

Case No: 70526
Event No: 621828
Dec.No: 325/11/COL

EFTA SURVEILLANCE AUTHORITY DECISION
of 19 October 2011
on the acquisition of Byr hf by Íslandsbanki and the prolongation of the temporary
approval of the subordinated loan facility granted to Byr hf

(Iceland)

The EFTA Surveillance Authority (“the Authority”)

HAVING REGARD to the Agreement on the European Economic Area (“the EEA Agreement”), in particular to Article 61(3)(b) and Protocol 26 thereof,

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

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

Whereas:

I. FACTS

1 Procedure

- (1) Following a telephone conference between the Icelandic authorities and the Authority on 14 July 2011 the Icelandic authorities submitted some information concerning the envisaged acquisition of Byr hf (“Byr”) by Íslandsbanki by letter dated 8 September (Event No 608445).
- (2) By letter dated 14 September 2011 (Event No 608609), the Authority requested additional information and a notification of the acquisition itself. It also asked for a notification of the envisaged extension of the loan facility for Byr that had been temporarily approved for 6 months by the Authority in Decision No. 126/11/COL of 13 April 2011 (“the Byr Decision”). The authorisation of the aid approved temporarily in this decision was contingent upon the submission of a restructuring plan for Byr within 6 months.
- (3) The Icelandic authorities notified the extension of the subordinated loan facility granted to Byr hf as well as the acquisition of Byr by Íslandsbanki, pursuant to Article 1(3) of Part I of Protocol 3 by letter of 22 September (Event No 609429). The Icelandic authorities requested in this notification the prolongation of the temporary approval of the subordinated loan facility in favour of Byr up until the formal merger of Byr and Íslandsbanki has taken place, and the Authority’s approval of the acquisition as such. Further clarifications were submitted by the Icelandic authorities by email on 27 September (Event No 609702), and in various emails in the period between 28 September and 14 October 2011 (Event No 610346, 610353 and

611470). A letter from the Icelandic authorities (Event No 611730) containing additional information and two commitments was received by the Authority on 13 October 2011.

- (4) The Authority had previously opened the formal investigation procedure regarding state aid granted for the establishment of Íslandsbanki in Decision No. 494/10/COL on 15 December 2010. This investigation is still pending. On 31 March 2011 Íslandsbanki submitted a restructuring plan (Event No 593307). An amended restructuring plan for Íslandsbanki must be submitted at the latest on 20 October 2011.

2 Description of the proposed measures

2.1 Background

2.1.1 Previous interventions by the State in Byr

- (5) As described in detail in Decision No. 494/10/COL, the Icelandic financial system entered into a state of systemic crisis in October 2008, following years of economic prosperity which saw the country's banking system multiply in size. This crash of the financial system called for various interventions by the State and a range of state aid measures that were put in place to restore the financial system are still being assessed by the Authority¹. Whilst a complete collapse of Icelandic banking system was avoided, it is still undergoing a process of restructuring and consolidation.
- (6) As for Byr, the events leading up to April 2011 that describe in detail its financial difficulties and the intervention by the Icelandic State were set out by the Authority in the Byr Decision. It suffices for the purposes of the present decision to recall that the Icelandic government granted state aid for the establishment of Byr, which continued the operations of its predecessor, Byr savings bank ("Old Byr"), as a new legal entity. In this process the creditors of Old Byr became the shareholders of (new) Byr, along with the Icelandic State who had provided capital for the establishment of the new company.
- (7) When the Byr Decision was adopted on 13 April 2011, the annual accounts for the year 2010 were still unavailable. However, at that point the management of Byr was confident that the rescue measures that were temporarily approved by the Authority in the Byr Decision would suffice to secure the operations of the bank at least until a restructuring plan establishing long term viability could be submitted to the Authority.

2.1.1 The events from April 2011 onwards

- (8) In the course of auditing the bank's accounts for the first half of 2011, it became evident that further write-downs of Byr's assets were necessary which in turn decreased the Capital Adequacy ratio ("CAD ratio") of the bank. Those write-downs were mainly due to foreign currency indexed loans, new valuations from the Icelandic Property Registry, decreasing the value of securities of mortgages and further write-downs of other loans in particular claims relating to [XY Bank].
- (9) On 29 April 2011, the Board of Directors of Byr sent a letter to the Icelandic Financial Supervisory Authority (FME), disclosing the Board's concerns as to the CAD ratio of

¹ See in particular the Authority's Decisions No. 492-494/10/COL of 15.12.2010 opening the formal investigation procedures into state aid granted for the establishment and capitalisation of Íslandsbanki, Arion Bank and Landsbanki.

the bank. According to the information provided in that letter, Byr lacked ISK [...] bn to meet the legal requirements for the CAD ratio, i.e. 8% Tier 1, and ISK [...] bn to meet the FME's temporary requirements for a 12% CAD ratio in Tier 1. The bank consequently made several attempts to obtain additional equity or reduce its asset base, but did not succeed. Thus the Board decided to issue new shares in the company which would be sold in an open sales procedure, and in order to increase the chances of a successful tender allowed for the simultaneous purchase of the old shares in the bank. This meant that a potential new investor could buy the entirety of shares in Byr.

- (10) By letter of 8 June 2011, the FME granted the bank a grace period until 8 August 2011 during which it was exempt from CAD ratio minimum requirements²; this grace period was later extended to 3 October, then to 6 October and then to 21 October 2011.
- (11) The sales procedure (see further below) started on 6 June 2011 and was concluded on 12 July 2011 when a share purchase agreement and a subscription agreement with Íslandsbanki were signed. The pending merger of Byr and Íslandsbanki was notified to the Icelandic Competition Authority (ICA) on 18 July 2011.
- (12) On 27 September 2011 the FME concluded that Íslandsbanki is eligible to acquire a qualifying holding in Byr, i.e. that no financial stability consideration bars this acquisition.
- (13) According to Article 85(3) of the Icelandic Act No. 161/2002 on financial undertakings,

“shareholdings and subordinated claims in other financial undertakings or in undertakings connected with the financial sector [...] which are included in the consolidated accounts of the financial undertaking in question [...] shall not be deducted from the capital base of the undertaking in question”.

