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The logo of the EFTA Surveillance Authority, consisting of the text "EFTA SURVEILLANCE AUTHORITY" in white capital letters on a dark blue rectangular background.

Public version of¹
EFTA SURVEILLANCE AUTHORITY DECISION
of 27 June 2012
on restructuring aid granted to Íslandsbanki
(Iceland)

The EFTA Surveillance Authority (“the Authority”)

HAVING REGARD to the Agreement on the European Economic Area (“the EEA Agreement”), in particular to Article 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 to Article 1(3) of Part I, Article 7(3) of Part II, and Article 13 of Part II,

Whereas:

I. FACTS

1 Procedure

- (1) Following informal correspondence in October 2008, and the passing on 6 October by the Icelandic Parliament (the Althingi) of Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc. (referred to as the “Emergency Act”), which gave the Icelandic state wide-ranging powers to intervene in the banking sector, the President of the Authority wrote on 10 October 2008 to the Icelandic authorities and requested that state aid measures taken under the Emergency Act be notified to the Authority. Further contact and correspondence followed periodically including notably a letter sent by the Authority on 18 June 2009 reminding the Icelandic authorities of the need to notify any state aid measures, and of the standstill clause in Article 3 of Protocol 3. Following further correspondence state aid involved in the restoration of certain operations of Glitnir and the establishment and capitalisation of a new Glitnir Bank (by then re-named “Íslandsbanki”) was eventually notified retrospectively by the Icelandic authorities on 15 September 2010.²

¹ This document is made available for information purposes only. In this public version, some information has been omitted so as not to divulge confidential information. This is denoted by [...] or a range in square brackets providing for a non-confidential approximation of the relevant figure.

² See for a more thorough description of the procedure the opening decision, referred to in footnote 2.

- (2) By letter dated 15 December 2010³ the EFTA Surveillance Authority (the Authority) informed the Icelandic authorities that it had decided to initiate the procedure laid down in Article 1(2) of Part I of Protocol 3 in respect of the measures undertaken by the Icelandic State to restore certain operations of (old) Glitnir Bank hf and establish and capitalise New Glitnir Bank hf, now renamed Íslandsbanki (the opening decision).⁴ The Authority also required that a detailed restructuring plan for Íslandsbanki be submitted within six months.
- (3) By email of 24 March 2011⁵, the Authority received one comment from interested parties, which was forwarded to the Icelandic authorities on 25 May 2011. The Icelandic authorities did not respond to this comment.
- (4) By letter of 31 March 2011, the Icelandic authorities submitted a restructuring plan for Íslandsbanki. Following the acquisition of Byr in November 2011, the Icelandic authorities submitted a new restructuring plan for Íslandsbanki on 22 February 2012.⁶
- (5) The Authority requested information with regards to the restructuring plan on 11 July 2011 and 13 February 2012. The request for information was answered by the Icelandic Authorities on 17 October 2011 and 13 March 2012. The final versions of the commitments were submitted on 16 May 2012 and on 6 June 2012.⁷
- (6) In addition, the Authority met with the Icelandic authorities on 7 June 2011 and 27-28 February 2012.

2 Background

- (7) The Authority will describe in this section those events, facts and economic, political and regulatory developments relating to the collapse and the reconstruction of the Icelandic financial system from October 2008 to date that appear necessary to set out the context in which the assessment of aid measures at hand is undertaken. Before doing so, it will recall in turn the chronology of Glitnir's breakdown.

2.1 The collapse of Glitnir Bank

- (8) In September 2008 a number of major global financial institutions began to experience severe difficulties. In the midst of the turbulence in global financial markets and following the collapse of Lehman Brothers in September 2008, Iceland's three biggest commercial banks, which had experienced extraordinary growth over the preceding years, encountered difficulties in refinancing their short-term debt and a run on their deposits. Lehman Brothers filed for bankruptcy protection on 15 September and on the same day it was announced that the Bank of America was to take over Merrill Lynch.

³ The Authority's Decision No 494/10/COL, opening the formal investigation procedure into state aid granted in the restoration of certain operations of (old) Glitnir Bank hf and the establishment and capitalisation of New Glitnir Bank hf (now renamed Íslandsbanki), OJ C 41, 10.2.2011, p. 51 and EEA Supplement to the Official Journal No 7, 10.2.2011, p.50.

⁴ Further information on the procedure leading up to the Authority's Decision No 494/10/COL, can be found in the procedure part of the decision.

⁵ Corrected by the interested parties on 25 May 2012.

⁶ See Authority's Decision No 325/11/COL, on the acquisition of Byr hf by Íslandsbanki and the prolongation of the temporary approval of the subordinated loan facility granted to Byr hf, OJ C 16, 19.1.2012, p.10 and the and EEA Supplement to the Official Journal No 3, 19.1.2012, p 1.

⁷ Regarding the competitive situation in the Icelandic banking sector and possible competition remedies, the Authority has co-operated with the Icelandic Competition Authority (ICA).

- (9) Elsewhere, one of the United Kingdom's biggest banks, HBOS, had to be taken over by Lloyds TSB. Glitnir meanwhile, was experiencing major difficulties in financing its activities. A bond issue had had to be cancelled due to a lack of interest, an asset sale was not completed, and a German bank refused to extend two loans estimated at 150 million Euros. Market conditions also worsened dramatically after the fall of Lehman Brothers.
- (10) On 24 September 2008, the Chairman of Glitnir's Board contacted the Central Bank of Iceland (CBI) to inform them that as a result of loans that had to be repaid in October, the bank had an immediate shortfall of 600 million Euros. On 29 September it was announced that the Icelandic government would provide Glitnir with 600 million Euros in return for 75% of its equity. The fact that 600 million Euros amounted to nearly a quarter of Iceland's foreign currency reserves, and that Glitnir had experienced refinancing problems for some time and had debt estimated at 1.4 billion Euros to repay over the following six months, according to publicly available information, suggested, however, that the proposal was not credible⁸. As it turned out, the value of issued Glitnir shares collapsed from over 200 billion ISK to 26 billion ISK in one day.
- (11) The Icelandic banks experienced massive withdrawals of deposits not only abroad but also within Iceland. Domestic withdrawals became so large that at one stage the Icelandic banks and the CBI were close to experiencing a shortage of cash. On 30 September 2008, the credit agency Moody's lowered Glitnir's credit rating, triggering repayment obligations for further loans. Margin calls of over a billion Euros also followed. On 7 October 2008 Glitnir was required to ask the Icelandic Financial Supervisory Authority (FME) to be taken under its control⁹.

2.2 The financial crisis and major causes of failure of the Icelandic banks

- (12) In their notification of the aid granted to New Glitnir Bank (later Íslandsbanki), the Icelandic authorities explained that the reasons for the collapse of the Icelandic banking sector and their need to intervene were set out in considerable detail in a report prepared by a Special Investigation Commission (SIC) established by the Icelandic Parliament¹⁰, whose remit was to investigate and analyse the processes leading to the collapse of the three main banks. The Authority summarises below the conclusions of the Commission concerning the causes of failure most relevant to the demise of Glitnir Bank. The information is drawn from Chapters 2 (Executive Summary) and 21 (Causes of the Collapse of the Icelandic Banks – Responsibility, Mistakes and Negligence) of the SIC report.
- (13) The global reduction in liquidity in financial markets that began in 2007 eventually led to the collapse of the three main Icelandic banks, whose business operations had become increasingly dependent on raising funding through international markets. The reasons for the demise of the Icelandic banks were however complex and numerous. The SIC investigated the reasons which led to the collapse of the main banks, and it is notable that

⁸ See the report of the Special Investigation Commission to the Icelandic Parliament, Chapter 2: Summary of the Report's Main Conclusions, page 13, available at <http://sic.althingi.is/pdf/RNAvef-Kafli2Enska.pdf>.

⁹ Landsbanki was also placed in receivership on the same day and Kaupthing Bank followed two days later on 9.10.2008.

¹⁰ The SIC's members were Supreme Court Judge, Mr. Páll Hreinsson; Parliamentary Ombudsman of Iceland, Mr. Trygvi Gunnarsson; and Mrs. Sigríður Benediktsdóttir Ph.D., lecturer and associate chair at Yale University, USA. The report is available in full in Icelandic at: <http://rna.althingi.is/> and parts translated into English (including the Executive Summary and the chapter on the causes of the collapse of the banks) are available at: <http://sic.althingi.is/>

the majority of the conclusions applied to all three banks and many are inter-related. Causes of failure related to the banks' activities are briefly summarised below.

Excessive and unsustainable expansion

- (14) The SIC concluded that in the years leading up to the collapse the banks had expanded their balance sheets and lending portfolios beyond their own operational and managerial capacity. The combined assets of the three banks had increased exponentially from 1.4 trillion ISK¹¹ in 2003 to 14.4 trillion ISK at the end of the second quarter of 2008. Significantly, a large proportion of the growth of the three banks was in lending to foreign parties, which increased substantially during 2007¹², most notably after the beginning of the international liquidity crisis. This led the SIC to conclude that much of this increase in lending resulted from loans made to undertakings that had been refused credit elsewhere. The report also concluded that inherently riskier investment banking had become an ever increasing feature of the banks' activities and growth had contributed to the problems.

The reduction in finance available on the international markets

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

The gearing of the banks' owners

- (16) In the case of each major Icelandic bank, the principal owners were among the biggest debtors¹³. Glitnir's loans to major shareholders of the Baugur Group and related parties, in particular the FL Group, were substantial. In the spring of 2007 a new Glitnir board was appointed after the Baugur and FL Groups significantly increased their shareholdings in the bank. Over the latter part of 2007 and beginning of 2008 loans to Baugur and companies related to Baugur nearly doubled, and at its peak lending to this group amounted to 80% of the bank's equity¹⁴. This increase in lending to major shareholders occurred despite the fact that Glitnir was starting to face liquidity and refinancing problems. The SIC was of the view that certain shareholders had abnormally easy access to borrowing from the banks in their capacity as owners. It also concluded that there were strong indications that Baugur and the FL Group had tried to exert undue influence on the bank's management, and that the boundaries between the interests of the largest shareholders and the interest of the bank were blurred. The emphasis on the major shareholders was therefore to the detriment of other shareholders and creditors. When the bank collapsed its outstanding loans to the Baugur Group and affiliated companies was approximately 2 billion Euros, around 70% of its equity. The SIC also questioned the operation of money market funds operated by subsidiaries of the banks, which invested heavily in securities connected to the owners of the banks. Glitnir Funds, a subsidiary of

¹¹ Icelandic *króna*.

¹² Lending to foreign parties increased by 11.4 billion Euros from 8.3 billion Euros to 20.7 billion Euros in six months.

¹³ Chapter 21.2.1.2 (page 6) of the Report.

¹⁴ The position was further exacerbated by foreign creditors of the largest Icelandic investment companies making margin calls as a result of reduced collateral values, leading to the three main banks taking over the financing so that the foreign banks could be repaid.

Glitnir, lent around 300 million Euros to Baugur and the FL Group by investing 20% of its total capital in their securities.

Concentration of risk

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

Weak equity

- (18) Although the capital ratio of Glitnir and the other two major Icelandic banks was always reported to be slightly higher than the statutory minimum, the SIC concluded that the capital ratios did not accurately reflect the financial strength of the banks. This was due to risk exposure of the banks' own shares through primary collaterals and forward contracts on the shares. Share capital financed by the companies themselves, referred to by the SIC as "weak equity"¹⁵, represented more than 25% of the banks' capital bases (or over 50% when assessed against the core component of the capital, i.e. shareholders' equity less intangible assets). Added to this were problems caused by the risk that the banks were exposed to by holding each other's shares. By the middle of 2008 direct financing by the banks of their own shares, as well as cross-financing of the other two banks' shares, amounted to approximately 400 billion ISK, around 70% of the core component of the capital. The SIC was of the opinion that the extent of financing of shareholders' equity by borrowing from the system itself was such that the system's stability was threatened. The banks held a substantial amount of their own shares as collateral for their lending and therefore as share prices fell the quality of their loan portfolios declined. This affected the banks' performance and put further downward pressure on their share prices; in response to which (the SIC assumed from the information in their possession), the banks attempted to artificially create abnormal demand for their own shares.

The size of the banks

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

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

- (20) The SIC concluded that the relevant supervisory bodies in Iceland lacked the credibility that was necessary in the absence of a sufficiently resourced lender of last resort. The report concludes that the FME and CBI lacked the expertise and experience to regulate the banks in difficult economic times, but that they could have taken action to reduce the level of risk that the banks were incurring. The FME, for example, did not grow in the same proportion as the banks and the regulator's practices did not keep up with the rapid developments in the banks' operations. The report is also critical of the government,

¹⁵ Chapter 21.2.1.4 of the Report.

concluding that the authorities should have taken action to reduce the potential impact of the banks on the economy by reducing their size or requiring one or more banks to move their headquarters abroad¹⁶.

Imbalance and overexpansion of the Icelandic economy as a whole

- (21) The SIC report makes reference to events concerning the wider economy that also impacted upon the banks' rapid growth and contributed to the imbalance in size and influence between the financial services sector and the remainder of the economy. The report concluded that government policies (in particular fiscal policy) most likely contributed to the overexpansion and imbalance and that the CBI's monetary policy was not sufficiently restrictive. The report also refers to relaxing the Icelandic Housing Financing Fund's lending rules as "one of the biggest mistakes in monetary and fiscal management made in the period leading up to the banks' collapse"¹⁷. The report is also critical of the ease with which the banks were able to borrow from the CBI, with the stock of CBI short-term collateral loans increasing from 30 billion ISK in the autumn of 2005 to 500 billion ISK by the beginning of October 2008.

The Icelandic króna, external imbalances and CDS spreads

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

2.3. Measures taken to reconstruct the banking sector

- (23) Following the collapse of the three biggest commercial banks in October 2008 (including Glitnir) the Icelandic authorities were faced with the unprecedented challenge of safeguarding continued banking operations in Iceland¹⁸. The policy followed by the Icelandic government is primarily laid down in the Emergency Act¹⁹ adopted by the Icelandic Parliament on 6 October 2008. The law grants extraordinary powers to the FME to take control of financial undertakings and to dispose of their assets and liabilities as required. The Minister of Finance was authorised, on behalf of the Treasury, to disburse funds in order to establish new financial undertakings. Moreover, in bankruptcy proceedings of financial undertakings, deposits would be given priority over other claims. The government declared that deposits in domestic commercial and savings banks and their branches in Iceland would be fully protected.
- (24) Policy priorities focused initially on securing the basic functioning of the domestic banking, payment and settlement systems. In the first weeks after the crash, the Icelandic Government also prepared an economic program in collaboration with the International Monetary Fund (the IMF), leading to the approval on 20 November 2008 of Iceland's request for a two year stand-by-arrangement from the Fund, which included a 2.1 billion USD loan from the IMF aimed at strengthening Iceland's currency reserves. Additional loans of up to 3 billion USD were secured from other Nordic countries as well as certain

¹⁶ It was in fact the then coalition government's stated policy to encourage more growth and to incentivise the banks to remain headquartered in Iceland.

¹⁷ Chapter 2, page 5 of the report.

¹⁸ For further general details of the measures taken by the Icelandic authorities see the report of the Minister of Finance to the Parliament on the resurrection of the commercial banks of May 2011 (Skýrsla fjármálaráðherra um endurreisn viðskiptabankanna), available at <http://www.althingi.is/altext/-139/s/pdf/1213.pdf>

¹⁹ Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc.

other trading partners. Of the IMF loan, 827 million USD was made available immediately, while the remaining amount was disbursed in eight equal instalments, subject to quarterly reviews of the program.

- (25) The IMF Program was a broad-based stabilisation program focusing on three key objectives. Firstly, to stabilise and restore confidence in the króna so as to contain the negative impact of the crisis on the economy. The measures included the introduction of capital controls aimed at stemming capital flight. Secondly, the program included a comprehensive bank restructuring strategy, ultimately aimed at rebuilding a viable financial system in Iceland as well as safeguarding the country's international financial relations. Among subsidiary goals was to ensure fair valuation of the banks' assets, maximise asset recovery and strengthen supervisory practices. Thirdly, the program aimed at ensuring sustainable public finances, by limiting the socialisation of losses in the failed banks and implementing a medium-term fiscal consolidation program.
- (26) The Icelandic authorities have underlined that due to the exceptional circumstances linked to the large size of the banking system in relation to the financial capacity of the Treasury, the policy options available to the authorities were limited. The solutions relied upon were therefore in many ways different to the measures taken by the governments of other countries facing threats to financial stability.
- (27) On the basis of the Emergency Act, the three large commercial banks, Glitnir Bank, Landsbanki Íslands and Kaupthing Bank, were split into "old" and "new" banks. The Minister of Finance founded three limited liability companies to take over the domestic operations of the old banks and appointed them boards of directors. The FME took control of the old banks, allocated essentially their domestic assets and liabilities (deposits) to the new banks which continued banking operations in Iceland, while the old banks were placed under the supervision of their respective resolution committees.²⁰ Foreign assets and liabilities were in the main placed in the old banks, which were later submitted to winding-up procedures and the eventual closure of all foreign operations.²¹
- (28) In the provisional opening balance sheets of the three new banks of 14 November 2008 it was estimated that the banks' combined total assets would amount to 2 886 billion ISK, with an equity to be provided by the State of 385 billion ISK. The total amount of bonds to be issued by the new banks in favour of the old banks as payment for the value of the assets transferred in excess of liabilities was estimated at 1 153 billion ISK. The FME appointed Deloitte LLP to perform assessments of the value of transferred assets and

²⁰ See also FME's Annual Report 2009 (July 2008 – June 2009), available at <http://en.fme.is/media/utgefid-efni/FME-Annual-Report-2009.pdf>

²¹ Further takeovers of financial undertakings were to follow. In March 2009, the FME took control of the operations of three financial undertakings; Straumur-Burdaras, the Reykjavik Savings Bank (SPRON) and Sparisjodabanki Íslands (Icebank), and decided on the disposal of the assets and liabilities of those undertakings. While a composition agreement with Straumur's creditors was later approved, SPRON and Sparisjodabanki were submitted to a winding-up procedure. Other financial undertakings were also severely affected by the collapse of the three main commercial banks and prevailing uncertainties in financial markets, and further financial undertakings were made subject to public administration in 2010. Thus, the FME appointed a provisional board of directors for VBS Investment Bank in March 2010. In April 2010, the FME took control of Keflavik Savings Bank and Byr Savings Bank, determining that their operations would be taken over by new financial undertakings, SpKef Savings Bank and Byr hf, respectively. As the financial conditions of these new undertakings turned out to be worse than initially anticipated, SpKef was later merged with Landsbankinn, by decision of the FME, and Byr hf. was merged with Íslandsbanki, following a tender for the shares in Byr. The Icelandic authorities were furthermore called upon, in 2009, to address the financial difficulties of Saga Capital Investment Bank and, in 2011, the Housing Financing Fund.

liabilities. In this process it transpired that the independent assessment would not result in fixed values of net assets transferred but valuations within certain ranges. It also emerged that the banks' creditors raised disagreements concerning the valuation process, which they considered not to be impartial, and complained that they were unable to protect their interests. These complications resulted in a change of policy for settling the accounts between the old and the new banks, entailing that instead of relying on valuations by an independent expert, the parties would try through negotiations to reach agreements on the value of the net assets transferred.

