

Case No: 69094
Event No: 583838
Dec. No: 494/10/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) Glitnir Bank hf and the establishment and
capitalisation of New Glitnir Bank hf (now renamed Islandsbanki)**

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 Guidelines¹,

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 the other two main Icelandic commercial banks) 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

¹ Available at: <http://www.eftasurv.int/state-aid/legal-framework/state-aid-guidelines/>

indicated that they would. On 14 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 Glitnir and the establishment and capitalisation of a new Glitnir Bank (by then re-named “Islandsbanki”) 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 Parliament², 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 Glitnir Bank. 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 The SIC’s members were Supreme Court Judge, Dr. jur. Páll Hreinsson; Parliamentary Ombudsman of Iceland, Mr. Trygvi 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/>

2.1 Causes of failure linked to the 2008 financial crisis and its impact on underlying problems of Glitnir 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 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 own operational and managerial capacity. The combined assets of the three banks had increased exponentially from 1.4 trillion ISK³ 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 2007⁴, 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 terms⁵. When access to European debt securities markets became more limited, the banks financed their activities on US markets, with Icelandic debt securities packaged into collateralised debt obligations. In the period before the collapse the banks were increasingly reliant on short-term borrowing, leading to major (and, according to the SIC, foreseeable) re-financing risks.

2.1.3 *The gearing of the banks' owners*

In the case of each major Icelandic bank, the principal owners were among the biggest debtors⁶. Glitnir's loans to major shareholders the Baugur Group and related parties, in particular the FL Group, were substantial. In the spring of 2007 a new Glitnir board was appointed after the Baugur and FL Groups significantly increased their shareholdings in the bank. Over the latter part of 2007 and beginning of 2008 loans to Baugur and companies related to Baugur nearly doubled, and at its peak lending to this group amounted to 80% of the bank's equity⁷. This increase in lending to major shareholders occurred despite the fact that Glitnir was starting to face liquidity and refinancing problems. The SIC was of the view that certain shareholders had abnormally easy access to borrowing from the banks in their capacity as owners. It also concluded that there were

³ Icelandic króna.

⁴ Lending to foreign parties increased by 11.4 billion Euros from 8.3 billion Euros to 20.7 billion Euros in six months.

⁵ Chapter 21.2.1.1 (page 4) of the Report.

⁶ Chapter 21.2.1.2 (page 6) of the Report.

⁷ The position was further exacerbated by foreign creditors of the largest Icelandic investment companies making margin calls as a result of reduced collateral values, leading to the three main banks taking over the financing so that the foreign banks could be repaid.

strong indications that Baugur and the FL Group had tried to exert undue influence on the bank's management, and that 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. When the bank collapsed its outstanding loans to the Baugur Group and affiliated companies was approximately 2 billion Euros, around 70% of its equity. The SIC also questioned the operation of money market funds operated by subsidiaries of the banks, which invested heavily in securities connected to the owners of the banks. Glitnir Funds, a subsidiary of Glitnir, lent around 300 million Euros to Baugur and the FL Group by investing 20% of its total capital in their securities.

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 Glitnir (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"⁸ represented more than 25% of the banks' capital bases (or over 50% when assessed against the core component of the capital, i.e. 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

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

⁸ Chapter 21.2.1.4 (page 15) of the Report.

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 banks⁹.

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 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 abroad¹⁰.

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”¹¹. 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, 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.

3 Description of the measures

3.1 Background

Prior to the financial crisis of 2008 Glitnir Bank was the third largest in Iceland. At the end of 2007 its balance sheet amounted to 2,949 billion ISK (c.32.3 billion Euros) and it made a net profit that year of 315 million Euros. The bank’s main markets were in Iceland and Norway where it offered a range of financial services, including corporate banking, investment banking, capital markets, investment management and retail banking. Glitnir also had operations in Finland, Sweden, Denmark, UK, Luxembourg, US, Canada, China and Russia. It held a number of subsidiary companies, the most significant being: Glitnir

⁹ These issues are discussed in more detail in the following paper by Willem H. Buiters and Anne Sibert: <http://www.cepr.org/pubs/PolicyInsights/PolicyInsight26.pdf>

¹⁰ 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.

¹¹ Chapter 2, page 5 of the report.

AB (Sweden); Glitnir Bank Oyi (Finland); Glitnir Bank ASA (Norway); Glitnir Bank Luxembourg SA; and Glitnir Asset Management Luxembourg. The bank's international expansion was based on two specialised industry sectors; seafood and sustainable energy¹². Shares in the bank were listed on the Icelandic OMX.