This provision is of significance for the present case in so far as it means that Byr and Íslandsbanki will *inter alia* continue to have separate accounts, and therefore separate CAD ratios until a full legal merger takes place.

2.1.2 The sale of Byr

- (14) The conditions of the sales procedure were laid down in a process letter by Byr's advisor, Arctica Finance ehf. Five parties signed a confidentiality agreement to gain access to the Data Room in the first phase of the sales procedure: [...], Íslandsbanki, [...], [...] and [XY Bank], of which all but [...] submitted indicative offers. Finally, two parties submitted binding offers - Íslandsbanki and [XY Bank], both of which included an offer for the existing shares as well as for new shares.
- (15) Both offers also included a range of conditions, most importantly relating to the authorisation of the deal by the relevant authorities (ICA and FME), as well as the commitment by the Government of Iceland to extend the subordinated loan facility (Tier 2) up to the amount of 5 bn ISK to Byr on the terms and conditions provided for in the Heads of Terms under which this instrument was initially granted to Byr (see further below for a more detailed description of the measure).

² The FME imposed minimum requirements of a 12% Core Tier 1 capital ratio and a 16% CAD ratio in total in August 2009 as the result of FME's sign-off project, based on stress-testing the banks' business plans. This requirement was to last for 3 years.
See further <http://www.althingi.is/altext/139/s/pdf/1213.pdf>.

(16) The most significant differences between the two offers were the following:

- a) Funding of the transaction: Íslandsbanki's offer was accompanied by a confirmation of funding signed by the Chairman of the Board of Directors of Íslandsbanki and the bank's auditors.

According to the Icelandic authorities the confirmation of funding from [XY Bank] was more uncertain, as it was conditional upon the successful subscription for new shares in [XY Bank] of ISK [...]. However, when the offer was submitted to Byr, [XY Bank] could only provide representation statements from [...] % of the shareholders declaring their intention to subscribe for new shares in [XY Bank] worth ISK [...] and it was thus unclear whether the necessary funding could be obtained.

- b) Purchase of old shares: Íslandsbanki's offer provided for two options: Option A, according to which ISK 6.6 bn would be paid by issuing a bond denominated in ISK, bearing a one month REIBOR interest plus margin of [...] % and having a final maturity date of [...] years after the completion date. Option B, which foresaw a payment of ISK [...] consisted of a cash payment amounting to ISK [...] and a bond issued by the Buyer in the nominal value of ISK [...] with the same interest margin as described in Option A. If Option B were chosen the sellers were obliged to purchase certain assets from Byr described in a separate agreement.

[XY Bank]'s offer appears to have been more complex. The consideration foreseen for the shareholders of Byr amounted to ISK [...] to be satisfied by the conversion of the Byr shares into a newly issued and separate class of shares of [XY Bank]. The consideration shares were to be credited as fully paid, issued at ISK [...] per share, of nominal value ISK 1 per share, apportioned between the shareholders in the same proportions as their shareholding in Byr. This would grant the shareholders of Byr approximately [...] % of the issued and outstanding shares of [XY Bank] [XY Bank]post merger, subject to further conditions. Those conditions provided that on [...] the assets of Byr were to be re-valued by an independent third party. This revaluation of assets was to be done at [...] intervals for the period of [...] years; should the assets increase in value, after calculating [XY Bank]'s required rate of return of holding the assets, the increased value was to be split between shareholders of [XY Bank]and shareholders of Byr so that the latter were entitled to [...] % of the increase through the issuance of new shares in [XY Bank]. Should the value of the assets however decrease in value, the number of consideration shares would be reduced by [...]. Finally, should the value of the assets have decreased by more than ISK [...] (i.e. the nominal price for the old shares that [XY Bank] offer to pay), the Government of Iceland would issue a guarantee whereby [XY Bank] would be held harmless and be fully indemnified. This guarantee would thus hold [XY Bank] harmless if it turned out that Byr's equity, after a revaluation of its assets, would be less than zero and/or would adversely affect [XY Bank]'s equity ratio. Moreover, the offer entailed a restriction pursuant to which the Byr shareholders were not authorised to sell any of the consideration shares for a period of [...] months from the date of the first revaluation of the assets without prior written consent of the Board of Directors of [XY Bank]. No voting rights were attached to the consideration shares for a period of [...] years from the date of the first revaluation of the assets.

- c) Subscription of new shares: Íslandsbanki offered to subscribe for ISK [...] in shares in Byr. [XY Bank] offered to subscribe for a total of ISK [...] in shares in

Byr. Both subscriptions were conditional upon the execution of the purchase agreements regarding the old shares, and subject to the conditions mentioned in this section.

- d) Unilateral right of termination: The obligations of Íslandsbanki under the agreement are contingent on the above mentioned conditions being fulfilled at the latest on 1 November 2011. After that date, Íslandsbanki is entitled to declare the agreement to be null and void, free of any liability towards Byr.
- e) Offer of further negotiations: [XY Bank] expressed its willingness to enter into discussions about other solutions such as the purchase of certain assets by Byr.
- (17) After having received the offers described above, the Board of Directors of Byr referred the decision on the matter to the bank's shareholders, i.e. Old Byr and the Icelandic Ministry of Finance, as both offers were conditional upon the purchase of existing shares and upon the conditions described above.
- (18) The shareholders engaged PWC to evaluate the offers. PWC concluded that there were too many uncertainties attached to the offer of [XY Bank] to determine its value, in particular due to the unknown value of [XY Bank] shares, the revaluation procedure and the special class of shares in [XY Bank] that the shareholders of Byr would receive. Consequently it recommended that Íslandsbanki's offer should be accepted.
- (19) According to the Icelandic authorities, the Icelandic Ministry of Finance found the confirmation of funding and the conditions attached to the offer regarding the guarantee to be provided to [XY Bank] to be unacceptable. First, there were serious concerns as to certainty of closing due to the lacking confirmation of funding³. Second, the Icelandic authorities were of the opinion that the requested guarantee would not conform with the obligations of the State under the EEA state aid regime and that the prerequisite legal basis for such a guarantee did not exist in domestic law. In addition, the Icelandic Ministry of Finance had been provided with a memorandum prepared by Byr's legal counsel according to which a merger of Íslandsbanki and Byr should be considered under the "failing firm defence". Hence, the Icelandic authorities concluded that the agreement would not have negative effects on competition in the market.
- (20) The shareholders, including the Icelandic Ministry of Finance, consequently entered into an agreement with Íslandsbanki as described above.