- (29) It was clear that it would be difficult for the parties to reach agreements on the valuations as they were evidently subject to numerous assumptions on which the parties were likely to disagree. The state aimed to reach agreements on base evaluations providing a firm foundation for the initial capitalisation of the new banks. Price performance of assets in excess of the base evaluation could be attributed to the creditors in the form of contingent bonds or increases in the value of the banks' share capital, as it had emerged in the negotiations that the resolution committees of Glitnir and Kaupthing and a majority of their creditors could be interested to acquire holdings in the new banks, and this would allow them to benefit from potential increases in the values of the assets transferred.
- (30) The full capitalisation of the three new banks and the basis of agreements with the creditors of the old banks were announced on 20 July 2009. The Government, as the sole owner of the three new banks, reached heads of agreements with the resolution committees of the old banks in relation to how compensation for the transfer of net assets into the new banks would be achieved and paid for. With regard to two of the new banks, Íslandsbanki and New Kaupthing (later named Arion Bank), this included conditional agreements for the old banks to subscribe for majority equity interests in the new banks.
- (31) On the basis of the above tentative agreements, the resolution committees of the old banks decided in October 2009 (Glitnir) and December 2009 (Kaupthing Bank and Landsbanki Islands) to exercise the negotiated options and subscribe to shareholding in the new banks. On 18 December 2009 the Government announced that bank reconstruction had been concluded and that agreements had been reached between the Icelandic authorities and the new banks, on the one hand, and the resolution committees of Glitnir Bank, Landsbanki Íslands and Kaupthing Bank on behalf of their creditors, on the other hand, on settlements concerning assets which were transferred from the old banks to the new ones, and that the new banks were then fully financed.
- (32) As it turned out, the Treasury's contribution to the new banks' equity was reduced substantially, from 385 billion ISK as originally envisaged to 135 billion ISK in the form of share capital and, in the case of two of the three banks, Íslandsbanki and Arion Bank, approximately 55 billion ISK of Tier II capital in the form of subordinated loans or a total of 190 billion ISK. In addition, the Treasury provided Íslandsbanki and Arion Bank with certain liquidity facilities. The share capital provided by the old banks to the new ones amounted in total to approximately 156 billion ISK. Total capitalisation of the new banks therefore amounted to approximately 346 billion ISK. Thus, instead of maintaining full ownership of the three banks, the agreements implied that the state's holdings would be reduced to approximately 5% in the case of Íslandsbanki, 13% in the case of Arion Bank and 81% in the case of Landsbankinn.
- (33) While this takeover of two of the three banks by the creditors of the old banks resolved major issues in the rebuilding of the financial sector and established firmer capital foundation for the new banks, numerous weaknesses remained which needed to be addressed. Since the autumn of 2009, the banks have concentrated their efforts mostly on internal issues, determining the overall strategy for their operations and in particular

restructuring their loan portfolios, which represent the greatest risk factor to their operations and long-term viability. The restructuring process has been complex due to various complicating factors, including Supreme Court rulings on illegality of loans granted in ISK but indexed to foreign currencies. As for Íslandsbanki, in so far as relevant for its restructuring, these matters are discussed further below.

Macroeconomic environment

- (34) Major economic turbulence followed the collapse of the banking system in October 2008. The difficulties in Iceland's financial system were coupled with a breakdown of confidence in its currency. The króna depreciated sharply in the first quarter of 2008 and again in the autumn, before and after the failure of the three commercial banks. Despite capital controls imposed in the autumn of 2008, currency volatility prevailed in the course of 2009.²² This turmoil resulted in a severe recession in Iceland's economy, with a contraction of GDP by 6.8% in 2009 and 4% in 2010.
- (35) Among the implications of the economic crisis was a sudden increase in unemployment from 1.6% in 2008 to 8% in 2009, a hike in inflation and a drop in real wages. Moreover, there was a sharp rise in corporate and household debt and of the share of non-performing loans in the banks' loan portfolios as well as a large scale takeover by the new banks of businesses in financial distress. At the same time the high fiscal cost of restructuring the banking system led to a sharp rise in the fiscal deficit and a major surge in public sector debt.
- (36) Following the deep recession provisional data from Statistics Iceland indicates a turnaround in the second half of 2011 and for the whole year a growth of GDP of 3.1% compared to the previous year.
- (37) Economic growth in 2011 was mostly due to an increase in domestic demand, particularly a 4% rise in private household consumption. This was supported by increases in wages and social benefits as well as certain policy initiatives undertaken to ease the payment burden of household debt, including a temporary interest rate subsidy, the freezing of payments on loans and the early reimbursement of private pension savings. Provisional data for 2011 also indicate a slow increase in investments, however from a particularly low level²³. Public consumption has remained at a subdued level during the past three years.
- (38) The general macroeconomic data disguise more significant sectoral differences. In addition to the collapse in the financial sector a major contraction has taken place in construction and many other domestic production and service activities. Growth has on the other hand taken place in certain export sectors. Due to the low exchange rate of the króna and relatively stable prices in foreign currency for both marine and aluminium products, export revenue rose following the onset of the economic crisis, also with respect to tourism and other services exports. At the same time, imports fell sharply, turning the trade balance²⁴ temporarily to a surplus of approximately 10% of GDP in 2010. However, with increased domestic demand in 2011, imports have grown again, leading to an overall smaller trade surplus of 8.2% of GDP.

²² As an example of the scale of the sharp depreciation, the monthly average exchange rate of the Euro to the Icelandic króna rose from 90.71 ISK in December 2007 to 184.64 ISK November 2009.

²³ During the years 2009-2011, the share of investments in GDP has been only 13-14%.

²⁴ Trade balance refers to the difference in earnings from exports and imports of goods and services. It does not include the balance on primary income from abroad, which has been negative in past years, particularly since 2008. This implies that despite the surplus on the trade balance, Iceland's overall current account has been negative during recent years although declining sharply since 2009.

- (39) Statistics Iceland forecast for 2012-2017 assumes that gradual economic recovery will continue with 2.6% growth in 2012. A similar growth rate is expected throughout the forecast period. This forecast is however subject to several uncertainties. Planned large scale industrial investments might be further delayed. Iceland's terms of trade would be negatively affected by a prolonged recession in the main trading countries, implying a lower growth rate in Iceland. Slower progress than anticipated in tackling the debt burden of households and corporates would furthermore restrain domestic demand and the growth prospects of the economy. Growth could also be threatened by continued price instability linked to currency volatility in the context of removal of capital controls.

2.3 Financial supervision and improvements in regulatory framework

- (40) Following the FME's initial work linked to the foundation of the new 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.
- (41) 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 three banks than the statutory minimum. The FME therefore set the minimum capital adequacy (CAD) ratio for the three banks at 16%, thereof a minimum of 12% for the Tier I capital ratio. The requirements were applicable for at least 3 years unless reviewed by the FME. Liquidity conditions were also specified, requiring that available liquid funds should at any point amount to a minimum of 20% of deposits and that cash or cash equivalents should amount to at least 5% of deposits. Furthermore, requirements were made regarding other matters such as restructuring of loan portfolios, risk assessment, corporate governance and ownership. Comparable capital requirements were introduced by the FME regarding other financial undertakings.
- (42) 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 Government invited the former Director General of the Finnish Financial Supervisory Authority, Mr. Kaarlo Jännäri, to carry out an assessment of the existing regulatory framework and supervisory practices. Among the improvements proposed by Mr. Jännäri was the creation of a National Credit Registry at the FME to diminish credit risks in the system. His report also suggested to lay down tougher rules and a stricter practice on large exposures and connected lending as well as to conduct more on-site inspections to verify off-site supervision and reports, particularly on credit risk, liquidity risk and foreign exchange risk. It was also recommended to review and improve the deposit guarantee system, following closely the developments within the EU.
- (43) The Government subsequently proposed a bill of law to the Althingi, based *inter alia* on proposals made by Jännäri as well as amendments made to EEA law on financial activities from 2009 onwards, which 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. These regulatory amendments are considered in more detail in Annex I.

2.4 Main challenges ahead²⁵

- (44) Despite major achievements in rebuilding a financial sector, Iceland continues to strive with the repercussions of the financial and currency crisis in the autumn of 2008. The financial crisis has revealed various flaws and deficiencies in the financial system, which must be addressed, if public confidence is to be restored. It seems evident that Iceland – as many other countries hard hit by the financial crisis - faces numerous challenges in adapting the legal and operating environment of financial services to support a viable and efficient financial system in the future and reduce as much as possible the risk of further systemic shocks to reoccur.
- (45) The most immediate challenges currently facing Icelandic financial undertakings are linked to the fact that the banks are operating in a sheltered environment with capital controls and a blanket deposit guarantee. The banks now need to prepare themselves to operate in a more exposed environment, when the capital controls are removed and deposit guarantees revert to the arrangement set out in the relevant EU/EEA directives²⁶. The Icelandic authorities have underlined that extreme caution must be exercised when introducing new rules in this regard.
- (46) Another major challenge is the need to adapt further the legal and regulatory framework to support a solid and efficient financial system which is also consistent with EEA and international law developments²⁷.

2.5 The state of competition in the Icelandic financial sector

- (47) According to recent information from the Icelandic authorities²⁸, competition on the financial market has changed radically since the banking collapse. The number of financial undertakings has decreased, as several savings banks, commercial banks and specialised lenders are either being wound up or have been merged with other

²⁵ On this subject see for instance the report of the Minister of Economic Affairs to the Althingi of March 2012, *Future Structure of the Icelandic Financial System*. According to the ministry, this report is seen as a catalyst to an informed discussion of this important subject as it does not present fully formed proposals but sets out the main issues and outlook with reference to international developments. The report is available at <http://eng.efnahagsraduneyti.is/media/Acrobat/Future-Structure.pdf>.

²⁶ Bringing deposit guarantees back to normal conditions does not only relate to abolishing the state backing of such guarantees, but also to review the provisions in the Emergency Act according to which deposits which enjoy deposit guarantees by law have priority in the winding-up of a financial undertaking. This comprises a considerable guarantee for depositors, not least while the 2008 banking collapse is still fresh in people's minds. This provision is on the other hand likely to represent a handicap for the banks to diversify their funding arrangement.

²⁷ See Chapter 9 of the report of the Minister of Economic Affairs referred to in footnote 25. When presenting that report, the Minister of Economic Affairs also appointed a group of banking experts, with participation of foreign experts, to prepare proposals on a comprehensive legal and regulatory framework for the financial market in Iceland as a whole. According to the same report, the Icelandic authorities also foresee to study other future options, including the possible separation of investment and commercial banking activities, the adoption of a financial stability legislation and possible amendment of the division of responsibility of financial services regulatory bodies. It is also clear from the statements of the Icelandic authorities that a review of the monetary policy framework remains on the agenda, with or without the possibility that Iceland will become a member of the European Union, as well as other possible means to improve economic management and ensure that regulators “see the forest for the trees” and effectively apply the most appropriate macro-prudential tools.

²⁸ See Chapter 6 of the report by the Minister of Economic Affairs to the Althingi, *The Future Structure of the Icelandic Financial System*, available at <http://eng.efnahagsraduneyti.is/publications/news/nr/3559>

undertakings²⁹. The number of financial undertakings is still decreasing, most recently with the mergers of Landsbankinn and SpKef in March 2011, of Íslandsbanki and Byr in December 2011 and the merger of Landsbankinn and Svarfdaelir Savings Bank, approved by the Authority on 20 June 2012 in Decision No 226/12/COL. With the reductions in the number of financial undertakings and the larger banks taking over deposits from the banks closing down, concentration in the domestic market has increased. The overall presence of the new banks on the EEA financial markets is on the other hand much smaller than that of their predecessors, as international banking operations have been closed down.

- (48) In addition, the domestic market has shrunk considerably as certain sub-markets have disappeared or are largely subdued. The near disappearance of the stock market and the introduction of capital controls have reduced operations in the stock and currency markets and resulted in limited investment options. With the level of investments in the economy at a historically low level and households and companies generally highly leveraged, demand for credit is low. Since the collapse, the banks have concentrated their efforts on internal issues and restructuring of their loan portfolios as well as the restructuring of some of their major corporate clients.
- (49) Before the financial crisis, the savings banks accounted collectively for a market share of approximately 20 - 25% in deposits. This has now collapsed to approximately 2 - 4%. The market shares lost by the savings banks and commercial banks exiting the market have been gained by the three major commercial banks, Arion Bank, Íslandsbanki and Landsbanki. Combined the three big banks now account for approximately 90-95% of the market instead of 60-75% earlier on, where Landsbankinn's market share is marginally highest. Apart from the 10 regional savings banks, currently accounting for approximately 2-4% of the market, the only other market player is the restructured MP Bank³⁰, with a market share of approximately 1-5%.
- (50) The Icelandic financial market is thus clearly oligopolistic and the three largest companies could collectively achieve a dominant market position. According to the Icelandic Competition Authority (ICA), which the Authority had asked for its views on the state of competition in Iceland and potential remedies, there are significant entry barriers to the Icelandic banking market. This has detrimental effects on competition. There are also certain impediments for consumers to switch banks. The Icelandic authorities furthermore acknowledged that the exchange rate risks associated with Iceland's small and non-traded currency, the Icelandic króna, has further restricted competition and deterred foreign banks and companies from entering the Icelandic market.
- (51) ICA has lately focused on a specific issue regarding IT infrastructure for the banks' operations and their co-operation in that regard. This relates to the financial institutions' jointly owned IT service provider, *Reiknistofa bankanna* (the Icelandic Banks' Data

²⁹ Since autumn 2008, several financial undertakings have disappeared from the market (in addition to the "old" big commercial banks, Glitnir, Kaupthing and Landsbanki): Sparisjóðabanki Íslands (formerly Icebank), the Reykjavik Savings Bank (SPRON), Sparisjóður Mýrarsýslu (Mýrarsýsla Savings Bank, SPM), VBS Investment Bank and Askar Capital Investment Bank. The operations of Straumur-Burdaras Investment Bank and Saga Capital Investment Bank have also diminished significantly.

³⁰ On 11 April 2011, a contract for the sale of (old) MP bank's operations in Iceland and Lithuania was approved at the bank's shareholder meeting, when over 40 new shareholders invested 5.5 billion ISK in new shares in the bank. Other operations of the old bank remained with the previous owners and were transferred to a new legal entity, EA fjárfestingarfélag hf. For further details, see MP bank's press releases of 11 April 2011 available at <https://www.mp.is/um-mp-banka/utgefid-efni/frettir/nr/1511> and <https://www.mp.is/um-mp-banka/utgefid-efni/frettir/nr/1510>

Centre; RB). This matter is of relevance for the assessment of the case at hand and was among the issues discussed by the Authority with the Icelandic authorities and the banks.

- (52) RB is jointly owned by the three main Icelandic banks, two saving banks, the Icelandic Savings Bank Association and the three main payment card processors in Iceland. Landsbankinn owns 36.84% of the shares in RB, Íslandsbanki holds 29.48% and Arion Bank 18.7%. Combined the three commercial banks therefore own 85.02% of shares in RB. RB's clients are the owners, the Central Bank of Iceland and other financial institutions as well as the government and public entities. The banks' co-operation in this area is extensive, as RB has developed the clearing and settlement system in Iceland. It also provides a number of core banking solutions which are multi-tenant solutions, used by most of the Icelandic banks. RB furthermore operates an e-invoicing and e-payment system for corporates and consumers.
- (53) According to ICA, the collapse in 2008 has made the smaller banks and savings banks particularly vulnerable. For the smaller financial undertakings, the required IT services were of crucial importance, as they can be viewed as one of the entry barriers for new market participants. The platform for IT services has been provided to a significant extent by RB as regards the bigger financial undertakings and, as regards the savings banks and smaller market players, by Teris. Following the closure of many smaller financial undertakings in recent years, Teris lost a significant share of its income, leading in January 2012 to the sale of some of its IT solutions to RB. According to RB and Teris, this transaction was *inter alia* aimed at securing continued provision of IT services to smaller financial undertakings.
- (54) The ICA has been investigating two cases regarding RB. Firstly, whether the joint ownership and co-operation of the banks and other financial undertakings in the RB forum should be considered to be a breach of the ban on restrictive practices under Article 10 of the Icelandic Competition Act. Secondly, the compatibility of RB's purchase of Teris's major assets is being assessed under the merger provisions of the same act. However, in May 2012 these two cases were concluded with a settlement between RB and its owners, on the one hand, and the ICA on the other hand.³¹
- (55) Aside from the above concerns that relate directly to the Icelandic financial market, the ICA has in particular pointed to the need for the sale and restructuring of operating companies³² to be completed without undue delay. Many operating companies have been taken over by the banks (being creditors of those companies) due to over indebtedness following the economic crash in 2008. According to ICA, it may create a conflict of interest when banks provide financial services to companies and own the companies at the

³¹ According to the settlement, RB and its owners have agreed to a number of commitments aimed at preventing distortions of competition resulting from RB's operations and the co-operations of its owners. The commitments require *inter alia* that RB shall be operated on general commercial terms independent from its owners and the majority of RB's board shall be composed of specialists independent from the owners, access to the systems and services provided by RB shall be provided on a non-discriminatory basis and the terms of services provided by RB shall be the same irrespective of whether or not the client is a shareholder in RB. Existing owners of RB have committed to offer regularly for sale part of their holdings in RB, with the aim of facilitating non-financial undertakings to acquire ownership in RB. Such invitations shall be made at least every second year, until at least a third of total shareholdings in RB have been sold to parties other than the current shareholders or offered for sale in a shares offering.

