

Case No: 69096
Event No: 643523
Dec. No: 290/12/COL



Public version of¹
EFTA SURVEILLANCE AUTHORITY DECISION
of 11 July 2012
on restructuring aid granted to Landsbankinn

(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” or “SCA”), in particular to Article 24,

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

Whereas:

I. FACTS

1. Procedure

- (1) Following informal correspondence in October 2008, and the passing of Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc. (referred to as the “Emergency Act”), which gave the Icelandic state wide-ranging powers to intervene in the banking sector, on 6 October by the Icelandic Parliament (the Althingi), the President of the EFTA Surveillance Authority (“Authority”) wrote on 10 October 2008 to the Icelandic authorities and requested that state aid measures taken under the Emergency Act be notified to the Authority.

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

- (2) Further contact and correspondence followed periodically including notably a letter sent by the Authority on 18 June 2009 reminding the Icelandic authorities of the need to notify any state aid measures, and of the standstill clause in Article 3 of Protocol 3. State aid involved in the restoration of certain operations of Landsbanki and the establishment and capitalisation of a new Landsbanki Bank (“NBI”, later renamed Landsbankinn) was eventually notified retrospectively by the Icelandic authorities on 15 September 2010.²
- (3) By letter dated 15 December 2010³ the Authority informed the Icelandic authorities that it had decided to initiate the procedure laid down in Article 1(2) of Part I of Protocol 3 in respect of the measures undertaken by the Icelandic State to restore certain operations of (old) Landsbanki Islands hf and establish and capitalise New Landsbanki Islands (NBI hf) (the opening decision). The Authority also required that a detailed restructuring plan for Landsbankinn be submitted within 31 March 2011.
- (4) By email of 24 March 2011, the Authority received one comment from interested parties, which was forwarded to the Icelandic authorities on 25 May 2011. The Icelandic authorities did not respond to this comment.
- (5) By letter of 31 March 2011, the Icelandic authorities submitted a restructuring plan for Landsbankinn. A revised restructuring plan, reflecting inter alia the non-notified transfer of deposits and assets from Spkef Savings Bank (SpKef) effectuated on 22 April 2010 and taking into account the acquisition of Sparisjodur Svarfdaela (“SpSv”) was submitted by letter dated 23 May 2012.
- (6) The Authority requested information with regards to the restructuring plan on 11 July 2011 and 13 February 2012. The request for information was answered by the Icelandic authorities on 17 October 2011 and 13 March 2012. The final versions of the commitments were submitted on 6 June 2012 and 13 June 2012.
- (7) On 20 June 2012, the Authority approved the potential use of state aid granted to Landsbankinn for the acquisition of SpSv in Decision No 212/12/COL (“the SpSv Decision”). The Authority had by its Decision No 253/10/COL, of 21 June 2011, temporarily approved a rescue aid scheme involving settlement of claims owned by the Central Bank of Iceland (“CBI”) on savings banks, including SpSv. By decision 127/11/COL of 13 April 2011 the Authority had approved amendments to the rescue aid scheme (“the Savings Banks Decisions”)
- (8) In addition, the Authority met with the Icelandic authorities on 7 June 2011 and 27-28 February 2012.

² Please see a more thorough description in the opening decision, referred to in footnote 2.

³ The Authority’s Decision No 493/10/COL, opening the formal investigation procedure into state aid granted in the restoration of certain operations of (old) Landsbanki Islands hf and the establishment and capitalisation of New Landsbanki Islands (NBI hf) (now renamed Landsbankinn), OJ C 41, 10.2.2011, p. 31 and EEA Supplement to the Official Journal No 7, 10.2.2011, p.26.

2. Background

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

2.1 The collapse of Landsbanki

- (10) Icelandic banks experienced massive withdrawals of deposits not only abroad but also within Iceland in autumn 2008. Domestic withdrawals became so large that at one stage the Icelandic banks and the CBI were close to experiencing a shortage of cash.
- (11) Access to foreign debt securities markets had been the main source of the Icelandic banks' growth, in particular between 2003 and 2006. This source of financing however began to diminish, and foreign credit-rating agencies also expressed concern that the ratio of the banks' lending to deposits was low in comparison to other (foreign) banks.
- (12) The Icelandic commercial banks (in particular Landsbanki) responded by accumulating deposits abroad. From the end of the third quarter of 2006 to the middle of 2007, customer deposits in Landsbanki tripled – an increase of almost 10 billion Euros. The largest proportion of this were accounts opened in the Landsbanki UK branch, in which retail deposits had grown from nothing to 6.6 billion Euros, while wholesale deposits (in branches in the UK and the Netherlands) had grown to 2.5 billion Euros.
- (13) On 3 October 2008 the European Central Bank issued a margin call to Landsbanki to the amount of 400 million Euros and although this was later withdrawn the bank's UK branch had begun to experience a run on its deposits, meaning that it had to make available large amounts in pounds sterling. Landsbanki's request for the assistance of the CBI was turned down on 6 October. When the bank failed to make the funds demanded by the UK Financial Services Authority available the UK authorities closed the branch. The following day the Dutch Central Bank requested that an insolvency practitioner be appointed for Landsbanki's Amsterdam branch. Also that day the FME suspended the board of directors of Landsbanki, took over the power of shareholders' meetings and appointed a Resolution Committee in its place using its powers under the Emergency Act⁴.

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

- (14) The Icelandic authorities explained in their submissions to the Authority that the reasons for the collapse of the Icelandic banking sector and their need to intervene were set out in considerable detail in a report prepared by a Special Investigation Commission ("SIC")

⁴ Glitnir Bank was also placed in receivership on the same day and Kaupthing Bank followed two days later on 9.10.2008. The SIC report (see paragraph 14 and footnote 4 of the present Decision) concluded (at page 86 of Chapter 21) that a key issue was that notwithstanding Landsbanki's liquidity in ISK, the bank had insufficient foreign currency at its disposal to honour its foreign obligations. The report also considered it noteworthy that the loan of 153 million Euros to its principal owner (referred to above) had taken place only days earlier, stating that it was therefore "*apparent that the principal owners of Landsbanki were not interested in or capable of helping the bank out of the difficult position that had arisen*".

established by the Icelandic Parliament⁵, whose remit was to investigate and analyse the processes leading to the collapse of the three main banks. The Authority summarises below the conclusions of the SIC concerning the causes of failure most relevant to the demise of Landsbanki. The information is drawn from Chapters 2 (Executive Summary) and 21 (Causes of the Collapse of the Icelandic Banks – Responsibility, Mistakes and Negligence) of the SIC report.

- (15) The global reduction in liquidity in financial markets that began in 2007 eventually led to the collapse of the three main Icelandic banks, whose business operations had become increasingly dependent on raising funding through international markets. The reasons for the demise of the Icelandic banks were however complex and numerous. The SIC investigated the reasons which led to the collapse of the main banks, and it is notable that the majority of the conclusions applied to all three banks and many are inter-related. Causes of failure related to the banks' activities are briefly summarised below.

Excessive and unsustainable expansion

- (16) The SIC concluded that in the years leading up to the collapse the banks had expanded their balance sheets and lending portfolios beyond their own operational and managerial capacity. The combined assets of the three banks had increased exponentially from 1.4 trillion ISK⁶ in 2003 to 14.4 trillion ISK at the end of the second quarter of 2008. Significantly, a large proportion of the growth of the three banks was in lending to foreign parties, which increased substantially during 2007⁷, most notably after the beginning of the international liquidity crisis. This led the SIC to conclude that much of this increase in lending resulted from loans made to undertakings that had been refused credit elsewhere. The report also concluded that inherently riskier investment banking had become an ever increasing feature of the banks' activities and growth had contributed to the problems.

The reduction in finance available on the international markets

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

⁵ The SIC's members were Supreme Court Judge, Mr. Páll Hreinsson; Parliamentary Ombudsman of Iceland, Mr. Tryggvi Gunnarsson; and Mrs. Sigríður Benediksdóttir Ph.D., lecturer and associate chair at Yale University, USA. The report is available in full in Icelandic at: <http://rna.althingi.is/> and parts translated into English (including the Executive Summary and the chapter on the causes of the collapse of the banks) are available at: <http://sic.althingi.is/>

⁶ Icelandic *króna*.

⁷ Lending to foreign parties increased by 11.4 billion Euros from 8.3 billion Euros to 20.7 billion Euros in six months.

The gearing of the banks' owners

- (18) In the case of each major Icelandic bank, the principal owners were among the biggest debtors⁸. Samson Holding Company (“Samson”) was the biggest shareholder in the Landsbanki since its privatisation. When Landsbanki collapsed Samson’s co-owner Björgólfur Thor Björgólfsson and companies affiliated to him were the bank’s largest debtors, while his father and co-owner of Samson, Björgólfur Guðmundsson was the bank’s third largest debtor. In total their obligations to the bank exceeded 200 billion ISK, which was greater than the bank’s equity. The SIC was of the view that certain shareholders had abnormally easy access to borrowing from the banks in their capacity as owners. This was notable in the case of Landsbanki from the fact that as late as 30 September 2008, when it was clear that Landsbanki did not have sufficient foreign currency to honour its obligations abroad, the bank provided a loan of 153 million Euros to a company owned by Björgólfur Thor Björgólfsson. It also concluded that there were strong indications that in the case of each bank the boundaries between the interests of the largest shareholders and the interest of the bank were blurred. The emphasis on the major shareholders was therefore to the detriment of other shareholders and creditors.

Concentration of risk

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

Weak equity

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

The size of the banks

- (21) In 2001 the balance sheets of the three main banks (collectively) amounted to just over a year of the gross domestic product (“GDP”) of Iceland. By the end of 2007 the banks had become

⁸ Chapter 21.2.1.2 (page 6) of the Report.

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

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

- (22) The SIC concluded that the relevant supervisory bodies in Iceland lacked the credibility that was necessary in the absence of a sufficiently resourced lender of last resort. The report concludes that the Icelandic Financial Supervisory Authority (the “FME”) and CBI lacked the expertise and experience to regulate the banks in difficult economic times, but that they could have taken action to reduce the level of risk that the banks were incurring. The FME, for example, did not grow in the same proportion as the banks and the regulator’s practices did not keep up with the rapid developments in the banks’ operations. The report is also critical of the government, concluding that the authorities should have taken action to reduce the potential impact of the banks on the economy by reducing their size or requiring one or more banks to move their headquarters abroad⁹.

Imbalance and overexpansion of the Icelandic economy as a whole

- (23) The SIC report makes reference to events concerning the wider economy that also impacted upon the banks’ rapid growth and contributed to the imbalance in size and influence between the financial services sector and the remainder of the economy. The report concluded that government policies (in particular fiscal policy) most likely contributed to the overexpansion and imbalance and that the CBI’s monetary policy was not sufficiently restrictive. The report also refers to relaxing the Icelandic Housing Financing Fund’s lending rules as “one of the biggest mistakes in monetary and fiscal management made in the period leading up to the banks’ collapse”¹⁰. The report is also critical of the ease with which the banks were able to borrow from the CBI, with the stock of CBI short-term collateral loans increasing from 30 billion ISK in the autumn of 2005 to 500 billion ISK by the beginning of October 2008.

The Icelandic króna, external imbalances and CDS spreads

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

⁹ It was in fact the then coalition government’s stated policy to encourage more growth and to incentivise the banks to remain headquartered in Iceland.

¹⁰ Chapter 2, page 5 of the report.

2.3 Measures taken to reconstruct the banking sector

- (25) Following the collapse of the three biggest commercial banks in October 2008 (including Landsbanki) the Icelandic authorities were faced with the unprecedented challenge of safeguarding continued banking operations in Iceland¹¹. The policy followed by the Icelandic Government is primarily laid down in the Emergency Act¹² adopted by the Icelandic Parliament on 6 October 2008. The law grants extraordinary powers to the FME to take control of financial undertakings and to dispose of their assets and liabilities as required. The Minister of Finance was authorised, on behalf of the Treasury, to disburse funds in order to establish new financial undertakings. Moreover, in bankruptcy proceedings of financial undertakings, deposits would be given priority over other claims. The Government declared that deposits in domestic commercial and savings banks and their branches in Iceland would be fully protected.
- (26) Policy priorities focused initially on securing the basic functioning of the domestic banking, payment and settlement systems. In the first weeks after the crash, the Icelandic Government also prepared an economic program in collaboration with the International Monetary Fund (the IMF), leading to the approval on 20 November 2008 of Iceland's request for a two year stand-by-arrangement from the Fund, which included a 2.1 billion USD loan from the IMF aimed at strengthening Iceland's currency reserves. Additional loans of up to 3 billion USD were secured from other Nordic countries as well as certain other trading partners. Of the IMF loan, 827 million USD was made available immediately, while the remaining amount was disbursed in eight equal instalments, subject to quarterly reviews of the program.
- (27) The IMF Program was a broad-based stabilisation program focusing on three key objectives. Firstly, to stabilise and restore confidence in the króna so as to contain the negative impact of the crisis on the economy. The measures included the introduction of capital controls aimed at stemming capital flight. Secondly, the program included a comprehensive bank restructuring strategy, ultimately aimed at rebuilding a viable financial system in Iceland as well as safeguarding the country's international financial relations. Among subsidiary goals was to ensure fair valuation of the banks' assets, maximise asset recovery and strengthen supervisory practices. Thirdly, the program aimed at ensuring sustainable public finances, by limiting the socialisation of losses in the failed banks and implementing a medium-term fiscal consolidation program.
- (28) The Icelandic authorities have underlined that due to the exceptional circumstances linked to the large size of the banking system in relation to the financial capacity of the Treasury, the policy options available to the authorities were limited. The solutions relied upon were therefore in many ways different to the measures taken by the governments of other countries facing threats to financial stability.
- (29) On the basis of the Emergency Act, the three large commercial banks, Glitnir Bank, Landsbanki Íslands and Kaupthing Bank, were split into "old" and "new" banks. The

¹¹ For further general details of the measures taken by the Icelandic authorities see the report of the Minister of Finance to the Parliament on the resurrection of the commercial banks of May 2011 (Skýrsla fjármálaráðherra um endurreisn viðskiptabankanna), available at <http://www.althingi.is/altext/139/s/-pdf/1213.pdf>

¹² Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc.

Minister of Finance founded three limited liability companies to take over the domestic operations of the old banks and appointed them boards of directors. The FME took control of the old banks, allocated essentially their domestic assets and liabilities (deposits) to the new banks which continued banking operations in Iceland. The old banks were placed under the supervision of their respective resolution committees.¹³ Foreign assets and liabilities were in the main placed in the old banks, which were later submitted to winding-up procedures and the eventual closure of all foreign operations.¹⁴

- (30) In the provisional opening balance sheets of the three new banks of 14 November 2008 it was estimated that the banks' combined total assets would amount to 2 886 billion ISK, with an equity to be provided by the State of 385 billion ISK. The total amount of bonds to be issued by the new banks in favour of the old banks as payment for the value of the assets transferred in excess of liabilities was estimated at 1153 billion ISK. The FME appointed Deloitte LLP to perform assessments of the value of transferred assets and liabilities. In this process it transpired that the independent assessment would not result in fixed values of net assets transferred but valuations within certain ranges. It also emerged that the banks' creditors raised disagreements concerning the valuation process, which they considered not to be impartial, and complained that they were unable to protect their interests. These complications resulted in a change of policy for settling the accounts between the old and the new banks. Instead of relying on valuations by an independent expert, the parties would try through negotiations to reach agreements on the value of the net assets transferred.
- (31) It was clear that it would be difficult for the parties to reach agreements on the valuations as they were evidently subject to numerous assumptions on which the parties were likely to disagree. The state aimed to reach agreements on base evaluations providing a firm foundation for the initial capitalisation of the new banks. Price performance of assets in excess of the base evaluation could be attributed to the creditors in the form of contingent bonds or increases in the value of the banks' share capital, as it had emerged in the negotiations that the resolution committees of Glitnir and Kaupthing and a majority of their creditors could be interested to acquire holdings in the new banks, and this would allow them to benefit from potential increases in the values of the assets transferred.
- (32) The full capitalisation of the three new banks and heads of agreements with the creditors of the old banks on how compensation for the transfer of net assets into the new banks would be paid was announced on 20 July 2009. With regard to two of the new banks, New Glitnir

¹³ See also FME's Annual Report 2009 (July 2008 – June 2009), available at <http://en.fme.is/media/utgefni/efni/FME-Annual-Report-2009.pdf>

¹⁴ Further takeovers of financial undertakings were to follow. In March 2009, the FME took control of the operations of three financial undertakings; Straumur-Burdaras, the Reykjavik Savings Bank (SPRON) and Sparisjodabanki Íslands (Icebank), and decided on the disposal of the assets and liabilities of those undertakings. While a composition agreement with Straumur's creditors was later approved, SPRON and Sparisjodabanki were submitted to a winding-up procedure. Other financial undertakings were also severely affected by the collapse of the three main commercial banks and prevailing uncertainties in financial markets, and further financial undertakings were made subject to public administration in 2010. Thus, the FME appointed a provisional board of directors for VBS Investment Bank in March 2010. In April 2010, the FME took control of Keflavík Savings Bank and Byr Savings Bank, determining that their operations would be taken over by new financial undertakings, SpKef Savings Bank and Byr hf, respectively. As the financial conditions of these new undertakings turned out to be worse than initially anticipated, SpKef was later merged with Landsbankinn, and Byr hf. was merged with Íslandsbanki, following a tender for the shares in Byr. The Icelandic authorities were furthermore called upon, in 2009, to address the financial difficulties of Saga Capital Investment Bank and, in 2011, the Housing Financing Fund.

