

EFTA SURVEILLANCE AUTHORITY DECISION

of 23 November 2011

to initiate the formal investigation procedure provided for in Article 1(2) in Part I of Protocol 3 to the Surveillance and Court Agreement with regard to state aid granted to three Icelandic investment banks through rescheduled loans on preferential terms

(Iceland)

The EFTA Surveillance Authority (“the Authority”),

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

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 Articles 4(4) and 6 of Part II.

Whereas:

I. FACTS

1. Procedure

- (1) By letter dated 22 June 2010, the EFTA Surveillance Authority (“the Authority”) received a complaint from the Icelandic securities firm H.F. Verðbréf hf. alleging that the Icelandic Treasury had in March 2009 granted unlawful state aid to the investment banks Saga Capital and VBS through conversion of short-term debt with the Central Bank of Iceland (“the CBI”) to long-term loans on favourable terms. The letter was received and registered by the Authority on 7 July 2010 (Event No 563424).
- (2) By letter dated 23 August 2010 (Event No 566722), the Authority requested additional information from the Icelandic authorities.
- (3) By letter dated 30 September 2010 (Event No 571668), the Icelandic authorities replied to the information request.

- (4) By letter dated 1 March 2011 (Event No 588538), the Authority again requested additional information from the Icelandic authorities.
- (5) The case was also discussed in a meeting on state aid between representatives of the Authority and of the Icelandic authorities in Reykjavík on 6 June 2011.
- (6) By letter dated 3 August 2011 (Event No 605881), the Icelandic authorities replied to the information request.

2. Description of the measures

2.1 Background

- (7) The measures to be assessed in this decision are linked to the CBI's collateral and securities lending. As part of its role as a central bank and lender of last resort and in line with the monetary policy of other central banks, the CBI provides short-term credit facilities to financial undertakings in the form of collateral loans¹, in accordance with the provisions of CBI rules pertaining thereto. Financial institutions have the option of requesting overnight loans or seven-day loans against collateral that the CBI deems eligible. Among the debt instruments meeting the requirements of the rules are Treasury instruments and financial undertakings' debt instruments fulfilling minimum criteria, including credit rating criteria.
- (8) In 2007 and 2008 collateral lending increased steadily, and the CBI became the financial undertakings' main source of liquidity. At year-end 2007, the balance of collateral loans stood at 302 billion ISK, its highest point until that time. Collateral loans peaked on 1 October 2008, just before the collapse of the banks, when the CBI loaned 520 billion ISK to financial institutions. Thus, at the time of the collapse of the three commercial banks in October 2008, the CBI had acquired considerable claims against domestic financial undertakings, which were backed by collateral of various types. At that time nearly 42% of the collateral for CBI loan facilities took the form of Treasury guaranteed securities or asset-backed securities while some 58% of the underlying collateral consisted of bonds issued by Glitnir, Kaupthing, and Landsbanki².
- (9) As a result of the banks' failure, the value of the collateral diminished and it became clear that the CBI had sustained losses due to unsound collateral. Following an authorisation by the Parliament, the Treasury and the Central Bank concluded an agreement in January 2009, with effect as from year-end 2008, according to which the CBI assigned a part of its claims of collateral loans against financial undertakings, along with underlying securities, to the Ministry. The takeover was based on the balance of the claims on 31 December 2008. The objective of the agreement was to ensure that the CBI would have an acceptable equity position. The Treasury, as the owner of the CBI, purchased securities with a book value of 345 billion ISK and paid for them with a government bond in the amount of 270 billion ISK, but 75 billion ISK were written off in the CBI's annual accounts for 2008. Towards the end of 2009, it was decided to set up the Central Bank of Iceland Holding Company (*Eignasafn Seðlabanka Íslands, ESÍ*), and in February 2010 the Ministry of Finance and the CBI agreed that the claims previously transferred by the CBI to the Ministry should be transferred back to the CBI/ESÍ at a reduced price as of 31 December 2009.

¹ Collateral loans are also named repo loans, where repos or repurchase agreements are contracts in which the seller of securities, such as Treasury bills, agrees to buy them back at a specified time and price.

² For an overview of developments in collateral loans, see the CBI's Annual Report 2008, p. 9-11, available at <http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=7076>

- (10) As for securities lending, the Government Debt Management (GDM), which is administered by the CBI, offers lending facilities to primary dealers of government securities. The purpose is to improve market functionality and to maintain liquidity in the market for bond series that the GDM is building up. The securities accepted by the GDM as collateral for the Treasury Bonds and Bills are all government bonds and mortgage benchmark bonds traded electronically in the secondary market. Other electronically traded securities may also be accepted depending on criteria specified in the facility. The interest rate for these loans is based on the CBI repo rate. The maximum contract period is 28 days.³

2.2 Conversion of short-term credit facilities to long-term loans

- (11) On 16 March 2009 the Ministry of Finance concluded two loan conversion agreements with Saga Capital Investment Bank hf. amounting in total to approximately 19.7 billion ISK; firstly, a loan agreement in the amount of 3.2 billion ISK for repayment of claims previously held by the CBI, deriving from the CBI's short-term collateral loans; and secondly, a loan agreement in the amount of 16.5 billion ISK, to settle short-term claims of the securities lending facility which the CBI offers on behalf of the Treasury to primary dealers of government securities.
- (12) On 23 March 2009 the Ministry made a similar loan agreement with VBS Investment Bank hf., amounting to 26.4 billion ISK. The debt stemmed from the CBI's short-term collateral lending to VBS.
- (13) The Ministry also concluded a loan agreement on similar terms with Askar Capital Investment Bank hf, in the amount of approximately 6.3 billion ISK.
- (14) The previous debt with the CBI was secured *inter alia* by bonds issued by the three commercial banks, Glitnir, Kaupthing and Landsbanki Íslands. Following the collapse of those banks in October 2008, the value of the underlying security became uncertain and diminished severely. From that time new collateral loans backed by securities of the failed banks were not granted and the outstanding balance of CBI's collateral loans declined.
- (15) The loan amounts were based on settlement of the respective liabilities in December 2008. The repayment terms of the loans to Saga and VBS are identical. They are repayable over the next seven years with indexation and an interest rate of 2% per annum. During the first two years, only interest is paid and subsequently the loan is paid with even instalments over five years, on 27 December each year, starting on 27 December 2011 (first instalment) till 27 December 2015 (last instalment). It is understood that the repayment terms of the loan to Askar Capital were similar, except that the annual interest rate is 3%.
- (16) The above measures were based on the proposals of a Working Group which on 20 January 2009 submitted a memorandum to the Minister of Finance for the restructuring of debt owed by financial undertakings due to collateral loan facilities with the CBI. The memorandum was based on information regarding the financial undertakings and their ability to repay the debt.
- (17) The Authority has requested that the Icelandic authorities provide a full justification for the terms of the loans. In their response the Icelandic authorities stressed that the agreements in

³ For further details see Rules on Central Bank of Iceland securities lending facilities on behalf of the Treasury for primary dealers dated 28 November 2008, available at <http://www.lanamal.is/assets/nyrlanasysla/regluren08.pdf>

question are agreements on conversion and payment of debt that had fallen due. The rationale for the terms of the loans was partly described by the Working Group's memorandum referred to above.