3.2 The collapse of Glitnir Bank

In September 2008 a number of major global financial institutions began to experience severe difficulties. In the midst of the turbulence in global financial markets and following the collapse of Lehman Brothers in September 2008, Iceland's three biggest commercial banks, which had experienced extraordinary growth over the preceding years, encountered difficulties in refinancing their short-term debt and a run on their deposits. Lehman Brothers filed for bankruptcy protection on 15 September and on the same day it was announced that the Bank of America was to take over Merrill Lynch. Elsewhere, one of the United Kingdom's biggest banks, HBOS, had to be taken over by Lloyds TSB. Glitnir meanwhile, was experiencing major difficulties in financing its activities. A bond issue had had to be cancelled due to a lack of interest, an asset sale was not completed, 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 publicly available) suggested, however, that the proposal was not credible¹³. The effect was a reduction in 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. 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. On 7 October 2008 Glitnir was required to ask the FME to be taken under its control¹⁴.

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

¹² Glitnir's Annual Report for 2007, p. 40. The report is available here:

http://tools.euroland.com/arinhtml/is-isb/2007/ar_eng_2007/ Glitnir's Consolidated Financial Statements 2007 are available here: http://en.sff.is/media/auglysingar/Glitnir_Annual_Report_2007.pdf

¹³ Page 13 of the Executive Summary to the Report (Chapter 2), fourth bullet point.

¹⁴ Landsbanki was also placed in receivership on the same day and Kaupthing Bank followed two days later on 9 October 2008.

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 basic banking in October 2008 through the formation of New Glitnir, the transfer of assets and liabilities, and the provision of initial capital and a commitment to fully capitalise; secondly, loans made to properly capitalise the new bank for the first time in the autumn of 2009 (before the majority of the bank was acquired by the creditors of the old bank); and thirdly the restructuring of the bank, which began when the bank was restored and is ongoing.

3.4.1 Phase 1: Restoration of certain operations of Glitnir Bank and the establishment of New Glitnir Bank

On 7 October 2008 the FME took control of Glitnir Bank in order to ensure the continuation of domestic retail banking operations. This was done through the appointment of a Resolution Committee for Glitnir, which assumed the authority of its board of directors; and the establishment by the Icelandic Government, on 8 October 2008, of New Glitnir Bank (later re-named Islandsbanki), wholly owned by the state. On 14 October 2008 the FME transferred the liabilities for deposits held in Glitnir, except for those held in foreign branches, to the new bank. The total amount of liability for domestic deposits transferred was 353,488,479,000 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 bank¹⁵. The FME also published an internal memorandum setting out "guiding principles" for what was to be transferred not only to Islandsbanki but also to new successor banks that were formed following the collapse of Kaupthing and Landsbanki¹⁶.

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.

¹⁵ . The decision of the FME was subsequently amended several times. The decisions are available here: <http://www.fme.is/?PageID=867>

¹⁶ The document is available here: <http://www.fme.is/lisalib/getfile.aspx?itemid=6021>

Initial capital

The state provided 775 million ISK (5 million Euros)¹⁷ in cash as initial capital to the new bank and in addition issued a commitment to contribute up to 110 billion ISK to the new bank in return for all of its equity. This figure was calculated as 10% of an initial assessment of the likely size of the bank's risk weighted asset balance, and was formally included in the state budget for the year 2009 as an allocation of government funds to address the extraordinary circumstances in financial markets. This allocation of capital was intended to provide an adequate guarantee of the operability of the banks until issues relating to their final re-capitalisation could be resolved, including the size of their opening balance based on a valuation of compensation payable to the old bank for assets transferred.

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 Fund (and published on the website of the Ministry of Economic Affairs and of the IMF) on 7 April 2010 (and repeated in a further letter of intent dated 13 September 2010). The letter (which was signed by the Icelandic Prime Minister, Minister of Finance, Minister of Economic Affairs and Governor of the CBI) states that "*At the present time, we remain committed to protect depositors in full, but when financial stability is secured we will plan for the gradual lifting of this blanket guarantee.*"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 Islandsbanki (New Glitnir) through recapitalisation

On 20 July 2009 the Icelandic Government announced that it had determined the basis for capitalisation of Islandsbanki and reached heads of agreement with the Resolution

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 December 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).

