Case No: 69096
Event No: 583836
Dec. No: 493/10/COL

EFTA SURVEILLANCE AUTHORITY DECISION
of 15 December 2010
opening the formal investigation procedure into state aid granted in the restoration of certain operations of (old) Landsbanki Islands hf and the establishment and capitalisation of New Landsbanki Islands (NBI hf)
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 13(1) of Part II,

HAVING REGARD to the temporary rules regarding the financial crisis in Part VIII of the Authority's State Aid Guidelines[1],

Whereas:

I. FACTS

1. Procedure

On 2 October 2008, the Icelandic authorities informed the Authority of their intention to inject 600 million Euros of capital into Glitnir bank in return for 75% of its shares. The information was provided by way of a draft notification said to be submitted for legal certainty only as it was contended that the measure did not involve state aid. This proposal was however subsequently abandoned due to a further deterioration in the financial position of the bank (and that of the other two main Icelandic commercial banks Landsbanki Islands[2] and Kaupthing) and on 6 October, the Icelandic Parliament (the *Althingi*) passed Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc. (referred to as the "Emergency Act"), which gave the state wide-ranging powers to intervene in the banking sector. On 10 October 2008 the President of the Authority wrote to the Icelandic authorities and (among other matters) requested that state aid measures taken under the Emergency Act be notified to the Authority, as the Icelandic authorities had previously indicated that they would. On 14

[1] Available at: http://www.eftasurv.int/state-aid/legal-framework/state-aid-guidelines/
[2] Referred to in this decision as "Landsbanki".

October 2008, the Icelandic authorities submitted a further draft notification, informing the Authority that in their opinion measures taken under the Emergency Act to establish new banks as a result of the failure of the commercial banks did not involve state aid. A letter in response was sent by the Authority on 20 October 2008 indicating that it considered this unlikely and referred to the information that would be required in a notification. The matter was also discussed shortly thereafter in a meeting in Reykjavik on 24 October 2008. Further contact and correspondence followed periodically including notably a letter sent by the Authority on 18 June 2009 reminding the Icelandic authorities of the need to notify any state aid measures, and of the standstill clause in Article 3 of Protocol 3. On 22 July 2009, the Icelandic authorities informed the Authority that heads of terms had been agreed with resolution committees appointed to administer the estate of the (old) failed banks, which would lead to each of the new banks being capitalised by the Icelandic State on 14 August 2009. The Icelandic authorities again insisted that no state aid was involved and provided little information beyond what was already publicly available. Correspondence continued and meetings between the respective authorities followed both in August and November 2009, during which the Authority made it clear that from the limited information it had received it believed that the capitalisation of the new banks was state aid that required notification. Given that the measures had already been implemented, the Authority subsequently sought to assist the Icelandic authorities in producing restructuring plans for the banks with the intention of proceeding directly to assess the measures in one procedure. It transpired, however, that the authorities and the banks were not yet in a position to produce definitive, detailed plans. State aid involved in the restoration of certain operations of Landsbanki and the establishment and capitalisation of a new Landsbanki Bank ("NBI") was eventually notified retrospectively by the Icelandic authorities on 15 September 2010, although the process of restructuring the bank in order to ensure its long term viability remains ongoing. The Icelandic authorities also submitted further information by letters of 9, 11, 15 and 28 November 2010 and in a meeting held in Reykjavik on 29 September 2010.

2. Background – the financial crisis and major causes of failure of the Icelandic banks

In their notification of the aid granted to New Glitnir/Islandsbanki, the Icelandic authorities explained that the reasons for the collapse of the Icelandic banking sector and their need to intervene in the banking sector were set out in considerable detail in a report prepared by a Special Investigation Commission ("SIC") established by the Icelandic Parliament[3], whose remit was to investigate and analyse the processes leading to the collapse of the three main banks. In sections 2.1 and 2.2 below, the Authority summarises the conclusions of the Commission concerning the causes of failure most relevant to the demise of Landsbanki. The information is drawn from Chapters 2 (Executive Summary) and 21 (Causes of the Collapse of the Icelandic Banks – Responsibility, Mistakes and Negligence) of the SIC Report.

2.1. Causes of failure based on the 2008 financial crisis and its impact on underlying problems of Landsbanki and the other main Icelandic banks

The global reduction in liquidity in financial markets that began in 2007 eventually led to the collapse of the three main Icelandic banks, whose business operations had become

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

increasingly dependant on raising funding through international markets. The reasons for the demise of the Icelandic banks were however complex and numerous. The SIC investigated the reasons which led to the collapse of the banks, and it is notable that the majority of the conclusions applied to each bank and many are inter-related. Causes of failure related to the banks' activities are briefly summarised below.

2.1.1. *Excessive and unsustainable expansion*

The SIC concluded that in the years leading up to the collapse each of the banks had expanded their balance sheets and lending portfolios beyond their operational and managerial capacity. The combined assets of the three banks had increased exponentially from 1.4 trillion ISK[4] in 2003 to 14.4 trillion ISK at the end of the second quarter of 2008. Significantly, a large proportion of the growth of the banks was in lending to foreign parties, which increased substantially during 2007[5], most notably after the beginning of the international liquidity crisis. This led the SIC to conclude that much of this increase in lending resulted from loans made to undertakings that had been refused credit elsewhere. The report also concluded that inherently riskier investment banking had become an ever increasing feature of the banks' activities (and growth) had contributed to the problems.

2.1.2. *The reduction in finance available on the international markets*

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

2.1.3. *The gearing of the banks' owners*

In the case of each major Icelandic bank, the principal owners were among the biggest debtors[6]. Samson Holding Company ("Samson") was the biggest shareholder in the Landsbanki since its privatisation. When Landsbanki collapsed Samson's co-owner Björgólfur Thor Björgólfsson and companies affiliated to him were the bank's largest debtors, while his father and co-owner of Samson, Björgólfur Guðmundsson was the bank's third largest debtor. In total their obligations to the bank exceeded 200 billion ISK, which was greater than the bank's equity. The SIC was of the view that certain shareholders had abnormally easy access to borrowing from the banks in their capacity as owners. This was notable in the case of Landsbanki from the fact that as late as 30 September 2008, when it was clear that Landsbanki did not have sufficient foreign currency to honour its obligations abroad, the bank provided a loan of 153 million Euros to a company owned by Björgólfur Thor Björgólfsson. It also concluded that that there were strong indications that in the case of each bank the boundaries between the interests of the largest shareholders and the interest of the bank were blurred. The emphasis on the major shareholders was therefore to the detriment of other shareholders and creditors.

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[4] Icelandic króna.

[5] Lending to foreign parties increased by 11.4 billion EUR from 8.3 billion EUR to 20.7 billion EUR in six months.

[6] Chapter 21.2.1.2 (page 6) of the Report.

2.1.4. *Concentration of risk*

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

2.1.5. *Weak equity*

Although the capital ratio of Landsbanki (and the other two major banks) was always reported to be slightly higher than the statutory minimum, the SIC concluded that the capital ratios did not accurately reflect the financial strength of the banks. This was due to the risk exposure of the bank's own shares through primary collaterals and forward contracts on the shares. Share capital financed by the company itself, referred to by the SIC as "weak equity"[7] represented more than 25% of the banks' capital bases (or over 50% when assessed against the core component of the capital, shareholders' equity less intangible assets). Added to this were problems caused by the risk the banks were exposed to by holding each other's shares. By the middle of 2008 direct financing by the banks of their own shares, as well as cross-financing of the other two banks' shares, amounted to approximately 400 billion ISK, around 70% of the core component of capital. The SIC was of the opinion that the extent of financing of shareholders' equity by borrowing from the system itself was such that the system's stability was threatened. The banks held a substantial amount of their own shares as collateral for their lending and therefore as share prices fell the quality of their loan portfolio declined. This affected the banks' performance and put further downward pressure on their share prices; in response to which (the SIC assumed from the information in their possession), the banks attempted to artificially create abnormal demand for their own shares.

2.2. **Causes of failure based on deficient regulation of the banks by the state and the size of the banks in relation to the rest of the Icelandic economy and currency.**

2.2.1. *The size of the banks*

In 2001 the balance sheets of the three main banks (collectively) amounted to just over a year of the gross domestic product ("GDP") of Iceland. By the end of 2007 the banks were international and held assets worth nine times Icelandic GDP. The SIC report notes that by 2006, observers were commenting that the banking system had outgrown the capacity of the Icelandic Central Bank ("CBI") and doubted whether it could fulfil the role of lender of last resort. By the end of 2007 Iceland's short term debts (mainly incurred financing the banks) were 15 times larger, and the foreign deposits of the three banks were 8 times larger, than the foreign exchange reserve. The Depositors and Investors Guarantee Fund also held minimal resources in comparison with the bank deposits it was meant to guarantee. These factors, the SIC concludes, made Iceland susceptible to a run on its banks[8].