2.2 Description of the measures under assessment

2.2.1 The use of state aid granted to Íslandsbanki for the acquisition of Byr

- (21) A detailed description of the measures for the establishment of Íslandsbanki is comprised in Decision No. 494/10/COL of 15 December 2010. Due to the fact that it cannot be excluded, as further explained below, that the acquisition of Byr by

³ According to the Icelandic government, there was "nothing to suggest that [XY Bank] is in a financial position to be capable of executing the transaction".

Íslandsbanki is (partly) funded with measures that constitute state aid, the use of this aid is assessed in the present decision⁴.

2.2.2 *The subordinated loan facility*

- (22) The subordinated loan facility (“SLF”) that was put at Byr’s disposal is described in detail in the Byr Decision. It suffices to recall for the present decision that this instrument, a Tier 2 debt facility that is subordinated to all other claims against Byr except for share capital, entitles Byr to draw upon it up to ISK 5 billion to the extent necessary to meet the CAD requirements laid down by the FME (or by national legislation)⁵. Byr has not drawn on the facility to date, as it is necessary to fulfil the Tier 1 requirements first.
- (23) The instrument bears an interest that is based on the 3 month EURIBOR/REIBOR⁶ (depending on the choice of denomination, i.e. either EUR or ISK), plus a margin of 4% per annum, with a step up to 5% after five years. Byr has the option to postpone interest payment up to six months if necessary to preserve the liquidity position of the bank. In such a case an extra 2% per annum will be added to the interest.
- (24) In the event that Byr no longer needs any part of the SLF to meet the minimum CAD ratio as set out by the FME, an additional 2% per annum will be added to the interest on that part, to the extent that New Byr has drawn on that part. Byr can choose to make prepayments either at any time after five years from the date of the facility or within three months following any interest rate step up.
- (25) It should be recalled that the instrument was authorised by the Authority for 6 months in the Byr decision (i.e. until 13 October 2011), and that the Icelandic authorities have solely requested the prolongation of the temporary approval of the SLF in favour of Byr up until the formal merger of Byr and Íslandsbanki has taken place, which is expected to be the case towards the end of 2011.

2.3 Recipients

2.3.1 *Byr*

- (26) Byr was founded on 22 April 2010 with the transfer of assets and liabilities from Old Byr, as described in Byr Decision. It is active on the Icelandic market for retail and corporate banking, mainly in Reykjavik and its surrounding towns. Byr is Iceland’s fourth largest operating bank in the retail and corporate sector. According to the annual accounts approved by the Board of Directors in June 2011, total assets amount to ISK 140.470.811 and total liabilities were ISK 138.462.012, the majority of which were regular deposits (ISK 122.073.613) and deposits from the CBI and other credit institution (ISK 7.975.249). Borrowing and subordinated loans amounted to ISK 3,7 million.

4 Without prejudice to the assessment of the compatibility of the aid currently under assessment following the opening of a formal investigation procedure with Decision No. 494/10/COL.

5 The FME’s CAD ratio requirements are 12% for Tier 1 and 4% for Tier 2, i.e. a total CAD ratio of 16%, whereas the legal minimum is 8%.

6 REIBOR denotes Reykjavik Inter Bank Offer Rate, representing the interbank market rate for short term loans at Icelandic commercial and savings banks. It is similar to the use of LIBOR or EURIBOR as the base rate for variable rate loans, but Icelandic banks use REIBOR (plus a premium) as the basis for supplying variable interest rate loans in the Icelandic currency, the króna.

- (27) According to the Icelandic government, Byr's CAD ratio is currently 5% (thereof 3.1% Tier 1 and 1.9% Tier 2). Were the new subscription of shares in Byr by Íslandsbanki included, the total CAD ratio would amount to approximately 14.6% (thereof 11.42% Tier 1 and 3.17% Tier 2). A full drawing on the SLF would raise the CAD ratio to approximately 19.3%.⁷

2.3.2 Íslandsbanki

- (28) Íslandsbanki (at that time named New Glitnir) was founded on 8 October 2008 with assets and liabilities transferred from Old Glitnir and with the support of a capital injection by the Icelandic government as described in the Authority's Decision No. 494/10/COL of 15 December 2010. On 15 October 2009 Glitnir's Resolution Committee decided, on behalf of its creditors, to exercise the option provided for in an agreement with the Icelandic Ministry of Finance and take over 95% of share capital in Íslandsbanki. The Icelandic Government still holds a minority of the ordinary share capital amounting to 5%. Íslandsbanki benefitted from a range of other measures, including a subordinated loan facility, a special liquidity facility and a government guarantee on deposits.
- (29) Íslandsbanki offers comprehensive financial services to individuals, households, corporations and professional investors in Iceland. According to Íslandsbanki's annual accounts for 2010, total assets amounted to ISK 683,222 and total liabilities were ISK 561,759m. The main liabilities were deposits from customers (ISK 327,158m) and credit institutions (ISK 96,238 m) or ISK 423,396 m in total. Borrowings and subordinated loans amounted to ISK 76,666 m. The Bank's equity was ISK 121,463 m on 31.12.2010 and the CAD ratio stood at 26.6%. According to the Icelandic authorities it is anticipated that post merger with Byr the group would have a CAD ratio of approximately 20,9%.

3 Comments by the Icelandic authorities

3.1 The subordinated loan facility

- (30) According to the Icelandic authorities the continued availability of the SLF remains necessary as it will enable Byr to comply with CAD ratio requirements set by the FME. Moreover, it is supposed to provide for a safety-net in order to be able to meet possible liquidity constraints resulting from a possible outflow of large deposits from Byr customers following the merger.
- (31) The Icelandic authorities are of the opinion that the beneficiary of the measure at hand is Byr, as the sought approval only relates to the period during which Byr will continue to operate as a standalone entity. However the Icelandic authorities take note of the fact that upon conclusion of the acquisition the two banks may be considered as one economic unit under the EEA competition rules, and that hence also Íslandsbanki could be considered as a beneficiary of the SLF.
- (32) Finally the Icelandic authorities submit that the presence of aid with regard to the merged entity will have to be assessed should Byr need to draw on the facility in the interim period, prior to the legal merger of the companies being finalised.