(later named Íslandsbanki) and New Kaupthing (later named Arion Bank), this included conditional agreements for the old banks to subscribe for majority equity interests in the new banks.

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

2.4 Macroeconomic environment

- (36) Major economic turbulence followed the collapse of the banking system in October 2008. The difficulties in Iceland's financial system were coupled with a breakdown of confidence in its currency. The króna depreciated sharply in the first quarter of 2008 and again in the autumn, before and after the failure of the three commercial banks. Despite capital controls being imposed in the autumn of 2008, currency volatility prevailed in the course of 2009.¹⁵ This turmoil resulted in a severe recession in Iceland's economy, with a contraction of Gross Domestic Product (GDP) by 6.8% in 2009 and 4% in 2010.

¹⁵ As an example of the scale of the sharp depreciation, the monthly average exchange rate of the Euro to the Icelandic króna rose from 90.71 ISK in December 2007 to 184.64 ISK November 2009.

- (37) Among the implications of the economic crisis was a sudden increase in unemployment from 1.6% in 2008 to 8% in 2009, a hike in inflation and a drop in real wages. Moreover, there was a sharp rise in corporate and household debt and of the share of non-performing loans in the banks' loan portfolios as well as a large scale takeover by the new banks of businesses in financial distress. At the same time the high fiscal cost of restructuring the banking system led to a sharp rise in the fiscal deficit and a major surge in public sector debt.
- (38) Following the deep recession provisional data from Statistics Iceland indicates a turnaround in the second half of 2011 and for the whole year a growth of GDP of 3.1% compared to the previous year.
- (39) Last year's economic growth was mostly due to an increase in domestic demand, particularly a 4% rise in private household consumption. This was supported by increases in wages and social benefits as well as certain policy initiatives undertaken to ease the payment burden of household debt, including a temporary interest rate subsidy, the freezing of payments on loans and the early reimbursement of private pension savings. Provisional data for 2011 also indicate a slow increase in investments, however from a particularly low level¹⁶, whereas public consumption has remained at a subdued level during the past three years.
- (40) The general macroeconomic data disguise more significant sectoral differences. In addition to the collapse in the financial sector a major contraction has taken place in construction and many other domestic production and service activities. Growth has on the other hand taken place in certain export sectors. Due to the low exchange rate of the króna and relatively stable prices in foreign currency for both marine and aluminium products, export revenue rose following the onset of the economic crisis, also with respect to tourism and other services exports. At the same time, imports fell sharply, turning the trade balance¹⁷ temporarily to a surplus of approximately 10% of GDP in 2010. However, with increased domestic demand in 2011, imports have grown again, leading to an overall smaller trade balance of 8.2% of GDP.
- (41) Statistics Iceland forecast for 2012-2017 assumes that gradual economic recovery will continue with 2.6% growth in 2012. A similar growth rate is expected throughout the forecast period. This forecast is however subject to several uncertainties. Planned large scale industrial investments might be further delayed. Iceland's terms of trade would be negatively affected by a prolonged recession in the main trading countries, implying a lower growth rate in Iceland. Slower progress than anticipated in tackling the debt burden of households and corporates would furthermore restrain domestic demand and the growth prospects of the economy. Growth could also be threatened by continued price instability linked to currency volatility in the context of removal of capital controls.

2.5 Financial supervision and improvements in regulatory framework

- (42) Following the FME's initial work linked to the foundation of the new banks and the assessment of the value of the net assets transferred from the old banks, the FME conducted in the spring of 2009 an audit of the new banks and their business plans, financial strength and capital requirements in a so-called sign-off project. This was done with the assistance of the international management consultant firm Oliver Wyman.

¹⁶ During the years 2009-2011, the share of investments in GDP has been only 13-14%.

- (43) Having concluded the above process, the FME granted the banks operating licenses subject to various conditions. In view of the quality of the asset portfolios and the anticipated economic uncertainty, it was considered necessary to place higher capital requirements on the three banks than the statutory minimum. The FME therefore set the minimum capital adequacy (“CAD”) ratio for the three banks at 16%, thereof a minimum of 12% for the Tier I capital. The requirements were applicable for at least 3 years unless reviewed by the FME. Liquidity conditions were also specified, requiring that available liquid funds should at any point amount to a minimum of 20% of deposits. Cash or cash equivalents should amount to at least 5% of deposits. Furthermore, requirements were made regarding other matters such as restructuring of loan portfolios, risk assessment, corporate governance and ownership. Comparable capital requirements were introduced by the FME regarding other financial undertakings.
- (44) The economic stabilisation program established in consultation with the IMF provided for a review of the entire regulatory framework of financial services and supervision to improve defence against future financial crisis. The Government invited the former Director General of the Finnish Financial Supervisory Authority, Mr. Kaarlo Jännäri, to carry out an assessment of the existing regulatory framework and supervisory practices. Among the improvements proposed by Mr. Jännäri was the creation of a National Credit Registry at the FME to diminish credit risks in the system. His report also suggested to lay down tougher rules and a stricter practice on large exposures and connected lending as well as to conduct more on-site inspections to verify off-site supervision and reports, particularly on credit risk, liquidity risk and foreign exchange risk. It was also recommended to review and improve the deposit guarantee system, following closely the developments within the EU.
- (45) The Government subsequently proposed a bill of law to the Althingi which was adopted and entered into force on 1 July 2010, as Act No. 75/2010. With the new law, extensive amendments were made to the Act on Financial Undertakings. Several other amendments were later introduced to the law on financial undertakings as well as of regulation and supervision of financial services. These regulatory amendments are considered in more detail in Annex I.

2.6 Main challenges ahead¹⁸

- (46) Despite major achievements in rebuilding a financial sector, Iceland continues to strive with the repercussions of the financial and currency crisis in the autumn of 2008. The financial crisis has revealed various flaws and deficiencies in the financial system, which must be addressed, if public confidence is to be restored. It seems evident that Iceland – as many other countries hard hit by the financial crisis - faces numerous challenges in adapting the legal and operating environment of financial services to support a viable and efficient financial system in the future and reduce as much as possible the risk of further systemic shocks to reoccur.
- (47) The most immediate challenges currently facing Icelandic financial undertakings are linked to the fact that the banks are operating in a sheltered environment with capital controls and a blanket deposit guarantee. The banks now need to prepare themselves to operate in a more

¹⁸ On this subject see for instance the report of the Minister of Economic Affairs to the Althingi of March 2012, *Future Structure of the Icelandic Financial System*. According to the ministry, this report is seen as a catalyst to an informed discussion of this important subject as it does not present fully formed proposals but sets out the main issues and outlook with reference to international developments. The report is available at <http://eng.efnahagsraduneyti.is/media/Acrobat/Future-Structure.pdf>.

exposed environment, when the capital controls are removed and deposit guarantees revert to the arrangement set out in the relevant EU/EEA directives¹⁹. The Icelandic authorities have underlined that extreme caution must be exercised when introducing new rules in this regard.

- (48) Another major challenge is the need to adapt further the legal and regulatory framework to support a solid and efficient financial system which is also consistent with EEA and international law developments²⁰.

2.7 The state of competition in the Icelandic financial sector

- (49) According to recent information from the Icelandic authorities²¹, competition on the financial market has changed radically since the banking collapse. The number of financial undertakings has decreased, as several savings banks, commercial banks and specialised lenders are either being wound up or have been merged with other undertakings²². The number of financial undertakings is still decreasing, most recently with the mergers of Landsbankinn and SpKef in March 2011, of Íslandsbanki and Byr in December 2011 and the forthcoming merger of Landsbankinn and Svarfdaelir Savings Bank, approved by the Authority in the the SpSv Decision on 20 June 2012. With the reductions in the number of financial undertakings and the larger banks taking over deposits from the banks closing down, concentration in the domestic market has increased. The overall presence of the new banks on the EEA financial markets is on the other hand much smaller than that of their predecessors, as international banking operations have been closed down.
- (50) In addition, the domestic market has shrunk considerably as certain sub-markets have disappeared or are largely subdued. The near disappearance of the stock market and the introduction of capital controls have reduced operations in the stock and currency markets and resulted in limited investment options. With the level of investments in the economy at a historically low level and households and companies generally highly leveraged, demand for

¹⁹ Bringing deposit guarantees back to normal conditions does not only relate to abolishing the state backing of such guarantees, but also to review the provisions in the Emergency Act according to which deposits which enjoy deposit guarantees by law have priority in the winding-up of a financial undertaking. This comprises a considerable advantage for depositors, not least while the 2008 banking collapse is still fresh in people's minds. This provision is on the other hand likely to represent a handicap for the banks to diversify their funding arrangement.

²⁰ See Chapter 9 of the report of the Minister of Economic Affairs referred to in footnote 25. When presenting that report, the Minister of Economic Affairs also appointed a group of banking experts, with participation of foreign experts, to prepare proposals on a comprehensive legal and regulatory framework for the financial market in Iceland as a whole. According to the same report, the Icelandic authorities also foresee to study other future options, including the possible separation of investment and commercial banking activities, the adoption of a financial stability legislation and possible amendment of the division of responsibility of financial services regulatory bodies. It is also clear from the statements of the Icelandic authorities that a review of the monetary policy framework remains on the agenda, with or without the possibility that Iceland will become a member of the European Union, as well as other possible means to improve economic management and ensure that regulators "see the forest for the trees" and effectively apply the most appropriate macro-prudential tools.

²¹ See Chapter 6 of the report by the Minister of Economic Affairs to the Althingi, *The Future Structure of the Icelandic Financial System*, available at <http://eng.efnahagsraduneyti.is/publications/news/nr/3559>

²² Since autumn 2008, several financial undertakings have disappeared from the market (in addition to the "old" big commercial banks, Glitnir, Kaupthing and Landsbanki): Sparisjóðabanki Íslands (formerly Icebank), the Reykjavik Savings Bank (SPRON), Sparisjóður Mýrarsýslu (Myrarsysla Savings Bank, SPM), VBS Investment Bank and Askar Capital Investment Bank. The operations of Straumur-Burdaras Investment Bank and Saga Capital Investment Bank have also diminished significantly.

credit is low. Since the collapse, the banks have concentrated their efforts on internal issues and restructuring of their loan portfolios as well as the restructuring of some of their major corporate clients.

- (51) Before the financial crisis, the savings banks accounted collectively for a market share of approximately 20 - 25% in deposits. This has now collapsed to approximately 2 - 4%. The market shares lost by the savings banks and commercial banks exiting the market have been gained by the three major commercial banks, Arion Bank, Íslandsbanki and Landsbankinn. Combined the three big banks now account for approximately 90-95% of the market instead of 60-75% earlier on, where Landsbankinn's market share is marginally highest. Apart from the 10 regional savings banks, currently accounting for approximately 2-4% of the market, the only other market player is the restructured MP Bank²³, with a market share of approximately 1-5%.
- (52) The Icelandic financial market is thus clearly oligopolistic and the three largest companies could collectively achieve a dominant market position. According to the Icelandic Competition Authority ("ICA") there are significant entry barriers to the Icelandic banking market. This has detrimental effects on competition. There are also certain impediments for consumers to switch banks. The Icelandic authorities furthermore acknowledged that the exchange rate risks associated with Iceland's small and non-traded currency, the Icelandic króna, has further restricted competition and deterred foreign banks and companies from entering the Icelandic market.
- (53) ICA has lately focused on a specific issue regarding IT infrastructure for the banks' operations and their co-operation in that regard. This relates to the financial institutions' jointly owned IT service provider, *Reiknistofa bankanna* (the Icelandic Banks' Data Centre; RB). This matter is of relevance for the assessment of the case at hand and was among the issues discussed by the Authority with the Icelandic authorities and the banks.
- (54) RB is jointly owned by the three main Icelandic banks, two savings banks, the Icelandic Savings Bank Association and the three main payment card processors in Iceland. Landsbankinn owns 36.84% of the shares in RB, Íslandsbanki holds 29.48% and Arion Bank 18.7%. Combined the three commercial banks therefore own 85.02% of shares in RB. RB's clients are the owners, the Central Bank of Iceland and other financial institutions as well as the government and public entities. The banks' co-operation in this area is extensive, as RB has developed the clearing and settlement system in Iceland. It also provides a number of core banking solutions which are multi-tenant solutions, used by most of the Icelandic banks. RB furthermore operates an e-invoicing and e-payment system for corporations and consumers.
- (55) According to ICA, the collapse in 2008 has made the smaller banks and savings banks particularly vulnerable. For the smaller financial undertakings, the required IT services were of crucial importance, as they can be viewed as one of the entry barriers for new market

²³ On 11.4.2011, a contract for the sale of (old) MP bank's operations in Iceland and Lithuania was approved at the bank's shareholder meeting, when over 40 new shareholders invested 5.5 billion ISK in new shares in the bank. Other operations of the old bank remained with the previous owners and were transferred to a new legal entity, EA fjárfestingarfélag hf. For further details, see MP bank's press releases of 11.4.2011 available at <https://www.mp.is/um-mp-banka/utgefing-efni/frettir/nr/1511> and <https://www.mp.is/um-mp-banka/utgefing-efni/frettir/nr/1510>

participants. The platform for IT services has been provided to a significant extent by RB as regards the bigger financial undertakings and, as regards the savings banks and smaller market players, by Teris. Following the closure of many smaller financial undertakings in recent years, Teris lost a significant share of its income, leading in January 2012 to the sale of some of its IT solutions to RB. According to RB and Teris, this transaction was *inter alia* aimed at securing continued provision of IT services to smaller financial undertakings.

- (56) The ICA has been investigating two cases regarding RB. Firstly, whether the joint ownership and co-operation of the banks and other financial undertakings in the RB forum should be considered to be a breach of the ban on restrictive practices under Article 10 of the Icelandic Competition Act. Secondly, the compatibility of RB's purchase of Teris's major assets is being assessed under the merger provisions of the same act. However, in May 2012 these two cases were concluded with a settlement between RB and its owners, on the one hand, and the ICA on the other hand.²⁴
- (57) Aside from the above concerns that relate directly to the Icelandic financial market, the ICA has in particular pointed to the need for the sale and restructuring of operating companies²⁵ to be completed without undue delay. Many operating companies have been taken over by the banks (being creditors of those companies) due to over indebtedness following the economic crash in 2008. According to ICA, it may create a conflict of interest when banks provide financial services to companies and own the companies at the same time. The ICA is of the opinion that the banks' direct and indirect ownership²⁶ is the most wide-spread and dangerous competition problem in the aftermath of the financial crisis, as this has an effect on almost every company and industry in Iceland. In ICA's view, faster restructuring of companies would improve competition in the financial market. When the banks' involvement in the restructuring of their corporate clients has been subject to the notification requirements under national merger control, the ICA has in this regard often set conditions regarding the banks' ownership. However, a comprehensive solution to the problem appears to be difficult, as it relates essentially to the high leverage of the Icelandic business sector.
- (58) In their submission to the Authority, the three commercial banks, Arion Bank, Íslandsbanki and Landsbankinn, have all expressed the view that no major changes have taken place in the conditions of competition in the Icelandic financial market since autumn 2008 which should give cause for concerns. Effective competition prevailed in the market, without any evidence of collusive behaviour of the three biggest players. When examining the conditions of

²⁴ According to the settlement, RB and its owners have agreed to a number of commitments aimed at preventing distortions of competition resulting from RB's operations and the co-operations of its owners. The commitments require *inter alia* that RB shall be operated on general commercial terms independent from its owners and the majority of RB's board shall be composed of specialists independent from the owners, access to the systems and services provided by RB shall be provided on a non-discriminatory basis and the terms of services provided by RB shall be the same irrespective of whether or not the client is a shareholder in RB. Existing owners of RB have committed to offer regularly for sale part of their holdings in RB, with the aim of facilitating non-financial undertakings to acquire ownership in RB. Such invitations shall be made at least every second year, until at least a third of total shareholdings in RB have been sold to parties other than the current shareholders or offered for sale in a shares offering.