- (18) The memorandum explains that upon the collapse of Iceland's main commercial banks, enormous uncertainty had emerged regarding the value of the collateral and the CBI's possibility to dispose of the collateral in order to settle the debt; the financial undertakings concerned were unable to pay the debt in full. According to the Icelandic authorities it should be borne in mind that at the time when decision was made on how to deal with the immediate problems of the said undertakings, in early 2009, "*the entire apparatus of the Icelandic authorities was preoccupied in an effort to keep the country's financial system operating and to protect the interests of deposit holders. That task had to take priority over tasks relating to the financial reorganizations of non-deposit-holding undertakings.*"
- (19) The reply of the Icelandic authorities further states that "*[w]hen deciding on the terms the Working Group emphasized preserving the value of the claims, by indexing the claims [according] to the national Consumer Price Index. In addition, taking into account e.g. that the undertakings' short-term ability to pay interest had diminished considerably following the damage already suffered on their asset portfolios, it was evident that the assets and interim financial condition of the undertakings would only be capable of supporting a minimum level of interest on the loan. Also bearing in mind that bonds received by the undertakings from the commercial banks no longer provided revenues in the form of interest payments, the interest paid was now an expense incurred without any direct income to finance such an expense. However, it was considered inevitable that despite this, the undertakings would have to pay interest. The interest would among other factors serve as an incentive to encourage them to expedite their work on their financial restructuring. As stated in the premise for the decision by the Working Group, the decision on the terms and conditions of the interest did not center on what fair and normal return on equity should be, since it was clear in advance that the undertakings in question were unlikely to repay in full the liabilities in question. Instead, the Working Group focused on finding an interest percentage sufficiently high to matter to the undertaking in question but not so high as to preclude the possibility for repayment, thus removing the incentive for these undertakings to restructure their finances.*"
- (20) According to the loan agreements, collateral issued for the CBI loans shall remain in place for the new loans, without the debtors being able to provide any significant new collateral to make up for the collapse of the former. However, the borrowers have agreed to additional conditions for the debt conversion listed in 12 points. Among these conditions are the following:
- the debtors are not authorised to pay dividends, unless there is a corresponding down payment of the loans,
 - bonuses to their employees must be moderate,
 - major risk commitments shall not exceed 20% of equity (CAD),
 - the debtors are obliged to provide the lender with detailed quarterly reports on their operations,
 - the debtors' CAD-ratios must not fall below 10%,

- the debtors must otherwise fulfil requirements of the Financial Supervisory Authority (FME) and the CBI on their operational soundness and liquidity reserves.

- (21) In case the liquidity position of the debtors turns out to be unacceptable in the view of the CBI or their CAD-ratios fall below 10%, the lender can require that the outstanding amount of the loans together with interest and other relevant costs be converted to equity.
- (22) The purpose of the above conditions was to increase the likelihood of full recovery of the loans and thus to safeguard the Treasury's interests.
- (23) Should the borrowers fail to uphold the conditions while the loan remains unpaid the debt may fall due in its entirety by a 30 day written notice to the borrower.
- (24) In view of publicly available information that the CBI had claims due to its collateral loan facilities on several financial undertakings other than the three referred to above, the Icelandic authorities have at the Authority's request provided the overview set out in the table below of all claims against financial undertakings, arising from collateral and securities lending, and owned by the Asset Holding Company of the CBI.

<i>Overview of CBI claims</i>					
Amounts in ISK					
	FME assumes power of board	Date of repite	Last day of lodging claims	Claim lodged (ISK)	Nom. value of longer-term bonds at issue (ISK)
Deposit holding undertakings					
Glitnir Bank	8 Oc 2008	22 April 2009	26 Nov 2009	9,572,694,410	NA
Kaupthing Bank	9 Oc 2008	22 April 2009	30 Dec 2009	352,875,238,957	NA
Landsbanki Islands	7 Oc 2008	22 April 2009	30 Oct 2009	101,122,143,559	NA
Sparisjodabanki Islands	21 March 2009	22 April 2009	3 Nov 2009	215,389,669,211	NA
Straumur	9 March 2009		18 July 2009	54,520,687,634	NA
SPRON	21 March 2009	30 Oct 2008	22 Jan 2010	48,938,174,394	NA
Total				782,418,608,165	NA
Non-deposit holding undertakings					
Askar Capital	14 July 2010	14 July 2010	19 Nov 2010	6,920,861,716	6,263,728,463
Saga Capital	NA	NA	NA	NA	19,668,664,668
VBS	3 March 2010	3 March 2010	12 Nov 2010	29,805,002,600	26,430,402,976
Total					52,362,796,107
Total of claims lodged and nominal value of longer-term bonds					834,781,404,272

- (25) As can be seen, the total number of financial undertakings on which the CBI had such claims was nine and the total amount of claims lodged plus the nominal value of longer-term bonds was approximately 834.8 billion ISK. Six out of these were deposit holding undertakings, where the claim amounted in total to 782.4 billion ISK, and three were non-deposit holding undertakings, with a total nominal amount of debt at the time of issue of the long-term bonds of 52.4 billion ISK. The table also provides an indication of the timing of public administration and of the lodging of claims to the undertakings' estates.

2.3 The objective of the measures

- (26) As for the objective of the measures, Iceland's submission refers to a verbal response to an inquiry in the Icelandic parliament, Althingi, on 4 March 2010, by the Minister of Finance where the reasons for concluding the agreements with Saga Capital and VBS are explained in the following manner (unofficial translation of the Ministry of Finance):

[...] What the state did at the time in the case of these two smaller independent financial undertakings was twofold. Firstly to try and secure the immense interests of the state amounting to 26 bn for VBS and 16 bn for Saga Capital, which otherwise would have been lost, and secondly to give these financial undertakings a chance to work out their matters and get through the difficulties. It was of course our hope that this might happen and that both would be accomplished, that these big interests would be as best preserved as possible, because presumably the distinguished MPs understand that one does not let 40 bn go down the drain without rescue efforts and on the other hand that the undertakings could subsequently work out their matters and hopefully get back on track. [...]

Concluding the agreements was first and foremost an effort to maximise the Treasury's recovery of the claim. ..."

2.4 National legal basis for the measures

- (27) According to the information submitted by the Icelandic authorities, the measures are based on an authorisation from the Icelandic parliament in paragraph 7.20 of the state supplementary budget for the year 2008, where the Minister of Finance, on behalf of the Treasury, is authorised to purchase from the Central Bank of Iceland commercial papers which have been pledged to the bank as collateral for loans as well as settling these claims in the most viable manner possible.

