

Case No: 69666
Event No: 597895
Dec No: 126/11/COL

[Non-confidential version]

EFTA SURVEILLANCE AUTHORITY DECISION
of 13 April 2011
on state aid for the establishment and capitalisation of Byr 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(3)(b),

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 Article 4(3) of Part II,

Whereas:

I. FACTS

1. Procedure

By letter of 21 March 2011 (Event No 591384) the Icelandic authorities notified rescue aid in favour of Byr hf., a limited liability company active in the market for retail banking in Iceland.

The above procedure was preceded by a pre-notification on the rescue and restructuring of the economic activity of Byr hf. initiated by the Icelandic authorities’ letter of 29 November 2010 (Event No 579154). That letter was followed by pre-notification discussions between the Icelandic authorities and the Authority which subsequently took place until submission of the notification on 21 March 2011.

2. Description of the proposed measures

2.1 Background

In October 2008, the Icelandic financial system entered into a state of systemic crisis. Three of Iceland's major banks, Kaupthing Bank hf., Landsbanki Íslands hf. and Glitnir Bank hf., which at that time together held a market share of more than 90% in most segments of the Icelandic financial market, collapsed within a time span of a few days.

The fall of these three Icelandic banks triggered a chain reaction of plummeting asset prices and bankruptcies. In March 2009, Sparisjóður Reykjavíkur og nágrennis (Reykjavík Savings Bank, abbreviated SPRON) and Sparisjóðabanki Íslands hf. (SPB) discontinued operations.

Due to the uncertainty in financial markets in Iceland, Byr Savings Bank ("Old Byr") filed an application to the Ministry of Finance on 20 March 2009 seeking an equity contribution from the State on the basis of Article 2 of Act No 125/2008 on Disbursements due to Unusual Financial Market Circumstances ("the Emergency Act")¹. According to this provision such equity contributions to savings banks could amount to 20% of Old Byr's book value of equity at year end 2007.

The Icelandic Financial Supervisory Authority ("the FME") subsequently requested a review of Old Byr's interim financial statement showing its financial position as at 30 April 2009. This review showed that additional impairments had caused the capital adequacy ("CAD") ratio to deteriorate down to 2% and subsequently a restructuring process was initiated with the involvement of a majority of the stakeholders. A financial due diligence report was introduced to the management of Old Byr on 22 May 2009, indicating the need for additional write-down of Old Byr's asset portfolio amounting to ISK 13.7 billion, leading to a significant decrease in the CAD ratio.

In order to qualify for a capital contribution under Article 2 of the Emergency Act, it was necessary for Old Byr to bring the CAD ratio up to the minimum, which meant that creditors would have to make certain concessions. In June 2009 Old Byr made an offer to its creditors by which creditors would concede large parts of their claims against Old Byr. On 16 June 2009, the FME called on Old Byr to increase its capital ratio and granted the bank a stay to work on the aforesaid measures until 15 July 2009. If the requirements were not met by this deadline the FME would revoke or restrict Old Byr's operating licence and the winding up of the company would follow. Old Byr sent a letter to the FME on 15 July 2009 stating that work had progressed according to the defined process. The FME was informed that all of Old Byr's creditors of syndicated loans denominated in foreign currency and the largest owners of debt securities in issue (72%) had agreed, by signing a special Memorandum of Understanding, to work towards the financial reorganisation of the company. The FME subsequently granted an extended deadline to Old Byr until 11 August 2009 to bring its equity base up to the minimum legal requirement.

In October 2009 the Icelandic authorities informed Old Byr's creditors that they would not contribute any capital to the company unless a thorough revaluation was conducted of Byr's

¹ Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances, etc., available at http://eng.efnahagsraduneyti.is/media/acts/Act_No_125-2008_unusual_financial_market_circumstances_13.10.2008.pdf

assets and liabilities. This revaluation, performed by PriceWaterhouseCoopers, indicated that the condition of Old Byr's assets was considerably worse than the figures relied upon by the management of Byr in its negotiations with creditors. These findings were confirmed by a revaluation performed by Deutsche Bank, as requested by Byr's creditors.

The final deadline to bring Old Byr's equity base up to the legal requirement was set by the FME on 21 April 2010. The discussions with Old Byr's creditors proved unsuccessful. Subsequently, on 22 April 2010 the Board of Directors of Old Byr requested that the FME take over its operations. On the same day, the Minister of Finance established a new financial undertaking, Byr hf. ("New Byr" or "Byr"), which took over the operations of the Old Byr. By decision of 22 April 2010, the FME transferred all assets and certain liabilities (mainly deposits) of the savings bank to the new company, which commenced operations immediately.² Furthermore, an interim Board of Directors was appointed for Old Byr, which later became the Winding-up Board ("WuB") of the company by a decision of the District Court of Reykjavík. Under Article 11 of the FME's Decision, Old Byr had a claim ("the Claim") on New Byr to the extent that the value of the transferred assets exceeded the liabilities assumed pursuant to the transfer. This claim includes all financial obligations that stem from the transfer, with no exceptions or exclusions.

Following the incorporation of New Byr, a new Board of Directors was appointed, the members of which were all independent from previous stakeholders and the Icelandic State. The transfer of Old Byr's operations to New Byr also brought about a change in the management of the company and a reduction in management salaries.

2.2 The beneficiary of the aid

Old Byr was a savings bank and had been created by mergers of four savings banks in the years 2006 to 2008. New Byr (Byr) was founded on 22 April 2010 with the transfer of all assets and certain liabilities from Old Byr.

