Case No: 73097
Event No: 688245
Dec. No.: 539/13/COL

EFTA SURVEILLANCE AUTHORITY

EFTA SURVEILLANCE AUTHORITY DECISION
of 18 December 2013
on restructuring aid to Nordfjordur Savings Bank

(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(3)(b)and Protocol 26 thereof,

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

HAVING REGARD to Protocol 3 to the Surveillance and Court Agreement ("Protocol 3"), in particular Article 1(3) of Part I and Articles 4(3) and 13 of Part II,

Whereas:

I. FACTS

1. Procedure

(1) On 10 June 2010, the Icelandic authorities notified a rescue aid scheme involving the settlement of the claims owned by the Central Bank of Iceland ("CBI") on five Icelandic savings banks ("the CBI Scheme" or "the Scheme").[1] The purpose of the Scheme was to ensure that the five savings banks would meet their respective regulatory capital requirements.

(2) By Decision dated 21 June 2010,[2] the Authority decided to approve temporarily for six months the Scheme. Furthermore, the Icelandic authorities were requested to submit restructuring or liquidation plans for the savings banks at the latest by 21 December 2010.

(3) By letter of 21 December 2010 (Event No 581546), the Icelandic authorities notified amendments to the Scheme but also requested an extension of the deadline for submitting a restructuring plan for each of the five savings banks until 30 April 2011.

[1] The CBI's ownership of claims on the savings banks results from a decision of the Icelandic Financial Supervisory Authority ("the FME") of 21 March 2009 on the allocation of assets and liabilities of the commercial bank Sparisjóðabanki Íslands (SPB) making the CBI responsible for the savings banks´ deposits in SPB, in return for which the CBI obtained SPB´s claims on the savings banks. The background is further explained in Chapter I.2.1 below.

[2] Decision No. 253/10/COL of 21 June 2010 on the rescue aid scheme involving settlement of claims owned by the Central Bank of Iceland on savings banks, OJ C 298 and EEA Supplement No. 61, 4.11.2010.

(4) By Decision of 13 April 2011[3], the Authority approved the notified amendments to the Scheme and granted the prolongation of the deadline to submit restructuring plans until 30 April 2011.

(5) At the request of the Icelandic authorities, the Authority subsequently granted several further extensions for the submission of restructuring plans for the savings banks.

(6) By letter dated 31 January 2012 (Event No 623690), the Icelandic authorities submitted restructuring plans for the four following savings banks: Nordfjordur Savings Bank (*Sparisjóður Norðfjarðar*; SpNor), Vestmannaeyjar Savings Bank (*Sparisjóður Vestmannaeyja*; SpVest), Bolungarvik Savings Bank (*Sparisjóður Bolungarvíkur*; SpBol) and Thorshofn Savings Bank (*Sparisjóður Þórshafnar*; SpTh). No restructuring plan was submitted for the fifth savings bank covered by the scheme, Svarfdaelir Savings Bank (*Sparisjóður Svarfdæla*; SpSv), as an agreement had been concluded for the acquisition by Landsbankinn of the assets and operations of SpSv.[4]

(7) By letter of 4 April 2012 (Event No 627995), the Authority requested the Icelandic authorities to provide certain additional information, to which the Icelandic authorities responded by letters of the Ministry of Finance dated 7 May 2012 (Event No 633946) and 11 May 2012 (Event No 634336). The restructuring plans for the savings banks were also discussed in a meeting with the Icelandic authorities in Reykjavík on 6 June 2012.

(8) By letter dated 29 May 2013 (Event No 672617), the Authority requested an updated restructuring plan for each of the savings banks under the CBI Scheme, copies of their annual financial statements for the year 2012 and of the FME reports for the banks based on the Supervisory Review and Evaluation Process (SREP).

(9) By email dated 4 June 2013 (Event No 675399), the Icelandic authorities submitted the annual financial statements of SpNor, SpVest, SpSv, SpBol and SpTh for 2012.

(10) By letter dated 16 September 2013 (Event No 683897) the Icelandic authorities submitted an updated restructuring plan for Nordfjordur Savings Bank, as well as FME's report on the savings bank based on the SREP process and a copy of the bank's interim financial statements on 30 June 2013.

(11) By email of 19 November 2013 (Event 690632) the Authority requested certain clarifications regarding SpNor's updated restructuring plan to which the Icelandic authorities responded by email of 22 November 2013 (Event 691083).

(12) The present decision concerns the restructuring plan submitted by the Icelandic authorities for Nordfjordur Savings Bank.

2. Background

2.1 The financial crisis in Iceland and the implications for the savings banks

(13) In October 2008, in the midst of a global financial turmoil, the Icelandic financial system entered into a state of systemic crisis. Three of Iceland's major banks, Glitnir Bank hf., Landsbanki Íslands hf. and Kaupþing Bank hf., which at that time together held a market

[3] Decision No. 127/11/COL of 13 April 2011 on amendments to the rescue aid scheme involving settlement of claims owned by the Central Bank of Iceland on savings banks, OJ C 222 and EEA Supplement No. 42, 28.7.2011.

[4] Following objections to this transaction by the Icelandic Competition Authority, this agreement was later cancelled.

share of more than 90% in most segments of the Icelandic financial market and had also grown rapidly abroad, collapsed within a time frame of few days.

(14) On 6 October 2008, the Icelandic Parliament passed Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances ("the Emergency Act").[5] The Emergency Act gives the Minister of Finance and the Financial Supervisory Authority ("the FME") extensive powers of intervention into the operations of financial undertakings in Iceland.

(15) According to Article 2 of the Emergency Act the responsible Minister is authorised to provide savings banks with additional equity of up to 20% of their equity base. In return, the Treasury would receive guarantee capital or shares in the savings bank corresponding to the same amount. However, the state intervention foreseen by this provision has not been implemented. Instead, it has been replaced by the measures of the CBI Scheme under examination in this decision, as described further below. Beneficiaries under that scheme have been required to withdraw application under Article 2 of the Emergency Act.

(16) Under the powers provided by the Emergency Act, the FME in October 2008 took control of the three biggest Icelandic banks, Glitnir, Landsbanki and Kaupþing. Three new state-owned banks were established to take over the domestic assets, liabilities and operations of the old banks while the three old banks entered a winding up procedure headed by resolution committees. The collapse of the three major banks unavoidably had contagious effects on the smaller financial undertakings in Iceland and on the economy as a whole.

(17) Savings banks are the oldest financial institutions in Iceland. Some of them were founded towards the end of the 19th and at the beginning of the 20th century, in the form of foundations and with the purpose of promoting economic development. Savings banks have served as fundamental institutions for deposit and lending operations in local communities across Iceland.[6] The savings banks conduct essential operations in retail banking in rural regions throughout the country, accounting for an appreciable share of customer deposits and lending outside the capital region with a focus on regional development. The savings banks' main operations are receiving repayable funds from the public in the form of deposits or debentures, granting of loans financed by repayable deposits, the handling of payment cards and other related financial services.

(18) The number of savings banks in Iceland peaked at 66 in 1950 and has since declined to 38 in 1985 and 17 in 2007. Although not expanding at a comparable rate to the exponential growth of the commercial banks prior to the crisis and its operations remaining national and mostly local in nature, the savings banks sector nevertheless experienced considerable growth during 2004-2007, with combined total assets increasing from about ISK 220 billion in 2004 to about ISK 600 billion in 2007. The combined share of the savings banks in domestic retail markets, measured in terms of their share of total deposits, was for long in the region of 15-20%. However, as from 2008 onwards the savings banks sector has contracted substantially. The biggest and more centrally located savings banks have exited the market.[7] The combined

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

[6] For further information on the developement of savings banks in Iceland, see Chapter 4 of master thesis in economics by Knútur Rúnar Jónsson at the University of Iceland, *„Framtíðarhorfur sparisjóða – með áherslu á Ísland og Evrópusambandið"*, January 2010, available (in Icelandic) at: http://skemman.is/stream/get/1946/4488/13074/1/knutur_runar_fixed.pdf.

[7] This includes Sparisjóður Reykjavíkur og nágrennis (SPRON), Byr, Sparisjóðurinn í Keflavík (SpKef) and Sparisjóður Mýrarsýslu (SPM).

assets of savings banks as a share of the total assets of credit institutions fell from 14% at year-end 2008 to just over 1.5% at year-end 2012.[8] There are currently nine savings banks operational in Iceland. This includes the five savings banks eligible under the CBI Scheme and four other savings banks that do not benefit from the Scheme.[9] All of these small financial undertakings are located outside the more densely populated south-west region of the country and provide services to individuals and SMEs in the local communities. Their total assets at year-end 2012 amounted collectively to ISK 57 billion (EUR 350 million) or 1.9% of the total assets of deposit money banks, with a workforce of about 110 employees in total.

(19) The savings banks most of which previously were viable and profitable financial undertakings were hard hit by the financial and economic crisis and were suddenly faced with catastrophic difficulties in their operations.[10] First, the economic collapse had a major effect on the ability of many debtors in Iceland to service their debt. Inflation soared, interest rates shot up and debt in foreign currency soared, due to the severe depreciation of the Icelandic króna. This rapidly led to defaults of debtors, causing liquidity problems, subsequent write-offs and loss on the balance sheets for the savings banks. Second, the Icelandic Stock Exchange caved in and the market in shares nearly disappeared overnight. Assets of many savings banks in the form of shares in companies registered on the Icelandic Stock Exchange became more or less worthless. Third, many of the savings banks held financial instruments issued by the three major banks on their books, now nearly worthless.

(20) Moreover, most savings banks owned shares in Sparisjóðabanki Íslands hf. ("SPB"), earlier named Icebank, which was taken over by the FME on 21 March 2009. SPB was a limited liability company founded in 1986 by 38 Icelandic savings banks. Operating under a commercial banking licence, SPB served a fundamental role for the savings banks. SPB acted as a central servicing bank for the savings banks, provided access to international sources of credit, foreign and domestic settlement systems and other banking services. SPB held a large portfolio of bonds issued by the other commercial banks and was therefore severely hit by their collapse.

