

Case No: 69095
Event No: 583839
Dec. No: 492/10/COL

EFTA SURVEILLANCE AUTHORITY DECISION
of 15 December 2010

opening the formal investigation procedure into state aid granted in the restoration of certain operations of (old) Kaupthing Bank hf and the establishment and capitalisation of New Kaupthing Bank hf (now renamed Arion Bank hf)

Iceland

The EFTA Surveillance Authority (“the Authority”),

HAVING REGARD to the Agreement on the European Economic Area (“the EEA Agreement”), in particular to Articles 61 and Protocol 26,

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

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

HAVING REGARD to the temporary rules regarding the financial crisis in Part VIII of the Authority’s State Aid Guidelines¹,

Whereas:

I. FACTS

1. Procedure

On 2 October 2008, the Icelandic authorities informed the Authority of their intention to inject 600 million Euros of capital into Glitnir Bank in return for 75% of its shares. The information was provided by way of a draft notification said to be submitted for legal certainty only as it was contended that the measure did not involve state aid. This proposal was however subsequently abandoned due to a further deterioration in the financial position of Iceland’s main commercial banks and on 6 October, the Icelandic Parliament (the *Althingi*) passed Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc. (referred to as the “Emergency Act”), which gave the state wide-ranging powers to intervene in the banking sector. On 10 October 2008 the President of the Authority wrote to the Icelandic authorities and (among other matters) requested that state aid measures taken under the Emergency Act be notified to the Authority as the Icelandic authorities had previously indicated that they would. On 14 October 2008, the Icelandic authorities submitted a further draft notification, informing the Authority that in their opinion the measures undertaken under

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

the Emergency Act to establish new banks as a result of the failure of the commercial banks did not involve state aid. A letter in response was sent by the Authority on 20 October 2008 indicating that it considered this unlikely and referred to the information that would be required in a notification. The matter was also discussed shortly thereafter in a meeting in Reykjavik on 24 October 2008. Further contact and correspondence followed periodically including notably a letter sent by the Authority on 18 June 2009 reminding the Icelandic authorities of the need to notify any state aid measures, and of the standstill clause in Article 3 of Protocol 3. On 22 July 2009, the Icelandic authorities informed the Authority that heads of terms had been agreed with resolution committees appointed to administer the estates of the (old) failed banks, which would lead to the new banks being capitalised by the Icelandic State on 14 August 2009. The Icelandic authorities again insisted that no state aid was involved and provided little information beyond what was already publicly available. Correspondence continued and meetings between the respective authorities followed both in August and November 2009, during which the Authority made it clear that from the limited information it had received it believed that the capitalisation of the new banks involved state aid that required notification. Given that the measures had already been implemented, the Authority subsequently sought to assist the Icelandic authorities in producing restructuring plans for the banks with the intention of proceeding directly to assess the measures in one procedure. It transpired, however, that the authorities and the banks were not yet in a position to produce definitive, detailed plans. State aid involved in the restoration of certain operations of (old) Kaupthing Bank and the establishment and capitalisation of New Kaupthing Bank was eventually notified retrospectively by the Icelandic authorities on 20 September 2010, although the process of restructuring the bank in order to ensure its long term viability remains ongoing. The Icelandic authorities also submitted further information in a meeting held in Reykjavik on 29 September 2010 and by letters of 9, 11, 15 and 28 November 2010.

2. Background - the financial crisis and major causes of failure of the Icelandic banks

In their notification of the aid granted to New Kaupthing Bank (later renamed Arion Bank), 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 Parliament², whose remit was to investigate and analyse the processes leading to the collapse of the three main banks. In sections 2.1 and 2.2 below, the Authority summarises the conclusions of the Commission concerning the causes of failure most relevant to the demise of Kaupthing Bank. The information is drawn from Chapters 2 (Executive Summary) and 21 (Causes of the Collapse of the Icelandic Banks – Responsibility, Mistakes and Negligence) of the SIC report.

2.1. Causes of failure linked to the global financial crisis and its impact on underlying problems of Kaupthing and the other main Icelandic banks

The global reduction in liquidity in financial markets that began in 2007 eventually led to the collapse of the three main Icelandic banks, whose business operations had become increasingly dependant on raising funding through international markets. The reasons for the demise of the Icelandic banks were however complex and numerous. The SIC investigated the reasons which led to the collapse of the main banks, and it is notable that

² The SIC’s members were Supreme Court Judge, Mr. Páll Hreinsson; Parliamentary Ombudsman of Iceland, Mr. Tryggvi 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.

2.1.1. Excessive and unsustainable expansion

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 ISK³ in 2003 to 14.4 trillion ISK at the end of the second quarter of 2008. Significantly, a large proportion of the growth of the three banks was in lending to foreign parties, which increased substantially during 2007⁴, most notably after the beginning of the international liquidity crisis. This led the SIC to conclude that much of this increase in lending resulted from loans made to undertakings that had been refused credit elsewhere. The report also concluded that inherently riskier investment banking had become an ever increasing feature of the banks' activities and growth had contributed to the problems.

2.1.2. The reduction in finance available on the international markets

Much of the banks' growth was facilitated by access to international financial markets, capitalising upon good credit ratings and access to European markets through the EEA Agreement. The Icelandic banks borrowed 14 billion Euros on foreign debt securities markets in 2005 on relatively favourable 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.