⁷ The most recent figures, showing that losses in 2010 were greater than expected, indicate however that the CAD ratio of Byr would amount to 13.5% after the subscription of new share. If the SLF was drawn fully the ratio would go up to 18.2%.

3.2 The acquisition of Byr by Íslandsbanki

- (33) According to the Icelandic authorities the aim of the sale of Byr to Íslandsbanki is to secure financial stability in Iceland. After a thorough evaluation of Byr's assets conducted in the first half of 2011, it had become clear that the long term viability of the bank as a standalone operation was not sustainable as it was inconceivable how it could, even beyond the near future, meet the CAD requirements.
- (34) In light of the amount of deposits held by the bank and its position on the market as the fourth largest bank in Iceland, intervention by the Icelandic authorities had been considered necessary, as an insolvency of the bank would have been a serious threat to financial stability in the country in the opinion of the Icelandic authorities. They contend that an insolvency of Byr and the corollary unavailability of deposits could have led to a run on other banks in the country resulting in a domino effect such as that experienced in autumn 2008.
- (35) The Icelandic authorities reiterate that the offer of Íslandsbanki was in their view the best if not the only offer for the shares held by the Ministry of Finance in Byr. The Icelandic authorities refer in particular to the fact that the other bidder, [XY Bank], could not provide confirmation of funding for the acquisition.
- (36) The Icelandic authorities explain that other alternatives such as a sale of certain assets that were weighing heavily on the CAD ratio of Byr, for example to the estate of Old Byr had been explored previously. These alternatives had however been discarded as they were not sufficient to solve Byr's problems in terms of the required CAD ratio. The option that had been put forward by [XY Bank] i.e. to explore the possibility of selling certain assets to [XY Bank], was likewise considered not to be feasible as that option would have left the authorities with the problem the sale process was intended to solve, namely to obtain a sufficient CAD ratio for Byr to sustain the deposits held by that bank.
- (37) According to the Icelandic authorities, a breakup of Byr by selling assets to third parties or a failure of the present sales procedure would therefore have called for the enactment of special measures under the Emergency Act by transferring liabilities, deposits in particular, to another financial institution. Given the wide gap in the CAD ratio this would have entailed state intervention of a larger scale as deposits would need to be accompanied by assets sustaining them or, in this case, additional funding or guarantees by the State. In addition, it had been clear that the recipient of such a transfer under the Emergency Act would have needed to be a financial institution capable of assuming the liabilities and assets without significant effect on legal requirements such as the prerequisite CAD ratio. In the current market situation that would have only applied to the three major banks in Iceland (Íslandsbanki, Landsbanki and Arion Banki, all of which have received state aid that is currently being assessed by the Authority).

3.3 Comments on the presence of state aid and compatibility

- (38) The Icelandic authorities concede that the SLF is to be considered as state aid. However, they submit that the sale of the stake of the Icelandic ministry of Finance in Byr was done at market terms and is therefore free of aid.
- (39) As regards the use of the state measures granted in the context of the establishment of Íslandsbanki for the acquisition of Byr, the Icelandic authorities are of the view that the bank has the financial strength to merge with Byr without making direct use of this

aid, but admit that it might be difficult to completely rule out the use of state aid granted to the bank for the acquisition of Byr.

- (40) The Icelandic authorities are of the view that Article 61(3)(b) of the EEA Agreement continues to apply, given the still fragile state of the Icelandic financial system and argue that it is imperative for the rebuilding of the Icelandic economy to secure the operations of financial institutions that have the capacity to inter alia complete debt restructuring programmes for consumers and companies alike.
- (41) On the premise that it was necessary for the State to ensure the availability of deposits in Byr to avoid serious disturbances in the economy, the Icelandic authorities contend that alternative routes would have entailed further involvement of state resources and greater losses for the State, and that therefore the measures are necessary and well targeted as they aim at securing financial stability whilst limiting State involvement as much as possible.
- (42) The Icelandic authorities are of the view that an FME takeover of Byr pursuant to the Emergency Act⁸ would have been the only realistic alternative to the acquisition. Pursuant to the provision of this Act the FME could assume the control of a bank in breach of mandatory capital or liquidity requirements (i.e. when conditions for revoking its banking license would be present). It would then transfer the liabilities, notably also deposits, along with assets matching their value to a receiver bank capable of absorbing the liabilities of the failed bank. A shortfall in assets would have to be compensated by the State.
- (43) The Icelandic authorities submit moreover that a merger on market terms should always be considered preferable to the enactment of special measures as a forced merger under the Emergency Act would always entail difficult negotiations on the value of assets transferred, and the liquidation of a financial institution is likely to deteriorate the value of assets, in particular immaterial assets such as customer base and goodwill. The Icelandic authorities submit that this has been the case with regard to deposits transferred from SPRON to Arion Bank and assets and deposits transferred from Spkef to Landsbanki.⁹
- (44) The Icelandic authorities reiterate that the sales procedure of Byr resulted in only one viable offer as [XY Bank] could not produce a satisfactory confirmation of financing demonstrating the financial capacity to fund the acquisition. Moreover, they submit that [XY Bank] had requested ‘unprecedented state aid’ and that therefore the offer made by the bank was ‘unrealistic and unacceptable’ and that the bank’s capabilities of producing an acceptable offer were evidently non-existent. In addition, they stress that in an open sales procedure the main conditions for offers are known in advance, and that it was impossible to resort to individual negotiation with one bidder after the completion of the procedure. They conclude that therefore the offer of [XY Bank] to negotiate other options could not be taken up.
- (45) As regards the distortions of competition resulting from the acquisition, the Icelandic authorities refer to the Authority’s Byr decision that concluded that the main competitors of Byr are the three larger commercial banks, Arion Bank, Landsbanki and Íslandsbanki, which were found to be collectively dominant on the relevant market by the Icelandic Competition Authority (ICA). The Icelandic authorities admit that the

8 See the Interim Provision VI of the Icelandic Act No. 161/2002 on financial undertakings.

9 See for a description of the SPRON transaction the Authority’s decision No. 492/10/COL of 15.12. 2010.

termination of Byr's operations might therefore have a negative impact on competition in the national market, but stress that the only realistic alternative – a takeover by the FME and a subsequent transfer of deposits (and assets) to one of the three commercial banks would have had an equivalent effect on competition.