²⁵ The ICA uses the term "operating companies" for the banks' holdings in normally non-financial businesses which the banks have acquired in relation to the restructuring of their loan portfolios through debt to equity swaps or otherwise. Likewise, the Authority uses the term "operating company" for real economy undertaking, which do not belong to the bank's core business in financial markets.

²⁶ In this context, the Authority understands that indirect ownership refers to the banks' possible influence and control over companies due to their high indebtedness to the bank.

competition in the market, the ICA had overlooked certain key factors, such as the fact that foreign banks have for long and still are actively competing with Icelandic banks for the provision of financial services to the biggest clients, such as undertakings in export-based activity (fisheries, power-intensive industry, etc.) as well as state and municipal activity.

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

3. Description of the measures

3.1 The beneficiary

- (60) As described above, Landsbanki collapsed in 2008, as did the two other large Icelandic commercial banks, Glitnir and Kaupthing. So as to ensure the continuing operation of the domestic banking sector, the Icelandic authorities undertook certain measures, and to restore certain operations of (old) Landsbanki, they established and capitalised New Landsbanki (now renamed Landsbankinn), described in more detail below.

3.1.1 Landsbanki

- (61) Prior to the financial crisis of 2008 Landsbanki was the second largest bank in Iceland. At the end of the second quarter of 2008 its balance sheet amounted to 3 970 billion ISK and it made a pre-tax profit during the first half of that year of 31 billion ISK. The published business strategy²⁷ of the bank was to transform the bank from a local commercial bank, operating exclusively in Iceland, “into a highly profitable corporate and investment banking operation stretching eastward from Iceland across Europe and westward over the Atlantic”. In 2000 Landsbanki began its activities abroad by acquiring a 70% holding in the Heritable Bank in London and over the following years the bank grew substantially both through acquisitions and the establishment of foreign branches. Prior to its collapse the bank held 7 main subsidiaries in the UK, Ireland, Luxembourg, France/Germany and Iceland itself. It also had branches in the UK (which in turn had offices in the Netherlands, Germany and the United States), Canada, Norway and Finland, and a sales office in Hong Kong.

3.1.2 Landsbankinn

- (62) Landsbanki’s successor, Landsbankinn, is a universal bank offering a comprehensive set of financial services to individuals, households, corporations and professional investors in Iceland. Landsbankinn is the largest bank in Iceland. Total assets amounted to 1 135 billion ISK at the end of 2011, and it has 1142 employees. According to the restructuring plan, Landsbankinn is mainly active in the following areas:

²⁷ Annual Report 2007, page 10. Available here: http://www.lbi.is/library/Opin-gogn/pdf/landsbanki_annual_report_2007.pdf?bcsi_scan_A7E1E556D7B2F94D=aB9LkrKRu+y0xx3fim/JyUDnRB0bAAAANp6SAg==&bcsi_scan_filename=landsbanki_annual_report_2007.pdf

3.1.2.1 Retail banking

- (63) The Retail Banking division handles all general service to individuals and small and medium sized companies. With 520 employees, 410 working out of the various branches, this is the Bank's largest division. According to the information provided by the Icelandic authorities, Landsbankinn has a market share of [>25] % in the retail sector.

3.1.2.2 Corporate banking

- (64) Corporate Banking deals with large companies and municipalities and larger financing projects. Three departments within the Corporate Banking division handle lending: Industry, Trade & Services, Fisheries & Seafood and Construction & General Credit Management. The division has 40 employees. According to the information provided by the Icelandic authorities, Landsbankinn has a market share of [>30] % in this market segment.

3.1.2.3 Markets, Treasury and Asset Management

- (65) The Treasury is responsible for the Bank's liquidity and funding, manages market risk, market making in the foreign exchange ("FX") market, money market and listed securities. The Markets division handles FX sales and securities brokerage in bonds, equities and derivatives to professional clients.
- (66) Asset management consist of three sub-departments, namely third-party asset management, private banking and financial advisory services.

3.2 Comparing the old and new bank

- (67) The Icelandic authorities have submitted an overview of the fundamental changes that have already taken place which the Authority considers to be relevant for the purposes of its current assessment.
- (68) As referred to above Landsbanki's business strategy involved expansion of its business internationally, and from 2004 the main goal of the bank was to grow in international investment and corporate banking markets focusing on services to small to medium sized corporate enterprises. A branch was opened in London in 2005, initially focused on leverage finance and asset based loans. Later branches, opened in Canada, Finland, Norway and the sales office in Hong Kong, were initially focused on asset-based lending and trade finance. The aim of this strategy²⁸ was to diversify the loan portfolio across countries and sectors. Due to this strategy lending to non-Icelandic companies accounted for an ever-larger share of the bank's operations. Nearly half of the 2644 people employed by Landsbanki and its subsidiaries in September 2008 were based outside Iceland.

²⁸ Annual report 2007, p. 61.

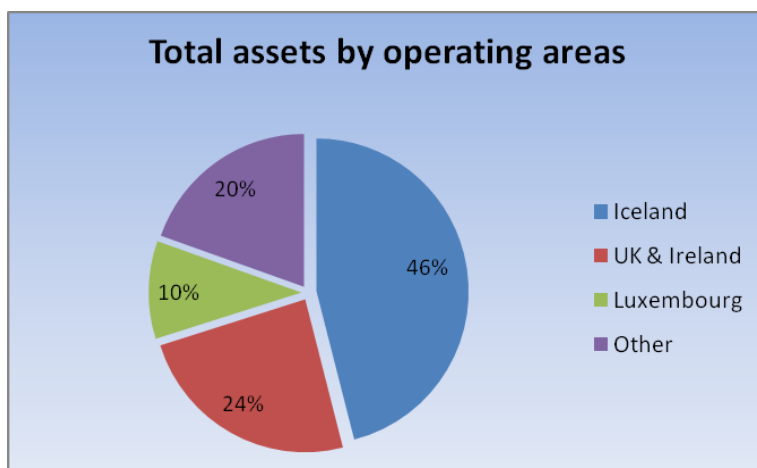


Chart 1: Distribution of assets by region – Q1 and Q2 2008

- (69) When examined geographically, 54% of total assets (of 3 970 billion ISK for Q1-Q2 2008), as shown in the chart above, were located outside Iceland. Moreover, 41% of revenues in the first half of 2008 originated in Iceland, 34% in the UK and Ireland, 6% in Luxembourg and 15% other areas.
- (70) The chart below shows that for the first half of 2008 (the last available numbers for the bank) the largest part of Landsbanki's pre-tax profit of 31 billion ISK came from investment banking and corporate banking. In the years following the privatisation of the bank (in 2002) the share of retail banking in pre-tax profits had been steadily declining.

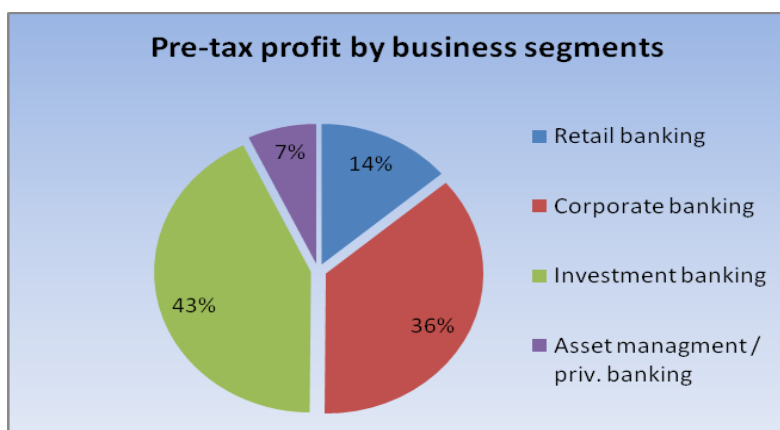


Chart 2: Distribution of profits by business segment – Q1 and Q2 2008

- (71) The new bank, Landsbankinn focuses solely on activities in Iceland. It is not an internationally oriented bank as its predecessor, and contrary to Landsbanki, which based its growth on a diverse funding mix, heavily relying on unsecured bonds sold worldwide, it relies mainly on deposits as a funding base. This limits Landsbankinn's potential to grow.
- (72) Moreover, the splitting between foreign and domestic assets meant a significant reduction in the size of the balance sheet of Landsbankinn when compared to Landsbanki:

Balance sheet LBI and Landsbankinn comparison (m. ISK)	30.6.2008	9.10.2008
Loans and advances to customers	2.571.470	655.725
Loans and advances to financial institutions	337.003	5.291

Table 1: Balance sheet of Landsbanki (LBI) and Landsbankinn

(73) As illustrated above by reference to the two most significant items on the asset side, the opening balance sheet of Landsbankinn was only about 25% of Landsbanki’s balance sheet for 30.06.2008. At the end of 2011, Landsbankinn’s total assets amount to 1 135 billion ISK.

(74) In terms of employees, there has been a reduction of more than 55% (from 2.644 to 1142).

3.3 National legal basis for the aid measure

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

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

- *Supplementary State Budget Act for 2008 (Article 4)*
- *State Budget Act for 2009 (Article 6)*

3.4 The aid measures

(76) The Icelandic authorities’ intervention following the failure of Landsbanki has been described above, and was set out in more detail in the opening decision. The essence of the interventions can be summarised in the following manner:

(77) The FME took control of Landsbanki on 7 October 2008, and domestic liabilities and (most) domestic assets were transferred to New Landsbanki on 9 October 2008. The estate of the old bank and its creditors were to be compensated for this transfer by receiving the sum of the difference between assets and liabilities. However, determining this difference proved to be difficult and time-consuming, and the State provided some initial capital, as well as a commitment to contribute further capital if need be. On 15 December 2009 an agreement was reached between the State and the creditors of the old bank, pursuant to which the State took

a 81.33% stake in the bank (by injecting 121.225 billion ISK) whilst the creditors of Landsbanki subscribed to 18.67% of the new shares. The compensation of the creditors for the transferred assets depends, according to the agreement between the State and the creditors, mainly on a contingent bond, further described below. The Authority considers the date on which the agreement was reached– 15 December 2009 – to mark the beginning of the 5 year restructuring period, which will consequently last until 15 December 2014.

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

3.4.1 Tier I capital

- (79) The State provided Tier I capital twice – once, when New Landsbanki was created in 2008, and then again when the bank was fully capitalised in 2009, after an agreement with the creditors of the old bank had been reached.

3.4.1.1 Initial capital

- (80) The state provided 775 million ISK²⁹ (5 million Euros) in cash as initial capital to the new bank. In addition it issued a commitment to contribute up to 200 billion ISK to the new bank in return for all of its equity. This figure was calculated as 10% of an initial assessment of the likely size of the bank’s risk weighted asset balance, and was formally included in the state budget for the year 2009 as an allocation of government funds to address the extraordinary circumstances in financial markets. This allocation of capital was intended to provide an adequate guarantee of the operability of the bank until issues relating to its final re-capitalisation could be resolved, including the size of its opening balance based on the valuation of compensation payable to the old bank for assets transferred from it.

3.4.1.2 The final capitalisation of Landsbankinn

- (81) On 20 July 2009 the Icelandic Government announced that it had determined the basis for the capitalisation of Landsbankinn and reached an agreement on a process for how the old banks would be compensated for the transfer of net assets. It also announced that the state would capitalise the new bank. Final agreement on the capitalisation was reached on 15 December 2009 (eventually to the total sum of 150 billion ISK, of which the state provided 121.225 billion ISK) when agreement was reached on compensation to creditors for the net value of the assets and liabilities transferred to Landsbankinn. As described above, the capital requirements imposed by the FME stipulated that Landsbankinn should hold at least 12% Core Tier I Capital³⁰ and an additional 4% of Tier II Capital as a ratio of risk-weighted assets. When Landsbankinn was formally capitalised on 20 January 2010, the Core Tier I Capital ratio of the bank was approximately 15%. The FME granted temporary relief from the (overall) 16% requirement conditional upon the submission of an acceptable plan illustrating how the full amount would be achieved. In June 2010 the bank reported that its Core Tier I exceeded 16% and on that basis the FME permanently exempted Landsbankinn from the requirement to hold Tier II capital as long as its Core Tier I ratio remains above 16%.

²⁹ Monetary figures are referred to in this section first in the currency in which the capital was provided, followed by a reference in brackets to the corresponding amount in ISK or Euros (as appropriate) where it has been provided by the Icelandic authorities.

³⁰ The definition of Core Tier I capital includes only equity, i.e. share capital and retained earnings, but does not include subordinated loans or other types of hybrid capital instruments.

- (82) This agreement followed a lengthy and complex negotiation process resulting in an outline agreement among the parties in a heads of terms on 10 October 2009 and more detailed sets of term sheets in relation to the debt instruments on 20 November 2009. There were also a number of subsequent meetings and discussions between the parties during which the outlined terms were modified and reflected in documentation. The resulting agreement comprises the issuance of three bonds denominated in Euros, Pound Sterling and US Dollars, respectively, having an aggregate principal amount equivalent to 260 billion ISK, and also involves Landsbanki (or in effect the old bank's creditors) taking an initial (and potentially temporary) 18.67% ownership stake in Landsbankinn.³¹
- (83) In addition, given the considerable uncertainty about the value of the transferred assets, Landsbankinn agreed to issue to Landsbanki a contingent bond (linked to its equity participation), the principal amount of which will not be determined until on or after 31 March 2013. Following the determination of the principal amount of the contingent bond, all or part of the shareholding held by Landsbanki may be surrendered to the Icelandic government.³²

3.4.2 *Deposit guarantee*

- (84) In order to comply with Directives 97/9/EC on investor-compensation schemes and 94/19/EC on deposit guarantee schemes, Iceland adopted Act No. 98/1999 on deposit guarantees and investor-compensation scheme and thereby set up the so-called Depositors' and Investors' Guarantee Fund ("TIF"). The fund has been financed by annual contributions from the banks, calculated in relation to the total deposits of that bank.
- (85) According to the Iceland authorities in addition to the bank rescue measures of the Icelandic Government of autumn 2008 they intended to give further assurance and comfort to the general public on the safety of their deposits when the crisis struck. Thus they provided an additional state backing of deposits in domestic commercial and savings banks, outside the scope of Act No. 98/1999 implementing the deposit guarantee Directive 94/19 and the investor-compensation Directive 97/9/EC.
- (86) An announcement from the Prime Minister's Office of 6 October 2008 stated that the "Government of Iceland underlines that deposits in domestic commercial and savings banks and their branches in Iceland will be fully covered"³³. This announcement has since been repeated by the Office of the current Prime Minister in February and December 2009.³⁴

³¹ On 15.6.2012, Landsbankinn announced that it would start paying back (parts of) those bonds Landsbanki earlier than expected. See <http://www.landsbankinn.com/news-and-notifications/2012/06/15/Landsbankinn-starts-to-repay-bond-before-schedule/>.

³² The contingent bond is linked to the valuation and performance of certain reference assets. To the extent that the values of these assets are higher on 31.12.2012 as estimated when the agreement was concluded, the contingent bond is intended to compensate the old bank for this difference. If the difference between the valuation on these two dates is zero or a negative amount, the new principal balance will be deemed to be zero and the contingent bond will be cancelled. However, if the value is positive the contingent bond will issued at this value and Landsbanki will surrender its shareholding to Landsbankinn, or part of its shareholding to the extent that the positive value is less than the value of the shareholding.

