

Case No: 69146  
Event No: 599706  
Dec No: 127/11/COL

## EFTA SURVEILLANCE AUTHORITY DECISION

of 13 April 2011

on amendments to the rescue aid scheme involving settlement of claims owned by the  
Central Bank of Iceland on savings banks

(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) thereof,

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

HAVING REGARD to Protocol 3 to the Surveillance and Court Agreement (“Protocol 3”), in particular to Article 1(3) of Part I,

Whereas:

### I. FACTS

#### 1. Procedure

The Icelandic authorities notified amendments to the rescue aid scheme involving settlement of claims owned by the Central Bank of Iceland (“the CBI”) on savings banks, pursuant to Article 1(3) of Part I of Protocol 3 by letter of 21 December 2010 (Event No 581546).

By letter of 15 February 2011 (Event No 585041), the Authority requested certain additional information to which the Icelandic authorities responded by letter of 22 February 2011 (Event No 588327). Further clarification was received from the Icelandic authorities by email of 22 March 2011 (Event No 591609).

#### 2. Description of the proposed measures

By Decision No 253/10/COL, the Authority raised no objections to the notified rescue aid scheme involving settlement of claims owned by the CBI on savings banks (“the CBI scheme”).

##### 2.1. The CBI scheme

The CBI scheme involves the settlement of claims that came into the possession of the CBI as a result of the collapse of the financial undertaking Sparisjóðabanki Íslands hf.

(“SPB”).<sup>1</sup> The scheme aimed at ensuring that five savings banks meet their regulatory capital requirements, while at the same time maximising the value of the CBI’s claims on the savings banks.

The five savings banks concerned by the CBI scheme are the following:

- Norðfjörður Savings Bank,
- Vestmannaeyjar Savings Bank,
- Svarfdælar Savings Bank,
- Bolungarvík Savings Bank and
- Þórshöfn Savings Bank.

The Icelandic authorities had indicated that as a result of the financial crisis, the capital ratios of the savings banks had dropped significantly and that without state intervention, the operational licence of the five savings banks would have to be revoked leading to their liquidation.

The Icelandic authorities have underlined that the savings banks have formed an integral and important part of the country’s financial system for decades. The savings banks conduct operations in retail banking in rural regions throughout Iceland, accounting for a significant share of customer deposits and lending outside the capital region with a focus on regional development.

The measures that were approved by the Authority by its Decision of 21 June 2010 entail rescue aid and financial restructuring of the five savings banks. In their notification, the Icelandic authorities committed themselves to notify to the Authority plans for restructuring of the savings banks at the latest by 21 December 2010.

## **2.2. The judgments of the Supreme Court of Iceland**

By two judgments on 16 June 2010 in Cases No. 92/2010 and No. 153/2010, the Supreme Court of Iceland ruled that loans in Icelandic krónur linked to the exchange rate of foreign currencies were illegal. Such loans were common on the Icelandic financial market. While the Supreme Court did not address the question whether other forms of indexation could be applied to the loans or what interest rates should be applied to the same loans once they were denominated in the Icelandic currency, the verdicts in the two cases nevertheless had a severe impact on loans of financial undertakings on the Icelandic market with repayment value linked to foreign currencies. It became evident that the book value of the savings banks’ assets in the form of such loans had become uncertain and would decline in value as a result of the rulings since the loans would need to be recalculated. The planned financial restructuring of the savings banks could consequently not be finalised until the effects of the judgments on the capital of the savings banks had been determined.

On 16 September 2010, the Supreme Court passed a judgment which clarified how to calculate interest on loans which had been declared illegally indexed to foreign currency exchange rates by the judgments of 16 June 2010.

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<sup>1</sup> See Decision No 253/10/COL for a detailed description of the scheme that was temporarily approved by the Authority for a duration of six months.

The representatives and auditors of the savings banks finalised assessments of the impact of the capital positions of the savings banks. These assessments formed the basis for a new proposal which was introduced to creditors and accepted in the second semester of 2010. For these banks that had a significant part of their portfolio in loans in Icelandic krónur linked to the exchange rate of foreign currencies, the CBI and other creditors postponed the implementation of financial restructuring measures until all uncertainties regarding value assessment were cleared.

Norðfjörður Savings Bank only held few illegally indexed loans and therefore the rescue aid measures regarding that bank were successfully implemented on 28 July 2010.

