

Case No: 65140  
Event No: 501213  
Dec. No: 168/09/COL

## EFTA SURVEILLANCE AUTHORITY DECISION

of 27 March 2009

on an additional loan category of the Housing Financing Fund on lending to banks, saving banks and other financial institutions for the purpose of temporarily refinancing mortgage loans

(Iceland)

### THE EFTA SURVEILLANCE AUTHORITY<sup>1</sup>

Having regard to the Agreement on the European Economic Area<sup>2</sup>, in particular to Articles 61 to 63 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<sup>3</sup>, in particular to Article 24 thereof,

Having regard to Article 1(3) of Part I and Article 4(3) of Part II of Protocol 3 to the Surveillance and Court Agreement<sup>4</sup>,

Having regard to the Authority's Guidelines on the application and interpretation of Articles 61 and 62 of the EEA Agreement<sup>5</sup>, in particular the Part VIII on the application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis,

Having regard to the Authority's Decision of 14 July 2004 on the implementing provisions referred to under Article 27 of Part II of Protocol 3<sup>6</sup>,

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<sup>1</sup> Hereinafter referred to as the Authority.

<sup>2</sup> Hereinafter referred to as the EEA Agreement.

<sup>3</sup> Hereinafter referred to as the Surveillance and Court Agreement.

<sup>4</sup> Hereinafter referred to as Protocol 3.

<sup>5</sup> Guidelines on the application and interpretation of Articles 61 and 62 of the EEA Agreement and Article 1 of Protocol 3 to the Surveillance and Court Agreement, adopted and issued by the Authority on 19 January 1994, published in the Official Journal of the European Union (hereinafter referred to as OJ) L 231 of 03.09.1994 p. 1 and EEA Supplement No 32 of 03.09.1994 p. 1. Hereinafter referred to as the State Aid Guidelines. The updated version of the State Aid Guidelines is published on the Authority's website: [http://www.eftasurv.int/fieldsOfWork/fieldstateaid/state\\_aid\\_guidelines/](http://www.eftasurv.int/fieldsOfWork/fieldstateaid/state_aid_guidelines/)

<sup>6</sup> Decision 195/04/COL of 14 July 2004, published in OJ 2006 L 139 and EEA Supplement No 26, as amended. A consolidated version of the Decision can be found on [www.eftasurv.int](http://www.eftasurv.int).

Whereas:

## I. FACTS

### 1 Procedure

Following a declaration by the Icelandic Government of 19 June 2008 concerning measures related to the real estate and financial markets, by letters dated 25 June 2008 (Event No 483061) and 18 July 2008 (Event No 486360), the Icelandic authorities informed the Authority, *inter alia*, about an additional loan category of the Icelandic Housing Financing Fund (hereinafter referred to as the HFF).

On 28 August 2008, the Authority requested the Icelandic authorities provide additional information regarding the new loan category (Event No 489262). The Icelandic authorities replied to this request by letter submitted on 18 September 2008 (Event No 491994). In parallel, they notified for legal certainty the above-mentioned loan category of the HFF, pursuant to Article 1(3) of Part I of Protocol 3 (Event No 492004).

The notification was subject to discussions between the Authority and the Icelandic authorities on 2 October 2008 in Brussels and at the package meeting on 24 October 2008 in Reykjavík.

By letters dated 16 October 2008 and 23 January 2009, the Authority requested additional information (Events No 493552 and 504955). Replies were provided by the Icelandic authorities on 18 November 2008 (Event No 498965), up-dated by letter submitted on 3 December 2008 (Event No 500670), and on 6 February 2009 (Event No 508043). The Icelandic Government complemented its answers by e-mail of 27 February 2009 (Event No 511051) and by letter of 18 March 2009 (Event No 512773).

