

Case No: 48084
Event No: 324014
Dec. No: 177/05/COL

EFTA Surveillance Authority Decision
of 15 July 2005

to amend the Authority's decision of 15 December 2004 to propose appropriate measures to the Principality of Liechtenstein regarding a State guarantee in favour of Liechtensteinische Landesbank

(Liechtenstein)

THE EFTA SURVEILLANCE AUTHORITY

HAVING REGARD TO the Agreement on the European Economic Area¹, in particular to Articles 61 to 63 thereof,

HAVING REGARD TO the Agreement between the EFTA States on the establishment of a Surveillance Authority and a Court of Justice², in particular to Article 24 thereof and Article 1 in Part I and Article 18 in Part II of Protocol 3 thereof,

HAVING REGARD TO the Procedural and Substantive Rules in the Field of State Aid³, and in particular Chapter 17 thereof,

HAVING REGARD TO the Authority's Decision of 15 December 2004⁴,

WHEREAS:

¹ Hereinafter referred to as the 'EEA Agreement'.

² Hereinafter referred to as the 'Surveillance and Court Agreement'.

³ Guidelines on the application and interpretation of Articles 61 and 62 of the EEA Agreement and Article 1 of Protocol 3 to the Surveillance and Court Agreement, adopted and issued by the EFTA Surveillance Authority on 19 January 1994, published in OJ 94 L 231, EEA Supplements 3.9.1994, No 32, last amended 17 June 2005, hereinafter "the State Aid Guidelines".

⁴ Decision No 385/04/COL.

A. Facts

1. Procedure

In connection with the introduction of new State Aid Guidelines on guarantees on 12 April 2000, the Authority invited the Liechtenstein authorities by letter dated 3 July 2000 (Doc. No 00-4765-D), to submit information on all guarantees and guarantee schemes which should have been notified in accordance with Article 1 (3) of Protocol 3 to the Surveillance and Court Agreement and regarding all State guarantees which might constitute existing aid.

The letter stated that information should be provided in particular with respect to the State guarantee to the Liechtensteinische Landesbank (hereinafter LLB). The State guarantee laid down in Article 5 of the Law concerning Liechtensteinische Landesbank ("*Gesetz über die Liechtensteinische Landesbank*", hereinafter LLBG) was originally reported to the Authority by letter dated 4 December 1995.

In a reminder letter of 24 November 2000 (Doc. No 00-8505-D) the Authority explicitly asked for information on the State guarantee to LLB.

In its reply by letter dated 6 December 2000 (Doc. No 00-9016-A), Liechtenstein referred the Authority to the information submitted in 1995 and informed it that the total amount covered by Article 5 LLBG amounted to approximately CHF 3.6 billion in 1999.

By letter of 8 May 2001 (Doc. No 01-3466-D), the Authority initiated a review according to Article 62 (1) of the EEA Agreement and Article 1 (1) of Protocol 3 to the Surveillance and Court Agreement. The Government of Liechtenstein was requested to submit comments on this matter and to provide the Authority with all information necessary to carry out an assessment of the State guarantee under the EEA state aid rules. Liechtenstein was further asked to submit information on the implementation of Directive No 94/19/EC on deposit-guarantee schemes.

By letter dated 29 June 2001 (Doc. No 01-5380-A), Liechtenstein submitted information on the implementation of Directive No 94/19/EC and stated that it was not exempted from participating in the obligatory deposit guarantee scheme. As regards the State guarantee, Liechtenstein stressed that LLB has a stated capital of 190 million CHF. Liechtenstein argued that due to the financial situation of LLB Article 5 LLBG does not give LLB a preferential position in attracting saving deposits or more favourable funding terms.

By letter dated 11 March 2004 (Event No 256909), the Authority informed the Liechtenstein authorities about its initial view concerning the State guarantee and gave them the possibility to comment. A meeting between representatives of the Liechtenstein coordination unit, representatives of LLB and representatives of the Authority's Competition and State Aid Directorate took place in Liechtenstein on 26 October 2004.