2.1.3. The gearing of the banks' owners

In the case of each major Icelandic bank, the principal owners were among the biggest debtors⁵. The SIC was of the view that certain shareholders had abnormally easy access to borrowing from the banks in their capacity as owners. The biggest shareholder in Kaupthing Bank was Exista hf., with just over a 20% share in the bank. Exista was also one of the bank's biggest debtors. During the period from 2005 to 2008, Kaupthing's total lending to Exista and related parties⁶ increased steadily from 400-500 million Euros to 1,400-1,700 million Euros and during 2007 and 2008 such lending was nearly equal to the bank's capital base. This increase in lending to major shareholders occurred despite the fact that Kaupthing was starting to face liquidity and refinancing problems. Loans to related parties were also often granted without any specific collateral⁷. Kaupthing's Money Market Fund was the biggest fund of the Kaupthing Bank Asset Management Company and in 2007 the fund invested significantly in bonds issued by Exista. At year end it owned securities to the value of around 14 billion ISK. This represented approximately 20% of the fund's total assets at that time. Robert Tchenguiz owned shares in Kaupthing Bank and Exista and also sat on the board of Exista. He also received major loan facilities from Kaupthing Bank in Iceland, Kaupthing Bank Luxembourg and Kaupthing Singer & Friedlander (KSF). In total, the loan facilities Robert Tchenguiz and

³ Icelandic *króna*.

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

⁵ Chapter 21.2.1.2 of the Report.

⁶ Exista, Exista Trading, Bakkavör Group, Bakkavor Finance Ltd, Bakkabraedur Holding B.V., Lýsing, Síminn, Skipti and other related companies.

⁷ More than half of such loans granted from the beginning of 2007 until the collapse of the bank, were granted without collateral

related parties had received from Kaupthing Bank's parent company at the collapse of the bank amounted to around 2 billion Euros⁸.

2.1.4. Concentration of risk

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

2.1.5. Weak equity

Although the capital ratio of Kaupthing 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"⁹, 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.

2.2. Causes of failure based on deficient regulation of the banks by the state and the size of the banks in relation to the rest of the Icelandic economy

2.2.1. The size of the banks

In 2001 the balance sheets of the three main banks (collectively) amounted to just over a year of the gross domestic product ("GDP") of Iceland. By the end of 2007 the banks were international and held assets worth nine times Icelandic GDP. The SIC report notes that by 2006, observers were commenting that the banking system had outgrown the capacity of the Central Bank of Iceland ("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, and the foreign deposits of the three banks were 8 times larger, than the foreign exchange reserve. The Depositors and Investors Guarantee Fund held minimal resources in comparison with the bank deposits it was meant to guarantee. These factors, the SIC concludes, made Iceland susceptible to a run on its banks¹⁰.

⁸ The minutes of the loan committee of Kaupthing Bank's board state, *inter alia*, that the bank often lent money to Tchenguiz in order for him to meet margin calls from other banks as his companies declined.

⁹ Chapter 21.2.1.4 of the Report.

¹⁰ These issues are discussed in more detail in the following paper by Willem H. Buiter and Anne Sibert: <http://www.cepr.org/pubs/PolicyInsights/PolicyInsight26.pdf>

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

The SIC concluded that the relevant supervisory bodies in Iceland lacked the credibility that was necessary in the absence of a sufficiently resourced lender of last resort. The report concludes that the Icelandic Financial Supervisory Authority (the “FME”) and CBI lacked the expertise and experience to regulate the banks in difficult economic times, but 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, 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 abroad¹¹.

2.2.3. *Imbalance and overexpansion of the Icelandic economy as a whole*

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”¹². 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.

2.2.4. *The Icelandic króna, external imbalances and CDS spreads*

The report notes that in 2006, the value of the Icelandic króna was unsustainably high, the Icelandic current account deficit 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 on Iceland and the banks rose exponentially.

3. Description of the measures

3.1. Background

Prior to the financial crisis of 2008, Kaupthing Bank was the largest bank in Iceland. At the end of 2007 its balance sheet amounted to 5,347 billion ISK (58.3 billion Euros) and it reported net earnings of 71 billion ISK (799 million Euros) in that year.¹³ Kaupthing was primarily a northern European bank operating in thirteen countries, including all of the Nordic countries, Luxembourg, Belgium, Switzerland, the United Kingdom, the United States, the United Arab Emirates (Dubai) and Qatar. Kaupthing offered integrated financial services to companies, institutional investors and individuals. These services were divided into five business segments: Banking (both Corporate Banking and Retail Banking), Capital Markets, Treasury, Investment Banking as well as Asset Management & Private Banking. In addition, the bank operated a retail branch network in Iceland, where it was headquartered, and to a lesser extent in Norway and Sweden. Kaupthing had

¹¹ 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.

¹² Chapter 2, page 5 of the report.

¹³ Kaupthing Bank Annual Report 2007. The bank’s recent annual reports are available at: <http://www.kaupthing.com/Investors/Financial-Reports-and-Data/Annual-Reports>

banking licences through subsidiaries in Denmark, Sweden, Luxembourg and the UK and branches in Finland, Norway and the Isle of Man. Kaupthing's principal subsidiaries were Kaupthing Singer & Friedlander (UK) and FIH Erhvervsbank (Denmark), but the bank operated sixteen other subsidiaries and branches in various countries in Europe, North America, Asia and the Middle East. At the end of 2007 the bank employed 3,334 people. Shares in the bank were listed on the OMX Nordic Exchange in Reykjavik and in Stockholm.