2.5 The beneficiaries

2.5.1 Saga Capital Investment Bank hf.

- (28) Saga was established under the name of Saga Capital Investment Bank hf. in the autumn of 2006 by a number of former staff members of the Icelandic commercial banks. The bank completed a closed share offer in spring 2007 which resulted in approximately 60 shareholders⁴. Saga became a member of the Iceland Stock Exchange in April 2007 and was granted an operating licence as an investment bank in August 2007.
- (29) Saga Investment bank is an independent financial undertaking providing a comprehensive range of investment services, including corporate finance, securities brokerage, asset management, bond issues and investment advice for companies, institutions and other professional investors. Saga's headquarters, which were previously in the town of Akureyri, northern Iceland, are now in Reykjavik where the service division is located, including Corporate Finances, Capital Markets and Investment Advisory, while support divisions remain in Akureyri.
- (30) Saga Capital's total assets at year-end 2008 amounted to approximately 29.3 billion ISK. Liabilities amounted in total to 23.1 billion ISK, the bulk of which consisted of borrowings (22.4 billion ISK), most of which were loans from the Icelandic Government and the Central Bank, amounting to approximately 20.4 billion ISK, while loans from other financial institutions amounted to approximately 0.6 billion ISK and other loans were 1.4 billion ISK.

⁴ According to the Saga Capital's financial statements for the year 2008, its main shareholders were the following: Thorvaldur Ludvik Sigurjonsson (12.07%), Sundagardar hf (10.3%), KEA eignir ehf (9.41%), Tammuz ehf (7.22%), AB-fjárfestingarfélag (5.15%), Byr sparisjodur (4.74%), Gnupverjar ehf (4.10%), AB 150 ehf (3.09%), Sparisjodur Svarfdaela (3.09%), Gift fjarfestingarfelag ehf (2.69%) and Sparisjodurinn i Keflavík (2.69%).

2.5.2 VBS Investment Bank hf.

- (31) The history of VBS Investment Bank (VBS fjárfestingarbanki hf.) dates back to 1996, with the foundation of its predecessor, Verðbréfastofan hf, which was a securities firm. In December 2005, the company received a license as an investment bank and adopted a new name at that time, while the scope of its operations was also broadened. As from 1 January 2007, the operations of FSP hf., an investment company owned by 20 savings banks, were merged with VBS. VBS took over the asset portfolio of FSP, the equity of VBS expanded and the owners of FSP acquired 48% shareholding in VBS.
- (32) By decision of 3 March 2010, the FME appointed VBS a provisional board of directors, and by a ruling of the Reykjavík District Court on 9 April 2010, a winding-up procedure of VBS was initiated, in accordance with Article 101 of Act No. 161/2002 on financial undertakings. Before its collapse the operations of VBS consisted in offering financial services to corporations and individuals in particular in the form of securities trading, asset management, financing of investment projects, corporate consultancy and lending operations.

2.5.3 Askar Capital Investment Bank hf.

- (33) Askar Capital, which was part of the Milestone Nordic Financial Group, was established at the end of 2006 after a series of mergers, building on the history of its founders as financial advisors. The firm was granted a license to operate as an investment bank in August 2007. The bank provided a range of complementary financial services in three units, Capital Markets, Real Estate Investment Advisory and Asset Financing. Avant Asset Financing was a wholly owned subsidiary of Askar Capital. The bank focused on alternative investments in emerging and niche markets.
- (34) Already in 2007, the bank experienced significant losses from investments in structured credit (sub-prime) products with US mortgages as underlying assets. The verdict of the Supreme Court of Iceland in June 2010 concluding that foreign currency denominated loans were illegal had serious repercussions for the bank and its subsidiary, which filed for bankruptcy on 14 July 2010.

2.6 Subsequent developments

2.6.1 Restructuring of Saga Capital

- (35) In December 2009 a restructuring plan was approved by the shareholders of Saga, according to which the bank was essentially divided into a “good bank” and a “bad bank”. The Icelandic authorities explain the reorganisation by referring in particular to Saga’s annual report for 2009, which describes the split in the following manner:

“[...] the operation of Saga Capital was divided into two sections so that the banking operations were isolated in saga Capital investment Bank while certain assets, including bonds issued by the fallen banks, were transferred to the company Hilda hf., a holding company owned by the shareholders. Moreover, Hilda hf. took over the Bank’s debt to the treasury in return for transferred assets. As a result of this restructuring, the Bank’s equity position is good and its liquidity ratio is acceptable.

[...]

Upon the establishment of the companies, assets were transferred from the Bank to Hilda hf., including claims on the fallen commercial banks, in addition to shares in Faroe Islands Bank.

As consideration Hilda hf. took over a loan from Eignasafn Seðlabanka Íslands (the Icelandic Central Bank Asset portfolio), which had been previously granted to the Bank.”

- (36) The Authority has invited the Icelandic authorities to present their views on the possible implications of Saga Capital’s financial restructuring for the security of the Treasury’s claims on the bank and whether the value of claims might have been diminished by leaving them in the „bad bank“. In their response, the Icelandic authorities refer to an agreement, dated 22 January 2010, between the Icelandic State and Saga Capital on the financial reorganization of Saga Capital. The agreement is based on the methodology of dividing the enterprise into an “operating bank” and an “asset company”, where the “operating bank” is formed with the aim to retain the undertaking’s goodwill and attract new investors.⁵
- (37) The Icelandic State’s conditions for participation in the restructuring of Saga Capital are set out in Article 6 of the agreement. These include that the Icelandic State shall receive as collateral all shares in the “operating bank”, and that no new liabilities could be assumed by the “asset company”, of which the Icelandic State was the sole creditor. This would secure the Icelandic State’s priority to all assets of the “asset company”.
- (38) According to the Icelandic authorities, these conditions would ensure the Icelandic State’s priority rights to all potential upside realized from the division into “operating bank” and “asset company”, in the form of increased value of the “operating bank”, thus increasing the recovery potential of the claims in question.
- (39) All equity in the “operating bank” was pledged against the loan agreement, which was placed in the “asset company”. Shortfall in the repayment of the loan in the “asset company”, would result in losses for the equity holders in the “operating bank”. According to the Icelandic authorities, the value of the loan therefore did not diminish as a result of the bank’s reorganisation.
- (40) The Icelandic authorities point out that the repayment of the claim on Saga Capital has developed favourably, with the claim being paid up faster than the terms call for. As of 3 August 2011, 4,986 million ISK have been paid in interest and down payment of the principal.
- (41) Saga’s operations and income have declined substantially in recent years. In 2008 the bank’s net operating income amounted to approximately 1.9 billion ISK. This fell to approximately 1.0 billion in 2009 and 0.4 billion ISK in 2011. According to a news report on 31 August 2011, MP Bank and Saga Investment Bank concluded an agreement on MP Bank’s acquisition of Saga’s Investment Advisory division. The agreement covers consultancy concerning corporate acquisition, sale and mergers as well as corporate and institutional financing services. The agreement implies that Saga’s staff members responsible for the functions covered by the agreement take up employment with MP Bank.⁶
- (42) On 20 October 2011, the FME announced that as from 3 October 2011, it had withdrawn the operating license of Saga Investment Bank, as the undertaking no longer met statutory

⁵ The Icelandic authorities note that at the year-end of 2009 the management of Saga Capital had entered into preliminary negotiations with two potential investors that had declared their interest in acquiring Saga Capital on the condition that unsolved problems from the past would be kept outside the scope of the transaction.