- (46) The Icelandic government also responded to a question of the Authority regarding [...], an IT company serving smaller financial undertakings and savings banks. As the largest shareholder and the largest customer of [...], Byr had borne the majority of the costs of that company's operations. The Icelandic government submits that Byr was – in the light of the increasing cost for running [...] – exploring options to sell its stake and that it was not in a position to sustain its operation in the long run. Therefore they contend that the acquisition of Byr by Íslandsbanki, which will in all likelihood see Byr terminate its involvement in [...], does not have an effect on the operation of [...] that affects its customers, inter alia the savings banks, beyond what would have been the case in the counterfactual.
- (47) As regards the compliance of the merger with paragraph 41 of the chapter on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the state aid rules of the Authority's State Aid (the "Restructuring Guidelines") they submit that further consolidation and reduction of costs in the Icelandic financial system is necessary, as the system remains too large to be sustainable in the longer run. They stress that the Icelandic authorities' main strategy has been to leave such measures up to the market forces and limit state intervention, but emphasise that ensuring the availability of deposits in order to preserve confidence in the financial system remains an essential prerequisite for financial stability.
- (48) The Icelandic authorities further submit that the acquisition process meets the requirements laid down by the Guidelines. The sales procedure had been open and transparent and aimed at securing equal opportunities of participants, but only one viable offer had been obtained. They contend, again, that the effect on competition is negligible as a liquidation or forced merger would have produced the same results in terms of the structure of the relevant market.
- (49) Finally, the Icelandic authorities are of the view that the continued operations of Byr as a stand-alone entity are not essential for maintaining a functional banking system, and submit that effective competition in the Icelandic financial markets will be ensured even after the envisaged merger.
- (50) As regards the SLF, the Icelandic authorities submit that the instrument is proportionate as it cannot provide Byr with more capital than what is the minimum required by the FME and hence cannot exceed what is necessary. They have also provided the Authority with a commitment according to which the Board of Directors of Byr confirms and declares that in the event of a requirement by the FME to draw on the SLF in order to meet the CAD ratio requirements of 16% (Tier 2), in the interim period from completion of the share subscription agreement with Íslandsbanki to completion of the legal merger of Byr and Íslandsbanki envisaged by that agreement, Byr will apply for an exemption from such requirement to avoid any draw downs on the SLF.
- (51) The Icelandic authorities commit that a restructuring plan for the merged entity consisting of Íslandsbanki and Byr will be submitted no later than 3 months after the execution of the share purchase and share subscription agreement.

II. ASSESSMENT

1 The presence of state aid

- (52) 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.”
- (53) The Authority already established in the Byr decision that the capitalisation measures granted to Byr, including the SLF, constitute state aid for the benefit of Byr.
- (54) It is less clear whether the SLF also constitutes state aid for the benefit of Íslandsbanki, as the SLF would for the time being only remain available during the interim period until the merger is fully implemented, and it could be argued that Íslandsbanki’s bid already reflected the availability of the SLF, in other words “priced in” the instrument. However, given the nature of the instrument – in essence that of an insurance against a decreasing CAD or a CAD contingent recapitalisation guarantee – it cannot be excluded that it also benefits Íslandsbanki, in so far as it removes a considerable element of risk from the transaction, namely that of Byr being more undercapitalised than anticipated. Moreover, it needs to be recalled that the SLF has not been drawn upon yet – and presumably the new owner of Byr will at least be able to influence the decision if and to what extent the SLF will be used by Byr. Thus it will likely only be drawn upon if it is in the commercial interest of Íslandsbanki. The Authority therefore is of the opinion at this stage that the SLF may comprise an element of aid to the benefit of Íslandsbanki.
- (55) As for the use of the measures originally granted for the establishment of Íslandsbanki, the Authority refers to its Decision No. 494/10/COL of 15 December 2010 where it reached the preliminary conclusion that the measures for the capitalisation of Íslandsbanki as well as the liquidity facility put at its disposal constitute state aid within the meaning of Art 61(1) of the EEA Agreement. The Authority has not concluded its investigation in that case, and cannot in this present decision take a final view on whether compatible aid was granted to Íslandsbanki. Furthermore, given the role played by the Icelandic state in its capitalisation and in the light of the fact that Íslandsbanki today has a sufficiently high CAD ratio to enable it to absorb a severely undercapitalised entity, the Authority shares the view of the Icelandic government that it cannot be excluded that this aid is used by Íslandsbanki for the acquisition of Byr. Rather to the contrary the Authority is of the view that without this aid Íslandsbanki would not be in a position to acquire a competitor today. Thus the Authority considers prima facie that the acquisition would not have been possible without the aid to Íslandsbanki, and it was (partly) financed by this aid.
- (56) The Authority is not aware at this stage of any indications that the sale of the government’s stake in Byr was not done in compliance with the market vendor principle, and could hence entail aid. Moreover, as the selling of this stake was not one of the notified measures it will therefore in this present decision not investigate this question further.

2 Procedural requirements

- (57) Pursuant to Article 1(3) of Part I of Protocol 3, “the EFTA Surveillance Authority shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid (...). The State concerned shall not put its proposed measures into effect until the procedure has resulted in a final decision”.
- (58) By submitting a notification of the prolongation of the SLF and the acquisition of Byr by Íslandsbanki with a letter dated 22 September (Event No 609429), the Icelandic authorities have complied with the notification requirement as regards these two measures.
- (59) However, as set out Decision No. 494/10/COL of 15 December 2010, the Icelandic authorities had not notified the various measures granted to Íslandsbanki to the Authority before their implementation. The Authority therefore reiterates that the Icelandic authorities had not respected their obligations pursuant to Article 1(3) of Part I of Protocol 3 in that respect and that the granting of the aid was therefore unlawful.

