million <sup>(3)</sup> (EUR 5 million) in cash as initial capital to the new bank and in addition issued a commitment to contribute up to ISK 200 billion to the new bank in return for all of its equity. This figure was calculated as 10 % of an initial assessment of the likely size of the bank's risk weighted asset balance, and 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 of the operability of the bank until issues relating to its final re-capitalisation could be resolved, including the size of its opening balance based on the valuation of compensation payable to the old bank for assets transferred from it.

#### Deposit guarantee

The initial rescue measures of the Icelandic Government also involved State backing of deposits in domestic commercial and savings banks. 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

<sup>(1)</sup> The decision was subsequently amended several times. The decisions are available here: <http://www.fme.is/?PageID=867>

<sup>(2)</sup> This document is available here: <http://www.fme.is/lisalib/getfile.aspx?itemid=6021>

<sup>(3)</sup> 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 EUR (as appropriate) where it has been provided by the Icelandic authorities.

and their branches in Iceland will be fully covered' <sup>(1)</sup>. This announcement has since been repeated by the Office of the current Prime Minister in February and December 2009 <sup>(2)</sup>. 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 for Finance, Minister for 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.' <sup>(3)</sup>. 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 <sup>(4)</sup>.

### 3.4.2. Phase 2: Rescue/Restructuring of NBI through recapitalisation

On 20 July 2009, the Icelandic Government announced that it had determined the basis for the capitalisation of NBI and reached an agreement on a process for how the old banks would be compensated for the transfer of net assets. It also announced that the State would capitalise the new bank to the amount of ISK 140 billion. Final agreement on the capitalisation was reached on 15 December 2009 (eventually to the total sum of ISK 150 billion, of which the State provided ISK 121 225 billion) when agreement was reached on compensation to creditors for the net value of the assets and liabilities transferred to NBI. The capital requirements imposed by the FME stipulated that NBI should hold at least 12 % Core Tier I Capital <sup>(5)</sup> and an additional 4 % of Tier II Capital as a ratio of risk-weighted assets. When NBI was formally capitalised on 20 January 2010, the Core Tier I Capital ratio of the bank was approximately 15 %. The FME granted temporary relief from the (overall) 16 % requirement conditional upon the submission of an acceptable plan illustrating how the full amount would be achieved. In June 2010, the bank reported that its Core Tier I exceeded 16 % and on that basis the FME permanently exempted NBI from the requirement to hold Tier II capital as long as its Core Tier I ratio remains above 16 %.

This agreement followed a lengthy and complex negotiation process resulting in an outline agreement among the parties in a heads of terms on 10 October 2009 and more detailed sets of term sheets in relation to the debt instruments on 20 November 2009. There were also a number of subsequent meetings and discussions between the parties during which the outlined terms were modified and reflected in documentation. The resulting agreement comprises the issuance of three bonds denominated in Euros, pound sterling and US dollars, respectively, having an aggregate principal amount equivalent to ISK 260 billion, and also involves Landsbanki (or in effect the old bank's creditors) taking an initial (and potentially temporary) 18,67 % ownership stake in NBI. In addition, NBI may issue to Landsbanki a contingent bond (linked to its equity participation) in euro or such other currency as may be agreed, the principal amount of which will not be determined until on or after 31 March 2012. Following the determination of the principal amount of the contingent bond, all or part of the shareholding held by Landsbanki may be surrendered to the Icelandic government as described below.

The compensation structure involves the creditors of the old bank holding secured debt instruments issued by NBI and 4 480 000 000 ordinary shares in NBI representing 18,67 % of NBI's issued share capital. The Ministry of Finance holds the remaining 19 520 000 000 ordinary shares in NBI. The total equity of NBI (on its share capital and share premium accounts) was ISK 150 000 000 000 comprised of 24 000 000 000 ordinary shares in NBI. Subsequently the Icelandic government subscribed for remainder of the ordinary shares in NBI and transferred to NBI a ISK 121 225 000 000 Icelandic government bond in consideration for the capitalisations described above. NBI issued to the Icelandic government 18 745 000 000 of ordinary shares with a nominal value of ISK 1 per share at a price per share of ISK 6,4670579. Together with the Icelandic government's existing holding of 775 000 000 ordinary shares, this resulted in the Icelandic government holding 19 520 000 000 ordinary shares in NBI. Landsbanki subscribed for 4 480 000 000 ordinary shares in NBI with a nominal value of ISK 1 per share at a price per share of ISK 6,25 in consideration for a release of claims against NBI of ISK 28 000 000 000 in aggregate.

<sup>(1)</sup> The English translation of the announcement is available at: <http://eng.forsaetisraduneyti.is/news-and-articles/nr/3033>

<sup>(2)</sup> <http://www.efnahagsraduneyti.is/frettir/frettatilkynningar/nr/2842>

<http://www.efnahagsraduneyti.is/frettir/frettatilkynningar/nr/3001> The Minister for Economic Affairs has also referred to it recently in an interview with *Víðskiptablaðið* on 2 december 2010, p. 8: '(The declaration) will be withdrawn in due course. We do not intend to maintain unlimited guarantee of deposits indefinitely. The question when it will be withdrawn depends, however, on when an alternative and effective deposit system will come into force and a financial system which will have fully resolved its issues' (the Authority's translation).

<sup>(3)</sup> The relevant paragraph can be found at Section 16 (p. 6) of the letter: [http://www.efnahagsraduneyti.is/media/Acrobat/Letter\\_of\\_Intent\\_2nd\\_review\\_-\\_o.pdf](http://www.efnahagsraduneyti.is/media/Acrobat/Letter_of_Intent_2nd_review_-_o.pdf)

<sup>(4)</sup> [http://hamar.stjr.is/Fjarlagavefur-Hluti-II/Greinargerdir/Raedur/Fjarlagafurvarp/2011/Seinni\\_hluti/Kafli\\_8.htm](http://hamar.stjr.is/Fjarlagavefur-Hluti-II/Greinargerdir/Raedur/Fjarlagafurvarp/2011/Seinni_hluti/Kafli_8.htm)

<sup>(5)</sup> The definition of Core Tier I capital includes only equity, i.e. share capital and retained earnings, but does not include subordinated loans or other types of hybrid capital instruments.



In view of the considerable uncertainty surrounding the relevant asset values and major differences in opinion between the old and new banks' negotiated initial values in respect of certain reference assets, to the extent that these values are lower than estimated values of the assets as at 31 December 2012, the contingent bond is intended to compensate the old bank for such differences. The contingent bond will be issued in euro or such other currencies as may be agreed between NBI and Landsbanki. If the valuation is zero or a negative amount, the new principal balance will be deemed to be zero and the contingent bond will be cancelled. If the value is positive the contingent bond will be issued at this value and Landsbanki will surrender its shareholding to NBI, or part of its shareholding to the extent that the positive value is less than the value of the shareholding.

#### *3.4.3. Phase 3: Restructuring of Landsbanki/NBI and the long-term viability of NBI*

According to the Icelandic authorities, the restructuring process, which began by necessity through the collapse of Landsbanki and the transfer of its domestic assets and liabilities for domestic deposits to NBI, remains incomplete. In view of the scale of the systemic collapse in comparison to the resources at the Icelandic Government's disposal, and the lack of information available at the time of taking control of the banks, it was not considered prudent to attempt to fully restructure the financial system at that stage. Instead it was decided that a two-staged approach should be adopted. As a first stage, the enforced split would simultaneously achieve the aims of maintaining domestic banking services and significantly scaling down the unsustainably large financial system. The domestic operations transferred were however likely to represent an upper limit for the appropriate size of a domestic Icelandic system and further restructuring was likely. In order to continue the process three further steps were required. The first was to settle the claims of international stakeholders (through the Resolution Committees of the old banks), the second was the re-capitalisation of the banks, and the third was to clearly establish their future ownership structure. Further restructuring of the newly formed banks was intended to follow after this was achieved.

A likely consequence of the fact that the rescue approach adopted in Iceland was not (predominantly) based on a 'good bank/bad bank split' is that extensive loan portfolio restructuring may have to be carried out by the new banks themselves. Despite numerous issues that have caused delays, the new banks have all taken important measures to avert impending losses by transferring impaired assets to specialised subsidiaries or selling them to new owners. They have also developed various programmes intended to resolve debt related issues in the retail and SME portfolios. Achievements have, however, been limited. Based on the ICAAP<sup>(1)</sup> process currently ongoing in all three new banks, the FME expects to be able to systematically enforce and document a definitive return to long-term sustainability by all three banks and conclude the restructuring of the Icelandic financial system.

A restructuring plan will therefore need to be submitted to the Authority in order for it to conclude its assessment of the State aid granted to NBI, and its assessment of the new bank's viability, as soon as possible.

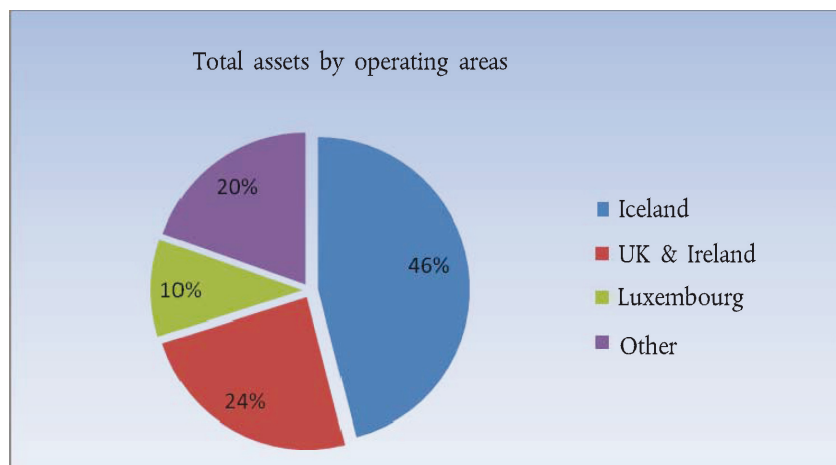
#### **3.5. A comparison of the old and new banks: Landsbanki and NBI**

The Authority will undertake a full assessment of aid paid to the new bank, including an analysis of the differences between the old and new banks and the potential for the same or similar problems to re-occur, following the submission by the Icelandic authorities of a detailed restructuring plan for the bank. The Icelandic authorities have, however, submitted an overview of the fundamental changes that have already taken place which the Authority considers to be relevant for the purposes of its current assessment.

As referred to above Landsbanki's business strategy involved expansion of its business internationally, and from 2004 the main goal of the bank was to grow in international investment and corporate banking markets focusing on services to small to medium-sized corporate enterprises. A branch was opened in London in 2005, initially focused on leverage finance and asset based loans. Later branches, opened in Canada, Finland, Norway and the sales office in Hong Kong, were initially focused on asset-based lending and trade finance. The aim of this strategy<sup>(2)</sup> was to diversify the loan portfolio across countries and sectors. Due to this strategy lending to non-Icelandic companies accounted for an ever-larger share of the bank's operations. Nearly half of the 2 644 people employed by Landsbanki and its subsidiaries in September 2008 were based outside Iceland.

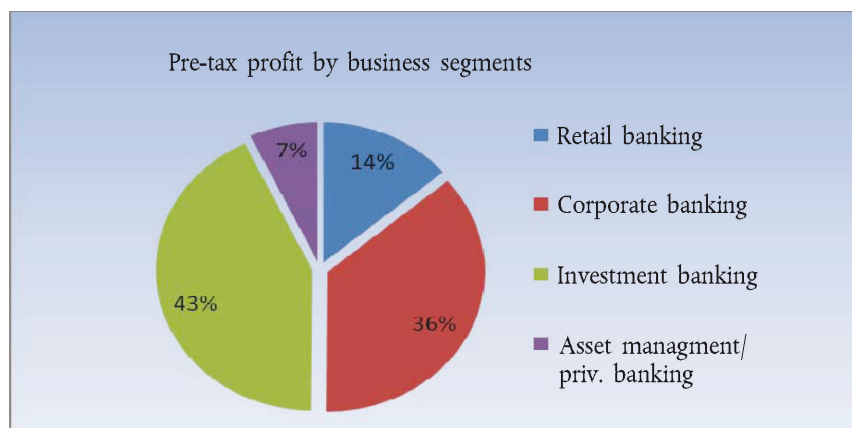
<sup>(1)</sup> Internal Capital Adequacy Assessment Process, cf. Pillar II of the Basel II recommendation of bank supervisors and central bankers stating that it shall be the responsibility of the financial regulator to monitor and assess the ICAAP of regulated banks.

<sup>(2)</sup> Annual report 2007, p. 61.



When examined geographically 41 % of revenues in the first half of 2008 originated in Iceland, 34 % in UK and Ireland, 6 % in Luxembourg and 15 % in other areas. Of total assets (of ISK 3 970 372 million for Q1-Q2 2008), as shown in the table above 54 %, were located outside Iceland.

The chart below shows that for the first half of 2008 (the last available numbers for the bank) the largest part of Landsbanki's pre-tax profit of ISK 31 140 million came from investment banking and corporate banking. In the years following the privatisation of the bank (in 2002) the share of retail banking in pre-tax profits had been steadily declining.



### 3.5.1. Corporate banking

Of the business segments referred to above, the corporate banking division was the most geographically diverse business, focused on asset-based lending ('ABL'), cash flow finance and trade finance. The ABL product was first introduced in 2005 and by 2008 the division had teams located in the UK (London, Birmingham and Manchester) and Germany (Frankfurt). The bank also had plans to enter the US and Spanish markets with the ABL product and had opened offices there to facilitate those plans. Teams in London and Amsterdam were also active in the European structured loan market (cash flow finance). These teams were both originating deals for syndication and participating in larger syndications. Trade finance focused on providing a full range of financial services to fisheries and seafood industry both in Iceland and internationally. The bank's business in seafood trade finance had teams located in Reykjavík, London, Amsterdam, Oslo, Halifax (Canada) and Hong Kong. The bank had adapted this product to other commodity industries worldwide including agricultural products such as sugar, coffee, corn and soya beans.

### 3.5.2. Investment banking

Landsbanki's investment banking provided large corporate, local government and institutional investors with a broad range of financial services, including securities brokerage, corporate finance, foreign exchange and derivatives trading. The investment banking sections also handled the bank's treasury, debt management and proprietary trading. The investment banking was provided through subsidiaries Kepler Equities and Merriion Capital, together with Landsbanki Securities. Kepler had operations in France, Spain, Germany, Switzerland,

Italy, the Netherlands and the US. Merrion had operations in Ireland and Landsbanki Securities operated in the UK. These subsidiaries, along with the head office, operated a variety of business lines comprising, equity brokerage, securities brokerage, foreign exchange and derivatives brokerage, structured products and derivatives, corporate finance, asset management and fixed income. In addition to this the bank provided equity research services complementing the securities brokerage.

### 3.5.3. Retail banking

In retail banking all business was located in Iceland except for the specialised lending of the subsidiary Heritable Bank through structured property finance for small and medium-sized property developers in the residential and commercial markets. Traditional retail banking services provided through branches were limited to Iceland, though retail services were also offered in the form of online (Icesave) savings accounts in the UK and the Netherlands. Part of the products on offer by Landsbanki were leasing services both to individuals and businesses through SP Fjármögnun. In addition, Vörður Insurance and Vörður Life Insurance were partly owned by the bank. The aim of these holdings was to strengthen the bank's capacity to provide integrated banking and insurance services and thereby offer a full range of financial services to clients.

### 3.5.4. Asset management and private banking

Internationally Landsbanki focused on institutional clients and offered a variety of equity, money market, and currency hedge and savings funds focused on the Nordic, German, wider European and global markets. Landsbanki Luxembourg and Merrion fund management were the main international service providers for asset management and private banking. Total assets under management by Landsbanki at year-end 2007 were ISK 513 billion.

### 3.5.5. Market share

At the end of 2007 the market share of Landsbanki in the domestic corporate lending market was 43 %. The breakdown for individual market segments was: retail market 60 %, fishing industry 50 %, and construction 45 %. Landsbanki's market share for individuals had been steady for the last 10 years <sup>(1)</sup> before the collapse at around 28 %.

## 3.6. The business activities of the new bank

The new bank was founded by the Ministry of Finance on 7 October 2008 and commenced operations on the basis of a decision by the FME on 9 October 2008. Originally the new bank was named New Landsbanki Íslands hf., but at a shareholders' meeting held on 21 October 2008 a resolution was passed to change the name to NBI hf. The bank has nevertheless operated under the trade name of 'Landsbankinn'. The bank's primary lines of business are corporate and retail banking, investment banking, asset management and leasing services.