Byr is active on the Icelandic market for retail and corporate banking, mainly in Reykjavík and surrounding towns and operates five branches, in Reykjavík, Hafnarfjörður, Kópavogur and Akureyri. It offers personal insurance plans and pension savings plans in association with its subsidiaries, as well as debit and credit cards, loans, mortgages and insurance. In the field of corporate banking, Byr offers services such as financing and loans, investments and foreign business transactions in addition to servicing locally small and medium-sized enterprises. Byr is Iceland's fourth largest operating bank in the retail and corporate sector. Before the financial crisis Old Byr had a total of 235 employees working in 214 full-time positions.

The Icelandic State contributed in April 2010 the initial share capital of ISK 900 million in New Byr,³ representing 100% of the issued share capital. However, precise information on Byr's finances still remains limited as neither Old Byr's financial statements for 2009 nor New Byr's financial statements for 2010 have been made available. As indicated above, repeated revaluations of Byr's assets have resulted in declining values. However, a draft

² See Decision of the FME of 22.4.2010 <http://www.fme.is/lisalib/getfile.aspx?itemid=7200>. See also the Central Bank of Iceland Financial Stability Report 2010, p. 33, available at <http://www.sedlabanki.is/?PageID=1101>.

³ ISK 900 million is the minimum amount required under Article 14 of Act No 161/2002 which stipulates that share capital of a financial undertaking must amount to a minimum of ISK 450 million, but never less than the equivalent of EUR 5 million, on the basis of the current official exchange rate (buying rate).

restructuring plan submitted as part of the pre-notification to the Authority provided the available information on Byr's balance sheet and income statement at the time. According to this preliminary information total assets at year-end 2010 amounted to ISK [...] billion (Euro [...] billion) and total liabilities were ISK [...] billion (Euro [...] billion), the majority of which were regular deposits (ISK 146 billion) and deposits from the Central Bank of Iceland (CBI) and other credit institutions (ISK 2 billion). Borrowings and subordinated loans amounted to ISK 3.7 billion.

2.3 The aid measures

The national legal basis for the aid measures is the Emergency Act referred to above. Further provisions are set out in the Heads of Terms explained below.

The Icelandic authorities have requested a temporary approval of the notified measures which would apply for the rescue phase, ending six months from the time of implementation of the envisaged loan facility. Upon the submission of a restructuring plan within the prescribed time limit, the approval would be automatically prolonged until the Authority reaches its decision concerning the plan.

2.3.1 *The initial share capital*

As described above, the Icelandic authorities established Byr hf. (New Byr), a limited liability company wholly owned by the Icelandic State, on 22 April 2010 and at that time the Ministry of Finance contributed ISK 900 million (approximately 5.6 million Euros) of share capital to the company.

2.3.2 *The Heads of Terms*

On 14 October 2010 Heads of Terms were signed between the Winding-up Board of Old Byr, New Byr and the Ministry of Finance on behalf of the Government of Iceland. The agreement provides for a financial settlement on the transfer of assets and liabilities of Old Byr to New Byr. The parties agreed to settle the Claim in full with equity in New Byr, in conjunction to which the Icelandic authorities would enter into a subordinated loan facility agreement with New Byr.

Upon conclusion of the settlement, Old Byr and New Byr would have no further claims against each other or against the Icelandic State, in relation to the transfer of assets and liabilities.

The Heads of Terms set out the principal provisions of the financial settlement and are subject to final documentation being agreed upon. The agreement is subject *inter alia* to the approval of the EFTA Surveillance Authority.

2.3.2.1 *The Settlement Agreement*

Old Byr has a claim on New Byr to the extent that the value of the transferred assets exceeds the liabilities assumed by New Byr. According to the Heads of Terms, this claim is to be settled in full with equity in New Byr. The parties to the Heads of Terms have agreed that New Byr will issue, transfer and assign to Old Byr new shares, equal to a value of ISK 16.3 billion, at a price per share of ISK 1 (being the same price at which the Icelandic authorities subscribed for its shares in April 2010). In return, Old Byr will transfer and assign the Claim to New Byr as consideration for the Byr shares. This equity of ISK 16.3 billion and the ISK

900 million in initial share capital in New Byr owned by the Icelandic State, will together constitute the total equity of New Byr amounting to ISK 17.2 billion.

2.3.2.2 *The Escrow Agreement*

According to the Heads of Terms, the shares in New Byr that are intended to be transferred to Old Byr are to be held by the Icelandic Government in escrow on terms and conditions set out in an escrow agreement (the “Escrow Agreement”). The background to this arrangement is that acquisition of a qualifying holding in a financial undertaking is subject to approval of the FME⁴. The FME has in previous cases decided that a company under liquidation does meet the requirements laid down for a qualifying holding. The estates of Glitnir, Kaupthing and Landsbanki, for example, hold shares in Íslandsbanki, Arion banki and NBI, respectively, via their subsidiaries. However, such a subsidiary must possess sufficient assets in order to qualify as a holder of the shares. This route was not open to Old Byr as all the assets of the company were transferred to New Byr. Furthermore, the WuB will not be in a position to transfer shares in New Byr to the creditors of Old Byr until later in the liquidation process, as there may be legal issues to settle pertaining to the claims lodged with the Board, such as the validity of individual claims and their priority ranking. It was therefore considered a necessary and appropriate interim solution to place the shares in New Byr in escrow and that the Ministry of Finance would act as an escrow agent.