(21) According to its decision of 21 March 2009 on the allocation of assets and liabilities of SPB, the FME made the CBI responsible for the savings banks' deposits in SPB.[11] As compensation, the CBI received SPB's claims on the savings banks.[12] Following the

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[8] CBI Financial Stability Report 2013/1, p. 31-32, available at: http://www.cb.is/publications-news-and-speeches/publications/financial-stability/.

[9] The four savings banks currently in operation which do not benefit from the CBI Scheme are Sparisjóður Strandamanna, Afl sparisjóður (Sparisjóður Skagafjarðar & Sparisjóður Siglufjarðar), Sparisjóður Höfðhverfinga and Sparisjóður Suður Þingeyinga).

[10] In August 2011, the Icelandic Parliament appointed a special commission to investigate the background and reasons for the difficulties and collapse of savings banks. At the time of writing, the report of the commission is still pending. Further information is available on the parliament's website at: http://www.rna.is/sparisjodir/.

[11] The FME decision of 21.3.2009 on the allocation of assets and liabilities of SPB is available in Icelandic at http://www.fme.is/media/akvardanir/21.-mars-2009_2.pdf.

[12] In April 2009, an agreement was signed between the CBI and BYR Savings Banks ("BYR") providing for the take-over by the latter of SPB's role regarding services due to the payment and settlement systems on behalf of the savings banks. However, following the collapse of BYR in April 2010, responsibility for the savings banks' deposits and services regarding payment systems was transferred to Byr hf., the undertaking which took over the assets and obligations of BYR Savings Bank. Byr hf. was later merged with Íslandsbanki and an agreement was made with the commercial bank MP Bank hf. to provide certain services to the savings banks as had earlier been provided by SPB, Byr Savings Bank and Byr hf.

foundation by the CBI of the holding company ESI[13], the CBI on 7 January 2011 transferred its claims on the savings banks to ESI. The measures under examination in the present decision are the settlement of claims on the savings banks that came into the possession of the CBI as a result of the collapse of the SPB together with the CBI´s responsibility for the savings banks´ deposits in SPB. These measures are described further in section 3.2 below. Measures in favour of SpNor are thus part of the CBI Scheme for smaller savings banks, which covers also the following four savings banks: Bolungarvík Savings Bank, Svarfdælir Savings Bank, Þórshöfn Savings Bank and Vestmannaeyjar Savings Bank. The main objective of the CBI Scheme is to ensure that the savings banks concerned meet their regulatory capital requirements, while at the same time maximising the value of the CBI´s claims on the savings banks.

(22) Many of the savings banks had taken loans from SPB in foreign currency and relent to their local customers. Since the start of the crisis, a considerable share of such loans were written off as debtors were declared bankrupt or unable to pay the loans which had in many cases doubled in amount in Icelandic króna due to the depreciation of the currency. These difficulties have been coupled with the implications of court rulings finding in many instances the terms of currency linked loans to be illegal. These complications have resulted in severe disruptions in the balance of assets and liabilities in most savings banks, causing equity to fall, in some instances below the minimum requirements under Icelandic law and regulation on financial undertakings.

2.2 Court rulings regarding loans indexed to foreign currencies

(23) By two judgment of 16 June 2010, the Supreme Court of Iceland ruled that loans granted in Icelandic krónur ("ISK") with repayment terms indexed to the exchange rate of foreign currencies were illegal and contravened the Act No. 38/2001 on Interest and Indexation.[14] Such loans were common on the Icelandic financial market. The Supreme Court did not address the question whether other forms of indexation could be applied to the loans or what interest rates should be applied to the same loans once they were denominated in the Icelandic currency. The court rulings nevertheless had a severe impact on loans of financial undertakings on the Icelandic market with repayment value linked to foreign currencies. It became evident that the book value of the savings banks' assets in the form of such loans had become uncertain and would decline in value as a result of the rulings since the loans would need to be recalculated. The planned financial restructuring of the savings banks could not be finalised until the effects of the judgments on the capital of the savings banks had been determined.

(24) On 30 June 2010 the FME and the CBI issued guidelines to financial undertakings due to non-binding clauses linking loans to exchange rates of foreign currencies. The representatives and auditors of the savings banks concerned, in consultation with the FME, subsequently assessed the impact of the judgments on the basis of the guidelines. The result revealed a further need for depreciation of claims for four of the five savings banks, in order to meet the FME capital requirements. Nordfjordur Savings Bank was the only bank that held few illegally indexed loans and therefore the judgment did not have the same negative effects as

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[13] On 30 December 2009, the CBI founded a limited liability company named *Eignasafn Seðlabanka Íslands* (ESI), fully owned by the CBI, for the holding and management of assets and claims held by the CBI as a result of the financial crisis in Iceland.

[14] Icelandic Supreme Court ruling No 92/2010 *Óskar Sindri Atlason gegn SP-Fjármögnun hf.*, 16.6.2010 and Icelandic Supreme Court ruling No 153/2010 *Lýsing hf. gegn Jóhanni Rafni Heiðarssyni og Trausta Snæ Friðrikssyni*, 16.6.2010.

on the other savings banks. The bank therefore underwent financial restructuring on 28 July 2010.

(25) On 16 September 2010, the Supreme Court issued a judgment, which clarified how to calculate interest on loans, which had been declared illegally indexed to foreign currency exchange rates by the judgments of 16 June 2010.[15] The court concluded that the interest rate specified in the contracts should not prevail as the premises for that interest rate no longer applied once exchange rate linkage had been deemed illegal. The result of the judgement was that financial undertakings could recalculate such loans on the basis of the lowest non-indexed interest rates determined by the CBI.

(26) Subsequently the representatives and auditors of the savings banks finalised assessments of the impact of the capital positions of the savings banks. These assessments formed the basis for a new proposal, which was introduced to creditors and accepted in the second semester of 2010. For the savings banks that had a significant part of their portfolio in loans in Icelandic krónur linked to the exchange rate of foreign currencies, the CBI and other creditors postponed the implementation of financial restructuring measures until all uncertainties regarding value assessment were cleared.

(27) However, SpNor only held relatively few loans illegally indexed to foreign currencies.[16] The judgments regarding such loans therefore did not affect SpNor to the same extent as other savings banks. Accordingly, the rescue aid measures regarding SpNor as notified on 10 June and approved by the Authority on 21 June 2010 were successfully implemented on 28 July 2010 and did not need any modification.

2.3 Efforts to restructure the savings bank sector

(28) `The Icelandic Savings Bank Association (i. Samband íslenskra sparisjóða; "SISP") has been working on a future strategy for the Icelandic savings banks system. A part of that task is to explore the minds of investors, both Icelandic and foreign, and find out whether they wish to invest in the savings banks system in some form. It is expected that the outcome of the work by SISP will lead to changes to the savings banks system, making it more efficient. Furthermore, the Savings Banks´ Guarantee Fund (i. Tryggingasjóður sparisjóða)[17] has in a few instances bought guarantee capital in savings banks and thus contributed to their financial restructuring. The Icelandic State Financial Investments (ISFI), the state holding company responsible for management of the state´s holdings in the five savings banks, has also been involved and has suggested different options regarding consolidations of the sector.[18]

(29) In June 2012 the Icelandic Parliament passed an amendment to the Act on Financial Undertakings.[19] The aim of the amendment is to increase the possibilities for the savings

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[15] Icelandic Supreme Court ruling No 471/2010 *Lýsing hf. gegn Guðlaugi Hafsteini Egilssyni*, 16.9.2010.

[16] Furthermore, the Supreme Court of Iceland ruled in its judgment of 10 October 2013 in Case No. 194/2013 that a loan agreement concluded by SpNor did not involve illegal indexation of commitments in Icelandic króna to foreign currencies.

[17] According to the statutes of the Savings Banks´ Guarantee Fund all savings banks are members to the fund. Its goal is to safeguard the interests of the clients of the savings banks and in that context the financial security of the savings banks. The statutes are available (in Icelandic) at http://stjornartidindi.is/Advert.aspx?ID=7f726f5b-1b46-4de2-879f-22266ccf733e.

[18] See for instance section 4.7, p. 52-55, of ISFI´s annual report for 2011, which sets out four alternative options: (i) Continued independent operations of existing savings banks; (ii) merger of savings banks; (iii) sale of individual savings banks; and (iv) merger with commercial bank(s). The report is available (in Icelandic only) at http://bankasysla.is/files/SkyrslaBR_2011_net_1596113727.pdf.

[19] Act No. 77/2012 on amendments to Act No. 161/2002 on Financial Undertakings (savings banks).

banks to acquire new capital and to promote investment in the savings banks. The amendments allow savings banks to change their legal form and to merge with other savings banks or financial undertakings.

(30) In August 2011, the sale of SpNor was initiated. In September 2011, all guarantee capital shares, including the State's 49.5% holding, were offered for sale in an open process. However, after negotiations with prospective buyers, the Board of Directors of SpNor, in cooperation with the bank's largest guarantee capital holders, decided to decline all offers. It was the assessment of the Board and the owners that the bids were too low and not in line with expectations.

(31) In August 2011, the Icelandic Parliament appointed a special commission to investigate the background and reasons for the difficulties and collapse of savings banks. At the time of writing, the report of this commission is still pending.

2.4 Financial supervision and improvements in regulatory framework

(32) Weaknesses in the regulatory framework and financial supervision have been identified as being one of the significant causes of the demise of Iceland's financial system in the autumn of 2008.[20] Following the FME's initial work linked to the foundation of the new commercial banks and the assessment of the value of the net assets transferred from the old banks, the FME conducted in the spring of 2009 an audit of the new banks and their business plans, financial strength and capital requirements in a so-called sign-off project. This was done with the assistance of the international management consultant firm Oliver Wyman.