By letter dated 3 November 2004 (Event No 297858) the Authority, under Article 17 (2) in Part II of Protocol 3 to the Surveillance and Court Agreement, informed the Liechtenstein authorities of its preliminary view with regard to the State guarantee and gave the Liechtenstein authorities the possibility to comment.

By letter dated 2 December 2004 (Event No 301554), the Liechtenstein authorities commented upon the Authority's letters of 11 March 2004 and 3 November 2004.

On 15 December 2004, the Authority suggested to the Liechtenstein authorities to take the appropriate measures to eliminate any incompatible aid resulting from Article 5 LLBG (Decision No 385/04/COL). The Authority stated that any such aid should be abolished with effect from 1 August 2005. The Liechtenstein authorities were given until 21 March 2005 to accept the proposal and to communicate to the Authority the relevant measures it was going to take.

A meeting between the Authority's services and the Liechtenstein authorities took place on 31 January 2005. By letter of 21 March the Liechtenstein authorities communicated to the Authority its intention to amend the existing state guarantee in that in the future the guarantee should be linked to a specific amount, no longer be open ended and be granted against the payment of an adequate premium. The letter was received and registered by the Authority on 22 March 2005 (Event No 313888, however it was sent earlier by email on 21 March 2005).

As the Liechtenstein authorities envisaged engaging an expert to establish the adequate market premium for the guarantee, they asked for an extension of the deadline to communicate the precise appropriate measures. By letter dated 6 April 2005 (Event No 315191), the Authority extended the deadline.

The expert's report was presented to the Authority's services in a meeting with the Liechtenstein authorities on 12 May 2005. By letter dated 18 May 2005 the Liechtenstein authorities informed the Authority of their intention to follow the approach of the expert's study of calculating the market premium and that a yearly premium should be paid by LLB to the Liechtenstein State. The letter was received and registered by the Authority on the same day (Event No 319408). Further details on the detailed payment modus were submitted to the Authority by the Liechtenstein authorities by letter dated 17 June 2005. The letter was received and registered by the Authority on the same day (Event No 323207).

By letter dated 4 July 2005, the Liechtenstein authorities complemented *inter alia* the information on the payment mechanism. The letter was received and registered by the Authority on 5 July 2005 (Event No 325055).

2. Description of the State guarantee

LLB is acting as an universal bank (in the meaning of a full-service bank) in Liechtenstein and abroad. It is organised as an "Aktiengesellschaft" (public limited liability company) according to Liechtenstein law. The Principality of Liechtenstein holds 67% of LLB's shares.

LLB was founded in 1861 as the first bank in the Principality of Liechtenstein. In 1993 LLB was transformed into a public limited liability company. The prerequisites for transforming LLB were laid down in Article 1 LLBG of 21 October 1992 which entered into force on 4 January 1993.

Article 5 LLBG contains a State guarantee for certain of LLB's activities. According to that article, the Principality of Liechtenstein is liable for savings deposits ("Spareinlagen") and medium-term deposit certificates ("Kassenobligationen") of the Liechtensteinische Landesbank, to the extent that LLB's own resources are insufficient. Article 5 LLBG reads:

“Staatsgarantie

Das Land Liechtenstein haftet für die Sparguthaben bei der Landesbank und die Kassenobligationen der Landesbank, soweit ihre Mittel nicht ausreichen.“

It follows from that provision that LLB's customers have a direct claim against the Principality of Liechtenstein for their savings deposits and medium term notes in case LLB's assets are not sufficient to satisfy the creditors. The guarantee, according to Article 5 LLBG, is – as it stands today - open-ended in terms of the amount and the duration of the guarantee. LLB does not pay any premium for the guarantee. The State guarantee according to Article 5 LLBG has not been altered since 1993.

LLB is the only bank in Liechtenstein with a State guarantee on savings deposits and medium term deposit certificates⁵.

On the basis of information submitted by the Liechtenstein authorities, LLB is covered by the general obligations to take part in the deposit guarantee scheme established pursuant to the Banking Act and the Ordinance to the Banking Act as amended in 2000 for the implementation of the Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantees⁶.