The duration of the Escrow Agreement is to be up to two years. The Agreement will however in any event terminate as soon as all of the shares in escrow have been released. Once the number of creditors with a stake in Old Byr’s estate is determined, the WuB can request the transfer of the New Byr shares held in escrow and start liquidating the estate to creditors in proportion to their claims.

While the Escrow Agreement is in force, the escrow agent (i.e. the Ministry of Finance) shall have all voting powers pertaining to the New Byr shares. The Escrow Agreement further stipulates limitations on the voting powers *inter alia* by provisions on certain veto powers of the WuB. Economic rights pertaining to New Byr shares remain with Old Byr.

According to the Escrow Agreement, Old Byr promises and agrees to indemnify and hold the escrow agent harmless from any outcome or consequences of actions taken by or on behalf of the agent, or by or on behalf of New Byr or its Board of Directors, for the duration of the Agreement. Old Byr furthermore promises to make no claims, at any time, against the escrow agent, relating to any loss or other detriment pertaining to such actions or to any reduction in the price of shares in New Byr.

2.3.2.3 *Option to purchase the Government’s stake*

According to the Head of Terms, Old Byr has the option to purchase the Icelandic Government’s shares in New Byr. The option provides that for a year from the date of issue, Old Byr will have the right to purchase the shares, at a price equal to the amount that the Icelandic authorities paid for the shares plus interest at the rate of interest on financial undertakings’ deposits with the Central Bank of Iceland,⁵ plus a margin of 1.5% per annum.

This is seen by the Icelandic authorities as an incentive for Old Byr, creditors and potential purchasers of shares in New Byr from creditors to remove the Icelandic authorities from the

⁴ Under Article 40 of Icelandic Act No 161/2002 on Financial Undertakings.

⁵ Cf. Article 3 of Rules No 540/2007 on Current Accounts in the Central Bank of Iceland.

group of owners. A further incentive derives from the provisions of the Heads of Terms which afford the Icelandic authorities the right to retain board representation with one board member, and one alternative board member, until such time as it does not hold shares in New Byr.

2.3.2.4 *Tag-a-long rights*

In the Heads of Terms the Icelandic authorities made a reservation stating that no transfer of any shares in New Byr representing in aggregate 20% or more of the shares then in issue may be made by any shareholder, excluding the Icelandic authorities, in a single transaction or a series of connected transactions, unless the proposed transferee has first made a written offer to the Icelandic authorities to purchase all shares held by it, on the same terms and conditions as accepted by the selling shareholders, and for the same price per share as would be received by the selling shareholders. This right continues as long as the Icelandic Government owns shares in New Byr.

2.3.2.5 *Subordinated Facility Agreement*

Under the Heads of Terms, the Icelandic Government commits itself, contingent upon success of the settlement, to enter into a subordinated loan facility agreement with New Byr for the amount of up to ISK 5 billion (approximately 31 million Euros). New Byr will have the option to draw on the facility if necessary to meet CAD requirements set by the FME and/or the relevant national legislation. The subordinated loan facility will only be at New Byr's disposal to the extent necessary to meet the CAD requirements laid down by the FME.⁶

The Subordinated Facility Agreement is a Tier II debt facility, subordinated to all other claims on New Byr except for share capital. The facility will be denominated in ISK or Euro at New Byr's option. The management of New Byr has stated its preference as to denomination in Euro.

The rate at which the subordinated Tier II instrument bears interest is based on the 3 month EURIBOR/REIBOR⁷ (depending on the choice of denomination), plus a margin of 4% per annum, with a step up to 5% after five years. New Byr will have the option to postpone interest payment up to six months if necessary to preserve the liquidity position of the bank. If the interest payment is postponed, an extra 2% per annum will be added to the interest. The terms of the Agreement further stipulate a 1% fee of the total amount drawn upon at each drawdown.

In the event that New Byr no longer needs any part of the subordinated debt facility to meet the then minimum CAD ratio as set out by the FME, an additional 2% per annum will be added to the interest on that part, to the extent that New Byr has drawn on or draws on that part. New Byr can choose to make prepayments either at any time after five years from the date of the facility or within three months following any interest rate step up.

According to Article 5 of the agreement, the borrower shall pay in full the outstanding balance of the facility in one payment six years from the date of the agreement. The borrower

⁶ The Icelandic authorities have confirmed this in a letter to the Authority dated 282011 (Event No 589009).

⁷ REIBOR denotes Reykjavik Inter Bank Offer Rate, representing the interbank market rate for short term loans at Icelandic commercial and savings banks. The approach is similar to the use of LIBOR or EURIBOR 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*.

has the option to extend the loan for a period of additional four years given that certain conditions are fulfilled. Among these conditions is that the EFTA Surveillance Authority has prior to such request accepted and approved that restructuring of New Byr is compatible with Article 61 of the EEA Agreement.

2.4 The aim of the measures

The Icelandic authorities submit that the measures are primarily aimed at maintaining confidence in the Icelandic financial system and thus to remedy a serious disturbance in the Icelandic economy. The possible collapse of New Byr would have led to depositors being temporarily unable to access their deposits and this would eventually have exposed the Icelandic State to the deposits held by the bank. This in turn could have seriously threatened financial stability in Iceland. The Icelandic authorities therefore consider that they were forced to intervene, firstly by founding New Byr in April 2010 and transferring assets, liabilities and operations of Old Byr to the new bank, and secondly, by providing the assistance envisaged by the Heads of Terms to ensure finalisation of the settlement between the two banks. The measures are a precondition for establishing the new bank's opening balance sheet and reducing uncertainty over New Byr's future.