### 2 Description of the proposed measures

The Icelandic authorities have explained that as a result of turmoil in the global financial markets, the residential housing market in Iceland slowed down significantly in 2008. They explained that there were two reasons for concern. First, there was the misfortune of buyers and owners in the residential market. Second, there was the effect this downturn could have on the general economy in Iceland, especially the weakening of the financial institutions and the building industry and thereafter the economic situation of the homeowners. Such a development could further undermine financial stability in the country in the long run.

In light of the above, the Icelandic Government decided to establish two new classes of HFF loans in order to provide financial institutions, engaged in lending against collateral in residential property, with the necessary liquidity on a short term basis. This was done in order to guarantee the security and availability of mortgage loans and to promote normal price formation in the real estate market.<sup>7</sup> The first loan category was aimed at temporary refinancing of banks, savings banks and other financial institutions (hereinafter referred to as the banks) for mortgage loans already granted by those institutions. The second focused

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<sup>7</sup> See Government Declaration of 19 June 2008 concerning measures related to the real estate and financial markets and the Government's press release of 18 July 2008.

on the financing of new mortgage loans to be granted by the establishments in question.<sup>8</sup> Only the first category of loans is subject to the present decision.

According to the information provided by the Icelandic authorities, the measure in question is primarily aimed at small savings banks that were dependent on access to liquidity from the domestic operators facing liquidity problems themselves.<sup>9</sup> There are approximately 22 saving banks in Iceland, which are mostly confined to providing traditional banking services to the local communities (individuals, corporate customers and local authorities) of which they form an integrated part. In many instances, the saving banks are the only financial institutions in the area of operation.<sup>10</sup>

The national legal basis of the scheme was initially Regulation No 715/2008 of 17 July 2008, amending Regulation No 458/1999 on the loan categories of the HFF, which entered into force on 18 July 2008. On 27 January 2009, a new Regulation No 57/2009 on the loan categories of the HFF was adopted, replacing Regulation No 458/1999. The rules regarding the scheme are now laid down in Articles 51-53 of Regulation No 57/2009. In addition, the board of the HFF adopted Rules No 733/2008 laying down the detailed arrangements for this loan category, which entered into force on 23 July 2008.<sup>11</sup> The scheme under investigation was developed by the Ministry of Social Affairs and Social Security, together with the Financial Supervisory Authority and the HFF, and in consultation with the Central Bank of Iceland, the Office of the Prime Minister, the Ministry of Finance and the Ministry for Industry.

The HFF does not directly provide the banks with liquidity on the basis of this additional loan category, but rather extends a collateral in favour of the banks, which is then accepted by the Central Bank of Iceland in exchange for cash loans. The measure takes the form of a temporary asset swap between the HFF bonds and the bonds of the banks covered by a portfolio of mortgage loans. As a result, the HFF acts as an intermediate by providing the banks with its bonds which, in turn, are exclusively used as collateral in the banks' transactions with the Central Bank of Iceland. The Icelandic authorities explained that the rules of the Central Bank require security to have a credit rating. Many of the beneficiaries of the scheme do not have credit rating due to the modest nature of their operations. The only possibility for these banks to benefit from the facilities of the Central Bank would be the bonds swap with the HFF.<sup>12</sup> Due to its specific nature, the measure in question has the same effect as a guarantee.

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<sup>8</sup> See Article 10 of the Act of 6 October 2008 No 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstance, amending the Housing Act No 44/1998 and Regulation of 26 November 2008 No 1081/2008 on the authority of the Housing Financing Fund to purchase bonds secured by mortgages in residential housing and issued by financial undertakings.

<sup>9</sup> The Icelandic banking sector at the time consisted largely of two segments: The first one comprising the three former major banks Glitnir, Landsbanki and Kaupthing which had relatively large international exposure. The second comprised small savings banks which traditionally rely on financing from the bigger banks.

<sup>10</sup> Letter from the Icelandic authorities of 18.11.2008, p. 3.

<sup>11</sup> Rules of the Housing Financing Fund regarding loans pursuant to Article 2, sub-paragraph 9 of Regulation No 458/1999 on the Housing Financing Fund's loan classes with subsequent amendments. Rules No 733/2008 were confirmed by the Minister in accordance with Article 3 of Regulation No 715/2008.