### 3.6.1. Operations and subsidiaries no longer run by NBI

#### 3.6.1.1. Heritable bank

In 2000, Landsbanki acquired Heritable Bank Plc, a Scottish bank headquartered in London. Heritable Bank specialised in advisory and financing services for housing development ventures. Heritable Bank was placed in administration under Scottish law on 7 October 2008 and the following day the majority of Heritable Bank's deposits were transferred to ING Direct.

#### 3.6.1.2. Kepler Equities

In September 2005, Landsbanki acquired the European securities brokers Kepler Equities ('Kepler'), previously Julius Bär Brokerage. Kepler specialised in the sale and mediation of equities to institutional investors, as well as operating a strong research division. The company's headquarters were in Paris but it also operated in the principal financial capitals of Europe and in New York. When the FME took over Landsbanki and appointed a Resolution Committee it became necessary to sell Kepler in order to avoid more deterioration in its value.

#### 3.6.1.3. Landsbanki Luxembourg

Landsbanki Luxembourg S.A. ('LLUX') was a fully owned subsidiary of Landsbanki. The main activity of LLUX was private banking. On 8 October 2008, LLUX was placed in moratorium and in liquidation proceedings on 12 December 2008.

#### 3.6.1.4. Landsbanki Securities UK

Landsbanki Securities UK ('LS') was created through the merger of stockbrokers Bridgewell and Teather & Greenwood upon Landsbanki's acquisition of Bridgewell in May 2007. Landsbanki had acquired Teather & Greenwood in February 2005 and operated it under that name. After Landsbanki could not fulfil major guarantees for its obligations, LS's management requested the company be declared insolvent in November 2008.

<sup>(1)</sup> Based on monthly market research by Gallup, asking customers 'what is your principal bank of business?'

### 3.6.1.5. Merrion Capital

Landsbanki's acquisition of a 50 % holding in the Irish stockbroker Merrion Capital ('Merrion') was concluded in November 2005. The bank was expected to acquire the company's entire share capital over the following three years and had gained a 84,11 % share when the Resolution Committee was appointed for Landsbanki Íslands hf. Merrion was sold shortly after the failure of Landsbanki in order to avoid more deterioration in its value.

### 3.6.2. The size and scope of operation of NBI compared to Landsbanki

The result of the transfer of assets and reduced scope of operations in Iceland was a reduction in the size of the balance sheet of NBI when compared to LBI and a reduction in the number of employees. Due to the collapse of the whole banking sector many business lines of NBI experienced greatly reduced transactions and some departments were closed altogether. There are also considerable differences in the way the new bank is funded, with NBI being reliant on deposits in contrast to the variety of funding sources of the old bank.

Balance sheet Landsbanki and NBI comparison (million ISK)	30 June 2008 (Landsbanki)	9 October 2008 (Opening Balance Sheet NBI)
Loans and advances to customers	2 571 470	655 725
Loans and advances to financial institutions	337 003	5 291

The opening balance sheet of NBI was approximately 25 % of the size of the balance sheet of the old bank on 30 June 2008. In September 2008, the number of full time positions in Iceland within the Landsbanki Group were 1,413. At the start of November 2008, there were 1,186 full time positions in NBI and by the end of 2009 there were 1,142. This is a reduction of nearly 20 % for Iceland but if the total number of positions in Landsbanki in September 2008 is used for comparison then the reduction is 57 %. This reduction would have been larger had it not been for the personnel required to deal with the difficulties of the bank's customers and general workload due to the difficult economic situation.

### 3.6.3. Operations of NBI were formed into four business segments

#### 3.6.3.1. Retail banking

Retail banking contains all services to individuals and small businesses. The new bank's market share for individuals remains around 28 % as it had for the old bank for many years. NBI has not launched any major new product initiatives except for various solutions aimed at helping customers in payment difficulties. These new products have been mirrored across the banking sector with each bank offering broadly the same solutions. In addition to this (subsidiary) SP Fjármögnun offers leasing services to individuals. This business has been greatly reduced as the sales of new cars are only a fraction of what it was before the autumn of 2008. No significant retail banking operations were discontinued following the creation of the new bank in October 2008.

#### 3.6.3.2. Corporate banking

The main emphasis of the corporate banking division since October 2008 has been to ensure the viability of the loan book through various solutions aimed at customers in difficulties, including payment holidays, write-downs and grace periods. No significant operations of corporate banking were discontinued following the formation of NBI in October 2008. Following the transfer of operations (comparing those in Iceland) the number of employees was reduced by 26 %.

#### 3.6.3.3. Investment banking

Investment banking provides investors with a range of financial services, including securities brokerage, corporate finance, foreign exchange and derivatives trading. Investment banking also handles the bank's treasury and debt management and proprietary trading. Following the collapse all parts of the investment banking division have seen greatly reduced levels of trading volumes. This is partly explained by the currency restrictions in place but also by the greatly reduced size of the equity and bond markets. Following the transfer of operations (comparing those in Iceland) the number of employees was reduced by 38 %.

#### 3.6.3.4. Asset management

Asset management and private banking includes fund and wealth management services, provided by divisions of the bank and its subsidiary Landsvaki hf. The volume of business has been greatly reduced post crisis and the market share of NBI fund services has been reduced from around 30 % pre crisis to around 10 % post crisis. No significant operations of asset management were discontinued following the formation of NBI. After the transfer of operations (comparing those in Iceland) the number of employees was reduced by 45 %.

#### 3.6.4. Summary

Following the collapse of LBI in the beginning of October 2008, no operations outside of Iceland were transferred to NBI. This had the effect that at inception NBI was a much smaller bank than LBI was previously both in terms of the size of balance sheet (the new bank being only 25 % of the size of its predecessor) and number of employees. Although most of the operations in place in Iceland were transferred to NBI, the size and scope of the operations was greatly reduced.

### 4. Position of the Icelandic authorities

#### 4.1. State aid nature of the measures and compatibility with the EEA Agreement

In their notification the Icelandic authorities now accept that measures undertaken in order to establish NBI constitute State aid. They contend however that the measures are compatible with the functioning of the EEA Agreement under Article 61(3)(b), on the basis that they were necessary in order to remedy a serious disturbance in the Icelandic economy.

The Icelandic authorities stress that the situation in Iceland in October 2008 was extreme and required immediate action in order to restore financial stability and confidence in the Icelandic economy. The Icelandic authorities' intentions at this stage of the process were straightforward and basic, ensuring that Icelanders had access to their deposit accounts and that some form of financial system survived. The implications not only for the Icelandic economy, but also for Icelandic society, were grave.

The measures regarding Landsbanki/NBI were considered necessary because if the bank had not been restored the systemic collapse that Iceland was already suffering would have intensified. The Authority has also been provided with a letter from the CBI affirming the necessity of the measures taken. The fact that NBI, and other Icelandic and European banks, suffered from the lack of liquidity as well as lack of market and investors' confidence meant it was not possible to fund the bank through the financial markets. The intervention of the Icelandic State was necessary to strengthen the bank's equity and liquidity position and maintain its viability.

According to the Icelandic authorities the Government contribution of capital to NBI was therefore necessary and essential to restore viability, and an important factor in restoring confidence in the financial market with the aim of reconstructing a bank that will be viable in the long term without State aid. Although it was not possible to ensure significant long-term involvement of the old bank's creditors, the State's contribution is limited in size to what is absolutely necessary to ensure that NBI meets minimum capital requirements, as defined by the FME.

According to the Authority's Recapitalisation Guidelines, State recapitalisations should be remunerated adequately. The part of the capitalisation of NBI borne by the Icelandic State as an owner of 81,33 % (and potentially 100 %) of the bank's shares, will be remunerated through the eventual sale of the bank by the State. The Icelandic authorities argue that as far as applicable, the measures are also in line with the principles set out in the Authority's Recapitalisation Guidelines and should be acceptable by all standards.

The Icelandic authorities also stress that the shareholders of Landsbanki before the financial crisis have lost their shares in the bank and have received no compensation from the State. The compensation provided to the creditors of Landsbanki, through the Resolution Committee, is not compensation for the losses suffered in connection with the collapse of the banks, but is compensation for assets allocated from the estate of the old banks. The losses stemming from the fall of the old banks have not therefore been mitigated by the Icelandic Government and the costs associated with the re-establishment of the bank must be seen as being borne by the investors of Landsbanki. The measures are therefore consistent with the principle that the bank should use its own resources to finance rescue and restructuring to the extent possible.

As regards competition in the banking market reference is made to decisions of the Icelandic Competition Authority concerning Glitnir/Íslandsbanki and Kaupthing/Arion<sup>(1)</sup>, where it is stated that the establishment of the three new banks has not changed the situation as regards competition in the retail banking market in Iceland.

#### 4.2. Possible alternatives

The Icelandic authorities are of the view that there were no other realistic alternatives to the actions taken in October 2008. The purpose of the measures undertaken with regard to all three banks was to eliminate the threat to the stability of the Icelandic economy that complete failure of the domestic banking system would have entailed. To do so, the measures had to remedy the identified causes of banks' problems — mainly their size relative to the size of the Icelandic economy and their reliance on foreign credit facilities. The instruments chosen by the Icelandic government represent the only credible measures available, given the

<sup>(1)</sup> Cases 48/2009 and 49/2009: [http://www.samkeppni.is/samkeppni/en/decisions/?page=1&wildparam1=Ndesicion=\\*2009\\*&s2=1](http://www.samkeppni.is/samkeppni/en/decisions/?page=1&wildparam1=Ndesicion=*2009*&s2=1)



status of the Icelandic economy, and were therefore both necessary and appropriate means to address these problems. The scope of the measures as regards Landsbanki/NBI is, in the opinion of the Icelandic authorities, limited to the minimum necessary, bearing in mind the serious economic situation of Iceland and the need to rebuild the financial system in the country.

The total revenue in the Icelandic State budget for 2008 was ISK 460 billion and total GDP in 2007 was ISK 1 308 billion <sup>(1)</sup>. The liabilities through deposits alone in the three large Icelandic banks were at the time of their collapse around ISK 2 700 billion, of which 1 500 billion was held in foreign currencies in the foreign branches of the banks. The foreign currency reserves of Iceland consisted of ISK 410 billion in October 2008, which amounted to around 25 % of the value of deposits in the non-domestic branches.

The Authority also notes in this context the conclusions of the SIC Report, which refers in Section 4.5.6.2 of Chapter 4 <sup>(2)</sup> to attempts made during the course of 2008, given the concerns about the overblown size of the Icelandic banking sector and limitations of the CBI as a lender of last resort, to strengthen the CBI's foreign currency reserves. Requests were made to other Nordic central banks, the Bank of England, the European Central Bank and the Federal Reserve Bank of New York for currency swap agreements, but despite extensive efforts the CBI managed only to secure agreements with Nordic central banks (Sweden, Denmark and Norway). The Bank of England considered the CBI's request carefully, but eventually declined to participate. A letter from the Bank of England governor, Mervyn King, to his Icelandic counterpart, Davíð Oddson, illustrates the views of the United Kingdom's central bank (letter of 23 April 2008):

'It is clear that the balance sheet of your three banks combined has risen to the level where it would be extremely difficult for you effectively to act as a lender of last resort. International financial markets are becoming more aware of this position and increasingly concerned about it. In my judgement, the only solution to this problem is a programme to be implemented speedily to reduce significantly the size of the Icelandic banking system. It is extremely unusual for such a small country to have such a large banking system ... I know you will be disappointed. But among friends it is sometimes necessary to be clear about what we think. We have given much consideration to your proposal. In my judgement, only a serious attempt to reduce the size of the banking system would constitute a solution to the current problem. I would like to think that the international central banking community could find a way to offer effective help to enable you more easily to construct a programme to reduce the size of the banking system. I shall be willing to do all in our power to help you achieve that.'

Later efforts included contacts with Timothy F. Geithner, President and CEO of the Federal Reserve Bank of New York. The request was eventually declined on 3 October 2008. According to the SIC report, the main reason given by the Federal Reserve was the size of the Icelandic banking system as for a currency swap agreement to be effective, it would have had to be for a bigger amount than the Federal Reserve could accept.

The Icelandic authorities did consider dividing the bank into a 'good bank' and a 'bad bank' by transferring the healthy and valuable assets to a 'good bank' that should generally be able to finance itself on the market and leaving the less valuable assets that are difficult to realise in a 'bad bank' funded by the State. However, it was considered that due to the financial crisis, even 'good' Icelandic banks would probably not have been able to seek sufficient capital to finance their operations despite a potentially healthy financial status. Another problem for Iceland in using the 'good bank/bad bank' solution was that running a 'bad bank' would require substantial equity contributions from the Government. Faced with a situation where aid was needed for three of the nation's biggest banks (over 80 % of the nation's banking system), which had collective liabilities over 10 times bigger than Iceland's GDP, it was the conclusion of the Icelandic authorities that such an attempt would almost certainly lead to the state suffering major financial difficulties. In combination therefore it was felt that such a solution would have lacked the credibility necessary in a situation where the immediate problem faced by the banks was the run on their liabilities through the termination of credit facilities and massive deposit withdrawals.

#### 4.3. *Timescales*

In so far as the period of time it has taken to reach this stage is concerned the Icelandic authorities argue that they faced severe and complex circumstances — a division of three commercial banks to save the domestic part of a banking system and through that the economy, had as far as they are aware never been done before. The task required the participation of many parties both domestic and foreign and in their view some aspects of the split proved more difficult than the 'good bank/bad bank' method used in some other countries where banking systems have encountered serious problems.

The first problem encountered was a practical one. One of the principal problems in executing the split was that it was practically impossible to obtain confirmations and summary statements from third parties at the

<sup>(1)</sup> See: [http://www.statice.is/?PageID=1267&src=/temp\\_en/Dialog/varval.asp?ma=THJ01102%26ti=Gross+domestic+product+and+Gross+national+income+1980%2D2009%26path=../Database/thjodhagsreikningar/landsframleidsla/%26lang=1%26units=Million+ISK](http://www.statice.is/?PageID=1267&src=/temp_en/Dialog/varval.asp?ma=THJ01102%26ti=Gross+domestic+product+and+Gross+national+income+1980%2D2009%26path=../Database/thjodhagsreikningar/landsframleidsla/%26lang=1%26units=Million+ISK)

<sup>(2)</sup> See: <http://rna.althingi.is/pdf/RNABindi1.pdf> (see pp. 167-181).



outset of the work. This, and the fact that the split was executed intra-month, led to the decision to leave all nostro <sup>(1)</sup> transactions in the old bank. In addition the bank had been subject to a bank-run during the last days of its existence as a single entity, which resulted in complexities in reconciling the accounts in question. In certain cases this proved impossible. Most of the transactions in question were only reconciled between the banks in 2009. Suspense and error accounts also contained an extraordinary number of records because the cash-flow of the bank had proceeded abnormally in the days preceding the crash.

Difficulties in communication with non-domestic banks also contributed to the fact that it was difficult to reconcile and verify the bank's positions in equity shares and other securities. During this period non-domestic financial institutions were reluctant to share information regarding their business with Icelandic banks, probably because of the high level of uncertainty surrounding the affairs of Landsbanki, including the fear of weakening their position in potential litigation.

Within a short period of time it became evident that the creditors of the old banks were very unhappy with the asset valuation process that had been established. They considered the process to be one-sided in that their input was not taken into account as a part of the valuation process. As a result the procedure was changed in February 2009 into a formal negotiating process with the participation of domestic and foreign creditors. This process proved time consuming as a large number of international creditors and their advisors needed to participate at the negotiation table <sup>(2)</sup>.

Another factor in the delay of the process was the development of each of the new banks' initial business plans — a necessary element in the negotiations with the creditors. The banks were not ready to present their business plans until they had had the opportunity to go through the valuation of transferred assets prepared by Deloitte, as the opening balance sheet would be the foundation of such business plans <sup>(3)</sup>. The banks presented five-year business plans to the creditors in June 2009 following which the negotiations were able to begin. In their business plans the new banks put forward their own valuation of transferred assets which was not consistent with the Deloitte valuation. As the Deloitte valuation was not an exact number but a wide range, a Deloitte valuation number could not be entered into the opening balance sheet of the new banks. The new banks' valuation of the assets transferred was at the low end or below the low end of the Deloitte valuation, while the creditors' view stood at the high end or above the high end of the Deloitte valuation. A complex negotiation process followed in which both sides were far apart. In the end it became necessary to develop contingent compensation instruments to bridge the gap between the parties.

When the split was made between each old and new bank it became evident that there would be a massive currency mismatch in the new banks' balance sheets. The deposits transferred were mainly ISK denominated and the loan assets mainly foreign currency denominated or linked. This created potentially major market risks in the new banks that had to be addressed before the capitalisation could take place. The process of addressing this issue was time consuming and only partially successful.