⁶ See MP Bank’s website on 31 August 2011: <https://www.mp.is/um-mp-banka/utgefild-efni/frettir/nr/1561>

requirements of minimum equity according to Act 161/2002 on financial undertakings⁷. However, the withdrawal of the license has, according to Saga, limited implications for the undertaking's operations as it had already sold off parts of its operations and withdrawn from other licensed operations. Current operations related mostly to managing Saga's asset portfolio as well as resolution with creditors. These operations would continue.⁸

3. Position of the Icelandic authorities

- (43) As has already been explained in section 2.3 above, the Icelandic authorities consider that the objective of the measures was twofold; firstly, to try to secure the immense interests of the state by maximising the Treasury's recovery of the claims, and, secondly, to give the financial undertakings a breathing space and a chance to work out their matters and get through the difficulties.
- (44) Iceland's submission adds the following clarifications:

"The result was agreements on payment of the debt in 7 years on the condition that further securities would be provided. The Ministry required that the agreements be inflation-adjusted but would bear minimal interests. By this the undertakings would hopefully be in a position to repay their debt. Enabling the undertakings to repay their debt rather than driving them bankrupt or trying to conclude composition agreements was considered to be in the best interest of the Treasury. Against this interest, the Icelandic authorities did not consider the bankruptcy of the undertakings to safeguard the structure of competition in the market, regardless of whether it might have protected certain competitors.

The Icelandic authorities have in responding to inquiries from the complainant in this case and in replies to the Althingi ombudsman regarding the matter emphasised on the fact that the agreements did not entail a state intervention as such, i.e. financing of the companies by the Ministry, but agreements on the conversion and payment of debts that had fallen due. The debt conversion loans were offered to small financial undertakings indebted to the Treasury due to collateral loan facilities with the CBI and only those undertakings were eligible for the loans.

As described above the claims stemmed from normal lending operations of the CBI. Once the claims fell due the CBI, and the Ministry when it took over the possession of the claims, were in a position of a creditor holding a due claim. As creditors they sought the most favourable settlement of these claims."

- (45) The Icelandic authorities maintain that the purpose of converting the short-term debt to long-term loans was to strengthen the likelihood of recovery of the collateralised debt and thus to better secure the state's interests. They submit that "*no state aid can be involved when central banks or public authorities actively pursue maximising the recovery of debt such as the one in question on equivalent terms with regard to all undertakings involved. Any economic advantage entailed in the recovery process is conferred on a non-selective basis. Thusly, the recovery of debt due to collateral loan facilities with the CBI by the Ministry can only be described as a non-selective measure.*"

⁷ See <http://www.fme.is/?PageID=14&NewsID=678>

⁸ See http://www.mbl.is/vidskipti/frettir/2011/10/20/starfsleyfi_saga_fjarfestingarbanka_afturkallad/

- (46) Iceland furthermore argues that, when considering whether a private creditor in this situation – as owner of claims on financial undertakings following a financial crisis – would have insisted on the enforcement of the claim, due consideration should be taken of the situation of the State as a creditor to the undertakings concerned as well as of the deteriorating securities held by the Icelandic authorities to enforce the debts by other means and the relatively uncertain prospects of the companies' performance.
- (47) The Icelandic authorities maintain that the debt in question is being collected in an equal manner towards all debtors, with the view in all cases to maximise recovery, and comparable claims are being treated in a comparable manner. It is also maintained that the agreements under assessment were effectively open to all undertakings in a comparable legal and factual situation. The measures should therefore be considered to qualify as general measures, as they do not favour certain undertakings or the production of certain goods. The fact that the measures are more favourable to the two or three undertakings than the alternative of enforcing the debt to the point of immediate bankruptcy does not change their nature as general measures.
- (48) It was the Ministry's assessment at the time that the recovery of claims on small non-depository financial institutions, stemming from collateral loan facilities with the CBI, would be better by making available conditional agreements on the repayment of their debt. The conclusion of the agreements was not an intervention as such but an appropriate response in the interest of the Treasury as a creditor although resulting in a smaller value of the claims. Therefore, the measures do not, according to the Icelandic authorities, constitute a method of financing an aid measure in favour of the companies involved.
- (49) Should the Authority after assessing the information submitted still conclude that the measures in question may have entailed state aid, the Icelandic authorities observe that such aid may qualify for an exemptions under Article 61(3) of the EEA Agreement and the Authority's Guidelines on Rescue and Restructuring Aid. In addition to protecting the financial interests of the State as a creditor the measures can be considered necessary to correct disparities caused by market failures in the Icelandic financial market.

II. ASSESSMENT

1. The presence of state aid

- (50) 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.”

- (51) This decision focuses in main on the question whether the Treasury's measures to convert short-term claims to long-term loans on favourable terms are compatible with the state aid provisions of the EEA Agreement. It is clear, nevertheless, that the state's involvement as a major creditor to the undertakings concerned, derives from earlier measures, namely the CBI's short-term collateral loans to financial undertakings and its securities lending, on

behalf of the Treasury, to prime traders of government securities. The background of the conversion loans is obviously the breakdown in the CBI's transaction with financial undertakings which in turn is related to the collapse of the financial system. It is therefore appropriate to consider whether the initial granting by the CBI of short-term credit facilities involved elements of state aid. In the following paragraphs the Authority will therefore, firstly, consider whether those measures possibly constitute state aid, and, secondly, examine in detail the loan conversion agreements in the light of Article 61 EEA.

1.1 CBI and the Treasury short-term credit facilities

- (52) Paragraph 51 of the Authority's banking guidelines⁹ sets out provision on other forms of liquidity assistance and central bank facilities in particular. On the latter the guidelines state that "*[t]he Authority considers that activities of central banks related to monetary policy, such as open market operations and standing facilities, are not caught by the state aid rules. Dedicated support to a specific financial institution may also be found not to constitute aid in specific circumstances. Following the Commission's decision-making practice, the Authority considers that the provision of central banks' funds to the financial institution in such a case may be found not to constitute aid when a number of conditions are met, such as:*

- the financial institution is solvent at the moment of the liquidity provision and the latter is not part of a larger aid package,*
- the facility is fully secured by collateral to which haircuts are applied, in function of its quality and market value,*
- the central bank charges a penal interest rate to the beneficiary,*
- the measure is taken at the central bank's own initiative, and in particular is not backed by any counter-guarantee of the state.”¹⁰*

- (53) The Icelandic authorities have underlined that the short-term credit facilities concerned belonged to regular monetary policy and financial market measures of the CBI and to the Treasury's regular government debt management. Looking closer at the measure taken in the run-up to the financial crisis in 2008, it is clear from publicly available information that due to the liquidity squeeze in the markets, the CBI took steps to increase access to liquidity¹¹. However, the CBI has pointed out that the European Central Bank, the US Federal Reserve Bank and many other central banks had taken significant steps to respond to deteriorating conditions in the global financial markets by enhancing access to liquidity, relaxing the rules on securities eligible as collateral for financial undertakings' transactions with them. The CBI

⁹ See Part VIII of the Authority's State Aid Guidelines, 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/?l=1&showLinkID=16604&l=1>

¹⁰ The European Commission has rarely deemed central bank operations to constitute aid. However, in particular where the State provided counter-guarantees (such as in Dexia – cf. http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_C9_2009) the presence of aid was established.