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/Fjarlagafurvarp/2011/Seinni_hluti/Kafli_8.htm

Committee of the old bank in relation to how the old bank would be compensated for the transfer of net assets into the new bank. The Government conditionally agreed with the Resolution Committee of Glitnir, that the creditors should, through the Committee, be granted the option of obtaining majority ownership of Íslandsbanki. This would in effect involve the old bank providing the majority of the capital in Íslandsbanki as a part of the compensation agreement. In the event that Glitnir would not complete the subscription for shares in Íslandsbanki, the Government would retain full ownership. On 14 August 2009, the Government announced that it had committed to capitalise Íslandsbanki with 65 billion ISK of Tier I capital in the form of government bonds, giving the bank a Core Tier I ratio of approximately 12 per cent²².

On 13 September 2009 the Government announced that definitive agreements with the Resolution Committee of Glitnir regarding the capitalisation of Íslandsbanki, and the basis for compensation to Glitnir and its creditors, had been signed. The agreement principally contained (alternative) provisions for:

1. Capitalisation under old bank (creditor) ownership (option 1)

Under this agreement the creditors of Glitnir had an opportunity to acquire control of Íslandsbanki by subscribing to new share capital. The payment for the new share capital was to be in the form of the compensation instrument issued by Íslandsbanki as payment for the net assets transferred from Glitnir to Íslandsbanki in October 2008. The Government would also contribute to the capital of the Íslandsbanki in the form of Tier II capital (subordinated loan) amounting to 25 billion ISK (giving the bank a Tier II ratio of approximately 4%). The Government would also hold minority ordinary share capital, amounting to 5 per cent of Íslandsbanki.

2. Capitalisation under Government ownership together with compensation for net-asset transfer from the old bank to the new bank with various mechanisms for re-assessment of fair value (option 2)

In the event that Glitnir's Resolution Committee decided not to acquire control of Íslandsbanki, the Government would continue to own the bank. In this case, the compensation for the transferred net asset value would be paid through bond instruments. The compensation was to consist of three bonds (A, B and C): the A bond was for a fixed (definite) amount of 52 billion ISK²³, and in the event that the performance of the bank exceeded certain parameters agreed between the parties a B bond (of 17 billion ISK, which taken together with Bond A would total 69 billion ISK) and a C bond (of 63 billion ISK, which taken together with Bonds A and B would total 132 billion ISK) would become effective. Glitnir was also to be granted an option to buy 90% of the Government's shares in Íslandsbanki exercisable between 2011 and 2015 at a price which would provide an appropriate level of return on the Government's investment.

²² Also in August 2009, the FME imposed a minimum requirement of a 12% Core Tier I capital ratio and a 16% CAD ratio as a discretionary minimum capitalisation for Íslandsbanki (the same as for NBI and Arion), to be maintained for at least 3 years. 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.

²³ This was the only valuation which appeared on the balance sheet of the bank as the other two bonds were contingent in nature and were referred to only in notes to the bank's financial report. The net nominal value of the transferred assets was 568.3 billion ISK.

Tier I capital contribution

On 15 October 2009 Glitnir's Resolution Committee decided, on behalf of its creditors, to exercise option 1 and take 95% of the share capital in Islandsbanki. This was done by the Resolution Committee accepting this share of the bank in return for relinquishing its rights under the agreed bonds (A, B and C). The option terms were fixed on 11 September 2009, when the accrued value of the government bonds used to capitalise the bank at ISK 65 billion as per 15 October 2008 was ISK 72.2 billion. On the basis of the accrued value of the on-balance sheet element²⁴ of the creditors' compensation instrument (i.e. bond A which had a nominal value 52 billion ISK and accrued value 66 billion ISK), the creditors were entitled to a share of 91.3% of the bank, but a further 3.7% share was conceded during negotiations. The state retained the remaining 5% through its contribution of 5.5 billion ISK in capital (6.2 billion ISK in accrued terms). The total share capital was therefore 72.2 billion ISK in accrued terms (corresponding to 65 billion ISK in 15 October 2008 terms). As part of the agreement it was agreed that the Resolution Committee (creditors) would remunerate the state for total interest accrued on its investment over the period the government held the bank to the sum of 8.3 billion ISK. This amounted to a yield of 12.8%, which annualised to 13.9%. This concluded the settlement concerning those assets transferred from Glitnir to Islandsbanki upon the collapse of the banks in October 2008.

Tier II capital contribution

The Government also provided the bank with a subordinated loan to strengthen its equity and liquidity position, and therefore comply with the capital requirements of the FME. The subordinated loan is available in Euros and amounts to 128,106,287 Euros (25 billion ISK) of tier II capital in a form of an instrument providing for Islandsbanki to issue unsecured subordinated notes. The term of the notes is ten years as of 30 December 2009. The instrument has built-in incentives for exit in the form of a step-up of interest after five years. Under the agreement the interest rate per annum for the first five years is 400 basis points above EURIBOR and in the period from five to ten years after the completion of the agreement the interest rate per annum is 500 basis points above EURIBOR.