During the negotiations it became evident that the creditors in the other two banks (Glitnir and Kaupthing) had an interest in capitalising the banks themselves and become the majority owners. To respond to this possibility, two alternative positions had to be formulated during the negotiations. After the creditors had opted for ownership of the bank a due diligence exercise had to be performed by the creditors' advisors, which also was time consuming.

Finally, the Icelandic authorities argue that account should be taken of the fact that from October 2008 until the autumn of 2009 the remainder of the financial sector in Iceland was far from stable, and in fact, during this period almost all financial undertakings in Iceland were taken over by the FME.

The Authority specifically requested information on why full business plans are still not available for the banks and why they have not been fully restructured. The Authority also requested information on why an assessment of the true value of the assets of the banks is yet to be completed. According to the Icelandic authorities, given the circumstances (in particular the impact on international creditors) it was considered important to abide by the principles of good public governance, including moderation. Specifically, it was thought that systematically and deliberately leaving damaged assets behind in the old banks (as would be the case in a 'good bank/bad bank' scenario) would exceed what was strictly necessary to ensure the short to

<sup>(1)</sup> An account at a foreign bank where a domestic bank keeps reserves of a foreign currency. Banks keep nostro accounts so that they do not have to make a currency conversion (which brings with it foreign exchange risk) should an account holder make a deposit or a withdrawal in that foreign currency.

<sup>(2)</sup> It is also notable that during this period Iceland suffered political upheaval. A new minority government came to power in February 2009, a government which later became a majority government after Parliamentary elections in April the same year. The new government had in some cases different views to the former government and some changes to the process had to be made.

<sup>(3)</sup> Uncertainty concerning the valuations is evident from the fact that the asset value attributed to the new banks on their provisional opening balance sheets was substantially different to the values eventually agreed upon and incorporated into the balance sheet when the banks were recapitalised.

medium-term operability of the new banks. For this reason, insofar as the basic principle of a domestic-foreign split was considered sufficient to ensure operability of the new banks in the short to medium term, 'cherry picking' of good assets was deliberately avoided. Another reason for doing so was that it was considered that successfully valuing the assets (and therefore their degree of impairment) was a highly complex exercise.

These considerations were borne out by the events. Despite considerable time and resources allocated to the task, the professional firm engaged to assess the true net value of the assets transferred was unable to give a precise estimate. After months of negotiations, supported by some of the world's most renowned professional firms and investment banks, the stakeholders eventually settled on contingent compensation instruments for all three banks due to this uncertainty. The likely implication is that although certain margins can be, and have already been, established regarding the lower limits of asset value, only time can tell with sufficient precision what the true value of the transferred asset portfolios will be. The Icelandic authorities also argue that it is clear that establishing the new banks without performing a 'good bank/bad bank split' — i.e. without ensuring that the level of impairment in their portfolios was kept within very strict boundaries — meant that the entities weren't inherently viable. According to the Icelandic authorities the long-term viability of the banks cannot be achieved without first creating banks that are operable and functional in the short to medium-term before undertaking further restructuring. The process of assessing the viability of the banks is therefore ongoing but the Icelandic authorities have committed to providing a restructuring plan as soon as possible.

## II. ASSESSMENT

### 1. The presence of State aid

State aid within the meaning of Article 61(1) EEA

Agreement 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.'

The Authority will assess the following measures below:

- the initial operating capital provided by the Icelandic State to the new bank,
  - the partial (and potentially full) State capitalisation of the new bank,
- (the above measures are referred to collectively below as 'the capitalisation measures').
- the Icelandic Government's statement to guarantee domestic deposits in all Icelandic banks in full.

#### 1.1. Presence of State resources

It is clear that the capitalisation measures are financed through State resources provided by the Icelandic Treasury.

The primary intention of the statement made by the Icelandic authorities safeguarding domestic deposits was to reassure deposit holders and to stop widespread run on deposits in the (old) banks. The deposit guarantee was implemented in practice through the use of powers under the Emergency Act to change the priority of deposit holders in bankruptcy proceedings and by transferring the liabilities for deposits to the newly established banks, which were initially fully capitalised by the State. According to statements made by the Icelandic authorities, however, a full guarantee of all deposits in Icelandic banks remains in place. The Authority wishes to further investigate whether the notice issued (and subsequent references to it) was a precise, firm, unconditional and legally binding statement such as to involve a commitment of State resources <sup>(1)</sup>.

#### 1.2. Favouring certain undertakings or the production of certain goods

Firstly, the aid measure must confer on the new bank advantages that relieve it of charges that are normally borne from its budget.

The Authority is again of the view that each of the capital measures confers an advantage on the new bank as the capital provided would not have been available to the bank without State intervention. The approach taken both by the European Commission (in numerous cases since the financial crisis began <sup>(2)</sup>) and by

<sup>(1)</sup> 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, not yet reported, paragraph 283 (on appeal).

<sup>(2)</sup> See for example Commission Decision of 10 October 2008 in Case NN 51/08 *Guarantee scheme for banks in Denmark*, at paragraph 32, and Commission Decision of 21 October 2008 in Case C 10/08 *IKB*, at paragraph 74.

the Authority <sup>(1)</sup> in assessing whether State intervention to recapitalise banks amounts to State aid assumes that, given the difficulties faced by the financial markets, the State is investing because no market economy investor would be willing to invest on the same terms. The market economy investor principle is considered not in apply to cases involving the capitalisation of financial institutions affected by the crisis that are in difficulty. The Authority considers this to be the case notwithstanding the eventual (conditional) transfer of 18,77 % of the capital of the new bank to the (largely private sector) creditors. The private investor involvement in the capitalisation of the new Icelandic banks is conditional and potentially temporary and is made up entirely of creditors of the old banks who are not therefore investors acting freely in an open market but are rather seeking to minimise their losses in the most efficient manner <sup>(2)</sup>.

Secondly, the aid measure must be selective in that it favours 'certain undertakings or the production of certain goods'. The capital measures are selective as they only benefit NBI. Similar measures were also implemented in the cases of the other two failed banks, and numerous other Icelandic financial institutions have required assistance from the government. However not all Icelandic banks have received State aid, and State support can in any event be selective in situations where one or more sectors of the economy benefit and others don't. This principle applies to the State guarantee on deposits which benefits the Icelandic banking sector as a whole.

The Authority also considers that it is possible that the bank has benefitted (indirectly) from the statements made by the Government safeguarding all domestic deposits, as in the absence of the guarantee the new bank could have suffered from a run on its deposits like its predecessor <sup>(3)</sup>. Accordingly, the Authority has doubts as to whether the guarantee entailed an advantage for the bank.

### 1.3. *Distortion of competition and affect on trade between Contracting Parties*

The measures strengthen the position of the new bank in comparison to competitors (or potential competitors) in Iceland and other EEA States and must therefore be regarded as distorting competition and affecting trade between the Contracting Parties to the EEA Agreement <sup>(4)</sup>.

### 1.4. *Conclusion*

The Authority's preliminary conclusion, therefore, is that each of the measures taken by the Icelandic State to capitalise the new bank involves State aid within the meaning of Article 61(1) of the EEA Agreement. It also cannot exclude that aid to NBI is also present as a result of the deposit guarantee.

## 2. *Procedural requirements*

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'.

The Icelandic authorities did not notify the aid measures 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 aid was therefore unlawful.

## 3. *Compatibility of the aid*

Assessment of the aid measure under Article 61(3) of the EEA Agreement.

### 3.1. *The necessity, proportionality and appropriateness of the aid*

In the Authority's view it is beyond dispute that Iceland faced, and still faces, a serious disturbance in its economy and that Landsbanki was of structural importance. In consequence the Authority will assess the potential compatibility of the aid under Article 61(3)(b) of the EEA Agreement and the guidelines based upon that sub-paragraph.

The Authority considers that this case, although not necessarily unique, is difficult to assess using the traditional and commonly understood notions of on the one hand 'rescue' aid and the other 'restructuring' aid. For instance the restoration of the bank as an emergency measure in October 2008 involved both

<sup>(1)</sup> 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>

<sup>(2)</sup> 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).

<sup>(3)</sup> 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.sedlabanki.is/lisalib/getfile.aspx?itemid=8260> p. 5. See also Commission Decisions NN 48/08 Guarantee Scheme for Banks in Ireland, paragraphs 46 and 47: [http://ec.europa.eu/community\\_law/state\\_aids/comp-2008/nn048-08.pdf](http://ec.europa.eu/community_law/state_aids/comp-2008/nn048-08.pdf); and NN 51/08 Guarantee Scheme for Banks in Denmark: [http://ec.europa.eu/community\\_law/state\\_aids/comp-2008/nn051-08.pdf](http://ec.europa.eu/community_law/state_aids/comp-2008/nn051-08.pdf)

<sup>(4)</sup> See in this respect Case 730/79 *Phillip Morris v Commission* (1989) ECR 2671.

rescue aid and immediate enforced restructuring. Through this decision the Authority intends to assess, retrospectively, the measures undertaken to restore the bank both through its initial creation and subsequent capitalisation as rescue measures. Such aid can only, however, be approved on a temporary and conditional basis. In the absence of a restructuring plan, the Authority is unable to fully assess the case and reach a conclusion and in consequence the measures will be assessed once again — on this occasion as a structural measure — upon receipt of the plan <sup>(1)</sup>. The Authority will at that stage assess the viability of the bank and the requirement that the aid provided was the minimum necessary to ensure its viability. The restructuring plan should include a full comparison of the old and new banks (for the purposes of demonstrating that that problems should not re-occur), as well as an assessment of how ongoing restructuring should secure the long-term viability of the bank.

In line with the general principles underlying the State aid rules of the EEA Agreement which require that the aid granted does not exceed what is strictly necessary to achieve its legitimate purpose and that distortions of competition are avoided or minimised as far as possible, and taking due account of the current circumstances, support measures must be:

- well targeted in order to be able to achieve effectively the objective of remedying a serious disturbance in the economy,
- proportionate to the challenge faced, not going beyond what is required to attain this effect, and
- designed in such a way as to minimise negative spill over effects on competitors, other sectors and other EEA States.

In assessing the rescue measures undertaken to date, therefore, the Authority takes into account the following.

#### 3.1.1. *The necessity of the measures*

The Authority accepts the argumentation of the Icelandic authorities, and believes that it is largely self-evident, that the State had to intervene in order to restore Landsbanki and the other two banks. The Authority also notes the views of the CBI in this respect. It also accepts given the run on the banks and the instability of the financial system that a State guarantee of deposits was required <sup>(2)</sup>.

#### 3.1.2. *The method of restoring the bank — the appropriateness of the means employed to achieve the objective*

The Authority accepts in principle the views of the Icelandic authorities that given the circumstances the approach taken of restoring the domestic operations of the banks was likely to be the only credible and effective means of safeguarding an Icelandic banking sector and the wider economy <sup>(3)</sup>. Bank rescue measures of a kind adopted elsewhere in the EEA; recapitalisation, restructuring, relief for impaired assets, or a combination of each were unlikely to succeed. The scale of the problem and the sums of public money that would have been necessary to remedy it, the disproportionate size of the three main Icelandic banks, and the realistic threat that the entire system could collapse meant that the State's options were limited.

The measures however involved wide-ranging restructuring of the bank's operations through the effective divestiture of foreign operations, and potential further restructuring of domestic operations. The measure can only therefore finally be considered to be appropriate if it can be demonstrated through the means of a detailed restructuring plan that the bank is viable in the medium to long term.

#### 3.1.3. *The proportionality of the measures — limiting aid and distortions of competition to the minimum necessary*

The Authority is conscious in this context that in light of the foreign operations of the Icelandic banks remaining in the old banks (which are under administration), and in light of the Icelandic authorities adopting similar measures to restore each of the three main banks in Iceland which make up over 80 % of the domestic market (as well as also rescuing others <sup>(4)</sup>), the impact on competition and trade across the EEA is limited.

<sup>(1)</sup> This approach is similar to the one taken by the European Commission in the case of emergency aid for Ethias — Belgium — case No NN 57/08.

<sup>(2)</sup> See paragraph 19 of the Authority's temporary rules on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis: <http://www.eftasurv.int/?1=1&showLinkId=16604&1=1>

<sup>(3)</sup> This decision does not relate to any aspects of the internal market rules of the EEA Agreement that may apply in so far as the division of foreign and domestic assets and liabilities is concerned.

<sup>(4)</sup> A number of other financial institutions have also required State assistance. On 22 April 2010, the FME decided to take control of BYR Savings Bank, to establish on its foundation a new limited liability company BYR hf. and to transfer to BYR hf. assets and liabilities of the failed savings bank. At the same time FME decided to take control of Keflavik Savings Bank and establish on its foundation SpKef Savings Bank to take over assets and liabilities of the failed Keflavik Savings Bank. Measures for recapitalization of these two savings banks are under way and the Authority awaits notification from the Icelandic authorities. On 21 June 2010, the Authority approved for a period of six months a rescue scheme in support of five smaller savings banks in Iceland through settlement of claims owned by the Central Bank of Iceland on the savings banks concerned.



The amount of the capital provided is the minimum necessary in order to enable NBI to comply with the minimum capital adequacy ratio set by the FME of 12 % Tier I capital and 4 % Tier II capital<sup>(1)</sup>.

In so far as the remuneration of the capital is concerned, paragraphs 26 to 30 of the Authority's rules on the recapitalisation of financial institutions specifies a method of calculating an 'entry level' price for capitalising fundamentally sound banks. Capitalisations of banks that are not fundamentally sound are subject to stricter requirements and in principle the remuneration paid by such banks should exceed the entry level. The Icelandic authorities do not envisage receiving a return in the form of a dividend on the shares that they hold in the company, but hope to receive remuneration through an eventual sale of the bank once it is in a sufficiently stable position to attract private investment. The Authority accepts that this is to be expected given the purpose of the measures, which is to restore part of a collapsed bank. As referred to in paragraph 11 of the Authority's temporary rules concerning the recapitalisation of financial institutions, a balance must be struck between competition concerns and the objectives of restoring financial stability, ensuring lending to the real economy and dealing with the risk of insolvency. On the basis that in the longer term the costs of the State's intervention in the bank will be reflected in the restructuring plan that must be submitted, the Authority considers that the Icelandic authorities' assumption that they will receive no return in the short to medium term to be acceptable. It is clear that (as envisaged by paragraph 44 of the rules) the bank has experienced far-reaching restructuring including a change in management and corporate governance.

The Authority will, therefore, assess the compatibility of the aid paid through the provision of capital (and the remuneration payable for the capital) as part of its full assessment of the restructuring of the bank. It will also assess the duration of the State guarantee in this context.

### 3.2. *Timescales*

While the Authority regrets that the normal time scales for the duration of rescue measures have been exceeded, a potential need for longer periods to restructure financial institutions was envisaged by the European Commission and the Authority when adopting guidelines for the assessment of rescue and restructuring aid granted as a result of the financial crisis<sup>(2)</sup>. The Authority accepts in particular that for the various reasons put forward by the Icelandic authorities, delays were inevitable at least until the assets of the bank could be valued and its ownership and capitalisation could be resolved. The Authority is also aware of domestic litigation in Iceland concerning loans linked to foreign currencies which has had the potential to have a major impact on the value of each bank's assets, and led to considerable uncertainty for many months<sup>(3)</sup>. In addition it notes the content of the CBI's financial stability report for 2010/2<sup>(4)</sup> which refers among other matters to the fact that non-performing loans (90 days or more in default) of the Icelandic commercial banks now total 39 % of all loans — a major political and economic issue given that many loans have already been written down. The Authority is therefore willing to accept that given the exceptional circumstances the rescue measures could be authorised and remain in place for a longer period than is normally allowed. However, whilst the Authority accepts that there are also justifiable reasons for further delay since the recapitalisation of the banks, the Authority is concerned at the lack of progress since the autumn of 2009 in concluding a detailed restructuring plan. In the absence of the restructuring plan therefore, the Authority has doubts concerning the compatibility of the measures with the EEA Agreement.

## 4. Conclusion

On the basis of the foregoing assessment, had the Icelandic authorities notified the capitalisation measures and deposit guarantee involved in Phase 1 and Phase 2 of the process of restoring and restructuring Landsbanki/NBI in advance, the Authority would in all probability temporarily approved the measures as aid compatible with the functioning of the EEA Agreement. The aid granted could, however, only have been considered compatible on a temporary basis, conditional upon the submission a detailed restructuring plan for the bank and a satisfactory assessment by the Authority of its future viability. Although the Icelandic authorities have committed to submit a restructuring plan for the Authority's assessment, in view of the time period that has elapsed since the aid was granted, the Authority is required to open a formal investigation procedure into the measures adopted. The decision to open a formal investigation procedure is without prejudice to the final decision of the Authority, which may conclude that the measures in question do not constitute State aid or are compatible with the functioning of the EEA Agreement.