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

The SIC concluded that the relevant supervisory bodies in Iceland lacked the credibility that was necessary in the absence of a sufficiently resourced lender of last resort. The report concludes that the Icelandic Financial Supervisory Authority (the "FME") and CBI lacked the expertise and experience to regulate the banks in difficult economic times, and

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[7] Chapter 21.2.1.4 (page 15) of the Report.

[8] These issues are discussed in more detail in the following paper by Willem H. Buiter and Anne Sibert: http://www.cepr.org/pubs/PolicyInsights/PolicyInsight26.pdf

could have taken action to reduce the level or risk that the bank were incurring. The FME for example did not grow in the same proportion as the banks and their practices did not keep up with the rapid developments in the banks' operations. The report is also critical of the government, concluding that the authorities should have taken action to reduce the potential impact of the banks on the economy by reducing their size or requiring one or more bank to move their headquarters abroad[9].

2.2.3. *Imbalance and overexpansion of the Icelandic economy as a whole*

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

2.2.4. *The Icelandic króna (ISK), external imbalances and CDS spreads*

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

2.3. **The global financial crisis and collapse of Glitnir Bank**

In September 2008 a number of major global financial institutions began to experience severe difficulties. Lehman Brothers filed for bankruptcy protection on 15 September, and on the same day it was announced that the Bank of America was to takeover Merrill Lynch. Elsewhere, one of the United Kingdom's biggest banks, HBOS, had to be taken over by Lloyds TSB. In Iceland meanwhile, Glitnir Bank was experiencing major difficulties in financing its activities. A bond issue had had to be cancelled as a result of a lack of interest, an asset sale did not complete, and a German bank refused to extend two loans estimated at 150 million Euros. Market conditions also worsened dramatically after the fall of Lehman Brothers. On 24 September 2008, the Chairman of Glitnir's Board contacted the CBI to inform them that as a result of loans that had to be repaid in October, the bank had an immediate shortfall of 600 million Euros. On 29 September it was announced that the Icelandic Government would provide Glitnir with 600 million Euros in return for 75% of its equity. The fact that 600 million Euros amounted to nearly a quarter of Iceland's foreign currency reserves, and that Glitnir had experienced refinancing problems for some time and had debt estimated at 1.4 billion Euros to repay over the following six months (information that was publically available) suggested, however, that the proposal was not credible[11]. The effect was a reduction on the value of issued Glitnir shares from over 200 billion ISK to 26 billion ISK in one day. The Icelandic banks experienced massive withdrawals of deposits not only abroad but also within Iceland.

[9] It was in fact the then coalition government's stated policy to encourage more growth and to incentivise the banks to remain headquartered in Iceland.
[10] Chapter 2, page 5 of the report.
[11] Page 13 of the Executive Summary to the Report (Chapter 2), fourth bullet point.

Domestic withdrawals became so large that at one stage the Icelandic banks and the CBI were close to experiencing a shortage of cash. On 30 September 2008, the credit agency Moody's lowered Glitnir's credit rating, triggering repayment obligations for further loans. Margin calls of over a billion Euros also followed and eventually on 7 October 2008 Glitnir's Board decided that it had no alternative but to submit the bank to the FME for actions to be taken under the newly passed Emergency Act. Within days the other two Icelandic commercial banks also failed and were taken over by the FME.

3. Description of the measures

3.1. Background

Prior to the financial crisis of 2008 Landsbanki was the second largest bank in Iceland. At the end of the second quarter of 2008 its balance sheet amounted to ISK 3,970 billion (c43.5 billion Euros) and it made a pre-tax profit during the first half of that year of 31 billion ISK, around 341 million Euros. The published business strategy[12] of the bank was to transform the bank from a local commercial bank, operating exclusively in Iceland, "into a highly profitable corporate and investment banking operation stretching eastward from Iceland across Europe and westward over the Atlantic". In 2000 Landsbanki began its activities abroad by acquiring a 70% holding in the Heritable Bank in London and over the following years the bank grew substantially both through acquisitions and the establishment of foreign branches. Prior to its collapse the bank held 7 main subsidiaries in the UK, Ireland, Luxembourg, France/Germany and Iceland itself. It also had branches in the UK (which in turn had offices in the Netherlands, Germany and the United States), Canada, Norway and Finland; and a sales office in Hong Kong.

3.2. The collapse of Landsbanki

Access to foreign debt securities markets had been the main source of the Icelandic banks' growth, in particular between 2003 and 2006. This source of financing however began to diminish, and foreign credit-rating agencies also expressed concern that the ratio of the banks' lending to deposits was low in comparison to other (foreign) banks. The banks (in particular Landsbanki) responded by strengthening their deposits by accumulating custom abroad. From the end of the third quarter of 2006 to the middle of 2007, customer deposits in Landsbanki tripled – an increase of almost 10 billion Euros. The largest proportion of this was "Icesave" accounts opened in the Landsbanki UK branch, in which retail deposits had grown from nothing to 6.6 billion Euros, while wholesale deposits (in branches in the UK and the Netherlands) had grown to 2.5 billion Euros. To put the figures in context, the increase in (foreign currency denominated) deposits over a period of merely 9 months amounted to nearly five times the monetary reserves of the CBI (which stood at just under 2 billion Euros). The SIC report concludes that on that basis it should have been clear that the Central Bank could no longer act as a lender of last resort if Landsbanki experienced a run on foreign deposit accounts. Despite this Landsbanki continued to choose to accumulate deposits in branches instead of subsidiaries, a decision that the SIC report concludes was "highly risky"[13]. The report also notes that that there is no indication that any evaluation was undertaken by the Icelandic regulatory authorities of the stability of Icesave accounts as a means of financing Landsbanki's activities, noting that accumulating deposits abroad entailed new risks. On 3 October 2008 the European Central Bank issued a margin call to Landsbanki to the amount of 400 million Euros and although this was

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

[13] Page 85 of Chapter 21 of the report. Operating as a subsidiary could have avoided currency risk. Subsidiaries would also be subject to local deposit guarantee scheme provisions.

later withdrawn the bank's UK branch had begun to experience a run on its deposits, meaning that it had to make available large amounts in pounds sterling. Landsbanki's request for the assistance of the Icelandic Central Bank was turned down on 6 October and when the bank failed to make the funds demanded by the UK Financial Services Authority available the UK authorities closed the branch. The following day the Dutch Central Bank requested that an insolvency practitioner be appointed for Landsbanki's Amsterdam branch. Also that day the FME suspended the board of directors of Landsbanki, took over the power of shareholders' meetings and appointed a Resolution Committee in its place using its powers under the Emergency Act[14].

3.3. National legal basis for the aid measure

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

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

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

- *State Budget Act for 2009 (Article 6)*

3.4. The intervention of the Icelandic state

The Icelandic authorities' intervention can be categorised into three phases as follows: firstly, restoration of NBI in October 2008 through the formation of the new bank, the transfer of assets and liabilities, and the provision of initial capital and a commitment to fully capitalise; secondly, the completion of the capitalisation (primarily by the state) in the autumn/winter of 2009; and thirdly the restructuring of the bank, which began when the banks were restored and is ongoing.

3.4.1. *Phase 1: Restoration of certain operations of Landsbanki and the establishment of NBI*

On 7 October 2008, the FME took control of Landsbanki in order to ensure the continuation of domestic retail banking operations. This was done through the appointment of a Resolution Committee for Landsbanki, which assumed the authority of its board of directors; and the establishment by the Icelandic Government, on 8 October 2008, of New Landsbanki (or NBI), wholly owned by the state. On 9 October 2008 the

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

FME transferred the liabilities for deposits held in Landsbanki, except for those held in foreign branches, to the new bank[15]. The total amount of liability for domestic deposits transferred was 462,069,454,174 ISK. Certain assets were also transferred to the new bank based on a principle (that was subject to certain exceptions) that assets connected to the old bank's domestic operations were to be credited to the new bank with the remainder staying with the old bank. The FME also published an internal memorandum setting out "guiding principles" for what was to be transferred not only to NBI but also to new successor banks that were formed following the collapse of Glitnir and Kaupthing[16].