(33) Having concluded the above process, the FME granted the banks operating licenses subject to various conditions. In view of the quality of the asset portfolios and the anticipated economic uncertainty, it was considered necessary to place higher capital requirements on the banks than the statutory minimum.[21] The FME therefore set the minimum capital adequacy (CAD) ratio for the banks at 16%, thereof a minimum of 12% for the Tier I capital ratio. Conditions were also set as regards liquidity reserves and risk management and governance. By letter of the FME to the savings banks dated 8 February 2010, similar conditions were defined with respect to the savings banks. The requirements were applicable for at least 3 years unless reviewed by the FME. More precisely, the FME required the savings banks to comply with the following conditions:

<u>Capital reserves</u>

- the savings banks must be capitalised with a minimum Core Tier 1 ratio of 12%, which must be maintained for at least three years after the initial capitalisation unless revised by the FME;
- the savings banks must maintain a CAD ratio above 16%, which must be retained for at least three years after the initial capitalisation unless revised by the FME;
- the owners of the savings banks must demonstrate an acceptable level of financial strength, i.e. the ability, but not the obligation, to inject more capital should it be needed.

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[20] See the report of the Icelandic Parliament's (Althingi's) Special Investigation Commission (SIC) delivered on 12.4.2010, but the role of the Commission was to investigate and analyse the processes leading to the collapse of the three main banks in Iceland. Excerpts in English of the SIC-report are available at http://sic.althingi.is/. See also the Authority's Decision 291/12/COL of 11.7.2012 on restructuring aid to Arion Bank, section I.2.2, available at http://www.eftasurv.int/media/decisions/291-12-COL.pdf.

[21] According to Article 84 of Act No. 161/2002 on financial undertakings, the capital base of a financial undertaking shall at any time correspond to a minimum of 8% of the undertaking's risk.

- a specific stress test will be performed to establish that the savings banks uphold a Core Tier 1 ratio of 4% after three years of losses.

Liquidity reserves

- the savings banks must demonstrate sufficient liquidity reserves to withstand the liquidity stress test defined by the CBI;
- liquid assets (funds, current account, assets eligible for central bank lending facilities) must amount to at least 10% of on-demand deposits and cash or cash equivalents must amount to at least 5% of on-demand deposits. The former requirement increases if deposits from foreign parties amount to more than 1% of deposits or if there is considerable concentration within the deposit base.

Risk management and governance

- the savings banks must present a report of independent evaluation of capital requirements (ICAAP report);
- the savings banks must improve their internal control procedures and their risk management in accordance with best practices and the FME's requirements based on a special assessment of internal controls and risk management;
- the savings banks must reduce their largest risk factors and make changes in line with a re-focusing on core operations.

(34) The economic stabilisation program established in consultation with the IMF provided for a review of the entire regulatory framework of financial services and supervision to improve defence against future financial crisis. The review took account *inter alia* of the advice of foreign experts and was aimed at establishing tougher rules and a stricter practice regarding large exposures and connected lending and firmer supervision of particularly credit risks, liquidity risks and foreign exchange risks. It was also recommended to review and improve the deposit guarantee system, following closely the developments within the EU.

(35) The Government subsequently proposed a bill of law to the Althingi, based *inter alia* on the above review as well as amendments made to EEA law relevant to financial services from 2009 onwards. The bill was adopted and entered into force on 1 July 2010, as Act No. 75/2010. With the new law, extensive amendments were made to the Act on Financial Undertakings. Several other amendments were later introduced to the law on financial undertakings as well as of regulation and supervision of financial services.[22]

3. Description of the measures

3.1 The beneficiary: Nordfjordur Savings Bank

(36) Nordfjordur Savings Bank (SpNor) was established in 1920 and currently operates in accordance with Act No 161/2002 on financial undertakings. Its core business is local retail banking, servicing individuals and small businesses on the east coast of Iceland by receiving repayable funds in the form of deposits or debentures and the granting of loans financed by deposits. In addition the savings bank issues and handles payment cards and electronic money and performs related financial services.

[22] For details of the changes to the regulatory and supervisory framework for financial markets in Iceland adopted after the financial crisis see Annex I to the EFTA Surveillance Authority Decision No. 291/12/COL of 11 July 2012 on restructuring aid to Arion Bank, available at: http://www.eftasurv.int/media/decisions/291-12-COL.pdf.

(37) The financial restructuring of SpNor was completed on 28 of June 2010 when an agreement was signed with the CBI. Post restructuring the savings bank guarantee capital was ISK 625,8 million held by 86 parties. The CBI holds 24.0% and the Icelandic Regional Development Institute (Byggðastofnun) holds 25.5%. Together the State´s holdings, amounting to 49.5%, are managed by the Icelandic State Financial Investments (Bankasýsla ríkisins the "ISFI"), the ISFI being the largest holder of guarantee capital. The second largest holder is the municipality Fjarðarbyggð that holds 22.4%. The Board of Directors of SpNor has five members, two are appointed by the ISFI. No definite changes of ownership are foreseen in the near future. It is the task of the ISFI to make proposals to the responsible minister as to whether and, if so, when specific holdings in the savings banks should be offered for public sale and to draft and prepare proposals for the sale of the state's holdings in them.[23]

(38) Nordfjordur Savings Bank´s headquarters are in Neskaupstaður. The total population where the savings bank has its operation is about 4500. In an effort to cut costs, the bank's branch in Reyðarfjörður which had four employees was closed in April 2012. Following this closure, SpNor has only six employees. The bank has no subsidiaries.

(39) Nordfjordur Savings Bank has not received rescuing or restructuring aid in the past. The changes to the CBI Scheme notified by the Icelandic authorities and temporarily approved by the Authority with Decision No. 217/11/COL of 13 April 2013, did not apply to Nordfjordur Savings Bank.

3.2 The aid measures

3.2.1 Settlement of claims of CBI

(40) The CBI Scheme entailed several types of measures: conversion of claims into guarantee capital, subordinated debt, a general loan agreement as well as the settlement of claims in cash and the writing down of claims. By the Authority´s Decision 253/10/COL of 21 June 2010, these rescue measures were temporarily approved, subject to the submission of restructuring plans or liquidation plans for the five banks.[24]

(41) Unlike the new commercial banks, the savings banks have continued to operate under the same licenses as before the financial crisis. The FME has nevertheless considered it imperative for the continued operation of the savings banks that they meet the same conditions as the commercial banks regarding capital and liquidity reserves, as has already been explained in section 2.4 above.

(42) The financial restructuring of Nordfjordur Savings Bank was aimed at raising the savings bank's CAD ratio to a level above the FME´s minimum. The guarantee capital injections by local parties were an important part of achieving that goal. After restructuring, the CAD ratio was 22.6% with Core Tier 1 ratio of 19.0% and Core Tier 2 ratio of 3.6%. Being somewhat above the FME´s CAD requirements was considered necessary due to the prevailing uncertainties in Iceland's financial market at the time.

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[23] See Article 4 of Act No. 88/2009 on the ISFI.

[24] For a detailed description of the measures included in the CBI rescue scheme, see Decision 253/10/COL of 21.6.2010 on the rescue aid scheme involving settlement of claims owned by the Central Bank of Iceland on savings banks, section 2.5.

(43) The negotiated financial restructuring of SpNor completed in June 2010 also involved the participation of a creditor other than the CBI.[25] The treatment of the claims of the CB claims as well as the claims of the other creditor involved is summarised in Table 1.[26] The remuneration of the various instruments applied is explained in section II.3.4 below.

Treatment of claims	CBI claims	Subordinated creditors	Total
Converted to guarantee capital		159	**159**
Converted to subordinated debt	150		**150**
Converted to general unsecured debt	140		**140**
Written down	269	37	**306**
Claims in total	**559**	**196**	**755**

Table 1: Financial restructuring of SpNor in June 2010
Summary of treatment of claims of creditors
Amounts are in million ISK

(44) In regard to the claims, the CBI, along with other creditors, first of all required a write-down of guarantee capital of existing owners in full or almost in full, in order to amend negative reserves.

(45) The CBI then wrote down its claims by 48% (ISK 269 million) and the Icelandic Regional Development Institute wrote down claims by 19 % (ISK 37 million).

(46) In addition to the two measures mentioned above, the creditors converted ISK 159 million in claims into guarantee capital (Tier 1 equity) and ISK 150 million into subordinated loans (Tier 2 equity). Local parties also agreed to inject ISK 253 million (ISK 218 million in 2009 and ISK 35 million in 2010) in new capital into SpNor. The above measures sufficed to bring the bank´s capital base up to the capital requirements set by the FME.

(47) The change in guarantee capital and the capital structure of SpNor resulting from the negotiated financial restructuring in June 2010 is set out in Table 2.

[25] The creditor holding subordinated claims was the Icelandic Regional Development Institute (Byggðastofnun). According to the financial statements of SpNor on 31 December 2009, debt other than the claims of the CBI and Byggðastofnun were mainly in the form of securities issues, in the total amount of ISK 179 million, maturing within a year.

[26] General unsecured creditors were not subjected to debt restructuring. At year-end 2009, outstanding borrowing amounted to about ISK 179 million maturing within 365 days.

Change in Guarantee Capital	
Guarantee Capital – 31.12.2009	484
Write-down of Guarantee Capital	202
Write-down of Guarantee Capital – %	41.7%
Increase in Guarantee Capital – The CBI	150
Increase in Guarantee Capital – Subordinated creditors	159
Increase in Guarantee Capital – Other parties	35
Guarantee Capital post restructuring	**626**
Guarantee Capital Holdings Post Restructuring	
Central Bank of Iceland	24.0%
Current Guarantee Capital Holders	10.0%
Other public entity (Regional Development Institute)	25.5%
Other parties	40.6%
Guarantee Capital Holdings Post Restructuring	**100.0%**
Capital Structure Post Restructuring	
Guarantee Capital	626
Reserves and Retained Earnings	0
Total equity	**626**
Capital Ratio Post Restructuring	
Tier 1 equity	19.0%
Tier 2 equity	3.6%
CAD Ratio Post Restructuring	**22.6%**

Table 2: Financial restructuring of SpNor in June 2010
Change in Guarantee Capital and Capital Structure
Amounts are in million ISK

(48) As a result of the above settlement with creditors, the bank´s CAD ratio rose to 22.6% on 30 June 2010 compared to 4.4% at year-end 2009.