¹¹ See the article on Financial Markets and Central Bank measures in the CBI's Monetary Bulletin 2008-1 (April 2008), available at <http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=5883>

was simply adapting to more flexible rules already introduced by European and other central banks. This argument finds support in independent sources¹².

- (54) The Authority has no reason to dispute that the CBI measures at issue belonged to monetary policy. The financial undertakings were solvent at the time of the liquidity provision. When the value of underlying collateral collapsed, the CBI made efforts to seek improved collateral and safeguard recovery¹³. Furthermore, collateral lending backed by securities of the failed commercial banks halted automatically once the banks were submitted to public administration. The CBI liquidity facilities were not part of a larger aid package. The transactions were based on the Rules on Central Bank of Iceland Facilities for Financial Undertakings, No. 808 of 22 August 2008¹⁴. These rules meet the conditions set out above including concerning full security by collateral to which haircuts are applied and according to Article 17 of the rules, financial undertakings shall pay penalty interest in cases of default. The measures were taken at the initiative of the financial undertakings concerned and the CBI and were not, at the time, backed by any counter-guarantee of the state.
- (55) In view of the above considerations, the Authority concludes that the CBI short-term collateral loans to financial undertakings did not involve state aid.

1.2 Treasury's loan conversion agreements

1.2.1 Presence of state resources

- (56) In order to qualify as aid under Article 61(1) EEA, the measure must be granted by the State or through state resources.
- (57) The measures under examination take the form of conversion of short-term claims which have fallen due to long-term loans on favourable terms. The loans were granted by the Ministry of Finance on the basis of an authorisation provided by the Icelandic parliament in the supplementary state budget for the year 2008. The measures are therefore clearly granted by the state and through state resources.

1.2.2 Favouring certain undertakings or the production of certain goods

- (58) This condition is twofold. Firstly, the measures must confer on the investment banks as aid beneficiaries advantages that relieve them of charges that are normally borne by their budgets. Secondly, the measures must be selective in that they favour “certain undertakings or the production of certain goods”.

Commercial advantage

¹² See for instance Bank State Aid in the Financial Crisis. Fragmentation or level playing field? A CEPS Task force report. October 2010. Centre for European Policy Studies, Brussels. See in particular chapter I, “An Overview of State Aid Provided during the Crisis”.

¹³ See the notice on the CBI website on collateral loans on 21.10.2011: <http://www.sedlabanki.is/?PageID=287&NewsID=1926> and the news reported in the newspaper *Morgunblaðið* on the same day, http://www.mbl.is/mm/gagnasafn/grein.html?grein_id=1250837&searchid=20673-303a-20fb. The news confirms that the CBI had reassessed the value of the securities provided for collateral loans and requested the financial undertakings concerned to provide new security to meet their commitments to the amount of approximately 150 billion ISK or otherwise repay the unsecured amount to the CBI.

¹⁴ These rules were replaced on 26 June 2009 by Rules No. 553 on the same subject (currently applicable rules).

- (59) Repayment of outstanding credit, including interest, and other costs associated with the investment banks' short-term credit facilities with the CBI are costs normally borne by the banks' budgets. Converting such credits to long-term loans on interest rate terms below market rates amounts to relieving the debtor of such costs.
- (60) The reason for converting the short-term claims to long-term loans was that following the collapse of the three biggest commercial banks in Iceland, the investment banks were unable to honour these claims and no funding on the market was available to them. The approach taken by the European Commission in numerous cases since the onset of the financial crisis¹⁵ and by the Authority¹⁶ in assessing whether state intervention to recapitalise banks amounts to state aid assumes that, given the difficulties faced in the financial markets, the state was investing because no market economy investor would be willing to invest on the same terms. The market economy investor principle was considered not to apply in cases involving capitalisation of financial institutions affected by the crisis that were in difficulty. The Authority considers the same logic to apply in the present case, *mutatis mutandis*, where the Icelandic state stepped in to provide rescheduling of debt due and no market solution was available to the debtors. This would imply that the debtors obtained a commercial advantage.
- (61) The question also arises whether the initial delay in settling payments of the CBI short term credit facilities, which is understood to have lasted from around 21 October 2008 until late March 2009, may involve state aid. In general, decisions by public bodies to tolerate late payments on a loan may entail an advantage to the debtor and involve state aid. While a temporary deferral of payment would probably correspond to the conduct of a private creditor and thus not involve state aid, such conduct, initially consistent with market conditions, could turn into state aid in cases of protracted delays in payment.¹⁷
- (62) As to the interest rate terms of the loans, the Icelandic authorities' explanation for them is essentially that the assets and financial condition of the borrowing undertakings were such that they were only capable of paying a minimum level of interest on the loan. The determination of the interest rate was thus made not principally with reference to market rates but primarily to the undertakings' limited ability to pay. As the rate of interest of 2% per annum is fixed over the seven-year term of the loans, the lending terms do not foresee any step-up of interest rates, should there be an improvement in the debtors' economy, which, however, is partly the goal of the measures.
- (63) To indicate the scale of the advantage, it is evident that the interest rates on the loans from the Treasury under examination are far below market rates. At the time when the loan agreements were concluded, in March 2009, yield on the bond market on medium- to long-term, inflation-indexed government bonds was in the region 4.6 to 6.7% depending on

¹⁵ 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.

¹⁶ See the Authority's decision of 8.5.2009 on a scheme for temporary recapitalisation of fundamentally sound banks in order to foster financial stability and lending to the real economy in Norway (205/09/COL), available at: <http://www.eftasurv.int/?l=1&showLinkID=16694&l=1> and the Authority's decision of 15.12.2010 opening the formal investigation procedure into state aid granted in the restoration of certain operations of (old) Glitnir Bank hf and the establishment and capitalisation of New Glitnir Bank hf (now renamed Islandsbanki), available at <http://www.eftasurv.int/media/decisions/494-10-COL.pdf> and similar decisions of the same date with respect to the two other major commercial banks in Iceland, available at <http://www.eftasurv.int/media/decisions/493-10-COL.pdf> and <http://www.eftasurv.int/media/decisions/492-10-COL.pdf>.

¹⁷ See Opinion of Advocate General Jacobs, Case C-256/97 *DM Transport* [1999] ECR I-3915, paragraph 38.

maturity¹⁸. The 2% fixed interest rate therefore appears to be substantially below the government's own borrowing terms. To determine appropriate lending terms the state would need to add a premium to take into account the particular risk characteristics of the borrower as well as administrative costs.