In return for the assets transferred to the new bank, the old bank was to be compensated to the sum of the difference between the value of the assets transferred and the amount of the liabilities (deposits) transferred. In accordance with Article 5 of the Emergency Act and the subsequent decisions of the FME on the disposal of assets and liabilities of the old Banks, the FME commissioned a valuation of the net assets transferred from the old banks to the respective new banks. Deloitte LLP was appointed by the FME on 24 December 2008 to prepare the net asset valuations of each of the new banks. The process of valuation was however to prove complex and lengthy.

Initial Capital

The state provided 775 million ISK[17] (5 million Euros) in cash as initial capital to the new bank and in addition issued a commitment to contribute up to ISK 200 billion to the new bank in return for all of its equity. This figure was calculated as 10% of an initial assessment of the likely size of the bank's risk weighted asset balance, and was formally included in the state budget for the year 2009 as an allocation of government funds to address the extraordinary circumstances in financial markets. This allocation of capital was intended to provide an adequate guarantee of the operability of the bank until issues relating to its final re-capitalisation could be resolved, including the size of its opening balance based on the valuation of compensation payable to the old bank for assets transferred from it.

Deposit guarantee

The initial rescue measures of the Icelandic Government also involved state backing of deposits in domestic commercial and savings banks. An announcement from the Prime Minister's Office of 6 October 2008 stated that the "*Government of Iceland underlines that deposits in domestic commercial and savings banks and their branches in Iceland will be fully covered*"[18]. This announcement has since been repeated by the Office of the current Prime Minister in February and December 2009.[19] Moreover, reference was made to it in a letter of intent sent by the Icelandic Government to the International Monetary

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[15] The decision was subsequently amended several times. The decisions are available here: http://www.fme.is/?PageID=867

[16] This document is available here: http://www.fme.is/lisalib/getfile.aspx?itemid=6021

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

[18] The English translation of the announcement is available at: http://eng.forsaetisraduneyti.is/news-and-articles/nr/3033 .

[19] http://www.efnahagsraduneyti.is/frettir/frettatilkynningar/nr/2842 http://www.efnahagsraduneyti.is/frettir/frettatilkynningar/nr/3001. The Minister of Economic Affairs has also referred to it recently in an interview with Viðskiptablaðið on 2.12.2010, page 8: *"[The declaration] will be withdrawn in due course. We do not intend to maintain unlimited guarantee of deposits indefinitely. The question when it will be withdrawn depends, however, on when an alternative and effective deposit system will come into force and a financial system which will have fully resolved its issues"* (the Authority's translation).

Fund (and published on the website of the Ministry of Economic Affairs and of the IMF) on 7 April 2010 (and repeated in a further letter of intent dated September 13 2010). The letter (which was signed by the Icelandic Prime Minister, Minister of Finance, Minister of Economic Affairs and Governor of the CBI) states that *"At the present time, we remain committed to protect depositors in full, but when financial stability is secured we will plan for the gradual lifting of this blanket guarantee."* [20] Furthermore, in the section of the bill for the Budget Act 2011 concerning state guarantees, reference is made in a footnote to the Icelandic Government's declaration that deposits in Icelandic banks enjoy a state guarantee.[21]

3.4.2. *Phase 2: Rescue/Restructuring of NBI through recapitalisation*

On 20 July 2009 the Icelandic Government announced that it had determined the basis for the capitalisation of NBI and reached an agreement on a process for how the old banks would be compensated for the transfer of net assets. It also announced that the state would capitalise the new bank to the amount of 140 billion ISK. Final agreement on the capitalisation was reached on 15 December 2009 (eventually to the total sum of 150 billion ISK, of which the state provided 121,225 billion ISK) when agreement was reached on compensation to creditors for the net value of the assets and liabilities transferred to NBI. The capital requirements imposed by the FME stipulated that NBI should hold at least 12% Core Tier I Capital[22] and an additional 4% of Tier II Capital as a ratio of risk-weighted assets. When NBI was formally capitalised on 20 January 2010, the Core Tier I Capital ratio of the bank was approximately 15%. The FME granted temporary relief from the (overall) 16% requirement conditional upon the submission of an acceptable plan illustrating how the full amount would be achieved. In June 2010 the bank reported that its Core Tier I exceeded 16% and on that basis the FME permanently exempted NBI from the requirement to hold Tier II capital as long as its Core Tier I ratio remains above 16%.

This agreement followed a lengthy and complex negotiation process resulting in an outline agreement among the parties in a heads of terms on 10 October, 2009 and more detailed sets of term sheets in relation to the debt instruments on 20 November, 2009. There were also a number of subsequent meetings and discussions between the parties during which the outlined terms were modified and reflected in documentation. The resulting agreement comprises the issuance of three bonds denominated in Euros, Pound Sterling and US Dollars, respectively, having an aggregate principal amount equivalent to ISK 260 billion, and also involves Landsbanki (or in effect the old bank's creditors) taking an initial (and potentially temporary) 18.67% ownership stake in NBI. In addition, NBI may issue to Landsbanki a contingent bond (linked to its equity participation) in Euros or such other currency as may be agreed, the principal amount of which will not be determined until on or after 31 March 2012. Following the determination of the principal amount of the contingent bond, all or part of the shareholding held by Landsbanki may be surrendered to the Icelandic government as described below.

The compensation structure involves the creditors of the old bank holding secured debt instruments issued by NBI and 4,480,000,000 ordinary shares in NBI representing 18.67%

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

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

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

of NBI's issued share capital. The Ministry of Finance holds the remaining 19,520,000,000 ordinary shares in NBI. The total equity of NBI (on its share capital and share premium accounts) was 150,000,000,000 ISK comprised of 24,000,000,000 ordinary shares in NBI. Subsequently the Icelandic government subscribed for remainder of the ordinary shares in NBI and transferred to NBI a 121,225,000,000 ISK Icelandic government bond in consideration for the capitalisations described above. NBI issued to the Icelandic government 18,745,000,000 of ordinary shares with a nominal value of ISK 1 per share at a price per share of 6.4670579 ISK. Together with the Icelandic government's existing holding of 775,000,000 ordinary shares, this resulted in the Icelandic government holding 19,520,000,000 ordinary shares in NBI. Landsbanki subscribed for 4,480,000,000 ordinary shares in NBI with a nominal value of ISK 1 per share at a price per share of 6.25 ISK in consideration for a release of claims against NBI of 28,000,000,000 ISK in aggregate.

In view of the considerable uncertainty surrounding the relevant asset values and major differences in opinion between the old and new banks' negotiated initial values in respect of certain reference assets, to the extent that these values are lower than estimated values of the assets as at 31 December 2012, the contingent bond is intended to compensate the old bank for such differences. The contingent bond will be issued in Euro or such other currencies as may be agreed between NBI and Landsbanki. If the valuation is zero or a negative amount, the new principal balance will be deemed to be zero and the contingent bond will be cancelled. If the value is positive the contingent bond will issued at this value and Landsbanki will surrender its shareholding to NBI, or part of its shareholding to the extent that the positive value is less that the value of the shareholding.

3.4.3. *Phase 3: Restructuring of Landsbanki/NBI and the long term viability of NBI*

According to the Icelandic authorities the restructuring process, which began by necessity through the collapse of Landsbanki and the transfer of its domestic assets and liabilities for domestic deposits to NBI, remains incomplete. In view of the scale of the systemic collapse in comparison to the resources at the Icelandic Government's disposal, and the lack of information available at the time of taking control of the banks, it was not considered prudent to attempt to fully restructure the financial system at that stage. Instead it was decided that a two-staged approach should be adopted. As a first stage, the enforced split would simultaneously achieve the aims of maintaining domestic banking services and significantly scaling down the unsustainably large financial system. The domestic operations transferred were however likely to represent an upper limit for the appropriate size of a domestic Icelandic system and further restructuring was likely. In order to continue the process three further steps were required. The first was to settle the claims of international stakeholders (through the Resolution Committees of the old banks), the second was the re-capitalisation of the banks, and the third was to clearly establish their future ownership structure. Further restructuring of the newly formed banks was intended to follow after this was achieved.

A likely consequence of the fact that the rescue approach adopted in Iceland was not (predominantly) based on a "good bank/bad bank split" is that extensive loan portfolio restructuring may have to be carried out by the new banks themselves. Despite numerous issues that have caused delays, the new banks have all taken important measures to avert impending losses by transferring impaired assets to specialised subsidiaries or selling them to new owners. They have also developed various programmes intended to resolve debt related issues in the retail and SME portfolios. Achievements have, however, been limited.

