Case No: 67159
Event No: 558811
Dec. No: 253/10/COL

EFTA SURVEILLANCE AUTHORITY DECISION
Of 21 June 2010
on 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) and Protocol 26 thereof,

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

HAVING REGARD to Article 1(3) of Part I and Article 4(3) of Part II of Protocol 3 to the Surveillance and Court Agreement ("Protocol 3"),

HAVING REGARD to the Authority's Guidelines on the application and interpretation of Articles 61 and 62 of the EEA Agreement[1], and in particular the Guidelines on the application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis ("the Banking Guidelines") and the Guidelines on the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition ("the Recapitalisation Guidelines"),

HAVING REGARD to the consolidated version of the Authority's Decision of 14 July 2004 on the implementing provisions referred to under Article 27 of Part II of Protocol 3 ("the Implementing Provisions Decision")[2],

Whereas:

[1] Guidelines on the application and interpretation of Articles 61 and 62 of the EEA Agreement and Article 1 of Protocol 3 to the Surveillance and Court Agreement, adopted and issued by the Authority on 19 January 1994, published in the Official Journal of the European Union (hereinafter referred to as OJ) L 231 of 03.09.1994 p. 1 and EEA Supplement No 32 of 03.09.1994 p. 1. Hereinafter referred to as the State Aid Guidelines. The updated version of the State Aid Guidelines is published on the Authority's website: http://www.eftasurv.int/state-aid/legal-framework/state-aid-guidelines/

[2] Decision 195/04/COL of 14.7..2004 published in OJ C 139 of 25.05.2006 p. 57 and EEA Supplement No 26 of 25.05.2006 p. 1 as amended.
Consolidated version available at: http://www.eftasurv.int/media/decisions/195-04-COL.pdf

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I. FACTS

1. Procedure

Pursuant to Article 1(3) of Part I of Protocol 3, and following pre-notification contacts with the Authority, by letter of 10 June 2010 (Event No 559892), the Icelandic authorities notified a scheme relating to the settlement of claims owned by the Central Bank of Iceland (”the CBI”) on savings banks (“the CBI scheme – Part I”).

2. Description of the proposed measures

2.1. The background

In October 2008, the Icelandic financial system entered into a state of systemic crisis. Three of Iceland’s major banks, Kaupþing 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.

On 6 October 2008, the Icelandic Parliament passed Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances (“the Emergency Act”). The Emergency Act gives the Minister of Finance and the Financial Supervisory Authority (the “FME”) extensive powers of intervention into the operations of financial institutions in Iceland.

Under the powers provided by the Emergency Act, the FME took control of the three biggest Icelandic banks, Glitnir, Landsbanki and Kaupþing. Three new state-owned banks were established to take over the domestic assets, liabilities and operations of the old banks, while the three old banks entered a winding-up procedure headed by resolution committees. The Icelandic authorities have explained that the collapse of the three major banks unavoidably had contagious effects on the smaller financial undertakings in Iceland and on the economy as a whole.

As long-standing financial institutions in Iceland, savings banks serve as fundamental institutions for deposit and lending operations in local communities across Iceland. Savings banks were hit hard by the financial and economic crisis.[3] First, the economic collapse had a major effect on the ability of many debtors in Iceland to service their debt. Inflation rose sharply, interest rates shot up and debt in foreign currency soared, due to sharp depreciation of the Icelandic króna. This rapidly led to defaults by debtors, causing severe liquidity problems, subsequent write-offs and loss on balance sheets for the savings banks. Second, as the Icelandic Stock Exchange caved in, assets of many savings banks in the form of shares in companies registered on that market became more or less worthless. Third, financial instruments issued by the three major banks became nearly worthless, but many of the savings banks held such securities on their books.

[3] The largest savings bank, Sparisjóður Reykjavíkur og nágrennis (“SPRON”) was appointed a Resolution Committee by the FME on 21.3.2009, having failed to undergo a viable financial reorganisation. On the same day, Sparisjóðabanki Íslands hf. (SPB), a bank which served as a clearinghouse for savings banks in Iceland, was also brought under public administration by decision of the FME to dispose of its assets and liabilities to New Kaupthing Bank hf. and the CBI as well as by decision of the FME on 27.3.2009 to appoint SPB a Resolution Committee. Furthermore, the savings bank Sparisjóður Mýrarsýslu (SPM) was appointed an interim board by a decision of the FME dated 2.7.2009. On 23.4.2010, the FME decided to take control of the savings banks Byr and Keflavík Savings Bank, following rejection by certain creditors of a proposal for debt restructuring.

Moreover, most savings banks owned shares in Sparisjóðabanki Íslands hf. ("SPB", earlier named Icebank) which was taken over by the FME on 21 March 2009. SPB, a limited liability company founded in 1986 by 38 Icelandic savings banks, served a fundamental role for the savings banks. Operating under a commercial bank licence, SPB acted as a central servicing bank for the savings banks, provided access to international sources of credit, foreign and domestic settlement systems and other banking services. SPB held a large portfolio of bonds issued by the other commercial banks and was therefore severely hit by their collapse.

The Icelandic authorities have explained that many of the savings banks had taken loans from SPB in foreign currency and relent to their local customers. Since the start of the crisis, a considerable proportion of such loans have been written off as debtors have declared bankruptcy or become unable to pay the loans, which have in many cases doubled in value due to the depreciation of the Icelandic krona. This led to severe disruption in the balance of assets and liabilities in most savings banks, causing equity to fall, in some instances below the minimum requirements under laws and regulations on financial undertakings.