3 Compatibility of the aid

3.1 Legal basis for the compatibility assessment – Art 61(3)(b)

- (60) While state aid to undertakings in difficulties is normally assessed under Article 61(3)(c) of the EEA Agreement, the Authority may, under Article 61(3)(b) of the Agreement allow state aid “to remedy a serious disturbance in the economy of an EC Member State or an EFTA State”. However, as is stated in paragraph 8 of the chapter on the application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis of the Authority’s State Aid Guidelines (“the Banking Guidelines”)10, the Authority reaffirms that, in line with the case law11 and the European Commission’s decision making practice12, 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.
- (61) It is worth noting that the European Commission has recently announced its intention to prolong the applicability of the financial crisis guidelines until the end of 2012 in the light of the recent developments in global and European financial markets13.
- (62) The Authority concurs with the Icelandic authorities that an insolvency of Byr, Iceland’s fourth largest bank, could have been a serious threat to financial stability and that the resulting unavailability of deposits could have destabilised the entire financial sector in the country. It is thus clear that the measures at hand aim at remedying a situation that is to be considered as serious disturbance in the economy of Iceland.

10 See the chapter on the application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis of the Authority’s State Aid Guidelines, available at <http://www.eftasurv.int/?1=1&showLinkID=16604&1=1>.

11 See for example Joined cases T-132/96 and T-143/96 Freistaat Sachsen, Volkswagen AG and Volkswagen Sachsen GmbH v Commission, [1999] ECR II-3663, at paragraph 167; and C-730/79 Philip Morris [1980] ECR 2671, at paragraph 17.

12 See Commission decision of 7.1.1987 in Case N XXX concerning Law 1386/1983 by which the Greek government grants aid to the Greek industry, OJ 1988 L 76/18.

13 See speech of Competition Commissioner Joaquin Almunia on 15.9.2011, available at: <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/11/577&format=HTML&aged=0&language=EN&guiLanguage=en>

- (63) The Authority therefore agrees with the Icelandic authorities that for the assessment of the measures described above Article 61(3)(b) of the EEA Agreement continues to apply.
- (64) Pursuant to paragraph 15 of the Banking Guidelines, the general principles underlying state aid rules of the EEA Agreement require that the aid granted does not exceed what is strictly necessary to achieve its legitimate purpose and that distortions of competition are avoided or minimised to the extent possible. Taking due account of current circumstances, all general support measures have to be:
 - (65) necessary and well-targeted in order to be able to achieve effectively the objective of remedying a serious disturbance in the economy,
 - (66) proportionate to the challenge faced, not going beyond what is required to attain the legitimate aim, and
 - (67) designed in such a way as to minimise negative spill over effects on competitors, other sectors and other EEA States.
- (68) In the following paragraphs, the Authority will therefore assess the compatibility of the notified measures in particular by taking into account the above criteria.

3.2 The prolongation of the SLF

- (69) The Authority concluded in the Byr decision that the SLF is a necessary and proportionate means to prevent a threat to financial stability, at least for the 6 months for which it was authorised. Given that the conditions of this instrument remain unaltered, and that the Icelandic authorities only seek a prolongation of the temporary approval until the merger between Byr and Íslandsbanki is legally implemented, the Authority will limit its assessment to whether the SLF remains a necessary and proportionate means for this interim period.
- (70) The Icelandic authorities have submitted that the SLF serves two purposes: to remedy a shortage of capital as compared to minimum capital requirements set forth in national legislation and by the FME, and to provide a safety-net that could counter potential liquidity constraints resulting from a possible outflow of deposits in the wake of the merger.
- (71) As for the latter purpose, the Authority doubts that the SLF is a suitable and appropriate means. First, it is questionable whether the SLF - contingent Tier 2 capital - is apt to make up for a sudden outflow of deposits, as these two types of debt have rather different characteristics, in particular as regards their cost. Second, and more important, the SLF can only be drawn upon should the CAD ratio be under 16%, and the FME has refused to grant an exemption from this requirement.¹⁴ It is not clear to the Authority if and how an outflow of deposits would impact the CAD ratio of Byr, and it is thus questionable whether the SLF could even be used in such circumstances.
- (72) Regarding the objective of bringing the CAD ratio to a level compatible with the FME requirement of 16%, it should be recalled that the anticipated CAD ratio of Byr on a

¹⁴ The Authority welcomes in this respect the commitment according to which Byr would, in the event of a requirement by the FME to draw on the SLF in order to meet the CAD ratio requirements of 16% (Tier 2), in the interim period from the completion of the share subscription agreement with Íslandsbanki to the completion of the legal merger of Byr and Íslandsbanki envisaged by that agreement, apply for an exemption from such requirement to avoid any draw downs on the SLF.

standalone basis after the subscription of new shares by Íslandsbanki will be 14,6%, i.e. slightly below the minimum requirement set by the FME. The SLF could be used to make up for this shortage, and as it would bring the capital ratio to over 19% were it fully drawn, it is without doubt a suitable means to reach the objective.

- (73) As for the proportionality of the SLF, it has to be borne in mind that the anticipated CAD ratio of Íslandsbanki after the integration of Byr will still be over 20%, thus considerably above the 16%. It arguably does not seem strictly necessary for financial stability to bring the CAD ratio of Byr fully in line with the FME requirements of 16% during the interim period, given that this shortage will be remedied with certainty within a short period of time (when the formal merger has taken place, probably towards the end of this year) and that Byr has been allowed to continue operations with a significantly lower CAD ratio since June this year. The Authority acknowledges however that whether compliance with the CAD requirements during the interim period is necessary for financial stability is ultimately for the FME to decide.
- (74) Furthermore, drawing on the SLF during this interim period comprises a certain risk of providing Íslandsbanki with surplus capital financed through State resources which could be used for aggressive commercial practices. It seems evident based on the figures submitted by the Icelandic authorities that Íslandsbanki is certainly not in need of extra capital. In any event, the Authority will take into account any drawing on the SLF in its assessment of the aid granted to Íslandsbanki.
- (75) The Authority considers that the commitment by the Icelandic authorities to seek actively an exemption from the FME requirements limits the risk described in the above paragraph considerably and allows the Authority to conclude that the SLF continues to be proportionate, as it will only be drawn upon if the FME concludes, upon a request by Byr for a temporary exemption from CAD requirements, that this is necessary, presumably for reasons of financial stability.