³² The ICA uses the term "operating companies" for the banks' holdings in normally non-financial businesses which the banks have acquired in relation to the restructuring of their loan portfolios through debt to equity swaps or otherwise. Likewise, the Authority uses the term "operating company" for real economy undertaking, which do not belong to the bank's core business in financial markets.

same time. The ICA is of the opinion that the banks' direct and indirect ownership³³ is the most wide-spread and dangerous competition problem in the aftermath of the financial crisis, as this has an effect on almost every company and industry in Iceland. In ICA's view, faster restructuring of companies would improve competition in the financial market. When the banks' involvement in the restructuring of their corporate clients has been subject to the notification requirements under national merger control, the ICA has in this regard often set conditions regarding the banks' ownership. However, a comprehensive solution to the problem appears to be difficult, as it relates essentially to the high leverage of the Icelandic business sector.

- (56) In their submission to the Authority, the three commercial banks, Arion Bank, Íslandsbanki and Landsbankinn, have all expressed the view that no major changes have taken place in the conditions of competition in the Icelandic financial market since autumn 2008 which should give cause for concerns. Effective competition prevailed in the market, without any evidence of collusive behaviour of the three biggest players. When examining the conditions of competition in the market, the ICA had overlooked certain key factors, such as the fact that foreign banks have for long and still are actively competing with Icelandic banks for the provision of financial services to the biggest clients, such as undertakings in export-based activity (fisheries, power-intensive industry, etc.) as well as state and municipal activity.
- (57) However, this view is contrary to the view expressed in the submission of the Icelandic authorities, as set out in the report referred to above by the Minister of Economic Affairs to the Althingi and to the views of ICA. Moreover, as will be outlined below, Íslandsbanki has, despite certain reservations regarding analysis of competition conditions, decided to provide certain commitments aimed at limiting distortion of competition linked to the aid measures concerned. Those commitments are reported in Annex I.

3 Description of the measures

3.1 The beneficiary

- (58) As described above, Glitnir collapsed in 2008, as did the two other large Icelandic commercial banks. So as to ensure the continuing operation of the domestic banking sector, the Icelandic authorities undertook certain measures, to restore certain operations of (old) Glitnir Bank hf, including the establishment and capitalisation of New Glitnir Bank hf (now renamed Íslandsbanki).

3.1.1 *Glitnir Bank*

- (59) Prior to the financial crisis of 2008 Glitnir Bank was the third largest bank in Iceland. Just before its collapse, at the end of June 2008 its balance sheet amounted to 3 862 billion ISK. The bank's main markets were in Iceland and Norway where it offered a range of financial services, including corporate banking, investment banking, capital markets, investment management and retail banking. Glitnir also had operations in Finland, Sweden, Denmark, UK, Luxembourg, US, Canada, China and Russia. It held a number of subsidiary companies, the most significant being: Glitnir AB (Sweden); Glitnir Bank Oyi (Finland); Glitnir Bank ASA (Norway); Glitnir Bank Luxembourg SA; and Glitnir Asset Management Luxembourg. The bank's international expansion was based on two

³³ In this context, the Authority understands that indirect ownership refers to the banks' possible influence and control over companies due to their high indebtedness to the bank.

specialised industry sectors; seafood and sustainable energy³⁴. Shares in the bank were listed on the Icelandic OMX.

3.1.2 Íslandsbanki

- (60) Glitnir's successor, Íslandsbanki, is a universal bank offering a comprehensive set of financial services to individuals, households, corporations and professional investors in Iceland, specialising in two industry sectors; seafood and geothermal energy. Following the merger with Byr, the bank's assets now amount to approximately ISK 800 billion. It has about 1100 employees, and is Iceland's third largest bank when measured in terms of total assets. The banking products and services fall into four divisions: Retail banking, Corporate Banking, Markets and Wealth Management. According to Íslandsbanki, it has a market share of between [20] and [40]% in all those business segments.

3.1.2.1 Retail banking – Iceland

- (61) Retail Banking provides banking services to individuals, households and small- to medium-sized companies (SMEs). The division comprises Íslandsbanki's branch network, the Bank's Asset-Based Financing division and an independently operated subsidiary, Kreditkort, a leading credit card issuer in Iceland.
- (62) The latest available figures, show that Íslandsbanki has a market share of [>30]% in the retail sector.

3.1.2.2 Corporate banking – Iceland

- (63) Corporate Banking (CB) provides lending and other credit services to medium-size and large companies in Iceland, usually called "the largest 300". Furthermore, Corporate Solutions, a division within CB, manages and leads the restructuring of the distressed large corporate portfolio.
- (64) The latest available figures, show that Íslandsbanki has a market share of [>30]% in the corporate banking market.

3.1.2.3 Markets

- (65) The markets division offers full range services in corporate finance, securities, and foreign exchange and money market products in Iceland as well as corporate finance advisory in the geothermal energy and seafood sectors in the USA.
- (66) The latest available figures, show that Íslandsbanki has a market share of [>5]% of the equity market³⁵, [>20]% of the bonds market, [>30]% of the foreign exchange (FX) market and around [35 - 45]% of the Corporate Finance market.³⁶

3.1.2.4 Wealth Management - VÍB

- (67) Wealth Management provides clients of all sizes with institutional sales, private banking (affluent) and private investment services (retail) and third-party funds. VÍB further offers fund management and administration through its independently managed and operated subsidiary Íslandssjóðir hf.

³⁴ Glitnir's Annual Report for 2007, p. 40. The report is available here: http://tools.euroland.com/arinhtml/is-isb/2007/ar_eng_2007/ Glitnir's Consolidated Financial Statements 2007 are available here: http://en.sff.is/media/auglysingar/Glitnir_-_Annual_Report_2007.pdf

³⁵ Íslandsbanki has the second highest market share on the NASDAQ OMX ICE, fixed income market according to turnover figures for 2011.

³⁶ However, as most of the transactions that determine the market share of the bank in this business segment are not publicly reported, these are just best estimates submitted by the Icelandic authorities.

- (68) The latest available figures, show that Íslandsbanki has a market share of [>30]% of the Corporate and Institutional Sales, [>30]% of Retail Investment Services, [>25]% of Private Banking markets, [>35]% of Mutual Fund Management markets and [>15]% of Private pension services market.³⁷

3.2 Comparing the old and new bank

3.2.1 A comparison of Glitnir and Íslandsbanki (2008)

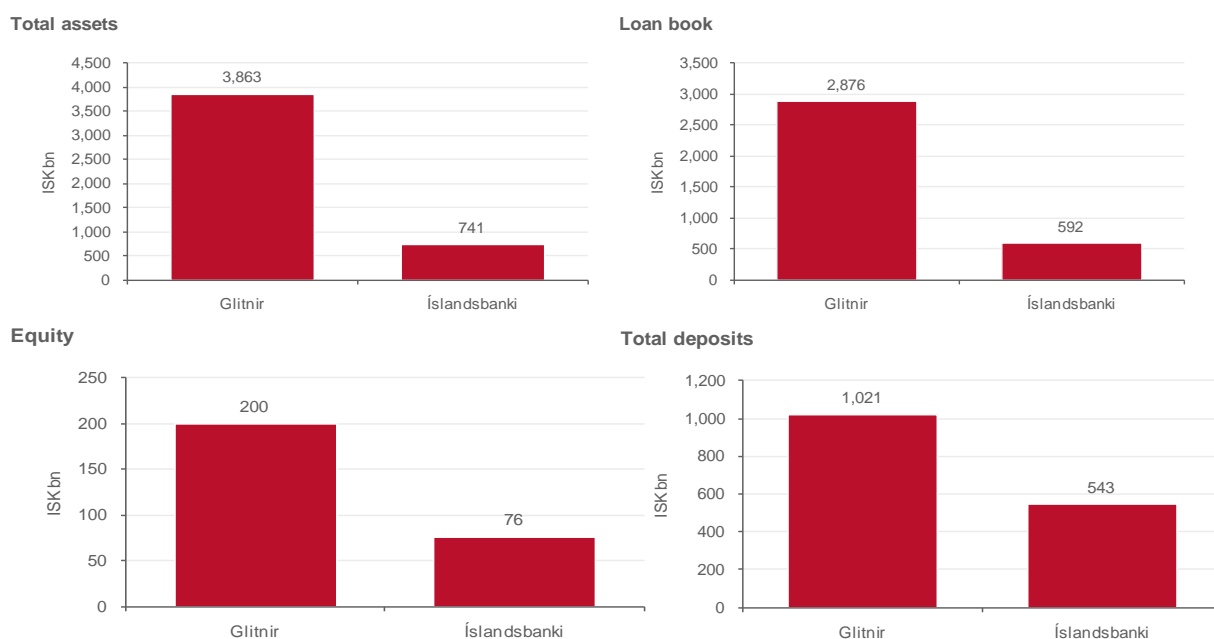
(ISK m)	Íslandsbanki hf. / Glitnir banki hf.		Δ %
	15/10/2008	30/06/2008	
Cash and balances with Central Bank	53,829	37,550	43%
Derivatives	0	278,404	-100%
Bonds and debt instruments	3,762	217,873	-98%
Shares and equity instruments	3,944	71,767	-95%
Securities used for hedging	0	162,332	-100%
Loans to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

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

- (69) There are major differences between the new and old bank both in terms of their operations and scale. Íslandsbanki is predominantly a domestic bank without any licensed banking operations overseas whereas Glitnir was an international bank with operations in 11 countries. Íslandsbanki has four business segments; Commercial/Retail Banking, Asset Management, Corporate and Investment Banking, and Treasury and Capital Markets, all of which are focused on the domestic market. Most notably the scale of Íslandsbanki's operations are substantially smaller than that of Glitnir; the old bank's balance sheet of 3 862 billion ISK compared to the new bank's 631 billion ISK amounts to a reduction of 84%. A comparison of the old bank's balance sheet at June 2008 with the new bank's opening balance sheet can be found at **Table 1** above.
- (70) Glitnir had a diverse funding mix and was a large issuer of bonds sold worldwide. Íslandsbanki, on the other hand, relies mainly on deposits for funding. This, together with the likely inability for the bank to have access to similar funding sources to its predecessor

³⁷ However, as most of the transactions that determine the market share of the bank in this business segment are not publicly reported, these are just best estimates submitted by the Icelandic authorities.

bank (in the short term at least), limits the bank's ability to grow. The comparison in Graph 1 of key indicators of the two banks shows considerable differences³⁸:



Graph 1: Íslandsbanki at establishment, compared with Glitnir 2008 (Q2), selected figures

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

3.3 National legal basis for the aid measure

- *Act No 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc, commonly referred to as the Emergency Act*
- (72) The Emergency Act gave the FME authority to intervene “in extreme circumstances” and assume powers of financial institutions’ shareholders meetings and board meetings, and decide on the disposal of their assets and liabilities. The FME was also granted power to appoint resolution committees to financial undertakings that it had taken over, which held the powers of shareholders’ meetings. In winding up the institutions, the Act gives priority status to claims by deposit holders and deposit guarantee schemes. The Act also authorised the Icelandic Ministry of Finance to establish new banks. The Emergency Act includes amendments of the Act on Financial Undertakings, No. 161/2002, the Act on Official Supervision of Financial Activities, no. 87/1998, the Act on Deposit Guarantees and Investor-Compensation Scheme, No. 98/1999, and the Act on Housing Affairs, No. 44/1998.
- *Supplementary State Budget Act for 2008 (Article 4)*
 - *State Budget Act for 2009 (Article 6)*

³⁸ The graphs are based on the figures for Glitnir in the first half of 2008 and Íslandsbanki in the first half of 2009.

3.4 The aid measures

- (73) The Icelandic authorities' intervention following the failure of Glitnir Bank has been described above, and was set out in more detail in the opening decision. The essence of the interventions can be summarised in the following manner: The FME took control of Glitnir on 7 October 2008, and domestic liabilities and (most) domestic assets were transferred to New Glitnir. The old bank/its creditors were to be compensated for this transfer by receiving the sum of the difference between assets and liabilities. As determining this difference proved to be difficult and time-consuming, the State provided some initial capital and a commitment to contribute further capital if need be. It then capitalised the bank, before finally an agreement was reached between the State and the creditors of the old bank in October, which led to the State's stake in the bank being reduced from 100% to 5%. The Authority considers this date – 15 October 2009 – to mark the beginning of the 5 year restructuring period, which will consequently last until 15 October 2014.
- (74) The following section is limited to describing those aspects of the State's intervention that constitute aid measures relevant for assessment under Article 61 of the EEA Agreement.

3.4.1 Tier I capital

- (75) The State provided Tier I capital twice – once, when New Glitnir was created, and then again when it capitalised the bank fully (and retroactively); followed by an agreement with the creditors of the old bank according to which the State retained a 5% stake in the bank.

3.4.1.1 Initial capital

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

3.4.1.2 Capital injection and retention of a 5% stake as a part of the settlement with the creditors of the old bank

- (77) On 20 July 2009, the Government of Iceland and the Resolution Committee of Glitnir concluded an agreement on the initial capitalisation of Íslandsbanki and the basis for the compensation payable to the creditors of Glitnir in return for the transfer of mostly domestic assets and deposits from Glitnir³⁹. On the basis of this agreement, the State committed on 14 August 2009 to provide Íslandsbanki with additional equity capital of 64.2 billion ISK, bringing the bank's total equity to 65 billion ISK, which was required for it to meet the FME's requirement of a Tier-I ratio of 12%. The agreement provided for two possible options regarding payment of net assets transferred and equity participation; either that Glitnir would subscribe for majority shareholding in Íslandsbanki and be paid for the assets transferred with shares in the bank or, if that subscription was not completed,

³⁹ Minor amendments were made to this agreement on 31 July 2009, 14 August 2009 and 4 September 2009, and a final agreement was signed on 13 September 2009.

that the government capitalisation would remain in place and the government would continue to own Íslandsbanki. Glitnir was given time until 30 September 2009 to decide which option to select; this deadline was later extended until 15 October 2008. On 15 October 2009 it was announced that Glitnir's Resolution Committee had decided, on behalf of its creditors, to take 95% of the share capital in Íslandsbanki as compensation for the assets that had been transferred from the old to the new bank. The state retained the remaining 5%.

- (78) As part of the deal it was agreed that the Resolution Committee (creditors) would remunerate the state for total interest accrued on its investment over the period the government held the bank to the sum of 8.3 billion ISK. This amounted to a yield of 12.8%, which annualised to 13.9%, and concluded the settlement concerning those assets transferred from Glitnir to Íslandsbanki upon the collapse of the banks in October 2008.

3.4.2 Tier II capital contribution

- (79) On 15 October 2009 the Government also provided the bank with a subordinated loan to strengthen its equity and liquidity position in order to comply with the capital requirements of the FME. The subordinated loan is available in Euros and amounts to 25 billion ISK of Tier II capital in a form of an instrument providing for Íslandsbanki to issue unsecured subordinated notes. The term of the notes is ten years as of 30 December 2009. The instrument has built-in incentives for exit in the form of a step-up of interest after five years. Under the agreement the interest rate per annum for the first five years is 400 basis points above EURIBOR⁴⁰ and in the period from five to ten years after the completion of the agreement the interest rate per annum is 500 basis points above EURIBOR.
- (80) In conjunction with the Tier I capital measures described above, the Tier II capital contribution ensured that Íslandsbanki complied with the FME's CAD requirement of 16% on 15 October 2009.

3.4.3 Deposit guarantee

- (81) 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.
- (82) According to the Iceland 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.
- (83) 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*"⁴¹. This announcement has since been repeated by the Office of the current Prime Minister in February and December

⁴⁰ Euro Interbank Offered Rate.

⁴¹ The English translation of the announcement is available at: <http://eng.forsaetisraduneyti.is/news-and-articles/nr/3033>.

2009.⁴² Moreover, reference was made to it in a letter of intent sent by the Icelandic Government to the International Monetary Fund (and published on the website of the Ministry of Economic Affairs and of the IMF) on 7 April 2010 (and repeated in a further letter of intent dated 13 September 2010). The letter (which was signed by the Icelandic Prime Minister, Minister of Finance, Minister of Economic Affairs and Governor of the CBI) states that “At the present time, we remain committed to protect depositors in full, but when financial stability is secured we will plan for the gradual lifting of this blanket guarantee.”⁴³ 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.⁴⁴

- (84) A recent statement of the current Minister of Economic Affairs and former Minister of Finance (2009-2011), Steingrímur Sigfússon in a debate in the Icelandic Parliament regarding the government’s cost related to Landsbankinn’s taking over SpKef, 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”.⁴⁵
- (85) 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 is currently foreseen for the end of 2013.

3.4.4 *Special Liquidity Facility*

- (86) In addition, as a condition for the creditors taking equity in the new bank, the Icelandic government concluded a further agreement with Íslandsbanki on 11 September 2009 that would come into force if Glitnir’s Resolution Committee decided to exercise its option to become the majority owner of the bank⁴⁶. Under the agreement the Ministry of Finance commits to lend repo-able government bonds in exchange for specifically defined assets on terms and conditions specified in the contract up to a value of 25 billion ISK.
- (87) The main terms of the agreement to provide liquidity are as follows:

Max. loan amount: 25 billion ISK

⁴² <http://www.efnahagsraduneyti.is/frettir/frettatilkygningar/nr/2842>
<http://www.efnahagsraduneyti.is/frettir/frettatilkygningar/nr/3001>. The Minister of Economic Affairs has also referred to it recently in an interview with Viðskiptablaðið on 2 December 2010, page 8: “[The declaration] will be withdrawn in due course. We do not intend to maintain unlimited guarantee of deposits indefinitely. The question when it will be withdrawn depends, however, on when an alternative and effective deposit system will come into force and a financial system which will have fully resolved its issues” (the Authority’s translation).

⁴³ The relevant paragraph can be found at section 16 (page 6) of the letter: http://www.efnahagsraduneyti.is/media/Acrobat/Letter_of_Intent_2nd_review_-_o.pdf

⁴⁴ http://hamar.stjr.is/Fjarlagavefur-Hluti-II/GreinargerdirogRaedur/Fjarlagafurvarp/2011/Seinni_hluti/Kafli_8.htm [Mbl 10 June 2012].

⁴⁵ Unofficial translation by the Authority of a statement reported in Morgunblaðið (www.mbl.is) on 10 June 2012.

⁴⁶ An addendum was also signed on 13 January 2010 and a new agreement was concluded on 19 July 2010 in response to certain remarks submitted by the FME.

Term:	Until September 2012
Remuneration:	3.0% on first 8 billion ISK; 3.5% on next 8 billion ISK; 4.0% for amounts above 16 billion ISK
Fee:	Íslandsbanki is required to pay 0.5% of the loan amount on each occasion new securities are provided
Counter-security:	Íslandsbanki is required to provide counter-security for the loan of Treasury securities, which can be financial assets in various forms.