Special Liquidity Facility

In addition, as a condition for the creditors taking equity in the new bank, the Icelandic Government concluded a further agreement with Islandsbanki on 11 September 2009 that would come into force if Glitnir's Resolution Committee decided to exercise its option to become the majority owner of the bank²⁵. Under the agreement the Ministry of Finance commits to lend repo-able government bonds in exchange for specifically defined assets on terms and conditions specified in the contract up to a value of 25 billion ISK.

The main terms of the agreement to provide liquidity are as follows:

Max. loan amount:	25 billion ISK
Term:	Until September 2012
Remuneration:	3.0% on first 8 billion ISK; 3.5% on next 8 billion ISK; 4.0% for amounts above 16 billion ISK
Fee:	Islandsbanki is required pay 0.5% of the loan amount on each occasion new securities are provided

²⁴ To be managed by the newly formed Icelandic State Banking Agency.

²⁵ An addendum was also signed on 13 January 2010 and a new agreement was concluded on 19 July 2010 in response to certain remarks submitted by the FME

Counter-security: Islandsbanki is required to provide counter-security for the loan of Treasury securities, which can be financial assets in various forms.

According to the Icelandic authorities, this liquidity facility is required because the creditors' decision to take ownership of Islandsbanki significantly reduced the bank's holding of repo-able assets and threatened its ability to comply with supervisory requirements regarding liquidity reserves.²⁶ According to the Icelandic authorities the facility is intended as an additional measure to be used only when other sources of liquidity are insufficient and the pricing and terms of the facility contain incentives to discourage its use if other options are available.

The decision of the Resolution Committee in October 2009 was subject to the approval of the FME and the Icelandic Competition Authority. Glitnir's Resolution Committee currently hold the shares on behalf of its creditors through a special holding company, ISB Holding ehf., subject to significant restrictions aiming to ensure good governance, provide incentives for a long-term perspective business model, and reduce excessive risk-taking.

3.4.3 Phase 3: Restructuring of Glitnir/Islandsbanki and the long term viability of Islandsbanki

According to the Icelandic authorities the restructuring process, which began by necessity through the collapse of Glitnir and the transfer of its domestic assets and liabilities for domestic deposits to Islandsbanki²⁷, 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 was intended to 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 optimum 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. The Icelandic authorities state that the three conditions were fulfilled in the first quarter of 2010 when new owners took control of the new banks and elected the first Boards of Directors with a mandate to develop a long-term business strategy on behalf of the future owners²⁸. Further restructuring of the newly formed banks was intended to follow.

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.

²⁶ One of the FME's conditions required that that cash or cash-like assets should amount to 5% of on-demand deposits and the banks should be able to withstand a 20% instantaneous outflow of deposits.

²⁷ Glitnir had actually begun a process of restructuring in the latter part of 2007 due to its financial difficulties. This included extensive cost cutting and redundancies.

²⁸ In the case of Islandsbanki this occurred on 25 January 2010.

Based on the ICAAP²⁹ 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 Islandsbanki, and its assessment of the new bank's viability, as soon as possible.

3.5 Straumur securities lending agreement

On 9 March 2009 the FME, acting under the authority conferred upon it by the Emergency Act, assumed the powers of the shareholders Straumur–Burdaras Investment Bank hf. (“Straumur”) and appointed a Resolution Committee to replace its Board of Directors³⁰. After consultation with the Resolution Committee, creditors, the CBI and the Ministry of Finance, on 17 March 2009 the FME transferred the liabilities for deposits of Straumur to Islandsbanki³¹. In return Straumur issued a bond collateralised against its assets, as repayment for assuming the deposit obligations. The bond was issued on 3 April 2009 for the amount of 43,679,014,232 ISK for a term up to 31 March 2013. The bond bears interest on that amount of [...] plus [...] basis points in the first [...] months before [...] to [...] plus [...] basis points thereafter until maturity. Simultaneously, Islandsbanki and the Ministry of Finance entered into a securities lending agreement, in which the Government effectively pledges repo-able government notes as security for the Straumur claim, in return for which Islandsbanki can obtain liquidity from the CBI to the extent that liquidity is required as a result of Islandsbanki assuming the liability for Straumur's deposits.