Following the collapse of SPB on 21 March 2009, the FME made the CBI responsible for the savings banks' deposits in SPB. As compensation, the CBI received SPB's claims on the savings banks. In April 2009, an agreement was signed between the CBI and BYR Savings Bank ("BYR") providing for the take over by the latter of SPB's role regarding services due to the payment and settlement systems on behalf of the savings banks. However, following the collapse of BYR in April 2010, responsibility for the savings banks' deposits and services regarding payment systems was transferred to Byr hf., the undertaking which took over the assets and obligations of BYR Savings Bank.

2.2. The objective of the CBI scheme – Part I

The CBI scheme – Part I involves settlement of claims that came into the possession of the CBI as a result of the collapse of the financial undertaking SPB. The scheme aims at ensuring that the five savings banks meet their regulatory capital requirements, while at the same time maximizing the value of the CBI's claims on the savings banks. In the view of the Icelandic authorities, this should contribute to the sustainability of savings banks, strengthening them as viable and important financial undertakings in Icelandic society.

As a result of the financial crisis, the capital ratios of the savings banks dropped significantly. Without state intervention, the operational licence of the five savings banks would have to be revoked leading to their liquidation.[4]

2.3. Savings banks and their importance

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.

In the CBI's 2009 Financial Stability Report, the role of the savings banks is described in the following manner (p. 66):

[4] The FME has repeatedly granted the savings banks suffering from capital ratios below the legal minimum a time limit for them to bring the ratio back to the required legal minimum.

"*Savings banks are numerous but small in comparison with the commercial banks. Together, their assets now constitute roughly one-fifth of total assets of the banking system. In spite of their small size, they render essential financial services in many rural locations in Iceland, as well as providing the commercial banks with important competition. The savings banks vary in terms of their financial position. The strongest among them are some of those operating in geographical areas where the recent upswing made little of the impact seen in the greater Reykjavík area.*"

The Icelandic authorities are of the view that the collapse of one or more of the remaining savings banks would undermine public trust in the financial system which the State has been striving to re-build as well as trust in deposit guarantees.

The Icelandic Competition Authority (Samkeppniseftirlitið, "SE") has given its view on the importance of savings banks in its Decision No. 50/2008 of 26 September 2008 on the proposed merger of Kaupthing and SPRON and the purchase by Kaupthing of Mýrasýsla Savings Bank (SPM). In a summary of the decision, the SE described the role of the savings banks in the following manner.[5]

"*The aggregate market share of [the three large commercial banks] is between 65-85% in commercial banking for individuals and corporate banking for smaller businesses. SPRON's share is little less than 10%. SPRON and other savings banks have in some ways differentiated themselves by their market behaviour and thus contributed to a more active competition than if only the three commercial banks had been operating in the market. The fact that SPRON will disappear from the market as an independent competitor will strengthen the oligopoly of the three commercial banks and is capable of causing consumers and businesses harm as competition is concerned.*"[6]

2.4. The profile of the savings banks beneficiaries of the CBI scheme – Part I

At the time of notification to the Authority, eight savings banks remain operational in Iceland. According to the Icelandic authorities, these savings banks currently account for less than 2% of the domestic banking market with a work force of 80 employees. While the CBI scheme – Part I is in principle open to any savings bank meeting the conditions of the scheme, the Icelandic authorities have indicated that only five banks will effectively be covered by the scheme.

As a result of the recent financial turmoil, the capital ratios of the savings banks have suffered. Without state intervention, the operational licence of the savings banks to be covered by the CBI scheme – Part I would have to be revoked and the savings banks required to wind down their operations and liquidate.

The FME has presented requirements for the sustained viability of the five savings banks that require financial restructuring. These requirements are considered in some detail in section II.3.3 below. By letters to the five savings banks, dated 23 and 24 March and 7 April 2010, the FME confirmed that the five savings banks will, after the proposed financial restructuring, fulfil the FME's requirements for viability, although pointing out

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[5] Unofficial translation into English by the Icelandic Ministry of Finance.

[6] This assessment of the SE was made in September 2008, when the bigger savings banks, SPRON, SPM, Byr and SPK were still operational. As has been explained by the Icelandic authorities, the combined market share of the remaining smaller savings banks is currently much smaller or close to 2%.

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that in absolute terms the equity of four of the five banks remains below the legally prescribed minimum of Euro 5 million.[7] The five savings banks in question are:

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

The following table presents key figures on the financial situation of the five savings banks at year end 2009 and provides their capital structure and CAD ratios at that time:

Savings Banks – Financial Statements at Year-End 2009
Numbers are in ISK millions and EUR millions. EURISK rate is 164,38.