(49) In July 2013, the ongoing Supervisory Review and Evaluation Process (SREP) was finalised. According to the SREP report, the FME specified a new minimum CAD requirement for SpNor of 16.9% replacing the 16% requirement determined by the FME in February 2010, as explained in section 2.4 above. The banks CAD ratio, at the time the SREP was finalised, was 18.55% and thus above the minimum requirement.

3.2.2 Responsibility by the CBI for the bank's deposits previously held by SPB

(50) According to the FME decision of 21 March 2009 on the disposal of assets and liabilities of Sparisjódabanki Íslands, it was decided that the CBI would take over the obligations of Sparisjódabanki Íslands due to deposits of savings banks in SPB. As for SpNor, its deposits in financial undertakings and other claims on them amounted to ISK 1359 million at year-end 2008 or 23.3% of total assets.

3.2.3 Additional state backing of deposits in commercial and savings banks

(51) In order to comply with Directives 97/9/EC on investor-compensation schemes and 94/19/EC on deposit guarantee schemes, Iceland adopted Act No. 98/1999 on deposit guarantees and investor-compensation scheme and thereby set up the so-called Depositors' and Investors' Guarantee Fund ("TIF"), which has been funded by annual contributions from the banks, calculated in relation to the total deposits of that bank.

(52) According to the Icelandic authorities, and so as to provide further assurance and comfort to the general public on the safety of their deposits when the crisis struck, the bank rescue measures of the Icelandic Government of autumn 2008 also entailed an additional state

backing of deposits in domestic commercial and savings banks, outside the scope of Act No. 98/1999 implementing the deposit guarantee Directive 94/19 and the investor-compensation Directive 97/9/EC.

(53) 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"*. This announcement has since been repeated by the Office of the Prime Minister in February and December 2009. 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: *"[a]t 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."* 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.

(54) In a debate in the Icelandic Parliament in June 2012 regarding the Government's cost related to Landsbankinn's taking over the savings bank SpKef, a statement of the then Minister of Economic Affairs, Steingrímur Sigfússon, illustrates the above further. According to the Minister, one must keep in mind regarding this matter the State's declaration in the autumn of 2008 that all deposits in savings banks and commercial banks would be safe and protected. *"Work has since in all instances been based on this (i.e. the declaration) and it is unfortunately correct that this (i.e. payments due to SpKef) will be one of the bigger bills footed directly by the state as costs for securing the deposits of all inhabitants of Suðurnes ... and all SpKef´s clients in the West Fjords and the West and North-West area ... I do not expect that anyone has thought that deposit holders in those areas would be treated differently from other inhabitants, so the state did not have much of a choice in this matter"*.[27]

(55) According to the Icelandic Government, the additional deposit guarantee will be lifted before the capital controls are fully abolished, which according to the Icelandic authorities was foreseen to take place before the end of 2014. According to recent statements from the Icelandic authorities, it appears that the lifting of capital controls could be delayed. A new deadline has so far not been announced.

4. The restructuring plan

4.1 Initial situation in the market and the need for the measures

(56) In the years before the financial crisis in 2008, there was considerable growth in the operations of SpNor. Thus, total assets grew from approx. ISK 2 billion at year-end 2003 to ISK 5.7 billion at year-end 2007. During the same period deposits increased from about ISK 1.5 billion to ISK 3.3 billion and lending from ISK 1.5 billion to ISK 3.2 billion. In those years the bank earned modest profits in the order of ISK 50 – 80 million annually. A particularly strong growth was recorded in 2007 when the bank's net after-tax earnings reached ISK 305 million, mostly as a result of increased gains on marketable securities and other financial income. As a result of the financial collapse in October 2008, the bank´s

[27] Unofficial translation by the Authority. Direct Icelandic quotation can be found in mbl.is on 10.06.2012, available at: http://www.mbl.is/frettir/innlent/2012/06/10/rikid_atti_ekki_mikid_val/.

financial position and operating conditions deteriorated in many respects.[28] Significant assets of the bank evaporated, in particular its shares in other financial undertakings, and securities issued by them also lost value. At the same time mortgage securities dropped in value and credit losses and credit risks increased when the payment capacity of clients deteriorated. Foreign credit facilities disappeared overnight. Currency hedging was scarcely available anymore. This could imply that the bank´s risk exposures became unmanageable. The sharp depreciation of the Icelandic króna also had extensive and unforeseen implications. All in all, net financial income including market and exchange gains dropped from ISK 394 million in 2007 to a net loss of ISK 770 million in 2008.

(57) Following the financial crisis in the autumn of 2008, Nordfjordur Savings Bank was operating on an exemption from the CAD ratio requirements of the FME, as the ratio fell to minus 0.9% at year-end 2008 from 15.3% at year end 2007 (see Table 4 below). In the absence of the CBI rescue measures and the related financial restructuring of the bank, the FME was required to revoke the bank's operating licence, which in turn would have led to the bank's insolvency. In insolvency proceedings the CBI's claim on the savings bank would have been a general claim in accordance to Section 113 of the Insolvency Act No. 21/1991. When the measures were implemented it was foreseen that the value of the claim would be higher after the State's intervention than in insolvency proceedings. However the Icelandic Regional Development Institute's claim would have been a subordinated claim according to Section 114 of the before mentioned Act with the likely result that nothing would have been obtained towards the claim.

4.2 Description of the restructuring plan

4.2.1 Main content and assumptions

(58) The Icelandic authorities submitted a restructuring plan for SpNor on 31 January 2012 and further information was received on 7 May 2012. An updated restructuring plan, based on the bank´s financial statements for 2012, was submitted on 12 September 2013, together with the FME report on the Supervisory Review and Evaluation Process (SREP) dated 1 July 2013 setting out the capital requirements for SpNor.

(59) The macro-economic assumption of the restructuring plant take account of CBI forecasts. Assumed inflation in 2013 is 3.4%, declining gradually to 2.5% in 2017, the CBI´s inflation target. Interest rates are assumed to stay relatively stable during the restructuring period.

(60) As the possibility exists of losing customers after closure of the Reyðarfjörður branch, the bank will emphasise that it is a financial institution owned by local parties and the State and is operated for the local community. In this way it hopes to hold on to old customers and gain new ones. Prudently, only a modest increase in lending and deposits is anticipated.

(61) The restructuring plan entails different sets of measures and addresses the substantive issues of viability, reduction in operating costs and sale of assets. This was done to maintain the bank's role as a provider of financial services to individuals and small businesses in the local communities.

(62) The CBI rescue measures and the financial restructuring in June 2010 laid the foundations for continued operations of the bank. The aim of the measures was to ensure that the bank's CAD ratio fully met the FME's minimum requirements. The capital injection by local parties were also important to achieve the goal. Further measures have also been prepared to ensure

long-term viability of the bank's operations. The restructuring plan can thus be described as falling into two parts as further set out below. Firstly, financial restructuring which was mostly implemented in June 2010. Secondly, other restructuring measures aimed at ensuring long-term viability in the bank's operations.

4.2.2 Other restructuring measures

(63) Other measures to promote the long-term viability of the bank's operations have been prepared. Some of these measures have already been implemented while others are still being processed.

(64) SpNor will continue to operate as a savings bank and to focus on the core values and businesses which have traditionally been the goals of the savings banks. Restructuring will be attained through the following measures:

- *Sale of assets*

(65) In February 2012, the savings bank decided to sell certain non-core assets.

- *Laying off staff and containing salary costs*

(66) As already mentioned the Reyðarfjörður branch office was closed in 2012. In the bank's view this was a necessary step of restoring viability. Four employees of the Reyðarfjörður branch were laid off along with one employee in the Neskaupstaður branch. Reduction in labour costs will be effective at the end of the employees´ term of notice. The salary of the CEO and the office manager have been reduced. Moreover, all grants to external beneficiaries will be reduced by half for the next two years.

- *Reduction of IT costs and other operating expenses*

(67) With the closing of Reyðarfjörður branch, IT costs and other expenses were reduced. Contracts regarding IT, security and ATMs among other things were terminated in the end of 2011.

(68) By year-end 2013 the rationalisation will be fully effective. It is estimated that it will result in annual cost reduction of about ISK 29 million, excluding the one-off gain of sale of assets. These measures have already been implemented and completed in accordance with the plan.

- *Amended internal rules on risk management, behaviour rules, etc.*

(69) The board of directors of SpNor have adopted new rules on risk management to ensure that the savings banks stays solvent and to ensure it continues to operate within the capital base requirements for financial institutions which are set out in Act No. 161/2002 on financial institutions. New rules of conduct have been adopted for the board of directors and management that are based on FME´s guidelines No. 1/2010.

(70) Moreover, the amendments mentioned above of the provisions on savings banks in Act No. 161/2002 on financial institutions imply that earlier provisions preventing the sale of active guarantee capital holdings without the board´s approval have been abolished in 2010. The rule that each party can only hold 5% of voting rights has also been abolished. Thus, guarantee capital can now be traded freely and has now become a more attractive option for investors.

- *Full disclosure of impaired assets*

(71) SpNor confirms that all impaired assets, including lending, shareholdings and bonds have been accounted for.

(72) All loans in ISK linked to the exchange rate of foreign currencies that Icelandic courts have deemed illegal have been written down. Four credit facilities linked to the exchange rate of foreign currencies remain that Nordfjordur Savings Bank considers legitimate.

4.2.3 Financial overview in main case scenario

(73) The calculation of the base case scenario in Nordfjordur Savings Bank's 5-year restructuring plan is based on the bank's financial statements for 2012 and covers the years 2013-2017. On the basis of the above assumptions and measures of the restructuring plan, the implication for the bank's profit and loss statement and balance sheet is set out in Tables 3 and 4 below.