3. The Authority's Decision of 15 December 2004

On 15 December 2004, the Authority concluded that the unlimited State guarantee which was granted to LLB without remuneration in the form of an adequate premium in favour of its savings deposits and medium-term notes, constituted state aid within the meaning of Article 61 (1) of the EEA Agreement. The Authority noted that by foregoing a market premium, the State incurred losses which constitute state resources. The guarantee also granted LLB an advantage, as it could receive better financial terms for a loan than those normally available on the market. The State guarantee grants a further advantage to LLB as it significantly reduces or even eliminates the risk of creditors entering into business with LLB. Further, the Authority found the guarantee to distort or threaten to distort competition and affect trade between the Contracting Parties. The aid could also not be justified under Article 59 (2) or 61 (3) c) of the EEA Agreement.

Article 5 LLBG existed before the entry into force of the EEA Agreement in Liechtenstein. The State guarantee given to LLB by virtue of Article 5 LLBG was therefore considered by the Authority to constitute existing aid within the meaning of Article 1(1) in Part I of Protocol 3 to the Surveillance and Court Agreement.

⁵ See for more details, Authority's Decision of 15 December 2004.

⁶ Implemented into Annex IX to the EEA Agreement by Joint Committee decision No 18/94 (OJ No L 325, 17.12.1994, p.70 and EEA Supplement No. 50, 17.12.1994, p. 52) e.i.f. 1.7.1995.

The Authority proposed to the Principality of Liechtenstein to take the appropriate measures to eliminate any aid resulting from Article 5 LLBG until 1 August 2005 and to communicate the acceptance of the proposal, together with the measures envisaged, until 21 March 2005. The Liechtenstein authorities did not explicitly accept the proposal for appropriate measures as stated in the Authority's Decision of 15 December 2004 within that given time frame, however, they communicated to the Authority – by letter dated 21 March 2005 – their intention to amend the existing State guarantee in that it should be linked to a specified amount, no longer be open-ended and be remunerated with a premium. The details, as outlined in the following section, were then further discussed between the Authority and the Liechtenstein authorities.

4. Comments by the Liechtenstein authorities

Liechtenstein stated, by letters dated 21 March 2005 and 18 May 2005, its will to amend the State guarantee to cover only a specified amount, to limit the guarantee in time and to provide for the payment of an adequate premium.

As regards the remuneration of the guarantee, the Liechtenstein authorities commissioned an expert study⁷ to establish the adequate market premium for a State guarantee covering LLB's savings deposits. The study was carried out by an expert in financial mathematics. The questions to be addressed were:

- a. to establish the credit risk attached to LLB based on an analysis of the probability of default,
- b. what would be the loss in case of default, and
- c. what would an insurer require in annual premium to cover the risk of default given current interest rates.

LLB is not rated by any of the international credit rating agencies like Moody's or Standard and Poor's. The expert therefore chose to carry out for all Moody's credit ratings, AAA, AA1 etc., an analysis of default probabilities based on European bond data. For this purpose he applied a model developed by the financial company J.P. Morgan, which he describes to be the market standard in credit risk evaluation⁸. On the basis of this model and assumptions of recovery rates for defaulted European bond issues, as well as further actuarial principles, he calculated a range of annual premiums to be paid by LLB for risk coverage. The premiums would - for a given amount of savings (exemplified by the amount of savings deposits in 2004) - depend on the length of the guarantee period and on the credit rating which LLB would be accorded. Concerning the latter factor the expert proposed to rate LLB similarly to the LGT (Liechtenstein Global Trust) bank in Liechtenstein Ltd, which is rated AA3 by Moody's. The conclusion of the expert in this regard was based on LLB's performance as derived from LLB's annual reports, information on LLB and LGT on the internet and the financial analysis carried out by Bloomberg on LLB and LGT.