	Bolungarvík savings bank	Svarfdælir savings bank	Norðfjörður savings bank	Þórshöfn savings bank	Vestmannaeyjar savings bank	Totals	Totals in EUR
Statement of Comprehensive Income (Income Statement)							
Net Operating Income	-103	-167	102	-58	304		
Salaries and Related Expense	90	56	64	66	178		
Other Operating Expense	208	109	95	94	216		
Impairment of Assets	2,231	231	189	203	1,149		
Extraordinary and Non-Recurring Items	-	229	-	-	-		
Earnings Before Income Tax	-2,632	-334	-245	-421	-1,240		
Income Tax	372	64	62	48	189		
Net Earnings	-2,260	-270	-183	-373	-1,051		
Statement of Financial Position (Balance Sheet)							
Cash and Balances with the Central Bank	701	27	24	42	3,011		
Loans and Receivables to Credit Institutions	129	961	2,140	709	3,354		
Loans and Receivables to Customers	3,618	2,733	2,884	1,492	7,616		
Bonds and Debt Instruments	1,654	32	138	421	460		
Shares and Equity Instruments with Variable Income	148	298	65	49	223		
Investments in Associates	24	17	14	6	43		
Intangible Assets	-	-	-	-	-		
Tax Assets	452	64	146	125	250		
Other Assets	120	63	142	45	439		
Total Assets	6,846	4,194	5,551	2,888	15,396	34,875	212
							-
Due to Credit Institutions and the Central Bank	3,876	725	559	915	2,215	8,290	50
Deposits	3,758	3,457	4,382	2,263	12,127	25,986	158
Borrowings	522	-	179	-	797	1,498	
Subordinated Debt	368	207	196	133	385	1,290	
Other Liabilities	351	42	113	56	561	1,123	
Total Liabilities	8,875	4,431	5,429	3,366	16,085	38,187	232
Guarantee Capital	791	651	484	2	357		
Reserves and Retained Earnings	-2,821	-888	-361	-480	-1,047		
Total equity	-2,029	-237	123	-478	-690	-3,311	-20
Total Liabilities and Equity	6,846	4,194	5,551	2,888	15,396	34,875	212
Capital Structure – 31.12.2009							
Guarantee Capital	791	651	484	2	357	2,285	14
Retained Earnings	-2,821	-888	-361	-480	-1,047	-5,596	-34
Total Equity	-2,029	-237	123	-478	-690	-3,311	-20
CAD Ratio – 31.12.2008	2.4%	-10.8%	-0.9%	-11.7%	3.8%		
CAD Ratio – 31.12.2009	-48.7%	-15.2%	4.7%	-25.3%	-8.3%		

The Icelandic authorities have indicated that they consider the savings banks concerned to be financially sound. They point out that the savings banks were not suffering from structural difficulties before the global financial crisis hit in autumn 2008. They consider that the savings banks should be described as fundamentally sound institutions, but that their financial position was heavily impacted by the financial crisis. They should therefore be distinguished from financial institutions that suffer from more structural solvency problems.

[7] This qualification does not apply to Vestmannaeyjar savings banks, whose total equity will amount to ISK 1,056 million (Euro 6.4 million) following capital restructuring.

2.5. The CBI scheme – Part I and financial restructuring

2.5.1. The measures and their remuneration

The measures entail rescue aid and financial restructuring of five savings banks. In their notification the Icelandic authorities commit themselves to notify to the Authority plans for restructuring of the savings banks within six months from the date of notification or as otherwise agreed upon between the Authority and the Icelandic authorities.

The proposed measures are defined in the CBI's Governor's draft decision of 22 January 2010 where the CBI has offered savings banks the possibility to negotiate settlement of their claims on terms and conditions stipulated in the draft decision. A distinction is made between two situations.

Firstly, where the CBI is a small creditor of individual savings banks, the CBI would agree to write off claims, provided that negotiations with other creditors and the Government would lead to that outcome.

Secondly, where the CBI is among the main creditors, which is the case for the five savings banks at issue, the CBI has made it a condition for its participation in the financial restructuring that other creditors, including other savings banks, participate in the same manner. In this regard the CBI has required the savings banks to ensure that other creditors with long-term claims also participate in financial restructuring in the same manner as the CBI. Following restructuring, the savings banks will withdraw their applications for a capital injection from the State on the basis of Art. 2 of the Emergency Act.[8]

Looking at the savings banks' combined liabilities at year-end 2009, deposits account for 68% and CBI claims amount to 21.7% of total liabilities. Other creditors account on average for 3.9% in the form of borrowings, 3.4% in subordinated debt and 2.9% in other liabilities. While the composition of creditors varies from one savings bank to the other, the CBI is the major creditor in all instances.

The CBI has negotiated with each savings bank a draft agreement on financial restructuring. Where relevant, these agreements are conditional upon approval of other creditors on a particular treatment of their claims. For two of the five banks, agreements cover general unsecured creditors (borrowings) other than the CBI, amounting in total to ISK 1 319 million (EUR 8 million). In the first case these claims are converted to subordinated debt (55%), to general unsecured debt (35%) and settled in cash (10%). In the second case, general unsecured credits are converted to guarantee capital (19%), to subordinated debt (10%), retained in unsecured debt (29%), settled in cash (13%) and written off (29%).

All agreements cover subordinated creditors (other than the CBI), amounting in total to ISK 1 518 million (EUR 9 million). While the settlement of this debt varies somewhat from one bank to the other, it includes in all instances write offs. On average, 49% of such claims of other creditors are to be written off, according to the draft agreements.

Turning now to the CBI claims, depending on the claim on each of the savings bank in question and its capital structure, the CBI's claims, amounting in total to ISK 8 293 million (EUR 50 million), will be settled using one or more of the instruments outlined

[8] According to this provision the Minister of Finance was authorized to provide savings banks with capital injection amounting to up to 20% of their equity. In return the Treasury was to receive guarantee capital shares corresponding to its contribution. The Icelandic authorities have confirmed that no capital injections have been made on the basis of this provision.

below. The proposed treatment of the CBI's claims as well as the negotiated financial restructuring is summarised in the following table, which also shows the capital structure and capital ratios post restructuring:

Savings Banks – Treatment of CBI's Claims & Capital Structure

Numbers are in ISK millions and EUR millions. EUR/ISK rate is 164,38.