- (64) For the purposes of this decision, precise determination of the appropriate market rate is not required. However, an indication of a relevant market rate and of the consequent level of subsidisation can be obtained by considering the debtors' own estimation of the relevant market rate as reflected in their own financial reports. Saga and VBS treat the Treasury loans in a similar manner in their financial statements. In both cases the loan transactions, which took place in March 2009, are booked retrospectively and included in the banks' financial statements for the year 2008. For Saga, which signed a loan contract to the total amount of 19,682 million ISK, the financial implication for the bank of the lending terms are explained as follows:

*"The Bank applies International Financial Reporting Standards in preparing the financial statements. As interests according to the loan terms are considerably lower than market interests, according to the IFRS, payments on the loan shall be discounted based on market interests, which were estimated at 12%, and the loan shall be recognised at fair value upon initial recognition. The difference thus arising is recognised in the income statement. Due to this, the amount of ISK 6,970 million is recognised as income in the financial statements for the year 2008. The carrying amount of the loan is ISK 13,053 million at year end 2008. Subsequently, effective interests are expensed in the income statement based on the same rate as for the initial discounting of the payments, or 12%."*¹⁹

- (65) The Treasury's loan to VBS is treated in a similar fashion in the bank's financial statements for the year 2008. VBS also considers the loan to have been provided on interest rates below market terms and that market rates for the bank were 12% per annum. While the bank concluded a loan agreement with the Ministry of Finance in the amount of 26,430 million ISK, the loan is expressed in the bank's balance sheet at a discounted and fair value of 17,075 million ISK. The difference of 9,355 million ISK is booked as earnings in 2008, while in subsequent years, interest costs would be booked on the basis of the same rate as applied for discounting, i.e. 12% per annum. These accounting practices resulted in a corresponding improvement in the banks' profits and equity in the same year.²⁰
- (66) While the failure of the three major commercial banks clearly had devastating effects on the operating environment of the three investment banks and other smaller financial undertakings engaged in repo transactions with the CBI, there can be no doubt that those of the affected undertakings whose short-term debt to the CBI was converted to long-term loans on favourable terms obtained a clear commercial advantage by that measure as such. Thus, according to Saga's financial statements for 2008, its total equity on 31 December 2008 was approximately 6.2 billion ISK, providing an equity ratio of 15%, while without the loan conversion, Saga's equity would have been negative. The same applies to the loan and accounting practice of VBS; without the 9.4 billion ISK booked as earnings due to the favourable terms of the loan from the Treasury, VBS's equity would have been negative by

¹⁸ Information retrieved from the CBI website, <http://www.sedlabanki.is/?PageID=224>

¹⁹ Saga Capital Investment Bank financial statements for the year 2008, point 46 of explanatory notes, available at http://www.sagabanki.is/static/files/arsskyrlur/Arsskyrsla_08_heimasida.pdf

²⁰ See VBS's financial statements for 2008, explanatory note 58, available at <http://www.vbs.is/files/224-1.pdf>

year-end 2008. It can therefore be argued that the investment banks were temporarily rescued with the loan conversion provided by the state.

- (67) The Icelandic authorities submit that, in the light of the facts and arguments which they have put forward, merely comparing the terms of the loans with possible market terms was not reasonable. With regard to the treatment of the loans in the accounts of Saga Capital and VBS they submit that neither the CBI nor the Ministry had any influence on the manner in which those accounts were created and that any proclamations of profit made on the loans are solely the responsibility of the boards of the undertakings and their accountants. They note, finally, that such proclamations were of no assistance to the undertakings in their restructuring efforts since the FME informed them that assessments of their equity would not take such proclamations into account. However, this last statement appears to be contradicted by the following statement in the same letter from the Icelandic authorities on the implication of the loan conversion for the undertakings' financial statements: "*Without an extension from the CBI, those statements would not have been valid for certification by the entities' accountants that the undertakings were fit for operation, since the accountants would in such circumstances in all likelihood have been required to request that the undertakings be taken over by the FME. ...*". The Authority considers it important that without the measures under assessment, the financial statements for the undertakings concerned for the year 2008 would not have been valid for certification by their accountants and that they would in all likelihood have been required to request that the undertakings be taken over by the FME.

Private creditor test

- (68) The Icelandic authorities contend that the measures under assessment do not involve state aid as the conduct of the state in this case meets the requirements of the so-called private creditor test.
- (69) The private creditor test, developed and refined by the courts of the European Communities²¹, serves to establish whether the conditions under which a public creditor's claim is to be repaid, possibly by rescheduling payments, constitutes state aid. When the state is in the position, not as an investor or a promoter of a project, but as a creditor trying to maximise the recovery of an outstanding debt, lenient treatment alone, in the form of deferment of payment or interest rates below market terms, may not be sufficient to presume favourable treatment in the sense of state aid. In such circumstances the conduct of the public creditor is to be compared with that of a hypothetical private creditor in a comparable factual and legal situation²². As concerns interest rates, the correct term of reference is not the market interest rate but the rate deemed acceptable by a private creditor in similar circumstances. The crucial question is whether a private creditor would have granted similar favourable

²¹ See cases C-342/96 *Spain v. Commission* [1999] ECR I-2459, paragraphs 46 *et seq.*; T-46/97 *SIC v. Commission* [2000] ECR II-2125, paragraph 98 *et seq.*; C-256/97 *DM Transport* [1999] ECR I-3913, paragraphs 19 *et seq.*; C-480/98 *Spain v. Commission* [2000] ECR I-8717, paragraphs 19 *et seq.*; T-152/99 *HAMSA v. Commission* [2002] ECR II-3049, paragraph 167; Judgment of 14 September 2004, C-276/02 *Spain v. Commission* [2004] ECR I-8091, paragraphs 31 *et seq.*; Judgment of 21 October 2004, T-36/99 *Lenzig v. Commission* [2004] ECR II-3597, paragraphs 134 *et seq.*; Judgment of 8 July 2004, T-198/01 *Technische Glaswerke Ilmenau v. Commission* [2004] ECR II-2717, paragraphs 97 *et seq.*; C-525/04 P *Spain v. Commission* [2007] ECR I-9947, paragraphs 43 *et seq.*; T-68/03 *Olympiaki Aeroporia Ypiresies v. Commission* [2007] ECR II-2911, and T-1/08 *Buzek Automotive v. Commission*, Judgment of 17 May 2011 (not yet reported), paragraphs 65 *et seq.*

²² For a helpful exposition of the application of the private creditor test, see also *The EC State Aid Regime: Distortive Effects of State Aid on Competition and Trade*, Michael Sanchez Rydelski (Ed.), Ch. 7.

treatment to a debtor in similar circumstances. Commercial advantage in the sense of Art. 61(1) EEA can be presumed if the amount owed can be paid back to the public creditor on more favourable terms than would be accepted by a private creditor.