³³ The English translation of the announcement is available at: <http://eng.forsaetisraduneyti.is/news-and-articles/nr/3033>.

³⁴ <http://www.efnahagsraduneyti.is/frettir/frettatilkynningar/nr/2842>
<http://www.efnahagsraduneyti.is/frettir/frettatilkynningar/nr/3001>. The Minister of Economic Affairs has also referred to it recently in an interview with *Viðskiptablaðið* on 2.12.2010, page 8: "[The declaration]

Moreover, reference was made to it in a letter of intent sent by the Icelandic Government to the International Monetary Fund (and published on the website of the Ministry of Economic Affairs and of the IMF) on 7 April 2010 (and repeated in a further letter of intent dated 13 September 2010). The letter (which was signed by the Icelandic Prime Minister, Minister of Finance, Minister of Economic Affairs and Governor of the CBI) states that “At the present time, we remain committed to protect depositors in full, but when financial stability is secured we will plan for the gradual lifting of this blanket guarantee.”³⁵ Furthermore, in the section of the bill for the Budget Act 2011 concerning state guarantees, reference is made in a footnote to the Icelandic government’s declaration that deposits in Icelandic banks enjoy a state guarantee.³⁶

- (87) A recent statement of the current Minister of Economic Affairs and former Minister of Finance (2009-2011), Steingrímur Sigfússon in a debate in the Icelandic Parliament regarding the government’s cost related to Landsbankinn’s taking over SpKef, illustrates the above further: According to the Minister, one must keep in mind regarding this matter the State’s declaration in the autumn of 2012 that all deposits in savings banks and commercial banks would be safe and protected. “Work has since in all instances been based on this (i.e. the declaration) and it is unfortunately correct that this (i.e. payments due to SpKef) will be one of the bigger bills footed directly by the state as costs for securing the deposits of all inhabitants of Suðurnes ... and all SpKef’s clients in the West Fjords and the West and North-West area ... I do not expect that anyone has thought that deposit holders in those areas would be treated differently from other inhabitants, so the state did not have much of a choice in this matter”.³⁷
- (88) According to the Icelandic government, the additional deposit guarantee will be lifted before the capital controls are fully abolished, which according to the Icelandic authorities is currently foreseen for the end of 2013.

3.4.3 *Rescue and transfer of operations from Spkef to Landsbankinn*

- (89) In March 2009 the capital position of Keflavik Savings Bank fell short of the statutory required minimum. According to the Icelandic authorities, this was caused in parts by spill-over effects of the financial turmoil that was described above, and also by particular strong impact of the economic crisis on the regions in which the bank was active.
- (90) This bank had offered savings accounts and loans to retail customers and small and medium-sized enterprises. It had also offered asset management and securities brokerage in addition to traditional financial services such as payment services, collection services, banking services for housing associations, premium banking, online banking and ATM services. Its headquarters were located in Keflavik and the bank operated sixteen branches in the

will be withdrawn in due course. We do not intend to maintain unlimited guarantee of deposits indefinitely. The question when it will be withdrawn depends, however, on when an alternative and effective deposit system will come into force and a financial system which will have fully resolved its issues” (the Authority’s translation).

³⁵ The relevant paragraph can be found at section 16 (page 6) of the letter: http://www.efnahagsraduneyti.is/media/Acrobat/Letter_of_Intent_2nd_review_-_o.pdf

³⁶ http://hamar.stjr.is/Fjarlagavefur-Hluti-II/GreinargerdirogRaedur/Fjarlagafrumvarp/2011/Seinni_hluti/Kafli_8.htm [Mbl 10.6.2012].³⁶

³⁷ Unofficial translation by the Authority of a statement reported in Morgunblaðið (www.mbl.is) on 10.6.2012.

Suðurnes Area, the West Fjords, Hvammstangi and Ólafsvik. The bank had about 3% market share measured in total deposits in financial institutions in Iceland.

- (91) After the CAD ratio had fallen below the required minimum, the FME granted repeated extension periods for the bank to reorganise its finances in collaboration with its creditors and bring its capital base to the minimum of 16%. The final deadline for increasing Keflavik Savings Bank's capital base expired on 21 April 2010. In a letter dated 22 April 2010 Keflavik Savings Bank informed the FME that part of the savings bank's creditors had rejected proposals on financial reorganisation and, given the situation of the bank at the time, it was requested that the FME took over the bank's operations.
- (92) The next day, the Minister of Finance established a new financial undertaking, Spkef, which took over the operations of Keflavik Savings Bank in accordance with a Decision by the FME. The deposits, part of other liabilities and most of the assets of the savings bank were transferred to the new undertaking which commenced operations immediately.
- (93) Initially, according to the Icelandic authorities, it had been intended to restore the viability of Spkef by injecting capital and making it viable on a stand-alone basis. However, in February 2011, and following further deterioration of the economic conditions in the areas in which Spkef was active, the management and board of Spkef estimated the financial difference in the respective values of deposits and assets to be 11.2 billion ISK, which meant that 19.4 billion ISK were needed to meet the FME's CAD ratio requirements. According to the Icelandic authorities, this estimation was by far worse than what previous assessments had indicated and other, less costly means to remedy the situation were therefore considered.
- (94) On 5 March 2011 an agreement was reached between Landsbankinn and the Icelandic authorities whereby the operations, assets and liabilities of Spkef would be merged with Landsbankinn. According to the Icelandic authorities, this was considered to be the best course of action to safeguard financial stability and the interest of customers, creditors and the Icelandic state as Landsbankinn's capital adequacy ratio had become sufficient to take over Spkef without the need for an additional state contribution. The Icelandic authorities submit that offsetting the negative asset position (against commitments in deposits) of Spkef was in any event necessary, due to the deposit guarantee. Thus the agreement on the takeover between Landsbankinn and the Icelandic State entailed a commitment by the State to set off the negative asset position of Spkef. A special mechanism to determine this difference – and hence the scope of the State's obligation – was included, according to which, in the absence of a mutually agreed outcome of the valuation exercise, the dispute would be put before an arbitration committee.
- (95) As the parties to the agreement could not agree on the difference between transferred assets and liabilities, the aforementioned arbitration committee was charged with this task. On 8 June 2012 it concluded its work, and decided that the compensation due to Landsbankinn following the takeover of deposits and assets of Spkef amounts to 19.2 billion ISK.³⁸ According to the Icelandic authorities, the settlement will be made in the form of treasury bonds.

³⁸ See <http://www.fjarmalaraduneyti.is/frettatilkynningar/nr/15527>.

3.4.4 The rescue and acquisition of Sparisjodur Svarfdaela

- (96) As for Sparisjodur Svarfdaela, the events leading up to April 2011 that describe its financial difficulties and the intervention by the Icelandic State were set out in the Savings Banks Decisions referred to above. The subsequent acquisition by Landsbankinn was described and approved by the Authority in the SpSv Decision referred to above.
- (97) The Icelandic government granted state aid to SpSv by issuing a subordinated loan in April 2011 as well as by settling claims owned by CBI against SpSv. These claims were converted to guarantee capital transferred to the Icelandic State Financial Investments (“the ISFI”). These rescue measures were held to be temporarily compatible with the EEA Agreement based on the Savings Banks Decisions, subject to the submission of a restructuring plan for SpSv. As Landsbankinn has taken over all assets and operations of the SpSv, which amount to approximately 0.311% of the assets of Landsbankinn on that same date, the Authority considers Landsbankinn’s restructuring plan as the restructuring plan for the merged entity.

3.5 The restructuring plan

- (98) The Icelandic authorities submitted a restructuring plan for Landsbankinn on 31 March 2011. The plan was amended, updated and resubmitted by the Icelandic authorities on 23 May 2012 (hereinafter the “restructuring plan”).
- (99) The restructuring plan addresses the substantive issues of viability, burden-sharing and limitations of distortions of competition. According to the restructuring plan, Landsbankinn will focus on its core business and the restructuring of the household and corporate loan portfolios.
- (100) As indicated above, the Authority considers the restructuring period to last until 15 December 2014.

3.5.1 Description of the restructuring plan

- (101) The Icelandic authorities and the Bank consider that the restructuring of Landsbankinn will ensure its return to being a solid, well-funded bank with sound capital ratios so that it can maintain its role as a supplier of credit to the real economy. Based on the information in the restructuring plan and the written answers to questions by the Authority, this will be achieved in particular through:
- (i) Deleveraging the balance sheet by the winding up the old bank and establishing a new bank;
 - (ii) Establishing and maintaining a strong capital ratio position and a healthy balance sheet;
 - (iii) Achieving satisfactory profitability;
 - (iv) Establishing and maintaining a strong liquidity position;
 - (v) Finalising the restructuring of the loan portfolio, both for private households and for businesses;
 - (vi) Improving the funding strategy;
 - (vii) Improving cost efficiency;
 - (viii) Improving risk management.

- (102) Before describing each of the above points in more detail, the bank's view on how the weaknesses that contributed to Landsbanki's demise are being addressed in the restructuring plan, is briefly set out below. The bank claims that although Landsbankinn is based on the domestic operations of Landsbanki, it is a different bank.
- (103) The Icelandic authorities submit that weaknesses that characterised Landsbanki prior to the collapse of the banking system are discussed in detail in the report of the Special Investigation Commission, described earlier. In addition, the bank emphasises that in particular poor risk management, excessive risk appetite, the unusually close relation between owners and largest borrowers, too much growth over too short a period, the lack of experience in global markets, lenient lending rules, the lack of internal checks and controls and a flawed corporate culture and strategy were factors that led to the collapse. It also submits that key changes have been made to the bank's business model since Landsbankinn commenced operations in fall 2008 and that the above mentioned factors served as a guidance for implementation of the Bank's new strategy and governance.
- (104) Aside from a long list of measures to re-organise internal work processes and replace key staff, the most relevant changes seem to be the following: A greater focus on domestic operations, in particular on retail banking and the branch network, strongly reduced investment banking activities, an emphasis on restructuring the loan portfolio, revised risk management and a greater significance of corporate responsibility and compliance with high ethical standards.
- (105) Thus, whilst Landsbankinn just as its predecessor provides a broad range of financial services in the Icelandic market, the difference between pre- and post-crisis banking for Landsbankinn is more visible in "how" the bank does business (processes, procedures, documentation, rules and regulation) rather than "what" service and product range it offers in Iceland.
- (i) *Deleveraging the balance sheet by the winding up of the old bank and establishing a new bank;*
- (106) As mentioned above, most of Landsbanki's domestic assets and liabilities were transferred to Landsbankinn in the course of October 2008. As a result of this process, most of the wholesale debt remained in the estate of Landsbanki, and thus Landsbankinn has never been leveraged in the way Landsbanki was. According to the restructuring plan, this means that the issue of deleveraging the balance sheet of the bank was solved in essence already in October 2008.
- (ii) *Establishing and maintaining a strong capital ratio position and a healthy balance sheet*
- (107) As a result of the capitalisation measures described above, and the developments since the bank's establishment, particularly the re-evaluation of assets (further elaborated on below), Landsbankinn has achieved CAD ratios well above the capital requirements of the FME. The CAD ratio increased from 13.0% at the end of 2008 to 15.0% at the end of 2009, 19.5% at the end of 2010 and 21.4% at the end of 2011.
- (108) According to the restructuring plan, this ratio is forecasted to increase further during the course of the restructuring period, to reach [>20] at the end of 2014. Landsbankinn thus anticipates to stay well above the capital requirements of the FME during the restructuring period and beyond. [...].

- (109) During this period the balance sheet is expected to shrink slightly, from approximately 1 135 billion ISK to [...] billion ISK. On the assets side of the balance sheet, the significance of equities and equity instruments will decrease strongly, presumably due to the intended sale of operating companies. Likewise, the amount of loans to financial institutions is expected to decrease by approx. [...] % until 2014. On the other hand, loans to customers will increase by roughly [...] % to approx. [...] billion ISK according to the restructuring plan.
- (110) On the liabilities side, the significance of deposits will increase (from currently approx. 444 billion ISK to [...] billion ISK, whilst the share of secured bonds and liabilities due to financial institutions and the CBI will diminish.

(iii) Achieving a satisfactory profitability

- (111) According to the restructuring plan, and as illustrated below in **table 2**, the return on equity of Landsbankinn has been healthy since 2009.

	2009	2010	2011
Return on Equity (ROE) ³⁹	9.5%	15.9%	8.8%

Table 2: Past ROE

Moreover, the restructuring plan predicts the following ROE for the remaining restructuring period (**Table 3**).

	2012	2013	2014
Return on Equity (ROE)	[5-15]%	[5-15]%	[5-15]%

Table 3: ROE forecast

- (112) This forecast is the result of more detailed financial planning entailed in the restructuring plan:
- Operating income will increase from about 30 billion ISK to [...] billion ISK, whereas profits will remain relatively stable, fluctuating around [...] billion ISK annually;
 - Net interest income will fluctuate between [...] and [...] billion ISK;
 - Fee and commission income is expected to increase by about [...] %, from approximately 4 billion ISK to [...] billion ISK;
 - The net interest margin is expected to fall from [...] % in 2012 to [...] % in 2014;

³⁹ When referring to “Return on Equity/ROE” the ROE after taxes is meant.

- The number of employees is expected to decrease by about [...], from 1158 to [...] in 2016;
- The cost/income ratio is expected to fall from 57.2% in 2011 to [...] % in 2014.

(113) According to the Icelandic authorities, the solid performance of Landsbankinn since its establishment is to a certain extent due to the fact that assets in the loan portfolio that was acquired by the bank from Landsbanki have been written up significantly since then. Whilst these valuation gains are to some extent offset by the contingent bond, the “discount” has been and will remain an important part of the bank’s revenues while the loan portfolio is being restructured.

(114) In support of this view the Icelandic authorities have submitted a calculation (**table 4**) indicating what the annual results would have been without the discount and other “irregular items”.

	7.10.2008 - 31.12.2008	2009	2010	2011	Budget 2012	Budget 2013	Budget 2014	Budget 2015
Profit for the year	-6 936	14 332	27 231	16 957	[...]	[...]	[...]	[...]
<i>Adjustments to profitability:</i>								
Re-evaluation of transferred assets		-23 772	-49 702	-58 489	[...]	[...]	[...]	[...]
Fair value changes of contingent bond		10 241	16 269	34 316				
FX verdicts		0	18 158	40 726				
Equity and Bonds		-7 983	-7 318	-18 017				
FX gain / loss		3 000	-14 623	759				
Discontinued operations		- 693	-2 769	-6 255				
Funding cost of equity positions		2 804	1 019	1 223				
Adjusted profitability		-2 072	-11 735	11 221	[...]	[...]	[...]	[...]
Adjusted ROE		-1.4%	-6.9%	5.8%	[5-10]%	[5-10]%	[5-10]%	[5-10]%

Table 4: Profits net of irregular items

(115) According to this data, the bank would from 2010 onwards still have made profits, and would during the remainder of the restructuring period make profits even in the absence of the discount.⁴⁰

(iv) Establishing and maintaining a strong liquidity position

(116) Regarding liquidity, the FME requires that cash or cash-like assets should amount to 5% of on-demand deposits and the banks should be able to withstand a 20% instantaneous outflow of deposits. In addition, the Central Bank of Iceland sets rules on credit institutions’ liquidity⁴¹ according to which credit institutions’ liquid assets and liabilities are classified by type and maturity and assigned weights according to risk. Credit institutions must have liquid assets in excess of the next three months’ liabilities. The rules also entail a certain stress test where a discount is applied to various equity items, but where it is assumed, on the one hand, that all obligations must be paid upon maturity, and on the other, that a portions of other obligations, such as deposits, must be paid at short notice or none at all. According to the

⁴⁰ The ISFI’s report for 2011 (on the banks’ operations in 2010) comes to a similar conclusion; the “core profitability” of Landsbankinn according to this report is even higher. See http://www.bankasysla.is/files/SkyrslaBR_2011_net_74617143.pdf

⁴¹ See the CBI’s Rules on Liquidity Ratios No. 317 of 25.4.2006, available at <http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=4713>

Icelandic authorities, Landsbankinn complies with the above rules. In fact, according to the restructuring plan, it currently holds 42.5% liquid assets against total deposits.