	Bolungarvík savings bank	Svarfdælir savings bank	Norðfjörður savings bank	Þórshöfn savings bank	Vestmannaeyjar savings bank	Totals*	Totals in EUR*
Treatment of CBI's claims							
Converted to guarantee capital	543	382	150	250	555	1,880	11
Converted to subordinated debt	-	-	140	106	310	556	3
Converted to general unsecured debt	620	-	-	-	850	1,471	9
Settled in cash	388	-	-	-	-	388	2
Written down	2,326	343	269	561	500	3,999	24
CBI's claims in total	**3,877**	**725**	**559**	**917**	**2,215**	**8,293**	**50**
Treatment of CBI's claims – In Percentage Terms							
Converted to guarantee capital	14%	53%	27%	27%	25%		
Converted to subordinated debt	-	-	25%	12%	14%		
Converted to general unsecured debt	16%	-	-	-	38%		
Settled in cash	10%	-	-	-	-		
Written down	60%	47%	48%	61%	23%		
CBI's claims in total	**100%**	**100%**	**100%**	**100%**	**100%**		
Change in Guarantee Capital							
Guarantee Capital – 31.12.2009	791	651	484	2	357	2,285	14
Write-down of Guarantee Capital	761	608	202	-	257	1,829	11
Write-down of Guarantee Capital – %	96.2%	93.5%	41.8%	-	72.0%		
Increase in Guarantee Capital – Credit Inst. & The CBI	543	382	150	250	555	1,880	11
Increase in Guarantee Capital – General Unsecured Creditors	-	-	-	-	149	149	1
Increase in Guarantee Capital – Subordinated Creditors	92	-	159	88	49	389	2
Increase in Guarantee Capital – Other Parties (Capital Injection)	-	-	35	-	150	185	1
Guarantee Capital post restructuring*	**665**	**424**	**626**	**341**	**1,004**	**3,060**	**19**
Guarantee Capital Holdings Post Restructuring							
Central Bank of Iceland	81.6%	90.0%	24.0%	73.4%	55.3%		
Current Guarantee Capital Holders	4.6%	10.0%	10.0%	0.6%	10.0%		
Public Sector Entities (Byggðastofnun)	9.8%	-	25.5%	26.0%	-		
Creditors	4.1%	-	-	-	19.8%		
Other Parties	-	-	40.6%	-	14.9%		
Guarantee Capital Holdings Post Restructuring	**100%**	**100%**	**100%**	**100%**	**100%**		
Capital Structure Post Restructuring							
Guarantee Capital	665	424	626	341	1,004		
Reserves and Retained Earnings	- 1.2	-	0.2	0.3	52		
Total equity	**664**	**424**	**626**	**341**	**1,056**		
Capital Ratio Post Restructuring							
Tier 1 equity	12.1%	14.7%	19.0%	14.8%	12.3%		
Tier 2 equity	6.1%	2.1%	3.6%	2.9%	4.7%		
CAD Ratio Post Restructuring	**18.20%**	**16.80%**	**22.60%**	**17.67%**	**17.00%**		

The general approach to the debt restructuring can be outlined as follows. The CBI, along with other creditors, first of all proposes to require a write-down of guarantee capital of existing owners in full or almost in full, in order to amend negative reserves. After write-down of guarantee capital, if not sufficient to amend negative reserves, the CBI and other creditors will proportionally write down claims until negative reserves are amended. Subsequent to the two measures above, creditors, including the CBI, will convert claims into guarantee capital on the one hand (Tier 1 equity) and subordinated loans on the other hand (Tier 2 equity), bringing the savings bank up to the requirements set by the FME on equity and CAD ratio. Any claims left after these measures have been implemented are converted to general loans.

The Icelandic authorities underline that a contribution of both the current owners as well as other creditors of the banks is a condition for the participation of the CBI in the financial restructuring. The restoration of viability of the savings banks first and foremost entails necessary financial restructuring.

The individual measures of the CBI scheme – Part I are outlined in more detail below.

<u>Claims converted to guarantee capital</u>

A certain portion of CBI claims will be converted to guarantee capital. All guarantee capital shares owned by the CBI will be taken over by the Ministry of Finance. The

Icelandic State Financial Investments (Bankasýsla ríkisins, the "ISFI")[9] will be responsible for administering the State's holdings in the savings banks.

Remuneration will be in the form of dividend payments and/or the sale of the guarantee capital when market conditions permit. As will be discussed further below, the ISFI has in this respect proposed an arrangement on the possible redemption rights of savings banks and the price that the State should require in such transaction.

Claims converted to subordinated debt

Subordinated loans will be granted for seven years. Remuneration will be in the form of capital income as set out below:

a. For loans in foreign currency: 400 bp premium on LIBOR interest rates for the first two years. The premium rises to 500 bp at the end of that period.

b. For loans in ISK: 300 bp premium on REIBOR interest rates for the first two years. The premium rises to 400 bp at the end of that period.

Claims converted to a general loan agreement

The duration of general loans will be five years. The borrower may pay down or pay off a general loan at any time at no extra charge. Remuneration will be in the form of capital income as defined below:

a. General loan in foreign currency, w/o collateral: 350 bp premium on LIBOR interest rates.

b. General loan in foreign currency, with collateral: 300 bp premium on LIBOR interest rates.

c. General loan in ISK, w/o collateral: 250 bp premium on REIBOR interest rates.

d. General loan in ISK, with collateral: 200 bp premium on REIBOR interest rates.

Claims settled in cash

As part of the debt restructuring, the CBI Governor's draft decision offers savings banks the option to pay off in cash CBI claims before 1 July 2010, provided that the savings bank demonstrates that such payment will not threaten its liquidity position and that all other relevant conditions for financial restructuring are met. In return for this type of

[9] The ISFI is a state agency set up by Act no. 88 on 18.8.2009. The agency falls under the Ministry of Finance, but has a three person Board of Directors appointed by the Minister of Finance. The ISFI is responsible for holding and administering the State's holdings in financial institutions, according to law, good administration and business practices as well as the State's ownership policy at each time. This entails exercising the Treasury's voting rights at shareholders' meetings and nominating on behalf of the state directors to the boards of financial undertakings under its auspices. The ISFI shall conclude agreements with the Boards of the financial undertakings where the state has a majority stake, setting general and specific objectives regarding their operations. On behalf of the State, the ISFI contributes capital to financial institutions on the basis of appropriations in the State budget. According to the law, the ISFI shall in its operations endeavour to reconstruct an efficient and viable domestic financial market and support effective and normal competition in that market, ensure transparency in all decisions related to the State's participation in financial activity and secure adequate provision of information on those matters to the public. The ISFI shall have concluded its tasks within six years from the date of establishment and shall then be closed.

settlement, the CBI will reduce the claim by 12% in the final settlement. Only one of the five savings banks covered by this scheme has proposed to make use of this option. The Icelandic authorities regard this measure as being an incentive to encourage savings banks to settle in full their claims with the CBI and achieve the proposed financial restructuring.