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Net interest income	157	88	127	126	151	168	196	211	218	225	231
Net fee and commission income	36	39	33	26	24	26	22	23	23	24	25
Other income	414	-763	-58	57	54	46	16	16	17	17	17
- Thereof: market & exchange difference and net financial income	394	-779	-84	37	36	10					
Net operating income (- Loss)	606	-635	102	209	229	240	234	250	258	266	273
Salaries and related expenses	-96	-118	-64	-75	-77	-77	-67	-69	-71	-73	-74
depreciation	-106	-130	-95	-108	-116	-111	-105	-108	-111	-114	-116
Impairment of assets	-37	-115	-189	-205	-42	-21	-20	-20	-20	-20	-20
Financial restructuring				269							
Income tax and bank levy	-63	182	62	-4	-6	-11	-10	-12	-13	-14	-14
Net earnings (- Loss)	305	-816	-183	87	-12	19	31	40	43	45	48
Return on equity (ROE)		-603.4%	-148.8%	14.7%	0.9%	3.3%	5.3%	6.4%	6.4%	6.4%	6.3%
Interest margin	3.2%	1.5%	2.3%	2.4%	2.9%	3.2%	3.7%	3.9%	4.0%	4.0%	4.1%
Cost to average total assets ratio		4.3%	2.8%	3.4%	3.8%	3.6%	3.3%	3.3%	3.3%	3.4%	3.4%
Cost to net operating income ratio		-39.1%	151.1%	87.5%	85.3%	76.6%	73.6%	70.9%	70.5%	70.2%	70.0%

Table 3: Financial overview 2007-2012 and forecast 2013-2017 (base case scenario)
Amounts in million ISK

(74) Table 3 provides an overview of the main components of the Profit and Loss Statement for the years 2007-2012 and a forecast for 2013-2017. Based on the assumptions of the restructuring plan this leads under the base case scenario to annual profits for SpNor during the restructuring period in the order of ISK 31 to 48 million. Net interest income for the same period is estimated to be in the order of ISK 196 to 230 million implying an interest margin of 3.7 to 4.1%. While income from financial trading was considerable in the past, no estimates are made for such earnings in the restructuring plan. Return on equity will be in the order of 5.3% to 6.4%.

(75) Table 4 below provides the main components of the balance sheet and of capital ratios in the past six years and a forecast of the same key financial data for the restructuring period. Based on these projections, the outcome is that the CAD ratio, which was 18.7% at year-end 2012, will be 19.2% at year-end 2013 and will gradually rise to 25.4% at year-end 2017. This is above the regulatory requirements set by the FME, which as from July 2013 were changed from 16% to 16.9%. It shall be noted that on 30 August 2013, SpNor issued its interim financial statements for the first half of 2013, according to which the CAD ratio is 18.8% on 30 June 2013, well above the FME´s requirements.

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Cash and receivables to credit inst.	544	1,383	1,966	1,745	1,277	1,674	2,100	2,152	2,233	2,288	2,346
Loans and appropriated assets	3,218	3,492	2,884	2,640	2,760	2,669	2,831	2,899	2,958	3,015	3,071
Bonds, shares & equity instruments	1,822	707	414	569	932	653	151	139	106	107	108
Other assets	149	246	287	270	261	246	240	225	209	192	175
Total assets	**5,734**	**5,828**	**5,551**	**5,223**	**5,230**	**5,242**	**5,323**	**515**	**5,506**	**5,602**	**5,700**
	0	0	0	0	0	0	0	0	0	0	0
Deposits	3,252	3,847	4,382	4,424	4,428	3,432	3,400	3,536	3,668	3,806	3,938
Borrowings	1,004	1,360	179	0	0	726	487	355	218	0	0
Other debt	87	143	113	84	94	54	55	55	55	55	55
Liabilities	223	163	0	0	0	166	161	166	171	176	180
Subordinated liabilties	155	181	196	124	131	277	288	298	307	316	324
Total debt and liabilities	**4,720**	**5,693**	**4,869**	**4,633**	**4,652**	**4,656**	**4,390**	**4,411**	**4,419**	**4,353**	**4,498**
	0	0	0	0	0	0	0	0	0	0	0
Guarantee capital	217	314	484	626	626	668	514	514	514	514	514
Retained earnings	796	-179	-361	-35	-47	-224	2	11	25	40	59
Total equity	1,013	135	123	591	578	444	515	525	539	554	573
	0	0	0	0	0	0	0	0	0	0	0
Total debt, liabilities and equity	**5,734**	**5,828**	**5,551**	**5,223**	**5,230**	**5,100**	**4,905**	**4,936**	**4,958**	**4,907**	**5,071**
Tier 1 ratio	11.8%	-2.6%	2.6%	16.7%	15.4%	16.5%	17.9%	19.4%	21.5%	23.2%	25.4%
Tier 2 ratio	3.5%	1.7%	1.8%	0.0%	2.8%	2.2%	1.3%	0.7%	0.3%	0.0%	0.0%
CAD ratio	15.3%	-0.9%	4.4%	16.7%	18.2%	18.7%	19.2%	20.1%	21.8%	23.2%	25.4%

Table 4: Balance sheet and capital ratios year-end 2007-2012 and forecast 2013-2017
Amounts in million ISK

4.2.4 Stress testing

(76) The restructuring plan includes certain stress testing. In the best case scenario, the main underlying assumptions are that inflation will be steady at 1.0% for the whole period. Positive court rulings regarding FX linked loans will justify revising prior impairments in 2013 in the amount of ISK 20 million. Special taxes on financial companies will be abolished, such as Financial Administrative Tax.

(77) The implications of the best case scenario are *inter alia* that annual net interest income will be ISK 213-244 million during 2013-2017, implying an interest margin of 4 – 4.5%. Costs in proportion to operating income during the same period are estimated to decline to 61-63%. This scenario would lead to annual after-tax profits rising to ISK 70-85 million and return on equity to reach 12.7%. Finally, the CAD ratio would rise from 18.7% at year-end 2012 to 31.6% in 2017.

(78) In the worst case scenario, the main underlying assumptions are that annual inflation will be 7% during the forecast period. Negative results in court rulings regarding foreign exchange loans would lead to additional impairments of ISK 160 million. Financial Administrative Tax would rise from 6.75% to 9.25%. Furthermore, there would be contraction in the fishing industry and lower aluminium prices resulting in additional impairments of ISK 25 million a year.

(79) The implications of the worst case scenario are that for the years 2013-2017 net interest income would be ISK 158-183 million, implying an interest margin of 3.0 - 3.2%. Costs in proportion to operating income would be around 86 - 90%. Cumulative profits for the same years would be negative by ISK 195 million And return on equity would also be negative, by -22.3% in 2013 and -3.5% in subsequent years. This would also imply a decline in the CAD ratio from 18.6% at year-end 2012 to 12.7% at year-end 2017.

4.3 Burden sharing and exit strategy

(80) The financial restructuring completed in June 2010 implied, amongst other things, that the guarantee capital of existing owners was written down by 41.7% (ISK 202 million). However, it must be taken into account that in 2009 several local parties had already agreed

to inject ISK 218 million in new capital into the savings bank. The write-down did not affect those holders per se, only the existing guarantee capital holders who were left with ISK 62 million after the write-down, implying a write-down of 76.4% for these parties. The increase in guarantee capital following this write-down, amounting in total to ISK 344, was 43.6% through the conversion of CBI claims but 56.4% by other subordinated creditors and an injection from other parties.

(81) As concerns the restructuring of debt, it was a prerequisite that creditors other than the CBI participated actively in the restructuring measures. Thus, of the total conversion of claims of ISK 755 million, ISK 196 concerned the claims of creditors other than the CBI.

(82) As concerns exit strategy, all state-owned guarantee capital shares have been taken over by the Ministry of Finance which has assigned the ISFI the task of administering the holding. The savings bank will be able to purchase the guarantee capital holding later. While no definite changes are currently foreseen in the ownership of Nordfjordur Savings Bank in the near future, it is the task of the ISFI to make proposals to the Minister of Finance as to whether and, if so, when specific holdings in the savings banks should be offered for public sale and to draft and prepare proposals for the sale of the state´s holding in them. As concerns claims converted to general unsecured debt, the Icelandic authorities have informed that the duration of the general loans will be five years. However, given the remuneration for these loans (cf. section II.3.4 below), the borrower may pay down or pay off a general loan at any time at no extra charge. This is meant to act as an incentive for the bank to seek alternative forms of capital in the short term.

(83) Information has also been provided on the remuneration of the aid instruments as well as on steps taken to ensure that the aid is limited to what is necessary in order to achieve the objectives. Further details on burden sharing, remuneration and exit strategy are considered in section II.3.4 below.

4.4 Measures to limit distortions of competition

(84) The Icelandic authorities have argued that the measures were extremely well targeted to maximise the recovery of the claims on the savings bank whilst stabilising the Icelandic economy.

(85) Furthermore, the Icelandic authorities do not anticipate that there will be any adverse spill over effects on other EEA States or undue distortions of competition. This is especially true as the savings bank is active mostly only on local markets in Iceland.

(86) The Icelandic authorities have indicated that no behavioural commitments have been or will be imposed upon Norfjordur Savings Bank. In their view such commitments are unnecessary and would not prevent distortions of competition but rather encourage them by making it virtually impossible for the savings banks to compete with the larger commercial banks.

II. ASSESSMENT

1. The presence of state aid

(87) 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."

1.1 Presence of state resources

(88) In order for a measure to constitute state aid, it must be granted by the State or through state resources.

(89) The Authority considers that as concerns the settlement of claims by the CBI on the savings bank, those measures involve the use of state resources, given the fact that the CBI is a part of the Icelandic State.

(90) The same applies to the measure to instruct the CBI to take over the obligations of Sparisjódabanki Íslands due to deposits of SpNor in that bank. This instruction is made by the FME, the state institution responsible for financial supervision, on the basis of the Emergency Act No. 125/2008, and is taken on by the CBI, which is part of the State.

(91) As regards the additional state backing of deposits in commercial and savings banks, the Authority has in its decisions regarding restructuring aid to three Icelandic commercial banks already concluded that this measure includes the use of state resources and involves state aid.[29] This conclusion applies equally in the case of savings banks.