- (88) According to the Icelandic authorities, this liquidity facility is required because the creditors' decision to take ownership of Íslandsbanki significantly reduced the bank's holding of repo-able assets and threatened its ability to comply with supervisory requirements regarding liquidity reserves.⁴⁷ According to the Icelandic authorities the facility is intended to be an additional measure to be used only when other sources of liquidity are insufficient. The pricing and terms of the facility contain incentives to discourage its use if other options are available. To date, the facility has never been drawn upon.

3.4.5 *Straumur securities lending agreement*

- (89) On 9 March 2009 the FME, acting under the authority conferred upon it by the Emergency Act, assumed the powers of the shareholders of Straumur–Burdaras Investment Bank hf. (“Straumur”) and appointed a Resolution Committee to replace its Board of Directors⁴⁸. After consultation with the Resolution Committee, creditors, the CBI and the Ministry of Finance, on 17 March 2009, the FME transferred the liabilities for deposits of Straumur to Íslandsbanki⁴⁹. In return Straumur issued a bond collateralised against its assets, as repayment for assuming the deposit obligations. The bond was issued on 3 April 2009 for the amount of 43 679 014 232 ISK for a term up to 31 March 2013. The bond bears interest on the amount of REIBOR⁵⁰ plus 190 basis points in the first 12 months before reducing to REIBOR plus 100 basis points thereafter until maturity. Simultaneously, Íslandsbanki and the Ministry of Finance entered into a securities lending agreement, in which the government effectively pledges repo-able government notes as security for the Straumur claim, in return for which Íslandsbanki can obtain liquidity from the CBI to the extent that liquidity is required as a result of Íslandsbanki assuming the liability for Straumur's deposits.
- (90) In the agreement Íslandsbanki is committed to returning to the state the amount of the government bonds that equal the payments the bank receives under the bond issued by Straumur. The parties also agreed that in the event that Íslandsbanki does not receive full payment under the bond, and in the event that the state had not paid the remaining debt, Íslandsbanki would retain the outstanding government bonds. In essence, therefore, Íslandsbanki assumed Straumur's liabilities for deposits in return for a matching amount of government guaranteed assets.

⁴⁷ As mentioned above, one of the FME's conditions required that cash or cash-like assets should amount to 5% of on-demand deposits and the banks should be able to withstand a 20% instantaneous outflow of deposits.

⁴⁸ The decision is available in English at: <http://fme.is/lisalib/getfile.aspx?itemid=6055>

⁴⁹ The decision is available in English at: <http://fme.is/lisalib/getfile.aspx?itemid=6077>

⁵⁰ REIBOR denotes Reykjavik Interbank Offered Rate, representing the interbank market rate for short term loans at Icelandic commercial and savings banks. The approach is similar to how many countries use LIBOR as the base rate for variable rate loans, but Icelandic banks use REIBOR (plus a premium) as the basis for supplying variable interest rate loans in the Icelandic currency, the króna.

- (91) As indicated above, the Straumur bond was to mature on 31 March 2013. However, in the meanwhile the bond has been paid in full, without the Icelandic State having to step in.

3.4.6 The capitalisation and acquisition of Byr, and the subordinated loan facility granted to Byr

- (92) As described in detail in Decision No. 126/11/COL of 13 April 2011 (“the Byr Decision”) the Icelandic government granted state aid in the form of capital and a subordinated loan facility for the establishment of Byr, which continued the operations of its predecessor, Byr savings bank (“Old Byr”). In this process the creditors of Old Byr became the shareholders of (new) Byr, along with the Icelandic State which had provided capital for the establishment of the new company.
- (93) When the Byr Decision was adopted on 13 April 2011, the annual accounts for the year 2010 were still unavailable. However, at that point the management of Byr was confident that the rescue measures that were temporarily approved by the Authority in the Byr Decision would suffice to secure the operations of the bank at least until a restructuring plan establishing long term viability could be submitted to the Authority. In the course of auditing the bank’s accounts for the first half of 2011, it became evident that further write-downs of Byr’s assets were necessary which in turn decreased the CAD ratio of the bank.
- (94) As described in detail in Decision No. 325/11/COL of 19 October 2011 (“the second Byr Decision”), the resulting capital shortage could not be remedied, and Byr was put up for sale. The subsequent acquisition, in particular the potential use of state aid for this purpose by Íslandsbanki, was approved by the Authority in the second Byr Decision, without prejudice to the Authority’s formal investigation procedure on whether the aid granted to Íslandsbanki was compatible with the EEA Agreement, which is assessed in the decision at hand.
- (95) In addition, the Authority considered the continued availability of the subordinated loan facility for the interim period until the formal merger between Byr and Íslandsbanki could take place, i.e. for as long as Byr was a separate legal entity under national law, to be compatible with the functioning of the EEA Agreement. According to the Icelandic authorities, neither Byr nor Íslandsbanki have ever drawn on the subordinated loan facility.
- (96) The Authority indicated that the outcome of the final assessment of these measures depended on the information in the restructuring plan for the merged entity of Íslandsbanki and Byr that the Icelandic government had committed to submit no later than 3 months after the execution of the envisaged transaction. Indeed, as described above, a restructuring plan for the merged entity was submitted in time, which the Authority will assess below.

The restructuring plan

- (97) The Icelandic authorities submitted a restructuring plan for Íslandsbanki on 31 March 2011. Following the acquisition of Byr, the plan was amended, updated and resubmitted by the Icelandic authorities on 22 February 2012 (hereinafter the “restructuring plan”). The restructuring plan was supplemented with a 5-year business plan dated 14 January 2012⁵¹ and an Internal Adequacy Assessment Process (ICAAP) report (submitted to the FME on 1 April 2012).

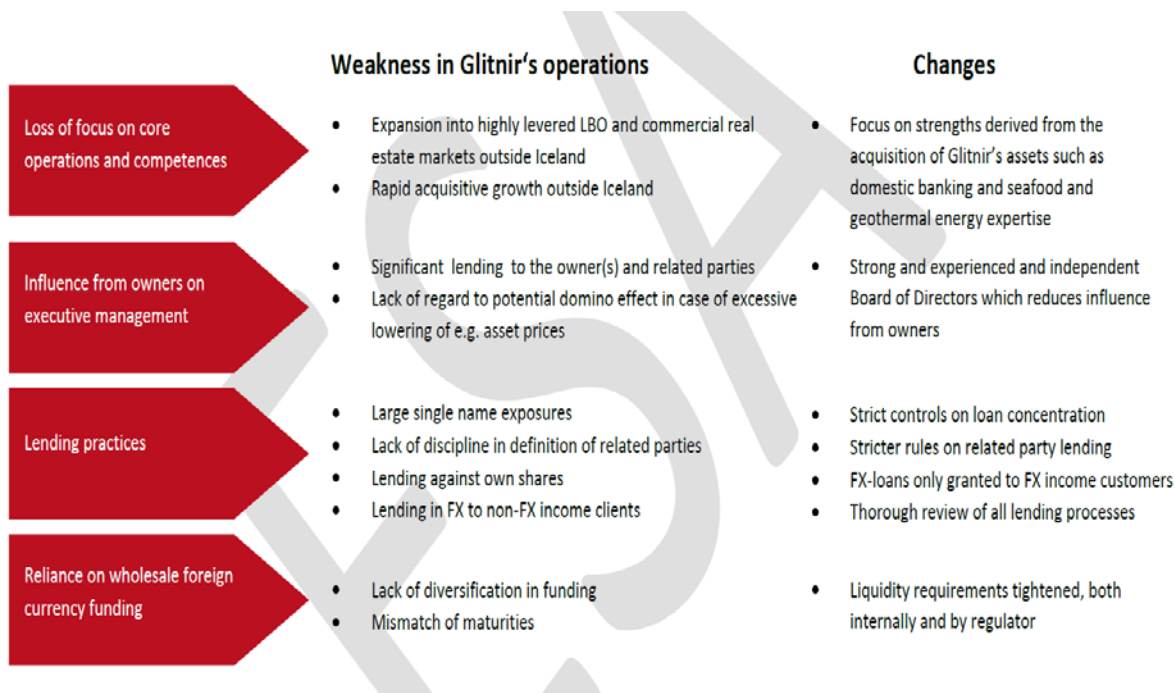
⁵¹ The 5-year business plan has also been supplemented by a presentation of the main changes in the 5-Year Business Plan, prepared for the Board Meeting of 27 March 2012, and reflected in the ICAAP-report.

- (98) The restructuring plan, together with the 5-year business plan, addresses the substantive issues of viability, burden-sharing and limitation of distortions of competition. According to the restructuring plan, Íslandsbanki will focus on its core business and the restructuring of the household and corporate loan portfolios.
- (99) In addition, the Icelandic authorities have submitted an ICAAP report for 2012 to demonstrate Íslandsbanki's ability to withstand stress.
- (100) As indicated above, the Authority considers the restructuring period to last until 15 October 2014.

3.4.7 Description of the restructuring plan

- (101) The Icelandic authorities and the Bank consider that the restructuring of Íslandsbanki will ensure its return to being a solid, well-funded bank with sound capital ratios so that it can maintain its role as a supplier of credit to the real economy. They submit that this will be achieved through the following steps:
- (i) Deleveraging the balance sheet by the winding up the old bank and establishing a new bank;
 - (ii) Establishing and maintaining a strong capital ratio position
 - (iii) Achieving satisfactory profitability
 - (iv) Establishing and maintaining a strong liquidity position
 - (v) Restructuring the loan portfolio, both for households and businesses.
 - (vi) Improving the funding strategy
 - (vii) Achieving cost efficiency
 - (viii) Improving the corporate governance
- (102) Before describing each of the above points in more detail, the bank's view on how the weaknesses that contributed to Glitnir's demise are being addressed in the restructuring plan for Íslandsbanki, is briefly set out below. It is underlined that although Íslandsbanki is based on the domestic operations of Glitnir, it is a different bank. It is also submitted that material changes have been made to address weaknesses that are thought to have contributed to the collapse of the predecessor. Among the most important changes are amendments to rules on related party lending, abolishment of lending with stock as collateral and FX-lending⁵² to non-FX income clients and otherwise stricter discipline on loan approvals. While Íslandsbanki just as Glitnir intends to provide a broad range of financial services in the Icelandic market, the difference between pre- and post-crisis banking for Íslandsbanki is more visible in "how" the bank does business (processes, procedures, documentation, rules and regulation) rather than "what" service and product range it offers. Íslandsbanki's views on this matter are otherwise summarised in the graph 2 below:

⁵² FX-lending stands for lending in foreign currencies. Covered foreign currency loan, and normally relates to loans denominated in a currency other than that of the borrower's home country.



Graph 2: Past weaknesses and the changes addressing these weaknesses

(103) The restructuring plan, as well as the 5-year business plan, is based on a set of general and economic assumptions.⁵³ These assumptions constitute the economic underpinning of the base scenario, as referred to below.

(104) The general assumptions include that:

- restructuring will be completed by year-end [...] in Corporate Banking and [...] in Retail Banking. Interest reset on mortgages will be completed at year-end [...]. The amortisation of the discount, further described below, on the portfolio acquired from Glitnir will be distributed accordingly;
- the bank will have ISK [...] billion of additional gain on [...];
- the capital controls will be lifted in stages
- there will be no limits to lending based funding in ISK. It is not assumed that lending based funding in FX will exceed repayments of currently outstanding FX denominated loans in 2012; access to FX funding is assumed to become more easily available from 2012 and onwards.

(105) In addition, the Board of Directors of Íslandsbanki has put forward a set of financial targets:

- Return on Equity (ROE): Risk free rate + [...]%. The risk free rate is considered to be the Central Bank current account rate (3.75% at December 2011). The target assumes a Tier 1 ratio of [...]%
- CAD Capital Ratio: [...]% [...]
- Tier 1 ratio: [...]% [...]

(106) The macro-economic assumptions include

⁵³ The economic assumptions on which the projections are based are prepared by the Bank's Research Department. The general assumptions were compiled by relevant department heads and senior employees and signed off by the Bank's Executive Management Board.

- Economic growth will continue in 2012 and beyond although at a slower pace than anticipated earlier. Households will be in a better economic position as purchasing power increases with falling unemployment.
- Inflation will remain just above the CBI's target i.e. just below 3% from 2013 onwards. This is based on a stable ISK exchange rate (with modest strengthening at the beginning of the period) and a balanced labour market with moderate wage increases and gradual house price rises.

Change between years average (%)	2012	2013	2014	2015	2016
GDP growth	2.2	2.1	3.4	2.3	3.0
Unemployment	6.6	6.0	5.4	5.0	4.4
Inflation	4.4	2.9	2.8	2.7	2.6
Wages	6.7	4.7	4.8	5.0	4.8

Short-term interest rates will stay unchanged around 5%⁵⁴ in 2012 but gradually rise as the economy recovers.

- While conditions in the labour market will improve, unemployment will still remain somewhat higher than before the financial crisis. Wage growth will pick up as the unemployment rate falls.
- Finally, it is assumed that the ISK will continue to be Iceland's currency throughout the restructuring period. Currency controls will be lifted in steps from 2012 and onwards. Some restrictions on capital flows will remain throughout the decade.

(i) *Deleveraging the balance sheet by the winding up of the old bank and establishing a new bank;*

(107) As mentioned above, most of Glitnir's domestic assets and liabilities were transferred to Íslandsbanki in the course of October 2008. As a result of this process, most of the wholesale debt remained in the estate of Glitnir, and thus Íslandsbanki has never been leveraged in the way Glitnir was. According to the restructuring plan, this means that the issue of deleveraging the balance sheet of the bank was solved in essence already in October 2008.

(ii) *Establishing and maintaining a strong capital ratio position*

(108) As a result of the capitalisation measures described above, and the developments since the bank's establishment, particularly the re-evaluation of assets (further elaborated on below), Íslandsbanki has had capital ratios well above the capital requirements of the FME, as indicated below in **Table 2**:

	31.12.2008	31.12.2009	31.12.2010	31.12.2011 ⁵⁵
Tier 1 capital	68 030	91 996	120 993	120 530
Tier 2 capital	-	24 843	21 251	21 937

⁵⁴ As from 16.5.2012, the CBI seven-day collateralised lending rate has been 5.5%.

⁵⁵ At the time the restructuring plan was submitted, the financial reporting for 2011 was not completed, and the data from 30 September 2011 was used in the final restructuring plan. After the publication of Íslandsbanki's financial statement for 2011, the Authority up-dated the figures.

Total capital	68 030	116 839	142 244	142 234
Risk-Weighted Assets (RWA)	656 713	589 819	534 431	629 419
Tier 1 ratio	10.4%	15.6%	22.6%	19.1%
CAD ratio	10.4%	19.8%	26.6%	22.6

Table 2: Capital ratios during 2008-2011, amounts in million ISK

- (109) Furthermore, according to the ICAAP report submitted with the restructuring plan, Íslandsbanki forecasts the following capital ratios for the period of 2012 to 2016 (**Table 3**):

	2012	2013	2014	2015	2016
Risk-Weighted Assets (RWA)	[...]	[...]	[...]	[...]	[...]
Tier I ratio	[20-25]%	[15-20]%	[10-20]%	[10-15]%	[10-15]%
CAD ratio	[20-30]%	[15-25]%	[15-20]%	[10-20]%	[10-15]%

Table 4: Forecasted capital ratios 2012-2016 and RWA, amounts in billion ISK

- (110) According to these figures, Íslandsbanki anticipates to stay well above the capital requirements of the FME during the restructuring period and beyond. [...]

(iii) Achieving a satisfactory profitability

- (111) According to the restructuring plan, and as illustrated below in **table 5**, the return on equity of Íslandsbanki has been healthy since the establishment of the bank in 2008 (with the exception of 2011)⁵⁶.

	2008	2009	2010	2011
ROE	17.2%	30.0%	28.5%	1.5%

Table 5: Past Return on Equity (ROE)

Moreover, the restructuring plan predicts the following return on capital during the course of the restructuring and beyond (**Table 6**).

	2012	2013	2014	2015	2016

⁵⁶ The reason given for the fall in ROE in 2011 was the Supreme Court ruling on FX-leading of 15/2/2012 and the writing off of goodwill following the merger with Byr.

ROE	[5-15]%	[10-20]%	[5-15]%	[5-15]%	[5-15]%
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Table 6: Return on Equity (ROE) forecast

(112) This forecast is the result of more detailed financial planning in the restructuring plan, the most relevant aspects of which are the following:

- Profit from the most important business segments is expected to [...]; this is mainly due to an increase in funding cost and the absence of a “discount revenue” from 2014 onwards.
- Profit in the markets business segment are forecasted to increase from [...] to [...] ISK until 2016, predominately due to greater fee and commission income.
- The net interest margin is expected to [...] in 2014 and then expected to stay stable.
- The number of employees is expected to decrease by [...]
- The cost/income ratio is expected to fall from 75% in 2011 to [...] % in 2014.

(113) According to the Icelandic authorities, the very solid performance of Íslandsbanki since its establishment is to a certain extent due to the fact that the loan portfolio was acquired by the bank from Glitnir at deep discount⁵⁷. The discount has been and will remain an important part of the Bank’s revenues while the loan portfolio is being restructured. However, according to the forecast, the discount will have been amortised in full when the restructuring will be completed.

(114) In support of this view the Icelandic authorities have submitted a calculation (**table 7**) indicating what the annual results would have been without the discount and other “irregular items”, such as the writing off of goodwill resulting from the Byr transaction.

ISK m	Profit for the year	"irregular items"	Profit net of "irregular items"
2008	2366	- 1.543	14909
2009	23982	801	23181
2010	29369	14507	14862
2011	9613	- 11074	20687
2012	[...]	[...]	[...]
2013	[...]	[...]	[...]
2014	[...]	-	[...]
2015	[...]	-	[...]
2016	[...]	-	[...]

Table 7: Profits net of irregular items

⁵⁷ The “deep discount” was twofold, according to the Icelandic authorities, and consisted of an impairment and a discount. The impairment reflects the difference in claim value and estimated recovery of the loan assets. Moreover, the acquired loan portfolio was not valued at market rates and the discount reflects the difference in contractual interest rates and market rates.

(115) According to this data, the bank would still have made and will during the restructuring period make profits even in the absence of the discount.⁵⁸ It is not clear however, if both aspects of the “deep discount” mentioned above are reflected in these figures.