<sup>12</sup> In the view of the Icelandic authorities, the adjustment of the rules of the Central Bank, enabling banks without credit rating to engage in transactions with the Central Bank, was not desirable, due to the risk of undermining stability in the financial markets. See the letter of 18.11.2008, p. 2.

During the entire operation, the HFF remains the owner of its bonds while the banks continue to maintain the ownership of their mortgage loans portfolio.<sup>13</sup> This means that the cash flow of the respective assets belongs to the respective owners.<sup>14</sup> In certain cases, the HFF is entitled to purchase the underlying mortgage pool held as collateral against the HFF bond. This occurs, however, only where the equity ratio of the bank falls below 9%, or if the HFF bond is not returned on the due date, *i.e.* as a result of default on the side of the beneficiary bank. The Icelandic authorities confirmed that such permanent swaps have so far not taken place under the scheme and that the HFF may not keep the beneficiaries' bonds in any other cases in the context of the present scheme.

The book value of the bank's collateral must represent 110% of the value of the HFF bond, calculated on the basis of the average yield at the time of the application deadline. That means that the haircut rate is about 9.1%. The security must be expressed in Icelandic kronas (ISK). Additional requirements are applicable with regard to which mortgage loans can be accepted in the portfolio for the exchange with the HFF bonds, in particular in respect of the loan-to-value (LTV) ratio of the property, proof of the accuracy of the property's market value, priority ranking and credit history of the borrower (cf. Article 4 of Rules 733/2008). Each mortgage loan in the underlying pool is subject to scrutiny according to these criteria.

The eligible aid recipients are all banks, saving banks and credit institutions which have been granted a licence to operate in Iceland in accordance with the provisions of Act No 161/2002 on financial undertakings, provided that their equity ratio is at least 9%. The application must be accompanied by a statement declaring that the bank considers itself capable of meeting all collateral requirements and committing to returning the HFF bonds at the date of maturity.<sup>15</sup> Only one application per beneficiary is permitted.

For the operation of the bond swap, the HFF charges 75 basis points of interest increment per annum calculated on the basis of the HFF bond's value, cf. Article 7 paragraph 9 of Rules 733/2008. This is somewhat below the usual HFF's interest rate premium of 95 basis points, which normally consists of 20 basis points of credit risk, 25 basis points of operation risk and 50 basis points of prepayment risk. However, as explained by the Icelandic authorities, due to the temporary nature of the transaction under assessment and less homogeneous character of the underlying mortgage loans (compared to HFF loans), this formula has been adapted, in particular through reduction of the prepayment risk to 25 basis points and increase the operational costs by 5 basis points.<sup>16</sup> Since the funding does not come through HFF auctions in primary markets, no interest premium is added to the base yield resulting from auctions.

At the outset, the Icelandic authorities envisaged a duration of three months for the measure with a possibility of a prolongation for an additional three months, upon application. However, in the course of the operation of the scheme, it appeared necessary to prolong the measure for some of the beneficiaries beyond the initially intended six

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<sup>13</sup> This is different from the normal HFF bond auctions in primary markets, in which the ownership over the HFF bonds changes in each transaction.

<sup>14</sup> See Article 7 of Rules No 733/2008.

<sup>15</sup> See the letter of 18.11.2008, p. 2.

<sup>16</sup> Letter of 18.11.2008, p. 6.

months.<sup>17</sup> The Icelandic authorities have nevertheless stressed that the measure under investigation is by nature of temporary character and will not in any event exceed a duration of 12 months. Should this period be exceeded, the Icelandic authorities have committed themselves to submitting a new notification to the Authority.