In the case of Bolungarvík Savings Bank, other creditors were obliged to undergo further write-downs of their claims but the CBI did not undertake any amendments to the settlement of its claims. The rescue aid measures regarding Bolungarvík Savings Bank were implemented on 22 September 2010.

The settlement of the CBI claims had to be reviewed with regards to the following three savings banks:

- Vestmannaeyjar Savings Bank,
- Þórshöfn Savings Bank,
- Svarfdælir Savings Bank.

### **2.3. The notified changes to the CBI scheme**

#### **2.3.1. The described changes**

The Icelandic authorities therefore notified amendments to the rescue measures that had been temporarily approved by the Authority. The notified measures are described in more detail here under for each of the three savings banks.

##### *2.3.1.1 Vestmannaeyjar Savings Bank*

The judgment of the Supreme Court resulted in an additional ISK 400 million loss for the bank. To maintain the minimum capital adequacy required by the Icelandic Financial Supervisory Authority (“the FME”), the savings bank’s capital needed to be increased by ISK 399 million.

The CBI and the other creditors therefore had to undergo an additional write down of the claims representing a total amount of ISK 399 million. The claims of the creditors were written down *pro rata* and the share of the state ownership consequently remained at 55,3% as previously notified.

The rescue measures were finalised on 16 December 2010 and the State’s share in the savings bank was transferred to the Icelandic State Financial Investments (“the ISFI”)<sup>2</sup> on the same day.

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<sup>2</sup> The ISFI is a state agency responsible for holding and administering state holdings in financial institutions according to law, good administration and business practices as well as the Icelandic State’s ownership policy.

### 2.3.1.2 Þórshöfn Savings Bank

The Supreme Court judgment resulted in an additional ISK 320 million loss for the bank. In order to meet the minimum CAD ratio of 16% the savings bank's capital needed to be increased by ISK 311 million. The CBI and the Icelandic Regional Development Institute (Byggðastofnun), both public sector entities, were the only creditors of the savings bank.

The CBI undertook an additional write-down of its claims in the amount of ISK 251 million. In addition to the earlier write-down of ISK 561 million, the CBI's total write-down was therefore ISK 812 million. The remaining amount of CBI's claims of ISK 105 million was converted into guarantee capital. The Savings Banks' Guarantee Fund<sup>3</sup> contributed ISK 60 million to the savings bank and as a result holds 23,2% of the bank's guarantee capital.

Despite the above measures, the savings bank is ISK 19 million short of fulfilling FME's capital adequacy requirements. To react to this situation, the savings bank is aiming at a later stage to sell its shares in the securities firm Íslensk verðbréf hf. In the meantime, it has been proposed that the CBI's Holding Company (Eignasafn Seðlabanka Íslands) will issue a subordinated loan to the savings bank amounting to ISK 19 million. The loan will have a term of six years. Only interest will be paid in the first year, but after that, repayment will take place semi-annually in ten equal instalments. The loan will be indexed to the consumer price index and will carry an interest rate of 12% *per annum*. Provided the FME agrees, the loan may be prepaid any time during its term.

### 2.3.1.3 Svarfdællir Savings Bank

The judgment of the Supreme Court resulted in an additional ISK 70 million loss for the savings bank. The savings bank sold its share in Valitor Holding which yielded a profit of ISK 35 million. As a result of the sale the bank's capital base and CAD ratio improved, implying that it fulfilled the 16% capital requirement made by the FME and no further write-downs were needed.

However, during the financial restructuring, it appeared that the shares which the savings banks held in financial undertakings were considered to have been over estimated. As a result, it transpired that the savings bank is currently ISK 20 million short of fulfilling the FME requirements. The savings bank is seeking ways to finance itself on the market, which is expected to open up in the coming months. In the meantime, it has been proposed that the CBI's Holding Company will issue a subordinated loan to the savings bank in the amount of ISK 20 million. The terms of the loan will be identical to those applicable to Þórshöfn Savings Bank.

## 2.3.2. The submission of restructuring plan

In addition to the modification of the settlement of the claims for the three savings banks mentioned above, the Icelandic authorities notified the proposed extension of the deadline for submitting a restructuring plan for each of the five savings banks to 30 April 2011.

## II. ASSESSMENT

### 1. The presence of state aid

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

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<sup>3</sup> The Savings Banks' Guarantee Fund is a reserve fund run by the savings banks without support or involvement of the Icelandic State.