- (117) Moreover, according to the Icelandic government, Landsbankinn has recently changed its liquidity policy in order to monitor and ensure compliance with the requirements of Basel III. Currently its liquidity coverage ratio (LCR) is [...]%.
(118) The impact on the liquidity position of the bank in case of stress, such as an immediate removal of the capital controls, is further described below.
- (v) *Finalising the restructuring of the loan portfolio, both for private households and for businesses.*
- (119) Prior to the financial crises in 2008, both the bank's private and commercial customers took on a high level of debt. When the economy and, in particular, real estate prices fell in the wake of the crisis, the suddenly over-leveraged customers could often not service their debt any longer, and held negative equity. Aside from the general threat to the economic welfare of Iceland, the sudden deterioration in the bank's lending portfolio became a major risk for the bank's future viability. For this reason the restructuring of the private and commercial loan portfolios (deleveraging), as reflected in the restructuring plan, has become a priority for Landsbankinn.
- (120) According to the Icelandic authorities, Landsbankinn has developed specific debt relief programmes and co-operated with the state and other banks on general debt relief measures (e.g. the 110% mortgage adjustment).⁴²
- (121) By 30 March 2012 the financial restructuring of more than 75% of over indebted companies with obligations towards the bank in excess of 100 million ISK and more than 75% of the total debt had been restructured. The restructuring plan assumes that by the end of 2012 this figure will have increased to 92%. Moreover, already restructured loans are to a large extent performing. For example, only 2.6% of the total loan value of already restructured companies is more than 30 days overdue.
- (vi) *Improving the funding strategy*
- (122) According to the Icelandic authorities, Landsbankinn's funding profile is sufficiently well diversified, and no major refinancing need is expected for the short or medium term. The current composition of funding is approximately as follows: 10% deposits from financial institutions, 40% deposits from customers (of which 80% are on-demand and 20% are term deposits of up to 5 years), 30% secured borrowing, maturing in 2014-2018 and 20% equity.
- (123) As indicated above, deposits are Landsbankinn's most important source of funding. According to the restructuring plan, the significance of deposits will even increase during the restructuring period. At the same time, Landsbankinn intends to increase the share of term deposits so as to make them "stickier".
- (124) Secured borrowings will remain an important source of funding. Such are also the most likely refinancing option when the current secured borrowings mature, whereas unsecured bond

⁴² The main Icelandic banks agreed to offer all overleveraged customers a 110% mortgage adjustment, i.e. that principal of mortgages is set to 110% of the registered value of the property.

issuance is not a likely funding option for Landsbankinn for the short or medium term. The bank intends to fund long-term assets such as mortgages with secured bonds in the future and this could represent up to 5% of the bank's total funding in the future. However, this is not assumed to materialise in the time period covered by the restructuring plan submitted to the Authority.

(vii) Improving cost efficiency

- (125) According to the restructuring plan, Landsbankinn continues to focus on efficient and streamlined operations in order to counter increased infrastructure cost following from tighter regulatory controls, increased taxation and the expenses linked to the restructuring work.
- (126) The restructuring plan assumes that general operating cost will decrease by [...]% (taking into account inflation), mainly as a result of being able to merge Spkef and other subsidiaries with the bank. According to Landsbankinn, this provides an opportunity to reduce cost, in particular by reducing staff ([...]% of full-time employees over the next 3 years). Moreover, the bank submits that a major project has been launched which aims at streamlining Landsbankinn's service chain. Finally, the bank has committed to close [...] branches in the course of the restructuring period. Those measures, as well as a reduction in staff, are expected to lead to the cost/income ratio falling from 57.2% in 2011 to [...]% in 2014.

(viii) Improving risk management

- (127) Landsbankinn has informed the Authority that one of their priorities is to improve its risk management practices. In this regard, Landsbankinn has established a Risk Management division. The division is responsible for all traditional risk management, measuring and assessing market risk, liquidity risk, operational and credit risk. According to Landsbankinn, risk management has been greatly enhanced through the Bank's new organisational structure. The division has 44 employees.

3.5.2 Ability to reach viability under a base and stress scenario

- (128) In the restructuring plan the Icelandic authorities have submitted a base and 3 stress scenarios for Landsbankinn with the aim of demonstrating Landsbankinn's ability to achieve long-term viability, and its resilience to adverse macro-economic developments.

3.5.2.1 The base scenario

- (129) The restructuring plan as described above constitutes the base case. According to the Icelandic authorities, the underlying macro-economic indicators are similar to those of the CBI's baseline forecast for the next years, and are reflected below in **table 5**:

Key indicator	2011	Forecast		
		2012	2013	2014
GDP	3.2%	1.7%	2.3%	3.9%
Private consumption	3.4%	1.5%	3.4%	3.2%
Public consumption	-0.2%	1.3%	1.5%	1.0%
Total investment	6.6%	23.9%	6.4%	13.4%
Exports	2.7%	2.0%	2.0%	2.5%
Imports	4.1%	3.4%	4.9%	3.1%
Output Gap	-2.7%	-1.6%	-0.8%	1.1%
Short Term IR	4.5%	4.9%	6.4%	6.9%
Unemployment	7.4%	6.2%	5.0%	4.0%
ISK/EUR exchange rate	162.6	163.5	163.5	163.5
Inflation	4.0%	4.6%	3.0%	2.6%

Table 5: Macroeconomic forecast, base scenario

3.5.2.2 The stress scenarios

- (130) The restructuring plan includes 3 stress scenarios – mild recession, international economic depression and króna depreciation, including the methodology used to build those scenarios, and the impact on the capital position of the bank. The scenarios are designed against the background of unlikely but plausible severe changes in the economic environment in which the bank operates. For example, the international economic depression scenario is based on a potential break-up of the Euro zone and the resulting effects on the European economy. The resulting macro economic variables for this scenario would be the following:

Scenario 3 - International Depression						
Key indicator	2012		2013		2014	
GDP	-3.5%	-5.2%	-3.6%	-5.9%	-0.8%	-4.7%
Private consumption	-5.6%	-7.1%	-3.9%	-7.3%	3.6%	0.4%
Public consumption	1.3%	0.0%	1.5%	0.0%	1.0%	0.0%
Total investment	-15.7%	-39.6%	-1.4%	-7.8%	0.6%	-12.8%
Exports	-5.8%	-7.8%	-4.0%	-6.0%	2.8%	0.3%
Imports	-16.3%	-19.7%	0.4%	-4.5%	13.7%	10.6%
Output Gap	-4.0%	-2.5%	-9.7%	-9.0%	-12.8%	-13.9%
Short Term IR	4.8%	-0.1%	4.0%	-2.4%	2.3%	-4.6%
Unemployment	6.9%	0.7%	7.3%	2.3%	7.7%	3.7%
ISK/EUR exchange rate	196.2	32.7	196.2	32.7	196.2	32.7
Inflation	6.7%	2.1%	3.8%	0.8%	1.3%	-1.3%

*Figures in gray show difference from baseline forecast

Table 6: Macro-indicators in the international economic depression scenario

- (131) In the stress test exercise that Landsbankinn has submitted, different methods are used to translate these 3 scenarios into an impact measurement on the bank's financial statements, the loan loss and the economic capital. By means of example, the below chart 3 demonstrates how loss given default (LGD) is related to GDP performance.

[Graph on the correlation between loss given default and GDP

Values not disclosed for reasons of professional secrecy]

Chart 3: GDP-LDG correlation

- (132) The main finding of the stress tests is that the capitalisation of Landsbankinn is such that it stays above both internal and external minimum CAD requirements in all scenarios, and according to the restructuring plan, has in fact [...] % excess capital.
- (133) In addition, Landsbankinn's restructuring plan includes a quasi-stress test of the liquidity ratio of the bank. In this case, the bank assumes that all deposits held by financial institutions would be withdrawn immediately, following for example the removal of the capital controls. According to the information submitted by the Icelandic authorities, even in such a case Landsbankinn's liquidity position would stay strong, in particular because it could liquidate additional assets relatively quickly and without overly detrimental effect on the balance sheet, such as for example its ISK denominated mortgage book (through lending operations with the CBI). Chart 4 below illustrates this scenario:

[Graph on Landsbankinn's liquidity position

Values not disclosed for reasons of professional secrecy]

Chart 4: Core liquidity position after withdrawals of all institutional deposits and varying withdrawals from customers

- (134) According to this calculation, the bank could withstand an additional withdrawal of [...] % of customer deposits without having to start liquidating assets. This result indicates that the Bank is well positioned to meet unexpected liquidity disruptions.

4. Grounds for initiating the formal investigation procedure, the Spkef transaction and the measures temporarily approved in the Savings banks Decisions

- (135) In the opening decision, the Authority preliminarily concluded that the measures by the Icelandic State to capitalise Landsbankinn entail state aid pursuant to Article 61 EEA. Furthermore it could not exclude that state aid was present in the unlimited deposit guarantee. The opening decision did not cover the aid measures related to the acquisition of SpSv, which were temporarily approved by the Authority in the Savings Banks Decisions. The Authority will take a final view on these measures, which continue to have a bearing on the assessment at hand, in the present decision. Finally, the measures related to the transfer of operations from Spkef to Landsbankinn were not covered by the opening decision, and the Authority will thus also assess them below.
- (136) As for the compatibility of the measures assessed in the opening decision, the Authority considered that a final view could only be taken on the basis of a restructuring plan, which had not been submitted when the Authority opened the formal investigation procedure on 15 December 2010. It was in particular due to the absence of a restructuring plan more than two

years after the establishment of Landsbankinn and one year after the agreement with Landsbanki's creditors that the Authority expressed doubts about the compatibility of the aid.

4.1 Comments from interested parties

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

4.2 Comments from the Icelandic authorities

- (138) The Icelandic authorities accept that measures undertaken in establishing NBI, now Landsbankinn, constitute state aid. In the view of the Icelandic authorities, the measures are however compatible with the functioning of the EEA Agreement on the basis of Article 61(3)(b) of the Agreement, as they are necessary, proportionate and appropriate to remedy a serious disturbance in the Icelandic economy. In the view of the Icelandic authorities the measures taken are in all aspects in line with the principles set out in the Authority's state aid guidelines, and submit that the aid is necessary and limited to the minimum amount necessary.
- (139) Moreover, the Icelandic authorities emphasise that the former shareholders of Landsbanki have lost all their shares and received no compensation from the state and that the aid is well designed to minimize negative spill-over effect on competitors.
- (140) As for the transfer of operations from Spkef to Landsbankinn, the Icelandic authorities acknowledge that the State's obligation to make up for a shortfall in transferred assets (compared to the amount of transferred liabilities) constitute state aid pursuant to Article 61 (1) of the EEA Agreement, even though they are of the view that the nature of the agreement precludes Landsbankinn from receiving a direct financial advantage. They concede, however, that the measure could strengthen Landsbankinn's position as it enlarges its customer base and might provide opportunities to streamline operations.
- (141) In any event, the Icelandic authorities maintain that the aid is compatible with Article 61(3)(b) of the Agreement. As they state's contribution is limited to covering precisely the difference between assets and liabilities, and that difference is determined by an independent committee, they submit that the aid is limited to the minimum necessary. They submit that the aid was also proportionate, as Landsbankinn was the only bank that could take on the operations of Spkef at the time, and that alternatives, such as a forced merger by the FME, would have been more disruptive and potentially more costly for the State.
- (142) The Icelandic authorities do not regard the deposit guarantee as entailing state aid.

4.3 Commitments by the Icelandic authorities

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

II. ASSESSMENT

1. The presence of state aid

(144) 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.”

(145) The Authority will assess the following measures⁴³ below:

- The initial operating capital provided by the Icelandic State to the new bank;
- The (initial) full state capitalisation of the new bank; and the retention of a majority shareholding by the State.

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

- The Icelandic Government’s guarantee to domestic deposits in all Icelandic banks and
- The transfer of operations from Spkef to Landsbankinn (“the Spkef transaction”).

(146) The Authority also recalls that the temporarily approved rescue measures for SpSv, which will now be merged with Landsbankinn, constitute state aid, the final compatibility of which depends on the restructuring plan for the merged entity.

1.1 Presence of state resources

(147) As the Authority already preliminarily concluded in the opening decision, it is clear that the capitalisation measures are financed through state resources provided by the Icelandic Treasury. As for the Spkef transaction, the State assumed the risk that the assets of Spkef would be insufficient to cover the transferred liabilities (deposits) of Spkef bank. In essence, it guaranteed to make up for the shortfall, which entailed a (potential) transfer of state resources. As indicated above, the arbitration committee decided recently that the State had to pay Landsbankinn 19.2 billion ISK. It is therefore evident that this measure entails a transfer of state resources.

(148) Regarding the deposit guarantee, the Authority emphasises at the outset that its assessment is limited to the additional deposit guarantee described above, consisting in essence of the statements made by the Icelandic government that deposits in domestic commercial and savings banks and their branches in Iceland will be fully covered.

⁴³ Described in detail in Chapter 3 of the present decision.

- (149) This assessment is without prejudice to the Authority's view on the compatibility of Act No. 98/1999 and the actions of the Icelandic Government and the TIF during the financial crisis with EEA law, in particular Directive 94/19/EC. As regards the implementation of Directives 97/9/EC and 94/19/EC the Authority is of the view that to the extent such measures constitute state aid, the use of state resources to comply with obligations under EEA law would generally not raise concerns under Article 61 EEA. The present decision is therefore not concerned with those measures.
- (150) The Authority stated in the opening decision that it would investigate further whether the statements by the Icelandic Government described above are sufficiently precise, firm, unconditional and legally binding such as to involve a commitment of state resources⁴⁴. In assessing whether these criteria are met, the Authority notes that the declarations entailed an irrevocable commitment of public resources as shown by the fact that the Icelandic state has done its utmost to protect depositors: Not only has it changed the priority of deposit holders in insolvent estates (which would not entail the use of state resources), but it has also made it clear that it would not allow depositors to suffer any losses. The Government's blanket guarantee of all deposits in domestic commercial and savings banks is furthermore distinct from any deposit guarantee scheme based on EEA acts due to the fact that the protection is unlimited in amount and no financial contribution is made by the banks benefitting from the measure.
- (151) The Icelandic Government's understanding of its declaration is illustrated by the state interventions in the financial sector that have occurred since October 2008 which have been motivated by the intention to honour this declaration. Those interventions have included measures to cover deposits of financial undertakings, such as the foundation of the three commercial banks, the transfer of SPRON deposits to Arion Bank, the transfer of Straumur deposits to Íslandsbanki, the CBI takeover of the deposits of 5 savings banks in Sparisjóðabanki Íslands the transfer of deposits in Byr Savings Bank to Byr hf, the transfer of deposits from Keflavík Savings Bank to SpKef and the State's responsibility for deposits in SpKef following the merger with Landsbankinn.
- (152) In fact, the Icelandic authorities have argued in several state aid cases that the Authority is currently investigating, some of which were mentioned above, that the respective chosen measure was the financially least burdensome option for the Icelandic state to comply with its pledge to protect depositors in full.
- (153) In the light of the above the Authority considers that there is a legally binding, precise, unconditional and firm measure in place. On this basis, the Authority therefore concludes that the statements by the Icelandic state according to which deposits are fully guaranteed entail a commitment of state resources in the meaning of Article 61 EEA

⁴⁴ See in this respect the judgment of the General Court in joined Cases T-425/04, T-444/04, T-450/04 and T-456/04, *France and others v Commission*, judgment of 21.5.2010, ECR [2010] II-02099, paragraph 283 (on appeal) as well as the Opinion delivered by AG Mengozzi in the appeal case, i.e. Case C-399/10 *Bouygues*, paragraph 47, considering these conditions as too restrictive for the finding of state aid.