The budget of the scheme amounts to ISK 30 billion (approximately EUR 246 million<sup>18</sup>), with a minimum loan amount of ISK 1.5 billion per beneficiary. In line with Article 1 of Rules No 733/2008, the HFF advertised the granting of the support in the form described above with a deadline for applications on 6 August 2008. The number of applicants amounted to 14 with a total value of mortgage loans of approximately ISK 29.8 billion. The total value of approved applications was lower than the total value of HFF bonds available, as only seven applicants<sup>19</sup> with the total amount of mortgage loans of approximately 8.9 billion were accepted. The aid was granted on 17 September 2008.

At this stage, the Icelandic authorities do not envisage advertising the measure again. Since the bonds used in this scheme were the same that the HFF sells in financial markets to provide funds for its other types of lending activities, the remaining part of the HFF bonds amounting to ISK 21.1 billion will remain at the HFF's disposal.

### **3 Comments by the Icelandic authorities**

In the notification, the Icelandic authorities submitted that the establishment of the additional loan category as described above does not constitute state aid. The notification was submitted for the reasons of legal certainty, as the Icelandic Government considers that the measure in question does not provide any advantage to the beneficiaries. This is based on the fact that the HFF charges normal market interest rates and, thus that the transaction is in line with the private market investor principle. The Icelandic authorities supported this view by a comparison of the interest rate premium charged by the HFF to market rates such as Kaupthing's bond auction results from June 2008.

The Icelandic authorities confirmed that the measure under investigation is independent from the measures envisaged under the provisions of Regulation No 1081/2008.

As a supplementary argument, in the event the Authority came to the conclusion that the measure under investigation constitutes state aid, the Icelandic authorities submitted that the aid is compatible on the basis of Article 61(3)(b) EEA.

## **II. ASSESSMENT**

### **4 The presence of state aid within the meaning of Article 61(1) EEA**

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*

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<sup>17</sup> Five beneficiaries applied for the second above-mentioned loan category of the HFF on the basis of Article 10 of the Act No 125/2008. In view of a lengthy process of negotiations of the transaction terms, further prolongations were accorded in respect of those beneficiaries, until 30 April 2009.

<sup>18</sup> Calculated with the exchange rate of the European Central Bank of 6 August 2008, the deadline for application.

<sup>19</sup> One applicant withdrew the application, whereas some others did not fulfil the criteria. See the letter of 18.11.2008, p. 1 and Annex a to this letter.

*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.”*

#### **4.1 Presence of state resources**

The aid measure must be granted by the state or through state resources. In line with the case law of the Court of Justice of the European Communities (hereinafter referred to as the Court of Justice), this means that the aid can be granted directly by the state or by public or private bodies established or appointed by it to administer the aid.<sup>20</sup>

In exchange for their mortgage loans portfolio, the beneficiaries receive HFF bonds which constitute assets of the HFF. The HFF was established by the Housing Act No 44/1998 as a state housing agency, wholly owned by the Icelandic State and under the administrative purview of the Minister of Social Affairs. The Minister appoints the five-member board of directors of the Fund. The tasks of the HFF comprise of extending loans to individuals, municipalities and companies with the purpose of financing acquisition or construction of residential housing. These tasks are governed by statutory rules as laid down in the Housing Act and secondary legislation, such as the above-mentioned Regulation No 57/2009 on the loan categories of the HFF. Those factors are sufficient to establish that the HFF acts under the control of the Icelandic State and thus, its conduct is imputable to the Icelandic State.<sup>21</sup>

In addition, different public authorities have been involved in the creation of the scheme, including the Ministry of Social Affairs and the Financial Supervisory Authority, in consultation with the Central Bank of Iceland. On this basis, it can be concluded that the granting of the aid is not based on an autonomous decision of the HFF but is a result of an action attributable to the Icelandic State.<sup>22</sup> Thus, the measure in question is granted through state resources.

#### **4.2 Favouring undertakings or the production of goods**

The aid measure must confer on beneficiaries advantages that relieve them of charges that are normally borne from the budget.

The Icelandic Government argues that the interest rate premium of 75 basis points charged by the HFF for the exchange of its bonds with the banks represents a market rate as it is comparable to Kaupthing's bond auction results from June 2008.