*“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 above provision implies that in order for a measure to qualify as state aid it needs to meet all conditions considered in sections 1.1 – 1.3 below.

### **1.1. Presence of state resources**

The aid measure must be granted by the State or through state resources. The Authority notes that the notified measures are to be undertaken by the CBI Holding Company, owned by the Icelandic State. The CBI is in charge of monetary policy implementation in Iceland. It is ultimately under the administration of the Prime Minister and a supervisory board. For the same reasons, the CBI Holding Company is also a state owned entity. Consequently, state resources are involved as the measures are financed by state entities.

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

Firstly, the aid measure must confer to the beneficiaries advantages that relieve them of charges that are normally borne from their budget. The Authority considers that this condition is met as the savings banks will be able to absorb impairments of their assets and to avoid insolvency whereas their competitors faced with similar difficulties will have to absorb such losses without government support.

Secondly, the aid measure must be selective in that it favours “*certain undertakings or the production of certain goods*”. The Authority considers that the measures are selective as they only benefit the savings banks in question.

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

The aid measure must distort competition and affect trade between the Contracting Parties to the EEA Agreement.

The savings banks focus on providing financial services to individuals and SMEs in the region where they are located. While the scale of the savings banks’ operations is modest<sup>4</sup>, the measures nevertheless aim to enable the banks to continue operations. They will thus improve their competitive position compared to other market operators. Furthermore, financial services are traded widely across borders within the EEA and according to Article 36 of the EEA Agreement, there shall be no restrictions on freedom to provide *inter alia* financial services within the EEA. Consequently, the measures are liable to distort competition and affect trade between the Contracting Parties.

## **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 submitted a notification of the amendment to the rescue aid scheme involving settlement of claims owned by the CBI together with a request to extend

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<sup>4</sup> The scale of financial undertakings’ operations is commonly measured by the size of their balance sheets. At the end of 2009, the total assets of each of the five savings banks ranged between ISK 2 888 million (approximately EUR 18 million) and ISK 15 396 (approximately EUR 97 million).

the deadline to submit restructuring plans to 30 April 2011 with a letter dated 21 December 2010 (Event No 581546). By submitting a notification of the measure, the Icelandic authorities have complied with the notification requirement. However, the Icelandic authorities put the amendments into effect before the Authority had taken its final decision on the case. The Authority therefore concludes that the Icelandic authorities have not respected their obligations pursuant to Article 1(3) of Part I of Protocol 3.

### 3. Compatibility of the aid

The Authority will consider the three different measures involved, namely: the additional write down of claims, the conversion of claims into guarantee capital and the grant of a subordinated loan by CBI Holding Company.

#### 3.1. Claims written down and converted to guarantee capital

The Authority does not consider that the change in the amount of the claims written down and converted to guarantee capital (see above Section 2.3.1) has any impact on the compatibility assessment carried out in Decision No 253/10/COL.

#### 3.2. Claims converted to subordinated loans

The main diversion from the earlier settlement is to be found in the conditions of CBI Holding Company's grant of subordinated loans. The beneficiaries of the subordinated loans under the new conditions are Þórshöfn Savings Bank and Svarfdælir Savings Bank.

In order to bridge their capital needs and to ensure that the banks will be able to comply with the minimum equity requirements of 16% determined by the FME, the CBI Holding Company proposes to provide Þórshöfn Savings Bank with a subordinated loan with a term of six years in the amount of ISK 19 million (EUR 118 000) and Svarfdælir Savings Bank a corresponding loan in the amount of ISK 20 million (EUR 124 000). The loan amounts will be indexed to the consumer price index and will carry an interest rate of 12% *p.a.*, *i.e.* the real rate of interest is 12% *p.a.*

The Authority's Chapter of the State Aid Guidelines on the Recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortion of competition ("the Recapitalisation Guidelines")<sup>5</sup> sets out guidance concerning remuneration of state recapitalisation measures in the context of the current financial crisis. The Recapitalisation 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*

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<sup>5</sup> Available on the Authority's website at: <http://www.eftasurv.int/?1=1&showLinkID=16015&1=1>

*addition, pricing conditions should provide an incentive for the bank to redeem the State as soon as the crisis is over.”*

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)<sup>6</sup>, (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.

In the present case, assessment of the above requirements is complicated by lack of relevant information, on the one hand, due to particularities of the Icelandic financial market and on the other hand, the small size of the financial undertakings involved. No CDS spreads are available for the two banks nor have the banks 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<sup>7</sup>, 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.”