1.2 Favouring certain undertakings or the production of certain goods

1.2.1 Advantage

- (154) First, the aid measures must confer on the new bank advantages that relieve it of charges that are normally borne from its budget. In line with the preliminary conclusion it reached in the opening decision, the Authority remains of the view that each of the capitalisation measures confers an advantage on Landsbankinn as the capital provided would not have been available to the bank without state intervention.
- (155) In determining whether an investment in an undertaking, for example by means of a capital injection, entails an advantage, the Authority applies the market economy investor principle, and assesses whether a private investor of a comparable size to that of the public body operating in normal market conditions would have made such an investment.⁴⁵ Since the onset of the financial crisis, the approach taken both by the European Commission (in numerous cases since the financial crisis began⁴⁶) and by the Authority⁴⁷ has been that state recapitalisations of banks amount to state aid given the turmoil and uncertainty that have characterised financial markets since the autumn of 2008. This general consideration applies in particular to the Icelandic financial markets in 2008 and 2009, when the entire system collapsed. Thus the Authority considers the capitalisation measures to confer an advantage on Landsbankinn notwithstanding the eventual transfer of a minority shareholding to the (largely private sector) creditors. The private sector involvement in the capitalisation of Landsbankinn is made up entirely of creditors of the old banks who are solely seeking to minimise their losses⁴⁸. Moreover, given the contingent bond mechanism described above, they cannot be considered to have invested at the same terms as the State.
- (156) Regarding the Spkef transaction, the Authority notes that the transaction aimed at providing Landsbankinn with compensation equalling solely the difference between transferred assets and liabilities. Moreover, the mechanism to determine this difference, with an independent arbitration committee as the final arbiter, ensured a high degree of objectivity in this process. However, the entire risk of the assets of Spkef being of less value than the transferred deposits, and the obligation to make up for any potential shortfall, was allocated to the State. It follows that Landsbankinn was able to acquire goodwill and additional market shares, without taking on any risk. The Authority concludes that this constitutes an advantage.
- (157) Finally, the Authority also needs to assess whether the additional deposit guarantee conveys an advantage on Landsbankinn and Icelandic banks in general. In this regard, the Authority notes that when the statement that deposits would be guaranteed were first made by the Icelandic authorities, it was not entirely clear how this guarantee would work in practice, in particular what effect such intervention would have on a failing bank. Today it appears that such a bank would be allowed to fail, but that the Icelandic state would ensure – for example

⁴⁵ See for example T-228/99 *WestLB* [2003] ECR-435.

⁴⁶ 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.

⁴⁷ 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/?1=1&showLinkID=16694&1=1>

⁴⁸ See in this context similar reasoning adopted by the European Commission in respect of investments made by suppliers of a firm in difficulty in Commission Decision C 4/10 (ex NN 64/09) – Aid in favour of Trèves (France).

by transferring deposits to another bank and making up for the shortfall in assets – that deposits could be paid in full, and the depositors would never lose access to the full amount of their deposits.

- (158) The Authority considers that it is of secondary importance how the State would act in complying with the unlimited guarantee on domestic deposits. What matters is that it has assumed the obligation to step in if a bank would fail to pay out deposits, to an unlimited extent.
- (159) This unlimited guarantee has, in the Authority’s view, favoured Landsbankinn: First, as it provides a valuable competitive advantage – an unlimited state guarantee, and hence a significant safety net – over alternative investment options and providers. This is illustrated for example by a recent report of the Minister of Economic Affairs which states that: “Icelandic financial undertakings are currently operating in a sheltered environment with capital controls and a blanket deposit guarantee. Under such conditions, bank deposits are practically the only secure option for Icelandic savers”.⁴⁹
- (160) Second, it seems clear that in the absence of the guarantee Landsbankinn could have more easily suffered from a run on its deposits like its predecessor⁵⁰. Thus the bank would likely have had to pay higher interest rates (to compensate for the risk) in order to attract or even simply retain the same amount of deposits. Accordingly, the Authority concludes that the deposit guarantee entails an advantage for the bank.

1.2.2 Selectivity

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

1.3 Distortion of competition and affection of trade between Contracting Parties

- (163) The measures strengthen the position of Landsbankinn in comparison to competitors (or potential competitors) in Iceland and other EEA States. Landsbankinn is an undertaking which is active, as described above, on financial markets, which are open for international competition in the EEA. Whilst the Icelandic financial markets are currently, particularly due

⁷³ Report of the Minister of the Minister of Economic Affairs to the Althingi (March 2012), “The Future Structure of the Icelandic Financial System”, Ch. 9.6, available at <http://eng.efnahagsraduneyti.is/publications/publications/nr/3556>.

⁵⁰ The Authority notes in this respect comments of the Governor of the CBI, who states in the foreword to the bank’s Financial Stability report for the second half of 2010 that the “*financial institutions’ capitalisation is currently protected by the capital controls and the Government’s declaration of deposit guarantee*”. See <http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=8260>, p. 5. See also Commission Decisions NN48/2008 Guarantee Scheme for Banks in Ireland, paragraphs 46 and 47: http://ec.europa.eu/community_law/state_aids/comp-2008/nn048-08.pdf; and NN51/2008 Guarantee Scheme for Banks in Denmark: http://ec.europa.eu/community_law/state_aids/comp-2008/nn051-08.pdf

to the capital controls, rather isolated, (a potential for) cross-border trade still exists, which will increase as soon as the capital controls are lifted. All measures under assessment must therefore be regarded as distorting competition and affecting trade between the Contracting Parties to the EEA Agreement.⁵¹

1.4 Conclusion

- (164) The Authority, therefore, comes to the conclusion that the measures taken by the Icelandic State to capitalise the new bank, the deposit guarantee and the Spkef transaction involve state aid within the meaning of Article 61(1) of the EEA Agreement. The Authority recalls that it reached the same conclusion regarding the capitalisation measures granted to SpSv in the Savings banks decisions.

2. Procedural requirements

- (165) Pursuant to Article 1(3) of Part I of Protocol 3 SCA, “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”.
- (166) The Icelandic authorities did not notify the aid measures covered by the opening decision to the Authority in advance of their implementation. The same applies to the Spkef transaction. The Authority therefore concludes that the Icelandic authorities have not respected their obligations pursuant to Article 1(3) of Part I of Protocol 3. The granting of those aid measures was therefore unlawful.

3. Compatibility of the aid

- (167) As a preliminary remark, the Authority notes that whilst Landsbankinn is a new legal entity that was established in 2008, it is – as regards domestic operations – evidently the economic successor of Landsbanki, in the sense that there is an economic continuity between those two entities. In fact, the Icelandic authorities have explained that the similarity of names of old and new bank are intended to allow Landsbankinn to capitalise on the goodwill still associated with the name “Landsbanki” in Iceland. As those economic operations that were carried out by Landsbankinn from the autumn of 2008 onwards could not have continued in the absence of the aid, the Authority considers the bank as an undertaking in difficulties.
- (168) Moreover, the measures under assessment are at the same time rescue and restructuring measures. As stated in the opening decision, the Authority would probably have temporarily approved the measures as compatible rescue aid had they been notified before their implementation, before then taking a final view on them on the basis of a restructuring plan. However, in the absence of a timely notification, the Authority initiated the formal investigation procedure and requested the submission of a restructuring plan. As indicated above, the final compatibility of these measures depends on whether the restructuring plan meets the criteria of the Authority’s applicable state aid guidelines for undertakings in difficulties.

⁵¹ See in this respect Case 730/79 *Phillip Morris v Commission* [1980] ECR 2671.

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

- (169) While state aid to undertakings in difficulties such as Landsbankinn is normally assessed under Article 61(3)(c) of the EEA Agreement, Article 61(3)(b) of the Agreement allows state aid “to remedy a serious disturbance in the economy of an EC Member State or an EFTA State”. As is stated in paragraph 8 of the Banking Guidelines⁵², 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.
- (170) The Icelandic authorities have explained, as described in detail above, that Iceland's financial system entered into a state of systemic crisis in October 2008, leading to the collapse of its major banks as well as major savings banks within a time span of a few days. The combined market share of the collapsed financial institutions exceeded 90% in most segments of the Icelandic financial market. The difficulties were coupled with a breakdown of confidence in the country's currency. Iceland's real economy has been severely hit by the financial crisis. Although more than three years have passed since the onset of the crisis, the Icelandic financial system is still vulnerable. Even if the situation has eased significantly since 2008, it is evident that at the time that the measures were taken, they were intended to remedy a serious disturbance in the Icelandic economy.
- (171) Consequently, Article 61(3)(b) of the EEA Agreement is considered to apply in this case.

The application of the Restructuring Communication

- (172) The Authority's State Aid Guidelines on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules⁵³ (“the Restructuring Guidelines”) set out the state aid rules applicable to the restructuring of financial institutions in the current crisis. According to the Restructuring Guidelines, in order to be compatible with Article 61(3)(b) EEA, the restructuring of a financial institution in the context of the current financial crisis has to:
- (i) Lead to the restoration of the viability of the bank;
 - (ii) Include sufficient own contribution by the beneficiary (burden-sharing);
 - (iii) Contain sufficient measures limiting the distortion of competition.
- (173) The Authority will thus assess below, based on the restructuring plan submitted for Landsbankinn whether these criteria are met and if the aid measures described above constitute compatible restructuring aid.

⁵² 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>

⁵³ Return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, adopted by the Authority on 25.11. 2009 under chapter VII: Temporary Rules regarding the Financial Crisis, as extended by the Financial Crisis Guidelines 2012. Available at the Authority's website at: <http://www.eftasurv.int/media/state-aid-guidelines/Part-VIII---Return-to-viability-and-the-assessment-of-restructuring-measures-in-the-financial-sector.pdf>.

3.2 Restoration of viability

- (174) Restoring the long-term viability of a beneficiary in receipt of restructuring aid is the main objective of such aid, and the assessment of whether restructuring aid will attain this, is an important aspect in determining its compatibility.
- (175) As indicated above, the turmoil in the Icelandic economy in the wake of autumn 2008, the presence of extra-ordinary measures such as the capital controls, an evolving regulatory environment and a macro-economic outlook that remains somewhat uncertain, make it challenging to operate a bank profitably and ensure its long-term viability. The Authority emphasises at the outset that this consideration needs to be borne in mind in the below assessment.
- (176) Section 2 of the Restructuring Guidelines sets out that the EEA State should provide a comprehensive and detailed restructuring plan which provides complete information on the business model and which restores the bank's long-term viability. Paragraph 10 of the Restructuring Guidelines requires that the restructuring plan identifies the causes of the bank's difficulties and the bank's own weaknesses, and outlines how the proposed restructuring measures remedy the bank's underlying problems.
- (177) The causes of Landsbanki's difficulties are, as described above, spelt out both in the restructuring plan, but also in the report of the Special Investigation Commission. Amongst the main causes identified at the bank's level in the latter were poor risk management, excessive risk appetite, the inordinately close relation between owners and largest borrowers, too much growth over too short a period, the lack of experience in global markets, lenient lending rules, the lack of internal checks and controls and a flawed corporate culture and strategy were factors that led to the collapse.. The bank also relied heavily on short-term wholesale funding and had to obtain large amount of deposits abroad to be able to fund its operations. This aggravated the already existing currency imbalances.

Regulatory viability measures

- (178) The Authority considers that the failure of Landsbanki, and the collapse of the Icelandic financial industry, was also caused by a number of factors specific to Iceland, relating to its small size and the regulatory and supervisory shortcomings highlighted by the Special Investigation Commission. The long-term viability of Landsbankinn, such as that of any other Icelandic bank, thus also depends on whether those supervisory and regulatory shortcomings have been remedied.
- (179) In this regard the Authority notes positively the amendments to the regulatory and supervisory framework that the Icelandic authorities have made, as explained in Annex I.
- (180) First, the powers and competences of the FME have been enhanced, inter alia with new responsibilities regarding large single exposures and the risks related thereto, which in the Authority's view addresses one of the factors that led to the financial collapse.
- (181) Second, the temporary high CAD ratio requirements, and a number of provisions relating to collateralisation, in particular the prohibition of extending credit against pledges of own shares, aims at ensuring that Icelandic banks cannot once operate on a weak capital position.

The Authority considers that these measures will contribute to the resilience of the Icelandic banks.

- (182) Third, a range of measures have been implemented relating to the eligibility of directors and board members, as well as their remuneration. Moreover, lending to related parties (such as owners) has been subjected to stricter rules, and the FME can now prohibit a bank from performing specific activities. External and internal accounting rules have also been amended. For example the duration for which an external accountant can work for the same bank has been shortened. The Authority notes positively that these measures are aimed at preventing a repetition of events in so far as the owners and high executives are concerned. The measures also increase external risk monitoring, both of which reduce threats to the banks' viability.
- (183) Fourth, according to the Icelandic authorities, the already mentioned possibility for the FME to limit a bank's activities, is also prompted by the large-scale deposit taking by Icelandic commercial banks before the crisis. Moreover, the new rules on liquidity and foreign exchange balance⁵⁴ also appear, in the Authority's understanding, to entail certain restrictions as regards the banks' possibility to attract disproportionately large amounts of foreign deposits if that were to make the bank's business more fragile and vulnerable to foreign currency exchange and liquidity risks. The Authority welcomes that the Icelandic authorities have responded to this aspect of regulatory failure.

Landsbankinn's restructuring plan

- (184) As for the restructuring plan and the measures at the bank's level, Landsbankinn has in essence reverted to a more traditional banking model, focusing on its core strength in domestic retail and corporate banking, which will be predominately funded through domestic customer deposits.
- (185) As indicated above, Landsbankinn was – if compared to its predecessor – from the moment of its establishment substantially less leveraged. As most wholesale debt remained in the estate of Landsbanki, it will, according to the restructuring plan, not have to rely on refinancing by issuing unsecured bonds on international markets, which, in the current climate, would likely be a challenging prospect.

⁵⁴ New Rules on Foreign Exchange Balance adopted by the CBI entered into force on 1 January 2011. The purpose of the rules is to limit foreign exchange risk by preventing foreign exchange balances from exceeding defined limits. One of the most important changes from previous versions of the Rules is that the permissible open foreign exchange position in individual currencies has been reduced from 20% to 15% of equity, and the permissible total foreign exchange balance has been lowered from 30% to 15%. Foreign exchange balance reporting is also more detailed than before, as foreign-denominated assets and liabilities are classified by type: loans, bonds, equity securities, shares in mutual funds, deposits, interest-bearing agreements, debts to the Central Bank, and so on. Should the foreign exchange balance deviate from the limits set forth in the rules, the financial undertaking concerned must take action so as to eliminate the difference within a maximum of three business days. If a financial undertaking's measures fail to achieve this, the CBI may calculate periodic penalties. The CBI has also taken other steps to limit foreign exchange imbalances, for instance by concluding a currency swap agreement with one of the commercial banks as well as purchasing foreign currency. According to the CBI, these measures promote increased financial stability and bolster the CBI's non-borrowed foreign exchange reserves.

- (186) In fact, the reliance on wholesale markets and later on foreign deposits for refinancing turned out to be one of the main reasons for Landsbanki's demise. Landsbankinn's funding, on the other hand, has so far been based to a large extent on deposits and equity (over 70%), and the restructuring plan foresees a slight increase in the share of deposits of total liabilities. The restructuring plan shows that no major refinancing need arises in the course of the restructuring period [...], and the Authority notes positively that neither a successful return to international markets for unsecured debt nor the less challenging issuance of secured bonds form part of the assumptions on which the funding forecast is based.
- (187) As regards the aforementioned possibility of successfully issuing unsecured bonds, the bank submits that the currently limited appetite of investors for such debt could pick up again once the unlimited deposit guarantee – in particular the deposit priority - is lifted, which currently decreases the attractiveness of other forms of debt.
- (188) Based on the facts submitted by the Icelandic authorities, the Authority considers that the bank's funding situation appears to be sound until the end of the restructuring period. Given the uncertainties surrounding the deposit guarantee and the capital controls, as well as the ambiguous future developments of (sovereign) debt markets, it cannot conclude on whether Landsbankinn's long term funding strategy will materialise as foreseen in the long run. However, given the stability of the funding prospects, in particular the strong reliance on deposits and equity during the restructuring period, and the large share of those types of debt on the balance sheet, the Authority concedes that slight variations to the funding strategy would not threaten the bank's viability.
- (189) As regards the assets side of the balance sheet, most of the risky, international assets were also kept in Landsbanki's estate. As a result, the balance sheet has shrunk by approximately 75%. A main weakness of Landsbanki's business model – the reliance on risky international assets, and in particular the strong dependence on profits from investment banking (43% of pre-crisis profits) without appropriate risk assessment and limited market knowledge - has thus been remedied. The Authority welcomes that pursuant to the restructuring plan, the bank will not engage in similar business in the future, but rather focus on its traditional core business.
- (190) Evidently, the bank has grown since its establishment, in particular through the acquisitions of Spkef and SpSv as described above. However, according to the restructuring plan, this does not have a major impact on the business model of Landsbankinn, as SpKef and SpSv mainly disposed of domestic assets of similar characteristics as those in Landsbankinn's portfolio. In any event, the Authority considers that the committed divestments, further discussed below, will contribute to letting Landsbankinn focus on its core business. The committed closure of [...] branches during the restructuring period will contribute to letting Landsbankinn realise efficiency gains.
- (191) A considerable challenge for the bank is the restructuring of the loans that were transferred from Landsbanki. In this regard the Authority notes positively that this restructuring process is a priority for the bank, as illustrated by the many generic and tailor-made proposals that the bank has made to its overleveraged customers. It has also created a well-staffed restructuring division. Whilst the process has not progressed as swiftly as initially planned, much has been already achieved. For example, by 30 March 2012, 75% of the total debt in need of restructuring had undergone some form of debt-adjustment. Moreover according to the

figures submitted by the Icelandic authorities, the vast majority of those were able to service their debt post restructuring.