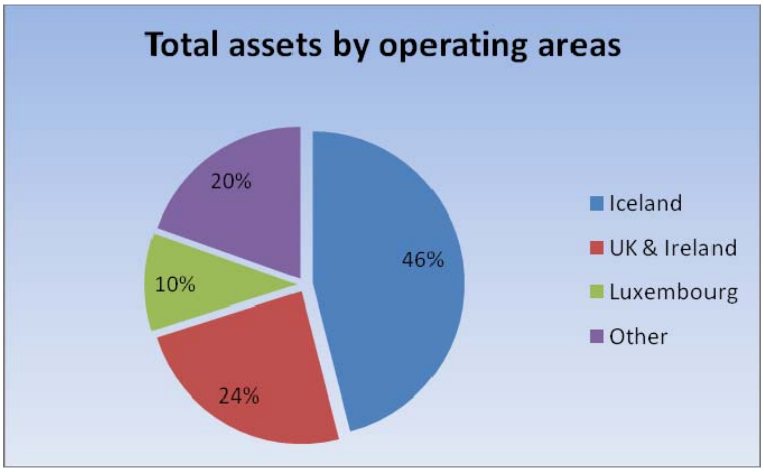
Based on the ICAAP[23] process currently ongoing in all three new banks, the FME expects to be able to systematically enforce and document a definitive return to long-term sustainability by all three banks and conclude the restructuring of the Icelandic financial system.

A restructuring plan will therefore need to be submitted to the Authority in order for it to conclude its assessment of the state aid granted to NBI, and its assessment of the new bank's viability, as soon as possible.

3.5. A comparison of the old and new banks: Landsbanki and NBI

The Authority will undertake a full assessment of aid paid to the new bank, including an analysis of the differences between the old and new banks and the potential for the same or similar problems to re-occur, following the submission by the Icelandic authorities of a detailed restructuring plan for the bank. The Icelandic authorities have, however, submitted an overview of the fundamental changes that have already taken place which the Authority considers to be relevant for the purposes of its current assessment.

As referred to above Landsbanki's business strategy involved expansion of its business internationally, and from 2004 the main goal of the bank was to grow in international investment and corporate banking markets focusing on services to small to medium sixed corporate enterprises. A branch was opened in London in 2005, initially focused on leverage finance and asset based loans. Later branches, opened in Canada, Finland, Norway and the sales office in Hong Kong, were initially focused on asset-based lending and trade finance. The aim of this strategy[24] was to diversify the loan portfolio across countries and sectors. Due to this strategy lending to non-Icelandic companies accounted for an ever-larger share of the bank's operations. Nearly half of the 2644 people employed by Landsbanki and its subsidiaries in September 2008 were based outside Iceland.



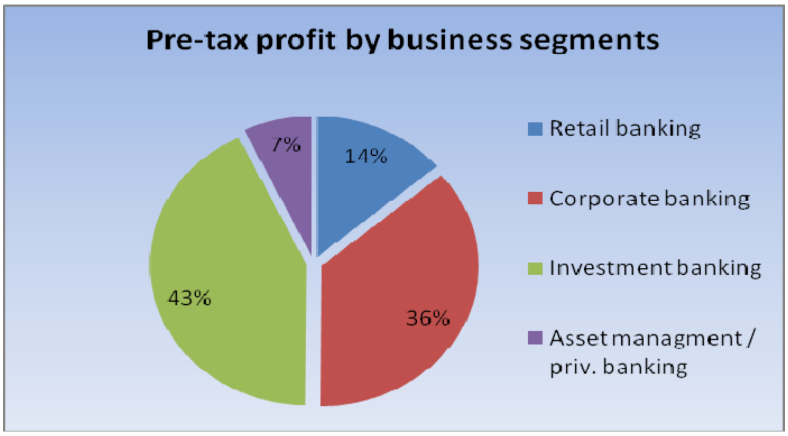
When examined geographically 41% of revenues in the first half of 2008 originated in Iceland, 34% in UK and Ireland, 6% in Luxembourg and 15% other areas. Of total assets (of 3,970,372 million ISK for Q1-Q2 2008), as shown in the table above 54% were located outside Iceland.

The chart below shows that for the first half of 2008 (the last available numbers for the bank) the largest part of Landsbanki's pre-tax profit of 31,140 million ISK came from

[23] Internal Capital Adequacy Assessment Process, cf. Pillar II of the Basel II recommendation of bank supervisors and central bankers stating that it shall be the responsibility of the financial regulator to monitor and assess the ICAAP of regulated banks.

[24] Annual report 2007, p. 61.

investment banking and corporate banking. In the years following the privatisation of the bank (in 2002) the share of retail banking in pre-tax profits had been steadily declining.



3.5.1. *Corporate banking*

Of the business segments referred to above, the corporate banking division was the most geographically diverse business, focused on asset-based lending ("ABL"), cash flow finance and trade finance. The ABL product was first introduced in 2005 and by 2008 the division had teams located in the UK (London, Birmingham and Manchester) and Germany (Frankfurt). The bank also had plans to enter the US and Spanish markets with the ABL product and had opened offices there to facilitate those plans. Teams in London and Amsterdam were also active in the European structured loan market (cash flow finance). These teams were both originating deals for syndication and participating in larger syndications. Trade finance focused on providing a full range of financial services to fisheries and seafood industry both in Iceland and internationally. The bank's business in seafood trade finance had teams located in Reykjavík, London, Amsterdam, Oslo, Halifax (Canada) and Hong Kong. The bank had adapted this product to other commodity industries worldwide including agricultural products such as sugar, coffee, corn and soya beans.

3.5.2. *Investment banking*

Landsbanki's investment banking provided large corporate, local government and institutional investors with a broad range of financial services, including securities brokerage, corporate finance, foreign exchange and derivatives trading. The investment banking sections also handled the bank's treasury, debt management and proprietary trading. The investment banking was provided through subsidiaries Kepler Equities and Merrion Capital, together with Landsbanki Securities. Kepler had operations in France, Spain, Germany, Switzerland, Italy, the Netherlands and the US. Merrion had operations in Ireland and Landsbanki Securities operated in the UK. These subsidiaries, along with the head office, operated a variety of business lines comprising, equity brokerage, securities brokerage, foreign exchange and derivatives brokerage, structured products and derivatives, corporate finance, asset management and fixed income. In addition to this the bank provided equity research services complementing the securities brokerage.

3.5.3. *Retail banking*

In retail banking all business was located in Iceland except for the specialised lending of the subsidiary Heritable Bank through structured property finance for small and medium-sized property developers in the residential and commercial markets. Traditional retail banking services provided through branches were limited to Iceland, though retail services were also offered in the form of online (Icesave) savings accounts in the UK and the

Netherlands. Part of the products on offer by Landsbanki were leasing services both to individuals and businesses through SP Fjármögnun. In addition Vörður Insurance and Vörður Life Insurance were partly owned by the bank. The aim of these holdings was to strengthen the bank's capacity to provide integrated banking and insurance services and thereby offer a full range of financial services to clients.

3.5.4. *Asset management and private banking*

Internationally Landsbanki focused on institutional clients and offered a variety of equity, money market, and currency hedge and savings funds focused on the Nordic, German, wider European and global markets. Landsbanki Luxembourg and Merrion fund management were the main international service providers for asset management and private banking. Total assets under management by Landsbanki at year-end 2007 were 513 billion ISK.

3.5.5. *Market share*

At the end of 2007 the market share of Landsbanki in the domestic corporate lending market was 43%. The breakdown for individual market segments was; retail market 60%, fishing industry 50%, and construction 45%. Landsbanki's market share for individuals had been steady for the last 10 years[25] before the collapse at around 28%.

3.6. **The business activities of the new bank.**

The new bank was founded by the Ministry of Finance on 7 October 2008 and commenced operations on the basis of a decision by the FME on 9 October 2008. Originally the new bank was named New Landsbanki Íslands hf., but at a shareholders' meeting held on 21 October 2008 a resolution was passed to change the name to NBI hf. The bank has nevertheless operated under the trade name of "Landsbankinn". The bank's primary lines of business are corporate and retail banking, investment banking, asset management and leasing services.