<sup>(1)</sup> The minimum capital requirement is in fact met through 16 % Tier I capital due to the State's ownership.

<sup>(2)</sup> See paragraphs 10 and 24, and footnote 13, of the Authority's guidelines: <http://www.efasurv.int/?1=1&showLinkId=16604&l=1>

<sup>(3)</sup> The issue is referred to in the CBI's Financial Stability Report for the second half of 2010 (pp. 18-21), <http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=8260> and the Annual Report of the FME for 2010 (currently only available in Icelandic, pp. 31-32): <http://www.fme.is/lisalib/getfile.aspx?itemid=7604> See also the following news reports: <http://www.businessweek.com/news/2010-07-29/iceland-debt-outlook-cut-to-negative-at-moody-s-on-bank-ruling.html> <http://www.businessweek.com/news/2010-09-17/iceland-ruling-may-save-banks-4-billion-in-losses.html>

<sup>(4)</sup> <http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=8260>

The Authority also regrets that the Icelandic authorities did not respect their obligations pursuant to Article 1(3) of Part I of Protocol 3. The Icelandic authorities are therefore reminded that any plans to grant further restructuring (or other) aid to the bank must be notified to the Authority and approved in advance,

HAS ADOPTED THIS DECISION:

*Article 1*

The formal investigation procedure provided for in Article 1(2) of Part I of Protocol 3 is opened into the measures undertaken by the Icelandic State to restore of certain operations of (old) Landsbanki hf and establish and capitalise NBI hf.

*Article 2*

The Authority requires that a detailed restructuring plan for NBI be submitted as soon as possible and in any event no later than 31 March 2011.

*Article 3*

The measures involve 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 aid in accordance with Article 1(3) of Part I of Protocol 3.

*Article 4*

The Icelandic authorities are requested to provide within one month from notification of this Decision all documents, information and data needed for assessment of the compatibility of the aid measure.

*Article 5*

This Decision is addressed to the Republic of Iceland.

*Article 6*

Only the English language version of this Decision is authentic.

Done at Brussels, 15 December 2010.

*For the EFTA Surveillance Authority*

Per SANDERUD  
*President*

Sverrir Haukur GUNNLAUGSSON  
*College Member*

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**Invitation à présenter des observations, en application de l'article 1<sup>er</sup>, paragraphe 2, de la partie I du protocole 3 de l'accord entre les États de l'AELE relatif à l'institution d'une Autorité de surveillance et d'une Cour de justice, sur des éléments d'aides d'État concernant le rétablissement de certaines opérations de (l'ex-) Glitnir Bank hf et la mise en place et la capitalisation de New Glitnir Bank hf (aujourd'hui renommée Islandsbanki)**

(2011/C 41/06)

Par décision n° 494/10/COL du 15 décembre 2010, reproduite dans la langue faisant foi dans les pages qui suivent le présent résumé, l'Autorité de surveillance AELE a ouvert la procédure prévue à l'article 1<sup>er</sup>, paragraphe 2, de la partie I du protocole 3 de l'accord entre les États de l'AELE relatif à l'institution d'une Autorité de surveillance et d'une Cour de justice. Les autorités islandaises ont reçu copie de la décision.

Par la présente, l'Autorité de surveillance AELE invite les États de l'AELE, les États membres de l'UE et les parties intéressées à soumettre leurs observations sur la mesure en cause dans un délai d'un mois à compter de la publication de la présente communication, à l'adresse suivante:

Autorité de surveillance AELE  
Greffé  
Rue Belliard 35  
1040 Bruxelles  
BELGIQUE

Ces observations seront communiquées aux autorités islandaises. L'identité des parties intéressées qui présentent des observations peut faire l'objet d'un traitement confidentiel sur demande écrite et motivée.

#### RÉSUMÉ

##### Procédure

À la suite de discussions approfondies menées entre l'Autorité et les autorités islandaises depuis l'effondrement du système financier islandais en octobre 2008, l'aide d'État concernant le rétablissement de certaines opérations de Glitnir Bank et la mise en place et la capitalisation de New Glitnir Bank a été notifiée rétrospectivement par les autorités islandaises le 15 septembre 2010. Les autorités islandaises ont également communiqué d'autres informations lors d'une réunion qui s'est tenue à Reykjavik le 29 septembre 2010 et par lettres datées des 9, 11, 15 et 28 novembre 2010.

##### Les faits

En octobre 2008, les trois principales banques commerciales islandaises, Glitnir, Kaupthing et Landsbanki, ont rencontré des difficultés pour refinancer leur dette à court terme et ont été confrontées à une vague de retraits. Le parlement islandais a voté une loi d'urgence, qui conférait à l'État des droits étendus pour intervenir dans le secteur bancaire. Sur cette base, l'autorité de surveillance financière islandaise a décidé, les 7 et 9 octobre 2008, de prendre le contrôle des activités de ces trois banques et a désigné des comités d'administration provisoires chargés de reprendre les attributions des assemblées générales des actionnaires et des conseils d'administration. Parallèlement, trois nouvelles banques ont été créées, New Glitnir (renommée ensuite Islandsbanki), New Kaupthing (renommée ensuite Arion Bank) et NBI (opérant sous la dénomination Landsbankinn), pour reprendre les actifs nationaux, les opérations et engagements nationaux liés aux dépôts. Au départ, ces nouvelles banques appartenaient entièrement à l'État.

Mesures applicables à Islandsbanki:

- 1) En octobre 2008, l'État a octroyé à la banque une somme en numéraire de 775 millions d'ISK (5 millions d'EUR) en tant que capital initial et s'est engagé à capitaliser entièrement la banque.
- 2) Le 14 août 2009, l'État a accepté d'injecter dans Islandsbanki un capital de première catégorie de 65 milliards d'ISK sous la forme d'obligations d'État, ce qui a été mis à exécution le mois suivant.
- 3) Suite à un accord conclu le 15 octobre 2009 sur des règlements concernant les actifs et les engagements liés aux dépôts transférés de (l'ex-) Glitnir à Islandsbanki, le comité d'administration provisoire de (l'ex-) Glitnir a exercé une option d'achat de 95 % du capital social de Islandsbanki, les 5 % restants étant détenus par l'État. Le capital de l'État ne sera rémunéré qu'après sa vente finale.

- 4) Le capital de catégorie II accordé par l'État à la nouvelle banque sous forme d'un emprunt subordonné, libellé en euros, correspond à 25 milliards d'ISK. L'échéance des titres est de dix ans à compter du 30 décembre 2009 à un taux d'intérêt annuel pour les cinq premières années de 400 points de base au-dessus de l'EURIBOR, et de 500 points de base au-dessus de l'EURIBOR pour la période entre cinq et dix ans.

(Les mesures ci-dessus sont qualifiées collectivement de «mesures de capitalisation».)

- 5) La déclaration du gouvernement islandais garantissant entièrement les dépôts nationaux dans toutes les banques commerciales et caisses d'épargne islandaises.
- 6) Une garantie de l'État concernant les actifs payables à la banque en échange de son acceptation de la responsabilité pour les dépôts de la banque en faillite Straumur-Burdaras Investment Bank (Straumur).
- 7) Un accord sur une facilité de trésorerie spéciale prévoyant des prêts d'État pouvant être utilisés comme garantie pour les prêts à court terme auprès de la banque centrale d'Islande.

### Appréciation

La conclusion préliminaire de l'Autorité est que les mesures de capitalisation et l'accord spécial sur les liquidités comportent une aide d'État à Islandsbanki au sens de l'article 61, paragraphe 1, de l'accord EEE. L'Autorité ne peut pas non plus exclure qu'une aide supplémentaire ait été octroyée par la déclaration du gouvernement islandais sur les dépôts et la garantie par l'État des actifs dus à la banque résultant de l'accord Straumur.

L'Autorité appréciera l'aide accordée au titre de l'article 61, paragraphe 3, point b), de l'accord EEE, en se basant sur l'hypothèse selon laquelle cette aide était nécessaire pour remédier à une perturbation grave de l'économie islandaise. Toutefois, les mesures d'aide exigent la présentation d'un plan de restructuration détaillé en ce qui concerne Islandsbanki; en l'absence d'un tel plan, l'Autorité a des doutes quant à la compatibilité de ces mesures avec l'accord EEE.

### Conclusion

À la lumière des considérations qui précèdent, l'Autorité a décidé d'ouvrir la procédure formelle d'examen conformément à l'article 1<sup>er</sup>, paragraphe 2, de la partie I du protocole 3 de l'accord entre les États de l'AELE relatif à l'institution d'une Autorité de surveillance et d'une Cour de justice. Les parties intéressées sont invitées à présenter leurs observations dans un délai d'un mois à compter de la publication de la présente décision au *Journal officiel de l'Union européenne*.

## EFTA SURVEILLANCE AUTHORITY DECISION

**No 494/10/COL**

**of 15 December 2010**

**opening the formal investigation procedure into State aid granted in the restoration of certain operations of (old) Glitnir Bank hf and the establishment and capitalisation of New Glitnir Bank hf (now renamed Islandsbanki)**

**(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 and Protocol 26,

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 and Articles 4(4) and 13(1) of Part II,

Having regard to the temporary rules regarding the financial crisis in Part VIII of the Authority's State Aid Guidelines <sup>(1)</sup>,

Whereas:

## I. FACTS

### 1. Procedure

On 2 October 2008, the Icelandic authorities informed the Authority of their intention to inject EUR 600 million of capital into Glitnir Bank in return for 75 % of its shares. The information was provided by way of a draft notification said to be submitted for legal certainty only as it was contended that the measure did not involve State aid. This proposal was however subsequently abandoned due to a further deterioration in the financial position of the bank (and the other two main Icelandic commercial banks) and on 6 October, the Icelandic Parliament (the *Althingi*) passed 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 State wide-ranging powers to intervene in the banking sector. On 10 October 2008, the President of the Authority wrote to the Icelandic authorities and (among other matters) requested that State aid measures taken under the Emergency Act be notified to the Authority, as the Icelandic authorities had previously indicated that they would. On 14 October 2008, the Icelandic authorities submitted a further draft notification, informing the Authority that in their opinion measures taken under the Emergency Act to establish new banks as a result of the failure of the commercial banks did not involve State aid. A letter in response was sent by the Authority on 20 October 2008 indicating that it considered this unlikely and referred to the information that would be required in a notification. The matter was also discussed shortly thereafter in a meeting in Reykjavik on 24 October 2008. 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. On 22 July 2009, the Icelandic authorities informed the Authority that heads of terms had been agreed with resolution committees appointed to administer the estate of the (old) failed banks, which would lead to each of the new banks being capitalised by the Icelandic State on 14 August 2009. The Icelandic authorities again insisted that no State aid was involved and provided little information beyond what was already publicly available. Correspondence continued and meetings between the respective authorities followed both in August and November 2009, during which the Authority made it clear that from the limited information it had received it believed that the capitalisation of the new banks was State aid that required notification. Given that the measures had already been implemented, the Authority subsequently sought to assist the Icelandic authorities in producing restructuring plans for the banks with the intention of proceeding directly to assess the measures in one procedure. It transpired, however, that the authorities and the banks were not yet in a position to produce definitive, detailed plans. State aid involved in the restoration of certain operations of Glitnir and the establishment and capitalisation of a new Glitnir Bank (by then renamed 'Íslandsbanki') was eventually notified retrospectively by the Icelandic authorities on 15 September 2010, although the process of restructuring the bank in order to ensure its long-term viability remains ongoing. The Icelandic authorities also submitted further information by letters of 9, 11, 15 and 28 November 2010 and in a meeting held in Reykjavik on 29 September 2010.

### 2. Background — the financial crisis and major causes of failure of the Icelandic banks

In their notification of the aid granted to New Glitnir/Íslandsbanki, the Icelandic authorities explained that the reasons for the collapse of the Icelandic banking sector and their need to intervene in the banking sector were set out in considerable detail in a report prepared by a Special Investigation Commission ('SIC') established by the Icelandic Parliament <sup>(2)</sup>, whose remit was to investigate and analyse the processes leading to the collapse of the three main banks. In Sections 2.1 and 2.2 below, the Authority summarises the conclusions of the Commission concerning the causes of failure most relevant to the demise of Glitnir 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.

<sup>(1)</sup> Available at: <http://www.eftasurv.int/state-aid/legal-framework/state-aid-guidelines/>

<sup>(2)</sup> The SIC's members were Supreme Court Judge, Dr jur. 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/>

## **2.1. Causes of failure linked to the 2008 financial crisis and its impact on underlying problems of Glitnir and the other main Icelandic banks**

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 dependant 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 banks, and it is notable that the majority of the conclusions applied to each bank and many are inter-related. Causes of failure related to the banks' activities are briefly summarised below.

### **2.1.1. Excessive and unsustainable expansion**

The SIC concluded that in the years leading up to the collapse each of 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 ISK 1,4 trillion <sup>(1)</sup> in 2003 to ISK 14,4 trillion at the end of the second quarter of 2008. Significantly, a large proportion of the growth of the banks was in lending to foreign parties, which increased substantially during 2007 <sup>(2)</sup>, 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.

### **2.1.2. The reduction in finance available on the international markets**

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 EUR 14 billion on foreign debt securities markets in 2005 on relatively favourable terms <sup>(3)</sup>. 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.

### **2.1.3. The gearing of the banks' owners**

In the case of each major Icelandic bank, the principal owners were among the biggest debtors <sup>(4)</sup>. Glitnir's loans to major shareholders the Baugur Group and related parties, in particular the FL Group, were substantial. In the spring of 2007, a new Glitnir board was appointed after the Baugur and FL Groups significantly increased their shareholdings in the bank. Over the latter part of 2007 and beginning of 2008 loans to Baugur and companies related to Baugur nearly doubled, and at its peak lending to this group amounted to 80 % of the bank's equity <sup>(5)</sup>. This increase in lending to major shareholders occurred despite the fact that Glitnir was starting to face liquidity and refinancing problems. The SIC was of the view that certain shareholders had abnormally easy access to borrowing from the banks in their capacity as owners. It also concluded that there were strong indications that Baugur and the FL Group had tried to exert undue influence on the bank's management, and that the boundaries between the interests of the largest shareholders and the interest of the bank were blurred. The emphasis on the major shareholders was therefore to the detriment of other shareholders and creditors. When the bank collapsed, its outstanding loans to the Baugur Group and affiliated companies was approximately EUR 2 billion, around 70 % of its equity. The SIC also questioned the operation of money market funds operated by subsidiaries of the banks, which invested heavily in securities connected to the owners of the banks. Glitnir Funds, a subsidiary of Glitnir, lent around EUR 300 million to Baugur and the FL Group by investing 20 % of its total capital in their securities.

### **2.1.4. Concentration of risk**

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.

<sup>(1)</sup> Icelandic króna.

<sup>(2)</sup> Lending to foreign parties increased by EUR 11,4 billion from EUR 8,3 billion to EUR 20,7 billion in six months.

<sup>(3)</sup> Chapter 21.2.1.1 (page 4) of the Report.

<sup>(4)</sup> Chapter 21.2.1.2 (page 6) of the Report.

<sup>(5)</sup> The position was further exacerbated by foreign creditors of the largest Icelandic investment companies making margin calls as a result of reduced collateral values, leading to the three main banks taking over the financing so that the foreign banks could be repaid.

### 2.1.5. *Weak equity*

Although the capital ratio of Glitnir (and the other two major 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 the risk exposure of the bank's own shares through primary collaterals and forward contracts on the shares. Share capital financed by the company itself, referred to by the SIC as 'weak equity' <sup>(1)</sup> 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 this were problems caused by the risk 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 ISK 400 billion, around 70 % of the core component of 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 portfolio 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.

## 2.2. ***Causes of failure based on deficient regulation of the banks by the State and the size of the banks in relation to the rest of the Icelandic economy***

### 2.2.1. *The size of the banks*

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 were international and held assets worth nine times Icelandic GDP. The SIC report notes that by 2006, observers were commenting that the banking system had outgrown the capacity of the Icelandic Central Bank ('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 financing the banks) were 15 times larger, and the foreign deposits of the three banks were eight times larger, than the foreign exchange reserve. The Depositors and Investors Guarantee Fund held minimal resources in comparison with the bank deposits it was meant to guarantee. These factors, the SIC concludes, made Iceland susceptible to a run on its banks <sup>(2)</sup>.

### 2.2.2. *The sudden growth of the banks in comparison with the regulatory and financial infrastructure*

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 Icelandic Financial Supervisory Authority (the 'FME') and CBI lacked the expertise and experience to regulate the banks in difficult economic times, and could have taken action to reduce the level or risk that the bank were incurring. The FME for example did not grow in the same proportion as the banks and their 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 bank to move their headquarters abroad <sup>(3)</sup>.