The Authority considers it unlikely that in the current financial crisis the measures would have been provided by a market economy investor on a comparable scale and on similar conditions in favour of the participating banks.

As a point of departure, as mentioned above, the 75 basis points interest rate premium charged in the notified scheme is lower than the 95 basis points premium HFF normally adds on the funding cost in HFF bond auctions.

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<sup>20</sup> Case 78/76 *Steinike and Weinlig v Federal Republic of Germany* [1977] ECR 595, para 21.

<sup>21</sup> See for comparison T-358/94 *Compagnie nationale Air France v Commission* [1996] ECR II-2109, para 58-59.

<sup>22</sup> C-305/89 *Italy v Commission* [1991] ECR I-1603, para 14 and C-482/99 *Stardust Marine* [2002] ECR I-4397, para 52.

Moreover, as explained by the Icelandic authorities, the loan category was established in order to enable banks without credit rating access to capital from the Central Bank. This was considered necessary because interbank lending was drying up so that the smaller banks could no longer obtain necessary financing in the markets they normally would go to.

The Icelandic Government has referred to the results of the Kaupthing bond auction from June 2008 as a comparison and submitted that, as the interest rate premium demanded by the HFF in the transactions under investigation is comparable to the market rates Kaupthing achieved in June 2008, the aid measure does not confer an advantage on the beneficiaries. Furthermore, the Icelandic Government is of the opinion that the fact that Kaupthing still chose to auction out bonds, after the measure under assessment was announced, is in itself an indication of the non-beneficiary character of the aid measure.

The Authority does not find the comparison with the Kaupthing bond auction relevant. Firstly, Kaupthing had access to a wider range of sources of capital, and had presumably a lower cost of capital than the banks which participated in the swap scheme. Secondly, it is unlikely that a financial institution would provide the participating banks with capital against unrated mortgage covered bonds on a comparable scale and on similar conditions as the HFF did. At the time of the introduction of the measure, the interbank financial markets were characterised by falling interbank confidence, resulting in a decline in accessible liquid financial means. In addition, this fall in confidence was also connected to a general fall in the mortgage market. It is therefore unlikely that a financial institution would provide the participating banks with capital, against unrated mortgage covered bonds, on a comparable scale and on similar conditions as the HFF did. HFF therefore took a risk that most market participants would not have taken at the time without an appropriate risk premium. It is unlikely that the 75 basis points interest rate premium charged in the notified scheme would cover this risk.

The Authority is therefore of the opinion that the aid measure is likely to confer an advantage on the beneficiaries.

### **4.3 Selectivity**

The scheme under investigation is selective in nature, as it favours only certain financial institutions, *i.e.* the beneficiaries of the scheme.

### **4.4 Distortion of competition and effect on trade between Contracting Parties**

The aid measure is liable to distort competition and affects trade between the Contracting Parties because the services and products in the banking and financial sectors are traded internationally. Thus, the measure aimed at supporting small saving banks involved in mortgage loans activities in Iceland strengthens the position of those beneficiaries and thereby affects trading conditions across the European Economic Area.

## **5 Procedural requirements**

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

The Icelandic authorities notified the measure by letter of 18 September 2008 (Event No 491994). However, the legal basis for the measure had already entered into force on 23 July 2008, and the aid was granted on 17 September 2008, *i.e.* before the Authority had taken a final decision thereon. The Authority therefore concludes that the Icelandic authorities have not respected their obligations pursuant to Article 1(3) of Part I of Protocol 3.

## 6 Compatibility of the aid

In the view of the Authority, the notified measure closely resembles a guarantee, as it provides the banks with collateral (*i.e.* the HFF bonds) that they could use as security in transactions with the Central Bank. Thus, the Government provides guarantees to allow unrated banks access to the lending facilities of the Central Bank. Accordingly, the Authority will assess the notified measures as a guarantee.