(iv) Establishing and maintaining a strong liquidity position

(116) Regarding liquidity, the FME requires that that cash or cash-like assets should amount to 5% of on-demand deposits and the banks should be able to withstand a 20% instantaneous outflow of deposits. In addition, the Central Bank of Iceland sets rules on credit institutions’ liquidity⁵⁹ according to which credit institutions’ liquid assets and liabilities are classified by type and maturity and assigned weights according to risk. Credit institutions must have liquid assets in excess of the next three months’ liabilities. The rules also entail a certain stress test where a discount is applied to various equity items, but where it is assumed, on the one hand, that all obligations must be paid upon maturity, and on the other, that a portions of other obligations, such as deposits, must be paid at short notice or none at all.

(117) As **figure A** and **B** show, Íslandsbanki has maintained liquidity reserves within the supervisory requirements in 2009, 2010 and 2011.

Central Bank liquidity ratios if government liquidity facility is excluded				FME liquidity ratios if government liquidity facility is excluded			
Requirement to be above 100% for 0-1 and 0-3 months				Requirement to be above 20% in liquid assets ratio and above 5% in the cash ratio			
	31.12.2009	31.12.2010	31.12.2011		21.12.2009	31.12.2010	31.12.2011
ON - 1 m	2,34	2,73	1,32	Liquid assets ratio	N/A	33%	31%
0 - 3 m	2,41	2,73	1,31	Cash ratio	N/A	17%	22%
* A change in classification results in a significant drop in the ratios between year-end 2010 and 2011				Not implemented until after year-end 2009			

Figures A and B: Íslandsbanki’s compliance with supervisory liquidity requirements

(118) As figure C below shows, Íslandsbanki has had improving liquidity ratios for liabilities maturing within the next 3 and 6 months in 2010 and 2011, while the 12 months indicator is more stagnant.

[...]

[Graph showing Íslandsbanki’s liquidity ratios

Values not disclosed for reasons of professional secrecy]

Figure C: Historical liquidity ratios:

- Liquidity ratio A shows the coverage of liabilities maturing within the next 3 months
- Liquidity ratio B shows the coverage of liabilities maturing within the next 6 months
- Liquidity ratio C shows the coverage of liabilities maturing within the next 12 months

⁵⁸ The ISFI’s report for 2011 (on the banks’ operations in 2010) comes to a similar conclusion; the “core profitability” of Íslandsbanki according to this report is even higher. See http://www.bankasysla.is/files/SkyrslaBR_2011_net_74617143.pdf

⁵⁹ See the CBI’s Rules on Liquidity Ratios No. 317 of 25 April 2006, available at <http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=4713>

- (119) The expected development of Íslandsbanki's liquidity position, in particular in case of a stress event, is further discussed below.
- (v) *Finalising the restructuring of the loan portfolio, both for private households and for businesses.*
- (120) Prior to the financial crises in 2008, both the bank's private and commercial customers took on a high level of debt. When the economy and, in particular, real estate prices fell in the wake of the crisis, the suddenly over-leveraged customers could often not service their debt any longer, and held negative equity. Aside from the general threat to the economic welfare of Iceland, the sudden deterioration in the bank's lending portfolio became a major risk for the bank's future viability. For this reason the restructuring of the private and commercial loan portfolios (deleveraging), as reflected in the restructuring plan, has become a priority for Íslandsbanki.
- (121) According to the Icelandic authorities, Íslandsbanki has developed specific debt relief programmes and co-operated with the state and other banks on general debt relief measures (e.g. the 110% mortgage adjustment).⁶⁰
- (122) Íslandsbanki has submitted an outline of the restructuring methods it uses to the Authority, based on information compiled in November 2010. The methods distinguish between debt restructuring for companies and for households and individuals. Tailor made solutions are designed for larger companies, whereas SMEs are offered an adjustment of the principal, and/or adjustment of the outstanding debt/interest to either the value of the assets in the company or the free cash flow.
- (123) Households and individuals are offered a variety of restructuring options, such as payment holidays, extension of terms and flexible payment schemes.
- (124) In order to monitor and ensure the progress in restructuring, Íslandsbanki has also developed a so-called "Restructuring Dashboard", which has been submitted to the Authority.
- (125) According to the Icelandic authorities, and in spite of some unexpected events such as the recent ruling of the Icelandic Supreme Court on FX-loans, Íslandsbanki will complete the restructuring of its corporate loan portfolio by year-end 2012 and in 2013 in Retail Banking. The resetting of interest rates on mortgages is forecasted to be completed at year-end 2014.
- (vi) *Improvement of the funding strategy;*
- (126) Íslandsbanki's deposit base has remained fairly stable at around ISK 400 billion since the establishment and increased to ISK 535 billion at year end 2011 due to Íslandsbanki's merger with Byr. Deposits currently amount to almost 80% of total liabilities.
- (127) The Bank's deposit/loan ratio has been around and above 80% during 2010 and 2011. Íslandsbanki assumes that the current low deposit rates will encourage investors to move some of their funds into higher yielding investments as the economy recovers and risk appetite increases. As a result, the bank foresees that the deposit/loan ratio may fall to around [...] % by 2016. Moreover, foreign currency deposits are expected to [...]. Íslandsbanki aims at gradually diversifying its funding mix.
- (128) [...].⁶¹

⁶⁰ The main Icelandic banks agreed to offer all overleveraged customers a 110% mortgage adjustment, i.e. that principal of mortgages is set to 110% of the registered value of the property.

(129) As for the funding needs in ISK, [...]. On the other hand, Íslandsbanki was the first Icelandic bank to issue a covered bond. The first issuance was in December 2011, a CPI⁶²-linked ISK 4 billion issue. The issuance was well received by institutional investors and oversubscribed. Íslandsbanki expects to be able to issue short-term paper in 2012 as well as expanding the current covered bond issuance at a rate of ISK 10 billion per year. [...].

(130) According to the restructuring plan, the change in the funding mix will raise the cost of funding over the planned period. The cost of borrowings is assumed to be some [...]bp above base rate for the Bank's mix of CPI-indexed bonds and [...]bp for non-indexed bonds, whereas the cost of deposits is around [...]bp above the base rate.

(vii) Cost efficiency

(131) According to the restructuring plan, Íslandsbanki continues to focus on efficient and streamlined operations in order to counter increased infrastructure cost which has occurred as a result of tighter regulatory controls and increased taxation. The bank submits that substantial work was completed in 2011 in order to increase cost efficiency but emphasises that this is a long term project that requires changes to processes and on-going analysis. According to the restructuring plan, the focus on cost awareness will continue in 2012 as well as the reduction of cost and cost analysis, during which the bank's internal procedures will be reviewed and improved where needed. As indicated above, those measures, as well as a reduction in staff, are expected to lead to the cost/income ratio falling from 75% in 2011 to [...] % in 2014.

(viii) Improvements to the corporate governance and risk management

(132) Íslandsbanki has informed the Authority that one of their priorities is to bring its corporate governance structures and processes in line with national and international best practices. In this regard, Íslandsbanki has established a Risk Management and Credit Control division. The division oversees risk management and credit control issues; work that is linked into everyday processes in every division throughout the Bank. In 2011 Íslandsbanki published for the first time a comprehensive Risk Book⁶³ together with the Annual Report. The Risk Book, which will be published annually, provides additional information about the Bank's risk management framework, capital structure and adequacy, material risk exposures and risk assessment processes.

3.4.8 Ability to reach viability under a base and stress scenario

(133) In the restructuring plan, with reference made to the ICAAP report, the Icelandic authorities have submitted a stress scenario for Íslandsbanki with the aim of demonstrating Íslandsbanki ability to achieve long-term viability.

3.4.8.1 The base scenario

(134) The restructuring plan as described above including the assumptions on which it is based constitute the base case.

⁶¹ Íslandsbanki has stressed that the deposit priority in Iceland limits the ability to issue unsecured debt [...].

⁶² Consumer Price Index.

⁶³ The Risk Book is available on the Bank's website www.Íslandsbanki.is/riskbook.

3.4.8.2 The stress scenario

- (135) In chapter 5.9.3 of the restructuring plan, Íslandsbanki has made reference to a stress scenario presented in the ICAAP report, submitted to the Icelandic Financial Authority on 1 April 2012.
- (136) The main findings of the 2012 ICAAP report are that the capitalisation of Íslandsbanki is well above both internal and external minimum requirements and in excess of what can be viewed as a long-term target for a Bank operating under "normal" business conditions. According to the report, the internal minimum capital requirements and the results from the stress tests conducted in the current ICAAP indicate that the foreseen dividend payments in the 5-year business plan appear reasonable.
- (137) According to the ICAAP report, decisions on each year's dividend payment should be based on up to date capital adequacy analysis and also take into account the Bank's liquidity position.
- (138) According to the ICAAP report the minimum capital ratio for the Bank is in the range of [...]% - [...]% of RWA. At year-end 2012, the minimum amount of capital needed is estimated to be ISK [...] billion, whereof ISK [...]billion is required under Pillar 2a, due to risk factors that are not covered or are underestimated under Pillar 1. In reality, however, the capital ratio of the Bank was 22.6% at the end of 2011. Results from stress tests indicate that part of the excess capital is needed to meet possible adverse events to the Bank's operations but a gradual payment of excess capital in the form of dividends is reasonable. The capital estimated necessary to meet stress events amounts to ISK [...]billion at the beginning of 2012 and excess capital at the end of 2012 is [...]billion, as illustrated below in **Table 8**:

	Pillar 1 ⁶⁴	Pillar 2a ⁶⁵	Pillar 2b	CAD required
ISK billion	Minimum requirement	Add-on	Stress testing	All levels combined
Credit risk	[...]	[...]		[...]
Market risk	[...]	[...]		[...]
Operational risk	[...]			[...]
Concentration risk		[...]		[...]
Minimum capital required under Pillar (1 and 2a)	[...]	[...]		[...]
Stress testing			[...]	[...]
CAD required	[...]	[...]	[...]	[...]

⁶⁴ The first step in assessing the capital requirements is based on the Pillar 1 calculations.

⁶⁵ According to the ICAAP report, the additional capital requirements under Pillar 2 (Pillar 2a and 2b) are estimated as follows:

- a. Other risk types and risk not fully covered under Pillar 1: In addition to the minimum capital required under Pillar 1 further capital might be required under Pillar 2a due to other risk factors or due to understatement of the Pillar 1 risk factors. The capital requirements under Pillar 1 and Pillar 2a form the baseline capital requirement for the Bank.
- b. Reduction in available capital due to stress testing and for strategic purposes: The baseline capital requirement is estimated based on "normal business conditions". The Bank however needs to make sure that its capital is sufficient to support the business under stressed market conditions and that it supports the Bank's business strategy for the years to come. Thus, the Bank might need to hold a capital buffer in order to be able to withstand stressed market conditions and to support intended growth. In order to estimate the size of the capital buffer needed, the Bank's business plan is stressed based on various assumptions relevant to the Bank's risk profile and business strategy.

CAD as of (year-end 2012)				[...]
Capital surplus				[...]

Table 8: Overview ICAAP report

- (139) In the ICAAP report, Íslandsbanki has assessed the aggregated possible losses due to credit risk, market risk (in trading book and in banking book), operational risk, business risk (impact of increased funding costs and less reduction in operational cost, and the impact of [...] % less growth in market revenues), as well as legal and political risk (e.g. the impact of the recent Supreme Court ruling on FX-loans, no additional recovery for the corporate (seafood) portfolio and other legal and political risk factors).
- (140) In addition, Íslandsbanki has performed stress testing of the liquidity ratio of the bank. Here, Íslandsbanki has made one base stress scenario⁶⁶ and a more severe stressed scenario, where the different sources of cash inflows and cash outflows are stressed to varying degrees. The result indicates that the Bank is well positioned to meet unexpected liquidity disruptions.

3.4.9 Exit strategy/repayment of the State

- (141) As already described above, the Tier II capital contribution has 10 year duration from December 2009. As for the remuneration, there is a built in step-up clause after 5 years (i.e. 2014), from 400bp to 500bp over EURIBOR. According to the Icelandic authorities, this step-up should act as an incentive for the bank to pay back this capital as from this time.
- (142) As for the 5% equity stake that the State retains in Íslandsbanki, the government's holdings in financial undertakings are managed by the Icelandic State Financial Investments (the ISFI)⁶⁷. According to the State Budget for 2012, the government has been authorised to sell the stakes that it currently holds in savings banks, but no decision has yet been made regarding sale of state's holdings in the three major commercial banks. A working group has however been established by the responsible ministers to explore possible ways of disposing of shareholdings in the commercial banks. The government has indicated that while it has no intention of reducing its holdings in Landsbankinn below two-thirds of the bank's share capital, the stakes in Íslandsbanki and Arion Bank could soon be offered for sale or sold with the banks in their entirety if their majority owners decide to sell, subject to certain prerequisites being resolved⁶⁸.
- (143) The special liquidity facility is only available until September 2012 and has never been used. The Icelandic authorities envisage to remove the government's declaration on a blanket deposit guarantee in the near future, before the capital controls are lifted.

⁶⁶ The Bank's internal liquidity ratios represents a stressed situation rather than normal business conditions.

⁶⁷ The ISFI is a state body with an independent Board of Directors, reporting to the Minister of Finance, which was established with Act No. 88/2009 and came into effect in August 2009. The ISFI shall have completed its duties no later than 5 years after its foundation. The ISFI manages the holdings in accordance with the law, good governance and business practices and the state's ownership policy. It aims to restore and reconstruct a dynamic domestic financial market, while at the same time promoting effective competition in the market as well as guaranteeing transparency in all decisions regarding the state's participation in financial activities

⁶⁸ These prerequisites concern in particular uncertainties resulting from recent Supreme Court rulings regarding FX-denominated loans and that the assets of the insolvent estates of the old banks have been wound up satisfactorily. See Chapter 9.7 of the report the Future Structure of the Icelandic Financial System, available at <http://eng.efnahagsraduneyti.is/media/Acrobat/Future-Structure.pdf>

- (144) As for the Straumur agreement, while the bond was to mature by the end of March 2013, it was actually paid up in full by Straumur in early 2012. As from that time, the State's assumption of risk for the sufficiency of the underlying assets was terminated.

4 Grounds for initiating the formal investigation procedure and the measures temporarily approved in the Byr decisions

- (145) In the opening decision, the Authority preliminarily concluded that the measures by the Icelandic State to capitalise Íslandsbanki, as well as the liquidity facility, entail state aid pursuant to Article 61 EEA. Furthermore it could not exclude that state aid was present in the deposit guarantee and the Straumur agreement. The opening decision did not cover the aid measures related to the acquisition of Byr, which were temporarily approved by the Authority in the Byr decisions. The Authority will take a final view on these measures, which continue to have a bearing on the assessment at hand, in the present decision.
- (146) As for the compatibility of the measures assessed in the opening Decision, the Authority considered that a final view could only be taken on the basis of a restructuring plan, which had not been submitted when the Authority opened the formal investigation procedure on 15 December 2010. It was in particular due to the absence of a restructuring plan more than one year after the establishment of Íslandsbanki that the Authority expressed doubts about the compatibility of the aid.

4.1 Comments from interested parties

- (147) The Authority received a statement on behalf of the creditors of the old bank, in which they emphasised that they were to be considered as interested parties, and indicated to possibly submit further comments at a later stage.

4.2 Comments from the Icelandic authorities

- (148) The Icelandic authorities accept that measures undertaken in establishing New Glitnir Bank, now Íslandsbanki, constitute state aid. In the view of the Icelandic authorities, the measures are however compatible with the functioning of the EEA Agreement on the basis of Article 61(3)(b) of the Agreement, as they are necessary, proportionate and appropriate to remedy a serious disturbance in the Icelandic economy. In the view of the Icelandic authorities the measures taken are in all aspects in line with the principles set out in the Authority's state aid guidelines, and submit that the aid is necessary and limited to the minimum amount necessary.
- (149) Moreover, the Icelandic authorities emphasise that the former shareholders of Glitnir Bank have lost all their shares and received no compensation from the state, that the aid is well designed to minimize negative spill-over effect on competitors and that the terms of the loans (the Tier II capital) are comparable to market rates.
- (150) The Icelandic authorities do not regard the deposit guarantee as entailing state aid.

4.3 Commitments by the Icelandic authorities

- (151) The Icelandic authorities have submitted a number of commitments, most of which related to the distortions of competition caused by the aid under assessment, and which are set out in Annex 1.

II. ASSESSMENT

The presence of state aid

(152) Article 61(1) EEA Agreement Article 61(1) of the EEA Agreement reads as follows:

“Save as otherwise provided in this Agreement, any aid granted by EC Member States, EFTA States or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Contracting Parties, be incompatible with the functioning of this Agreement.”

(153) The Authority will assess the following measures⁶⁹ below:

- The initial operating capital provided by the Icelandic State to the new bank;
- The (temporary) full state capitalisation of the new bank;
- The retention by the State of the 5% share capital remaining after 95% of the share capital in the new bank was transferred to the creditors of Glitnir; and
- The provision by the State of Tier-II capital to the new bank by way of subordinated debt.

The above measures are referred to collectively below as “the capitalisation measures”. In addition, the Authority will assess:

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

(154) The Authority also recalls that it has identified Íslandsbanki as a potential beneficiary of aid granted to Byr in the second Byr decision, in particular of the subordinated loan facility that was kept available until Byr could be merged with Íslandsbanki. Moreover, the Authority reiterates that the temporarily approved rescue measures for Byr, which has now been merged with Íslandsbanki, constitute state aid, the final compatibility of which depends on the restructuring plan for the merged entity.

4.4 Presence of state resources

(155) As the Authority already preliminarily concluded in the opening decision, it is clear that the capitalisation measures are financed through state resources provided by the Icelandic Treasury. State resources are also evidently present in the liquidity facility available to Íslandsbanki. As for the Straumur agreement, the State assumed the risk that the assets of Straumur would be insufficient to cover the transferred liabilities (deposits) of Straumur bank. In essence it guaranteed to make up for the shortfall, which entails a (potential) transfer of state resources.

⁶⁹ Described in detail in Chapter 3 of the present decision.