⁷ Bewertung der Ausfallhaftung des Fürstentums Liechtenstein für die Liechtensteinische Landesbank AG, Ao. Univ. Prof Dr. Markus Fulmek (hereinafter 'the expert'), Fakultät für Mathematik, Universität Wien, Nordbergstraße 15, A 1090 Wien, Österreich, 3 Mai 2005 (hereinafter 'the expert study').

⁸ Its methodology is based on probability of moving from one credit rating class to another within a given time horizon (credit migration analysis). In the expert study, annual transition rates are used.

The study was conducted on the basis of a savings deposit amount of CHF 2 960 292 000 (data from 2004⁹). Over a given 15 year period that would lead to annual premium of CHF 351 184. This equals a rate of [...]‰.

The Liechtenstein authorities stated that they wish to keep a State guarantee for 15 years (calculated from 1 August 2005) and that the State guarantee should also continue to cover the medium term notes. This means that the base amount will be extended to cover also the medium term notes and the amount of the premium will have to be adjusted accordingly. The amount of medium-term notes in 2004 was CHF 528 481 000. The hypothetical premium for the sum of the savings deposits and medium term notes (i.e CHF 3 488 773 000), for the complete year of 2004 would therefore, based on the rate established by the expert of [...]‰, be CHF [...].

The Liechtenstein authorities stated that the scheme would be reviewed once a year by 1 June. By that date the amount of savings deposits and medium term notes would be established for the previous year (e.g. in 2007 on the basis of the data 2006). The amount would be calculated as the yearly average of savings amounts and medium term notes, based on quarterly figures.

On the basis of the guaranteed amount so established, the Liechtenstein authorities will then calculate the premium, according to the methodology established in the expert's report. The premium will be paid retroactively each year for the previous year.

For the year 2005, the premium will be calculated pro rata for the time after 1 August 2005.

The Liechtenstein authorities will provide the Authority with the annual report of LLB, the average yearly amounts of savings deposits and bonds covered by the State guarantee (including documentation on the respective average, based on quarterly figures) and the calculated premium on 1 June of each year during the duration of the 15 years State guarantee. The Liechtenstein authorities will further document that the respective premium payment has been effectuated.

II. Appreciation

1. Procedure

While the appropriate measures dated 15 December 2004 were not explicitly accepted by the Liechtenstein authorities, they presented to the Authority within the time limit for acceptance (21 March 2005) a proposal to alter the State guarantee in that it should be linked to a specified amount, no longer be open-ended and be remunerated with a premium.

In light of the proposal to substantially alter the State guarantee and also given the fact that these alterations would still be carried out until 1 August 2005, which was the original

⁹ The amount is the amount of savings deposits on 31 December 2004. However, as can be seen below, in the future the amount of savings deposits (and of medium term notes) will be established by the calculation of the yearly average.

* Brackets throughout the text indicate figures which have been deleted because they are covered by the obligation of professional secrecy.

deadline in the Authority's Decision of 15 December 2004, the Authority did not see any need to follow the procedure laid down in Article 19 (2) in Part II of Protocol 3 to the Surveillance and Court Agreement. Instead, the Authority will amend its earlier proposal of appropriate measures.

2. General provisions relevant for the assessment of State guarantees

Article 61(1) of the EEA Agreement provides that:

“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.”

Chapter 17 of the Authority's State Aid Guidelines outlines the Authority's approach to state aid granted in the form of guarantees. Usually, State guarantees are associated with a loan or other financial obligations to be contracted by a borrower with a lender. The State guarantee enables the borrower to obtain better financial terms for a loan than those normally available on the financial markets. State guarantees might facilitate the creation of new businesses and enable certain undertakings to raise money in order to pursue new activities. According to point 17.2.1. of the Authority's State Aid Guidelines, State guarantees generally fall within the scope of Article 61 (1) of the EEA Agreement, provided that trade between Contracting Parties is affected and no market premium is paid.

According to point 17.2.1.(3) of the State Aid Guidelines the Authority also regards

“as aid in the form of a guarantee the more favourable funding terms obtained by enterprises whose legal form rules out bankruptcy or other insolvency problems or provides an explicit State guarantee or coverage of losses by the State.”