3.2. The collapse of Kaupthing Bank

In September 2008 a number of major global financial institutions began to experience severe difficulties. In the midst of the turbulence in global financial markets, Iceland's three biggest commercial banks, which had experienced extraordinary growth over the preceding years, encountered difficulties in refinancing their short term debt and a run on their deposits. Lehman Brothers filed for bankruptcy protection on 15 September, and on the same day it was announced that the Bank of America was to take over Merrill Lynch. Elsewhere, one of the United Kingdom's biggest banks, HBOS, had to be taken over by Lloyds TSB. The problems in the Icelandic financial sector unfolded more clearly on 29 September 2008, when the Icelandic Government announced that it had reached an agreement with Glitnir Bank whereby it would inject 600 million Euros of equity into the bank in return for 75% of its shareholdings. However, the Government's planned take-over of Glitnir Bank failed to reassure markets and was subsequently abandoned. The share prices of the three commercial banks plummeted and credit ratings were downgraded. Withdrawals of deposits from non-domestic branches of Landsbanki and Kaupthing increased dramatically and domestic branches also experienced massive withdrawals of cash. On the first weekend in October it became clear that another one of the three large banks, Landsbanki, was in severe difficulty. Glitnir Bank and Landsbanki were taken over by the FME on 7 October 2008. For a while it was hoped that Kaupthing Bank could escape the same fate and on 6 October 2008, the CBI granted Kaupthing a loan to the amount of EUR 500 million against collateral in Kaupthing's Danish subsidiary, FIH Erhvervsbanken. However, the loan agreements and debt securities of Kaupthing Bank generally contained a clause stating that in the event of one of the bank's large subsidiaries defaulting, this would constitute a default by Kaupthing Bank which could lead to the bank's loans becoming due. On 8 October 2008, the UK authorities placed Kaupthing's subsidiary in Britain, Kaupthing Singer & Friedlander (KSF), under cessation of payments. The following day, the FME took control of the bank using powers conferred upon it by the Emergency Act.

3.3. National legal basis for the aid measures

- *Act No 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc, commonly referred to as the Emergency Act*

The Emergency Act gave the FME authority to intervene "in extreme circumstances" and assume powers of financial institutions' shareholders meetings and board meetings, and decide on the disposal of their assets and liabilities. The FME was also granted power to appoint resolution committees to financial undertakings that it had taken over, which held the powers of shareholders' meetings. In winding up the institutions, the Act gives priority status to claims by deposit holders and deposit guarantee schemes. The Act also authorised the Icelandic Ministry of Finance to establish new banks. The Emergency Act includes amendments of the Act on Financial Undertakings, No. 161/2002, the Act on Official Supervision of Financial Activities, no. 87/1998, the Act on Deposit Guarantees and Investor-Compensation Scheme, No. 98/1999, and the Act on Housing Affairs, No. 44/1998.

- *Supplementary State Budget Act for 2008 (Article 4)*
- *State Budget Act for 2009 (Article 6)*

3.4. The intervention of the Icelandic state

The Icelandic authorities' intervention can be categorised into three phases as follows: firstly, restoration of basic banking in October 2008 through the formation of New Kaupthing; secondly, contributions made to properly capitalise the new bank for the first time in the autumn of 2009 (before the majority of the bank was acquired by the creditors of the old bank); and thirdly the restructuring of the bank, which began when the bank was restored and is ongoing.

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

On 9 October 2008, the FME took control of Kaupthing Bank in order to ensure the continuation of domestic retail banking operations. This was done through the appointment of a Resolution Committee for Kaupthing, which assumed the powers of shareholders' meetings and the board of directors; and subsequently the establishment by the Icelandic Government of New Kaupthing Bank, wholly owned by the state.

On 21 October 2008, the FME transferred the liability for all deposits held in Kaupthing, except for those held in foreign branches, to the new bank. The total amount of liability for domestic deposits transferred was 417,391 million ISK. Certain assets were also transferred to the new bank based on a principle that assets connected to the old bank's domestic operations were to be credited to the new bank with the remainder staying with the old bank. This was, however, subject to certain exceptions.¹⁴ The FME also published an internal FME memorandum setting out "guiding principles" for what was to be transferred not only to New Kaupthing but also to two other new successor banks that were formed following the collapse of Glitnir and Landsbanki.¹⁵

In return for the assets transferred to the new bank, the old bank was to be compensated to the sum of the difference between the value of the assets transferred and the amount of the liabilities (deposits) transferred (if a positive value). In accordance with Article 5 of the Emergency Act and the subsequent decisions of the FME on the disposal of assets and liabilities of the old banks, the FME commissioned a valuation of the net assets transferred from the old banks to the respective new banks. Deloitte LLP was appointed by the FME on 24 December 2008 to prepare the net asset valuations of each of the new banks. The process of valuation was however to prove complex and lengthy.

Initial capital

The state provided 775 million ISK¹⁶ (5 million Euros) in cash as initial capital to the new bank and in addition issued a commitment to contribute up to 75 billion ISK in total as Tier I risk capital to the new bank in return for its entire equity. This figure was calculated as 10% of an initial assessment of the likely size of the bank's total risk weighted assets. Appropriation to this amount was formally included in the state budget for the year 2009

¹⁴ The decision of the FME of 21.10.2008 on the disposal of assets and liabilities of Kaupthing Bank can be found at <http://www.fme.is/lisalib/getfile.aspx?itemid=5725>. The decision was subsequently amended on several occasions. The amendments are available on FME's website: www.fme.is.

¹⁵ The document is available at: <http://www.fme.is/lisalib/getfile.aspx?itemid=6021>

¹⁶ Monetary figures are referred to in this section first in the currency in which the capital was provided, followed by a reference in brackets to the corresponding amount in ISK or Euros (as appropriate) where it has been provided by the Icelandic authorities.

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 for the operability of the bank until issues relating to its definite re-capitalisation could be resolved, including the size of its opening balances and a valuation of compensation payable to the old bank for assets transferred.

Deposit guarantee

The initial rescue measures of the Icelandic Government also involved state backing of deposits in domestic commercial and savings banks. An announcement from the Prime Minister's Office of 6 October 2008 on Deposit Guarantee stated that the "*Government of Iceland underlines that deposits in domestic commercial and savings banks and their branches in Iceland will be fully covered*"¹⁷. This announcement has since been repeated by the Office of the current Prime Minister in February and December 2009.¹⁸ 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.*"¹⁹ 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.²⁰

3.4.2. Phase 2: Rescue/Restructuring of Arion Bank (New Kaupthing) through recapitalisation

On 20 July 2009 the Icelandic Government announced that it had reached heads of agreement with the Resolution Committee of Kaupthing in respect of the initial capitalisation of Kaupthing Bank (renamed Arion Bank as from 21 November 2009) and the basis for the compensation payable between the two parties for the transfer of net assets (if any) into the new bank following its creation in October 2008. The Government conditionally agreed with the Resolution Committee of Kaupthing that the creditors should, through the Committee, be granted the option of acquiring majority shareholding in Arion Bank in order to facilitate the bank's independent development. This would in effect involve the old bank providing the majority of the capital in Arion Bank, as a part of the compensation agreement. In the event that (old) Kaupthing Bank would not complete the subscription for shares in Arion Bank, the Government would retain full ownership.