In the agreement Islandsbanki is committed to returning to the state the amount of the government bonds that equal the payments the bank receives under the bond issued by Straumur. The parties also agreed that in the event that Islandsbanki does not receive full payment under the bond, and in the event that the state had not paid the remaining debt, Islandsbanki would retain the outstanding government bonds. In effect, therefore, Islandsbanki assumed Straumur's liabilities for deposits in return for government guaranteed assets.

²⁹ 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.

³⁰ The decision is available in English at: <http://fme.is/lisalib/getfile.aspx?itemid=6055>

³¹ The decision is available in English at: <http://fme.is/lisalib/getfile.aspx?itemid=6077>

3.6 A comparison of the old and new banks: Glitnir and Islandsbanki

(ISK m)	Íslandsbanki hf.	Glitnir banki hf.	Δ %
	15/10/2008	30/06/2008	
Cash and balances with Central Bank	53,829	37,550	43%
Derivatives	0	278,404	-100%
Bonds and debt instruments	3,762	217,873	-98%
Shares and equity instruments	3,944	71,767	-95%
Securities used for hedging	0	162,332	-100%
Loans to banks	10,597	328,027	-97%
Loans to customers	482,586	2,548,164	-81%
Investments in associates	296	540	-45%
Investment property	1,589	5,539	-71%
Property and equipment	1,773	4,897	-64%
Intangible assets	107	63,218	-100%
Deferred tax assets	84	2,018	-96%
Non-current assets held for sale	1,894	908	109%
Share subscription	64,225	0	100%
Other assets	6,279	141,560	-96%
Total Assets	630,965	3,862,797	-84%
Short positions	0	23,312	-100%
Derivatives	0	109,903	-100%
Deposits from Central Bank & banks	134,303	311,775	-57%
Deposits from customers	361,302	709,584	-49%
Debt issued and other borrowed funds	53,808	2,241,976	-98%
Subordinated loans	103	145,902	-100%
Post-employment obligations	0	696	-100%
Current tax liabilities	34	812	-96%
Deferred tax liabilities	0	4,937	-100%
Non-current liabilities held for sale	1,285	0	100%
Other liabilities	14,471	113,465	-87%
Total Liabilities and Equity	565,306	3,662,362	-85%
Share capital	10,000	14,647	-32%
Share premium	55,000	53,174	3%
Other reserves		37,143	-100%
Retained earnings		94,744	-100%
Minority interest	660	727	-9%
Total Equity	68,030	200,435	-66%
Total Liabilities and Equity	630,965	3,862,797	-84%

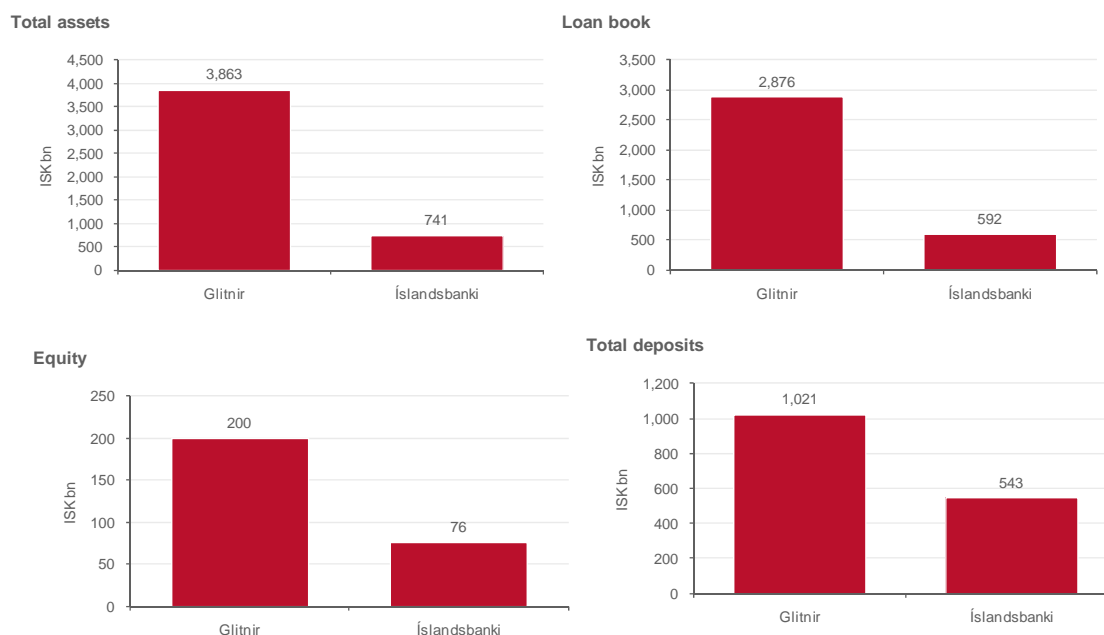
Table 1: Íslandsbanki's opening balance sheet compared with Glitnir's 2008 first half balance sheet

The Authority will undertake a full assessment of the business plan of 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.