### 2.2.3. *Imbalance and overexpansion of the Icelandic economy as a whole*

The SIC report also 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' <sup>(4)</sup>. The report is also critical of the ease in which the banks were able to borrow from the CBI, with the stock of CBI loans increasing from ISK 30 billion in the autumn of 2005 to ISK 500 billion by the beginning of October 2008.

### 2.2.4. *The Icelandic króna, external imbalances and CDS spreads*

The report notes that in 2006, the value of the Icelandic króna was unsustainably high, the Icelandic current account deficit amounted to 16 % and rising, 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 on Iceland and the banks rose exponentially.

<sup>(1)</sup> Chapter 21.2.1.4 (page 15) of the Report.

<sup>(2)</sup> These issues are discussed in more detail in the following paper by Willem H. Buiter and Anne Sibert: <http://www.cepr.org/pubs/PolicyInsights/PolicyInsight26.pdf>

<sup>(3)</sup> 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.

<sup>(4)</sup> Chapter 2, page 5 of the report.



### 3. Description of the measures

#### 3.1. Background

Prior to the financial crisis of 2008 Glitnir Bank was the third largest in Iceland. At the end of 2007 its balance sheet amounted to ISK 2,949 billion (EUR c. 32,3 billion) and it made a net profit that year of EUR 315 million. The bank's main markets were in Iceland and Norway where it offered a range of financial services, including corporate banking, investment banking, capital markets, investment management and retail banking. Glitnir also had operations in Finland, Sweden, Denmark, UK, Luxembourg, US, Canada, China and Russia. It held a number of subsidiary companies, the most significant being: Glitnir AB (Sweden); Glitnir Bank Oyi (Finland); Glitnir Bank ASA (Norway); Glitnir Bank Luxembourg SA; and Glitnir Asset Management Luxembourg. The bank's international expansion was based on two specialised industry sectors; seafood and sustainable energy <sup>(1)</sup>. Shares in the bank were listed on the Icelandic OMX.

#### 3.2. The collapse of Glitnir Bank

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 and following the collapse of Lehman Brothers in September 2008, 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. Glitnir meanwhile, was experiencing major difficulties in financing its activities. A bond issue had had to be cancelled due to a lack of interest, an asset sale was not completed, and a German bank refused to extend two loans estimated at EUR 150 million. Market conditions also worsened dramatically after the fall of Lehman Brothers. On 24 September 2008, the Chairman of Glitnir's Board contacted the CBI to inform them that as a result of loans that had to be repaid in October, the bank had an immediate shortfall of EUR 600 million. On 29 September, it was announced that the Icelandic Government would provide Glitnir with EUR 600 million in return for 75 % of its equity. The fact that EUR 600 million amounted to nearly a quarter of Iceland's foreign currency reserves, and that Glitnir had experienced refinancing problems for some time and had debt estimated at EUR 1,4 billion to repay over the following six months (information that was publicly available) suggested, however, that the proposal was not credible <sup>(2)</sup>. The effect was a reduction in the value of issued Glitnir shares from over ISK 200 billion to ISK 26 billion in one day. The Icelandic banks experienced massive withdrawals of deposits not only abroad but also within Iceland. Domestic withdrawals became so large that at one stage the Icelandic banks and the CBI were close to experiencing a shortage of cash. On 30 September 2008, the credit agency Moody's lowered Glitnir's credit rating, triggering repayment obligations for further loans. Margin calls of over a billion euro also followed. On 7 October 2008, Glitnir was required to ask the FME to be taken under its control <sup>(3)</sup>.

#### 3.3. National legal basis for the aid measure

- 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)

<sup>(1)</sup> Glitnir's Annual Report for 2007, p. 40. The report is available here: [http://tools.euroland.com/arinhhtml/is-isb/2007/ar\\_eng\\_2007/](http://tools.euroland.com/arinhhtml/is-isb/2007/ar_eng_2007/) Glitnir's Consolidated Financial Statements 2007 are available here: [http://en.sff.is/media/auglysingar/Glitnir\\_Annual\\_Report\\_2007.pdf](http://en.sff.is/media/auglysingar/Glitnir_Annual_Report_2007.pdf)

<sup>(2)</sup> Page 13 of the Executive Summary to the Report (Chapter 2), fourth bullet point.

<sup>(3)</sup> Landsbanki was also placed in receivership on the same day and Kaupthing Bank followed two days later on 9 October 2008.



### 3.4. *The intervention of the Icelandic State*

The Icelandic authorities' intervention can be categorised into three phases as follows: firstly, restoration of basic banking in October 2008 through the formation of New Glitnir, the transfer of assets and liabilities, and the provision of initial capital and a commitment to fully capitalise; secondly, loans made to properly capitalise the new bank for the first time in the autumn of 2009 (before the majority of the bank was acquired by the creditors of the old bank); and thirdly the restructuring of the bank, which began when the bank was restored and is ongoing.

#### 3.4.1. *Phase 1: Restoration of certain operations of Glitnir Bank and the establishment of New Glitnir Bank*

On 7 October 2008, the FME took control of Glitnir Bank in order to ensure the continuation of domestic retail banking operations. This was done through the appointment of a Resolution Committee for Glitnir, which assumed the authority of its board of directors; and the establishment by the Icelandic Government, on 8 October 2008, of New Glitnir Bank (later renamed Islandsbanki), wholly owned by the State. On 14 October 2008, the FME transferred the liabilities for deposits held in Glitnir, except for those held in foreign branches, to the new bank. The total amount of liability for domestic deposits transferred was ISK 353 488 479 000. Certain assets were also transferred to the new bank based on a principle (that was subject to certain exceptions) that assets connected to the old bank's domestic operations were to be credited to the new bank with the remainder staying with the old bank <sup>(1)</sup>. The FME also published an internal memorandum setting out 'guiding principles' for what was to be transferred not only to Islandsbanki but also to new successor banks that were formed following the collapse of Kaupthing and Landsbanki <sup>(2)</sup>.

In return for the assets transferred to the new bank, the old bank was to be compensated to the sum of the difference between the value of the assets transferred and the amount of the liabilities (deposits) transferred. In accordance with Article 5 of the Emergency Act and the subsequent decisions of the FME on the disposal of assets and liabilities of the old banks, the FME commissioned a valuation of the net assets transferred from the old banks to the respective new banks. Deloitte LLP was appointed by the FME on 24 December 2008 to prepare the net asset valuations of each of the new banks. The process of valuation was however to prove complex and lengthy.

#### Initial capital

The State provided ISK 775 million (EUR 5 million) <sup>(3)</sup> in cash as initial capital to the new bank and in addition issued a commitment to contribute up to ISK 110 billion to the new bank in return for all of its equity. This figure was calculated as 10 % of an initial assessment of the likely size of the bank's risk weighted asset balance, and 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 of the operability of the banks until issues relating to their final re-capitalisation could be resolved, including the size of their opening balance based on a valuation of compensation payable to the old bank for assets transferred.

#### Deposit guarantee

The initial rescue measures of the Icelandic Government also involved State backing of deposits in domestic commercial and savings banks. 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' <sup>(4)</sup>. This announcement has since been repeated by the Office of the current Prime Minister in February and December 2009 <sup>(5)</sup>. 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,

<sup>(1)</sup> The decision of the FME was subsequently amended several times. The decisions are available here: <http://www.fme.is/?PageID=867>

<sup>(2)</sup> The document is available here: <http://www.fme.is/lisalib/getfile.aspx?itemid=6021>

<sup>(3)</sup> 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 EUR (as appropriate) where it has been provided by the Icelandic authorities.

<sup>(4)</sup> The English translation of the announcement is available at: <http://eng.forsaetisraduneyti.is/news-and-articles/nr/3033>

<sup>(5)</sup> <http://www.efnahagsraduneyti.is/frettir/frettatilkynningar/nr/2842>

<http://www.efnahagsraduneyti.is/frettir/frettatilkynningar/nr/3001> The Minister for Economic Affairs has also referred to it recently in an interview with *Vísir* on 2 December 2010, p. 8: '[The declaration] will be withdrawn in due course. We do not intend to maintain unlimited guarantee of deposits indefinitely. The question when it will be withdrawn depends, however, on when an alternative and effective deposit system will come into force and a financial system which will have fully resolved its issues' (the Authority's translation).

Minister for Finance, Minister for 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' <sup>(1)</sup>. 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 <sup>(2)</sup>.

### 3.4.2. Phase 2: Rescue/Restructuring of Islandsbanki (New Glitnir) through recapitalisation

On 20 July 2009, the Icelandic Government announced that it had determined the basis for capitalisation of Islandsbanki and reached heads of agreement with the Resolution Committee of the old bank in relation to how the old bank would be compensated for the transfer of net assets into the new bank. The Government conditionally agreed with the Resolution Committee of Glitnir, that the creditors should, through the Committee, be granted the option of obtaining majority ownership of Islandsbanki. This would in effect involve the old bank providing the majority of the capital in Islandsbanki as a part of the compensation agreement. In the event that Glitnir would not complete the subscription for shares in Islandsbanki, the Government would retain full ownership. On 14 August 2009, the Government announced that it had committed to capitalise Islandsbanki with ISK 65 billion of Tier I capital in the form of government bonds, giving the bank a Core Tier I ratio of approximately 12 % <sup>(3)</sup>.

On 13 September 2009, the Government announced that definitive agreements with the Resolution Committee of Glitnir regarding the capitalisation of Islandsbanki, and the basis for compensation to Glitnir and its creditors, had been signed. The agreement principally contained (alternative) provisions for:

#### 1. Capitalisation under old bank (creditor) ownership (option 1)

Under this agreement the creditors of Glitnir had an opportunity to acquire control of Islandsbanki by subscribing to new share capital. The payment for the new share capital was to be in the form of the compensation instrument issued by Islandsbanki as payment for the net assets transferred from Glitnir to Islandsbanki in October 2008. The Government would also contribute to the capital of the Islandsbanki in the form of Tier II capital (subordinated loan) amounting to ISK 25 billion (giving the bank a Tier II ratio of approximately 4 %). The Government would also hold minority ordinary share capital, amounting to 5 % of Islandsbanki.

#### 2. Capitalisation under Government ownership together with compensation for net-asset transfer from the old bank to the new bank with various mechanisms for re-assessment of fair value (option 2)

In the event that Glitnir's Resolution Committee decided not to acquire control of Islandsbanki, the Government would continue to own the bank. In this case, the compensation for the transferred net asset value would be paid through bond instruments. The compensation was to consist of three bonds (A, B and C): the A bond was for a fixed (definite) amount of ISK 52 billion <sup>(4)</sup>, and in the event that the performance of the bank exceeded certain parameters agreed between the parties a B bond (of ISK 17 billion, which taken together with Bond A would total ISK 69 billion) and a C bond (of ISK 63 billion, which taken together with Bonds A and B would total ISK 132 billion) would become effective. Glitnir was also to be granted an option to buy 90 % of the Government's shares in Islandsbanki exercisable between 2011 and 2015 at a price which would provide an appropriate level of return on the Government's investment.

#### Tier I capital contribution

On 15 October 2009, Glitnir's Resolution Committee decided, on behalf of its creditors, to exercise option 1 and take 95 % of the share capital in Islandsbanki. This was done by the Resolution Committee accepting this share of the bank in return for relinquishing its rights under the agreed bonds (A, B and C). The option terms were fixed on 11 September 2009, when the accrued value of the government bonds used to capitalise the bank at ISK 65 billion as per 15 October 2008 was ISK 72,2 billion. On the basis of the

<sup>(1)</sup> The relevant paragraph can be found at Section 16 (p. 6) of the letter: [http://www.efnahagsraduneyti.is/media/Acrobat/Letter\\_of\\_Intent\\_2nd\\_review\\_-\\_o.pdf](http://www.efnahagsraduneyti.is/media/Acrobat/Letter_of_Intent_2nd_review_-_o.pdf)

<sup>(2)</sup> [http://hamar.stjr.is/Fjarlagavefur-Hluti-II/Greinargerdir/Raedur/Fjarlagafrumvarp/2011/Seinni\\_hluti/Kafli\\_8.htm](http://hamar.stjr.is/Fjarlagavefur-Hluti-II/Greinargerdir/Raedur/Fjarlagafrumvarp/2011/Seinni_hluti/Kafli_8.htm)

<sup>(3)</sup> Also in August 2009, the FME imposed a minimum requirement of a 12 % Core Tier I capital ratio and a 16 % CAD ratio as a discretionary minimum capitalisation for Islandsbanki (the same as for NBI and Arion), to be maintained for at least 3 years. The definition of Core Tier I capital includes only equity, i.e. share capital and retained earnings, but does not include subordinated loans or other types of hybrid capital instruments.

<sup>(4)</sup> This was the only valuation which appeared on the balance sheet of the bank as the other two bonds were contingent in nature and were referred to only in notes to the bank's financial report. The net nominal value of the transferred assets was ISK 568,3 billion.

accrued value of the on-balance sheet element <sup>(1)</sup> of the creditors' compensation instrument (i.e. bond A which had a nominal value ISK 52 billion and accrued value ISK 66 billion), the creditors were entitled to a share of 91,3 % of the bank, but a further 3,7 % share was conceded during negotiations. The State retained the remaining 5 % through its contribution of ISK 5,5 billion in capital (ISK 6,2 billion in accrued terms). The total share capital was therefore ISK 72,2 billion in accrued terms (corresponding to ISK 65 billion in 15 October 2008 terms). As part of the agreement it was agreed that the Resolution Committee (creditors) would remunerate the State for total interest accrued on its investment over the period the government held the bank to the sum of ISK 8,3 billion. This amounted to a yield of 12,8 %, which annualised to 13,9 %. This concluded the settlement concerning those assets transferred from Glitnir to Islandsbanki upon the collapse of the banks in October 2008.

#### Tier II capital contribution

The Government also provided the bank with a subordinated loan to strengthen its equity and liquidity position, and therefore comply with the capital requirements of the FME. The subordinated loan is available in euro and amounts to EUR 128 106 287 (ISK 25 billion) of Tier II capital in a form of an instrument providing for Islandsbanki to issue unsecured subordinated notes. The term of the notes is ten years as of 30 December 2009. The instrument has built-in incentives for exit in the form of a step-up of interest after five years. Under the agreement the interest rate per annum for the first five years is 400 basis points above EURIBOR and in the period from five to ten years after the completion of the agreement the interest rate per annum is 500 basis points above EURIBOR.

#### Special Liquidity Facility

In addition, as a condition for the creditors taking equity in the new bank, the Icelandic Government concluded a further agreement with Islandsbanki on 11 September 2009 that would come into force if Glitnir's Resolution Committee decided to exercise its option to become the majority owner of the bank <sup>(2)</sup>. Under the agreement the Ministry of Finance commits to lend repo-able government bonds in exchange for specifically defined assets on terms and conditions specified in the contract up to a value of ISK 25 billion.

The main terms of the agreement to provide liquidity are as follows:

Max. loan amount: ISK 25 billion

Term: Until September 2012

Remuneration: 3,0 % on first ISK 8 billion; 3,5 % on next ISK 8 billion; 4,0 % for amounts above ISK 16 billion

Fee: Islandsbanki is required to pay 0,5 % of the loan amount on each occasion new securities are provided

Counter-security: Islandsbanki is required to provide counter-security for the loan of Treasury securities, which can be financial assets in various forms.

According to the Icelandic authorities, this liquidity facility is required because the creditors' decision to take ownership of Islandsbanki significantly reduced the bank's holding of repo-able assets and threatened its ability to comply with supervisory requirements regarding liquidity reserves <sup>(3)</sup>. According to the Icelandic authorities the facility is intended as an additional measure to be used only when other sources of liquidity are insufficient and the pricing and terms of the facility contain incentives to discourage its use if other options are available.

The decision of the Resolution Committee in October 2009 was subject to the approval of the FME and the Icelandic Competition Authority. Glitnir's Resolution Committee currently hold the shares on behalf of its creditors through a special holding company, ISB Holding ehf., subject to significant restrictions aiming to ensure good governance, provide incentives for a long-term perspective business model, and reduce excessive risk-taking.

<sup>(1)</sup> To be managed by the newly formed Icelandic State Banking Agency.

<sup>(2)</sup> An addendum was also signed on 13 January 2010 and a new agreement was concluded on 19 July 2010 in response to certain remarks submitted by the FME.

<sup>(3)</sup> One of the FME's conditions required that that cash or cash-like assets should amount to 5 % of on-demand deposits and the banks should be able to withstand a 20 % instantaneous outflow of deposits.