On 14 August 2009 the Government announced that it had committed to capitalise Arion Bank with 72 billion ISK of Tier I capital in the form of government bonds, giving the

¹⁷ The English translation of the announcement is available at: <http://eng.forsaetisraduneyti.is/news-and-articles/nr/3033>.

¹⁸ <http://www.efnahagsraduneyti.is/frettir/frettatilkynningar/nr/2842>
<http://www.efnahagsraduneyti.is/frettir/frettatilkynningar/nr/3001>. The Minister of Economic Affairs has also referred to it recently in an interview with *Viðskiptablaðið* on 2.12.2010, 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).

¹⁹ 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>

²⁰ http://hamar.stjr.is/Fjarlagavefur-Hluti-II/Greinargerdir/Raedur/Fjarlagafurvarp/2011/Seinni_hluti/Kafli_8.htm

bank a Core Tier I ratio of approximately 12 per cent²¹. The Government capitalisation of Arion Bank was executed on 9 October 2009, involving an injection of 71,225 million ISK into the bank, back-dated to 22 October 2008, in addition to the initial 775 million ISK in cash which the bank had received when it was founded on 22 October 2008. Total Government share capital was therefore 72 billion ISK. In addition, the Government paid to Arion Bank 9.2 billion ISK in accrued interest on the bonds.

On 4 September 2009 the Government announced that definitive agreements with the Resolution Committee of Kaupthing regarding the capitalisation of Arion Bank and the basis for compensation had been signed. The agreement principally contained (alternative) provisions for:

1. Capitalisation under old bank (creditor) ownership (Joint Capitalisation Agreement)

Under this agreement the creditors of (old) Kaupthing had an opportunity to acquire (through the Resolution Committee) control of Arion Bank by subscribing to new share capital. Kaupthing was to pay for the new share capital from the old bank's own assets, as the value of the liabilities transferred to New Kaupthing (Arion Bank) exceeded the value of the assets transferred. The Government would hold minority ordinary share capital, amounting to 13 per cent of Arion Bank. In order to comply with the supervisory sign-off requirement of the FME for an additional 4% of Tier II capital, the Government would also contribute to the capital of Arion Bank in the form of a subordinated loan amounting to 24 billion ISK²².

2. Capitalisation under Government ownership (Alternative Capitalisation Agreement)

In the event that Kaupthing's Resolution Committee decided not to acquire control of Arion Bank, the Government would continue to fully own the bank. The compensation would actually come from Kaupthing (the old bank) to Arion Bank (the new bank), as the value of the liabilities transferred to Arion Bank exceeded the value of the assets transferred. The amount of that compensation was calculated at 38 billion ISK, but was to be re-evaluated on a regular basis, based upon future performance of a certain loan portfolio. Kaupthing would also be granted an option to acquire the Government's shareholding exercisable between 2011 and 2015 at a price which provided the Government with an appropriate level of return on its investment.

Tier I capital contribution

On 1 December 2009 an agreement was reached between the Government and Arion Bank, on the one hand, and Kaupthing's Resolution Committee on behalf of Kaupthing's creditors, on the other, on settlements concerning assets and liabilities (deposits) transferred from Kaupthing to the new bank established in October 2008. On the same day

²¹ Also in August 2009, the FME imposed a minimum requirement of a 12% Core Tier I capital ratio and a 16% CAD ratio as a discretionary minimum capitalisation for Arion (the same as for Islandsbanki and NBI), to be maintained for at least 3 years. The definition of Core Tier I capital includes only equity, i.e. share capital and retained earnings, but does not include subordinated loans or other types of hybrid capital instruments.

²² This was later revised upwards to 29.5 billion ISK during negotiations, cf. explanation of Tier II capital contribution below.

the Resolution Committee of Kaupthing decided²³ to exercise the option provided for in the Joint Capitalisation Agreement to take over 87% of the share capital in Arion Bank. The Government would retain the remaining 13% of Tier I capital.

Kaupthing paid for its acquisition of the majority shareholding in Arion Bank by transferring assets from its estate valued at 66 billion ISK to Arion Bank. For this purpose Kaupthing used a combination of cash, Icelandic related corporate loans and a portfolio of mortgages and loans to Icelandic Government related entities. The Government capitalisation from 9 October 2009 was subsequently reversed and Arion Bank returned 32.6 billion ISK in government bonds to the Government and issued a subordinated bond in favour of the Government to the sum of 29.5 billion ISK.

Complexities arose in respect of the 12% Tier I and 4% additional Tier II capital adequacy requirement as the transfer of non-risk free assets to Arion Bank implied an increase in the bank's risk-weighted asset base. Since Arion Bank was re-capitalised by a transaction that involved a significant increase in risk-weighted assets, more capital was needed under the Joint Capitalisation Agreement than under the Government capitalisation, which was financed exclusively by government bonds. A greater portion of the funds returned to the Government had to take the form of a Tier II obligation than would otherwise have been the case. For the same reason, Kaupthing paid 66 billion ISK for 87% of the shares instead of the 62.6 billion ISK that was originally envisaged (i.e. 87% of 72 billion ISK). The Government paid 12.208 billion ISK for its 13% share in Arion. To invest in Tier I capital on the same terms as Kaupthing Bank the Government would have paid approximately 2.3 billion ISK less for its 13% share than was actually the case.

Tier II capital contribution

The state also provided the new bank with a subordinated loan in order to strengthen its equity and liquidity position, and therefore comply with the capital requirements of the FME. The Tier II instrument provided by the Government is, according to the Icelandic authorities, based on a need to ensure a strong capital structure and is in accordance with the requirements of the FME.