The measures described above further constitute an important step in preventing further financial disturbances in the Icelandic financial system and the economy as a whole. The possible collapse of New Byr would be a severe blow to the confidence of deposit holders in Iceland and this could undermine financial stability to the detriment of the Icelandic economy as a whole.

The measures will give New Byr time to address any remaining uncertainty regarding the quality of the bank's assets and rebuild customers' confidence, whilst finalising a restructuring plan contributing to the long term viability of the bank. Furthermore, the measures are aimed at enabling Byr to repay the subordinated loan facility with an acceptable return for the Government.

3. Position of the Icelandic authorities

The Icelandic authorities consider the initial share capital injection and the Subordinated Facility Agreement to constitute state aid within the meaning of Article 61(1) of the EEA Agreement.

According to the Icelandic authorities New Byr would not be able to maintain the required capital ratio under law without the measures, and its banking licence would be revoked or restricted by the FME, leading to a winding-up process under Act No 161/2002 on Financial Undertakings.

The Icelandic authorities argue that alternative options, such as transfer of Old Byr's assets and liabilities to another bank operating on the market, are not available as the assets to meet liabilities are severely impaired and this would imply unacceptable risks for the prospective receiving bank. In the scenario where also New Byr was subject to winding-up proceedings this would, in the opinion of the Icelandic authorities, be the most expensive outcome for the Icelandic State and least advantageous for competition. A winding-up process would effectively result in the Icelandic State being liable for all deposits residing within New Byr,

amounting to approximately ISK 148 billion.⁸ The value of already severely impaired assets against such liabilities would be further reduced within a bankrupt estate. The envisaged measures involve amounts and costs constituting only a fraction of the funds that would be utilised if New Byr would go into winding-up proceedings.

The Icelandic authorities point out that the restructuring of debts of companies and individuals alike is pivotal to the restructuring of the Icelandic economy. Byr is particularly exposed in the property sector and a large proportion of its customers are individuals. For comparison the Icelandic authorities point to their experience in resolving the financial difficulties of the Reykjavík Savings Bank (SPRON). After the collapse of SPRON in March 2009, its deposits were transferred to another financial institution (Arion Bank) and its operations discontinued. Household debts of former SPRON's customers are managed by SPRON's Winding up Board. This approach has in fact added to the difficulties in tackling the issue of household debts of former SPRON customers. The Icelandic authorities are therefore of the opinion that discontinuing Byr's operations would further add to the problem of tackling household debt currently faced by the Icelandic Government.

The Icelandic authorities submit that the collapse of New Byr would be a severe blow for the financial system and in particular to the confidence of deposit holders in Iceland. The state intervention to resolve problems in the operation of New Byr was therefore necessary to contribute to the restoration of the Icelandic economy, keeping the involvement of state resources to the minimum necessary and avoiding severe losses for the Icelandic State.

The Icelandic authorities have notified the measures as rescue aid for six months after which the Icelandic authorities will submit a liquidation or restructuring plan. The approval of the measures would therefore be limited to six months.

In light of the foregoing, the Icelandic authorities consider that the measures can be declared compatible with the EEA Agreement as they aim to remedy a serious disturbance in the Icelandic economy pursuant to Article 61(3)(b) EEA.

II. ASSESSMENT

1. The presence of state aid

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.”

To constitute state aid within the meaning of Article 61(1) EEA a measure must satisfy the following four cumulative criteria: (i) the measure must confer on recipients an economic advantage which is not received in the normal course of business; (ii) the advantage must be granted by the State or through State resources; (iii) the measure must be selective by

⁸ These numbers are from September 2010; the amount has decreased somewhat since then.

favouring certain undertakings or the production of certain goods; and (iv) the measure must distort competition and affect trade between Contracting Parties.

The Authority considers that the measures relevant for assessment under Article 61 of the EEA Agreement are the following:

- Contribution by the Icelandic State of ISK 900 million in initial share capital to Byr hf
- The Icelandic Government's commitment to enter into a subordinated loan facility agreement with Byr hf. up to a maximum of ISK 5 billion, and
- The Icelandic Government's commitment under the escrow agreement.

The question whether the above cumulative criteria of Article 61(1) EEA are met with respect to the above measures will be considered in sections 3.1 – 3.3 below.

1.1 Presence of state resources

The aid measure must be granted by the State or through state resources.

The Icelandic authorities have contributed ISK 900 million as initial share capital to Byr and are planning to enter into a Subordinated Facility Agreement with Byr for up to ISK 5 billion, under which Byr will have the option to draw on the facility if necessary to meet CAD requirements set by the FME. These capitalisation measures in favour of Byr must therefore be considered to be granted by the Icelandic State.

Under the Escrow Agreement, the Ministry of Finance shall act as an escrow agent and hold the shares in New Byr until the WuB requests a handover of the New Byr shares, which can happen once the number of creditors with a stake in Old Byr's estate will be determined.