The Authority's guidelines recognises that the drying-up of interbank lending due to an erosion of confidence between financial institutions may also justify guaranteeing certain types of wholesale deposits and even short and medium-term debt instruments.<sup>23</sup> The present swap arrangement falls under this category of measures.

In line with the Authority's Guidelines on the application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, the Authority considers that this measure falls to be assessed under Article 61(3)(b) EEA.

Article 61(3)(b) EEA enables the Authority to declare aid compatible with the functioning of the EEA Agreement if it has the effect "*to remedy a serious disturbance in the economy of an EC Member State or an EFTA State*". The Authority recalls that, in line with the case law of the Court of Justice and the decision making practice of the European Commission (hereinafter referred to as the Commission), Article 61(3)(b) needs to be applied restrictively and must tackle a disturbance in the entire national economy.<sup>24</sup>

In order to be declared compatible with the EEA Agreement, the aid must be granted on the basis of non-discriminatory criteria, be appropriate in terms of being well targeted to remedy a serious disturbance in the economy and be necessary and proportionate thereto. In the following, the Authority will assess the notified measure under these criteria.

**Non-discrimination:** The Authority considers the measure to be non-discriminatory, as it is open to all financial institutions having an operating licence in Iceland. Eligible

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<sup>23</sup> Part VIII of the Guidelines on the application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, paragraph 21.

<sup>24</sup> Joined Cases T-132/96 and T-143/96 *Freistaat Sachsen and Volkswagen AG v Commission* [1999] ECR II-3663, paragraph 167. See also Commission's Decision 98/490/EC in Case C 47/96 *Crédit Lyonnais* (OJ L 221, 8.8.1998, p. 28), point 10.1, Commission's Decision 2005/345/EC in Case C 28/02 *Bankgesellschaft Berlin* (OJ L 116, 4.5.2005, p. 1), points 153 et seq. and Commission's Decision 2008/263/EC in Case C 50/06 BAWAG (OJ L 83, 26.3.2008, p. 7), point 166. See Commission's Decision in Case NN 70/07 *Northern Rock* (OJ C 43, 16.2.2008, p. 1), Commission's Decision in Case NN 25/08 *Rescue aid to WestLB* (OJ C 189, 26.7.2008, p. 3), Commission's Decision of 4 June 2008 in Case C 9/08 *SachsenLB*, (OJ C 71, 18.3.2008, p. 14-23).

applicants include also subsidiaries of foreign banks established in Iceland and branches of foreign companies.<sup>25</sup>

**Appropriateness:** The aid has to be well targeted to its objective, *i.e.* in this case to remedy a serious disturbance in the entire economy. This would not be the case if the disturbance were to disappear in the absence of the measure, or if the measure was not appropriate to remedy the disturbance.

In this context, the Icelandic authorities underlined that the measure in question has been chosen carefully in order not to upset the markets. The Government has preferred to act through an intermediary (the HFF) instead of providing open and direct assistance to the affected banks.

**Necessity:** The aid measure must, in its amount and form, be necessary to achieve the objective. That implies that it must be of the minimum amount necessary to reach the objective, and take the form most appropriate to remedy the disturbance. In other words, if a lesser amount of aid or measure in a less distortive form (*e.g.* a temporary and limited guarantee instead of a capital injection) were sufficient to remedy a serious disturbance in the entire economy, the measure in question would not be necessary.<sup>26</sup>

According to the Icelandic authorities, taking no measures could undermine the whole banking sector.<sup>27</sup> Moreover, the Icelandic Central Bank has provided a statement in which it recalled its participation in the consulting group to prepare the new legislation. It also confirmed the necessity of the measure in question in order to relieve financial undertakings of shortage of liquid assets at the time.<sup>28</sup>

The Authority recognises that the measure under investigation was taken against the background of the current international financial crisis. In Iceland, small saving banks faced liquidity problems as a result of financial difficulties of the larger banks which traditionally provided funding to the saving banks' sector. Unlike the larger financial undertakings, the saving banks did not have direct access to funding by the Central Bank. Thus, the Authority considers that the newly established loan category was necessary to remedy the temporary market failure experienced by the saving banks.