Despite Glitnir having made extensive changes to its operations in the months preceding its collapse, there are major differences between the new and old banks both in terms of their operations and scale. Islandsbanki is a wholly domestic bank with no overseas obligations or operations whereas Glitnir was an international bank with operations in 11 countries. Islandsbanki has four business segments; Commercial/Retail Banking, Asset Management, Corporate and Investment Banking, and Treasury and Capital Markets, all of which are focused on the domestic market. Most notably the scale of Islandsbanki's operations are substantially smaller than that of Glitnir; the old bank's balance sheet of 3,862 billion ISK compared to the new bank's 631 billion ISK amounts to a reduction of 84%. A comparison of the old bank's balance sheet at June 2008 with the new bank's opening balance sheet can be found at **Table 1** above.

Glitnir had a diverse funding mix and was a large issuer of bonds and short term paper sold worldwide. Islandsbanki on the other hand relies mainly on deposits for funding. This, together with the likely inability for the bank to source similar funding streams to its

predecessor bank (in the short at least), limits the bank's ability to grow. When compared, key indicators of the two banks show considerable differences³²:



The new bank also has significantly fewer staff members. The average number of full time equivalent staff employed by Glitnir during the first half of 2008 was 2,174 compared to 1,110 for Íslandsbanki (including subsidiaries) during the first 2009, a difference of 49%. Again comparing the figures over the same period for domestic operations only, the new bank also employed 242 fewer staff than had previously been retained by Glitnir.

3.7 The business activities of the new bank

Across each of the new bank's business segments, the operations were very different to those domestic operations undertaken by the old bank before the collapse. A large proportion of the Commercial/Retail Banking department's activities was devoted to developing schemes to benefit customers in need of some type of debt or payment adjustment, for which a special individual debt restructuring unit was formed. High interest rates and high pre-existing household debt meant that new lending was very low. Asset management activities (while stable in terms of volume due to the process of liquidating corporate bond funds, deleveraging of clients and marking down of assets) suffered due to the impact of the financial sector collapse on the Icelandic equity market and corporate bond markets. To adapt to the radically different landscape in Icelandic financial markets, the liquidation of what had been large mutual funds as well as a marked change in the risk appetite of clients, Asset Management focused on a government bond fixed income market. In this respect three funds were established during the period as an option for clients whose previous investments had been in funds that were liquidated. As in Retail Banking, debt restructuring was at the forefront of the new bank's Corporate and Investment Banking operations after the new bank was formed. Staff spent a significant amount of their time assisting current customers, many of whom are in distressed situations, in solving immediate challenges including payment holidays or some form of flexible payment schemes, extending maturities and in some cases new lending. The

³² The graphs are based on the figures for Glitnir in the first half of 2008 and Íslandsbanki in the first half of 2009.

Treasury and Capital Markets segment also experienced drastic change due to a collapse in the Icelandic equities market, both in terms of turnover and number of listed companies, and due to the capital controls on the Icelandic Krona. The focus of trading activities was therefore on the government bond fixed income market, currently the only truly active market in Iceland.

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 Islandsbanki 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 Glitnir/Islandsbanki 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 Islandsbanki, 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. The fact that the creditors of Glitnir opted to acquire 95% of Islandsbanki in lieu of compensation for the assets transferred from Glitnir to Islandsbanki also greatly decreased the need for a State contribution to the bank.

According to the Icelandic authorities the Government contribution of Tier II capital to Islandsbanki and the liquidity facility was 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. The overall contribution is limited in size to what is absolutely necessary to ensure that Islandsbanki meets minimum capital requirements, as defined by the FME. In order to minimise the effect on competition, the same Tier II funding was made available to all of the three main banks, which were in a comparable situation. According to the Icelandic authorities it is currently very difficult to benchmark the interest against the market rates. Using market standards from the past it was customary for Tier II instruments to bear interest a little higher than general unsecured bonds (25-50 basis points). The bond negotiated between Islandsbanki and the Glitnir Resolution Committee on the other hand had a LIBOR plus 300 basis points coupon and by comparison the interest negotiated by the Icelandic Authorities on the Tier II bond is well above "market" standard. The interest coupon is therefore acceptable.