1.2 Favouring certain undertakings or the production of certain goods

(92) In order for a measure to qualify as state aid, it must firstly confer on the savings bank advantages that relieve it of charges it normally bears from its budget. The settlement of claims on SpNor by the CBI implies that the bank will be able to absorb its impairments and losses of financial assets and thus avoid insolvency whereas competitors faced with similar difficulties would have to absorb such losses without government support. The Authority therefore considers that this condition is met with regard to the CBI settlement.

(93) The responsibility shouldered by CBI for the bank's deposits previously in SPB also represents an advantage for SpNor, as the bank would otherwise have faced the risk of those assets losing value in the liquidation of SPB.

(94) Second, the measures must be selective in that they favour "*certain undertakings or the production of certain goods*". The Authority considers that all the measures are selective as they benefit either only the savings bank in question or all commercial and savings banks, whereas undertakings in other sectors receive no such benefits.

(95) Furthermore, the proposed measures would not have been provided by a market economy investor expecting a reasonable return on investment. Indeed, the intervention by the CBI to take responsibility for the savings bank´s deposits in SPB and later to adjust its claims on the bank was already dictated by the Icelandic authorities´ will to save the Icelandic savings banks network, exceeding any private economy operator logic.

1.3 Distortion of competition and effect on trade between Contracting Parties

(96) For the measures to qualify as state aid they must distort competition and affect trade between the Contracting Parties. The Authority considers that the measures may distort competition as they favour particular undertakings whereas they do not benefit some of their competitors. Although minor in nature in the EEA context the measures are also capable of affecting trade between the Contracting Parties. The savings banks, although primarily active

[29] See for instance the Authority's Decision No. 292/12/COL of 11 July 2012 on restructuring aid to Arion Bank, section II.1, available at http://www.eftasurv.int/media/decisions/291-12-COL.pdf.

on local Icelandic markets, operate on financial markets which are in principle open to trade and competition within the EEA, implying for instance that the savings banks provide financial services to *inter alia* export companies, hold loans in foreign currencies and have borrowed via SPB on foreign capital markets.

2. Procedural requirements

(97) 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"*.

(98) By submitting a notification of the restructuring scheme on 31 January 2012 and an updated restructuring plan on 16 September 2013, the Icelandic authorities have complied with their requirement to do so under Article 1(3) of Part I of Protocol 3.

3. Compatibility of the aid

3.1 Legal basis for assessment of compatibility – Article 61(3)(b) EEA

(99) While state aid to undertakings in difficulties is normally assessed under Article 61(3)(c) of the EEA Agreement, the Authority may, under Article 61(3)(b) of the Agreement allow state aid *"to remedy a serious disturbance in the economy of an EC Member State or an EFTA State"*.[30] As stated in paragraph 8 of the Banking Guidelines, as amended and prolonged as of 1 January 2012[31], the Authority reaffirms that, in line with the case law[32] and the Authority´s[33] and the European Commission's decision making practice[34], Article 61(3)(b) of the EEA Agreement necessitates a restrictive interpretation of what can be considered a serious disturbance of an EFTA State's economy. Invoking this provision is therefore

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[30] Prior to 2008, the corresponding exemption under European Union law, now Article 107(3)(b) of the Treaty on the Functioning of the European Union (TFEU), was rarely applied by the Commission, mainly because of the strict interpretation given to the concept of "serious disturbance in the economy of a Member State".

[31] See the chapter on the application, from 1.1.2012, of state aid rules to support measures in favour of banks in the context of the financial crisis, available at: http://www.eftasurv.int/media/state-aid-guidelines/Part-VIII--Financial-Crisis-Guidelines-2012.pdf.

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

[33] See the Authority´s decisions from June and July 2012 regarding restructuring aid to the three Icelandic commercial banks, Arion Bank, Íslandsbanki and Landsbankinn, available at http://www.eftasurv.int/state-aid/state-aid-in-the-eea/articles/nr/1742

[34] See e.g. Commission decision 88/167/EEC of 7.1.1987 concerning Law 1386/1983 by which the Greek government grants aid to the Greek industry, OJ 1988 L 76/18, Commission Decision 98/490/EC in Case C 47/96 *Crédit Lyonnais* (OJ L 221, 8.8.1998), point 10.1; Commission Decision 2005/345/EC in Case C 28/02 *Bankgesellschaft Berlin* (OJ L 116, 4.5.2005), points 153 *et seq.*; and Commission Decision 2008/263/EC in Case C 50/06 *BAWAG* (OJ L 83, 26.3.2008), point 166. See also Commission Decision in Case NN 70/07 *Northern Rock* (OJ C 43, 16.2.2008). In the early months of the financial crisis, the Commission maintained a strict approach to the interpretation of the provision, see e.g. Commission Decision in Case NN 25/08 *Rescue aid to Risikoabschirmung WestLB* (OJ C 189, 26.7.2008) and Commission Decision of 4 June 2008 in State aid C 9/08 *SachsenLB* (OJ L 104, 24.4.2009). However, the systemic nature of the turbulence in the European financial sector and the close interconnection of financial activity has since then been widely acknowledged with the adoption of the temporary financial crisis guidelines based on this provision and of more than 360 decisions during 2008-2013 on state aid to banks in most EU Member States.

possible only as long as the crisis situation persists, creating genuinely exceptional circumstances where financial stability at large is at risk.[35]

(100) As regard compatibility of the measure, it must therefore be assessed whether the aid remedies a serious disturbance in the economy of Iceland.

(101) The Icelandic authorities have explained that Iceland's financial system entered into a state of systemic crisis in October 2008, leading to the collapse of its major commercial banks within a time span of a few days. The combined market share of the collapsed financial institutions exceeded 90% in most segments of the Icelandic financial markets. The difficulties were coupled with a breakdown of confidence in the country's currency and Iceland's real economy has been severely hit by the financial crisis. It was under these circumstances that aid under the CBI Scheme was introduced to remedy a serious disturbance in Iceland's savings bank sector and approved by the Authority in June 2010 on the basis of Article 61(3)(b) of the EEA Agreement. Although more than four years have passed since the onset of the crisis, the Icelandic financial system still remains vulnerable. While the situation has eased significantly since 2008, it is nevertheless evident that at the time the measures were taken, they were intended to remedy a serious disturbance in the economy, as the insolvency of SpNor and four other small savings banks could have lead to spill-over effects that could have posed a threat to financial stability.

(102) Even though SpNor is a very small bank,[36] its counterparts might not have distinguished between financial institutions and as a result, the failure of one bank could have generated a lack of confidence that could have extended to the whole sector. It cannot be excluded that this might have led to an unavailability of deposits, which in turn could have destabilised the entire financial sector in the country. Measures in support of SpNor must therefore be seen as a part of Iceland's overall effort to promote the sustained operations of the country's remaining savings banks. The failure of one bank could affect the entire savings banks sector and possibly also other financial undertakings and the economy as a whole. The Authority therefore takes the view that the restructuring of SpNor and other savings banks aims to remedy a situation that could result in a serious disturbance for the economy of Iceland. Accordingly, the measures may be examined under Article 61(3)(b) of the EEA Agreement.

3.2 The application of the Restructuring Guidelines

(103) In Decisions No. 253/10/COL and No. 127/11/COL[37], approving temporarily as rescue aid the scheme under assessment in this case, the measures were assessed on the basis of the Banking and the Recapitalisation Guidelines. This involved assessing *inter alia* the appropriateness of the measures, their necessity and proportionality together with the remuneration of the aid instruments. Given that there has been no change that would invalidate these evaluations, the assessments remain valid also in this decision. The

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[35] 2013 Banking Guidelines, point 6 (not yet published) and Banking Guidelines 2008, point 11, available at: http://www.eftasurv.int/state-aid/legal-framework/state-aid-guidelines/

[36] See the Commission assessment of small banks, in e.g. Commission Decision SA 33639, 2011/N *Rescue Aid for Max Bank*, OJ C 343, 23.11.2011, p.13, esp. points 57-61 and Commission Decision N 560/2009 *Aid for the liquidation of Fionia Bank*, OJ C 76, 10.03.2011, p. 3-6, esp. points 66-70. Article 107(3)(b) of the TFEU and the financial crisis communications have also been applied by the Commission to aid measures in support of regional savings banks, including savings banks in Spain. See for instance the following state aid cases: SA.34546, Restructuring of CEISS, OJ C 96, 04.04.2013, SA.35488 Restructuring of Bank Mare Notrum, OJ C 96, 04.04.2013, SA.35489 Restructuring of Caja3, OJ C 96, 04.04.2013, and SA.35490 Restructuring of Liberbank, OJ C 96, 04.04.2013.

[37] Decision No. 127/11/COL does not apply to Nordfjordur Savings Banks and was thus not explained in any detail in the restructuring plan.

temporary approval was subject to the submission of a satisfactory restructuring plan which is the subject under review in the present decision.

(104) The Authority's State Aid Guidelines on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the state aid rules ("Restructuring Guidelines")[38] sets out the state aid rules applicable to the restructuring of financial institutions in the current crisis.[39] According to the Restructuring Guidelines, in order to be compatible with Article 61(3)(b) EEA, the restructuring of a financial institution in the context of the current financial crisis has to:

(i) Lead to a restoration of the long-term viability of the bank;
(ii) Include sufficient own contribution by the beneficiary (burden-sharing);
(iii) Limit distortion of competition and ensuring a competitive banking sector.

(105) The Authority will assess below, based on the restructuring plan submitted, the compatibility of the notified restructuring measures in particular by taking into account the above criteria.

3.3 Restoration of viability

(106) Restoring the long-term viability of a beneficiary in receipt of restructuring aid is the main objective of such aid, and the assessment of whether the restructuring plan will attain this is an important aspect in determining compatibility.

(107) As indicated above, the turmoil in the Icelandic economy in the wake of autumn 2008, the presence of extra-ordinary measures such as the capital controls, an evolving regulatory environment and a macro-economic outlook that, in spite of some recent stabilisation, remains somewhat uncertain, given in particular the ongoing economic woes of the Euro zone, make it challenging to operate a bank profitably and ensure its long-term viability. The Authority emphasises at the outset that this consideration needs to be borne in mind in the below assessment.