3.3 Use of state aid granted to Íslandsbanki for the acquisition of Byr

- (76) As indicated above, the Authority considers for the purposes of this decision that Íslandsbanki is a recipient of unlawful restructuring aid. It recalls that a formal investigation procedure is ongoing in order to determine whether the aid that Íslandsbanki has received is compatible with the EEA Agreement. The Restructuring guidelines which are applicable to Íslandsbanki will in particular guide the Authority in its assessment concerning the aid that Íslandsbanki has received. These guidelines provide in paragraphs 39 to 41 that

“(39) state aid must not be used to the detriment of competitors which do not enjoy similar public support.

(40) Subject to point 41, banks should not use state aid for the acquisition of competing businesses.

(41) In exceptional circumstances and upon notification, acquisitions may be authorised by the Authority where they are part of a consolidation process necessary to restore financial stability or to ensure effective competition. The acquisition process should respect the principles of equal opportunity for all potential acquirers and the outcome should ensure conditions of effective competition in the relevant markets.”

- (77) Pursuant to paragraphs 39-40 of the Restructuring Guidelines, Íslandsbanki – as any other bank that has received restructuring aid – should in principle be barred from

using that aid for the acquisition of a competitor. It is evident that Byr is a competitor of Íslandsbanki, and that under normal circumstances the use of the aid that Íslandsbanki has received for this acquisition would be incompatible with the EEA Agreement.

- (78) However, paragraph 41 of the Restructuring Guidelines provides for an exception to this rule. Given the pending formal investigation regarding the state aid granted to Íslandsbanki, the Authority stresses that it will limit its assessment in the present decision to whether the acquisition of Byr complies with the conditions set forth in said paragraph 41 of the Restructuring Guidelines. The Authority emphasises that this present decision is thus without prejudice to the conclusions that the Authority will reach in its final decision regarding the compatibility of the state aid granted to Íslandsbanki.¹⁵
- (79) As for the compliance of the acquisition with paragraph 41 of the Restructuring Guidelines, the Authority is of the view that the situation in the Icelandic financial market – where inter alia almost all banks have received state aid, a blanket guarantee on deposits and capital controls are in place and a large percentage of existing loans are in need of restructuring – is still such that it is justified to invoke ‘exceptional circumstances’.
- (80) It also shares the opinion of the Icelandic authorities that the envisaged merger can be considered to form part of a consolidation process, as indeed there seems to be a need to shrink the Icelandic banking sector and make it more efficient. The Authority shares the view of the Icelandic authorities that the Icelandic financial system remains too large to be sustainable in the long run, and might in its present, oversized form constitute a permanent threat to financial stability. Furthermore, it seems likely that the acquisition of the 4th largest bank by the 3rd largest bank in Iceland will lead to certain efficiency gains; indeed a considerable reduction of branches, staff and back-office cost is foreseen. However, the Authority cannot at this stage take a final view on whether these envisaged consolidation efforts will suffice to restore the long-term viability of the merged entity and the sector. The Authority will assess this question in particular on the basis of the forthcoming restructuring plan of the merged entity, and will in its assessment balance the consolidation effects of this transaction with the detrimental impact on competition described below. In this context the Authority refers again to the requirement of said paragraph 41 that consolidation should ensure effective competition in the markets concerned. Nevertheless the Authority is of the preliminary view that the notified acquisition fulfils the condition of paragraph 41 of the Restructuring Guidelines of having to form part of a consolidation process.
- (81) As for the sales procedure, the Authority has, based on the information that has been submitted to it by the Icelandic authorities, no reason to doubt that the principle of equal opportunity for all potential acquirers was respected. The interest of five companies to participate in the initial stages of the process can be considered as an indication that the sales process was sufficiently open and transparent, and it did not receive information that would indicate that those five parties were treated in a discriminatory manner.
- (82) It is however less evident whether this acquisition was necessary to restore financial stability and that the outcome ensures conditions of effective competition in the relevant market. In the Authority’s view, these two conditions have to be read in

¹⁵ See also the Authority’s Decision No. 494/10/COL of 15.12.2010.

conjunction, taking into account the general requirement of necessity and proportionality. Taking into consideration the discretion that the EEA States enjoy in choosing the means to achieve a certain legitimate objective by granting state aid, the assessment is essentially a matter of whether the acquisition of Byr by Íslandsbanki is firstly capable of and necessary to prevent a risk to financial stability, and secondly if the Icelandic authorities had other means at their disposal that would have been more proportionate, in particular in the sense of being less harmful to competition.

- (83) The Authority, as indicated above in its considerations regarding the applicable legal basis for the compatibility assessment, concurs with the Icelandic authorities that an insolvency of Byr, Iceland's 4th largest bank, could have been a serious threat to financial stability and that the resulting unavailability of deposits could have destabilised the entire financial sector in the country. Thus the Authority is of the view that any measure capable of ensuring the lasting availability of deposits in a de facto insolvent bank such as Byr is prima facie a suitable means to safeguard financial stability. Given in particular the large capital buffer that is presently at Íslandsbanki's disposal, and the FME's decision that Íslandsbanki is deemed capable of acquiring a controlling stake in Byr, the Authority sees no grounds for questioning the capacity of the envisaged merger to attain the objective of preventing a threat to financial stability.
- (84) However, the Authority cannot but express its concerns about the impact on competition in the Icelandic financial markets that this transaction will likely have. As stated above, the three largest banks already jointly share almost 90% of the market, and the taking over of their largest competitor by one of them, Íslandsbanki, will inevitably aggravate the situation. It would thus have been undoubtedly more advantageous for competition in the Icelandic market had Byr been acquired by a smaller player such as [XY Bank].
- (85) In this context the Authority wishes to emphasise that it is not in a position to assess whether the state aid that [XY Bank] requested for the acquisition was incompatible with the EEA Agreement, as the Icelandic authorities contend. The requested guarantee appears to have had the purpose of shielding [XY Bank] fully from a potential downside resulting from a revaluation of the assets in Byr. The Authority stresses that it has neither formally nor informally been consulted regarding the compatibility of this measure.
- (86) Nevertheless the Authority finds no reason to doubt the Icelandic authorities' assertion that [XY Bank]'s bid had to be rejected, as it indeed seemed uncertain whether the necessary financing for the acquisition could be obtained. For this reason the Authority accepts the Icelandic government's view that selling Byr to [XY Bank] would not have ensured attaining the objective of safeguarding financial stability.
- (87) As the Authority also finds no reason to doubt that selling parts of Byr or divesting certain assets would not have been a suitable means to bring the CAD ratio up to the necessary level, it thus appears that the Icelandic government was faced with two options to safeguard financial stability: either agreeing to the acquisition of Byr by Íslandsbanki, or effectively bringing about a take-over of Byr by the FME, which according to the Icelandic authorities would have led to one of the three larger commercial banks obtaining (most of) the market share previously held by Byr.
- (88) The Icelandic authorities have demonstrated that the latter option would have been in all likelihood more burdensome for the State, and would have been essentially equivalent as regards the impact on competition. It therefore seems that all realistic