- (192) The Authority considers this to be an indicator of the soundness of Landsbankinn restructuring methods, and as evidence that the bank has indeed made the restructuring of its loan portfolio a priority. Moreover, based on the progress made so far, it appears realistic that the bank can meet its target of completing 92% of the restructuring (in terms of total loan volume) by year-end 2012.
- (193) The Authority also notes positively that the restructuring plan only predicts an increase of [...] % in terms of loans to customers over the restructuring period. This seems plausible in the current economic environment. It also considers that the decreased significance of equities and equity instruments, and in particular the committed sale of [...] (see Annex I), will further reduce the riskiness of Landsbankinn's assets portfolio.
- (194) Overall, barring unexpected developments in the macro-economic environment in Iceland or abroad, this would appear to suggest that at the latest at the end of the restructuring period, Landsbankinn will have a relatively healthy balance sheet and well-performing loan portfolios.
- (195) As indicated above, the weak capitalisation of Landsbankinn was one of the factors that led to its downfall. Landsbankinn's restructuring plan predicts that the bank will stay well above the minimum CAD ratio of 16% throughout the restructuring period. This ratio is also well above the future Basel III minimum requirement of 10.5%. Even in the sufficiently severe stress tests which Landsbankinn has performed and which are in line with the Restructuring Guidelines' requirement of a "a combination of stress events, including a protracted global recession" (cf. paragraph 13 thereof), the CAD ratio would not fall below this high benchmark. The Authority considers it prudent and comforting that even in the stress case with the strongest impact on Landsbankinn capital base – essentially a disintegration of the Euro zone – the bank would retain [...] % excess capital, which, in an operating environment as described above, provides Landsbankinn with a significant buffer to deal with unexpected adversities.
- (196) Moreover, Landsbankinn's CAD ratio will continue to gradually increase during the restructuring period. On this basis the Authority considers that the capitalisation of Landsbankinn makes the bank sufficiently resilient.
- (197) As for the banks' liquidity position, the Authority notes that it currently appears to be sufficiently robust, and that there are no indications that the situation should deteriorate substantially during the restructuring period. The Authority notes positively that the bank has already started to adapt its liquidity policy to comply with the future Basel III requirement. It considers that the bank's current LCR of [...] % is a comforting indicator, in particular compared to the average of 83% that was determined in a study comprising over 200 banks by the Bank for international settlements⁵⁵. Moreover, the Authority considers that the stress testing of the bank's liquidity ratio that Landsbankinn's liquidity situation is sound.

⁵⁵ Cf. <http://www.bis.org/press/p120412a.htm>.

- (198) The Authority also welcomes the changes to Landsbankinn's corporate governance and the replacement of key staff. In the same vein, the greater role of risk management, as described above, addresses in the Authority's view a weakness in Landsbankinn's business model and will contribute to a more objective and professional risk assessment in the bank's operations.
- (199) The Restructuring Guidelines also provide that the restructuring plan should demonstrate how the bank will restore its long-term viability without state aid as soon as possible. In particular, the bank should be able to generate an appropriate return on equity, while covering all costs of its normal operation and complying with the relevant regulatory requirements. In particular, point 13 of the Restructuring Guidelines indicates that long-term viability is achieved when a bank is able to cover all its costs including depreciation and financial charges and provide an appropriate return on equity, taking account of the risk profile of the bank.
- (200) At this point, the Authority recalls that the economic environment in which Landsbankinn operates would be challenging for any bank. Moreover, the Authority considers that a difficult balance has to be struck for any bank in Iceland at the moment between the goal of increasing profitability and maintaining a safe (i.e. high) capital balance. With this in mind, the Authority is satisfied with the restructuring plan's forecasted profitability, which, in spite of the high capital ratio, will be adequate throughout the restructuring period. Between 2009 and 2014, the ROE fluctuates between [>5] % and [>15] %.
- (201) However, as described above, this fluctuation is also due to irregular situations and events, such as for example the valuation gains from the assets transferred from Landsbanki. One-off events such as unexpectedly successful sales of subsidiaries on one hand, and the write-downs caused by the recent Supreme Court ruling on FX-loans on the other hand, may also have an impact. The calculation submitted by the Icelandic authorities in which the Profit and Loss Statement (P&L) has been cleansed of those irregular items indicates that the bank has made and will continue to make relatively stable profits from 2011 onwards. The report by the Icelandic State Financial Investments ("ISFI") referred to above would seem to support this conclusion. It is not clear if these calculations are such as to solely reflect the "core profitability" of the bank. However, the Authority notes that the significance of the discount decreases rapidly over the restructuring period, and the bank expects to report "core" profits between approx. [...] and [...] billion ISK annually according to the restructuring plan in the period between 2012 and 2014.
- (202) Some of the most relevant and more detailed aspects of the financial planning were mentioned above. The Authority is of the view that these assumptions overall seem sufficiently prudent, given the challenging operating environment. As regards the interest rate margin, the Authority notes that even after the anticipated decrease to [...] %, it would be rather high in international comparison.⁵⁶ According to the Icelandic authorities, the margin has been approximately at that level or higher throughout the last decades. This is due, amongst other factors, to the high-interest rate environment in Iceland, the lower share of mortgages in the loan portfolio and the smaller size of the banks. The Authority considers these explanations reasonable, and therefore finds this aspect of the financial planning to be sufficiently plausible.

⁵⁶ Cf. for example the CBI's Financial Stability report 2011:2, according to which the interest rate margin is about 2-3 times higher in Iceland than in other Nordic countries.

- (203) Another important driver of future profitability is greater fee and commission income, which is forecasted to increase by approximately [...]%. This increase would then yield profits of over [...] billion ISK in 2014. The Icelandic authorities submit that these projections are plausible, as business such as stock market related transactions and foreign currency trade have practically come to a standstill after the collapse and the introduction of the capital controls.
- (204) The bank has taken a number of initiatives, as described above, to increase efficiency and reduce cost, amongst others the planned reduction of staff described above, the committed closure of [...] branches and a general streamlining of operations. These measures should overall reduce the cost to income ratio from 57.2% to [...]% in 2014. The Authority welcomes these efforts, as the current ratio appears quite high in international comparison. The Authority also considers it to be plausible that this target can be reached.
- (205) In addition to the above, it is evident that the restructuring plan is based on a large number of other assumptions. The Authority has aimed to scrutinise those that seems most pertinent and of greatest influence to the future viability of Landsbankinn. The macroeconomic assumptions appear to be in line with the forecasts of the CBI. Overall the assumptions on which the restructuring plan is based appear to be sufficiently prudent to allow the conclusion that the restructuring measures undertaken by the bank are sufficient to ensure its long-term viability, barring unexpected adverse events of unforeseen scale and consequences.
- (206) Taking into account the above elements, the Authority considers that the restructuring plan demonstrates the restoration of the long-term viability of the bank. The Authority therefore concludes that the provisions of section 2 of the Restructuring Guidelines are complied with.

3.3 Own contribution/burden-sharing

- (207) Paragraph 22 of the Restructuring Guidelines reads as follows: “In order to limit distortions of competition and address moral hazard, aid should be limited to the minimum necessary and an appropriate own contribution to restructuring costs should be provided by the aid beneficiary. The bank and its capital holders should contribute to the restructuring as much as possible with their own resources. This is necessary to ensure that rescued banks bear adequate responsibility for the consequences of their past behaviour and to create appropriate incentives for their future behaviour”.
- (208) The Authority recalls in this regard a decisive aspect of the case at hand. When Landsbankinn was established on the basis of the domestic operations of Landsbanki, the investments of the shareholders in Landsbanki were fully wiped out and have thus contributed to the maximum possible to the restructuring of Landsbankinn. Moreover, the creditors of Landsbanki had to take considerable losses⁵⁷, or at least they had to take on the risk of their investment depending on the performance of the assets transferred to Landsbankinn (via the contingent bond). Therefore, as far as the owners and creditors of Landsbanki are concerned, the criterion of burden-sharing is satisfied and the issue of moral hazard addressed.

⁵⁷ The exact extent of the losses is still uncertain, and varies according to the ranking. An indication of the losses, according to current estimates, can be inferred from http://www.lbi.is/library/Opin-gogn/skyrslan/Opna%20netið%20-%20CreditorsMeeting_31Mai2012%20-%20ÍslenskaME.pdf, according to which liabilities are approx 3 times greater than assets in the estate.

- (209) In addition to the above, the Authority needs to assess whether the state aid that Landsbankinn has received was limited to the minimum necessary.
- (210) As regards the capitalisation measures, the initial capitalisation of Landsbankinn at its establishment was below the FME's capital requirements (13% instead of 16%). In 2009, after the agreement with Landsbanki had been reached the CAD ratio reached 15%, 1 percentage point short of the minimum ratio set forth by the FME, which granted a temporary exemption. In this context, the Authority notes that the (future) capital ratio depended mainly on whether valuation of the assets that had been transferred from Landsbanki to Landsbankinn had been done accurately. The fact that Landsbankinn's CAD ratio subsequently grew strong enough to allow it to absorb the operations of Spkef, and later SpSv, has been explained with the writing up of the book value of the assets that had been transferred. That the CAD ratio developed so strongly later is in the Authority's view no reason to consider that Landsbankinn was overcapitalised by the State at the outset.
- (211) Paragraph 26 of the Restructuring Guidelines provides that banks in receipt of restructuring aid "should be able to remunerate capital, including in the form of dividends and coupons on outstanding subordinated debt, out of profits generated by their activities".
- (212) The Authority clarified its State aid guidelines with regard to capital injections made through shares in 2012. Paragraphs 7-8 of the 2012 Financial Crisis Guidelines provide: "In view of the regulatory changes and the changing market environment, the Authority anticipates that State capital injections may in the future more commonly take the form of shares bearing a variable remuneration. Clarification of the rules on pricing of capital injections is desirable given that such shares are remunerated in the form of (uncertain) dividends and capital gains, making it difficult to assess directly *ex ante* the remuneration on such instruments. The Authority will therefore assess the remuneration of such capital injections on the basis of the issue price of the shares. Capital injections should be subscribed at a sufficient discount to the share price (after adjustment for the "dilution effect") immediately prior to the announcement of the capital injection to give a reasonable assurance of an adequate remuneration for the State"⁵⁸
- (213) In the Authority's view, this provision is not directly applicable to the case at hand, as, technically, the State capitalised a new bank. Thus it could not dilute the old shareholders in the exact sense of the word. However, the rationale underlying the provision is that sufficient diluted ownership and future profits would be allocated to the State who had to take on risk by injecting capital in a company in difficulty.
- (214) In the case at hand, it is evident that the State obtained most (81,33%) of Landsbankinn's ownership and will consequently receive the same share of future profits, whereas former shareholders receive none. The current minority shareholders who are former creditors will participate to some extent in future profits. However, they will in all likelihood still have to bear significant losses, as set out above.

⁵⁸ Financial crisis Guidelines 2012, adopted by the Authority on 14.12.2011 under chapter VII: Temporary Rules regarding the Financial Crises. Available at the Authority's website at: <http://www.eftasurv.int/media/state-aid-guidelines/Part-VIII---Financial-Crisis-Guidelines-2012.pdf>. Emphasis added.

- (215) In addition, Landsbankinn's performance since its establishment has been adequate, and the restructuring plan predicts stable profits for the next years. Therefore the Authority considers that the requirement of Paragraph 26 of the Restructuring Guidelines, in conjunction with Paragraph 8 of the 2012 Financial Crisis Guidelines has been complied with.
- (216) Whilst the Spkef transaction, as described above, entails elements of state aid, the Authority considers that it is constructed in a manner that aims at excluding a direct financial advantage for Landsbankinn. In this regard, it recalls that the final compensation for taking on Spkef's deposits was determined by an independent arbitration committee. Therefore, this transaction constitutes in essence a negotiated compensation for Landsbankinn in exchange for taking on the deposit liabilities of Spkef. The Authority does not consider that this aid is of great significance for its burden-sharing assessment. However, the additional goodwill and market share that Landsbankinn acquired through the transaction has a more significant bearing on the assessment of the distortions of the competition below.
- (217) Finally, as regards the deposit guarantee, the Authority has already indicated in the opening decision that – in light of the extraordinary circumstances at the time - it might constitute a proportionate means to safeguard financial stability in Iceland. It is evident however that such aid cannot be approved indefinitely.
- (218) Thus, in order for this state aid to be considered as limited to the minimum necessary, the Authority is of the view that it needs to be terminated as soon as possible. The Authority therefore welcomes the intention of the Icelandic authorities to abolish the deposit guarantee before the capital controls are lifted, thus, pursuant to current planning, no later than the end of 2013.
- (219) So as to cater for delays in the lifting of the capital controls, and to reflect the Authority's view that a viable bank should be able to compete on the market without the protection of such a blanket guarantee on deposits, it will therefore authorise the deposit guarantee until the end of 2014.⁵⁹ After that time, protection of deposits should be governed only by the applicable EEA legislation regarding deposit guarantees.
- (220) The Authority concludes that the restructuring plan of Landsbankinn ensures that the aid is limited to the minimum necessary and that the beneficiary, the shareholders and debt holders of its predecessor bank have participated significantly in the burden-sharing. The restructuring aid thus complies with section 3 of the Restructuring Guidelines.

3.4 Limiting distortions of competition

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

“Financial stability remains the overriding objective of aid to the financial sector in a systemic crisis, but safeguarding systemic stability in the short-term should not result in longer-term damage to the level playing field and competitive markets. In this context, measures to limit distortions of competition due to state aid play an important role. [...] Measures to limit the distortion of competition should be tailor-made to address the distortions identified on the markets where the beneficiary bank operates following its return to viability post restructuring, while at the same time adhering to a

⁵⁹ At the end of 2014, the restructuring periods of all Icelandic banks for which a formal investigation has been initiated will have come to an end.

common policy and principles. The Authority takes as a starting point for its assessment of the need for such measures, the size, scale and scope of the activities that the bank in question would have upon implementation of a credible restructuring plan as foreseen in Section 2 of this Chapter. [...] The nature and form of such measures will depend on two criteria: first, the amount of the aid and the conditions and circumstances under which it was granted and, second, the characteristics of the market or markets on which the beneficiary bank will operate.