The part of the capitalisation of Islandsbanki borne by the Icelandic State as an owner of 5% of the bank's shares will be remunerated through the eventual sale of the State's share. As far as applicable, the measures are also in line with the principles set out in the Authority's Recapitalisation Guidelines. The Icelandic authorities argue that the risk

profile of the new banks is relatively low and that in consequence the pricing of capital provided should be at the lower end. They also argue that built-in incentives for exit are in place (step-up of interest in five years) and that in consequence the remuneration should be compatible with the EEA Agreement.

The Icelandic authorities also stress that the parties that were shareholders of Glitnir 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 Glitnir, 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 Glitnir. 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 decision no.48/2009 of the Icelandic Competition Authority regarding Glitnir's takeover of 95% of shares in Islandsbanki, 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.

The Icelandic authorities contend that no aid is present in the transfer of assets and liabilities of Straumur Bank to Islandsbanki, arguing that the transaction was made on commercial terms between two private market operators.

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 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 Glitnir/Islandsbanki 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 ISK³³. The liabilities through deposits alone in the three large Icelandic banks were at the time of their collapse 2,761 billion ISK, of which 1,566 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.

³³ See:

http://www.statice.is/?PageID=1267&src=/temp_en/Dialog/varval.asp?ma=THJ01102%26ti=Gross+dome+stic+product+and+Gross+national+income+1980%2D2009%26path=../Database/thjodhagsreikningar/land+sframleidsla/%26lang=1%26units=Million+ISK

The Authority also notes in this context the conclusions of the SIC Report, which refers in section 4.5.6.2 of Chapter 4³⁴ 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 European Central Bank, the Bank of England 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 22 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.”³⁵

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.

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 state. 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 more 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.

³⁴ See: <http://rna.althingi.is/pdf/RNABindi1.pdf> (see p. 167-181). This Chapter is only available in Icelandic.

³⁵ Pages 172 and 173 of Chapter 4.

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. The intra-month transfer date for the assets and liabilities (14 October 2008) caused major technical and audit difficulties. Entries for almost all assets and liabilities had to be accrued manually on spreadsheets for the period between 30 September and 14 October. In addition on a given intra-month date thousands of transfers are held in intermediary accounts waiting to be recorded on the general ledger and reconciled on both sides. Auditing teams had to manually trace and reconcile each open transaction with respect to its source and destination and determine whether it belonged to the new or old bank. This work was not completed until February 2009.

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 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 table³⁶.

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 plans³⁷. 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

³⁶ 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.

³⁷ 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.

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 two of the banks (Glitnir and Kaupthing) had an interest in capitalising the banks themselves to 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 creditor 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 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 were not 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 (temporary) full state capitalisation of the new bank;
- The retention by the state of the 5% share capital remaining after 95% of the share capital in the new bank was transferred to the creditors of Glitnir; and
- The provision by the state of Tier II capital to the new bank by way of subordinated debt.

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

- The special liquidity facility agreement;
- The Icelandic Government’s statement to guarantee domestic deposits in all Icelandic banks in full; and
- The Straumur agreement.

1.1 Presence of state resources

It is clear that the capitalisation measures are financed through state resources provided by the Icelandic Treasury. State resources are also present in the provision of liquidity to the bank as part of the compensation for accepting the liabilities (deposits) of Straumur bank.

The primary intention of the statement made by the Icelandic authorities safeguarding domestic deposits was to reassure deposit holders and to stop the widespread run of deposits on 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 insolvent estates and by transferring the liabilities for deposits to the newly established banks. 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 resources³⁸.

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 capitalisation 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 began³⁹) and by the Authority⁴⁰ 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 to apply in 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 transfer of 95% 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 made up entirely of creditors of the old banks who are not therefore investors acting freely in an open market but rather are seeking to minimise their losses in the most efficient manner⁴¹.

Secondly, the aid measure must be selective in that it favours “*certain undertakings or the production of certain goods*”. The capitalisation measures are selective as they only benefit Islandsbanki. 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 benefit and others do not. This principle applies to the state guarantee on deposits which benefits the Icelandic banking sector as a whole.

In so far as the special liquidity facility is concerned, paragraph 51 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” provides that, following the Commission’s decision-making practice⁴², the Authority considers that the provision of a central bank’s funds to financial institutions will not constitute aid when the following conditions are met:

- the financial institution is solvent at the moment of the liquidity provision and the latter is not part of a larger aid package,

³⁸ 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).