3.6.1. *Operations and subsidiaries no longer run by NBI*

3.6.1.1. *Heritable bank*

In 2000 Landsbanki acquired Heritable Bank Plc, a Scottish bank headquartered in London. Heritable Bank specialised in advisory and financing services for housing development ventures. Heritable Bank was placed in administration under Scottish law on 7 October 2008 and the following day the majority of Heritable Bank's deposits were transferred to ING Direct.

3.6.1.2. *Kepler Equites*

In September 2005 Landsbanki acquired the European securities brokers Kepler Equities ("Kepler"), previously Julius Bär Brokerage. Kepler specialized in the sale and mediation of equities to institutional investors, as well as operating a strong research division. The company's headquarters were in Paris but it also operated in the principal financial capitals of Europe and in New York. When the FME took over Landsbanki and appointed a Resolution Committee it became necessary to sell Kepler in order to avoid more deterioration in its value.

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[25] Based on monthly market research by Gallup, asking customers "what is your principal bank of business?"

3.6.1.3. *Landsbanki Luxembourg*

Landsbanki Luxembourg S.A. ("LLUX") was a fully owned subsidiary of Landsbanki. The main activity of LLUX was private banking. On 8 October 2008 LLUX was placed in moratorium and in liquidation proceedings on 12 December 2008.

3.6.1.4. *Landsbanki Securities UK*

Landsbanki Securities UK ("LS") was created through the merger of stockbrokers Bridgewell and Teather & Greenwood upon Landsbanki's acquisition of Bridgewell in May 2007. Landsbanki had acquired Teather & Greenwood in February 2005 and operated it under that name. After Landsbanki could not fulfil major guarantees for its obligations, LS's management requested the company be declared insolvent in November 2008.

3.6.1.5. *Merrion Capital*

Landsbanki's acquisition of a 50% holding in the Irish stockbroker Merrion Capital ("Merrion") was concluded in November 2005. The bank was expected to acquire the company's entire share capital over the following three years and had gained a 84.11% share when the Resolution Committee was appointed for Landsbanki Íslands hf. Merrion was sold shortly after the failure of Landsbanki in order to avoid more deterioration in its value.

3.6.2. *The size and scope of operation of NBI compared to Landsbanki*

The result of the transfer of assets and reduced scope of operations in Iceland was a reduction in the size of the balance sheet of NBI when compared to LBI and a reduction in the number of employees. Due to the collapse of the whole banking sector many business lines of NBI experienced greatly reduced transactions and some departments were closed altogether. There are also considerable differences in the way the new bank is funded, with NBI being reliant on deposits in contrast to the variety of funding sources of the old bank.

Balance sheet Landsbanki and NBI comparison (million ISK)	**30.6.2008 (Landsbanki)**	**9.10.2008 (Opening Balance Sheet NBI)**
Loans and advances to customers	2,571,470	655,725
Loans and advances to financial institutions	337,003	5,291

The opening balance sheet of NBI was approximately 25% of the size of the balance sheet of the old bank on 30 June 2008. In September 2008 the number of full time positions in Iceland within the Landsbanki Group were 1,413. At the start of November 2008 there were 1,186 full time positions in NBI and by the end of 2009 there were 1,142. This is a reduction of nearly 20% for Iceland but if the total number of positions in Landsbanki in September 2008 is used for comparison then the reduction is 57%. This reduction would have been larger had it not been for the personnel required to deal with the difficulties of the bank's customers and general workload due to the difficult economic situation.

3.6.3. *Operations of NBI were formed into four business segments.*

3.6.3.1. *Retail banking*

Retail banking contains all services to individuals and small businesses. The new bank's market share for individuals remains around 28% as it had for the old bank for many years. NBI has not launched any major new product initiatives except for various solutions aimed at helping customers in payment difficulties. These new products have been mirrored across the banking sector with each bank offering broadly the same solutions. In addition to this (subsidiary) SP Fjármögnun offers leasing services to individuals. This business has been greatly reduced as the sales of new cars are only a fraction of what it was before the autumn of 2008. No significant retail banking operations were discontinued following the creation of the new bank in October 2008.

3.6.3.2. *Corporate banking*

The main emphasis of the corporate banking division since October 2008 has been to ensure the viability of the loan book through various solutions aimed at customers in difficulties, including payment holidays, write-downs and grace periods. No significant operations of corporate banking were discontinued following the formation of NBI in October 2008. Following the transfer of operations (comparing those in Iceland) the number of employees was reduced by 26%.

3.6.3.3. *Investment banking*

Investment banking provides investors with a range of financial services, including securities brokerage, corporate finance, foreign exchange and derivatives trading. Investment banking also handles the bank's treasury and debt management and proprietary trading. Following the collapse all parts of the investment banking division have seen greatly reduced levels of trading volumes. This is partly explained by the currency restrictions in place but also by the greatly reduced size of the equity and bond markets. Following the transfer of operations (comparing those in Iceland) the number of employees was reduced by 38%.

3.6.3.4. *Asset management*

Asset management and private banking includes fund and wealth management services, provided by divisions of the bank and its subsidiary Landsvaki hf. The volume of business has been greatly reduced post crisis and the market share of NBI fund services has been […] from around […]% pre crisis to around […]% post crisis. No significant operations of asset management were discontinued following the formation of NBI. After the transfer of operations (comparing those in Iceland) the number of employees was reduced by 45%.

3.6.4. *Summary*

Following the collapse of LBI in the beginning of October 2008 no operations outside of Iceland were transferred to NBI. This had the effect that at inception NBI was a much smaller bank than LBI was previously both in terms of the size of balance sheet (the new bank being only 25% of the size of its predecessor) and number of employees. Although most of the operations in place in Iceland were transferred to NBI, the size and scope of the operations was greatly reduced.

4. Position of the Icelandic authorities

4.1. State aid nature of the measures and compatibility with the EEA Agreement

In their notification the Icelandic authorities now accept that measures undertaken in order to establish NBI constitute State aid. They contend however that the measures are compatible with the functioning of the EEA Agreement under Article 61(3)(b), on the basis that they were necessary in order to remedy a serious disturbance in the Icelandic economy.

The Icelandic authorities stress that the situation in Iceland in October 2008 was extreme and required immediate action in order to restore financial stability and confidence in the

Icelandic economy. The Icelandic authorities' intentions at this stage of the process were straightforward and basic, ensuring that Icelanders had access to their deposit accounts and that some form of financial system survived. The implications not only for the Icelandic economy, but also for Icelandic society, were grave.

The measures regarding Landsbanki/NBI were considered necessary because if the bank had not been restored the systemic collapse that Iceland was already suffering would have intensified. The Authority has also been provided with a letter from the CBI affirming the necessity of the measures taken. The fact that NBI, and other Icelandic and European banks, suffered from the lack of liquidity as well as lack of market and investors' confidence meant it was not possible to fund the bank through the financial markets. The intervention of the Icelandic state was necessary to strengthen the bank's equity and liquidity position and maintain its viability.

According to the Icelandic authorities the Government contribution of capital to NBI was therefore necessary and essential to restore viability, and an important factor in restoring confidence in the financial market with the aim of reconstructing a bank that will be viable in the long term without state aid. Although it was not possible to ensure significant long term involvement of the old bank's creditors, the state's contribution is limited in size to what is absolutely necessary to ensure that NBI meets minimum capital requirements, as defined by the FME.

According to the Authority's Recapitalisation Guidelines, State recapitalisations should be remunerated adequately. The part of the capitalisation of NBI borne by the Icelandic State as an owner of 81.33% (and potentially 100%) of the bank's shares, will be remunerated through the eventual sale of the bank by the State. The Icelandic authorities argue that as far as applicable, the measures are also in line with the principles set out in the Authority's Recapitalisation Guidelines and should be acceptable by all standards.

The Icelandic authorities also stress that the shareholders of Landsbanki before the financial crisis have lost their shares in the bank and have received no compensation from the state. The compensation provided to the creditors of Landsbanki, through the Resolution Committee, is not compensation for the losses suffered in connection with the collapse of the banks, but is compensation for assets allocated from the estate of the old banks. The losses stemming from the fall of the old banks have not therefore been mitigated by the Icelandic Government and the costs associated with the re-establishment of the bank must be seen as being borne by the investors of Landsbanki. The measures are therefore consistent with the principle that the bank should use its own resources to finance rescue and restructuring to the extent possible.

As regards competition in the banking market reference is made to decisions of the Icelandic Competition Authority concerning Glitnir/Islandsbanki and Kaupthing/Arion[26], where it is stated that the establishment of the three new banks has not changed the situation as regards competition in the retail banking market in Iceland.