For the present purposes, however, the Authority does not consider it necessary to make a precise determination on the basis of the relevant assessment criteria reviewed above. According to the notification, the proposed subordinated loans will carry a real rate of interest of 12% *p.a.* The interest rate terms of the subordinated loan offered by the CBI Holding Company to the savings banks of 12% real rate of interest appear to be above the minimum rates required by the ECB Recommendations. Such terms are also stringent compared to the banks’ alternative sources of funding on the Icelandic market. The remuneration can therefore be considered to meet the test of closeness of pricing to market prices and not to provide an excessive subsidy to the beneficiaries. Given that the banks would be paying higher rates on the loans than they would be able to charge on their own lending<sup>8</sup>, there is a clear incentive for them to minimise the use of this facility and redeem the State as soon as possible. Furthermore, the Authority takes note of the fact that the CBI Holding Company considers the measure at issue to be the most appropriate

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<sup>6</sup> The government bond yield would be computed as the sum of (i) the average yield on the EMU benchmark 5-year bond over the 20 business days prior to the capital injection, and (ii) the average sovereign yield spread for the country of domicile of the financial institution over the reference period 1 January 2007 through 31 August 2008. The European Commission has used the German 5 year government bond yield as the EMU benchmark 5-year bond.

<sup>7</sup> The lowest rating category to be considered is A, as there is no sufficient data available for the rating category BBB.

<sup>8</sup> According to a list applicable as from 1 March 2011, interest rates on indexed term deposits vary between 2,2% and 3,3%. As for indexed loans offered on fixed rates, the interest rates vary between 5,9% and 7,9%, while the current interest rate on indexed housing loans is 5,1%.

alternative for the two banks to meet their capital requirements. In light of these facts, the Authority considers that the remuneration is compatible with the requirements of its Recapitalisation Guidelines and Article 61(3)(b) of the EEA Agreement.

The Authority considers that the notified amendments do not affect the compatibility assessment it carried out in the decision 253/10/COL of 21 June 2010 on the rescue aid scheme involving settlement of claims owned by the CBI on savings banks.

#### **4. Extension of the deadline to submit restructuring plans**

In addition to the notified amendments to the measures regarding the settlement of claims, the Icelandic authorities have requested the extension for the deadlines for submitting restructuring plans for each of the five savings banks concerned by Decision No 253/10/COL of 21 June 2010 until 30 April 2011.

The Authority, in the light of the severe difficulties the Icelandic financial sector is still faced with, grants the Icelandic authorities the requested extension of the deadline to submit a restructuring or a liquidation plan and takes note of their commitment to submit such a plan for each of the five savings banks mentioned in Decision No 253/10/COL by 30 April 2011.

#### **5. Conclusion**

On the basis of the foregoing assessment, the Authority considers that the amendments to the rescue aid scheme involving settlement of claims owned by the CBI on savings banks are compatible with the functioning of the EEA Agreement within the meaning of Article 61(3)(b) of the EEA Agreement.

The Authority regrets, however, that the Icelandic authorities did not respect their obligations pursuant to Article 1(3) of Part I of Protocol 3.

The Icelandic authorities are reminded about the obligation resulting from Article 21 of Part II of Protocol 3 in conjunction with Articles 5 and 6 of Decision No 195/04/COL to provide annual reports on the implementation of the scheme.

The Icelandic authorities have committed to submit an in-depth restructuring plan or a liquidation plan for each of the savings banks at the latest by 30 April 2011.

The Icelandic authorities are also reminded that all plans to modify this scheme must be notified to the Authority.

HAS ADOPTED THIS DECISION:

#### *Article 1*

The notified measures involve unlawful state aid from 21 December 2010 to the date of this decision in view of the failure by the Icelandic authorities to comply with the requirement to notify the Authority before implementing the aid in accordance with Article 1(3) of Part I of Protocol 3.

*Article 2*

The EFTA Surveillance Authority has, however, decided to temporarily approve the notified amendments to the rescue aid scheme involving settlement of claims owned by the Central bank of Iceland on savings banks until 30 April 2011.

*Article 3*

The Icelandic authorities are obliged to submit an in-depth restructuring plan or a liquidation plan for each savings bank benefiting from the scheme at the latest by 30 April 2011.

*Article 4*

This Decision is addressed to the Republic of Iceland.

*Article 5*

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