- (156) Regarding the deposit guarantee, the Authority emphasises at the outset that its assessment is limited to the additional deposit guarantee described above, consisting in essence of the statements made by the Icelandic government that deposits in domestic commercial and savings banks and their branches in Iceland will be fully covered.
- (157) This assessment is without prejudice to the Authority's view on the compatibility of Act No. 98/1999 and the actions of the Icelandic Government and the TIF during the financial crisis with EEA law, in particular Directive 94/19/EC. As regards the implementation of Directives 97/9/EC and 94/19/EC the Authority is of the view that to the extent such measures constitute state aid, the use of state resources to comply with obligations under EEA law would generally not raise concerns under Article 61 EEA. The present decision is therefore not concerned with those measures.
- (158) The Authority stated in the opening decision that it would investigate further whether the statements by the Icelandic State described above are sufficiently precise, firm, unconditional and legally binding such as to involve a commitment of state resources⁷⁰. In assessing whether these criteria are met, the Authority notes that the declarations entailed an irrevocable commitment of public resources as shown by the fact that the Icelandic state has done its utmost to protect depositors: Not only has it changed the priority of deposit holders in insolvent estates (which would not entail the use of state resources), but it has also made it clear that it would not allow depositors to suffer any losses. The Government's blanket guarantee of all deposits in domestic commercial and savings banks is furthermore distinct from any deposit guarantee scheme based on EEA acts due to the fact that the protection is unlimited in amount and no financial contribution is made by the banks benefitting from the measure.
- (159) The Icelandic government's understanding of its declaration is illustrated by the state interventions in the financial sector that have occurred since October 2008 which have been motivated by the intention to honour this declaration. Those interventions have included measures to cover deposits of financial undertakings, such as the foundation of the three commercial banks, the transfer of SPRON deposits to Arion Bank, the transfer of Straumur deposits to Íslandsbanki, the CBI takeover of the deposits of 5 savings banks in Sparisjóðabanki Íslands, the transfer of deposits in Byr Savings Bank to Byr hf, the transfer of deposits from Keflavík Savings Bank to SpKef and the State's responsibility for deposits in SpKef following the forced merger with Landsbankinn.
- (160) In fact, the Icelandic authorities have argued in several state aid cases that the Authority is currently investigating, some of which were mentioned above, that the respective chosen measure was the financially least burdensome option for the Icelandic state to comply with its pledge to protect depositors in full.
- (161) In the light of the above the Authority considers that there is a legally binding, precise, unconditional and firm measure in place. On this basis, the Authority therefore concludes that the statements by the Icelandic state according to which deposits are fully guaranteed entail a commitment of state resources in the meaning of Article 61 EEA

4.5 Favouring certain undertakings or the production of certain goods

4.5.1 Advantage

- (162) First, the aid measures must confer on the new bank advantages that relieve it of charges that are normally borne from its budget. In line with the preliminary conclusion it reached

⁷⁰ See in this respect the judgment of the General Court in joined Cases T-425/04, T-444/04, T-450/04 and T-456/04, *France and others v Commission* [2010] ECR II-02099, paragraph 283 (on appeal).

in the opening decision, the Authority remains of the view that each of the capitalisation measures confers an advantage on the new bank as the capital provided would not have been available to the bank without state intervention.

- (163) In determining whether an investment in an undertaking, for example by means of a capital injection, entails an advantage, the Authority applies the market economy investor principle, and assesses whether a private investor of a comparable size to that of the public body operating in normal market conditions would have made such an investment.⁷¹ As regards capitalisation measures for the benefit of banks in difficulties, since the onset of the financial crisis, the approach taken both by the European Commission (in numerous cases since the financial crisis began⁷²) and by the Authority⁷³ has been in general that state recapitalisations of banks amount to state aid given the turmoil and uncertainty that have characterised financial markets since the autumn of 2008. This general consideration applies in particular to the Icelandic financial markets in 2008 and 2009, when the entire system collapsed. Thus the Authority considers the capitalisation measures to confer an advantage on Íslandsbanki notwithstanding the eventual transfer of 95% of the capital of the new bank to the (largely private sector) creditors. The private sector involvement in the capitalisation of Íslandsbanki is made up entirely of creditors of the old bank who are solely seeking to minimise their losses⁷⁴.
- (164) Similar consideration apply in so far as the special liquidity facility is concerned, which was negotiated as part of a package of state assistance measures aiming to restore operations of a failed bank in a newly formed bank and to encourage equity participation in the new bank by the creditors of the failed bank. It is evident that the State stepped in as it was not clear if sufficient liquidity could be obtained by Íslandsbanki on the market. Thus, rather than acting as a private investor, the State replaced the role of private market participants who shied away from lending to financial undertakings. Therefore the Authority confirms the preliminary conclusion that it reached in the opening decision and considers the special liquidity facility as conferring an advantage on Íslandsbanki.
- (165) Regarding the transfer of assets and liabilities of Straumur Bank – the Straumur agreement, the Authority notes positively that the overall transaction aims at providing Íslandsbanki with compensation equalling solely the amount of the transferred liabilities. However, the entire risk of the assets of Straumur being of less value than the transferred deposits, and the obligation to make up for any potential shortfall, is allocated to the State. It thus seems that Íslandsbanki, aside from receiving some revenue (through interest payments on the bond) is able to acquire goodwill and additional market shares, without taking on any risk. The Authority concludes that this constitutes an advantage.
- (166) Finally, the Authority also needs to assess whether the additional deposit guarantee conveys an advantage on Íslandsbanki and Icelandic banks in general. In this regard, the Authority notes that when the statement that deposits would be guaranteed were first made by the Icelandic authorities, it was not entirely clear how this guarantee would work in

⁷¹ See for example T-228/99 WestLB [2003] ECR-435.

⁷² See for example Commission decision of 10 October 2008 in case NN 51/2008 *Guarantee scheme for banks in Denmark*, at paragraph 32, and Commission decision of 21 October 2008 in case C 10/2008 *IKB*, at paragraph 74.

⁷³ See the Authority's decision of 8 May 2009 on a scheme for temporary recapitalisation of fundamentally sound banks in order to foster financial stability and lending to the real economy in Norway (205/09/COL) available at: <http://www.eftasurv.int/?l=1&showLinkID=16694&l=1>

⁷⁴ See in this context similar reasoning adopted by the European Commission in respect of investments made by suppliers of a firm in difficulty in Commission Decision C 4/10 (ex NN 64/09) – Aid in favour of Trèves (France).

practice, in particular what effect such intervention would have on the bank that could not live up to its financial obligations vis-à-vis its depositors anymore. In the meanwhile, it appears that such a bank would be allowed to fail, but that the Icelandic state would ensure – for example by transferring deposits to another bank and making up for the shortfall in assets – that deposits could be paid in full, and the depositors would never lose access to the full amount of their deposits.

- (167) The Authority considers that it is of secondary importance how exactly the State would act in complying with the unlimited guarantee on domestic deposits. What matters is that it has assumed the obligation to step in if a bank would fail to pay out deposits, to an unlimited extent.
- (168) This unlimited guarantee has, in the Authority's view, favoured Íslandsbanki: First, as it provides a valuable competitive advantage – an unlimited state guarantee, and hence a significant safety net – over alternative investment options and providers. This is illustrated for example by a recent report of the Minister of Economic Affairs which states that: "Icelandic financial undertakings are currently operating in a sheltered environment with capital controls and a blanket deposit guarantee. Under such conditions, bank deposits are practically the only secure option for Icelandic savers".⁷⁵
- (169) Second, it seems clear that in the absence of the guarantee Íslandsbanki could have more easily suffered from a run on its deposits like its predecessor⁷⁶. Thus the bank would likely have had to pay higher interest rates (to compensate for the risk) in order to attract or even simply retain the same amount of deposits were it not for the additional unlimited deposit guarantee that the Icelandic state has taken upon itself. Accordingly, the Authority concludes that the deposit guarantee entails an advantage for the bank.

4.5.2 Selectivity

- (170) Second, the aid measure must be selective in that it favours "*certain undertakings or the production of certain goods*". The capitalisation measures, the liquidity facility and the Straumur agreement are selective as they only benefit Íslandsbanki.
- (171) Moreover, as state support can be selective even in situations where one or more sectors of the economy benefit and others do not, the Authority also considers the state guarantee on deposits which benefits the Icelandic banking sector as a whole as selective. This conclusion also follows from the considerations set out above according to which banks are favoured over other undertakings that offer possibilities to save and invest money.

4.6 Distortion of competition and affection of trade between Contracting Parties

- (172) The measures strengthen the position of Íslandsbanki in comparison to competitors (or potential competitors) in Iceland and other EEA States. Íslandsbanki is an undertaking which is active, as described above, on financial markets, which are open for international competition in the EEA. Whilst the Icelandic financial markets are currently, particularly

⁷⁵ Report of the Minister of the Minister of Economic Affairs to the Althingi (March 2012), "The Future Structure of the Icelandic Financial System", Ch. 9.6, available at <http://eng.efnahagsraduneyti.is/publications/publications/nr/3556>.

⁷⁶ The Authority notes in this respect comments of the Governor of the CBI, who states in the foreword to the bank's Financial Stability report for the second half of 2010 that the "*financial institutions' capitalisation is currently protected by the capital controls and the Government's declaration of deposit guarantee*". See <http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=8260>, p. 5. See also Commission Decisions NN48/2008 Guarantee Scheme for Banks in Ireland, paragraphs 46 and 47: http://ec.europa.eu/community_law/state_aids/comp-2008/nn048-08.pdf; and NN51/2008 Guarantee Scheme for Banks in Denmark: http://ec.europa.eu/community_law/state_aids/comp-2008/nn051-08.pdf

due to the capital controls, rather isolated, (a potential for) cross-border trade still exists, which will increase as soon as the capital controls are lifted. All measures under assessment must therefore be regarded as distorting competition and affecting trade between the Contracting Parties to the EEA Agreement.⁷⁷

4.7 Conclusion

- (173) The Authority, therefore, comes to the conclusion that the measures taken by the Icelandic State to capitalise the new bank, as well as the liquidity facility, the deposit guarantee and the Straumur agreement involve state aid within the meaning of Article 61(1) of the EEA Agreement. The Authority recalls that it reached the same conclusion regarding the capitalisation measures granted to Byr in the Byr decisions.

5 Procedural requirements

- (174) Pursuant to Article 1(3) of Part I of Protocol 3 SCA, “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”.
- (175) The Icelandic authorities did not notify the aid measures covered by the opening decision to the Authority in advance of their implementation. The Authority therefore concludes that the Icelandic authorities have not respected their obligations pursuant to Article 1(3) of Part I of Protocol 3. The granting of those aid measures was therefore unlawful.

6 Compatibility of the aid

- (176) As a preliminary remark, the Authority notes that whilst Íslandsbanki is a new legal entity that was established in 2008, it is – as regards domestic operations – evidently the economic successor of Glitnir, in the sense that there is an economic continuity between those two entities. As those economic operations that were carried out by Íslandsbanki from the autumn of 2008 onwards could not have continued in the absence of the aid, the Authority considers the bank as an undertaking in difficulties.
- (177) Moreover, the measures under assessment are at the same time rescue and restructuring measures. As stated in the opening decision, the Authority would probably have temporarily approved the measures as compatible rescue aid had they been notified before their implementation, before then taking a final view on them on the basis of a restructuring plan. However, in the absence of a timely notification, the Authority initiated the formal investigation procedure and requested the submission of a restructuring plan. As indicated above, the final compatibility of these measures depends on whether the restructuring plan meets the criteria of the Authority’s applicable state aid guidelines for undertakings in difficulties.

6.1 Legal basis for assessment of compatibility: Article 61(3) of the EEA Agreement and the Authority’s Restructuring Guidelines

- (178) While state aid to undertakings in difficulties such as Íslandsbanki 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”. As is stated in paragraph 8 of the Banking

⁷⁷ See in this respect Case 730/79 *Phillip Morris v Commission* [1980] ECR 2671.

Guidelines⁷⁸, the Authority reaffirms that, in line with the case law and the European Commission's decision making practice, 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.

(179) The Icelandic authorities have explained, as described in detail above, that Iceland's financial system entered into a state of systemic crisis in October 2008, leading to the collapse of its major banks as well as major savings 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 market. The difficulties were coupled with a breakdown of confidence in the country's currency. Iceland's real economy has been severely hit by the financial crisis. Although more than three years have passed since the onset of the crisis, the Icelandic financial system is still in a state of turmoil. Even if the situation has eased significantly since 2008, it is evident that at the time that the measures were taken, they were intended to remedy a serious disturbance in the Icelandic economy.

(180) Consequently, Article 61(3)(b) of the EEA Agreement is considered to apply in this case.

The application of the Restructuring Communication

(181) 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 rules⁷⁹ ("the Restructuring Guidelines") sets out the state aid rules applicable to the restructuring of financial institutions in the current crisis. 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 viability of the bank;
- (ii) Include sufficient own contribution by the beneficiary (burden-sharing);
- (iii) Contain sufficient measures limiting the distortion of competition.

(182) The Authority will thus assess below, based on the restructuring plan submitted for Íslandsbanki, which also reflects the acquisition of Byr, whether these criteria are met, and if therefore the aid measures described above, as well as those identified by the Authority in the Byr decision constitute compatible restructuring aid.

3.2 Restoration of viability

(183) 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 restructuring aid will attain this, is an important aspect in determining its compatibility.

(184) 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.

⁷⁸ See Part VIII of the Authority's State Aid Guidelines. Temporary rules regarding financial crisis. The application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, available at <http://www.eftasurv.int/?1=1&showLinkId=16604&1=1>

⁷⁹ Return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, adopted by the Authority on 25.11.2009 under chapter VII: Temporary Rules regarding the Financial Crisis, as extended by the Financial Crisis Guidelines 2012. Available at the Authority's website at: <http://www.eftasurv.int/media/state-aid-guidelines/Part-VIII--Return-to-viability-and-the-assessment-of-restructuring-measures-in-the-financial-sector.pdf>.

The Authority emphasises at the outset that this consideration needs to be borne in mind in the below assessment.

- (185) Section 2 of the Restructuring Guidelines sets out that the EEA State should provide 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.
- (186) The causes of Íslandsbanki's difficulties are, as described above, spelt out both in the restructuring plan, but also in the report of the Special Investigation Commission. Amongst the main causes identified at the bank's level in the latter were the excessive and unsustainable expansion, the gearing of the bank's owners, the concentration of risk, weak equity and the size of the banks as compared to the Icelandic economy. Moreover, Glitnir had expanded into highly leveraged LBOs⁸⁰ and commercial real estate markets outside Iceland. It also relied predominately on short-term wholesale funding and took on major risk by lending to its owners, and the bank had large single exposures.

Regulatory viability measures

- (187) Whilst the Íslandsbanki's restructuring plan addresses many of the bank's weaknesses as identified above, the Authority considers that the failure of Glitnir, and the collapse of the Icelandic financial industry, was also caused by a number of factors specific to Iceland, relating to its small size and the regulatory and supervisory shortcomings highlighted by the Special Investigation Commission. The long-term viability of Íslandsbanki, 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.
- (188) In this regard the Authority notes positively the amendments to the regulatory and supervisory framework that the Icelandic authorities have made, as explained in Annex I.
- (189) 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 addresses one of the factors that led to the financial collapse.
- (190) Second, the temporary high CAD ratio requirements, and a number of provisions relating to collateralisation, in particular the prohibition of extending credit against pledges of own shares, aims 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.
- (191) 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. The measures also increase external risk monitoring, both of which reduces threats to the banks' viability.

⁸⁰ Leveraged Buyouts.

(192) 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 balance⁸¹ 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 bank's business more fragile and vulnerable to foreign currency exchange and liquidity risks. The Authority welcomes that the Icelandic authorities have responded to this aspect of regulatory failure.

Íslandsbanki's restructuring plan

(193) As for the restructuring plan and the measures at the bank's level, Íslandsbanki has in essence reverted to a more traditional banking model, focusing on its core strength (domestic banking, seafood and geothermal industry), which will be predominately funded through customer deposits.

(194) The deposit-to-loan ratio will fall further from about 80% to [...] % at the end of the restructuring period [...].

(195) Moreover, as indicated above, Íslandsbanki was – if compared to Glitnir – from the moment of its establishment substantially less leveraged, and as most wholesale debt remained in the estate of Glitnir, it will, according to the restructuring plan, have to rely on refinancing on international markets for unsecured debt only to a very limited extent.

(196) In fact, the reliance on wholesale markets for refinancing turned out to be one of the main reasons for Glitnir's demise. Íslandsbanki's funding has so far been mostly based on deposits and equity, but the restructuring plan foresees a slight reduction in the significance of deposits from 80% to [...] % of total liabilities, [...]. Íslandsbanki intends to make up for this by means of issuing covered bonds on the domestic market. It has already successfully issued covered bonds for ISK 4 billion in December 2011, and [...].

(197) [...]. Íslandsbanki is of the view that the currently limited appetite of investors for unsecured Icelandic paper could grow once the unlimited deposit guarantee is lifted. The Authority considers that, based on the facts submitted by the Icelandic authorities, the bank's funding situation appears to be sound until the end of the restructuring period. Given the uncertainties surrounding the deposit guarantee and the capital controls, as well as the ambiguous future developments of (sovereign) debt markets, it cannot conclude on whether Íslandsbanki's funding strategy will materialise as foreseen in the long run. However, given the strong reliance on deposits and covered bonds during the restructuring

⁸¹ New Rules on Foreign Exchange Balance adopted by the CBI entered into force on 1 January 2011. The purpose of the rules is to limit foreign exchange risk by preventing foreign exchange balances from exceeding defined limits. One of the most important changes from previous versions of the Rules is that the permissible open foreign exchange position in individual currencies has been reduced from 20% to 15% of equity, and the permissible total foreign exchange balance has been lowered from 30% to 15%. Foreign exchange balance reporting is also more detailed than before, as foreign-denominated assets and liabilities are classified by type: loans, bonds, equity securities, shares in mutual funds, deposits, interest-bearing agreements, debts to the Central Bank, and so on. Should the foreign exchange balance deviate from the limits set forth in the rules, the financial undertaking concerned must take action so as to eliminate the difference within a maximum of three business days. If a financial undertaking's measures fail to achieve this, the CBI may calculate periodic penalties. The CBI has also taken other steps to limit foreign exchange imbalances, for instance by concluding a currency swap agreement with one of the commercial banks as well as purchasing foreign currency. According to the CBI, these measures promote increased financial stability and bolster the CBI's non-borrowed foreign exchange reserves.

period, and the large share of those types of debt on the balance sheet, the Authority concedes that slight variations to the funding strategy that might be necessary down the road would not threaten the bank's viability.