4.2. Possible alternatives

The Icelandic authorities are of the view that there were no other realistic alternatives to the actions taken in October 2008. The purpose of the measures undertaken with regard to all three banks was to eliminate the threat to the stability of the Icelandic economy that complete failure of the domestic banking system would have entailed. To do so, the

[26] Cases 48/2009 and 49/2009:
http://www.samkeppni.is/samkeppni/en/decisions/?page=1&wildparam1=Ndesicion=*2009*&s2=1

measures had to remedy the identified causes of banks' problems - mainly their size relative to the size of the Icelandic economy and their reliance on foreign credit facilities. The instruments chosen by the Icelandic government represent the only credible measures available, given the status of the Icelandic economy, and were therefore both necessary and appropriate means to address these problems. The scope of the measures as regards Landsbanki/NBI is, in the opinion of the Icelandic authorities, limited to the minimum necessary, bearing in mind the serious economic situation of Iceland and the need to rebuild the financial system in the country.

The total revenue in the Icelandic state budget for 2008 was 460 billion ISK and total GDP in 2007 was 1,308 billion ISK[27]. The liabilities through deposits alone in the three large Icelandic banks were at the time of their collapse around 2,700 billion ISK, of which 1,500 billion was held in foreign currencies in the foreign branches of the banks. The foreign currency reserves of Iceland consisted of 410 billion ISK in October 2008, which amounted to around 25% of the value of deposits in the non-domestic branches.

The Authority also notes in this context the conclusions of the SIC Report, which refers in section 4.5.6.2 of Chapter 4[28] to attempts made during the course of 2008, given the concerns about the overblown size of the Icelandic banking sector and limitations of the CBI as a lender of last resort, to strengthen the CBI's foreign currency reserves. Requests were made to other Nordic central banks, the Bank of England, the European Central Bank and the Federal Reserve Bank of New York for currency swap agreements, but despite extensive efforts the CBI managed only to secure agreements with Nordic central banks (Sweden, Denmark and Norway). The Bank of England considered the CBI’s request carefully, but eventually declined to participate. A letter from the Bank of England governor, Mervyn King, to his Icelandic counterpart, Davíð Oddson, illustrates the views of the United Kingdom’s central bank (letter of 23 April 2008):

> *“It is clear that the balance sheet of your three banks combined has risen to the level where it would be extremely difficult for you effectively to act as a lender of last resort. International financial markets are becoming more aware of this position and increasingly concerned about it. In my judgement, the only solution to this problem is a programme to be implemented speedily to reduce significantly the size of the Icelandic banking system. It is extremely unusual for such a small country to have such a large banking system. ..... I know you will be disappointed. But among friends it is sometimes necessary to be clear about what we think. We have given much consideration to your proposal. In my judgement, only a serious attempt to reduce the size of the banking system would constitute a solution to the current problem. I would like to think that the international central banking community could find a way to offer effective help to enable you more easily to construct a programme to reduce the size of the banking system. I shall be willing to do all in our power to help you achieve that.”*

Later efforts included contacts with Timothy F. Geithner, President and CEO of the Federal Reserve Bank of New York. The request was eventually declined on 3 October 2008. According to the SIC report the main reason given by the Federal Reserve was the size of the Icelandic banking system as for a currency swap agreement to be effective, it would have had to be for a bigger amount than the Federal Reserve could accept.

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[27]See: http://www.statice.is/?PageID=1267&src=/temp_en/Dialog/varval.asp?ma=THJ01102%26ti=Gross+domestic+product+and+Gross+national+income+1980%2D2009%26path=../Database/thjodhagsreikningar/landsframleidsla/%26lang=1%26units=Million ISK

[28] See: http://rna.althingi.is/pdf/RNABindi1.pdf (see p. 167-181)

The Icelandic authorities did consider dividing the bank into a "good bank" and a "bad bank" by transferring the healthy and valuable assets to a "good bank" that should generally be able to finance itself on the market and leaving the less valuable assets that are difficult to realise in a "bad bank" funded by the state. However, it was considered that due to the financial crisis, even "good" Icelandic banks would probably not have been able to seek sufficient capital to finance their operations despite a potentially healthy financial status. Another problem for Iceland in using the "good bank/bad bank" solution was that running a "bad bank" would require substantial equity contributions from the Government. Faced with a situation where aid was needed for three of the nation's biggest banks (over 80% of the nation's banking system), which had collective liabilities over 10 times bigger than Iceland's GDP, it was the conclusion of the Icelandic authorities that such an attempt would almost certainly lead to the state suffering major financial difficulties. In combination therefore it was felt that such a solution would have lacked the credibility necessary in a situation where the immediate problem faced by the banks was the run on their liabilities through the termination of credit facilities and massive deposit withdrawals.

4.3. **Timescales**

In so far as the period of time it has taken to reach this stage is concerned the Icelandic authorities argue that they faced severe and complex circumstances – a division of three commercial banks to save the domestic part of a banking system and through that the economy, had as far as they are aware never been done before. The task required the participation of many parties both domestic and foreign and in their view some aspects of the split proved more difficult than the "good bank / bad bank" method used in some other countries where banking systems have encountered serious problems.

The first problem encountered was a practical one. One of the principal problems in executing the split was that it was practically impossible to obtain confirmations and summary statements from third parties at the outset of the work. This, and the fact that the split was executed intra-month, led to the decision to leave all nostro[29] transactions in the old bank. In addition the bank had been subject to a bank-run during the last days of its existence as a single entity, which resulted in complexities in reconciling the accounts in question. In certain cases this proved impossible. Most of the transactions in question were only reconciled between the banks in 2009. Suspense and error accounts also contained an extraordinary number of records because the cash-flow of the bank had proceeded abnormally in the days preceding the crash.

Difficulties in communication with non-domestic banks also contributed to the fact that it was difficult to reconcile and verify the bank's positions in equity shares and other securities. During this period non-domestic financial institutions were reluctant to share information regarding their business with Icelandic banks, probably because of the high level of uncertainty surrounding the affairs of Landsbanki, including the fear of weakening their position in potential litigation.

Within a short period of time it became evident that the creditors of the old banks were very unhappy with the asset valuation process that had been established. They considered the process to be one-sided in that their input was not taken into account as a part of the valuation process. As a result the procedure was changed in February 2009 into a formal

[29] An account at a foreign bank where a domestic bank keeps reserves of a foreign currency. Banks keep nostro accounts so that they do not have to make a currency conversion (which brings with it foreign exchange risk) should an account holder make a deposit or a withdrawal in that foreign currency.

negotiating process with the participation of domestic and foreign creditors. This process proved time consuming as a large number of international creditors and their advisors needed to participate at the negotiation table[30].

Another factor in the delay of the process was the development of each of the new banks' initial business plans – a necessary element in the negotiations with the creditors. The banks were not ready to present their business plans until they had had the opportunity to go through the valuation of transferred assets prepared by Deloitte, as the opening balance sheet would be the foundation of such business plans[31]. The banks presented 5 year business plans to the creditors in June 2009 following which the negotiations were able to begin. In their business plans the new banks put forward their own valuation of transferred assets which was not consistent with the Deloitte valuation. As the Deloitte valuation was not an exact number but a wide range, a Deloitte valuation number could not be entered into the opening balance sheet of the new banks. The new banks' valuation of the assets transferred was at the low end or below the low end of the Deloitte valuation, while the creditors' view stood at the high end or above the high end of the Deloitte valuation. A complex negotiation process followed in which both sides were far apart. In the end it became necessary to develop contingent compensation instruments to bridge the gap between the parties.

When the split was made between each old and new bank it became evident that there would be a massive currency mismatch in the new banks' balance sheets. The deposits transferred were mainly ISK denominated and the loan assets mainly foreign currency denominated or linked. This created potentially major market risks in the new banks that had to be addressed before the capitalisation could take place. The process of addressing this issue was time consuming and only partially successful.

During the negotiations it became evident that the creditors in the other two banks (Glitnir and Kaupthing) had an interest in capitalising the banks themselves and become the majority owners. To respond to this possibility, two alternative positions had to be formulated during the negotiations. After the creditors had opted for ownership of the bank a due diligence exercise had to be performed by the creditors' advisors, which also was time consuming.

Finally, the Icelandic authorities argue that account should be taken of the fact that from October 2008 until the autumn of 2009 the remainder of the financial sector in Iceland was far from stable, and in fact, during this period almost all financial undertakings in Iceland were taken over by the FME.