### 3.4.3. Phase 3: Restructuring of Glitnir/Islandsbanki and the long-term viability of Islandsbanki

According to the Icelandic authorities, the restructuring process, which began by necessity through the collapse of Glitnir and the transfer of its domestic assets and liabilities for domestic deposits to Islandsbanki <sup>(1)</sup>, remains incomplete. In view of the scale of the systemic collapse in comparison to the resources at the Icelandic government's disposal, and the lack of information available at the time of taking control of the banks, it was not considered prudent to attempt to fully restructure the financial system at that stage. Instead it was decided that a two-staged approach should be adopted. As a first stage, the enforced split was intended to simultaneously achieve the aims of maintaining domestic banking services and significantly scaling down the unsustainably large financial system. The domestic operations transferred were however likely to represent an upper limit for the optimum size of a domestic Icelandic system and further restructuring was likely. In order to continue the process three further steps were required. The first was to settle the claims of international stakeholders (through the Resolution Committees of the old banks), the second was the re-capitalisation of the banks, and the third was to clearly establish their future ownership structure. The Icelandic authorities state that the three conditions were fulfilled in the first quarter of 2010 when new owners took control of the new banks and elected the first Boards of Directors with a mandate to develop a long-term business strategy on behalf of the future owners <sup>(2)</sup>. Further restructuring of the newly formed banks was intended to follow.

A likely consequence of the fact that the rescue approach adopted in Iceland was not (predominantly) based on a 'good bank/bad bank split' is that extensive loan portfolio restructuring may have to be carried out by the new banks themselves. Despite numerous issues that have caused delays, the new banks have all taken important measures to avert impending losses by transferring impaired assets to specialised subsidiaries or selling them to new owners. They have also developed various programmes intended to resolve debt related issues in the retail and SME portfolios. Achievements have, however, been limited. Based on the ICAAP <sup>(3)</sup> process currently ongoing in all three new banks, the FME expects to be able to systematically enforce and document a definitive return to long-term sustainability by all three banks and conclude the restructuring of the Icelandic financial system.

A restructuring plan will therefore need to be submitted to the Authority in order for it to conclude its assessment of the State aid granted to Islandsbanki, and its assessment of the new bank's viability, as soon as possible.

### 3.5. Straumur securities lending agreement

On 9 March 2009, the FME, acting under the authority conferred upon it by the Emergency Act, assumed the powers of the shareholders Straumur-Burdaras Investment Bank hf. ('Straumur') and appointed a Resolution Committee to replace its Board of Directors <sup>(4)</sup>. After consultation with the Resolution Committee, creditors, the CBI and the Ministry of Finance, on 17 March 2009 the FME transferred the liabilities for deposits of Straumur to Islandsbanki <sup>(5)</sup>. In return Straumur issued a bond collateralised against its assets, as repayment for assuming the deposit obligations. The bond was issued on 3 April 2009 for the amount of ISK 43 679 014 232 for a term up to 31 March 2013. The bond bears interest on that amount of REIBOR <sup>(6)</sup> plus 190 basis points in the first 12 months before reducing to REIBOR plus 100 basis points thereafter until maturity. Simultaneously, Islandsbanki and the Ministry of Finance entered into a securities lending agreement, in which the Government effectively pledges repo-able government notes as security for the Straumur claim, in return for which Islandsbanki can obtain liquidity from the CBI to the extent that liquidity is required as a result of Islandsbanki assuming the liability for Straumur's deposits.

In the agreement Islandsbanki is committed to returning to the State the amount of the government bonds that equal the payments the bank receives under the bond issued by Straumur. The parties also agreed that in the event that Islandsbanki does not receive full payment under the bond, and in the event that the State had not paid the remaining debt, Islandsbanki would retain the outstanding government bonds. In effect, therefore, Islandsbanki assumed Straumur's liabilities for deposits in return for government guaranteed assets.

<sup>(1)</sup> Glitnir had actually begun a process of restructuring in the latter part of 2007 due to its financial difficulties. This included extensive cost cutting and redundancies.

<sup>(2)</sup> In the case of Islandsbanki this occurred on 25 January 2010.

<sup>(3)</sup> Internal Capital Adequacy Assessment Process, cf. Pillar II of the Basel II recommendation of bank supervisors and central bankers stating that it shall be the responsibility of the financial regulator to monitor and assess the ICAAP of regulated banks.

<sup>(4)</sup> The decision is available in English at: <http://fme.is/lisalib/getfile.aspx?itemid=6055>

<sup>(5)</sup> The decision is available in English at: <http://fme.is/lisalib/getfile.aspx?itemid=6077>

<sup>(6)</sup> REIBOR denotes Reykjavik Interbank Offered Rate, representing the interbank market rate for short-term loans at Icelandic commercial and savings banks. The approach is similar to how many countries use LIBOR as the base rate for variable rate loans, but Icelandic banks use REIBOR (plus a premium) as the basis for supplying variable interest rate loans in the Icelandic currency, the króna.

## 3.6. A comparison of the old and new banks: Glitnir and Íslandsbanki

Table 1

## Íslandsbanki's opening balance sheet compared with Glitnir's 2008 first half balance sheet

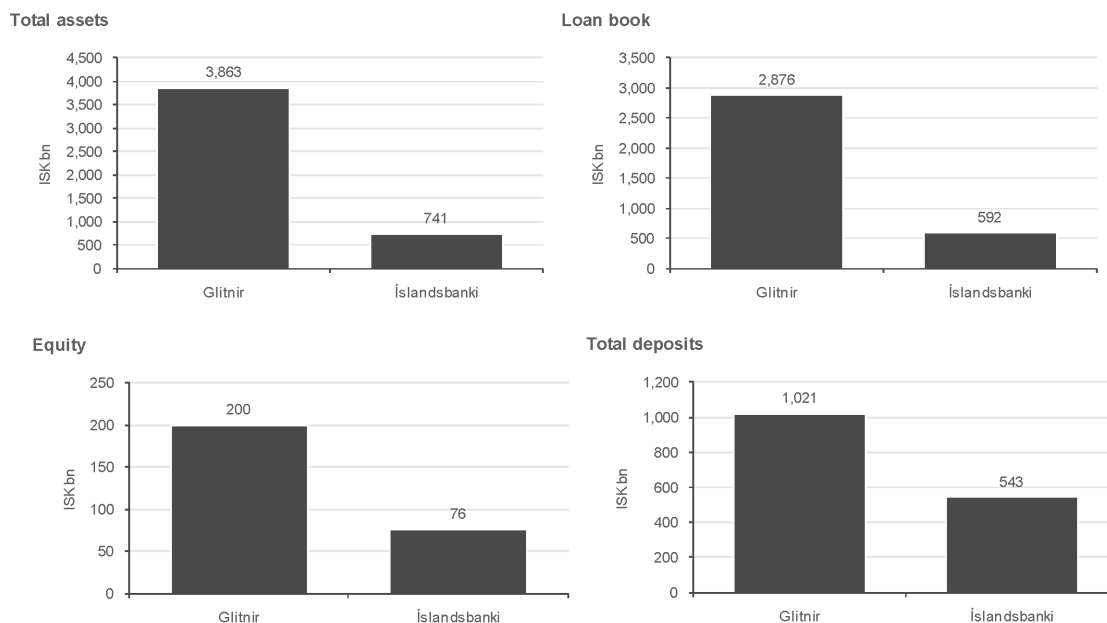
Íslandsbanki hf.		Glitnir banki hf.	
(ISK m)	15.10.2008	30.6.2008	Δ%
Cash and balances with Central Bank	53,829	37,550	43%
Derivatives	0	278,404	– 100%
Bonds and debt instruments	3,762	217,873	– 98%
Shares and equity instruments	3,944	71,767	– 95%
Securities used for hedging	0	162,332	– 100%
Loans to banks	10,597	328,027	– 97%
Loans to customers	482,586	2,548,164	– 81%
Investments in associates	296	540	– 45%
Investment property	1,589	5,539	– 71%
Property and equipment	1,773	4,897	– 64%
Intangible assets	107	63,218	– 100%
Deferred tax assets	84	2,018	– 96%
Non-current assets held for sale	1,894	908	109%
Share subscription	64,225	0	100%
Other assets	6,279	141,560	– 96%
<b>Total Assets</b>	<b>630,965</b>	<b>3,862,797</b>	<b>– 84%</b>
Short positions	0	23,312	– 100%
Derivatives	0	109,903	– 100%
Deposits from Central Bank & banks	134,303	311,775	– 57%
Deposits from customers	361,302	709,584	– 49%
Debt issued and other borrowed funds	53,808	2,241,976	– 98%
Subordinated loans	103	145,902	– 100%
Post-employment obligations	0	696	– 100%
Current tax liabilities	34	812	– 96%
Deferred tax liabilities	0	4,937	– 100%
Non-current liabilities held for sale	1,285	0	100%
Other liabilities	14,471	113,465	– 87%
<b>Total Liabilities and Equity</b>	<b>565,306</b>	<b>3,662,362</b>	<b>– 85%</b>
Share capital	10,000	14,647	– 32%
Share premium	55,000	53,174	3%
Other reserves		37,143	– 100%
Retained earnings		94,744	– 100%
Minority interest	660	727	– 9%
<b>Total Equity</b>	<b>68,030</b>	<b>200,435</b>	<b>– 66%</b>
<b>Total Liabilities and Equity</b>	<b>630,965</b>	<b>3,862,797</b>	<b>– 84%</b>



The Authority will undertake a full assessment of the business plan of the new bank, including an analysis of the differences between the old and new banks and the potential for the same or similar problems to re-occur, following the submission by the Icelandic authorities of a detailed restructuring plan for the bank. The Icelandic authorities have, however, submitted an overview of the fundamental changes that have already taken place which the Authority considers to be relevant for the purposes of its current assessment.

Despite Glitnir having made extensive changes to its operations in the months preceding its collapse, there are major differences between the new and old banks both in terms of their operations and scale. Islandsbanki is a wholly domestic bank with no overseas obligations or operations whereas Glitnir was an international bank with operations in 11 countries. Islandsbanki has four business segments; Commercial/Retail Banking, Asset Management, Corporate and Investment Banking, and Treasury and Capital Markets, all of which are focused on the domestic market. Most notably the scale of Islandsbanki's operations are substantially smaller than that of Glitnir; the old bank's balance sheet of 3 ISK 862 billion compared to the new bank's ISK 631 billion amounts to a reduction of 84 %. A comparison of the old bank's balance sheet at June 2008 with the new bank's opening balance sheet can be found at Table 1 above.

Glitnir had a diverse funding mix and was a large issuer of bonds and short-term paper sold worldwide. Islandsbanki on the other hand relies mainly on deposits for funding. This, together with the likely inability for the bank to source similar funding streams to its predecessor bank (in the short at least), limits the bank's ability to grow. When compared, key indicators of the two banks show considerable differences <sup>(1)</sup>:



The new bank also has significantly fewer staff members. The average number of full time equivalent staff employed by Glitnir during the first half of 2008 was 2 174 compared to 1 110 for Islandsbanki (including subsidiaries) during the first 2009, a difference of 49 %. Again comparing the figures over the same period for domestic operations only, the new bank also employed 242 fewer staff than had previously been retained by Glitnir.

### 3.7. The business activities of the new bank

Across each of the new bank's business segments, the operations were very different to those domestic operations undertaken by the old bank before the collapse. A large proportion of the Commercial/Retail Banking department's activities was devoted to developing schemes to benefit customers in need of some type of debt or payment adjustment, for which a special individual debt restructuring unit was formed. High interest rates and high pre-existing household debt meant that new lending was very low. Asset management activities (while stable in terms of volume due to the process of liquidating corporate bond funds, deleveraging of clients and marking down of assets) suffered due to the impact of the financial sector collapse on the Icelandic equity market and corporate bond markets. To adapt to the radically different landscape in Icelandic financial markets, the liquidation of what had been large mutual funds as well as

<sup>(1)</sup> The graphs are based on the figures for Glitnir in the first half of 2008 and Islandsbanki in the first half of 2009.



a marked change in the risk appetite of clients, Asset Management focused on a government bond fixed income market. In this respect three funds were established during the period as an option for clients whose previous investments had been in funds that were liquidated. As in Retail Banking, debt restructuring was at the forefront of the new bank's Corporate and Investment Banking operations after the new bank was formed. Staff spent a significant amount of their time assisting current customers, many of whom are in distressed situations, in solving immediate challenges including payment holidays or some form of flexible payment schemes, extending maturities and in some cases new lending. The Treasury and Capital Markets segment also experienced drastic change due to a collapse in the Icelandic equities market, both in terms of turnover and number of listed companies, and due to the capital controls on the Icelandic króna. The focus of trading activities was therefore on the government bond fixed income market, currently the only truly active market in Iceland.

#### **4. Position of the Icelandic authorities**

##### **4.1. State aid nature of the measures and compatibility with the EEA Agreement**

In their notification the Icelandic authorities now accept that measures undertaken in order to establish Islandsbanki constitute State aid. They contend however that the measures are compatible with the functioning of the EEA Agreement under Article 61(3)(b), on the basis that they were necessary in order to remedy a serious disturbance in the Icelandic economy. The Icelandic authorities stress that the situation in Iceland in October 2008 was extreme and required immediate action in order to restore financial stability and confidence in the Icelandic economy. The Icelandic authorities' intentions at this stage of the process were straightforward and basic; ensuring that Icelanders had access to their deposit accounts and that some form of financial system survived. The implications not only for the Icelandic economy, but also for Icelandic society, were grave.

The measures regarding Glitnir/Islandsbanki were considered necessary because if the bank had not been restored the systemic collapse that Iceland was already suffering would have intensified. The Authority has also been provided with a letter from the CBI affirming the necessity of the measures taken. The fact that Islandsbanki, and other Icelandic and European banks, suffered from the lack of liquidity as well as lack of market and investors' confidence meant it was not possible to fund the bank through the financial markets. The intervention of the Icelandic State was necessary to strengthen the bank's equity and liquidity position and maintain its viability. The fact that the creditors of Glitnir opted to acquire 95 % of Islandsbanki in lieu of compensation for the assets transferred from Glitnir to Islandsbanki also greatly decreased the need for a State contribution to the bank.

According to the Icelandic authorities the Government contribution of Tier II capital to Islandsbanki and the liquidity facility was necessary and essential to restore viability, and an important factor in restoring confidence in the financial market with the aim of reconstructing a bank that will be viable in the long-term without State aid. The overall contribution is limited in size to what is absolutely necessary to ensure that Islandsbanki meets minimum capital requirements, as defined by the FME. In order to minimise the effect on competition, the same Tier II funding was made available to all of the three main banks, which were in a comparable situation. According to the Icelandic authorities it is currently very difficult to benchmark the interest against the market rates. Using market standards from the past it was customary for Tier II instruments to bear interest a little higher than general unsecured bonds (25-50 basis points). The bond negotiated between Islandsbanki and the Glitnir Resolution Committee on the other hand had a LIBOR plus 300 basis points coupon and by comparison the interest negotiated by the Icelandic Authorities on the Tier II bond is well above 'market' standard. The interest coupon is therefore acceptable.

The part of the capitalisation of Islandsbanki borne by the Icelandic State as an owner of 5 % of the bank's shares will be remunerated through the eventual sale of the State's share. As far as applicable, the measures are also in line with the principles set out in the Authority's Recapitalisation Guidelines. The Icelandic authorities argue that the risk profile of the new banks is relatively low and that in consequence the pricing of capital provided should be at the lower end. They also argue that built-in incentives for exit are in place (step-up of interest in five years) and that in consequence the remuneration should be compatible with the EEA Agreement.

The Icelandic authorities also stress that the parties that were shareholders of Glitnir before the financial crisis have lost their shares in the bank and have received no compensation from the State. The compensation provided to the creditors of Glitnir, through the Resolution Committee, is not compensation for the losses suffered in connection with the collapse of the banks, but is compensation for assets allocated from the estate of the old banks. The losses stemming from the fall of the old banks have not therefore been mitigated by the Icelandic Government and the costs associated with the re-establishment of the bank must be seen as being borne by the investors of Glitnir. The measures are therefore consistent with the principle that the bank should use its own resources to finance rescue and restructuring to the extent possible.

As regards competition in the banking market reference is made to Decision No 48/2009 of the Icelandic Competition Authority regarding Glitnir's takeover of 95 % of shares in Islandsbanki, where it is stated that the establishment of the three new banks has not changed the situation as regards competition in the retail banking market in Iceland.

The Icelandic authorities contend that no aid is present in the transfer of assets and liabilities of Straumur Bank to Islandsbanki, arguing that the transaction was made on commercial terms between two private market operators.