- (198) As regards the assets side of the balance sheet, the most risky, international assets – such as the commercial real estate securities abroad - were also kept in Glitnir's estate. As a result, the balance sheet has shrunk by 85%. A main weakness of Glitnir's business model – the reliance on risky international assets without appropriate risk assessment and limited market knowledge - has thus been remedied. The Authority welcomes that pursuant to the restructuring plan, the bank will not engage in similar business in the future, but rather focus on its traditional core business.
- (199) Evidently, the bank has grown since its establishment, in particular through the acquisition of Byr. However, according to the restructuring plan, this does not have a major impact on the business model of Íslandsbanki, as Byr mainly disposed of domestic assets of similar characteristics as those in Íslandsbanki's portfolio. In any event, the Authority considers that the committed divestments, further discussed below, will contribute to letting Íslandsbanki focus on its core business.
- (200) A considerable challenge for the bank as regards its asset portfolio remains the restructuring of the loans that were transferred from Glitnir. In this regard the Authority notes positively that this restructuring process is a priority for the bank, as illustrated by the many generic and tailor-made proposals that the bank has made to its overleveraged customers. Whilst the process has not progressed as swiftly as was initially planned, much has been already achieved. For example, on 8 February 2012, 2,680 companies had undergone some form of restructuring, and according to the Icelandic authorities, the vast majority of those were able to service their debt post restructuring.
- (201) The Authority considers this to be an indicator of the soundness of Íslandsbanki's restructuring methods. Moreover, based on the data in the bank's restructuring dashboard, it appears realistic that the bank can meet its target of completing the restructuring of its corporate debt by year-end 2012 and of retail debt by 2013. Overall, barring unexpected developments in the macro-economic environment in Iceland or abroad, this would mean that at the latest at the end of the restructuring period, Íslandsbanki will, in the Authority's view, have a relatively healthy balance sheet and well-performing loan portfolios.
- (202) As indicated above, the weak capitalisation of Glitnir was one of the factors that led to its downfall. Íslandsbanki's restructuring plan predicts that the bank will stay well above the minimum CAD ratio of 16% required by the FME throughout the restructuring period. This ratio is well above the future Basel III minimum of 10,5%. Even pursuant to the stress case, which Íslandsbanki has submitted in conjunction with this year's ICAAP report attached to the restructuring plan, the CAD ratio would not fall below this high benchmark. In fact, according to the restructuring plan, Íslandsbanki will gradually reduce its capital ratio in order to increase profitability by starting to pay out dividends.⁸² The Authority considers it prudent and comforting that even in the stress case submitted by Íslandsbanki, which seems to be based on sensible parameters, a capital surplus of over ISK [...] billion remains, which, in an operating environment as described above, provides Íslandsbanki with a significant capacity to deal with unexpected adversities.

⁸² However, in the ICAAP-report, Íslandsbanki underlines that decisions on each year's dividend payment, will be based on up to date capital adequacy analysis and also take into account the Bank's liquidity position.

- (203) As for the banks' liquidity position, the Authority notes that the current situation, pursuant to the restructuring plan, appears sufficiently robust, and that there are no indications that the situation could deteriorate substantially during the restructuring period. Moreover, the Authority considers that stress testing the bank's liquidity ratio in the context of the ICAAP report, according to which the bank is well prepared for adverse events, suggests that Íslandsbanki's liquidity situation is sound.
- (204) The Authority also welcomes the changes to Íslandsbanki's corporate governance and risk management, as described above, which address a weakness in Glitnir's business and will contribute to a more objective and professional risk assessment in the bank's operation.
- (205) As regards profitability, the Restructuring Guidelines also provide that the restructuring plan should demonstrate how the bank will restore its long-term viability without State aid as soon as possible. In particular, the bank should be able to generate an appropriate return on equity, while covering all costs of its normal operation and complying with the relevant regulatory requirements. In particular, point 13 of the Restructuring Guidelines indicates that long-term viability is achieved when a bank is able to cover all its costs including depreciation and financial charges and provide an appropriate return on equity, taking account of the risk profile of the bank.
- (206) At this point, the Authority recalls what was already mentioned above, namely that the economic environment in which Íslandsbanki operates would be challenging for any bank. With this in mind, the Authority is satisfied with the restructuring plan's forecasted profitability, which, in spite of the high capital ratio, will be adequate and mostly above Íslandsbanki's own profitability targets throughout most of the restructuring period and beyond. Between 2009 and 2014, the ROE fluctuates between [...] % and [...] %. However, as described above, [...] fluctuation is mainly due to irregular situations and events, such as the valuation gains from the assets transferred from Glitnir on one hand, and the write-downs caused by the recent Supreme Court ruling on FX-loans and the acquisition of Byr on the other hand. According to the restructuring plan, such irregular events are not foreseen to occur beyond 2013, and from 2014 to 2016 the ROE is expected to increase from [...] % to [...] %. The calculation submitted by the Icelandic authorities in which the Profit and Loss Statement (P&L) has been cleansed of those irregular items indicates that the bank has made and will continue to make relatively stable profits from 2008 to 2016. The report by the Icelandic State Financial Investments ("ISFI") referred to above would seem to support this conclusion. Whilst it is not clear if these calculations fully reflect the gains stemming from the deep discount, the Authority notes that after 2013, when the discount is forecasted to be fully absorbed, the bank will make profits of between [...] and [...] billion ISK annually according to the restructuring plan.
- (207) Some of the most relevant and more detailed aspects of the financial planning on which the restructuring plan is based were mentioned above, such as the decreasing income from core business segments corporate and retail bank during the restructuring period. It appears to the Authority that this is mainly a result of the discount being absorbed, and reflects the increasing funding costs (resulting from greater diversification on the liabilities side, with a larger share of debt with longer maturities) as well as a decrease in the net interest margin from currently 4.4% to [...] %. The Authority is of the view that it is prudent to not rely on increasing revenue in these segments. Indeed, it appears probable that funding costs will increase slightly (according to the restructuring plan, by up to [...] bp). As regards the interest rate margin, the Authority notes that even after the anticipated decrease to [...] %, it would be rather high in international comparison.⁸³

⁸³ Cf. for example the CBI's Financial Stability report 2011:2, according to which the interest rate margin is about 2-3 times higher in Iceland than in other Nordic countries.

According to the Icelandic authorities, the margin has been approximately at that level or higher throughout the last decades, and is due, amongst other factors, to the high-interest rate environment in Iceland, the lower share of mortgages in the loan portfolio and the smaller size of the banks. The Authority considers these explanations reasonable, and therefore finds this aspect of the financial planning to be sufficiently plausible.

- (208) Another important driver of future profitability according to the restructuring plan is a greater fee and commission income, which is forecasted to increase [...] over the planning period [...]. This increase would then yield profits of ISK [...] in 2016. The Icelandic authorities submit that these projections are plausible, as commission fee yielding business such as stock market related transactions and foreign currency trade have practically come to a standstill after the collapse and as a result of the capital controls. However, as it is, according to the Icelandic authorities, realistic to expect a substantial increase in stock exchange activity, and the capital controls are supposed to be lifted at the end of 2013, the Authority does not question the plausibility of these figures.
- (209) The revenue side of the P&L forecast aside, the bank has taken a number of initiatives, as described above, to increase efficiency and reduce cost, amongst others a reduction of staff by almost 10%, which should overall reduce the cost to income ratio from 75% to [...] % in 2014. The Authority welcomes these efforts, as the current ratio appears quite high in international comparison. The Authority also considers it, based on the restructuring plan, plausible that this target can be reached, as indeed the finalisation of the restructuring of the portfolio inherited from Glitnir and anticipated reduction of supervisory work should make it possible to trim down the bank's head count, and efficiency gains still appear attainable in the bank's operation.
- (210) In addition to the above, it is evident that the restructuring plan is based on a large number of other assumptions. The Authority has aimed to scrutinise those that seems most pertinent and of greatest influence to the future viability of Íslandsbanki. As regards the macroeconomic assumptions, they appear broadly in line with the forecasts of the IMF and Statistics Iceland, for example as regards GDP growth and unemployment. Overall the assumptions on which the restructuring plan is based appear to be sufficiently prudent to allow, in conjunction with the considerations set out by the Authority above, the conclusion that the restructuring measures undertaken by the bank are sufficient to ensure its long-term viability, barring unexpected adverse events of unforeseen scale and consequences.
- (211) Taking into account the above elements, the Authority considers that the restructuring plan comprises sufficient elements contributing to the restoration of the long-term viability of the bank for the Authority to conclude that the provisions of section 2 of the Restructuring Guidelines are complied with.

1.3 Own contribution/burden-sharing

- (212) Paragraph 22 of the Restructuring Guidelines reads as follows: "In order to limit distortions of competition and address moral hazard, aid should be limited to the minimum necessary and an appropriate own contribution to restructuring costs should be provided by the aid beneficiary. The bank and its capital holders should contribute to the restructuring as much as possible with their own resources. This is necessary to ensure that rescued banks bear adequate responsibility for the consequences of their past behaviour and to create appropriate incentives for their future behaviour".
- (213) The Authority recalls in this regard a decisive aspect of the case at hand. When Íslandsbanki was established on the basis of the domestic operations of Glitnir, the shareholders in Glitnir Bank were fully wiped out and have thus contributed the maximum

possible to the restructuring of Íslandsbanki. Moreover, the creditors of Íslandsbanki had to take considerable losses⁸⁴, or at least had to take on the risk of their investment depending on the profitability of Íslandsbanki. Therefore, as far as the owners and creditors of Glitnir are concerned, the criterion of burden-sharing is optimally satisfied and the issue of moral hazard addressed.

- (214) In addition to the above, the Authority needs to assess whether the state aid that Íslandsbanki has received was limited to the minimum necessary.
- (215) As regards the capitalisation measures, the initial capitalisation of Íslandsbanki, until the agreement with the creditors of Glitnir reduced the State's stake to 5%, was just sufficient to meet the FME's capital requirements. In 2009, after the agreement on Glitnir's acquisition of Íslandsbanki had been reached, and the Tier-II capital had been granted to Íslandsbanki, the CAD ratio reached approximately 19%, 3 percentage point more than the minimum ratio set forth by the FME. In this context, the Authority notes that the capital ratio depended mainly on whether valuation of the assets that had been transferred from Glitnir to Íslandsbanki had been done accurately. Moreover, it has to be borne in mind that at the time the economic outlook for Iceland was cast in uncertainty. In view of the foregoing, the Authority considers that the amount of capital provided by the Icelandic state to Íslandsbanki was limited to the minimum necessary, as it amounted to nothing more than the regulatory minimum plus a reasonable buffer.
- (216) This conclusion is not undone by the fact that Íslandsbanki's CAD ratio subsequently grew strong enough to allow it to absorb a severely undercapitalised bank – Byr – in 2011. The increase of the CAD ratio was almost exclusively due to the writing up of the book value of the assets that had been transferred from Glitnir to Íslandsbanki. It could not have been predicted with any certainty that this would happen, and the fact that the CAD ratio developed so strongly later is in the Authority's view no reason to consider that Íslandsbanki was overcapitalised by the State at the outset.⁸⁵
- (217) Paragraph 26 of the Restructuring Guidelines provides that banks in receipt of restructuring aid “should be able to remunerate capital, including in the form of dividends and coupons on outstanding subordinated debt, out of profits generated by their activities”.
- (218) In this context, it is worth recalling that the State made an annualised return of almost 14% on the capital which was redeemed already in the autumn of 2009. The prospect of a satisfactory return for the 5% stake that the State retained appear promising too, given the overall good performance of Íslandsbanki since its establishment.
- (219) However, it also should be stressed that the remuneration for the Tier-II capital deviates from the Authority's Recapitalisation Guidelines⁸⁶. As correctly submitted by the Icelandic authorities, the required remuneration pursuant to the Recapitalisation Guidelines amounts to approximately 15.7% (consisting of the government's funding cost of 8%, Glitnir's pre-crisis CDS-spread of 5.7% and an add-on fee of 2%). The

⁸⁴ According to current estimates, the losses could amount to 70-75% of the loans they had granted to Glitnir; see for example <http://glitnirbank.com/press-room/tilkynningar-a-islensku/448-athugasemdfraclidastjorn.html>

⁸⁵ In fact, the state capitalisation of Íslandsbanki was based directly on the difference between the initial valuation of assets and liabilities transferred, and the capital requirement of the FME.

⁸⁶ Return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, adopted by the Authority on 25.11. 2009 under chapter VII: Temporary Rules regarding the Financial Crisis, as extended by the Financial Crisis Guidelines 2012. Available at the Authority's website at: <http://www.eftasurv.int/media/state-aid-guidelines/Part-VIII--Return-to-viability-and-the-assessment-of-restructuring-measures-in-the-financial-sector.pdf>

remuneration that Íslandsbanki pays, EURIBOR plus 4% add-on falls significantly short of this benchmark. According to paragraph 25 of the Restructuring Guidelines, such derogation from adequate ex-ante burden-sharing (i.e. appropriate remuneration) can inter alia be justified by farther-reaching restructuring, including measures to limit distortions of competition. As will be shown below, the Authority considers that the restructuring of Íslandsbanki is sufficiently far-reaching for this condition to be met.

- (220) Whilst the Straumur agreement, as described above, entails elements of state aid, the Authority considers that it is constructed in a manner that aims at limiting if not excluding a direct financial advantage for Íslandsbanki. The agreement constitutes in essence a negotiated compensation for Íslandsbanki in exchange for taking on the deposit liabilities of Straumur, and it is likely that Íslandsbanki obtains matching assets for the transferred liabilities. The Authority does not consider that this aid is of great significance for its burden-sharing assessment.
- (221) Finally, as regards the deposit guarantee, the Authority has already indicated in the opening decision that – in light of the extraordinary circumstances at the time - it might constitute a proportionate means to safeguard financial stability in Iceland. It is evident however that such aid cannot be approved indefinitely.
- (222) Thus, in order for this state aid to be considered as limited to the minimum necessary, the Authority is of the view that it needs to be terminated as soon as possible. The Authority therefore welcomes the intention of the Icelandic authorities to abolish the deposit guarantee before the capital controls are lifted, thus, pursuant to current planning, no later than the end of 2013.
- (223) So as to cater for delays in the lifting of the capital controls, and to reflect the Authority's view that a viable bank should be able to compete on the market without the protection of such a blanket guarantee on deposits, it will therefore authorise the deposit guarantee until the end of 2014.⁸⁷ After that time, protection of deposits should be governed only by the applicable EEA legislation regarding deposit guarantees.
- (224) On the basis of the above elements, the Authority concludes that the restructuring plan of Íslandsbanki ensures that the aid is limited to the minimum necessary and that the beneficiary, the shareholders and debt holders of its predecessor bank have participated significantly in the burden-sharing. The restructuring aid thus complies with section 3 of the Restructuring Guidelines.

1.4 Limiting distortions of competition

- (225) The Restructuring Guidelines provide in section 4, paragraphs 29-32:

“Financial stability remains the overriding objective of aid to the financial sector in a systemic crisis, but safeguarding systemic stability in the short-term should not result in longer-term damage to the level playing field and competitive markets. In this context, measures to limit distortions of competition due to state aid play an important role. [...] Measures to limit the distortion of competition should be tailor-made to address the distortions identified on the markets where the beneficiary bank operates following its return to viability post restructuring, while at the same time adhering to a common policy and principles. The Authority takes as a starting point for its assessment of the need for such measures, the size, scale and scope of the activities that the bank in question would have upon implementation of a

⁸⁷ At the end of 2014, the restructuring periods of all Icelandic banks for which a formal investigation has been initiated will have come to an end.

credible restructuring plan as foreseen in Section 2 of this Chapter. [...] The nature and form of such measures will depend on two criteria: first, the amount of the aid and the conditions and circumstances under which it was granted and, second, the characteristics of the market or markets on which the beneficiary bank will operate.

As regards the first criterion, measures limiting distortions will vary significantly according to the amount of the aid as well as the degree of burden sharing and the level of pricing. Generally speaking, where there is greater burden sharing and the own contribution is higher, there are fewer negative consequences resulting from moral hazard.

As regards the second criterion, the Authority will analyse the likely effects of the aid on the markets where the beneficiary bank operates after the restructuring. First of all, the size and the relative importance of the bank on its market or markets, once it is made viable, will be examined. The measures will be tailored to market characteristics to make sure that effective competition is preserved. [...] Measures limiting distortions of competition should not compromise the prospects of the bank's return to viability.”

- (226) It follows from the above that the size of the aid, particularly in relative terms, and the market characteristics are decisive in the Authority's assessment of the appropriateness of measures to limit distortions of competition. At the same time, it is evident that such measures must not jeopardise the viability of the beneficiary of restructuring aid, and competition concerns must be addressed with a view to the overriding goal of financial stability in the present crisis.
- (227) Against the background of the above legal framework, the Authority will set out below the considerations that it deems essential for its assessment of the measures limiting distortions of competition.
- (228) First and foremost the Authority considers that given the particular situation on the Icelandic financial markets and the economic conditions, as described in previous chapters, a careful assessment of the market conditions and the competitive environment is necessary. The measures limiting the distortion of competition should reflect the currently difficult circumstances, while ensuring that the distortions of competition are limited to a minimum both in the short-term and the long-term.
- (229) Second, as set out above in the section on burden-sharing, the greatest possible contribution from the former owners of Glitnir, and to some extent, of Glitnir's creditors has been addressed. Consequently, the need for additional competition measures has been limited.
- (230) Third, as regards the characteristics of the relevant market and as described above, the collapse of the financial system in Iceland, followed by the interventions of the Icelandic authorities, including the establishment of Íslandsbanki on the basis of Glitnir's domestic operations, led to a greater concentration in the Icelandic market for financial services, and substantially increased the market share by the three major banks – Íslandsbanki, Arion Bank and Landsbankinn. Only few other and small market players remain, and the immediate prospect of a new entry is extremely slim, not only due to the already mentioned barriers to entry and the small size of the market, but in particular also due to the capital controls. Íslandsbanki enjoys a very significant position on this concentrated market, with a market share of over [...] % in the most relevant and economically important segments.