The Authority takes note of the Icelandic authorities' submission that the State's role as an agent under the Escrow Agreement does not entail any further commitments on behalf of the State, nor does it constitute a guarantee by the State. According to the Agreement Old Byr undertakes and agrees to indemnify and hold the Icelandic Government harmless from any outcome or consequences of actions taken by or on behalf of the Government as an escrow agent, or by or on behalf of New Byr or its board of directors, for the duration of the agreement, and to make no claims, at any time, on the escrow agent, relating to any loss or other detriment pertaining to such actions or to any reduction in the price of shares in New Byr.

There is no financing or guarantee by the State involved in the Escrow Agreement and any economic advantage conferred to Old Byr through the arrangement does not stem from any allocation of state resources but only from the performance of New Byr. However, the State undertakes to provide a service as escrow agent and the agreement does not envisage any payment for that service. On this point the Icelandic authorities state that they are not aware of a market price for the type of escrow agent service to be rendered. While this matter is likely to be of minor significance, the Authority nevertheless considers that providing such services free of charge to undertakings would normally entail the granting of state aid. Any such possible aid will have to be assessed in the context of the Authority's final examination of this case.

The Authority considers that the Settlement Agreement does not entail state aid, within the meaning of Article 61(1) EEA, as it is a negotiated settlement based exclusively on assets and liabilities transferred from Old Byr to New Byr and does therefore not involve any state resources.

1.2 Favouring certain undertakings or the production of certain goods

Firstly, the aid measure must confer on Byr advantages that relieve it of charges that are normally borne from its budget. The Icelandic authorities have submitted that Byr cannot, without the measures in question, meet the CAD requirement set by the FME under Act No 161/2002. If the Icelandic authorities did not provide the capitalisation measures in question, Byr would not be able to continue its economic activities and would become subject to winding-up proceedings. The Authority is of the view that the capitalisation measures confer an advantage on New Byr 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 began⁹) and by the Authority¹⁰ in assessing whether state intervention to recapitalise banks amounts to state aid assumes that, given the difficulties faced in 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 undertakings in difficulty affected by the crisis. The Authority considers this to be the case notwithstanding the eventual transfer of approximately 94.8% of the share capital of New Byr to the (largely private sector) creditors. The private investor involvement in the capitalisation of New Byr is made up entirely of creditors of Old Byr who are not investors acting freely in an open market but rather are seeking to minimise their losses in the most efficient manner.

Secondly, the aid measure must be selective in that it favours “*certain undertakings or the production of certain goods*”. The Authority considers that the above measures are selective as they only benefit Byr. Similar capitalisation measures have also been implemented in support of Iceland’s three biggest commercial banks, and other Icelandic financial institutions have required assistance from the government. However not all Icelandic banks and financial undertakings 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.

1.3 Distortion of competition and effect on trade between Contracting Parties

The measures strengthen the position of New Byr 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.

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*

⁹ See for example Commission decision of 10.10.2008 in case NN 51/2008 *Guarantee scheme for banks in Denmark*, at paragraph 32, and Commission decision of 21.10.2008 in case C 10/2008 *IKB*, at paragraph 74.

¹⁰ See the Authority’s decision of 8.5.2009 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/?l=1&showLinkID=16694&l=1>

aid (...). The State concerned shall not put its proposed measures into effect until the procedure has resulted in a final decision”.

By submitting a notification of the rescue aid to Byr with a letter dated 21 March 2011 (Event No 591384), the Icelandic authorities have complied with the notification requirement pursuant to Article 1(3) of Part I of Protocol 3 to the Surveillance and Court Agreement, as concerns the measures belonging to the Heads of Terms. As for the Icelandic authorities’ decision to provide New Byr with initial capital, which the Authority was informed of at the time of the decision, that measure was implemented without awaiting the Authority’s approval. Consequently, that aid was granted unlawfully.

3. Compatibility of the aid

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 April 2010 involved both rescue aid and immediate partial recapitalisation of the new bank.

Through this decision the Authority intends to assess, retrospectively, as rescue aid the measures undertaken to restore the bank through its initial creation as well as the proposed full capitalisation through *inter alia* the liquidity provided by the State via the subordinated facility agreement. Such aid can only, however, be approved on a temporary and conditional basis. The Authority will assess these measures and any other possible intervention amounting to state aid to Byr¹¹ as structural measures upon receipt of a restructuring or liquidation plan. 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 or alternatively the controlled winding-up of the bank.

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.

It is furthermore recalled that in its decisions of 15 December 2010 to open the formal investigation procedure into state aid granted in the restoration of certain operations of Iceland’s three biggest commercial banks, etc.¹², the Authority stated that it considered it possible that the banks benefitted (indirectly) from the statements made by the Government safeguarding all domestic deposits, as in the absence of the guarantee the new banks could have suffered from a run on their deposits like their predecessors. Accordingly, the Authority had doubts as to whether the guarantee entailed an advantage for the banks. The same applies in the present case. As has been mentioned above, deposits in Byr account for some ISK 148 billion out of the banks total liabilities of approximately ISK [...] billion. While the government statement is aimed at safeguarding confidence of deposit holders, it cannot be

¹¹ In particular, reference must be made to the Authority’s Decision No 76/10/COL of 10.3.2010 to initiate the formal investigation procedure with regard to the transfer of mortgage loans secured against collateral in residential property from financial undertakings to the Housing Finance Fund.