(108) Section 2 of the Restructuring Guidelines sets out that the EEA State should present a comprehensive and detailed restructuring plan which provides complete information on the business model and which restores the bank's long-term viability. Paragraph 10 of the Restructuring Guidelines requires that the restructuring plan identifies the causes of the bank's difficulties and the bank's own weaknesses, and outlines how the proposed restructuring measures remedy the bank's underlying problems.

(109) The savings banks in Iceland were hit hard by the financial crisis. Firstly, the economic collapse had a major effect on the ability of many debtors in Iceland to service their debt. Inflation rose sharply, interest rates shot up and debt in foreign currency soared, due to sharp depreciation of the Icelandic krona. This rapidly led to defaults by debtors, causing severe liquidity problems, subsequent write-offs and loss on balance sheets for the savings banks. Secondly, as the Icelandic stock exchange caved in, assets of many savings banks in the form of shares in companies registered on that market became more or less worthless. Thirdly,

[38] The guidelines adopted on 25 November 2009 were published in OJ L 292 and EEA Supplement No. 61, 10.9.2011. They are also available at the Authority´s website at: http://www.eftasurv.int/state-aid/legal-framework/state-aid-guidelines/.

[39] On 27 November 2013, the Authority adopted new Banking Guidelines ("2013 Banking Guidelines") , replacing the temporary Banking Guidelines adopted in January 2009. The new guidelines also supplement the Restructuring Guidelines. However, as the measures currently under assessment were notified and approved temporarily prior to the adoption of the new guidelines, the new guidelines are not applicable in the present case.

financial instruments issued by the three major banks became nearly worthless, but many of the savings banks held such securities on their books.

(110) Moreover, most savings banks owned shares in SPB which was taken over by the FME on 21 March 2009 and is now in winding-up proceedings. The causes of the savings bank difficulties are not the least to be found in the collapse of SPB which served the role of a clearing house for the savings banks before the crisis as well as providing them with access to *inter alia* foreign credit and providing various other common services.

(111) As concerns SpNor in particular, investments in shares and bonds had grown during the years prior to the onset of the financial crisis and earnings on those investments accounted for a growing proportion of net earnings. Thus, net income from financial assets had grown from ISK 8 million in 2003 to ISK 394 million in 2007. As it turned out, this diversification in the savings bank´s operation was also the main weakness in its strategy, when prices of financial assets tumbled. The financial investments made pre-crisis by SpNor were to a large extent linked to shares in the collapsed banks, other financial undertakings or securities issued by those undertakings. The collapse of those undertakings therefore implied that financial trading, which had become a growing part of the savings bank's operation, stopped abruptly and the assets largely evaporated. This had clear implications for the operations of SpNor, largely eliminating a significant part of its earnings and reducing significantly the value of its assets.

(112) The main reason for the bank´s difficulties are linked to the implication of the financial and currency crisis, which unravelled in October 2008 and the collapse of the three commercial banks. In addition to the direct negative effect on the bank´s assets and liability, outlined above, the traditional operations of the bank were adversely affected. The economic implications showed up *inter alia* in the collapse of the currency, increased inflation, steeply rising unemployment and falling real estate prices. This led in turn to reduced ability of the bank´s clients to service their debt and hence to increased credit losses and higher credit risks.

(113) Furthermore, of particular importance is the very sharp fall in the value of shares and bonds, which is a direct consequence of the collapse of the commercial banks and the tumbling stock and securities markets. In 2007, income and gains of financial assets amounted to ISK 394 million, while in 2008 the bank suffered a loss of such operations of ISK 770 million.

3.3.1 The restructuring plan for SpNor

(114) The financial difficulties experienced by SpNor are largely related to the financial crisis in Iceland. While the bank is of course part of the Icelandic financial sector, the Authority considers that significant causes of the bank's difficulties are external, given the small size of the bank and the fact that its growth up until October 2008, although significant, was not comparable to the excessive and unsustainable expansion of the commercial banks, which was among the main causes of the crisis.

(115) In so far as internal weaknesses have contributed to the bank's difficulties, these relate mostly to increased focus on financial trading, as is for instance reflected by the increased share of income from such trading in relation to the bank's total income. However, this "speculative" part in the bank's operations was almost automatically removed overnight, when the bigger financial undertakings in which SpNor held shares or bonds, collapsed in October 2008 and March 2009.

(116) The financial restructuring implemented in June 2010 remedied the immediate financial difficulties of SpNor. The operability of this small financial undertaking will continue to

remain challenging.[40] The bank will need to increase its interest margin and profitability will remain modest, with return on equity in the order of 5.3 – 6.3% in the base case scenario. The restructuring plan is nevertheless expected to ensure that the bank will continue to meet regulatory CAD requirements well above the FME's minimum.

(117) According to the restructuring plan, the bank's strategy is to continue to focus on traditional savings banks operations of receiving deposits from the public and granting loans on that basis, together with related retail financial services to the local community. The bank aims to largely dispose of its assets in the form of shares and equity instruments, and the restructuring plan does not rely on any net earnings on such financial assets. The bank plans to gradually increase its net interest income, mostly through increased lending or other means to obtain higher returns on available liquid funds. Provided the bank's capital needs will not be compromised, this is likely to improve its long-term viability.

(118) According to the restructuring plan, the banks strategy includes several measures aimed at reducing costs and increasing operational efficiency. The bank has, among other things, laid off staff by closing the Reyðarfjörður branch office, limiting salary costs of executives and limiting the rise in IT costs. While the scale of those measures is modest they must nevertheless be considered significant, given the small size of the bank where the scope for such internal restructuring measures is inevitably limited.

(119) The measures being taken by the bank to amend its internal rules on risk management and investment policy, in line with FME guidelines, must also be regarded positively and likely to support the bank's long-term viability.

(120) As explained in section I.4.2.4, the restructuring plan includes certain stress testing. A best case scenario is provided assuming that *inter alia* that annual net interest income and the interest margin will rise considerably. and the implication of this scenario are that the CAD ratio would rise from 18.7% at year-end 2012 to '31.6% in 2017. The worst case scenario would on the other hand lead to the cumulative operating profits of Nordfjordur Saving Bank for the years 2013-2017 to be negative in the amount of ISK 195 million and the CAD ratio would decline from 18.7% at year-end 2012 to 12.7% in 2017. Thus, while SpNor would at the end of the restructuring period remain solvent and meet the minimum capital adequacy requirements as set by national law, it would not meet the regulatory requirements as set by the FME.

(121) According to the FME liquidity requirements, the bank's total liquid assets (funds, current account, assets eligible for central bank lending facilities) must amount to at least 10% of on-demand deposits and cash or cash equivalents must amount to at least 5% of on-demand assets. The SREP report completed on 1 July 2013 confirms that SpNor currently meets these liquidity stress test. Indeed, its liquidity position is very solid, as the former ratio was 50% and the latter was 29%. For these reasons, the FME saw no need to require additional measures to safeguard the bank´s liquidity position. The SREP report furthermore reveals that SpNor managed to reduce the ratio of non-performing loans in its loan portfolio from 17.8% to 8.2% in the course of 2012.

[40] While studies on economies of scale in banking reveal mixed results and size in itself is not an overriding determinant of the viability of banks, the currently applicable FME rules No. 216/2007 on financial undertakings´ large exposures clearly restrict the scope for lending to bigger and even medium-sized customers especially of the smallest financial undertakings. According to the rules large single exposures must not exceed 25% of the bank´s capital base. In view of the capital base of SpNor at year-end 2012, this implies that the limit on large single exposures is below ISK 130 million.

3.3.2 Regulatory viability measures

(122) Whilst the SpNor restructuring plan addresses many of the bank's weaknesses as identified above, the Authority considers that the collapse of the Icelandic commercial banks, which had dire consequences for the savings bank, was also caused by a number of factors specific to Iceland, relating to the regulatory and supervisory shortcomings highlighted by the Special Investigation Commission.[41] The long-term viability of SpNor, such as that of any other Icelandic bank, thus does not depend solely on the measures taken at the bank's level, but also on whether those supervisory and regulatory shortcomings have been remedied.

(123) In this regard the Authority notes positively the amendments to the regulatory and supervisory framework that the Icelandic authorities have made, as outlined in Section I.2.3 above.[42]

(124) First, the powers and competences of the FME have been enhanced, *inter alia* with new responsibilities regarding large single exposures and the risks related thereto, which in the Authority's view address one of the factors that led to the financial collapse.

(125) Second, the temporary high CAD ratio requirements should contribute to the resilience of the savings bank. There are also a number of provisions relating to collateralisation, in particular the prohibition of extending credit against pledges of own shares, aim at ensuring that Icelandic banks cannot once again build up a weak capital position. The Authority considers that these measures will contribute to the resilience of the Icelandic banks.

(126) Third, a range of measures have been implemented relating to the eligibility of directors and board members, as well as their remuneration. Moreover, lending to related parties (such as owners) has been subjected to stricter rules, and the FME can now prohibit a bank from performing specific activities, if it sees reason to do so. External and internal accounting rules have also been amended, for example the duration for which an external accountant can work for the same bank has been shortened. The Authority notes positively that these measures are aimed at preventing a repetition of events in so far as the owners and high executives are concerned, and the measures also increase external risk monitoring, both of which reduce threats to the banks' viability.

(127) Fourth, according to the Icelandic authorities, the already mentioned possibility for the FME to limit a bank's activities, is also prompted by the large-scale deposit taking by Icelandic commercial banks before the crisis, which seems to at least have accelerated their demise. Moreover, the new rules on liquidity and foreign exchange balance also appear, in the Authority's understanding, to entail certain restrictions as regards the banks' possibility to attract disproportionately large amounts of foreign deposits if that were to make the banks' business more fragile and vulnerable to foreign currency exchange and liquidity risks. The

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[41] The Icelandic Parliament set up a Special Investigation Commission ("SIC") to investigate and analyse the processes leading to the collapse of Iceland's three main banks. Its 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/.