- (231) Fourth, the crisis led to a number of very specific problems, such as the extremely high degree of direct and indirect ownership of the large banks in the real economy, and the existence of a de-facto monopoly for banking IT-services (RB), majority owned by the three major banks.
- (232) Fifth, the relative size of aid that Íslandsbanki has received is significant. In this regard, the Authority notes that at the outset the entire capital of the bank was provided by the State. In addition, the bank has benefited from a variety of aid measures – the Straumur agreement, the special liquidity facility and the deposit guarantee. At the same time, Íslandsbanki remains a small bank, at least by international standards.
- (233) Sixth, the banks acquisition of Byr calls for additional competition measures. In the second Byr decision, the Authority required that the forthcoming restructuring plan should comprise measures which would ensure that the Icelandic financial market would benefit from effective competition in the future, so as to address the concerns that the Authority raised about the state of competition in the Icelandic financial market.
- (234) Against this background, the Authority notes that a number of measures have been or will be taken that limit the distortions of competition resulting from the state aid granted to Íslandsbanki.
- (i) *Measures and regulatory developments undertaken or committed to by the Icelandic authorities*
- (235) The Icelandic government has specifically made two commitments (see Annex I) which in the Authority's view can contribute to creating a regulatory environment that favours competition in financial markets:
- (236) First, by appointing a working group that will review Act No. 36/1978 on Stamp Duty, and by examining in particular whether to abolish stamp duties for bonds issued by individuals when transferred between creditors (e.g. when individuals transfer their loans from one loan institution to another). The Authority considers that the current law – which inter alia obliges customers to pay stamp duty on the amount of the respective bond⁸⁸ when switching lenders – may be capable of constituting an impediment to competition, as it may lock customers to existing contracts on long term loans. The Authority thus welcomes the commitment for this law to be reviewed.
- (237) Second, the Authority takes note that, in accordance with a resolution passed by the Icelandic parliament on 21 March 2012, a committee will be appointed by the government with the mandate to review consumer protection in the financial market. This will include a specific mandate for the review of switching facilitation and switching costs reduction, and for the committee to work closely with the ICA as regards that issue. The Committee shall present its report no later than 15 January 2013. The Authority is of the opinion that a closer assessment could be of benefit for competition in the long-run. In the meantime the bank-specific commitment by Íslandsbanki discussed below should contribute to making switching easier, and thereby will increase competition.
- (238) As for the competition concerns identified by the Authority regarding RB, the Authority welcomes the settlement that ICA and the owners of RB, including the three major banks, have reached on this issue. This endeavours to ensure access to essential IT-infrastructure on a non-discriminatory basis and at reasonable cost for small competitors and potential

⁸⁸ The stamp duty varies depending on the type of legal document concerned, but is normally 15 ISK for each started thousand ISK (i.e. approximately 1.5%) on the amount of interest-bearing bonds secured by a mortgage or other security.

new market entrants. The Authority is of the view that its concerns, as voiced inter alia in the second Byr decision, have been addressed in a satisfactory manner by this settlement, and that there is no need for the Authority to further address this issue in the current decision.

- (239) Finally, the Authority takes note of the regulatory amendments that have been made since 2008, as discussed in Annex I. As regards competition concerns, the introduction of Article 22 in the Act on financial undertakings No. 161/2002 is of particular relevance in this regard. It includes provisions which limit the participation of financial undertakings in activities falling outside the scope of their operating licenses. According to this new rule, such activities may only be pursued on a temporary basis and for the purpose of concluding transactions or reorganising the activities of customers. A reasoned notification to this effect must be sent to the FME, and time limits have been introduced for financial undertakings to complete reorganisation of their customers and dispose of appropriated assets.
- (240) The Authority regards this change as an appropriate regulatory response to the issue of the disproportionately large ownership by financial institutions in the real economy. This provision appears to at least remedy this situation – which is a direct result of debt-to-equity-swaps (and similar transactions) involving over-indebted companies in the wake of the crisis – from becoming a permanent one. As it addresses one of the most pressing competition issues that is linked to the state aid to the three banks, the Authority takes it duly into account in its assessment.

(ii) Measures specific to Íslandsbanki

- (241) The Authority emphasises that Íslandsbanki's market presence and size is only a fraction of that of Glitnir – as total assets have been reduced by 84%, as described above and unlike Glitnir, Íslandsbanki is only active in the Icelandic market. Whilst most of this reduction is evidently a result of the winding up of Glitnir's international operations, the Authority is of the view that this process is of particular relevance as regards the distortions of competition, as it was in particular Glitnir's risky overseas strategy that led to its collapse and caused distortions in the EEA financial markets in the past.⁸⁹
- (242) In addition, the Authority welcomes Íslandsbanki's commitments (see Annex I) to reduce its domestic market presence further by [...] divestments relating to [...]. On the basis of the final restructuring plan, and recalling that Íslandsbanki is a small bank by EEA standards, the Authority agrees with Íslandsbanki that further structural measures could endanger the bank's prospects of restoring long-term viability.⁹⁰
- (243) The Authority takes note of the commitment that Íslandsbanki will not acquire financial institutions until 15 October 2014, except if it obtains the Authority's approval beforehand. This means, unless further mergers would be necessitated by financial stability considerations, that further concentration of the Icelandic financial market through acquisitions by Íslandsbanki can be prevented. This commitment also ensures that the aid that has been granted to Íslandsbanki is used for restoring its viability rather than it being used to consolidate and further expand its market presence in Iceland. The same is true for Íslandsbanki's commitment pursuant to which it will, until 15 October 2014, neither enforce contract clauses nor introduce new contract clauses which make special terms on interest rates contingent upon maintaining minimum range of business with the bank, as

⁸⁹ Cf. for example Commission Decision in Case SA.28264, Restructuring aid for Hypo Real Estate, in which the Commission accepted the separation of a large part of the Hypo Real Estate's overseas business as a measure to limit distortions of competition for the bank's successor PBB.

⁹⁰ For the same reasons the Authority accepts the divestments are subject to the condition that [...].

well as for the commitment not to invoke state involvement as a source of a competitive advantage when marketing its services.

- (244) As described above, the Icelandic financial market currently presents a challenging operating environment for any bank, which is reflected also by the almost complete absence of interest from abroad to enter this market at the present time. The Authority thus welcomes the commitments by Íslandsbanki relating to facilitating the switching between banks and providing basic payment processing as well as money distribution services. The Authority is of the view that those measures, in conjunction with the agreement between the three major banks and ICA on RB mentioned above ensure that smaller market participants can access the most essential infrastructure and services at reasonable prices without the larger players being able to block their access. The Authority is of the view that this will reduce the barriers to entry for future (potential) market participants, and could allow existing smaller players to expand their market shares if they are able to offer better services than their larger competitors. Moreover, the measures aimed at facilitating switching will contribute to more fierce competition between the existing large players, and could contribute to prevent or dissolve a situation of potential collective dominance.
- (245) Lastly, Íslandsbanki commits to sell, as soon as possible, shareholdings in operating companies, which have been taken over due to restructuring in line with Article 22 of the Act on financial undertakings No. 161/2002, commits to follow the procedure and time-limits, which are set out in this provision, and will maintain up-to-date information on its website or of a subsidiary on subsidiaries and shareholdings that are held for sale. The Authority welcomes Íslandsbanki's commitment to divest as soon as possible all companies and shareholdings that are not related to its core business, not the least because of viability concerns. Whilst the Authority is of the view that it is self-evident that the bank needs to respect domestic legal obligations such as Article 22 of the Act on financial undertaking, it takes note of this commitment and draws the Icelandic authorities' and beneficiaries' attention to the fact that in this regard a breach of national law might also entail a misuse of aid. The Authority moreover considers that by having to include information about foreseen divestments and sales on its website, more transparency about the current ownership situation in the Icelandic economy is introduced. This remedies, at least to some extent, this particular competition concern that currently characterises Iceland's markets.
- (246) On the basis of all of the above, given in particular the specific situation in Iceland and the fact that the Authority considers that the above measures address the main competition issues that the Authority has identified in collaboration with the ICA, and taking into account the overriding objective of financial stability, the Authority concludes that the commitments limit distortions of competition to a satisfactory degree. The restructuring aid therefore complies with section 4 of the Restructuring Guidelines.

III. Conclusion

- (247) On the basis of the foregoing assessment and in the light of the restructuring plan submitted by the Icelandic authorities for Íslandsbanki, the Authority's doubts expressed in the opening decision as regards the nature and the compatibility of the aid measures for Íslandsbanki are allayed. The Authority therefore approves the aid measures as restructuring aid compatible with the functioning of the EEA Agreement pursuant to Article 61(3)(b) EEA subject to Iceland and Íslandsbanki adhering to the commitments as set out in Annex I.

HAS ADOPTED THIS DECISION:

Article 1

The initial operating capital, the (temporary) full state capitalisation, the retention by the State of the 5% share capital and the Tier-II capital granted to Íslandsbanki as well as the special liquidity facility, the unlimited deposit guarantee and the Straumur agreement constitute state aid within the meaning of Article 61(1) of the EEA Agreement.

Article 2

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

Article 3

The measures enumerated in Article 1 as well as the measures for Byr described in Decision No. 126/11/COL, are compatible with the functioning of the EEA agreement pursuant to Article 61(3)(b) EEA subject adhering to the commitments as set out in Annex I. The authorisation for the unlimited deposit guarantee expires at the end of 2014.

Article 4

This Decision is addressed to the Republic of Iceland.

Article 5

Only the English language version of this decision is authentic.

Decision made in Brussels, on 27 June 2012.

For the EFTA Surveillance Authority

Oda Helen Sletnes
President

Sabine Monauni-Tömördy
College Member

ANNEX I: Commitments and relevant changes to the legal framework for banking

Commitments by the Icelandic authorities

The Icelandic authorities have made two commitments which are enumerated below.

Amendment of stamp duty to preclude state aid and reduce switching costs

The Ministry of Finance will appoint a working group with the mandate to review Act No. 36/1978 on Stamp Duty. The working group is to submit a report to the Minister of Finance by October 2012, along with a draft bill. The assignment of the working group will be, in particular, to examine the abolishment of stamp duties for bonds issued by individuals, when transferred between creditors (i.e. when individuals transfer their loans from one loan institution to another). The group shall furthermore examine how the provision of stamp duty may be amended in order to simplify procedures and promote competition.

Measures to facilitate switching and reduce switching costs

In accordance with a resolution passed by the Icelandic parliament on 21 March 2012, a committee will be appointed by the government with the mandate to review consumer protection in the financial market and present proposals as to how the position of individuals and households can be strengthened vis-à-vis loan institutions. The appointment of the committee will include a specific mandate for the review of switching facilitation and switching costs reduction, and for the committee to work closely with the ICA as regards that issue. The Committee shall present its report no later than 15 January 2013.

Moreover, the Icelandic authorities have endorsed and will enforce the following commitments by Íslandsbanki:

Limitation of acquisitions

Íslandsbanki commits itself not to acquire financial institutions until 15 October 2014.

Notwithstanding this commitment, Íslandsbanki may, after obtaining the Authority's approval, acquire businesses, in particular if this is necessary in order to safeguard financial stability.

Divestment of [...]

Íslandsbanki commits itself to divest of its shareholding in [...] by [date], and commits to offer the below shareholdings publicly for sale [...].

[...]e [...]

[...].

Divestment of shares in companies under restructuring

Íslandsbanki commits itself to sell, as soon as possible, shareholdings in operating companies, which have been taken over due to restructuring, cf. Article 22 of the Act on financial institutions No. 161/2002. Furthermore, the bank commits itself to follow the procedure and time-limits, which are set out in the above-mentioned legal provision.

Finally, the bank will maintain up-to-date information on its website (or website of a relevant subsidiary, e.g. Midengi ehf.) on such shareholdings that are held for sale.

Measures benefitting new and small competitors

Íslandsbanki commits itself to enact the following measures for the benefit of new and small competitors:

- a. Íslandsbanki will, until 15 October 2014, neither enforce contract clauses nor make new contract clauses, which make special terms on interest rates contingent upon maintaining minimum range of business with the bank.
- b. Íslandsbanki will provide for easily accessible information, at the bank's website, on the process of switching banking services to another financial institution. Furthermore, the website will make easily accessible the necessary documents to switch between financial institutions. Finally, the same information and business-transfer forms will be available at the branches of the bank.
- c. Íslandsbanki will execute all requests for transfer of banking services in a swift manner.
- d. Íslandsbanki will not invoke state involvement as a source of competitive advantage when marketing.
- e. Provided that competitive service offers are not available, Íslandsbanki is willing to offer the following services at a price that will be based on cost plus reasonable margin:
 - f. Payment processing services for ISK.
 - (i) Payment processing services for FX.
 - (ii) Distribution of bank notes and coins.
 - I. Sale and delivery of bank notes and coins to the premises of the service recipient.
 - II. Maintaining a stock of special cassettes containing bank notes which are placed inside ATM machines. However, a security firm contracted by the new/small party would "feed" the folders into the ATM's.

7 Relevant adaptations and changes to the regulatory and supervisory framework for financial markets in Iceland adopted after the crisis

The Icelandic authorities have submitted the following overview of amendments made to the legislation which was in effect in the autumn of 2008:

- FME's (The Icelandic Financial Supervisory Authority) authorisations to intervene (to take over the powers of shareholders' meetings and dispose of assets, cf. the emergency legislation) have been increased; FME has been given expanded supervisory authorisations; additional provisions have been adopted enabling FME to evaluate the operations or behaviour of individual supervised parties. These include both decision-making authorisations, such as on the closing of establishments or termination of specific activities without actual revocation of operating licences, as well as a more detailed definition of concepts whose interpretation has been disputed by FME and supervised entities or appellate bodies.
- Rules on individual large exposures have been clarified and made more specific; both the role and responsibility of risk management have been increased and FME authorised to accord risk management higher status in the organisation of financial undertakings; provisions on the application of stress tests have been tightened.

- Provisions for a special registry of larger borrowers have been legalised, in order to provide better overview of large, individual exposures to two or more financial undertakings. The registry is important for linking exposures together and assessing their systemic impact if difficulties should arise in the borrowers' operations. Entities not subject to FME supervision, but which are listed in the registries of financial undertakings, must provide FME with information on all their obligations. FME can prohibit the provision of services to such parties should they refuse to provide the information requested.
- Provisions on sound business practices have been reinforced and the existence of the Complaints Committee on Transactions with Financial Undertakings enshrined in law; detailed information must be disclosed on all major owners of financial undertakings.
- The time limits allowing financial undertakings to dispose of appropriated assets have been shortened.
- Provisions on financial undertakings' holdings in own shares have been tightened and defined in more detail. Holdings of subsidiaries are now considered own shares, as are off-balance-sheet contracts concerning own shares.
- Financial undertakings have been prohibited from extending credit against pledges of their own shares or guarantee capital certificates.
- FME is now to lay down rules as to how loans secured by a mortgage on the shares of other financial undertakings are to be calculated in the risk base and capital base.
- Both the responsibility and role of internal auditing section has been increased. There are detailed rules concerning the balance between the size and diversity of the activities of the financial undertaking concerned and the scope of its internal auditing section.
- Five-year limits have been placed on the period for which an auditing firm may carry out the audit of the same financial undertaking; financial undertakings' ability to dismiss a "difficult" auditor is reduced.
- All provisions on calculation of equity and various other technical aspects have been reviewed.
- Rules on exercising qualifying holdings, i.e. 10% or more of voting rights, have been reviewed. FME is authorised to reverse the onus of proof in assessing parties intending on acquiring or adding to qualifying holdings, e.g. when it is uncertain who is/are the beneficial owner/-s of a holding company with a qualifying holding.
- Additional demands on eligibility have now been made of directors, their responsibility for supervision or operations have been increased and executive chairmen of the Board are prohibited; FME has been assigned a greater supervisory role for Boards of Directors; personally identifiable information must be disclosed on remuneration to senior management.
- Rules have been set concerning credit transactions of financial undertakings with directors, managing directors, key employees and owners of qualifying holdings in the financial undertaking concerned. Similar rules apply to parties closely connected with the above-mentioned. FME has adopted rules as to what is considered satisfactory collateral for such transactions.
- Rules concerning arrangements for incentive schemes and bonuses to management and employees and on termination contracts have been adopted.
- Provisions on the reorganisation and winding-up of financial undertakings have been tightened.

- An overall revision of special rules on savings banks has been carried out. The status and rights of guarantee capital owners of savings banks have been clarified, restrictions set on dividends, clear rules have been adopted on guarantee capital transactions, rules have been set on write-downs of guarantee capital and rules on savings banks' authorisations for formal co-operation have been clarified. Savings banks have been prohibited from altering their legal form.

According to the Icelandic authorities, Icelandic rules in some respects go beyond the pan-European framework. The main deviations from rules adopted by the EU which have been taken up in the EEA Agreement are the following:

- FME is authorised to restrict the activities of individual establishments of financial undertakings, if it sees reason to do so. Furthermore, it is authorised to set special requirements for individual establishments of financial undertakings to continue their activities. FME may also limit provisionally the activities which a financial undertaking may pursue, in full or in part, whether subject to license or not, if the Authority sees reason to do so. This is naturally prompted not least by the activities of branches and deposit accounts established by them in other European states until 2008 (Icesave, Edge and Save-and-Save).
- Considerably more detailed provisions are set concerning the role of internal audit in Icelandic law than in the EU directives.
- Considerably more detailed provisions are set on how stress tests are to be carried out than in the EU directives.
- Financial undertakings must keep a special registry (a credit registry) of all parties to whom they extend credit and submit an updated list to FME at the end of each month. Furthermore, a similar list shall be sent on parties closely connected with financial undertakings, their Boards of Directors and managers and groups of connected clients, to the extent that these parties are not on the above-mentioned list. This list will provide a better opportunity to monitor inter-linkages between financial undertakings, their directors and management.
- If FME is of the opinion that the borrowing of a single party on the credit registry, which is not subject to official supervision of financial activities, could have a systemic impact, it may demand information from the party concerned on its obligations.
- Should a party not subject to official supervision listed on the credit registry refuse to disclose information to FME, the Authority may order supervised entities to refrain from providing the said party with further service. The same applies if the information disclosure of the party concerned is unsatisfactory. The provisions on a credit registry and extensive authorisations to supervisors concerning parties not subject to official supervision are not in EU/EEA rules.
- There are considerably more detailed and restrictive provisions on related party lending and collateral than in EU/EEA rules.
- FME must refuse the owner of a qualifying holding the right to exercise the holding if there is doubt as to who is or will be its beneficial owner.
- The maximum length of time external auditors can work for the same financial undertaking is shorter than in EU/EEA rules.
- There are considerably more detailed provisions on the eligibility of directors in financial undertaking than in the EU directives.
- Provisions are adopted on arrangements for bonus schemes and termination contracts.

- Recently formal rules have been set on remuneration policies in EU directives, but rules on termination contracts have not yet been adopted in this forum.

On 23 March the Minister of Economic Affairs introduced a report on the future on the Icelandic financial system and financial supervision. The Minister has further appointed an expert group to prepare a legislative frame for all financial activities in Iceland.