The subordinated loan, denominated in foreign currency, corresponds to an amount of 29.5 billion ISK in the form of a capital instrument providing for Arion Bank 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 in five years. The interest rate per annum for the first five years is 400 basis points above EURIBOR, but in the period from five to ten years the interest rate per annum is 500 basis points above EURIBOR.

Special liquidity facility

The government financing of Arion Bank was carried out by means of an infusion of 72 billion ISK in repo-able government bonds in return for the bank's entire equity. Kaupthing Bank's decision to exercise its option to acquire 87% of shares in the bank,

²³ Subject to the approval of the FME and the Icelandic Competition Authority. Kaupthing's Resolution Committee currently controls the bank's holding on behalf of its creditors through a special holding company, Kaupskil. On 23.12.2009, the Icelandic Competition Authority cleared Kaupthing's acquisition of 87% of shares in Arion Bank subject to certain conditions. Following the conclusion of an agreement on the ownership of Arion Bank between Kaupthing Bank and the Ministry of Finance, the FME on 11.1.2010 granted Kaupskil permission to own a qualifying holding in Arion Bank on behalf of Kaupthing Bank.

however, meant that the majority of these bonds were returned to the government. Kaupthing Bank transferred assets from its estate to Arion Bank in return for the equity, significantly reducing the bank's holding of repo-able assets and threatening its capability to comply with supervisory requirements regarding liquidity reserves.²⁴ In view of this and in the context of Kaupthing exercising the option referred to above, the Government agreed to provide an additional liquidity facility for Arion Bank. The liquidity facility was formulated as an extension to a SPRON swap arrangement which is described in section 3.5 below.

Phase 3: Restructuring and long term viability of Arion Bank

According to the Icelandic authorities the restructuring process, which began by necessity through the collapse of Kaupthing and the transfer of its domestic assets and liabilities for domestic deposits to Arion Bank, remains incomplete. In view of the scale of the systemic collapse in comparison to the resources at the Icelandic government's disposal, and the lack of information available at the time of taking control of the banks, it was not considered prudent to attempt to fully restructure the financial system at that stage. Instead it was decided that a two-staged approach should be adopted. As a first stage, the enforced split would simultaneously achieve the aims of maintaining domestic banking services and significantly scaling down the unsustainably large financial system. The domestic operations transferred were however likely to represent an upper limit for the appropriate size of the Icelandic financial system and further restructuring was likely. In order to continue the process three further steps were required. The first was to settle the claims of international stakeholders (through the Resolution Committees of the old banks), the second was the re-capitalisation of the banks, and the third was to clearly establish their future ownership structure. The Icelandic authorities state that the three conditions were fulfilled in the first quarter of 2010 when new owners took control of the new banks and elected the first Boards of Directors with a mandate to develop a long-term business strategy on behalf of the future owners²⁵.

A likely consequence of the fact that the rescue approach adopted in Iceland was not predominantly based on a "good bank/bad bank split" is that extensive loan portfolio restructuring may have to be carried out by the new banks themselves. Despite numerous issues that have caused delays, the new banks have all taken important measures to avert impending losses by transferring impaired assets to specialised subsidiaries or selling them to new owners. They have also developed various programmes intended to resolve debt related issues in the retail and SME portfolios. Achievements have, however, been limited. Based on the ICAAP process²⁶ currently ongoing in all three new banks, the FME expects to be able to systematically enforce and document a definitive return to long-term sustainability by all three banks and conclude the restructuring of the Icelandic financial system.

A restructuring plan will therefore need to be submitted to the Authority in order for it to conclude its assessment of the state aid granted to Arion Bank, and its assessment of the new bank's viability, as soon as possible.

²⁴ The FME second sign-off condition stated that 5% of on-demand deposits should be in cash or cash-like assets and the bank should be able to withstand a 20% instantaneous outflow of deposits. The deposits exceeded 417 billion ISK.

²⁵ In the case of Arion Bank this occurred on 25.1.2010.

²⁶ Internal Capital Adequacy Assessment Process, cf. Pillar II of the Basel II recommendation of bank supervisors and central bankers stating that it shall be in the hands of the financial regulator to monitor and assess the ICAAP of regulated banks.

3.5. The SPRON swap agreement and special liquidity facility

On 21 March 2009, using its powers under the Emergency Act, the FME took control of Reykjavík Savings Bank (SPRON) and transferred most of its deposits to Arion Bank. A limited liability company to be owned by SPRON was established to take over SPRON's assets and also all collateral rights, including all mortgages, guarantees and other similar rights connected to SPRON's claims. The subsidiary, named Drómi hf, took over SPRON's obligations to Arion Bank for the deposits transferred and issued a bond to Arion Bank on 22 June 2009 for the amount of 96.7 billion ISK. All assets of SPRON were committed as collateral for the bond, including its shares in Drómi. The parties were unable to reach an agreement on the interest to be paid on the bond and referred the matter to the FME. The FME decided on 5 June 2009 that under the circumstances a rate of [...] + [...] % was an appropriate rate. The FME analysed the deposit rates, the risk of outflow (and other funding cost), cost of handling and other relevant issues in determining the applicable interest rate. The FME will revise its decision bi-annually and is currently in the process of doing so for the first time.

In heads of terms signed on 17 July 2009 the Government agreed to hold Arion Bank harmless with respect to the value of SPRON bond²⁷. The parties further agreed to work towards the SPRON bond being made eligible as collateral for funding from the CBI. In a letter to Arion Bank on 3 September 2009, the government extended the terms of the SPRON swap arrangement to cover not only potential outflow of the SPRON deposits (indemnifying the bank for taking over of the deposits) but also the liquidity required in order to comply with the FME's conditions. In the letter, the Government pledged to provide up to 75 billion ISK in government bonds if Kaupthing Bank decided to exercise its option to become the majority owner of Arion bank. The amended facility envisages that other assets than the SPRON bond can serve as collateral on less favourable terms.