Claims written down

The CBI Governor's draft decision states in the first paragraph, point 2b: "*If reserve funds are negative and cannot be balanced with a reduction in current guarantee capital, a portion of the debt will be written off so that the goal of a positive reserve fund is reached and the capital adequacy ratio above the FME's minimum requirement*".

This measure is related to the CBI general terms and conditions set out in the draft decision, which in turn are linked to FME requirements. Point 6 of the second paragraph of the draft decision reads as follows: "*The reserve fund may not be negative; that is, existing guarantee capital must be written down by the amount of the negative reserve balance. If such a write-down does not balance the reserve fund of a savings bank that otherwise meets the Central Bank's requirements, the Central Bank will consider reducing claims to the extent necessary to make the reserve fund positive. However, the Central Bank will consider the importance of guarantee capital owners for the position and business of the savings banks if any of the existing guarantee capital holdings can be maintained but will not exceed the offer made by creditors in other savings banks*".

In the notification the Icelandic authorities further explain this measure as being a necessary part of the overall capital restructuring. The CBI has seen no alternative to requiring write-down of existing guarantee capital in order to amend negative reserves. In cases where this is not sufficient, the CBI and other creditors propose to write off a part of their claims to the point necessary to amend what might be left of negative reserves. After these measures had been undertaken, the CBI and other creditors intend to remit a part of their claims and convert them to guarantee capital (Tier 1 equity) and subordinated loans (Tier 2 equity) in order for the respective funds to fulfil FME requirements for minimum CAD ratio. Any remains of CBI's claims would be converted to a general loan in accordance with terms set by the CBI.

The Icelandic authorities state that neither the CBI nor other creditors are in a position to receive remuneration or compensation for the write-offs. In negotiations between the savings banks and their creditors, the CBI has emphasised that no creditors are to receive better terms than the CBI was to agree on. The Icelandic authorities consider that with respect to this measure, the CBI has followed the approach of a market economy investor.

2.5.2. Exit mechanisms

Regarding the claims to be converted to guarantee capital, all guarantee capital shares will be taken over by the Ministry of Finance which will assign the ISFI the task of administering the holding.[10] The savings banks will be able to purchase the guarantee capital holding later.

For subordinated loans, with a duration of seven years, the premium will rise by 100 points after two years. The Icelandic authorities regard this step up as an exit incentive.

[10] It is also the task of the ISFI to make proposals to the Minister of Finance as to whether and, if so, when specific holdings in financial undertakings should be offered for public sale and to draft and prepare proposals for the sale of the state's holdings in financial undertakings.

The Icelandic authorities have indicated that the duration of the general loans will be of five years which is meant to act as an incentive for the banks to seek alternative forms of capital in the short term.

3. Position of the Icelandic authorities

The Icelandic authorities consider the envisaged measures to be in line with the Authority's Banking Guidelines. They consider the measures to be particularly well targeted to maximising the recovery of the CBI claims while at the same time contributing to the sustainability of the savings banks.

The measures are limited to the minimum necessary for the savings banks to fulfil the requirement set out by the FME on viability. The insolvency of one or more of the savings banks could have significant negative consequences for the Icelandic economy at large, *inter alia* with regard to market confidence. The amount of capital intervention is proportionally small and limited to the absolute minimum for the savings banks to fulfil the FME's viability criteria. The Icelandic authorities point out that no new capital is provided as the scheme involves settlement of existing claims which came into the possession of the CBI as a result of the collapse of the SPB.

The limited nature of the intervention entails limited distortion of competition and the measures can be considered essential to foster active competition in the small Icelandic banking system.

The Icelandic authorities acknowledge that the measures contain elements of state aid, but nevertheless consider them compatible with Article 61(3)(b) of the EEA Agreement as they are necessary, proportionate, limited in scope, require an adequate remuneration and provide safeguards to minimise distortions of competition.

In assessing the measures, the Icelandic authorities consider that due account should be taken of the fact that the intervention by the CBI does not include any new capital provided by the CBI or the Icelandic State. The CBI participates in the restructuring on equal terms with other creditors, and as such acts as a market economy investor in the transactions. By its participation, the CBI aims to maximise the value of the claims that came into its possession. Due account should also be taken of the circumstances under which the claims were transferred to the CBI. In view of this, the Icelandic authorities consider that the settlement of the claims contributes to remedy a serious disturbance in Iceland's economy.

Particular attention should also be paid to the fact that the transactions are an important factor in avoiding further disturbances of Iceland's financial system and the build up of trust in the financial system. The sustainability of savings banks is a part of the overall restructuring of the financial system, of which little remains, and as such a step in addressing the on-going difficulties of the Icelandic economy. The measures are thus of systemic importance for the Icelandic economy as a whole.

In short, it is the Icelandic authorities' view that the measures constitute necessary and adequate means to remedy a serious disturbance in the Icelandic economy and are therefore compatible with Article 61(3)(b) of the EEA Agreement.