In its assessment, the Authority has also taken into account the fact that the continuation of operations of the saving banks is vital to local communities in Iceland. The measure was undertaken in order to keep the banks' customer confidence and remove the risk of a possible bankruptcy through restoring of liquidity problems.

The aid measure is limited in nature, both in scope and time. The overall budget of the scheme is restricted to ISK 30 billion. It foresaw a minimum threshold of available financing per beneficiary of ISK 1.5 billion, which, however, has so far not been applied due to smaller number of beneficiaries and lower value of the swap per undertaking than initially expected.

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<sup>25</sup> The Icelandic authorities stressed, however, that at the material time there were no subsidiaries or branches of foreign financial undertakings in Iceland.

<sup>26</sup> Case 730/79, *Philip Morris*, [1980] ECR 2671 and C-390/06, *Nuova Agricast v Ministero delle Attività Produttive*, judgment of 15 April 2008, not yet reported.

<sup>27</sup> Letter of 18.11.2008, p. 6.

<sup>28</sup> See Annex 1 to the letter dated 6.2.2009.

**Proportionality:** The positive effects of the measure must be properly balanced against the distortions of competition, which should be limited to the minimum necessary to reach the measures' objectives.<sup>29</sup>

In the Commission's practice,<sup>30</sup> the remuneration for state guarantees is assessed by using the methodology set out in the Recommendation of the Governing Council of the European Central Bank on government guarantees for bank debt (hereinafter referred to as the Recommendation).<sup>31</sup> Paragraph 5 of this Recommendation states that "*the pricing of credit guarantees on bank debt with maturities of less than or equal to 1 year should be based on an overall flat fee of 50 basis points, without an add-on fee. A flat fee on short-term debt is considered appropriate, as CDS spreads may not provide an adequate measure of credit risk for such debt*".

The Authority notes that the pricing of 75 basis points in the swap scheme under investigation, which has a maturity of maximum six months, is above the flat fee of 50 basis points in the Recommendation. On this basis, the Authority considers the contribution of the beneficiary banks in the form of an interest increment of 75 basis points as appropriate.

In principle, the swap does not imply change of ownership of the HFF bonds on the one hand and the mortgage loans portfolio on the other hand. However, there are certain safeguards foreseen in favour of the HFF. For instance, in case of repayment of the mortgage loan granted by the bank, the money has to be deposited into HFF's bank account until the end of the loan period, cf. Article 3 paragraph 4 of Rules 733/2008. In addition, the bank carries the risk of default of the mortgage loan holder (cf. letter of 18 November 2008, p. 3).

Bearing in mind the above, the Authority considers that the scheme contains certain safeguards that the HFF, the granting institution, obtains certain return on the swap of its bonds against mortgage loans of the banks which, in turn, mitigates the advantage for the banks.

Furthermore, the Authority has also considered the effect of the measure on the banking and financial sector in the EEA. Since all participating banks in the scheme were small saving banks, the effects of the measure on competition and trade in the EEA are not significant due to the limited size of the beneficiaries and the local character of their activities. The saving banks have limited international exposure, their lending activities are 98% directed at Icelandic residents and their funding is largely generated in the domestic market.<sup>32</sup> Furthermore, most of the saving banks mainly serve customers in rural areas, which are not significantly exposed to international competition in the banking and financial services sectors. Also the above-described lack of credit rating limits the

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<sup>29</sup> See the Commission Decision in Case N 567/2008 *Guarantee Scheme for banks' funding in Finland*, Commission Decision in Case N 520a/2008 *Support Measures for the Credit Institutions in Italy and Greece* and Commission Decision in Case N 560/2008 *Support Measures for the Credit Institutions in Greece*.