- (70) From the point of view of a private creditor, enforcement of a claim that has become due is the self-evident norm. This also applies if the debtor undertaking is in financial difficulties as well as in the case of insolvency. Private creditors will not normally be willing in such circumstances to accept further deferral of payment if this does not bring them any clear advantage. On the contrary, once a debtor runs into financial difficulty, further loans or rescheduling of debt would only be granted to the debtor under stricter terms, e.g. at a higher interest rate or with more comprehensive securities, as repayment is endangered.
- (71) Exceptions may be justifiable in individual cases where non-enforcement seems to be the economically more sensible alternative. This would be the case when non-enforcement offers clearly improved prospects of collecting a substantially higher proportion of the claims in comparison with other possible alternatives or if even greater consequential losses can be averted in this way. It can be in the interest of a private creditor to keep the business of the debtor company running instead of liquidating its assets and thus, under certain circumstances, only collecting a part of the debt. When a private creditor accepts to refrain from enforcing his claim in full, he will normally require the debtor to provide additional securities and when this is not available, in cases of debtors in financial difficulty, he will seek assurances of maximum compensation should the financial condition of the debtor later improve. If insufficient securities or commitments are made by the debtor, a private creditor would generally not accept to conclude debt rescheduling agreements.
- (72) While the Icelandic authorities admit that their purpose was partly to give the financial undertakings a chance to cope with their financial difficulties, the main objective of the loan conversion agreements was to best secure the immense interests of the State. The measures would, according to Iceland, maximise the Treasury's recovery of the claims rather than enforcing the short-term claims of the CBI and the Treasury, which would have driven the companies to bankruptcy.
- (73) The Authority considers that the available evidence so far suggests that the Icelandic state has in the present case in many respects endeavoured to best secure the interests of the state and tried to maximise the Treasury's recovery of the claims. In return for agreeing to an extensive rescheduling of the claims to a seven-year loan, the state received consideration in the form of the conditions attached to the loan. Nevertheless, the Authority has doubt as to whether the terms agreed upon by the state were sufficiently valuable to the creditor to meet the requirement of the private creditor test. Most importantly, as explained above, the interest rate terms of the loans provided by the state are far below market rates and are fixed over the seven-year term. The aim of the measure is partly to enable the debtors to consolidate their finances and seek recovery. Nevertheless, no step-up of interest rates is foreseen in case there was an upside in the debtors' economy. While the conditions attached to the loans impose restrictions *inter alia* on the debtors' ability to pay dividends to shareholders and bonuses to employees, they nevertheless do not secure the creditor any share in the possible upside in the debtors' operations. Under such circumstances, the maximum remuneration which the creditor would receive is the indexation and sub-market interest rate agreed for the loans. In the Authority's preliminary view, it appears not to be consistent with the conduct of a private creditor to accept such terms. As will be seen in section 3 below, the Authority also has doubts as to whether such terms meet principal requirements of compatibility for

remuneration of state aid according to the Authority's temporary rules on aid to financial undertakings in the current financial crisis.

- (74) The Authority points out that the measures under examination must be assessed at the time when they were implemented in March 2009 and without using the benefit of hindsight at a later point in time. Thus, the state's agreement with Saga Capital in January 2010 on the bank's financial restructuring, providing *inter alia* that the state would receive as collateral all shares in the "operating bank" in return for concluding the agreement, may have resembled the conduct of a private creditor faced with similar circumstances. However, this did not alter the initial conduct of the state in March 2009, when agreeing to grant subsidised rescheduling loans without securing itself an adequate share in the possible upside of the debtors' economy.
- (75) The Authority also notes that the Icelandic authorities have confirmed that the Treasury did not require other creditors of Saga and VBS to actively participate and contribute to rescheduling the companies' debts. While the share of other creditors in the undertakings' debt appears minimal, such conduct would nevertheless appear not to be consistent with that of a private creditor.
- (76) Moreover, the Authority notes that the Icelandic authorities' appeal to the private creditor principle cannot be reconciled with the view which they also firmly maintain that the measures qualify as general measures and therefore do not involve state aid.
- (77) In light of the above, the Authority concludes that it has doubts as to whether the measures under assessment are consistent with the conduct of a private creditor finding himself in a comparable legal and factual situation.

Selectivity

- (78) The Icelandic authorities claim that when implementing the measures comparable claims were treated in a comparable manner and that the agreements under assessment were effectively open to all undertakings in a comparable legal and factual situation. In their view, the authorities did not enjoy sufficient discretion in order for the measures to be selective. The measures should therefore be considered to qualify as general measures, as they did not favour certain undertakings or the production of certain goods.
- (79) However, as indicated above, this argument cannot be reconciled with the plea made by Iceland that the measures are compatible with the conduct of a hypothetical private creditor. By their nature, such debt collection efforts apply only to the debtor(s) to which they are effectively applied and therefore do not have the character of non-selective general measures.
- (80) With regard to other financial undertakings active in repo trade with the CBI, Glitnir Bank, Kaupthing Bank and Landsbanki Islands were taken into administration by the FME already on 7-9 October 2008 and it was therefore not relevant to offer these banks the loan conversion at issue. The same does not apply to the three other deposit holding undertakings, Sparisjodabanki Islands, Straumur and SPRON, where according to the information submitted by the Icelandic authorities, the CBI's claims lodged amounted in total to approximately 318.8 billion ISK. Straumur was taken into administration by the FME on 9 March 2009 and Sparisjodabanki Islands and SPRON on 21 March 2009. This was about the same time when decisions were taken to provide Saga and VBS with the loan conversion agreement, based on proposals dated 20 January 2009 to the Minister of Finance for the

restructuring of debt owed by financial undertakings due to collateral loan facilities with the CBI. Unlike what appears to be suggested by the Icelandic authorities, a distinction between depositary financial undertakings (which included Sparisjodabanki Islands, Straumur and SPRON) and non-depository financial undertakings (including the three investment banks) would not appear relevant under the assessment of selectivity.

- (81) The Icelandic authorities state that the Ministry of Finance and the CBI had taken part in negotiations between creditors of SPRON and Sparisjodabankinn on financial reorganisation of these undertakings and that the creditors of both undertakings had agreed in year-end 2008 to comparable stand-still agreements aimed at ensuring their equal standing at reorganisation. In both cases substantial debt write-off was needed for the undertakings to be able to meet minimum CAD requirements. Straumur was also in contact with the CBI regarding the CBI's loan to the undertaking, which had fallen due and was granted repeated extensions to seek solutions to its capital and liquidity needs. However, it became evident that the challenges facing these undertakings were so substantial that merely restructuring the CBI's loans would not solve them. As with SPRON and Sparisjodabankinn, it was necessary that all of Straumur's creditors would take part in the undertaking's financial reorganisation. None of the undertakings were however at the time able to reach an agreement with their creditors on the restructuring of their debts. Therefore, the FME assumed power of the shareholder meeting of Straumur by a decision on 9 March 2009, and corresponding action was taken on 21 March 2009 with respect to Sparisjodabankinn and SPRON.
- (82) The Icelandic authorities consider that the situation of VBS and Saga Capital differed from that of the aforementioned undertakings, firstly due to the fact that when the working group presented its memorandum to the Minister of Finance in January 2009, negotiations with creditors, other than the CBI, had not begun. Secondly, while the depositary undertakings mentioned above were already in default on their obligations to their creditors, the only claims on VBS and Saga due were loans from the CBI. Hence, it was necessary for VBS and Saga to negotiate with the CBI on a new maturity date in order to have the possibility to continue operating and to reach a broader agreement on their financial reorganisation.
- (83) When assessing selectivity under state aid review, the Authority does not consider the above considerations of the Icelandic authorities to be decisive. According to established case law, a measure is normally considered to be selective if it favours one particular economic sector, as opposed to other sectors which do not derive any benefit from it²³. Thus, even assuming that the Icelandic authorities were correct in stating that the agreements were potentially available to all undertakings indebted to the CBI due to short-term collateral and securities lending, this does not necessarily render the measures non-selective.
- (84) Furthermore, the Icelandic authorities have so far not presented clear evidence that the favourable loan conversion agreements were effectively made available to all undertakings in a comparable legal and factual situation as Saga Capital, VBS and Askar Capital.
- (85) The Authority has also noted the subsequent development of Straumur, which apparently was not offered to conclude a loan conversion agreement for payment of its short-term debt to the

²³ See for instance Case C-75/97 *Belgium v. Commission (Maribel bis/ter)* [1999] ECR I-3671 as well as recent judgment in joined Cases C-106/09 P and C-107/09 P *Commission v. Government of Gibraltar*, not yet reported, paragraph 75.