On 21 September 2010, the Ministry of Finance and Arion Bank formalised the government's undertaking in the letter of 3 September by concluding an agreement on the loan of government bonds to be used as collateral. The Ministry of Finance agreed to lend to Arion Bank government bonds eligible for obtaining liquidity facilities through repo transactions with the CBI, in accordance with the CBI's existing rules. The market value of the government bonds is a maximum of 75 billion ISK. The facility terminates on 31 December 2014, which coincides with the maturity of the SPRON bond.

The amount of each drawdown on the facility shall be a minimum of one billion ISK. The government bonds shall only be used to secure loans against collateral from the CBI for the purpose of acquiring liquidity for Arion Bank. Arion Bank is not permitted to sell the bonds or use them for any other purpose than that stated in the agreement. If Arion Bank uses the SPRON bond as counter-collateral to secure its loan of government bonds, Arion pays no fee for draw-down up to 25 billion ISK, but for the remainder of the facility, it shall pay a consideration of 1.75% for permission to pledge the government bonds. However, Arion pays no consideration if it can clearly demonstrate that more than 25 billion ISK of the loan relates to withdrawals of SPRON deposits. If Arion uses assets other than the SPRON bond as counter-collateral to secure its loan, the consideration rises to 3% of the loan amount which was granted in relation to that collateral only. In such cases, Arion shall furthermore pay a special fee amounting to 0.5% of the loan amount on each occasion government bonds are utilised.

²⁷ This was later confirmed in a letter sent by the Ministry of Finance to Arion Bank dated 20.8.2009.

3.6. A comparison of the old and new banks: Arion Bank and Kaupthing Bank

The Authority will undertake a full assessment of the business plan of the new bank, including an analysis of the differences between the old and new banks and the potential for the same or similar problems to re-occur, following the submission by the Icelandic authorities of a detailed restructuring plan for the bank. The Icelandic authorities have, however, submitted an overview of the fundamental changes that have already taken place which the Authority considers to be relevant for the purposes of its current assessment.

There is a vast difference in the scope of Arion Bank's operations compared to those of Kaupthing Bank. As previously outlined, Kaupthing was an international bank with operations in various countries. Arion Bank was established by the transfer of mainly the domestic assets and operations of Kaupthing Bank, while other assets and operations of Kaupthing remain under the control of the Resolution Committee and the Winding-up Committee of Kaupthing.

	Arion Bank 31.12.2009	Kaupthing Bank 30.06.2008	AB as a % of KB
Assets			
Cash and balances with Central Bank	41,906	154,318	27.2%
Loans and receivables to credit institutions	38,470	529,620	7.3%
Loans and receivables to customers	357,734	4,169,181	8.6%
Bonds and debt instruments	173,482	676,316	25.7%
Shares and equity instruments with variable income	7,078	172,286	4.1%
Derivatives	6	328,217	0.0%
Derivatives used for hedging		27,742	0.0%
Securities used for hedging	2,236	81,207	2.8%
Compensation instrument	34,371	-	nm.
Intangible assets	-	85,757	0.0%
Investment property	22,947	37,013	62.0%
Investment in associates	5,985	107,574	5.6%
Property and equipment	10,700	39,240	27.3%
Tangible assets	3,512	-	nm.
Tax assets	1,415	12,027	11.8%
Non-current assets and disposal groups held for sale	41,527	-	n.m
Other assets	15,975	183,217	8.7%
Total assets	757,344	6,603,715	11.5%
Liabilities			
Due to credit institutions and Central Bank	113,647	670,930	16.9%
Deposits	495,465	1,848,155	26.8%
Borrowings	11,042	2,883,261	0.4%
Financial liabilities at fair value	88	230,663	0.0%
Subordinated loans	-	328,153	0.0%
Tax liabilities	2,841	18,099	15.7%
Non-current liabilities and disposal groups held for sale	19,230	-	nm.
Other liabilities	24,997	186,758	13.4%
Total liabilities	667,310	6,166,019	10.8%
Equity			
Share capital	12,646	7,187	176.0%
Share premium	59,354	148,362	40.0%
Other reserves	1,729	61,196	2.8%
Retained earnings	16,150	207,461	7.8%
Total shareholder's equity	89,879	424,206	21.2%
Non-controlling interest	155	13,490	1.1%
Total equity	90,034	437,696	20.6%
Total liabilities and equity	757,344	6,603,715	11.5%

Table 1: Comparison of the balance sheets of Arion Bank and Kaupthing Bank

A comparison of the old and new banks' balance sheets presented in Table 1 reveals a substantial difference in the size of the two operations as the total assets of Arion Bank at the end of 2009 were only 11.5% of those of Kaupthing Bank at mid-year 2008. The loan portfolio is the largest single asset category. The book value of Kaupthing Bank's loan portfolio at the end of June 2008 was 4,169 billion ISK, whereas the book value of Arion Bank's loan portfolio at the end of 2009 was 358 billion ISK, 8.6% of that of Kaupthing. The difference is due to the broad geographical scope of Kaupthing Bank compared to Arion Bank's Icelandic operations as well as impairments of the loan portfolio transferred

to Arion Bank due to the economic turbulence in Iceland²⁸. There is also a significant change in securities holdings of Arion Bank compared to Kaupthing Bank. Shares and derivatives are reduced by 96 – 100% and bonds held by Arion Bank amount to 25.7% of Kaupthing Bank's holdings. Furthermore, as can be seen in the income statement analysis in Table 2, activities related to equities, bonds and derivatives have dropped significantly which can be explained by inactive capital markets in Iceland following the introduction of capital controls in the autumn of 2008 and weak equity markets.