¹² See the Authority’s Decisions No.:
492/10/COL <http://www.eftasurv.int/media/decisions/492-10-COL.pdf>
493/10/COL <http://www.eftasurv.int/media/decisions/493-10-COL.pdf>
494/10/COL <http://www.eftasurv.int/media/decisions/494-10-COL.pdf>

excluded that it will at the same time benefit the bank. In the present case, however, which concerns assessment of temporary measures subject to submission of a restructuring or winding-up plan within 6 months, it is not required to take a position on this measure as it will be assessed in the context of the Authority's final determination on this case.

3.1 Legal basis for assessment of compatibility of the aid measures: the economic crisis in Iceland

While state aid to undertakings in difficulties is normally assessed under Article 61(3)(c) of the EEA Agreement, the Authority may, under Article 61(3)(b) of the Agreement allow state aid “*to remedy a serious disturbance in the economy of an EC Member State or an EFTA State*”. However, as is stated in paragraph 8 of the Banking Guidelines¹³, the Authority reaffirms that, in line with the case law and the European Commission's decision making practice, Article 61(3)(b) of the EEA Agreement necessitates a restrictive interpretation of what can be considered a serious disturbance of an EFTA State's economy.

The Icelandic authorities have in earlier cases notified to the Authority explained that Iceland's financial system entered into a state of systemic crisis in October 2008, leading to the collapse of its major banks as well as major savings banks within a time span of a few days. The combined market share of the collapsed financial institutions exceeded 90% in most segments of the Icelandic financial market. The difficulties were coupled with a breakdown in confidence in the country's currency. Iceland's real economy has been severely hit by the financial crisis. Although more than two years have passed since the onset of the crisis, the Icelandic financial system is still in a state of turmoil *inter alia* due to the ruling of the Supreme Court in June 2010 declaring certain types of foreign currency denominated loans to be unlawful. A general lack of confidence in financial institutions therefore remains a problem to be addressed by the authorities.

In light of the above considerations, the Authority concurs with the view that the collapse of Iceland's main financial institutions has resulted in a serious disturbance in Iceland's economy. While the collapse of Old Byr appears to have been caused partly by serious weaknesses in the bank's own company structure and risk management, the other main reasons were the severe difficulties associated more generally with the current financial crisis. The Authority therefore does not question the argument brought forward by the Icelandic authorities that Byr faced difficulties as a result of the meltdown of Iceland's financial institutions and of the global financial crisis. Consequently, Article 61(3)(b) of the EEA Agreement is considered to apply in this case.

3.2 Conditions for compatibility under Article 61(3)(b) of the EEA Agreement

As stated in paragraph 15 of the Banking Guidelines, the general principles underlying state aid rules of the EEA Agreement 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. Taking due account of current circumstances, all general support measures have to be:

¹³ See Part VIII of the Authority's State Aid Guidelines. Temporary rules regarding financial crisis. The application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, available at <http://www.eftasurv.int/?1=1&showLinkID=16604&1=1>

- necessary and 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 the legitimate aim, and
- designed in such a way as to minimise negative spill over effects on competitors, other sectors and other EEA States.

In the following paragraphs, the Authority will assess the compatibility of the notified measures on the basis of the above criteria.

3.2.1 Necessary and well-targeted measures

The Icelandic authorities have argued that the collapse of New Byr, which is Iceland's fourth biggest bank, would be a severe blow for the financial system and in particular to the confidence of deposit holders in Iceland. Alternative options to address those difficulties such as transfer of Old Byr's assets and liabilities to another bank or winding up New Byr's operations would pose risks to financial stability, be far more expensive for the Icelandic State and distort competition in the national market. State intervention to resolve problems in the operation of New Byr was therefore necessary to contribute to the restoration of the Icelandic economy, keeping the involvement of state resources to the minimum necessary and avoiding severe losses for the Icelandic State.

The measures will enable Byr to retain its banking licence and continue operating as well as to work with the impaired assets to meet the liabilities (deposits) that would otherwise fall on the Icelandic State. Comprehensive restructuring measures, addressing the main causes of Byr's predecessor's difficulties, are to be undertaken, and have partly commenced, with the aim of ensuring the long-term viability of Byr hf.

The Icelandic authorities have submitted that the measures in question represent the least costly alternative available to the State, since the demise of New Byr is likely to activate the State's liability for deposits in the bank and could in addition have spill-over effects on deposit holders in other banks increasing the State's risk.

The adequacy of the foreseen restructuring measures will only be assessed in the context of assessment of Byr's restructuring plan. However, in light of the above, the Authority considers that the measures in question are well-targeted in order to give Byr a temporary respite and enable it to prepare a restructuring plan aimed to secure its long-term viability.

3.2.2 Proportionality

The condition and current situation of New Byr explained in this decision as well as the current state of the Icelandic economy make it impossible for the company to seek funding on the financial markets to ensure sufficient capital and liquidity. The initial share capital of ISK 900 million, which the Icelandic authorities contributed to New Byr, is the minimum capital required for a financial undertaking under Act No 161/2002 on Financial Undertakings. The subordinated loan facility will only be at New Byr's disposal to the extent necessary to meet the CAD requirements laid down by the FME. By making the drawdown on the facility conditional upon the CAD ratio requirements of the company, the Icelandic authorities have ensured that the capital injection does not exceed what is necessary. Thus, the amount of the

capital provided with the two aid measures is limited to the minimum necessary in order to enable Byr to comply with the minimum capital adequacy ratio set by the FME of a total of 16% in Tier I and Tier II capital.