CBI, but announced in August 2011 that it had paid in full all loans granted to it by the CBI without the CBI or the Treasury incurring any losses or write-offs²⁴.

- (86) In view of the above the Authority concludes that the measures under assessment cannot be considered to represent general measures but must be considered to be selective in nature.

1.2.3 Distortion of competition and effect on trade

- (87) The aid measure must distort competition and affect trade between the Contracting Parties to the EEA Agreement.
- (88) Government measures favouring particular investment banks are liable to distort competition. While the investment banks concerned operate mostly on the Icelandic market and are of modest size, they are nevertheless engaged in provision of financial services which are fully open to competition and trade within the European Economic Area. This condition can therefore be presumed to be fulfilled.

1.2.4 Conclusion regarding presence of state aid

- (89) Since the measures under assessment apparently meet the conditions to qualify as state aid, the Authority is obliged to consider them as involving state aid.

2. Procedural requirements

- (90) 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”.
- (91) The Icelandic authorities did not notify the aid measure to the Authority. 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 the aid was therefore unlawful.

3. Compatibility of the aid

- (92) While it is the principal view of the Icelandic authorities that the measures under examination did not involve any state aid, they also argue that should the Authority consider otherwise, such aid can nevertheless be found compatible. In this context reference is made to Art. 61(3) EEA and the Authority’s rescue and restructuring aid guidelines.
- (93) In the Authority’s letters requesting information on the measures the Icelandic authorities have been invited to submit any information and observations which the Icelandic authorities

²⁴ Straumur-Burdaras Investment Bank went into moratorium in March 2009, but the undertaking eventually managed to secure the approval of its creditors on a composition proposal in July 2010. Straumur ceased investment banking activities and downsized the operation. The existing share capital was cancelled and the company’s unsecured creditors converted their claims to zero-coupon bonds and shares. The company was converted into an asset management company and its name was changed to ALMC. ALMC’s plan is to maximise returns for the company’s creditors and shareholders in a managed work-out of its assets. On 16 August 2011, ALMC announced that it had that day made the final payment, in the amount of 46 million Euro, on the secured loan granted by the CBI. According to ALMC, the company has since March 2009 paid over 450 million Euro towards secured loans granted by the CBI by proceeds from asset disposals and has paid in full all loans granted by the CBI without the CBI incurring any losses or write-offs. For further details, see website of ALMC, <http://www.almchf.com/new-and-events/nr/121>

consider relevant for the Authority to assess the compatibility of the measures with the state aid provisions of the EEA Agreement. Except for the principal view of the Icelandic authorities referred to above, the Authority has so far received no such information.

- (94) The Authority notes its finding above that the interest rate terms of the loans under assessment are far below market rates and that the Icelandic authorities provide no explanation for these exceptional terms except to say that the undertakings concerned would not be able to pay higher rates. The aim of the measures was nevertheless, partly, to give the undertakings concerned a breathing space to work out their matters and get through the difficulties.
- (95) While the Icelandic authorities have not submitted any evidence in favour of assessing compatibility of the measure under Article 61(3)(b) of the EEA Agreement and the Authority's temporary state aid guidelines regarding the financial crisis, which in general allow for more flexibility than is otherwise the case concerning aid for rescuing and restructuring firms in difficulty, it is nevertheless appropriate to briefly consider the measures at issue under those rules.
- (96) The temporary rules on aid to financial undertakings foresee limitation of aid to the minimum necessary and safeguards against undue distortion of competition. In particular, the guidelines set out rules to secure appropriate and adequate remuneration for state recapitalisation²⁵. Without going into the details of those rules, they underline the importance of closeness of pricing to market prices. Under certain circumstances the Authority may be prepared to accept the price for recapitalisations at rates below current market rates, if this is likely to favour the restoration of financial stability, but the total expected return to the state should not be too distant from market prices. The entry level price may thus be fairly low, but the price should normally be adjusted upwards to account for the need to encourage the redemption of state capital and prevent undue distortion of competition.
- (97) In the present case the repayment terms of the loans provided by the state appear not to take account of the above principles. The loans were granted with a repayment period of seven years, with indexation, and at fixed interest rates of 2% per annum, which is far below market rates. No step-up of interest rates is foreseen to encourage redemption of state capital. Any possible upside in the operation of the debtors, which is partly the aim of the measures, will thus not be redeemed by the state to limit state aid, but would accrue to the debtors. Lending terms of this kind are not compatible with the Authority's state aid guidelines.
- (98) Under those circumstances, the Authority has doubt as to the compatibility of the aid measures.

4. Conclusion

- (99) Based on the information submitted by the Icelandic authorities, the Authority cannot exclude the possibility that the measures examined above constitute state aid within the meaning of Article 61(1) of the EEA Agreement. The Authority also has doubts as to whether these measures comply with Article 61(3) of the EEA Agreement. The Authority, thererfore, doubts that the above measures are compatible with the functioning of the EEA Agreement.

²⁵ See for instance the Authority's recapitalisation guidelines available at
<http://www.eftasurv.int/?l=1&showLinkID=16015&l=1>

- (100) Consequently, and in accordance Article 4(4) of Part II of Protocol 3, the Authority is obliged to open the formal investigation procedure provided for in Article 1(2) of Part I of Protocol 3. The decision to open a formal investigation procedure is without prejudice to the final decision of the Authority, which may conclude that the measures in question are compatible with the functioning of the EEA Agreement.
- (101) In light of the foregoing considerations, the Authority, acting under the procedure laid down in Article 1(2) of Part I of Protocol 3, invites the Icelandic authorities to submit their comments within one month of the date of receipt of this Decision.
- (102) In light of the foregoing considerations the Authority request the Icelandic authorities to provide, within one month of receipt of this decision, all documents, information and data needed for assessment of the compatibility of the Treasury rescheduling loan agreements examined above.
- (103) The Authority requests the Icelandic authorities to forward a copy of this decision to the potential recipients of the aid immediately.
- (104) The Authority must remind the Icelandic authorities that, according to Article 14 of Part II of Protocol 3, any incompatible aid unlawfully granted to the beneficiaries will have to be recovered, unless, exceptionally, such recovery would be contrary to a general principle of EEA law.

HAS ADOPTED THIS DECISION:

Article 1

The formal investigation procedure provided for in Article 1(2) of Part I of Protocol 3 is opened regarding the state aid granted to three Icelandic investment banks through rescheduled loans on preferential terms.

Article 2

The Icelandic authorities are invited, pursuant to Article 6(1) of Part II of Protocol 3, to submit their comments on the opening of the formal investigation procedure within one month from the notification of this Decision.

Article 3

The Icelandic authorities are requested to provide within one month from notification of this Decision, all documents, information and data needed for assessment of the compatibility of the aid measure.

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 23 November 2011.

For the EFTA Surveillance Authority

Oda Helen Sletnes
President

Sverrir Haukur Gunnlaugsson
College Member