Article 5 LLBG provides for an explicit guarantee in favour of LLB for the savings deposits and the medium-term notes to the extent that LLB's assets are not sufficient. In its decision of 15 December 2004, the Authority considered that the conditions, under which a State guarantee scheme might not constitute state aid (point 17.4 (3) of the State Aid Guidelines), were likewise not fulfilled. The Authority noted that in particular the lack of an adequate premium constituted both a drain on State resources and an advantage for LLB. With the amendments envisaged by the Liechtenstein authorities, the Authority is now able to take a different view.

Point 17.4 (3) of the State Aid Guidelines stipulates six conditions under which a State guarantee scheme¹⁰ might not be considered state aid within the meaning of Article 61 (1) of the EEA Agreement:

¹⁰ According to Article 1 (d) in Part II of Protocol 3 to the Surveillance and Court Agreement, “an aid scheme means (...) any act on the basis of which aid which is not linked to a specific project may be awarded to one or several undertakings for an indefinite period of time and/or for an indefinite amount.” The Authority regards the State guarantee in favour of LLB, which is not given for a concrete project and not limited to a definite amount of savings deposits and medium term notes, to be an aid scheme in the meaning of this provision.

- a. The scheme does not allow guarantees to be granted to borrowers who are in financial difficulty,
- b. the borrowers would in principle be able to obtain a loan on market conditions from the financial markets without any intervention by the State,
- c. the guarantees are linked to a specific financial transaction, are for a fixed maximum amount, do not cover more than 80% of each outstanding loan or other financial obligation (except for bonds and similar instruments) and are not open-ended,
- d. the terms of the scheme are based on a realistic assessment of the risk so that the premiums paid by the beneficiary enterprises make it, in all probability, self-financing,
- e. the scheme provides for the terms on which future guarantees are granted and the overall financing of the scheme to be reviewed at least once a year,
- f. the premium cover both the normal risks associated with granting the guarantee and the administrative costs of the scheme, including, where the State provides the initial capital of the start-up of the scheme, a normal return on that capital.

The guarantee scheme in favour of LLB is not granted in favour of a borrower who is in financial difficulties and LLB would in principle be able to obtain a loan on market conditions from the financial markets without any intervention by the State. The fact that the expert's report evaluates the hypothetical rating of LLB not to be worse than AA 3 further illustrates that finding (first and second condition).

With the amendments to the guarantee, LLB will now be paying an adequate premium, which is based on a realistic risk assessment (fourth condition). The expert has estimated a default risk. He established a hypothetical credit rating for LLB, based on a comparison with its competitor and other available financial information. The Authority in particular notes that at various places in the expertise, the expert has opted for a more cautious approach (e.g. with regard to the recovery rate for defaulting bonds) in order not to underestimate the risk and thus the adequate premium. The Authority has no reason to question the expert's risk assessment, nor the calculation of the adequate premium. The Authority notes that with the payment of a market premium, the Authority's previous concerns, namely that the State foregoes revenues which coincides with an advantage of LLB (by not being required to pay an adequate remuneration), have now been relieved.

The Authority notes that the scheme will be reviewed and the premium will be adapted on a yearly basis (fifth condition). The administrative costs of the scheme (sixth condition) are negligible as both the guaranteed amount and the guarantee premium can be easily established each year without any great effort. The Authority therefore does not consider it necessary that the premium needs to be increased to cover administrative costs.

As to the third criterion, the Authority notes that the guarantee scheme is specified in so far as it only covers savings deposits and medium term notes and none of the other liabilities of LLB. The amounts of the savings funds and the medium term notes will be precisely established as of the end of each quarter in order to calculate the average annual amount and the adequate premium. The guarantee scheme will run for a fixed period, i.e. 15 years, i.e. is time-wise not open-ended.