#### 4.2. *Possible alternatives*

The Icelandic authorities are of the view that there were no other realistic alternatives to the actions taken in October 2008. The purpose of the measures undertaken with regard to all three banks was to eliminate the threat to the stability of the Icelandic economy that complete failure of the domestic banking system would have entailed. To do so, the measures had to remedy the identified causes of banks' problems — mainly their size relative to the size of the Icelandic economy and their reliance on foreign credit facilities. The instruments chosen by the Icelandic government represent the only credible measures available, given the status of the Icelandic economy, and were therefore both necessary and appropriate means to address these problems. The scope of the measures as regards Glitnir/Islandsbanki is, in the opinion of the Icelandic authorities, limited to the minimum necessary, bearing in mind the serious economic situation of Iceland and the need to rebuild the financial system in the country.

The total revenue in the Icelandic State budget for 2008 was ISK 460 billion and total GDP in 2007 was ISK 1 308 billion <sup>(1)</sup>. The liabilities through deposits alone in the three large Icelandic banks were at the time of their collapse ISK 2 761 billion, of which 1 566 billion was held in foreign currencies in the foreign branches of the banks. The foreign currency reserves of Iceland consisted of ISK 410 billion in October 2008, which amounted to around 25 % of the value of deposits in the non-domestic branches.

The Authority also notes in this context the conclusions of the SIC Report, which refers in Section 4.5.6.2 of Chapter 4 <sup>(2)</sup> to attempts made during the course of 2008, given the concerns about the overblown size of the Icelandic banking sector and limitations of the CBI as a lender of last resort, to strengthen the CBI's foreign currency reserves. Requests were made to other Nordic central banks, the European Central Bank, the Bank of England and the Federal Reserve Bank of New York for currency swap agreements, but despite extensive efforts the CBI managed only to secure agreements with Nordic central banks (Sweden, Denmark and Norway). The Bank of England considered the CBI's request carefully, but eventually declined to participate. A letter from the Bank of England governor, Mervyn King, to his Icelandic counterpart, Davíð Oddson, illustrates the views of the United Kingdom's central bank (letter of 22 April 2008):

'It is clear that the balance sheet of your three banks combined has risen to the level where it would be extremely difficult for you effectively to act as a lender of last resort. International financial markets are becoming more aware of this position and increasingly concerned about it. In my judgement, the only solution to this problem is a programme to be implemented speedily to reduce significantly the size of the Icelandic banking system. It is extremely unusual for such a small country to have such a large banking system ... I know you will be disappointed. But among friends it is sometimes necessary to be clear about what we think. We have given much consideration to your proposal. In my judgement, only a serious attempt to reduce the size of the banking system would constitute a solution to the current problem. I would like to think that the international central banking community could find a way to offer effective help to enable you more easily to construct a programme to reduce the size of the banking system. I shall be willing to do all in our power to help you achieve that' <sup>(3)</sup>.

Later efforts included contacts with Timothy F. Geithner, President and CEO of the Federal Reserve Bank of New York. The request was eventually declined on 3 October 2008. According to the SIC report, the main reason given by the Federal Reserve was the size of the Icelandic banking system as for a currency swap agreement to be effective, it would have had to be for a bigger amount than the Federal Reserve could accept.

The Icelandic authorities did consider dividing the bank into a 'good bank' and a 'bad bank' by transferring the healthy and valuable assets to a 'good bank' that should generally be able to finance itself on the market and leaving the less valuable assets that are difficult to realise in a 'bad bank' funded by the State. However, it was considered that due to the financial crisis, even 'good' Icelandic banks would probably not have been able to seek sufficient capital to finance their operations despite a potentially healthy financial status.

<sup>(1)</sup> See: [http://www.statice.is/?PageID=1267&src=/temp\\_en/Dialog/varval.asp?ma=THJ01102%26ti=Gross+domestic+product+and+Gross+national+income+1980%2D2009%26path=../Database/thjodhagsreikningar/landsframleidsla/%26lang=1%26units=Million+ISK](http://www.statice.is/?PageID=1267&src=/temp_en/Dialog/varval.asp?ma=THJ01102%26ti=Gross+domestic+product+and+Gross+national+income+1980%2D2009%26path=../Database/thjodhagsreikningar/landsframleidsla/%26lang=1%26units=Million+ISK)

<sup>(2)</sup> See: <http://rma.althingi.is/pdf/RNABindi1.pdf> (see pp. 167-181). This Chapter is only available in Icelandic.

<sup>(3)</sup> Pages 172 and 173 of Chapter 4.

Another problem for Iceland in using the 'good bank/bad bank' solution was that running a 'bad bank' would require substantial equity contributions from the State. Faced with a situation where aid was needed for three of the nation's biggest banks (over 80 % of the nation's banking system), which had collective liabilities over 10 times more than Iceland's GDP, it was the conclusion of the Icelandic authorities that such an attempt would almost certainly lead to the State suffering major financial difficulties. In combination therefore it was felt that such a solution would have lacked the credibility necessary in a situation where the immediate problem faced by the banks was the run on their liabilities through the termination of credit facilities and massive deposit withdrawals.

#### 4.3. *Timescales*

In so far as the period of time it has taken to reach this stage is concerned the Icelandic authorities argue that they faced severe and complex circumstances. A division of three commercial banks to save the domestic part of a banking system, and through that the economy, had as far as they are aware never been done before. The task required the participation of many parties both domestic and foreign and in their view some aspects of the split proved more difficult than the 'good bank/bad bank' method used in some other countries where banking systems have encountered serious problems.

The first problem encountered was a practical one. The intra-month transfer date for the assets and liabilities (14 October 2008) caused major technical and audit difficulties. Entries for almost all assets and liabilities had to be accrued manually on spreadsheets for the period between 30 September and 14 October. In addition on a given intra-month date thousands of transfers are held in intermediary accounts waiting to be recorded on the general ledger and reconciled on both sides. Auditing teams had to manually trace and reconcile each open transaction with respect to its source and destination and determine whether it belonged to the new or old bank. This work was not completed until February 2009.

Within a short period of time it became evident that the creditors of the old banks were very unhappy with the asset valuation process that had been established. They considered the process to be one-sided in that their input was not taken into account as a part of the valuation process. As a result the procedure was changed in February 2009 into a formal negotiating process with the participation of domestic and foreign creditors. This process proved time consuming as a large number of international creditors and their advisors needed to participate at the negotiation table <sup>(1)</sup>.

Another factor in the delay of the process was the development of each of the new banks' initial business plans — a necessary element in the negotiations with the creditors. The banks were not ready to present their business plans until they had had the opportunity to go through the valuation of transferred assets prepared by Deloitte, as the opening balance sheet would be the foundation of such business plans <sup>(2)</sup>. The banks presented five-year business plans to the creditors in June 2009 following which the negotiations were able to begin. In their business plans the new banks put forward their own valuation of transferred assets which was not consistent with the Deloitte valuation. As the Deloitte valuation was not an exact number but a wide range, a Deloitte valuation number could not be entered into the opening balance sheet of the new banks. The new banks' valuation of the assets transferred was at the low end or below the low end of the Deloitte valuation, while the creditors' view stood at the high end or above the high end of the Deloitte valuation. A complex negotiation process followed in which both sides were far apart. In the end it became necessary to develop contingent compensation instruments to bridge the gap between the parties.

When the split was made between each old and new bank it became evident that there would be a massive currency mismatch in the new banks balance sheets. The deposits transferred were mainly ISK denominated and the loan assets mainly foreign currency denominated or linked. This created potentially major market risks in the new banks that had to be addressed before the capitalisation could take place. The process of addressing this issue was time consuming and only partially successful.

During the negotiations it became evident that the creditors in two of the banks (Glitnir and Kaupthing) had an interest in capitalising the banks themselves to become the majority owners. To respond to this possibility, two alternative positions had to be formulated during the negotiations. After the creditors had opted for ownership of the bank a due diligence exercise had to be performed by the creditor advisors, which also was time consuming.

<sup>(1)</sup> It is also notable that during this period Iceland suffered political upheaval. A new minority government came to power in February 2009, a government which later became a majority government after Parliamentary elections in April the same year. The new government had in some cases different views to the former government and some changes to the process had to be made.

<sup>(2)</sup> Uncertainty concerning the valuations is evident from the fact that the asset value attributed to the new banks on their provisional opening balance sheets was substantially different to the values eventually agreed upon and incorporated into the balance sheet when the banks were recapitalised.

Finally, the Icelandic authorities argue that account should be taken of the fact that from October 2008 until the autumn of 2009 the remainder of the financial sector in Iceland was far from stable, and in fact, during this period almost all financial undertakings in Iceland were taken over by the FME.

The Authority specifically requested information on why full business plans are still not available for the banks and why they have not been fully restructured. The Authority also requested information on why an assessment of the true value of the assets of the banks is yet to be completed. According to the Icelandic authorities, given the circumstances (in particular the impact on international creditors) it was considered important to abide by the principles of good public governance, including moderation. Specifically, it was thought that systematically and deliberately leaving damaged assets behind in the old banks (as would be the case in a 'good bank/bad bank' scenario) would exceed what was strictly necessary to ensure the short to medium-term operability of the new banks. For this reason, insofar as the basic principle of a domestic-foreign split was considered sufficient to ensure operability of the new banks in the short to medium-term, 'cherry picking' of good assets was deliberately avoided. Another reason for doing so was that it was considered that successfully valuing the assets (and therefore their degree of impairment) was a highly complex exercise.

These considerations were borne out by the events. Despite considerable time and resources allocated to the task, the professional firm engaged to assess the true net value of the assets transferred was unable to give a precise estimate. After months of negotiations, supported by some of the world's most renowned professional firms and investment banks, the stakeholders eventually settled on contingent compensation instruments for all three banks due to this uncertainty. The likely implication is that although certain margins can be, and have already been, established regarding the lower limits of asset value, only time can tell with sufficient precision what the true value of the transferred asset portfolios will be. The Icelandic authorities also argue that it is clear that establishing the new banks without performing a 'good bank/bad bank split' — i.e. without ensuring that the level of impairment in their portfolios was kept within very strict boundaries — meant that the entities were not inherently viable. According to the Icelandic authorities the long-term viability of the banks cannot be achieved without first creating banks that are operable and functional in the short to medium term before undertaking further restructuring. The process of assessing the viability of the banks is therefore ongoing but the Icelandic authorities have committed to providing a restructuring plan as soon as possible.

## II. ASSESSMENT

### 1. The presence of State aid

State aid within the meaning of Article 61(1) EEA

Agreement 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.'

The Authority will assess the following measures 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 5 % share capital remaining after 95 % of the share capital in the new bank was transferred to the creditors of Glitnir, 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')
- the special liquidity facility agreement,
  - the Icelandic Government's statement to guarantee domestic deposits in all Icelandic banks in full, and
  - the Straumur agreement.

### 1.1. *Presence of State resources*

It is clear that the capitalisation measures are financed through state resources provided by the Icelandic Treasury. State resources are also present in the provision of liquidity to the bank as part of the compensation for accepting the liabilities (deposits) of Straumur bank.

The primary intention of the statement made by the Icelandic authorities safeguarding domestic deposits was to reassure deposit holders and to stop the widespread run of deposits on the (old) banks. The deposit guarantee was implemented in practice through the use of powers under the Emergency Act to change the priority of deposit holders in insolvent estates and by transferring the liabilities for deposits to the newly established banks. According to statements made by the Icelandic authorities however, a full guarantee of all deposits in Icelandic banks remains in place. The Authority wishes to further investigate whether the notice issued (and subsequent references to it) was a precise, firm, unconditional and legally binding statement such as to involve a commitment of State resources <sup>(1)</sup>.

### 1.2. *Favouring certain undertakings or the production of certain goods*

Firstly, the aid measure must confer on the new bank advantages that relieve it of charges that are normally borne from its budget. The Authority is again of the view that each of the capitalisation measures confers an advantage on the new bank as the capital provided would not have been available to the bank without State intervention. The approach taken both by the European Commission (in numerous cases since the financial crisis began <sup>(2)</sup>) and by the Authority <sup>(3)</sup> in assessing whether State intervention to recapitalise banks amounts to State aid assumes that, given the difficulties faced by the financial markets, the State is investing because no market economy investor would be willing to invest on the same terms. The market economy investor principle is considered not to apply in cases involving the capitalisation of financial institutions affected by the crisis that are in difficulty. The Authority considers this to be the case notwithstanding the eventual transfer of 95 % of the capital of the new bank to the (largely private sector) creditors. The private investor involvement in the capitalisation of the new Icelandic banks is made up entirely of creditors of the old banks who are not therefore investors acting freely in an open market but rather are seeking to minimise their losses in the most efficient manner <sup>(4)</sup>.

Secondly, the aid measure must be selective in that it favours 'certain undertakings or the production of certain goods'. The capitalisation measures are selective as they only benefit Islandsbanki. Similar measures were also implemented in the cases of the other two failed banks, and numerous other Icelandic financial institutions have required assistance from the government. However not all Icelandic banks have received State aid, and State support can in any event be selective in situations where one or more sectors of the economy benefit and others do not. This principle applies to the State guarantee on deposits which benefits the Icelandic banking sector as a whole.

In so far as the special liquidity facility is concerned, paragraph 51 of the Authority's temporary rules on the 'application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis' provides that, following the Commission's decision-making practice <sup>(5)</sup>, the Authority considers that the provision of a central bank's funds to financial institutions will not constitute aid when the following conditions are met:

- the financial institution is solvent at the moment of the liquidity provision and the latter is not part of a larger aid package,
- the facility is fully secured by collateral, to which haircuts are applied, in function of its quality and market value,
- the central bank charges a penal interest rate to the beneficiary, and
- the measure is taken at the central bank's own initiative, and in particular is not backed by any counter-guarantee of the State.

<sup>(1)</sup> 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, not yet reported, paragraph 283 (on appeal).

<sup>(2)</sup> See for example Commission Decision of 10 October 2008 in Case NN 51/08 *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.

<sup>(3)</sup> 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>

<sup>(4)</sup> 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).

<sup>(5)</sup> See for instance Northern Rock (OJ C 43, 16.2.2008, p. 1).



The Authority concludes that, given that the liquidity facility 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, the above conditions are not fulfilled.

From the information provided to the Authority to date, the Authority cannot exclude that Islandsbanki has also received a selective advantage through the transfer of assets and liabilities of Straumur Bank. An advantage is *prima facie* present to the extent that the revenue (interest) it receives through partially State guaranteed assets exceeds the cost (interest) of holding the deposits, and to the extent that the transfer of deposit holders equates to goodwill and additional market share.

The Authority also considers that it is possible that the bank has benefitted (indirectly) from the statements made by the Government safeguarding all domestic deposits, as in the absence of the guarantee the new bank could have suffered from a run on its deposits like its predecessor<sup>(1)</sup>. Accordingly, the Authority has doubts as to whether the guarantee entailed an advantage for the bank.

### 1.3. *Distortion of competition and affect on trade between Contracting Parties*

The measures strengthen the position of the new bank in comparison to competitors (or potential competitors) in Iceland and other EEA States and must therefore be regarded as distorting competition and affecting trade between the Contracting Parties to the EEA Agreement<sup>(2)</sup>.

### 1.4. *Conclusion*

The Authority's preliminary conclusion, therefore, is that the measures taken by the Icelandic State to capitalise the new bank, as well as the liquidity facility, involve State aid within the meaning of Article 61(1) of the EEA Agreement. It also cannot exclude that aid to Islandsbanki is also present in the transfer to it of Straumur's assets and liabilities and as a result of the deposit guarantee.

## 2. *Procedural requirements*

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'.

The Icelandic authorities did not notify the aid measures 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 aid was therefore unlawful.

## 3. *Compatibility of the aid*

Assessment of the aid measure under Article 61(3) of the EEA Agreement.

### 3.1. *The necessity, proportionality and appropriateness of the aid*

In the Authority's view it is beyond dispute that Iceland faced, and still faces, a serious disturbance in its economy and that Glitnir Bank was of structural importance. In consequence the Authority will assess the potential compatibility of the aid under Article 61(3)(b) of the EEA Agreement and the guidelines based upon that sub-paragraph.