[42] It shall be noted, though, that the boards and managements of savings banks have pointed out that the more stringent regulatory framework introduced following the financial crisis amounts to an extra regulatory burden on savings banks. Special taxes and additional public levies have also been introduced (this includes a special salaries´ based tax on financial undertakings, a special bank tax based on liabilities (irrespecitve of profit), increase in levies to fund financial supervision, new levies to finance the Debtors´ ombudman´s office and increased contributions to the deposit guarantee fund). While there is no reason to doubt that these have amounted to an increased regulatory burden for the savings banks, there are also reasons to expect that the regulatory amendments were necessary and will contribute to the long term viability of the savings banks.

Authority welcomes that the Icelandic authorities have responded to this aspect of regulatory failure.

(128) The Authority also notes positively the law amendment passed by the Icelandic parliament in June 2012 of the provisions on savings banks in the Act on Financial Undertakings. The amendments allow savings banks to change their legal form and thus facilitate mergers with other savings banks or financial undertakings. They should thus promote investments in savings banks and make it easier for them to acquire new capital which in turn enhances their viability.

3.4 Burden sharing, remuneration and exit strategy

(129) In order to limit distortion of competition and address moral hazard, aid should according to the Restructuring Guidelines be limited to the minimum necessary. The beneficiary should provide an appropriate own contribution to the restructuring costs and when activities do not generate sufficient profits, state aid should not be used to remunerate own funds (i.e. dividends on equity and subordinated debt). The aid measures should also include exit incentives.

(130) The CBI Scheme does not provide aid in the form of new capital injections by the state, but rather the restructuring of claims already owned by the CBI. It is designed to ensure that the savings banks concerned can meet the regulatory capital adequacy requirement under national law and as set by the Financial Supervisory Authority (the FME). The scheme is also to the benefit of the CBI, as the aim is at the same time to maximise the value of the claims to the CBI.[43]

(131) The CBI being a major creditor of the bank, the treatment of its claims decided upon in June 2010 were sufficient for the bank to match the minimum requirements. Given that SpNor only held relatively few illegally indexed loans, the judgments on such loans did not have the same negative effects as in the case of other savings banks. The initial aid measures were therefore largely sufficient. The aid measures in the form of write-down and conversion of CBI claims on SpNor have been limited to what was necessary for the bank to attain statutory capital requirements and have thus not been excessive.

(132) As concerns own contribution, the financial restructuring of SpNor implied firstly that the previous owners of guarantee capital in the bank lost to a significant extent their assets, as guarantee capital was written down (cf. section I.4.3 above). Secondly, the CBI made it a condition for implementing the measures that other creditors participated in the financial restructuring of the savings banks in a similar manner as the CBI, thus ensuring equality and fair burden sharing. Following restructuring, the savings banks withdrew their applications for a capital injection from the State under section 2 of the Emergency Act. The Icelandic authorities have confirmed that there will be no direct financial assistance from the State in addition to the rescue measures already undertaken.

(133) It must also be taken into account that as a part of the restructuring process, SpNor has decided to undertake various rationalisation measures, including closing its branch in Reyðarfjörður, reducing its staff and cutting salaries of its management.

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[43] In this regard the Icelandic authorities have submitted that after the SPB claims on the savings banks were transferred to the CBI it had two options: either to collect the claims, which would have resulted in the bankruptcy of the savings banks and a financial loss for the CBI, or maximising the value of the claims by working with the savings banks on their restructuring. According to the assessment of the CBI the latter option would lead to substantially higher recovery and was therefore chosen.

(134) As for remuneration, the claims converted into guarantee capital will be remunerated in the form of dividend payments and/or the sale of the guarantee capital when market conditions permit.

(135) For claims converted into subordinated loans, the term is seven years. Remuneration will be in the form of capital income of 400 bp premium on LIBOR interest rates for loans in foreign currency for the first two years, with a step up to 500 bp at the end of that period. For subordinated loans in ISK the remuneration is 300 bp on REIBOR interest rates for the first two years, rising to 400 bp at the end of that period.

(136) For claims converted into general loans, the duration is five years. This is to encourage the bank to seek alternative forms of capital in the short term. The borrower may pay down or pay off a general loan at any time at no extra charge. Remuneration will be in the form of capital income amounting to 350 bp premium on LIBOR interest rates for loans in foreign currency without collateral and 300 bp premium on LIBOR interest rates for such loans with collateral. For loans in ISK, the remuneration is 250 bp premium on REIBOR interest rates for loans without collateral and 200 bp for such loans with collateral.

(137) With reference to the above, the Authority is of the view that an adequate own contribution to the restructuring costs has been provided by the aid beneficiary and its owners and that the burden has been appropriately shared by those who had invested in the savings bank. The Authority also considers that the Icelandic authorities have demonstrated that SpNor will appropriately remunerate the CBI for the support it receives. This will further limit the amount of aid granted. It has furthermore been demonstrated to the Authority's satisfaction that an acceptable exit strategy is in place.

3.5 Limitations to distortions of competition

(138) The overriding purpose of aid to financial undertakings is to support financial stability in times of systemic crisis. However, such aid can nevertheless create distortions of competition in various ways. It is therefore normally required that restructuring plans of recipients of such aid include concrete measures designed to limit distortions of competition, aiming to maintain a competitive banking sector. Nevertheless, as explained in Chapter 4 of the Restructuring Guidelines, measures to limit distortions of competition should always be tailor-made to address the distortions identified on the markets where the beneficiary bank operates. As is acknowledged in paragraph 20 of the 2013 Banking Guidelines, the application of measures to limit distortion of competition has in practice depended on the degree of burden-sharing. In other words, enhanced burden-sharing implies a reduced need for measures addressing competition distortions. When evaluating the need for such measures, the Authority takes into account *inter alia* the size, relative importance and market presence of the bank and the characteristics of the market on which the beneficiary bank will operate following implementation of the restructuring plan, the amount of aid it will receive, the degree of burden sharing of the recipient, its owners and subordinate creditors as well as the conditions and circumstances under which the aid is granted.

(139) Before the emergence of the financial crisis in 2008, the operations of Iceland's three major commercial banks had for a few years grown exponentially, particularly with activities abroad. Following the collapse of those banks in the wake of the financial crisis, the Icelandic financial sector is being restructured where successor banks have been founded taking over mostly the domestic operations of their predecessors, while activities abroad have been discontinued. The market is thus national in nature to a significant degree. This has been amplified by restrictions on capital movements which were introduced in November 2008 following advice of the IMF and still remain in place. Most segment of the financial market

in Iceland are dominated by the three new commercial banks which collectively account for over 90% of the market shares in most areas.

(140) As has been explained above, the Icelandic savings banks sector, which has always remained national and mostly local in nature, was hard hit by the financial and economic crisis. From 2008 onwards, the sector has contracted substantially. The biggest and more centrally located savings banks have exited the market. As a result, the combined market share of savings banks in the domestic banking market has collapsed from about 15-20% before the financial crisis to presently about 2%. The sector now consists of 9 small undertakings providing for the most part rudimentary financial services to individuals and SMEs. This includes the five savings banks eligible under the CBI Scheme and four other small savings banks that do not benefit from the scheme. All of these small financial undertakings are located outside the more densely populated south-west region of Iceland. Their total assets at year-end 2012 amounted collectively to ISK 57 billion (EUR 350 million), with a work force in total of about 110 employees.

(141) In view of the small size of the savings banks that remain in operation, their very modest market presence, the significant burden-sharing of the owners and the sub-ordinated creditors of the savings banks eligible under the CBI scheme, the Authority considers it clear that their continued operation will not constitute a competitive threat to other market participants. On the contrary, it appears more likely that the continued operation of smaller savings banks may support market dynamics and help to restrain the consequences of an otherwise oligopolistic market structure. In this regard the Authority has *inter alia* followed the review of the Icelandic Competition Authority (ICA) of conditions of competition in the national financial market following the financial crisis.[44]

(142) In view of the above considerations, the Authority can exceptionally accept that the restructuring plan for SpNor does not include any specific measures aimed at limiting the distortion of competition resulting from the aid granted to SpNor. It is apparent that the most critical element in the restructuring plan for SpNor is whether it will ensure long term viability of the bank. Insisting on competition remedies to compensate for the limited distortion of the aid might, in the special circumstances of this case, in fact jeopardise the bank's long term viability.

4. Conclusion

(143) On the basis of the above assessment and in the light of the restructuring plan submitted by the Icelandic authorities for Nordfjordur Savings Bank, the Authority is satisfied that the conditions set by the Restructuring Guidelines are met. It can therefore approve the aid measures as restructuring aid compatible with the functioning of the EEA Agreement pursuant to Article 61(3)(b) EEA.

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[44] This includes ICA's Decision No. 18/2013 regarding the planned acquisition of Landsbankinn of the assets and operations of Svarfdaelir Savings Bank (SpSv). As the merger was abandoned following the infusion of equity capital of the Savings Banks Insurance Fund to SpSv, the ICA did not render a final decision on the merger. However, in a decision closing the case, a reference is made to the statement of objections, which indicated that ICA was of the preliminary view that the merger infringed the competition act. The merger would reinforce the joint collective dominance of Iceland's three main commercial banks, Arion Bank, Íslandsbanki and Landsbankinn, in the operating region of SpSv as well as nationally. In the Icelandic financial market, a reduction in the number of market players would reinforce entry barriers for new players. That development would also be to the detriment of the operating conditions of the few remaining savings banks and their ability to compete with the commercial banks.

HAS ADOPTED THIS DECISION:

Article 1

The measures which the Icelandic authorities implemented to rescue and restructure Nordfjordur Savings Bank as set out in section I.3.2 above constitute state aid within the meaning of Article 61(1) of the EEA Agreement.

Article 2

The aid measures referred to in Article 1 are compatible with the functioning of the EEA Agreement pursuant to Article 61(3)(b). The authorisation for the unlimited deposit guarantee expires at the end of 2014.

Article 3

This Decision is addressed to Iceland.

Article 4

Only the English language version of this decision is authentic.

Decision made in Brussels, on 18 December 2013.

For the EFTA Surveillance Authority

Oda Helen Sletnes
President

Sverrir Hauhur Gunnlaugsson
College member