The Authority specifically requested information on why full business plans are still not available for the banks and why they have not been fully restructured. The Authority also requested information on why an assessment of the true value of the assets of the banks is yet to be completed. According to the Icelandic authorities, given the circumstances (in particular the impact on international creditors) it was considered important to abide by the principles of good public governance, including moderation. Specifically, it was thought that systematically and deliberately leaving damaged assets behind in the old

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[30] It is also notable that during this period Iceland suffered political upheaval. A new minority government came to power in February 2009, a government which later became a majority government after Parliamentary elections in April the same year. The new government had in some cases different views to the former government and some changes to the process had to be made.

[31] Uncertainty concerning the valuations is evident from the fact that the asset value attributed to the new banks on their provisional opening balance sheets was substantially different to the values eventually agreed upon and incorporated into the balance sheet when the banks were recapitalised.

banks (as would be the case in a “good bank/bad bank” scenario) would exceed what was strictly necessary to ensure the short to medium-term operability of the new banks. For this reason, insofar as the basic principle of a domestic-foreign split was considered sufficient to ensure operability of the new banks in the short to medium term, “cherry picking” of good assets was deliberately avoided. Another reason for doing so was that it was considered that successfully valuing the assets (and therefore their degree of impairment) was a highly complex exercise.

These considerations were borne out by the events. Despite considerable time and resources allocated to the task, the professional firm engaged to assess the true net value of the assets transferred was unable to give a precise estimate. After months of negotiations, supported by some of the world’s most renowned professional firms and investment banks, the stakeholders eventually settled on contingent compensation instruments for all three banks due to this uncertainty. The likely implication is that although certain margins can be, and have already been, established regarding the lower limits of asset value, only time can tell with sufficient precision what the true value of the transferred asset portfolios will be. The Icelandic authorities also argue that it is clear that establishing the new banks without performing a “good bank/bad bank split” – i.e. without ensuring that the level of impairment in their portfolios was kept within very strict boundaries – meant that the entities weren’t inherently viable. According to the Icelandic authorities the long term viability of the banks cannot be achieved without first creating banks that are operable and functional in the short to medium-term before undertaking further restructuring. The process of assessing the viability of the banks is therefore ongoing but the Icelandic authorities have committed to providing a restructuring plan as soon as possible.

II. ASSESSMENT

1. The presence of state aid

State aid within the meaning of Article 61(1) EEA

Agreement 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.”

The Authority will assess the following measures below:

- The initial operating capital provided by the Icelandic state to the new bank;
- The partial (and potentially full) state capitalisation of the new bank;

(The above measures are referred to collectively below as “the capitalisation measures”.)

- The Icelandic Government’s statement to guarantee domestic deposits in all Icelandic banks in full.

1.1. Presence of state resources

It is clear that the capitalisation measures are financed through state resources provided by the Icelandic Treasury.

The primary intention of the statement made by the Icelandic authorities safeguarding domestic deposits was to reassure deposit holders and to stop widespread run on deposits in the (old) banks. The deposit guarantee was implemented in practice through the use of powers under the Emergency Act to change the priority of deposit holders in bankruptcy proceedings and by transferring the liabilities for deposits to the newly established banks, which were initially fully capitalised by the state. According to statements made by the Icelandic authorities, however, a full guarantee of all deposits in Icelandic banks remains in place. The Authority wishes to further investigate whether the notice issued (and subsequent references to it) was a precise, firm, unconditional and legally binding statement such as to involve a commitment of state resources[32].

1.2. Favouring certain undertakings or the production of certain goods

Firstly, the aid measure must confer on the new bank advantages that relieve it of charges that are normally borne from its budget.

The Authority is again of the view that each of the capital measures confers an advantage on the new bank as the capital provided would not have been available to the bank without state intervention. The approach taken both by the European Commission (in numerous cases since the financial crisis began[33]) and by the Authority[34] in assessing whether state intervention to recapitalise banks amounts to state aid assumes that, given the difficulties faced by the financial markets, the state is investing because no market economy investor would be willing to invest on the same terms. The market economy investor principle is considered not in apply to cases involving the capitalisation of financial institutions affected by the crisis that are in difficulty. The Authority considers this to be the case notwithstanding the eventual (conditional) transfer of 18.77% of the capital of the new bank to the (largely private sector) creditors. The private investor involvement in the capitalisation of the new Icelandic banks is conditional and potentially temporary and is made up entirely of creditors of the old banks who are not therefore investors acting freely in an open market but are rather seeking to minimise their losses in the most efficient manner[35].

Secondly, the aid measure must be selective in that it favours *"certain undertakings or the production of certain goods"*. The capital measures are selective as they only benefit NBI. Similar measures were also implemented in the cases of the other two failed banks, and numerous other Icelandic financial institutions have required assistance from the government. However not all Icelandic banks have received state aid, and state support can in any event be selective in situations where one or more sectors of the economy

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[32] See in this respect the judgment of the General Court in joined Cases T-425/04, T-444/04, T-450/04 and T-456/04, *France and others v Commission*, judgment of 21 May 2010, not yet reported, paragraph 283 (on appeal).

[33] See for example Commission decision of 10 October 2008 in case NN 51/2008 *Guarantee scheme for banks in Denmark*, at paragraph 32, and Commission decision of 21 October 2008 in case C 10/2008 *IKB*, at paragraph 74.

[34] See the Authority's decision of 8 May 2009 on a scheme for temporary recapitalisation of fundamentally sound banks in order to foster financial stability and lending to the real economy in Norway (205/09/COL) available at: http://www.eftasurv.int/?1=1&showLinkID=16694&1=1

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

benefit and others don't. This principle applies to the state guarantee on deposits which benefits the Icelandic banking sector as a whole.

The Authority also considers that it is possible that the bank has benefitted (indirectly) from the statements made by the Government safeguarding all domestic deposits, as in the absence of the guarantee the new bank could have suffered from a run on its deposits like its predecessor[36]. Accordingly, the Authority has doubts as to whether the guarantee entailed an advantage for the bank.

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

The measures strengthen the position of the new bank in comparison to competitors (or potential competitors) in Iceland and other EEA States and must therefore be regarded as distorting competition and affecting trade between the Contracting Parties to the EEA Agreement[37].

1.4. **Conclusion**

The Authority's preliminary conclusion, therefore, is that each of the measures taken by the Icelandic State to capitalise the new bank involves state aid within the meaning of Article 61(1) of the EEA Agreement. It also cannot exclude that aid to NBI is also present as a result of the deposit guarantee.

2. Procedural requirements

Pursuant to Article 1(3) of Part I of Protocol 3, *"the EFTA Surveillance Authority shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid (…). The State concerned shall not put its proposed measures into effect until the procedure has resulted in a final decision"*.

The Icelandic authorities did not notify the aid measures to the Authority in advance of their implementation. 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 aid was therefore unlawful.

3. Compatibility of the aid

Assessment of the aid measure under Article 61(3) of the EEA Agreement.

3.1. **The necessity, proportionality and appropriateness of the aid**

In the Authority's view it is beyond dispute that Iceland faced, and still faces, a serious disturbance in its economy and that Landsbanki was of structural importance. In consequence the Authority will assess the potential compatibility of the aid under Article 61(3)(b) of the EEA Agreement and the guidelines based upon that sub-paragraph.

The Authority considers that this case, although not necessarily unique, is difficult to assess using the traditional and commonly understood notions of on the one hand "rescue" aid and the other "restructuring" aid. For instance the restoration of the bank as an

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

[37] See in this respect Case 730/79 *Phillip Morris v Commission* [1989] ECR 2671

emergency measure in October 2008 involved both rescue aid and immediate enforced restructuring. Through this decision the Authority intends to assess, retrospectively, the measures undertaken to restore the bank both through its initial creation and subsequent capitalisation as rescue measures. Such aid can only, however, be approved on a temporary and conditional basis. In the absence of a restructuring plan, the Authority is unable to fully assess the case and reach a conclusion and in consequence the measures will be assessed once again – on this occasion as a structural measure - upon receipt of the plan[38]. The Authority will at that stage assess the viability of the bank and the requirement that the aid provided was the minimum necessary to ensure its viability. The restructuring plan should include a full comparison of the old and new banks (for the purposes of demonstrating that that problems should not re-occur), as well as an assessment of how ongoing restructuring should secure the long term viability of the bank.