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."

1.1. Presence of state resources

The aid measure must be granted by the State or through state resources. The Authority notes that regarding all notified measures by the CBI, state resources are involved as they are entirely financed by the State. 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. Furthermore, the ISFI[11] who will ultimately manage the state holdings in the savings banks is also a state agency.

1.2. Favouring certain undertakings or the production of certain goods

First, in order for them to qualify as state aid, the measures must confer on the savings banks advantages that relieve them of charges they normally bear from their budgets. The Authority considers that this condition is met as the five savings banks will be able to absorb their impairments and to avoid insolvency whereas their competitors faced with similar difficulties will have to absorb such losses without government support. The savings banks will increase their capital base as the notified measures will ensure that their capital base will comply with generally applicable regulatory requirements.

Second, the measures must be selective in that they favour *"certain undertakings or the production of certain goods"*. The Authority considers that the measures are selective as they only benefit the five savings banks in question.

Furthermore, the proposed measures would not have been provided by a market economy investor expecting a reasonable return on investment. Indeed, the intervention of the CBI in taking over the claims was already dictated by its will to save the Icelandic savings banks network, exceeding any private market economy operator logic. Moreover, in the manner it has decided to manage the transferred claims, the Icelandic State is only investing because no market economy operator is ready to invest on similar terms. The willingness to avoid further deterioration of the savings banks' financial position, which would have presented a threat to the stability of the financial system as a whole, has determined the state intervention, rather than the possible return for the State as an investor. Moreover, the CBI is not a financial institution that should hold interests from the State in other economic enterprises but an entity in charge of monetary policy in Iceland. To guarantee that the CBI carries out its role properly, it seemed advisable to first seek final settlement of the claims on the savings banks and second transfer any guarantee capital to the ISFI.

[11] See above footnote 9.

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

Finally, for the measures to qualify as state aid they must distort competition and affect trade between the Contracting Parties. The Authority considers that the measures distort competition as they will enable the savings banks to remain on the Icelandic banking market.

Furthermore, the Authority finds that the measures are also able to affect trade between the Contracting Parties as the savings banks, although primarily active on local Icelandic markets, operate on financial markets which are fully open to trade and competition within the EEA, implying for instance that the savings banks hold loans in foreign currencies.

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”*.

By submitting notification of the CBI scheme Part I with a letter dated 10 June 2010 (Event No 559892), the Icelandic authorities have complied with the notification requirement.

By committing not to implement the scheme until the Authority has approved the measure, the Icelandic authorities have complied with the standstill obligation.

The Authority can therefore conclude that the Icelandic authorities have respected their obligations pursuant to Article 1(3) of Part I of Protocol 3.

3. Compatibility of the aid

3.1. Legal basis for assessment of compatibility: 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 Guidelines, the Authority reaffirms that, in line with the case law and the 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 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 exceeds 90% in most segments of the Icelandic financial market. The difficulties were coupled with a breakdown in confidence in the country’s currency. It is also clear from publicly available information that the Icelandic government has been forced to take drastic measures to secure continued domestic banking services and to stabilise the country’s currency. IMF assistance was sought immediately after the onset of the financial crisis and Iceland has been taking part in a two-year Stand-by Arrangement agreed by the IMF Board on 19 November 2008. Iceland’s real economy has been severely hit by the financial crisis. Contraction of GDP in 2009 as compared to the previous year amounted to 6.5% and unemployment rose from

1.9% in 2008 to 9.4% in 2009. In view 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. The Authority does not question the argument brought forward by the Icelandic authorities that the smaller savings banks, who are the beneficiaries of the aid measures under consideration, faced difficulties as a result of the meltdown of Iceland's major financial institutions. Consequently, Article 61(3)(b) is considered relevant in this case.

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

As stated in point (15) of the Authority's 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:

- 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.

The fourth chapter of the Authority's Banking Guidelines, as well as the Recapitalisation Guidelines translate these general principles into conditions specific for recapitalisation schemes. In the following paragraphs, the Authority will assess the compatibility of the notified measure with the state aid rules of the EEA Agreement on the basis of these criteria.

3.3. Compatibility with the Banking and Recapitalisation Guidelines

3.3.1. Appropriateness of the measures

The Icelandic authorities have indicated that the FME considers it imperative, for the continued operation of the savings banks, that they meet the following conditions:

<u>Capital reserves</u>

- the savings banks must be capitalised with a minimum Core Tier 1 ratio of 12%, which must be maintained for at least three years after the initial capitalisation unless revised by the FME;
- the savings banks must maintain a CAD ratio above 16%, which must be retained for at least three years after the initial capitalisation unless revised by the FME;
- the owners of the savings banks must demonstrate an acceptable level of financial strength, i.e. the ability, but not the obligation, to inject more capital should it be needed.
- a specific stress test will be performed to establish that the savings banks uphold a Core Tier 1 ratio of 4% after three years of losses.

Liquidity reserves

- the savings banks must demonstrate sufficient liquidity reserves to withstand the liquidity stress test defined by the CBI;

- liquid assets (funds, current account, assets eligible for central bank lending facilities) must amount to at least 10% of on-demand deposits and cash or cash equivalents must amount to at least 5% of on-demand deposits. The former requirement increases if deposits from foreign parties amount to more than 1% of deposits or if there is considerable concentration within the deposit base.

Risk management and governance

- the savings banks must present a report of independent evaluation of capital requirements (ICAAP report);

- the savings banks must improve their internal control procedures and their risk management in accordance with best practices and the FME's requirements based on a special assessment of internal controls and risk management;

- the savings banks must reduce their largest risk factors and make changes in line with a re-focusing on core operations.