As for remuneration for the initial share capital, the State will be remunerated with possible dividends and the proceeds of its eventual sale of the State's shares in Byr. The State's share capital in Byr will be transferred to the Icelandic State Financial Investments (ISFI)¹⁴, which is the state's holding company on the financial market while reconstruction and restoration of the financial system is still in progress. ISFI aims *inter alia* to ensure that the administration of the holdings is professional and reliable and in line with the state's ownership policy¹⁵ which defines the objectives of the state as the owner of stakes in financial undertakings. This policy aims to ensure a sound and cost-effective use of the substantial financial contributions which the state has made into Icelandic financial undertakings and to secure adequate return on those investments. It shall be noted that Old Byr's option to purchase the Government's stake in New Byr stipulated in the Heads of Terms (cf. section I2.3.2.3 above) and the tag-a-long rights (cf. section I2.3.2.4 above) are likely to support the State's eventual exit from Byr.

According to paragraph 10 of the Banking Guidelines, "*the current circumstances may allow the approval of exceptional measures such as structural emergency interventions, protection of rights of third parties such as creditors, and rescue measures potentially going beyond 6 months.*"

Paragraph 15 of the Restructuring Guidelines¹⁶ states that "*restructuring should be implemented as soon as possible and should not last more than five years to be effective and allow for a credible return to viability of the restructured bank.*" According to Article 84 of the Icelandic Act 161/2002 on Financial Undertakings, a subordinated loan qualifying as Tier II capital must have a repayment period of not less than five years. The article also states that when five years of the loan period remain, the amount of the loan shall be scaled down by 20% for each remaining year. In view of these legal requirements the term of the loan was set at six years, when the full amount of the loan and outstanding interest is to be repaid. The amount and duration of the loan are therefore adjusted to the legally required minimum, as a five year term would require a higher loan amount due to the scale down mentioned above. An extension of the term of the loan could only be possible as a restructuring measure and, according to the Subordinated Facility Agreement, is subject to the Authority's approval.

In so far as remuneration for the subordinated facility is concerned, the interest rate is based on a 3 month EURIBOR/REIBOR, depending on the choice of denomination, plus a margin of 400 basis points per annum, with a step up to 500 basis points after five years. If it is necessary in order to preserve the liquidity position of the bank, New Byr is entitled to postpone interest payment up to six months, in which case an extra 200 basis points are added. Upon each drawdown on the facility, Byr must pay a 1% fee of the total amount drawn.

¹⁴ Information on the ISFI is available at: <http://www.bankasysla.is/en/frontpage/>

¹⁵ Information on the Icelandic State's ownership policy is available at: http://www.bankasysla.is/files/STATE%20OWNERSHIP%20POLICY%2020100811_1803806065.pdf

¹⁶ See Part VIII of the Authority's State Aid Guidelines. Temporary rules regarding financial crisis: chapter on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the state aid rules, available at <http://www.eftasurv.int/media/state-aid-guidelines/Part-VIII---Return-to-viability-and-the-assessment-of-restructuring-measures-in-the-financial-sector.pdf>

The Authority's Recapitalisation Guidelines¹⁷ set out guidance concerning remuneration of state recapitalisation measures in the context of the current financial crisis. The guidelines take account *inter alia* of the Recommendations of the Governing Council of the European Central Bank ("the ECB") of 20 November 2008, which proposed a methodology for benchmarking the pricing of state recapitalisation measures for fundamentally sound financial institutions in the Euro area. The ECB Recommendations placed particular emphasis on the effectiveness of recapitalisation measures with a view to strengthening financial stability and fostering the undistorted flow of credit to the real economy. At the same time, the need for market-oriented pricing and maintaining a level playing field between competing banks was underlined.

The Recapitalisation Guidelines set out the general principles governing different types of recapitalisation providing that "*closeness of pricing to market prices is the best guarantee to limit competition distortions. It follows that the design of recapitalisation should be determined in a way that takes the market situation of each institution into account, including its current risk profile and level of solvency, and maintains a level playing field by not providing too large a subsidy in comparison to current market alternatives. In addition, pricing conditions should provide an incentive for the bank to redeem the State as soon as the crisis is over.*"

The Authority places considerable weight on the distinction between fundamentally sound, well-performing banks on one hand and distressed, less-performing banks on the other. This distinction is important in view of the balance to be achieved between financial stability and competition objectives. In its assessment of recapitalisation measures the Authority therefore pays particular attention to the risk profile of the beneficiary. In principle, banks with a higher risk profile should pay more, while it may be necessary in duly justified cases, to accept lower remuneration in the short term for distressed banks, on the assumption and condition that in the longer term the costs of public intervention in their favour will be reflected in the restructuring necessary to restore viability and to take account of the competitive impact of the support given to them in compensatory measures. Among relevant indicators for determining differentiation of remuneration rates for different banks are compliance with regulatory solvency requirements of the national supervisory authority, pre-crisis CDS spreads and credit ratings.

Based on the ECB Recommendations, the Recapitalisation Guidelines elaborate in further detail a methodology for determining the price of recapitalisation, including by defining the calculation of a 'price corridor' on the basis of different components, reflecting *inter alia* the specific features of the individual institutions and of the EFTA States. As for subordinated debt, this methodology implies that the required rate of return should be determined as the sum of the following components: (i) the government bond yield of the country where the bank is domiciled (i.e. minimum risk represented by the funding cost of the government), (ii) the issuing bank's 5 year CDS spread on subordinated debt over a sampling period starting on 1 January 2007 and ending on 31 August 2008; and (iii) an add-on fee of 200 basis points per annum.