The Authority considers that this case, although not necessarily unique, is difficult to assess using the traditional and commonly understood notions of on the one hand 'rescue' aid and the other 'restructuring' aid. For instance the restoration of the bank as an emergency measure in October 2008 involved both rescue aid and immediate enforced restructuring. Through this decision the Authority intends to assess, retrospectively, the measures undertaken to restore the bank both through its initial creation and subsequent capitalisation as rescue measures. Such aid can only, however, be approved on a temporary and conditional basis. In the absence of a restructuring plan, the Authority is unable to fully assess the case and reach a conclusion and in consequence the measures will be assessed once again — on this occasion as a structural

<sup>(1)</sup> 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.sedlabanki.is/lisalib/getfile.aspx?itemid=8260> p. 5. See also Commission Decisions NN 48/08 Guarantee Scheme for Banks in Ireland, paragraphs 46 and 47: [http://ec.europa.eu/community\\_law/state\\_aids/comp-2008/nn048-08.pdf](http://ec.europa.eu/community_law/state_aids/comp-2008/nn048-08.pdf) and NN 51/08 Guarantee Scheme for Banks in Denmark: [http://ec.europa.eu/community\\_law/state\\_aids/comp-2008/nn051-08.pdf](http://ec.europa.eu/community_law/state_aids/comp-2008/nn051-08.pdf)

<sup>(2)</sup> See in this respect Case 730/79 *Phillip Morris v Commission* [1980] ECR 2671.



measure — upon receipt of the plan <sup>(1)</sup>. The Authority will at that stage assess the viability of the bank and the requirement that the aid provided was the minimum necessary to ensure its viability. The restructuring plan should include a full comparison of the old and new banks (for the purposes of demonstrating that that problems should not re-occur), as well as an assessment of how ongoing restructuring should secure the long-term viability of the bank.

In line with the general principles underlying the State aid rules of the EEA Agreement which require that the aid granted does not exceed what is strictly necessary to achieve its legitimate purpose and that distortions of competition are avoided or minimised as far as possible, and taking due account of the current circumstances, support measures must be:

- well targeted in order to be able to achieve effectively the objective of remedying a serious disturbance in the economy,
- proportionate to the challenge faced, not going beyond what is required to attain this effect, and
- designed in such a way as to minimise negative spill over effects on competitors, other sectors and other EEA States.

In assessing the rescue measures undertaken to date, therefore, the Authority takes into account the following.

#### 3.1.1. *The necessity of the measures*

The Authority accepts the argumentation of the Icelandic authorities, and believes that it is largely self-evident, that the State had to intervene in order to restore Glitnir and the other two banks and avoid a systemic failure of the Icelandic financial system. The Authority also notes the views of the CBI in this respect. It also accepts given the run on the banks and the instability of the financial system that a State guarantee of deposits was required <sup>(2)</sup>.

#### 3.1.2. *The method of restoring the bank — the appropriateness of the means employed to achieve the objective*

The Authority accepts in principle the views of the Icelandic authorities that given the circumstances, the approach taken of restoring the domestic operations of the banks and guaranteeing domestic deposits was likely to be the only credible and effective means of safeguarding an Icelandic banking sector and the wider economy <sup>(3)</sup>. Bank rescue measures of the kind adopted elsewhere in the EEA; recapitalisation, restructuring, relief for impaired assets, or a combination of each were unlikely to succeed. The scale of the problem and the sums of public money that would have been necessary to remedy it, the disproportionate size of the three main Icelandic banks, and the realistic threat that the entire system could collapse meant that the State's options were limited.

The measures however involved wide-ranging restructuring of the bank's operations through the effective divestiture of foreign operations, and potential further restructuring of domestic operations. The measure can only therefore finally be considered to be appropriate if it can be demonstrated through the means of a detailed restructuring plan that the bank is viable in the medium to long term.

#### 3.1.3. *The proportionality of the measures — limiting aid and distortions of competition to the minimum necessary*

The Authority is conscious in this context that in light of the foreign operations of the Icelandic banks remaining in the old banks, and in light of the Icelandic authorities adopting similar measures to restore the other two main banks in Iceland which together make up over 80 % of the domestic market <sup>(4)</sup>, the impact

<sup>(1)</sup> This approach is similar to the one taken by the European Commission in the case of Emergency aid for Ethias — Belgium — Case No NN 57/08.

<sup>(2)</sup> See paragraph 19 of the Authority's temporary rules on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis: <http://www.eftasurv.int/?1=1&showLinkId=16604&1=1>

<sup>(3)</sup> This decision does not relate to any aspects of the internal market rules of the EEA Agreement that may apply in so far as the division of foreign and domestic assets and liabilities is concerned.

<sup>(4)</sup> A number of other financial institutions have also required State assistance. In 22 April 2010 the FME decided to take control of BYR Savings Bank, to establish on its foundation a new limited liability company BYR hf. and to transfer to BYR hf. assets and liabilities of the failed savings bank. At the same time FME decided to take control of Keflavik Savings Bank and establish on its foundation SpKef Savings Bank to take over assets and liabilities of the failed Keflavik Savings Bank. Measures for recapitalisation of these two savings banks are under way and the Authority awaits notification from the Icelandic authorities. On 21 June 2010, the Authority approved for a period of six months a rescue scheme in support of five smaller savings banks in Iceland through settlement of claims owned by the Central Bank of Iceland on the savings banks concerned.

on competition and trade across the EEA is limited. The Authority is also of the view that the State intervention in the case of Islandsbanki is *prima facie* proportionate as the process of ensuring that the creditors of the old bank became the majority shareholders of the new bank meant that the Icelandic authorities were able to ensure:

- firstly that the aid payable was kept to the minimum necessary to ensure private sector involvement in the bank — something that may not otherwise have been achievable for many years, and
- secondly, that the amount of aid paid by the State was reduced substantially.

Although this was not achieved by undertaking a tender process due to the circumstances involved, the Authority is of the view that it would not have been realistic to expect any other private sector investors to have invested save for those already involved as creditors of the collapsed bank.

The amount of the capital provided is the minimum necessary in order to enable Islandsbanki to comply with the minimum capital adequacy ratio set by the FME of 12 % Tier I capital (achieved through the contribution of the creditors of Glitnir) and 4 % Tier II capital (provided by the subordinate loan of the State). The liquidity facility is also considered to be necessary by the regulator.

In so far as the remuneration of the capital is concerned, paragraphs 26 to 30 of the Authority's rules on the recapitalisation of financial institutions specifies a method of calculating an 'entry level' price for capitalising fundamentally sound banks. Capitalisations of banks that are not fundamentally sound are subject to stricter requirements and in principle the remuneration paid by such banks should exceed the entry level. Although the remuneration payable in the case of Islandsbanki does not most likely comply with these requirements it is clear that (as envisaged by paragraph 44 of the rules) the bank has experienced far-reaching restructuring including a change in management and corporate governance.

The Authority will further assess the aid granted through the remuneration payable for the capital and the terms of the liquidity facility, as well as any aid paid through the transfer of liabilities and guaranteed assets of Straumur, as part of its full assessment of the restructuring of the bank. It will also assess the duration of the State guarantee in this context.

### 3.2. Timescales

While the Authority regrets that the normal time scales for the duration of rescue measures have been exceeded, a need for longer periods to restructure financial institutions was envisaged by the European Commission and the Authority when adopting guidelines for the assessment of rescue and restructuring aid granted as a result of the financial crisis <sup>(1)</sup>. The Authority accepts in particular that for the various reasons put forward by the Icelandic authorities, delays were inevitable at least until the assets of the bank could be valued and its ownership and capitalisation could be resolved. The Authority is also aware of domestic litigation in Iceland concerning loans linked to foreign currencies which has had the potential to have a major impact on the value of each bank's assets, and led to considerable uncertainty for many months <sup>(2)</sup>. In addition it notes the content of the CBI's financial stability report for 2010/2 <sup>(3)</sup> which refers among other matters to the fact that non-performing loans (90 days or more in default) of the Icelandic commercial banks now total 39 % of all loans — a major political and economic issue given that many loans have already been written down. The Authority is therefore willing to accept that given the exceptional circumstances the rescue measures could be authorised and remain in place for a longer period than is normally allowed. However, whilst the Authority accepts that there are also justifiable reasons for further delay since the recapitalisation of the banks, the Authority is concerned at the lack of progress since the autumn of 2009 in concluding a detailed restructuring plan. In the absence of the restructuring plan, therefore, the Authority has doubts concerning the compatibility of the measures with the EEA Agreement.

## 4. Conclusion

On the basis of the foregoing assessment, had the Icelandic authorities notified the capitalisation measures and deposit guarantee involved in Phase 1 and Phase 2 of the process of restoring and restructuring Glitnir/Islandsbanki in advance, the Authority would in all probability temporarily approved the measures as aid compatible with the functioning of the EEA Agreement. The aid granted could, however, only have been considered compatible on a temporary basis, conditional upon the submission a detailed

<sup>(1)</sup> See paragraphs 10 and 24, and footnote 13, of the Authority's guidelines: <http://www.efasurv.int/?1=1&showLinkID=16604&1=1>

<sup>(2)</sup> The issue is referred to in the CBI's Financial Stability Report for the second half of 2010 (pp. 18-21), <http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=8260> and the Annual Report of the FME for 2010 (currently only available in Icelandic, pp. 31-32): <http://www.fme.is/lisalib/getfile.aspx?itemid=7604> See also the following news reports: <http://www.businessweek.com/news/2010-07-29/iceland-debt-outlook-cut-to-negative-at-moody-s-on-bank-ruling.html> <http://www.businessweek.com/news/2010-09-17/iceland-ruling-may-save-banks-4-billion-in-losses.html>

<sup>(3)</sup> <http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=8260>

restructuring plan for the bank and a satisfactory assessment by the Authority of its future viability. Although the Icelandic authorities have committed to submit a restructuring plan for the Authority's assessment, in view of the time period that has elapsed since the aid was granted, the Authority is required to open a formal investigation procedure into the measures adopted. The Authority must also further assess any aid paid as a result of the transfer of Straumur's assets and liabilities with the context of a restructuring plan. The decision to open a formal investigation procedure is without prejudice to the final decision of the Authority, which may conclude that the measures in question do not constitute State aid or are compatible with the functioning of the EEA Agreement.

The Authority also regrets that the Icelandic authorities did not respect their obligations pursuant to Article 1(3) of Part I of Protocol 3. The Icelandic authorities are therefore reminded that any plans to grant further restructuring (or other) aid to the bank must be notified to the Authority and approved in advance,

HAS ADOPTED THIS DECISION:

*Article 1*

The formal investigation procedure provided for in Article 1(2) of Part I of Protocol 3 is opened into the measures undertaken by the Icelandic State to restore of certain operations of (old) Glitnir Bank hf and establish and capitalise New Glitnir Bank hf (now renamed Islandsbanki).

*Article 2*

The Authority requires that a detailed restructuring plan for Islandsbanki be submitted as soon as possible and in any event no later than 31 March 2011.

*Article 3*

The measures involve 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 aid in accordance with Article 1(3) of Part I of Protocol 3.

*Article 4*

The Icelandic authorities are requested to provide within one month from notification of this decision, all documents, information and data needed for assessment of the compatibility of the aid measure.

*Article 5*

This Decision is addressed to the Republic of Iceland.

*Article 6*

Only the English language version of this decision is authentic.

Done at Brussels, 15 December 2010.

*For the EFTA Surveillance Authority*

Per SANDERUD  
*President*

Sverrir Haukur GUNNLAUGSSON  
*College Member*

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## V

(Avis)

PROCÉDURES RELATIVES À LA MISE EN ŒUVRE DE LA POLITIQUE DE  
CONCURRENCE

## COMMISSION EUROPÉENNE

## Notification préalable d'une concentration

(Affaire COMP/M.6147 — Rosneft Oil Company/BP/Ruhr Oel)

## Cas susceptible d'être traité selon la procédure simplifiée

(Texte présentant de l'intérêt pour l'EEE)

(2011/C 41/07)

1. Le 3 février 2011, la Commission a reçu notification, conformément à l'article 4 du règlement (CE) n° 139/2004 du Conseil <sup>(1)</sup>, d'un projet de concentration par lequel les entreprises Rosneft Oil Company («Rosneft», Russie), appartenant à l'État russe, et BP p.l.c. («BP», Angleterre et Pays de Galles) acquièrent, au sens de l'article 3, paragraphe 1, point b), du règlement CE sur les concentrations, le contrôle en commun des activités solvants industriels et services aux collectivités de l'entreprise Ruhr Oel GmbH («ROG's solvents and utilities services businesses», Allemagne), actuellement contrôlée par BP et Petroleos de Venezuela Europa BV («PDVE», Pays-Bas), cette dernière appartenant à Petroleos de Venezuela SA («PDVA», Venezuela).

2. Les activités des entreprises considérées sont les suivantes:

- Rosneft: prospection et production de pétrole et de gaz, fabrication de produits pétroliers et pétrochimiques et commercialisation de produits en Russie et à l'étranger,
- BP: prospection, développement et production de pétrole et de gaz; raffinage, fabrication et commercialisation de produits pétroliers et pétrochimiques et développement des énergies renouvelables,
- Activités solvants et services aux collectivités de ROG: production et distribution de solvants industriels et fourniture de services industriels et de services aux collectivités.

3. Après examen préliminaire et sans préjudice de sa décision définitive sur ce point, la Commission estime que l'opération notifiée pourrait entrer dans le champ d'application du règlement CE sur les concentrations. Conformément à la communication de la Commission relative à une procédure simplifiée de traitement de certaines opérations de concentration en application du règlement CE sur les concentrations <sup>(2)</sup>, il convient de noter que ce cas est susceptible d'être traité selon la procédure définie par ladite communication.

4. La Commission invite les tiers intéressés à lui présenter leurs observations éventuelles sur le projet de concentration.

<sup>(1)</sup> JO L 24 du 29.1.2004, p. 1 (le «règlement CE sur les concentrations»).

<sup>(2)</sup> JO C 56 du 5.3.2005, p. 32 (la «communication sur une procédure simplifiée»).

Ces observations devront lui parvenir au plus tard dans un délai de dix jours à compter de la date de la présente publication. Elles peuvent être envoyées par télécopie (+32 22964301), par courrier électronique à l'adresse COMP-MERGER-REGISTRY@ec.europa.eu ou par courrier postal, sous la référence COMP/M.6147 — Rosneft Oil Company/BP/Ruhr Oel, à l'adresse suivante:

Commission européenne  
Direction générale de la concurrence  
Greffes des concentrations  
J-70  
1049 Bruxelles  
BELGIQUE

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**Notification préalable d'une concentration**

**(Affaire COMP/M.6060 — Citigroup/Public Sector Pension Investment Board/DP World/DP World Australia JV)**

**Cas susceptible d'être traité selon la procédure simplifiée**

**(Texte présentant de l'intérêt pour l'EEE)**

(2011/C 41/08)

1. Le 28 janvier 2011, la Commission a reçu notification, conformément à l'article 4 du règlement (CE) n° 139/2004 du Conseil <sup>(1)</sup>, d'un projet de concentration par lequel l'entreprise Citigroup Alternative Investments LLC (États-Unis), appartenant à Citigroup Inc («Citigroup», États-Unis), le Public Sector Pension Investment Board («PSP», Canada) et l'entreprise DP World Limited («DP World», Émirats arabes unis) acquièrent, au sens de l'article 3, paragraphe 1, point b), du règlement CE sur les concentrations, le contrôle en commun de DP World Australia Limited («DPWA», Australie) par achat d'actions.

2. Les activités des entreprises considérées sont les suivantes:

- Citigroup: groupe mondial de services financiers,
- PSP: société d'État canadienne créée pour investir les contributions nettes des régimes de retraite du secteur public,
- DP World: opérateur maritime international fournissant des services de manutention de fret, ainsi que des services logistiques,
- DPWA: développement et exploitation de ports, gestion de terminaux et de parcs à conteneurs et services de manutention en Australie.

3. Après examen préliminaire et sans préjudice de sa décision définitive sur ce point, la Commission estime que l'opération notifiée pourrait entrer dans le champ d'application du règlement CE sur les concentrations. Conformément à la communication de la Commission relative à une procédure simplifiée de traitement de certaines opérations de concentration en application du règlement CE sur les concentrations <sup>(2)</sup>, il convient de noter que ce cas est susceptible d'être traité selon la procédure définie par ladite communication.

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Commission européenne  
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1049 Bruxelles  
BELGIQUE

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<sup>(1)</sup> JO L 24 du 29.1.2004, p. 1 (le «règlement CE sur les concentrations»).

<sup>(2)</sup> JO C 56 du 5.3.2005, p. 32 (la «communication sur une procédure simplifiée»).



**RECTIFICATIFS****Rectificatif au guide pour la préparation d'une demande d'autorisation***(«Journal officiel de l'Union européenne» C 28 du 28 janvier 2011)*

(2011/C 41/09)

Page de couverture, dans le titre:

*au lieu de:* «Guide pour la préparation d'une demande d'autorisation»

*lire:* «Projet de guide pour la préparation d'une demande d'autorisation»

Page 1, dans le titre:

*au lieu de:* «Guide pour la préparation d'une demande d'autorisation <sup>(1)</sup>»

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<sup>(1)</sup> Le présent document ne saurait en aucun cas être considéré comme une position officielle de la Commission.»

*lire:* «Projet de guide pour la préparation d'une demande d'autorisation <sup>(1)</sup>»

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<sup>(1)</sup> La version finale sera publiée par l'Agence européenne des produits chimiques sur son site internet.»

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