In co-operation with other creditors to the savings banks, the CBI has prepared a package of measures which should guarantee compliance with the minimum capital requirements for operations set by the FME while maximising the value of CBI's claims. In this light, the Authority considers that the proposed measures are efficient and straight forward as they will directly improve the total capital of the savings banks. As a result of the notified measures, the savings banks will meet their minimum regulatory capital ratio requirements established by the FME.

The Icelandic authorities have indicated that without such measures, the operational licence of many of the savings banks would have to be revoked and the savings banks required to wind down their operations and liquidate with severe effects for the local economies. They have further explained that "*savings banks are the oldest financial institutions in the country and serve as fundamental institutions for deposit and lending operation within the local communities around Iceland. Savings banks have built their operations on local deposits and conservative lending policies, based on in-depth knowledge of the local markets, the local population and social and commercial undertakings*".

In view of the exceptional impact of the financial crisis on the Icelandic economy and its effect on some of the savings banks, the Authority considers that the various instruments put forward in the notified scheme constitute an appropriate package. Indeed, the level of negative reserves and the limited amount of liquidity the Icelandic State has at its disposal has required that a debt write off be first carried out before recapitalisation measures may actually take place. Whenever possible, other creditors have also agreed to write off debt.

The implementation of the other measures foresee an appropriate remuneration for the state intervention and properly established exit mechanisms. At the same time, it is ensured that the state's involvement will remain of a temporary nature as the purpose of the ISFI is not only to hold the state's interests in the banks but also to sell the state's participation under the best possible conditions.

The Authority considers that the measures are appropriate as they meet their objective to ensure that all five savings banks will comply with the regulatory capital ratio requirements. Furthermore, by giving the savings banks the means to continue operating, the Icelandic authorities are acting to safeguard financial stability in Iceland.

3.3.2. Necessity of the measures

According to the Banking Guidelines, the aid measures must, in amount and form, be necessary to achieve the objective. The capital injections must therefore be of the minimum amount necessary to reach the objective.

The Banking Guidelines (para. 39) furthermore provide that "*capital interventions in* financial *institutions must be done on terms that minimise the amount of the aid. According to the instrument chosen (e.g. shares, warrants, subordinated capital…), the EFTA State concerned should, in principle, receive rights, the value of which corresponds to their contribution to the recapitalisation.(..) In order to ensure that the public support is only given in return for an appropriate counterpart, instruments such as preferred shares with adequate remuneration, will be regarded positively*".

The Recapitalisation Guidelines (para.43) provide that the recapitalisation of banks which are not fundamentally sound should be subject to stricter requirements. The remuneration should in principle reflect the risk profile of the beneficiary and be higher than for fundamentally sound banks.

In order to properly analyse whether the remuneration for the measures is sufficient, the Authority must first determine whether the five savings banks should be considered as fundamentally sound or financially distressed.

The Recapitalisation Guidelines (Annex I) provide for a set of criteria to be considered in order to determine whether a bank is fundamentally sound or distressed. The criteria are as follows:

- **capital adequacy:** the Icelandic authorities have indicated that the five savings banks had the following capital ratios: Vestmannaeyjar savings bank: - 8.3%; Svarfdælir savings bank: - 15.2%; Norðfjörður savings bank: 4.7%; Þórshöfn savings bank: - 25.3%; Bolungarvik savings bank: - 48.7%.

- **size of the recapitalisation**: the Icelandic authorities have indicated that the various capital injections represent from 9.2% to 17.9% of the risk-weighted assets (RWA) of the savings banks. These figures are much higher than the 2% threshold mentioned in the Recapitalisation Guidelines.

- **current CDS spreads**: the Icelandic authorities have indicated that the savings banks do not have CDS spreads.

- **current rating of the bank and its outlook**: the savings banks are not credit rated.

Based on the foregoing indicators, the Authority has come to the conclusion that the savings banks are not fundamentally sound. Some of the savings banks (Bolungarvik and Þórshöfn) are in a particularly distressed financial situation according to the criteria laid down in Annex I to the Recapitalisation Guidelines. Indeed, the savings banks cannot meet their capital requirements and the capital injections needed are significant.

The Recapitalisation Guidelines also provide (para. 15): "*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*". (Emphasis added)

In return for conversion of its claims on the savings banks, the State will, in the case of a general loan receive remuneration in the form of capital income amounting to 350 bp premium on LIBOR interest rates for loans in foreign currency without collateral and 300 bp premium on LIBOR interest rates for such loans with collateral. For loans in ISK the remuneration is 250 bp premium on REIBOR interest rates for loans without collateral and 200 bp for such loans with collateral. In the case of subordinated debt the remuneration is in the form of capital income of 400 bp premium on LIBOR interest rates for loans in foreign currency for the first two years, with a step-up to 500 bp at the end of that period. For subordinated loans in ISK the remuneration is 300 bp premium on REIBOR interest rates for the first two years, rising to 400 bp at the end of that period. According to the CBI, this interest margin is considered to ensure the CBI adequate rate of return. The Authority considers that the remuneration for the general and subordinated loans is of a satisfactory level.

For claims converted to guarantee capital, remuneration will be in the form of dividend payments and/or the sale of the guarantee capital when market conditions permit. In this regard the Authority notes that as a result of conditions imposed by the CBI as part of its capital intervention, the shares of existing guarantee capital owners will be written down almost in full and in return for conversion of its claims into new guarantee capital, the State will acquire substantial ownership rights in all of the five banks. When the measures have come into force, the CBI together with the Icelandic Regional Development Institute[12]also a creditor to some of the savings banks, will together hold ownership shares in the banks ranging between 49.5% and 99.4%. At the same time the share of current guarantee capital holders will diminish substantially, ranging in total between 0.6% and 10%.