In line with the general principles underlying the state aid rules of the EEA Agreement which 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 minimized as far as possible, and taking due account of the current circumstances, support measures must be:

- well-targeted in order to be able to achieve effectively the objective of remedying a serious disturbance in the economy,

- proportionate to the challenge faced, not going beyond what is required to attain this effect, and

- designed in such a way as to minimise negative spill over effects on competitors, other sectors and other EEA States.

In assessing the rescue measures undertaken to date, therefore, the Authority takes into account the following.

3.1.1. *The necessity of the measures*

The Authority accepts the argumentation of the Icelandic authorities, and believes that it is largely self-evident, that the state had to intervene in order to restore Landsbanki and the other two banks. The Authority also notes the views of the CBI in this respect. It also accepts given the run on the banks and the instability of the financial system that a state guarantee of deposits was required[39].

3.1.2. *The method of restoring the bank – the appropriateness of the means employed to achieve the objective*

The Authority accepts in principle the views of the Icelandic authorities that given the circumstances the approach taken of restoring the domestic operations of the banks was likely to be the only credible and effective means of safeguarding an Icelandic banking sector and the wider economy[40]. Bank rescue measures of a kind adopted elsewhere in the EEA; recapitalisation, restructuring, relief for impaired assets, or a combination of each were unlikely to succeed. The scale of the problem and the sums of public money that

[38] This approach is similar to the one taken by the European Commission in the case of Emergency aid for Ethias – Belgium – case no NN57/2008.

[39] See paragraph 19 of the Authority's temporary rules on the application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis: http://www.eftasurv.int/?1=1&showLinkID=16604&1=1

[40] This decision does not relate to any aspects of the internal market rules of the EEA Agreement that may apply in so far as the division of foreign and domestic assets and liabilities is concerned.

would have been necessary to remedy it, the disproportionate size of the three main Icelandic banks, and the realistic threat that the entire system could collapse meant that the state's options were limited.

The measures however involved wide-ranging restructuring of the bank's operations through the effective divestiture of foreign operations, and potential further restructuring of domestic operations. The measure can only therefore finally be considered to be appropriate if it can be demonstrated through the means of a detailed restructuring plan that the bank is viable in the medium to long term.

3.1.3. *The proportionality of the measures - limiting aid and distortions of competition to the minimum necessary*

The Authority is conscious in this context that in light of the foreign operations of the Icelandic banks remaining in the old banks (which are under administration), and in light of the Icelandic authorities adopting similar measures to restore each of the three main banks in Iceland which make up over 80% of the domestic market (as well as also rescuing others[41]), the impact on competition and trade across the EEA is limited.

The amount of the capital provided is the minimum necessary in order to enable NBI to comply with the minimum capital adequacy ratio set by the FME of 12% Tier I capital and 4% Tier II capital[42].

In so far as the remuneration of the capital is concerned, paragraphs 26 to 30 of the Authority's rules on the recapitalisation of financial institutions specifies a method of calculating an "entry level" price for capitalising fundamentally sound banks. Capitalisations of banks that are not fundamentally sound are subject to stricter requirements and in principle the remuneration paid by such banks should exceed the entry level. The Icelandic authorities do not envisage receiving a return in the form of a dividend on the shares that they hold in the company, but hope to receive remuneration through an eventual sale of the bank once it is in a sufficiently stable position to attract private investment. The Authority accepts that this is to be expected given the purpose of the measures, which is to restore part of a collapsed bank. As referred to in paragraph 11 of the Authority's temporary rules concerning the recapitalisation of financial institutions, a balance must be struck between competition concerns and the objectives of restoring financial stability, ensuring lending to the real economy and dealing with the risk of insolvency. On the basis that in the longer term the costs of the state's intervention in the bank will be reflected in the restructuring plan that must be submitted, the Authority considers that the Icelandic authorities' assumption that they will receive no return in the short to medium term to be acceptable. It is clear that (as envisaged by paragraph 44 of the rules) the bank has experienced far-reaching restructuring including a change in management and corporate governance.

[41] A number of other financial institutions have also required state assistance. In 22.4.2010 the FME decided to take control of BYR Savings Bank, to establish on its foundation a new limited liability company BYR hf. and to transfer to BYR hf. assets and liabilities of the failed savings bank. At the same time FME decided to take control of Keflavik Savings Bank and establish on its foundation SpKef Savings Bank to take over assets and liabilities of the failed Keflavik Savings Bank. Measures for recapitalization of these two savings banks are under way and the Authority awaits notification from the Icelandic authorities. On 21.6.2010 the Authority approved for a period of six months a rescue scheme in support of five smaller savings banks in Iceland through settlement of claims owned by the Central Bank of Iceland on the savings banks concerned.

[42] The minimum capital requirement is in fact met through 16% Tier I capital due to the state's ownership.

The Authority will, therefore, assess the compatibility of the aid paid through the provision of capital (and the remuneration payable for the capital) as part of its full assessment of the restructuring of the bank. It will also assess the duration of the state guarantee in this context.

3.2. Timescales

While the Authority regrets that the normal time scales for the duration of rescue measures have been exceeded, a potential need for longer periods to restructure financial institutions was envisaged by the European Commission and the Authority when adopting guidelines for the assessment of rescue and restructuring aid granted as a result of the financial crisis[43]. The Authority accepts in particular that for the various reasons put forward by the Icelandic authorities, delays were inevitable at least until the assets of the bank could be valued and its ownership and capitalisation could be resolved. The Authority is also aware of domestic litigation in Iceland concerning loans linked to foreign currencies which has had the potential to have a major impact on the value of each bank's assets, and led to considerable uncertainty for many months[44]. In addition it notes the content of the CBI's financial stability report for 2010/2[45] which refers among other matters to the fact that non-performing loans (90 days or more in default) of the Icelandic commercial banks now total 39% of all loans - a major political and economic issue given that many loans have already been written down. The Authority is therefore willing to accept that given the exceptional circumstances the rescue measures could be authorised and remain in place for a longer period than is normally allowed. However, whilst the Authority accepts that there are also justifiable reasons for further delay since the recapitalisation of the banks, the Authority is concerned at the lack of progress since the autumn of 2009 in concluding a detailed restructuring plan. In the absence of the restructuring plan therefore, the Authority has doubts concerning the compatibility of the measures with the EEA Agreement.

4. Conclusion

On the basis of the foregoing assessment, had the Icelandic authorities notified the capitalisation measures and deposit guarantee involved in Phase 1 and Phase 2 of the process of restoring and restructuring Landsbanki/NBI in advance, the Authority would in all probability temporarily approved the measures as aid compatible with the functioning of the EEA Agreement. The aid granted could, however, only have been considered compatible on a temporary basis, conditional upon the submission a detailed restructuring plan for the bank and a satisfactory assessment by the Authority of its future viability. Although the Icelandic authorities have committed to submit a restructuring plan for the Authority's assessment, in view of the time period that has elapsed since the aid was granted, the Authority is required to open a formal investigation procedure into the measures adopted. 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 do not constitute state aid or are compatible with the functioning of the EEA Agreement.

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[43] See paragraphs 10 and 24, and footnote 13, of the Authority's guidelines: http://www.eftasurv.int/?1=1&showLinkID=16604&1=1

[44] The issue is referred to in the CBI's Financial Stability Report for the second half of 2010 (p. 18-21), http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=8260 and the Annual Report of the FME for 2010 (currently only available in Icelandic, p. 31-32): http://www.fme.is/lisalib/getfile.aspx?itemid=7604. See also the following news reports: http://www.businessweek.com/news/2010-07-29/iceland-debt-outlook-cut-to-negative-at-moody-s-on-bank-ruling.html http://www.businessweek.com/news/2010-09-17/iceland-ruling-may-save-banks-4-billion-in-losses.html

[45] http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=8260

The Authority also regrets that the Icelandic authorities did not respect their obligations pursuant to Article 1(3) of Part I of Protocol 3. The Icelandic authorities are therefore reminded that any plans to grant further restructuring (or other) aid to the bank must be notified to the Authority and approved in advance.

HAS ADOPTED THIS DECISION:

Article 1

The formal investigation procedure provided for in Article 1(2) of Part I of Protocol 3 is opened into the measures undertaken by the Icelandic State to restore of certain operations of (old) Landsbanki hf and establish and capitalise NBI hf .

Article 2

The Authority requires that a detailed restructuring plan for NBI be submitted as soon as possible and in any event no later than 31 March 2011.

Article 3

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

Article 4

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 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 15 December 2010.

For the EFTA Surveillance Authority

Per Sanderud
President

Sverrir Haukur Gunnlaugsson
College Member