¹⁷ See Part VIII of the Authority's State Aid Guidelines. The recapitalization of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition, available at <http://www.eftasurv.int/?1=1&showLinkId=16015&1=1>

In the present case, assessment of the above requirements is complicated by a lack of information on relevant indicators to determine the appropriate remuneration to be paid by the beneficiary, *inter alia* due to the relatively small size of the financial undertaking involved and particularities of the financial market in Iceland. CDS spreads are not available for Byr nor has the bank been assigned credit ratings. Footnote 4 of the ECB Recommendations states that for banks without CDS data and without credit rating, the calculation of CDS spreads should be based on the Recommendations of the Governing Council of the ECB on government guarantees for bank debt of 20 October 2008, cf. paragraph 8 of that document. The latter recommendations provide that “[f]or banks without CDS data and without a credit rating, an equivalent CDS spread should be derived from the median value of 5 year CDS spreads during the same sampling period for the lowest rating category, based on a representative sample of euro area large banks, which will be defined by the Eurosystem. The calculated CDS spread, for this category of banks, may be adapted on the basis of a supervisory assessment. The total price of the credit guarantee should also include the add-on fee of 50 basis points.”

The interest rate terms of the subordinated facility and in particular the interest rate step up after five years and the additional interest charged when interest payments are postponed are likely to provide an incentive for New Byr to keep the use of the facility to the minimum possible and seek other ways to fund its operation at more favourable rates. It shall be noted that according to Article 12 of the subordinated debt facility, the agreement is subject *inter alia* to terms and conditions set by the EFTA Surveillance Authority, if the facility is found by the Authority to constitute state aid elements. However, information is currently not available to enable the Authority to determine the required remuneration, but this will have to be provided as part of the restructuring plan. As already mentioned above, the measure can only be temporarily approved and such approval is without prejudice to the Authority’s in-depth assessment of the measures, once a restructuring or winding-up plan has been submitted. The Authority will therefore further assess the aid measures, including the required remuneration, as part of its full assessment of the restructuring of the bank.

In view of the above, the Authority considers that the measures are proportionate to the challenge faced and that they do not go beyond what is required to attain their legitimate objective.

3.2.3 Negative spill-over effects

As Byr is active only on the Icelandic market, its main competitors are the three new Icelandic commercial banks, Arion Bank, Landsbankinn and Íslandsbanki. The remaining Icelandic savings banks are not operating in the same market area as Byr and therefore do not compete in the same geographical market. According to the information submitted by the Icelandic authorities, Byr has a market share of 8.8% in the retail market in Iceland as a whole and about 10% in the corporate market.

The Authority takes note of the fact that the Icelandic Competition Authority has found that the three commercial banks, mentioned above, are collectively dominant on the relevant market¹⁸. Termination of Byr’s operations may therefore have a negative impact on

¹⁸ See for instance the Icelandic Competition Authority’s Decision No. 36/2010 of 21.12.2010 on Byr Savings Bank’s takeover of Byr hf. available at: http://www.samkeppni.is/media/samkeppniseftirlit/akvardanir/2010/akvordun_36_2010_yfirtaka_byrs_sparisjods_a_byrhf.pdf

competition on the national market. The negative effects on competition in the EEA are mitigated by the remuneration profile for the subordinated facility discussed above. New Byr contributes from its own resources to its long-term viability through financial and organisational restructuring measures. The Authority notes in particular the burden sharing provided by the fact that Old Byr's guarantee capital owners have lost their investments in full and will not be compensated as well as by the substantial and inevitable write-downs of the claims of Old Byr's creditors.

The Icelandic authorities have committed to submitting a restructuring or a liquidation plan for Byr within six months. This entails a limitation in time of the rescue aid which contributes to limiting the risk of a distortion of competition.

In view of the above, the Authority considers that the measures in question are designed in such a way as to minimise negative spill over effects on competitors, other sectors and other EEA States.

The Authority can therefore temporarily approve the notified aid measure in favour of Byr hf. for a period of up to six months.

4. Conclusion

On the basis of the foregoing assessment, the Authority considers that the rescue aid to Byr which the Icelandic authorities are planning to implement is compatible with the functioning of the EEA Agreement within the meaning of Article 61 of the EEA Agreement.

HAS ADOPTED THIS DECISION:

Article 1

The EFTA Surveillance Authority has decided, on the basis of Article 61(3)(b) of the EEA Agreement, to temporarily approve the notified aid measures in favour of Byr hf. for a period of up to six months from the date of this Decision.

Article 2

The initial share capital contribution of the Icelandic State to Byr hf. involves unlawful aid from the date of its implementation to the date of this decision in view of the failure by the Icelandic authorities to comply with the requirement to notify the Authority before implementing the aid in accordance with Article 1(3) of Part I of Protocol 3 of the Surveillance and Court Agreement.

Article 3

The Icelandic authorities are obliged to submit an in-depth restructuring plan or a liquidation plan for Byr hf. within six months of the date in which the subordinated facility is made available to Byr hf.

Article 4

The implementation of the measures is authorised accordingly.

Article 5

This Decision is addressed to the Republic of Iceland.

Article 6

Only the English language version of this decision is authentic.

Decision made in Brussels, on 13 April 2011.

For the EFTA Surveillance Authority

Sabine Monauni-Tömördy
Acting President

Sverrir Haukur Gunnlaugsson
College Member



Signed version