State owned guarantee capital will be transferred to the ISFI, which will be responsible for holding and administering the state's holdings in financial undertakings. On 24 March 2010, the ISFI presented a proposal to the Minister of Finance regarding an arrangement for the redemption right of savings banks. The proposal provides on the one hand that current owners of guarantee capital would be given the opportunity to redeem the

[12] The Institute of Regional Development is an independent institution owned by the Icelandic State. The purpose of he Institute is to work toward the strengthening of regional and economic development in Iceland outside the greater Reykjavík area. In accordance with its purpose, the Institute engages in the preparation, organisation, and funding of projects and the granting of loans with the aim of supporting settlement, strengthening local economies, and encouraging industrial innovation.

proposed decline in their total guarantee capital up to a certain point and, on the other hand, that the State would recover its capital contribution as soon as possible with acceptable remuneration. The proposed arrangement also provides the savings banks and capital owners with the choice of accumulating new capital and use the new capital to repay the State for its contribution. In this regard the ISFI proposes that the equity capital provided by the State should be redeemed at a price corresponding to the amount of the State contribution with interest based on the interest rate that financial undertakings receive on their current account with the CBI plus a surcharge of 1.5% (currently a total of 9%).

Through the ownership of shares in the banks, the State may be able to obtain dividends and more importantly may accrue a gain when selling them in the future. In view of the state ownership rights and the announced policy of the ISFI with respect to possible redemption right of guarantee capital holders and the price that the State would require in such transaction, the Authority considers the remuneration in respect of guarantee capital to be adequate.

With respect to claims written down, the Icelandic authorities have underlined that this measure was a necessary part of the overall package to bring the capital ratios in line with the FME's requirement. A debt write off is applied only to the extent where reserve funds are negative and cannot be balanced with a reduction in current guarantee capital. According to regulatory requirements, eliminating negative reserves is an indispensible requirement. This measures must be viewed as part of the overall package to bring the capital of the savings banks in line with the requirements of the FME

For the above mentioned reasons, the Authority considers the level of remuneration for the package of measures proposed under the CBI scheme – Part I to be in line with the terms of the Recapitalisation Guidelines applicable to banks in distress. The Recapitalisation Guidelines provide that following the rescue recapitalisation measures, "either a comprehensive restructuring plan or a liquidation plan will have to be presented for these banks within six months of recapitalisation". The Authority notes that the Icelandic authorities have committed to submit a restructuring plan for the savings banks within six months.

3.3.3. Proportionality

The Recapitalisation Guidelines (para. 44) provide that "until redemption of the State, behavioural safeguards for distressed banks in the rescue and restructuring phases, should, in principle include: a restrictive policy on dividends, (including a ban on dividends at least during the restructuring period), limitation of executive remuneration or the distribution of bonuses, an obligation to restore and maintain an increased level of the solvency ratio compatible with the objective of financial stability, and a timetable for redemption of state participation".

The FME has laid down the following specific requirements regarding risk management and governance:

- the savings banks must present a report of independent evaluation of capital requirements;

- the savings banks must improve their internal control procedures and their risk management in accordance with best practices and the FME’s requirements based on a special assessment of internal controls and risk management, and

- the savings banks must reduce their largest risk factors and make changes in line with a re-focusing on core operations, which are personal and corporate banking services in rural regions throughout Iceland, mostly consisting of personal accounts, savings, mortgages and SME current accounts.

As mentioned above, state owned guarantee capital will be transferred to the ISFI. Among the primary tasks of the ISFI are to supervise the implementation of the state’s ownership policy regarding financial undertakings. This includes promoting the reconstruction of a sound and robust financial system, promoting efficiency and competition as well as ensuring transparency in all decision making of the State involving the financial market. In light of its ownership rights and in view of its objectives, the ISFI will be in a position and can be expected to implement the provisions in para. 44 of the Recapitalisation Guidelines referred to above.

Furthermore, the Authority has taken note of the very small size of the savings banks which currently account for less than 2% of the domestic banking market and employ less than 80 persons.

The Authority concludes that the measures are (i) appropriate to restore the solvency of the five savings banks, (ii) necessary as they are limited to the minimum, (iii) that the five savings banks are distressed, (iv) that the remuneration levels seem to be adequate, that the five savings banks are under an obligation to submit a restructuring plan before 21 December 2010, which will have to reflect the level of distress of the savings bank, the size of the recapitalisation and (v) there are sufficient measures limiting the negative spill-over effects for other competitors to enable the Authority to temporarily approve the recapitalisation as emergency aid.

The Authority can therefore temporarily approve for six months the notified aid scheme in favour of savings banks in Iceland.

4. Conclusion

On the basis of the foregoing assessment, the Authority considers that the CBI scheme Part I which the Icelandic authorities are planning to implement is compatible with the functioning of the EEA Agreement within the meaning of Article 61(3)(b) of the EEA Agreement.

The Icelandic authorities have committed to submit an in-depth restructuring plan or a liquidation plan for each of the five savings banks at the latest by 21 December 2010.

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 EFTA Surveillance Authority has decided to approve temporarily for six months the notified aid scheme in favour of savings banks in Iceland (the CBI scheme – Part I.).

Article 2

The Icelandic authorities will submit an in-depth restructuring plan or a liquidation plan for each savings bank benefiting from the scheme mentioned under Article 1 of this decision at the latest by 21 December 2010.

Article 3

The implementation of the measure is accordingly authorised.

Article 4

This Decision is addressed to the Republic of Iceland.

Article 5

Only the English language version is authentic.

Done at Brussels, 21 June 2010.

For the EFTA Surveillance Authority

Per Sanderud
President

Sverrir Haukur Gunnlaugsson
College member