³⁹ 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.

⁴⁰ 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>

⁴¹ 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).

⁴² See for instance Northern Rock (OJ C 43, 16.2.2008, p. 1).

- the facility is fully secured by collateral, to which haircuts are applied, in function of its quality and market value,
- the central bank charges a penal interest rate to the beneficiary, and
- the measure is taken at the central bank's own initiative, and in particular is not backed by any counter-guarantee of the state.

The Authority concludes that, given that the liquidity facility was negotiated as part of a package of state assistance measures aiming to restore operations of a failed bank in a newly formed bank and to encourage equity participation in the new bank by the creditors of the failed bank, the above conditions are not fulfilled.

From the information provided to the Authority to date, the Authority cannot exclude that Islandsbanki has also received a selective advantage through the transfer of assets and liabilities of Straumur Bank. An advantage is *prima facie* present to the extent that the revenue (interest) it receives through partially state guaranteed assets exceeds the cost (interest) of holding the deposits, and to the extent that the transfer of deposit holders equates to goodwill and additional market share.

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 predecessor⁴³. 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 Agreement⁴⁴.

1.4 Conclusion

The Authority's preliminary conclusion, therefore, is that the measures taken by the Icelandic State to capitalise the new bank, as well as the liquidity facility, involve state aid within the meaning of Article 61(1) of the EEA Agreement. It also cannot exclude that aid to Islandsbanki is also present in the transfer to it of Straumur's assets and liabilities and 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*

⁴³ 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

⁴⁴ See in this respect Case 730/79 *Phillip Morris v Commission* [1980] ECR 2671

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 Glitnir Bank 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 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 plan⁴⁵. 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 minimised 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.

⁴⁵ 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.

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 Glitnir and the other two banks and avoid a systemic failure of the Icelandic financial system. 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 required⁴⁶.

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 and guaranteeing domestic deposits was likely to be the only credible and effective means of safeguarding an Icelandic banking sector and the wider economy⁴⁷. Bank rescue measures of the 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 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, and in light of the Icelandic authorities adopting similar measures to restore the other two main banks in Iceland which together make up over 80% of the domestic market⁴⁸, the impact on competition and trade across the EEA is limited. The Authority is also of the view that the state intervention in the case of Islandsbanki is *prima facie* proportionate as the process of ensuring that the creditors of the old bank became the majority shareholders of the new bank meant that the Icelandic authorities were able to ensure:

⁴⁶ 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>

⁴⁷ 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.

⁴⁸ A number of other financial institutions have also required state assistance. In 22 April 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 June 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.

- firstly that the aid payable was kept to the minimum necessary to ensure private sector involvement in the bank – something that may not otherwise have been achievable for many years; and
- secondly, that the amount of aid paid by the state was reduced substantially.

Although this was not achieved by undertaking a tender process due to the circumstances involved, the Authority is of the view that it would not have been realistic to expect any other private sector investors to have invested save for those already involved as creditors of the collapsed bank.

The amount of the capital provided is the minimum necessary in order to enable Islandsbanki to comply with the minimum capital adequacy ratio set by the FME of 12% Tier I capital (achieved through the contribution of the creditors of Glitnir) and 4% Tier II capital (provided by the subordinate loan of the state). The liquidity facility is also considered to be necessary by the regulator.

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. Although the remuneration payable in the case of Islandsbanki does not most likely comply with these requirements 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.

The Authority will further assess the aid granted through the remuneration payable for the capital and the terms of the liquidity facility, as well as any aid paid through the transfer of liabilities and guaranteed assets of Straumur, 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 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 crisis⁴⁹. 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 months⁵⁰. In addition it notes the content of the CBI's

⁴⁹ See paragraphs 10 and 24, and footnote 13, of the Authority's guidelines: <http://www.eftasurv.int/?1=1&showLinkID=16604&1=1>

⁵⁰ 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>

financial stability report for 2010/2⁵¹ 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 Glitnir/Islandsbanki 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 Authority must also further assess any aid paid as a result of the transfer of Straumur's assets and liabilities with the context of a restructuring plan. 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.

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) Glitnir Bank hf and establish and capitalise New Glitnir Bank hf (now renamed Islandsbanki).

<http://www.businessweek.com/news/2010-09-17/iceland-ruling-may-save-banks-4-billion-in-losses.html>

⁵¹ <http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=8260>

Article 2

The Authority requires that a detailed restructuring plan for Islandsbanki 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 Gunnlaugson
College Member