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

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

- (222) It follows from the above that the size of the aid, particularly in relative terms, and the market characteristics are essential in the Authority’s assessment of the appropriateness of measures to limit distortions of competition. At the same time, it is evident that such measures must not jeopardise the viability of the beneficiary of restructuring aid, and competition concerns must be addressed with a view to the overriding goal of financial stability in the present crisis.
- (223) Against the background of the above legal framework, the Authority will set out below the considerations that it deems essential for its assessment of the measures limiting distortions of competition.
- (224) First and foremost the Authority considers that given the particular situation on the Icelandic financial markets a careful assessment of the market conditions and the competitive environment is necessary. The measures limiting the distortion of competition should reflect the current difficult circumstances, while ensuring that the distortions of competition are limited to a minimum both in the short-term and the long-term.
- (225) Second, as set out above in the section on burden-sharing, the greatest possible contribution from the former owners of Landsbanki, and to some extent, of Landsbanki’s creditors has been addressed. Consequently, the need for additional competition measures has been limited.
- (226) Third, as regards the characteristics of the relevant market, the collapse of the financial system in Iceland, followed by the interventions of the Icelandic authorities, led to a greater concentration in the Icelandic market for financial services, and substantially increased the market share by the three major banks – Íslandsbanki, Arion Bank and Landsbankinn. Only few other and small market players remain, and the immediate prospect of a new entry is slim, due to the already mentioned barriers to entry and the small size of the market and in particular due to the capital controls. Landsbankinn enjoys a very significant position on this

concentrated market, with a market share of over 30% in the most segments. It is the largest Icelandic bank in terms of balance sheet.

- (227) Fourth, the crisis led to a number of very specific problems, such as the extremely high degree of direct and indirect ownership of the large banks in the real economy, and the emergence of a de-facto monopoly for banking IT-services (RB), majority owned by the three banks.
- (228) Fifth, the relative size of aid that Landsbankinn has received is significant. In this regard, the Authority notes that at the outset the entire capital of the bank was provided by the State. In addition, the bank has benefited from other of aid measures – the Spkef transaction and the deposit guarantee. Moreover, SpSV has received aid before it was taken over by Landsbankinn. At the same time, Landsbankinn remains a small bank, at least by international standards.
- (229) Sixth, the bank's takeovers of Spkef and SpSv call for additional competition measures. In the SpSv decision, the Authority emphasised that Landsbankinn's restructuring plan needs to comprise such measures.
- (230) Against this background, the Authority notes that a number of measures have been or will be taken that limit the distortions of competition resulting from the state aid granted to Landsbankinn.

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

- (231) The Icelandic government has specifically made two commitments (see Annex I) which in the Authority's view can contribute to creating a regulatory environment that favours competition in financial markets:
- (232) First, by appointing a working group that will review Act No. 36/1978 on Stamp Duty, and by examining in particular whether to abolish stamp duties for bonds issued by individuals when transferred between creditors (e.g. when individuals transfer their loans from one loan institution to another). The Authority considers that the current law – which inter alia obliges customers to pay stamp duty on the amount of the respective bond⁶⁰ when switching lenders – may be capable of constituting an impediment to competition, as it may lock customers to existing contracts on long term loans. The Authority thus welcomes the commitment for this law to be reviewed.
- (233) Second, the Authority takes note of that in accordance with a resolution passed by the Icelandic parliament on 21 March 2012, a committee will be appointed by the government with the mandate to review consumer protection in the financial market. This will include a specific mandate for the review of switching facilitation and switching costs reduction, and for the committee to work closely with the ICA as regards that issue. The Committee shall present its report no later than 15 January 2013. Such a closer assessment could be of benefit

⁶⁰ The stamp duty varies depending on the type of legal document concerned, but is normally 15 ISK for each started thousand ISK (i.e. approximately 1.5%) on the amount of interest-bearing bonds secured by a mortgage or other security.

for competition in the long-run. In the meantime the bank-specific commitment by Landsbankinn discussed below should contribute to making switching easier, and thereby will increase competition.

- (234) The Authority welcomes the settlement that ICA and the owners of RB, including the three major banks, have reached on this issue as it endeavours to ensure access to essential IT-infrastructure on a non-discriminatory basis and at reasonable cost for small competitors and potential new market entrants. The Authority is of the view that its concerns, as voiced *inter alia* in the second Byr⁶¹ decision, have been addressed in a satisfactory manner by this settlement. Thus, there is no need for the Authority to further address this issue in the current decision.
- (235) Finally, the Authority takes note of the regulatory amendments that have been made since 2008, as discussed in Annex I. As regards competition concerns, the introduction of Art. 22 in Act on financial undertakings No. 161/2002 is of particular relevance. This provision limits the participation of financial undertakings in activities falling outside the scope of their operating licenses. According to this new rule, such activities may only be pursued on a temporary basis and for the purpose of concluding transactions or reorganising the activities of customers. A reasoned notification to this effect must be sent to the FME, and time limits have been introduced for financial undertakings to complete reorganisation of their customers and dispose of appropriated assets.
- (236) The Authority regards this change as an appropriate regulatory response to the issue of the disproportionately large ownership by financial institutions in the real economy. This provision appears to prevent that this situation – which is a direct result of debt-to-equity-swaps with becomes a permanent one.

(ii) Measures specific to Landsbankinn

- (237) The Authority emphasises that Landsbankinn's market presence and size is only a fraction of that of Landsbanki – as total assets have been reduced by 75%, as described above. Moreover, unlike Landsbanki, Landsbankinn is only active in the Icelandic market. Whilst most of this reduction is a result of the winding up of Landsbanki's international operations, the Authority is of the view that this process is of particular relevance as regards the distortions of competition, as it was in particular Landsbanki's risky overseas strategy that led to its collapse and caused distortions in the EEA financial markets in the past.⁶²
- (238) In addition, the Authority welcomes Landsbankinn's commitments (see Annex I) to reduce its domestic market presence further by [...] divestment relating to [...]. Moreover, the Authority notes positively that Landsbankinn has committed to close 9 branches during the restructuring period. On the basis of the final restructuring plan, and recalling that Landsbankinn is a small bank by EEA standards, the Authority agrees with Landsbankinn

⁶¹ Decision No. 325/11/COL of 19.10.2011.

⁶² Cf. for example Commission Decision in Case SA.28264, Restructuring aid for Hypo Real Estate, in which the Commission accepted the separation of a large part of the Hypo Real Estate's overseas business as a measure to limit distortions of competition for the bank's successor PBB.

that further structural measures could endanger the bank's prospects of restoring long-term viability.⁶³

- (239) The Authority takes note of the commitment that Landsbankinn will not acquire financial institutions until 15 December 2014, except if it obtains the Authority's approval beforehand. This means that further concentration of the Icelandic financial market through acquisitions by Landsbankinn can be prevented. This commitment also ensures that the aid that has been granted to Landsbankinn is used for restoring its viability rather than being used to consolidate and further expand its market presence in Iceland. The same is true for Landsbankinn's commitment pursuant to which it will, until 15 October 2014, neither enforce contract clauses nor introduce new contract clauses which make special terms on interest rates contingent upon maintaining minimum range of business with the bank, as well as for the commitment not to invoke state involvement as a source of a competitive advantage when marketing its services.
- (240) As described above, the Icelandic financial market currently presents a challenging operating environment for any bank. The Authority thus welcomes the commitments by Landsbankinn relating to facilitating the switching between banks and providing basic payment processing as well as money distribution services. The Authority is of the view that those measures, in conjunction with the agreement between the three major banks and ICA on RB mentioned above, ensure that smaller market participants can access the most essential infrastructure and services at reasonable prices without the larger players being able to block their access. The Authority is of the view that this will reduce the barriers to entry for future (potential) market participants. The measures could also allow existing smaller players to expand their market shares if they are able to offer better services than their larger competitors. Moreover, the measures aimed at facilitating switching will contribute to more fierce competition between the existing large players, and could contribute to prevent or dissolve a situation of potential collective dominance.
- (241) Lastly, Landsbankinn commits to sell, as soon as possible, shareholdings in operating companies, which have been taken over due to restructuring in line with Article 22 of the Act on financial undertakings No. 161/2002. It commits to follow the procedure and time-limits, which are set out in this provision, and will maintain up-to-date information on its website (or that of a subsidiary) on subsidiaries and shareholdings that are held for sale. Moreover, Landsbankinn has committed to sell [...] by certain deadlines within the restructuring period.
- (242) The Authority welcomes Landbankinn's general commitment to divest as soon as possible all companies and shareholdings that are not related to its core business. This will not only address the potentially competition concerns that could arise from the being such a dominant owner in the Icelandic real economy, but will also prevent putting the bank's viability at risk.
- (243) This draws the Icelandic authorities' and Landsbankinn's attention to the fact that due to the commitments breach of national law might also entail a misuse of aid. The Authority moreover considers that by having to include information about foreseen divestments and sales on its website, more transparency about the current ownership situation in the Icelandic economy is introduced. This remedies, at least to some extent, this particular competition concern that currently characterises Iceland's markets.

⁶³ For the same reasons the Authority accepts the divestments are subject to the condition that [...].

(244) On the basis the above the Authority considers that the above measures address the main competition issues that the Authority has identified in collaboration with the ICA. Taking into account the overriding objective of financial stability, the Authority concludes that the commitments limit distortions of competition to a satisfactory degree. The restructuring aid therefore complies with section 4 of the Restructuring Guidelines.

III. CONCLUSION

(245) On the basis of the foregoing assessment and in the light of the restructuring plan submitted by the Icelandic authorities for Landsbankinn, the Authority's doubts expressed in the opening decision as regards the nature and the compatibility of the aid measures for Landsbankinn are allayed. Moreover, the Authority raises no objections to the Spkef transaction and authorises the aid that SpSv has received. The Authority therefore approves the aid measures as restructuring aid compatible with the functioning of the EEA Agreement pursuant to Article 61(3)(b) EEA subject to Iceland and Landsbankinn adhering to the commitments as set out in Annex I.

HAS ADOPTED THIS DECISION:

Article 1

The initial operating capital and the final state capitalisation granted to Landsbankinn as well as the Spkef transaction and the deposit guarantee constitute state aid within the meaning of Article 61(1) of the EEA Agreement.

Article 2

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

Article 3

The measures enumerated in Article 1 as well as the measures for SpSv described in the Savings Banks decisions are compatible with the functioning of the EEA agreement pursuant to Article 61(3)(b) EEA subject adhering to the commitments as set out in Annex I. The authorisation for the deposit guarantee is limited to the end of 2014.

Article 4

This Decision is addressed to the Republic of Iceland.

Article 5

Only the English language version of this decision is authentic.

Decision made in Brussels, on 11 July 2012.

For the EFTA Surveillance Authority

Oda Helen Sletnes
President

Sverrir Haukur Gunnlaugsson
College Member

ANNEX I: Commitments and relevant changes to the legal framework for banking

1. Commitments by the Icelandic authorities

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

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

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

Measures to facilitate switching and reduce switching costs

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

Moreover, the Icelandic authorities have endorsed the following commitments by Landsbankinn:

Limitation on acquisitions

Landsbankinn commits itself not to acquire financial institutions until 15 December 2014. Notwithstanding this commitment, Landsbankinn may, after obtaining the Authority's approval, acquire financial institutions, in particular if this is necessary in order to safeguard financial stability.

Divestment of [...] and closure of branches

Landsbankinn commits itself to divest of its shareholding in [...] before [date]. [...]

Moreover, Landsbankinn commits to close [...] of its branches [date].

Divestment of shares in companies under restructuring

Landsbankinn commits itself in general to sell, as soon as possible, shareholdings in operating companies, which have been taken over due to restructuring, cf. Article 22 of the Act on Financial Undertakings No. 161/2002. Furthermore, the bank commits itself to follow the procedure and time-limits, which are set out in the above-mentioned legal provision.

Finally, the bank will maintain up-to-date information on its website (or website of a relevant subsidiary) on such shareholdings that are held for sale.

In particular, Landsbankinn commits to offer for sale its shareholdings in the following companies, provided that the companies, including their financial positions, operations and future prospects, will not be subject to significant legal/litigation risk or comparable uncertainties:

[...]

Measures benefitting new and small competitors

Landsbankinn commits itself to undertake the following measures for the benefit of new and small competitors:

- a. Landsbankinn will, until the end of 2014, neither enforce contract clauses nor make new contract clauses, which make special terms on interest rates contingent upon maintaining minimum range of business with the bank.
- b. Landsbankinn will provide for easily accessible information, at the Bank's website, on the process of switching banking services to another financial institution. Furthermore, the website will make easily accessible the necessary documents to switch between financial institutions. The same information and business-transfer forms will be available at the branches of the bank.
- c. Landsbankinn will execute all requests for transfer of banking services in a swift manner.
- d. Landsbankinn will not invoke state involvement as a source of competitive advantage when marketing.
- e. Provided that competitive service offers are not available, Landsbankinn is willing to offer the following services at a price that will be based on cost plus reasonable margin:
 - i. Payment processing services for ISK.
 - ii. Payment processing services for FX.
 - iii. Distribution of bank notes and coins.

2. Relevant adaptations and changes to the regulatory and supervisory framework for financial markets in Iceland adopted after the crisis

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

- FME's (The Icelandic Financial Supervisory Authority) authorisations to intervene (to take over the powers of shareholders' meetings and dispose of assets, cf. the emergency legislation) have been increased; FME has been given expanded supervisory authorisations; additional provisions have been adopted enabling FME to evaluate the operations or behaviour of individual supervised parties. These include both decision-making authorisations, such as on the closing of establishments or termination of specific activities without actual revocation of operating licences, as well as a more detailed definition of concepts whose interpretation has been disputed by FME and supervised entities or appellate bodies.
- Rules on individual large exposures have been clarified and made more specific; both the role and responsibility of risk management have been increased and FME authorised to accord risk management higher status in the organisation of financial undertakings; provisions on the application of stress tests have been tightened.

- Provisions for a special registry of larger borrowers have been legalised, in order to provide better overview of large, individual exposures to two or more financial undertakings. The registry is important for linking exposures together and assessing their systemic impact if difficulties should arise in the borrowers' operations. Entities not subject to FME supervision, but which are listed in the registries of financial undertakings, must provide FME with information on all their obligations. FME can prohibit the provision of services to such parties should they refuse to provide the information requested.
- Provisions on sound business practices have been reinforced and the existence of the Complaints Committee on Transactions with Financial Undertakings enshrined in law; detailed information must be disclosed on all major owners of financial undertakings.
- The time limits allowing financial undertakings to dispose of appropriated assets have been shortened.
- Provisions on financial undertakings' holdings in own shares have been tightened and defined in more detail. Holdings of subsidiaries are now considered own shares, as are off-balance-sheet contracts concerning own shares.
- Financial undertakings have been prohibited from extending credit against pledges of their own shares or guarantee capital certificates.
- FME is now to lay down rules as to how loans secured by a mortgage on the shares of other financial undertakings are to be calculated in the risk base and capital base.
- Both the responsibility and role of internal auditing section has been increased. There are detailed rules concerning the balance between the size and diversity of the activities of the financial undertaking concerned and the scope of its internal auditing section.
- Five-year limits have been placed on the period for which an auditing firm may carry out the audit of the same financial undertaking; financial undertakings' ability to dismiss a "difficult" auditor is reduced.
- All provisions on calculation of equity and various other technical aspects have been reviewed.
- Rules on exercising qualifying holdings, i.e. 10% or more of voting rights, have been reviewed. FME is authorised to reverse the onus of proof in assessing parties intending on acquiring or adding to qualifying holdings, e.g. when it is uncertain who is/are the beneficial owner/-s of a holding company with a qualifying holding.
- Additional demands on eligibility have now been made of directors, their responsibility for supervision or operations have been increased and executive chairmen of the Board are prohibited; FME has been assigned a greater supervisory role for Boards of Directors; personally identifiable information must be disclosed on remuneration to senior management.
- Rules have been set concerning credit transactions of financial undertakings with directors, managing directors, key employees and owners of qualifying holdings in the financial undertaking concerned. Similar rules apply to parties closely connected with the above-mentioned. FME has adopted rules as to what is considered satisfactory collateral for such transactions.
- Rules concerning arrangements for incentive schemes and bonuses to management and employees and on termination contracts have been adopted.

- Provisions on the reorganisation and winding-up of financial undertakings have been tightened.
- An overall revision of special rules on savings banks has been carried out. The status and rights of guarantee capital owners of savings banks have been clarified, restrictions set on dividends, clear rules have been adopted on guarantee capital transactions, rules have been set on write-downs of guarantee capital and rules on savings banks' authorisations for formal co-operation have been clarified. Savings banks have been prohibited from altering their legal form.

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

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

- There are considerably more detailed provisions on the eligibility of directors in financial undertaking than in the EU directives.
- Provisions are adopted on arrangements for bonus schemes and termination contracts.
- Recently formal rules have been set on remuneration policies in EU directives, but rules on termination contracts have not yet been adopted in this forum.

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