<sup>30</sup> See the Commission Decision in Case N 524/2008 *Support Measures for the Dutch Credit Institutions*, Commission Decision in Case N 520a/2008 *Support Measures for the Credit Institutions in Italy and Greece* and Commission Decision in Case N 560/2008 *Support Measures for the Credit Institutions in Greece*.

<sup>31</sup> See [http://www.ecb.eu/pub/pdf/other/recommendations\\_on\\_guaranteesen.pdf](http://www.ecb.eu/pub/pdf/other/recommendations_on_guaranteesen.pdf). The Recommendation was adopted on 20 October 2008.

<sup>32</sup> Letter of 18.11.2008, p. 4.

possibilities of the savings banks to access funding outside Iceland, which is liable to make the measures less likely to have adverse effects on competition and trade across EEA.

The Authority has also taken into consideration that the measure is directed at financially sound banks which in light of the turmoil on global financial markets faced temporary liquidity problems. In this regard, only undertakings having a CAD ratio of at least 9% are eligible to benefit from the scheme. Furthermore, each portfolio of mortgage loans put forward as security against the HFF bonds was subject to close scrutiny by the HFF according to pre-established criteria, such as for instance LTV ratio, priority ranking and credit history of the borrower. The Icelandic authorities have moreover confirmed that the scheme is directed towards undertakings without toxic debts and without exposure in debt instruments the validity of which has been cast into doubt.<sup>33</sup>

In light of the above and in view of a short duration of the scheme of initially three months, with additional limited prolongations up to a maximum of 12 months, upon an applicant's request, the Authority finds the scheme to be proportionate.

The possibility that the swap becomes permanent, *i.e.* that the HFF would take over the mortgage loans if the beneficiary bank goes into default, is limited to instances of the absolute impossibility of returning the HFF's bonds on the maturity date. As confirmed by the Icelandic authorities, this has not taken place so far.

The Icelandic authorities reported, however, that five beneficiaries of the present scheme have applied, under the provisions of Act No 125/2008, for HFF's take over of a collection of certain mortgage loans, some of which are subject to the present measure. This would mean that the HFF bonds would be permanently taken over by the recipient undertaking, but only after a proper evaluation by an independent body. In light of this and taking into account that the measure would be enacted on the basis of a different legal instrument, the Authority considers that this would create a separate measure which should be assessed in the context of a separate notification. The same applies to the recapitalisation scheme for savings banks provided for in Article 2 of the Act No 125/2008. The Icelandic authorities confirmed that it has not yet been decided whether the latter measure should be activated.

## 7 Conclusion

On the basis of the foregoing assessment, the Authority considers that the additional loan category of the HFF on lending to banks, saving banks and other financial institutions for the purpose of temporarily refinancing mortgage loans that have already been granted by these institutions against collateral in residential property is compatible with the functioning of the EEA Agreement on the basis of Article 61(3)(b) of the EEA Agreement.

The Authority regrets, however, that the Icelandic authorities did not respect their obligations pursuant to Article 1(3) of Part I of Protocol 3.

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<sup>33</sup> Letter of 18.11.2008, p. 5.

The Icelandic authorities are reminded about the obligation resulting from Article 21 of Part II of Protocol 3 in conjunction with Article 6 of Decision 195/04/COL to provide reports on the implementation of the scheme.

The Icelandic authorities are also reminded that all plans to modify this scheme must be notified to the Authority.

HAS ADOPTED THIS DECISION:

Article 1

The EFTA Surveillance Authority has decided not to raise objections to the additional loan category of the Housing Financing Fund on lending to banks, saving banks and other financial institutions for the purpose of temporarily refinancing mortgage loans that have already been granted by these institutions against collateral in residential property on the basis of Article 61(3)(b) of the EEA Agreement.

Article 2

This Decision is addressed to the Republic of Iceland.

Article 3

Only the English version is authentic.

Done at Brussels, 27 March 2009.

For the EFTA Surveillance Authority,

Per Sanderud  
President

Kurt Jaeger  
College Member