	Arion Bank 1.1 - 31.12 2009	Kaupthing Bank 1.1 - 31.12 2007	AB as a % of KB
Interest income	66,905	304,331	22.0%
Interest expense	(54,759)	(224,218)	24.4%
Net interest income	12,146	80,113	15.2%
Increase in value of loans and receivables	20,199	-	
FX gain on loans and receivables from ISK income customers	1,535	-	
Impairment on loans and receivables	(11,474)	-	
Changes in compensation instrument	(10,556)	-	
Net interest income less valuation changes on loans and receivables	11,850	80,113	
Fee and commission income	8,291	64,865	12.8%
Fee and commission expense	(2,429)	(9,844)	24.7%
Net fee and commission income	5,862	55,021	10.7%
Net financial income (expense)	1,638	4,282	38.3%
Net foreign exchange gain	8,715	10,151	85.9%
Share of profit or loss of associates	369	3,459	10.7%
Other operating income	21,201	12,792	165.7%
Operating income	49,635	165,818	29.9%
Salaries and related expenses	(10,413)	(46,647)	22.3%
Administration expense	(5,317)	(24,693)	21.5%
Depositors' and investors' guarantee fund	(683)	-	
Depreciation and amortisation	(1,161)	(6,550)	17.7%
Other operating expense	(16,279)	(841)	1935.7%
Net loss on non-current assets and disposal groups classified	(375)	-	
Impairment on loans and other assets	-	(6,180)	0.0%
Earnings before income tax	15,407	80,907	19.0%
Income tax expense	(2,536)	(9,716)	26.1%
Net earnings	12,871	71,191	18.1%

Table 2: Comparison of the income statements of Arion Bank and Kaupthing Bank

The income statements of the two entities display a similar difference in size and scope. Comparing Arion Bank in 2009 and Kaupthing Bank in 2007, net interest income of Arion Bank amounts to 15.2% of Kaupthing Bank and net fee and commission income of Arion was 10.7% of that of Kaupthing. Salaries and administration expenses for Arion Bank are just over 20% of Kaupthing Bank's expenses. However, other operating income and expenses for Arion Bank are substantially higher than for Kaupthing Bank due to the fact that following severe decline in economic activity in Iceland, Arion Bank has foreclosed on a number of companies in various sectors. Arion Bank employed 1,057 people at the end of 2009 (including employees of subsidiaries) compared to Kaupthing Bank's 3,334 employees at the end of 2007. The total number of employees at Arion was therefore 32% of the corresponding total for Kaupthing Bank²⁹. Comparing the Icelandic operations of both banks, Kaupthing Bank employed 1,133 people for the Icelandic operations (excluding employees of subsidiaries) at the end of June 2008, whereas in Arion Bank, there were 952 employees (excluding subsidiaries) at the end of 2009.

²⁸ According to the annual report of Kaupthing Bank for the year 2007, the book value of loans to customers in Iceland amounted to ISK 885 billion.

²⁹ Changes differ between business segments and in certain areas the reduction is up to 90%. A significant scale-down took place in the CEO's office, where 6% of Kaupthing's staff in Iceland were employed, whereas in the case of Arion Bank the corresponding number is 1%.

3.7. The business activities of the new bank

The operations of Arion Bank differ in important respects from the domestic operations of Kaupthing Bank, underlining the domestic focus of the new bank and different economic conditions. Activities related to Capital Markets have been reduced significantly and the same applies to Risk Management, Finance, Human Resources, IT and Marketing. However, with increased activities related to the restructuring of both companies and individuals, the number of employees in Corporate Finance has increased at Arion Bank compared to Kaupthing Bank.

Arion Bank now operates 26 branches and outlets across Iceland. Kaupthing Bank operated 34 branches and outlets at the end of 2007. Efforts have been made to align the bank's operations to a new economic reality by scaling down various functions such as IT and the branch network. As mentioned above, Arion Bank took over the deposit obligations of Reykjavík Savings Bank (SPRON). Furthermore, the bank acquired the regional Mýrasýsla Savings Bank (SPM), including all its assets and certain liabilities such as deposits. The two acquisitions brought 22,000 new customers to Arion Bank without expanding its existing branch network.

As a result of the economic turbulence in Iceland the debts of many companies and individuals are in need of restructuring. These activities have therefore increased substantially compared to the operations of Kaupthing Bank. The Corporate Finance division of Arion Bank is now focused on Iceland instead of the wide reaching operations of Kaupthing Bank's corporate finance and investment banking divisions. Merger and acquisition activity in Iceland has dropped substantially and the focus has been on the financial restructuring of companies. A special corporate recovery unit was established in 2009 and the position of Customers' Ombudsman was set up. Asset management companies were established for the management of foreclosed assets. The bank introduced a range of customised solutions designed to help households and individual borrowers to cope with their debt.

The asset management arm of Arion Bank has proven to be resilient. The number of employees in asset management has remained the same in Arion Bank as in the Icelandic asset management operations of Kaupthing Bank³⁰.

The financial crisis led to a collapse of the activities in capital markets, especially the currency market and equity market. The bonds market has been more resilient as investors have focused their investments towards bonds issued by the Icelandic government and government agencies. Capital controls were put in place whereby currency trading was only allowed for merchandise and services purposes but all capital account transactions were suspended.

The transition from Kaupthing Bank to Arion Bank was seamless in the sense that customers were able to access their savings throughout the whole process and complete their domestic transactions without disruption. However, the transfer of ownership of the assets from Kaupthing Bank to Arion Bank and the restructuring of assets in a new institution has posed numerous challenges, including the valuation of assets, putting in place a process to deal with the restructuring of the loan book and streamlining other operating activities to reflect the fact that it is now a domestic as opposed to international bank.

³⁰ Assets under management in Arion Bank amounted to 581 billion ISK at year end 2009 compared to 1,630 billion ISK at the end of June 2008 in Kaupthing Bank.

4. Position of the Icelandic authorities

4.1. State aid nature of the measures and compatibility with the EEA Agreement

In their notification the Icelandic authorities now accept that measures undertaken in order to establish Arion Bank constitute state aid. They contend however that the measures are compatible with the functioning of the EEA Agreement under Article 61(3)(b), on the basis that they were necessary in order to remedy a serious disturbance in the Icelandic economy.