In relation to the 80% rule the Authority first notes that this provision has to be read in the context of points 17.3 (4) and (5) of the State Aid Guidelines. These provisions indicate that a lending institution would have a sufficient incentive to assess the creditworthiness of the borrower and the risks related to a specific loan if at least 20% of the loan was not covered by the state guarantee. As the situation is different when financing is obtained from many lenders as in the case of bonds and similar instruments, the State Aid Guidelines state that the 80% rule does not apply to such lending. In the view of the Authority the instruments in the case at hand – medium term notes and savings deposits – are, in the meaning of the Guidelines, bonds or instruments similar to bonds.

The Authority notes that there is no maximum fixed for the amounts on savings deposits and medium term notes. While the maximum amount normally protects the State from assuming guarantees for an undetermined and not calculable risk, the Authority notes that in the present case the guarantee does not cover just any or all liabilities of LLB, but is limited to medium term notes and savings deposits, which in particular with regard to the savings deposits – which have been relatively stable over the last three years¹¹ – provides for a certain foreseeability. In any event, for the Authority it is decisive that the premium to be paid by LLB is fixed at a certain percentage of the guaranteed sum (i.e. []) and will therefore increase with the guaranteed sum. This ensures an adequate risk premium for the State. Based on the above and considering that according to point 17.3 (4) of the State Aid Guidelines, not all conditions have to be fulfilled for the measure not to constitute state aid, the Authority considers the absence of a maximum amount not to be decisive.

On the basis of the above reasoning, the Authority considers that with the above mentioned amendments, the State guarantee would not longer constitute state aid within the meaning of Article 61 (1) of the EEA Agreement.

3. Conclusion

The Authority concludes that with the suggested amendments, in particular the payment of an adequate premium, the limitation of the State guarantee to a duration of 15 years and the link of the guarantee to the amount of savings deposits and medium term notes, the State guarantee in favour of LLB would no longer constitute state aid within the meaning of Article 61 (1) of the EEA Agreement.

The Authority therefore will amend its earlier proposal of appropriate measures to Liechtenstein. The appropriate measures should be taken by Liechtenstein before 1 August 2005.

HAS ADOPTED THIS DECISION:

1. Pursuant to Article 1 (1) in Part I and Article 18 in Part II of Protocol 3 to the Surveillance and Court Agreement, the Authority proposes to the Principality of Liechtenstein the following amended appropriate measures:
 - a) The Liechtenstein authorities shall take, without delay, any legislative, administrative and other measures necessary to eliminate any incompatible aid

¹¹ The savings deposits were at CHF 2 431 319 in December 2002, CHF 2 876 447 in December 2003 and CHF 2 960 292 in December 2004. Medium term notes were at CHF 972 545, CHF 810 185 and CHF 528 481 over the same three year period.

resulting from section 5 LLBG. Any such aid should be abolished with effect from 1 August 2005.

The State guarantee will only be granted in favour of LLB's savings deposits and medium term notes, whose average yearly amount (based on quarterly figures) is to be established by 1 June of each year for the previous year. An adequate premium as established at [...] ‰ in the expert study, referred to under section A.4 of this Decision, will be paid for the so established guaranteed amount of savings deposits and medium term notes.

The State guarantee will be limited to a period of 15 years calculated from 1 August 2005. For the year 2005, the premium will be paid pro rata. On 1 June of each year the Liechtenstein authorities will report to the Authority the annual report of LLB of the previous year, the average amount of savings deposits and medium term notes of the previous year (including the documentation of the average, based on quarterly figures) as well as the premium calculated on the basis of this amount. The Liechtenstein authorities will further document to the Authority that the premium payment has been effectuated.

- b) The Liechtenstein authorities shall communicate to the Authority the relevant measures regarding the amendment of the State guarantee as described under a) as soon as possible and in any event no later than 31 July 2005.
2. The Authority asks the Liechtenstein authorities to accept this proposal for appropriate measures, pursuant to Article 19 (1) in Part II of Protocol 3 of the Surveillance and Court Agreement, and to communicate its acceptance no later than 31 July 2005.
3. This Decision is addressed to the Principality of Liechtenstein.
4. This Decision is authentic in the English language.

Done at Brussels, 15 July 2005

For the EFTA Surveillance Authority

Einar M. Bull
Acting President

Kurt Jäger
College Member