options available to Iceland would have had similarly negative effects on competition. Moreover, a forced takeover by the FME three years after the meltdown of autumn 2008 might in fact have created uncertainty about the state of financial stability in Iceland, and might therefore have been a less suitable means to attain the primary objective of restoring financial stability and preventing threats to it.

- (89) For the above reasons the Authority shares the view of the Icelandic government that in the present circumstances the option chosen – the acquisition of Byr by Íslandsbanki – was a necessary and proportionate means to safeguard financial stability. Therefore the Authority does not object to the use of the aid granted to Íslandsbanki for the acquisition of Byr but reiterates that this conclusion is without prejudice to its final view on the nature and compatibility of the measures subject to the pending formal investigation procedure regarding Íslandsbanki¹⁶.

3.4 The impact on competition and the restructuring of the three commercial banks

- (90) As already indicated above, the acquisition of Byr by Íslandsbanki has exacerbated the concerns by the Authority about the state of competition in the Icelandic market. The large market share by the three large commercial banks will be further increased by this acquisition, and it would seem that the disappearance of Byr will also affect the viability of the savings banks that depend on Teris, which will lose its largest customer and shareholder. This could lead to further concentration in the market.

- (91) In this context, the Authority recalls paragraph 30 of the Restructuring Guidelines, providing that

“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, [...] 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”.

- (92) In the light of the recent developments and in line with the case practice of the European Commission¹⁷ the Authority is of the view that the characteristics of the Icelandic financial market as described above require that the restructuring plan of Íslandsbanki entails measures to limit distortions of competition that address these characteristics and ensure that the market can benefit from effective competition. The Authority thus invites the Icelandic authorities to include such measures in the amended restructuring plan to be submitted.¹⁸
- (93) As for the requirement in the Byr decision that Byr needs to submit a restructuring plan within 6 month, this requirement has become meaningless as Byr will disappear as a standalone entity. However, the amended restructuring plan of Íslandsbanki will

¹⁶ See the Authority’s Decision No. 494/10/COL of 15.12.2010

¹⁷ See European Commission case practice regarding banks active in similarly concentrated markets for example the decisions in cases N 428/2009, *Restructuring of Lloyds Banking Group*, N 422/2009 and N 621/2009, *RBS* and N 546/2009, *Restructuring of Bank of Ireland*.

¹⁸ In this context the Authority emphasizes that it will not be able to conclude that the aid granted to the three commercial banks that are currently subject to a formal investigation procedure (Íslandsbanki, Arion Bank and Landsbanki) is compatible with the EEA Agreement if it has not been demonstrated that the Icelandic banking market will be characterised by effective competition after the restructuring plans of the three commercial banks will be implemented.

have to reflect the acquisition of Byr and in this context the Authority welcomes the commitment by the Icelandic authorities to submit it no later than 3 months after the execution of share purchase and share subscription agreements.

4 Conclusion

- (94) On the basis of the foregoing assessment, the Authority considers that maintaining the SLF available for the interim period until a formal merger between Byr and Íslandsbanki takes place, i.e. for as long as Byr is considered a separate legal entity under national law, is compatible with the functioning of the EEA Agreement within the meaning of Article 61 of the EEA Agreement.
- (95) Likewise the Authority authorises the use, if any, of state aid granted to Íslandsbanki for the acquisition of Byr. This is without prejudice to the formal investigation procedure on whether the aid granted to Íslandsbanki is compatible with the EEA Agreement. The outcome of this assessment depends on the information in the restructuring plan for the merged entity of Íslandsbanki and Byr that the Icelandic government has committed to submit no later than 3 month after the execution of the envisaged transaction. So as to address the Authority's concerns about competition in the Icelandic financial market as described above, the forthcoming restructuring plan should comprise measures that ensure that the Icelandic financial market will benefit - as required *inter alia* by paragraph 41 of the Restructuring Guidelines - from effective competition in the future.

HAS ADOPTED THIS DECISION:

Article 1

1. The notified prolongation of the subordinated loan facility granted to Byr is approved temporarily, that is only until the merger with Íslandsbanki has been formalised and has become effective under national Icelandic law.
2. The use of this state aid is subject to the commitment that Byr will request an exemption from the FME regarding the CAD minimum requirements.

Article 2

1. The use, if any, of state aid granted to Íslandsbanki for the acquisition of Byr is authorised.
2. This authorisation is without prejudice to the final view of the Authority on the nature and compatibility of the measures it assesses in its pending formal investigation procedure regarding the state aid granted to Íslandsbanki.

Article 3

The Icelandic authorities are requested to submit an amended restructuring plan for Íslandsbanki that reflects the merger with Byr no later than 3 months after the execution of the share purchase and share subscription agreements.

Article 4

The implementation of the measures is authorised accordingly.

Article 5

This Decision is addressed to the Republic of Iceland

Article 6

Only the English language version of this decision is authentic.

Decision made in Brussels, on 19 October 2011.

For the EFTA Surveillance Authority

Oda Helen Sletnes
President

Sverrir Haukur Gunnlaugsson
College Member