The Icelandic authorities stress that the situation in Iceland in October 2008 was extreme and required immediate action in order to restore financial stability and confidence in the Icelandic economy. The Icelandic authorities' intentions at this stage of the process were straightforward and basic, ensuring that Icelanders had access to their deposit accounts and that some form of financial system survived. The implications not only for the Icelandic economy but also for Icelandic society were grave.

The measures regarding Arion Bank/Kaupthing Bank were considered necessary because if the bank had not been restored, the systemic collapse that Iceland was already suffering would have intensified. The Authority has also been provided with a letter from the Central Bank of Iceland affirming the necessity of the measures taken. The fact that Arion Bank, and other Icelandic and European banks, suffered from lack of liquidity as well as lack of market and investors' confidence meant it was not possible to fund the bank through the financial markets. The intervention of the Icelandic state was necessary to strengthen the bank's equity and liquidity position in order to maintain its viability. The fact that the creditors of Kaupthing opted to acquire 87% of Arion Bank also greatly decreased the need for a State contribution to the bank.

The part of the capitalisation of Arion Bank borne by the Icelandic State as an owner of 13% of the bank's shares will be remunerated through the eventual sale of the State's share. According to the Icelandic authorities, it is not possible at this stage to assess whether the state will receive an adequate return on its Tier I investment in Arion Bank, stating that "*... the scale of the issues at stake and the potential implications with respect to financial stability and the success of the whole intervention, is such that a discrepancy of approximately ISK 2.3 billion was considered an acceptable upfront cost to the government to achieve the benefits associated with this conclusion of the rescue and restoration process*". Nevertheless the Icelandic authorities argue that as far as applicable, the measures are also in line with the principles set out in the Authority's Recapitalisation Guidelines. The Icelandic authorities argue that the risk profile of the new banks is relatively low and that in consequence the pricing of capital provided should be at the lower end.

According to the Icelandic authorities the Government contribution of Tier II capital to Arion Bank was necessary and essential to restore viability, and an important factor in restoring confidence in the financial market with the aim of reconstructing a bank that would be viable in the long term without state aid. The overall contribution is limited in size to what is absolutely necessary to ensure that Arion Bank meets minimum capital requirements, as defined by the FME. In order to minimise the effect on competition, the same Tier II funding was made available to all of the three main banks, which were in a comparable situation. According to the Icelandic authorities it is currently very difficult to benchmark the interest against the market rates. Using market standards from the past it was customary for Tier II instruments to bear interest a little higher than general unsecured bonds (25-50 basis points). The bond negotiated between Arion Bank and the Kaupthing Resolution Committee on the other hand had a LIBOR plus 300 basis points coupon. By

that comparison the interest negotiated by the Icelandic authorities on the Tier II bond was well above “market” standard. The Icelandic authorities furthermore argue that built-in incentives for exit are in place, in the form of step-up of interest in five years’ time. On this basis the Icelandic authorities consider that the interest coupon is acceptable and that the remuneration is compatible with the EEA Agreement.

The Icelandic authorities also stress that the parties that were shareholders of (old) Kaupthing before the financial crisis have lost their shares in the bank and have received no compensation from the state. In the case of Kaupthing, the agreement acknowledges that in the definitive split more liabilities than assets were transferred to Arion and the net effect of the transfer is to create an obligation of Kaupthing in favour of Arion. The losses stemming from the fall of the old banks have not therefore been mitigated by the Icelandic Government and the costs associated with the re-establishment of the bank must be seen as being borne by the investors in Kaupthing, as the losses stemming from the fall of Kaupthing were largely absorbed by these investors. The measures are therefore consistent with the principle that the bank should use its own resources to finance rescue and restructuring to the extent possible.

As regards competition in the banking market reference is made to decision of the Icelandic Competition Authority No. 49/2009 on Kaupthing’s take-over of majority shareholding in Arion Bank, where it is indicated that the establishment of the three new banks has not changed the situation as regards competition in the retail banking market in Iceland.

4.2. Possible alternatives

The Icelandic authorities are of the view that there were no other realistic alternatives to the actions taken in October 2008. The purpose of the measures undertaken with regard to all three banks was to eliminate the threat to the stability of the Icelandic economy that complete failure of the domestic banking system would have entailed. To do so, the measures had to remedy the identified causes of the banks’ problems - mainly their size relative to the size of the Icelandic economy and their reliance on foreign credit facilities. The instruments chosen by the Icelandic government represent the only credible measures available, given the status of the Icelandic economy, and were therefore both necessary and appropriate means to address these problems. The scope of the measures as regards Kaupthing/Arion Bank is, in the opinion of the Icelandic authorities, limited to the minimum necessary, bearing in mind the serious economic situation of Iceland and the need to rebuild the financial system in the country.

The total revenue in the Icelandic state budget for 2008 was 460 billion ISK and total

GDP in 2007 was 1,308 billion ISK³¹. The liabilities through deposits alone in the three large Icelandic banks were at the time of their collapse 2,761 billion ISK, of which 1,566 billion was held in foreign currencies in the foreign branches of the banks. The foreign currency reserves of Iceland consisted of 410 billion ISK in October 2008, which amounted to around 25% of the value of deposits in the non-domestic branches.

³¹ See:

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

The Authority also notes in this context the conclusions of the SIC Report, which refers in section 4.5.6.2 of Chapter 4³² to attempts made during the course of 2008, given the concerns about the overblown size of the Icelandic banking sector and limitations of the CBI as a lender of last resort, to strengthen the CBI's currency reserves. Requests were made to other Nordic central banks, the European Central Bank, the Bank of England and the Federal Reserve Bank of New York for currency swap agreements, but despite extensive efforts the CBI managed only to secure agreements with Nordic central banks (Sweden, Denmark and Norway). The Bank of England considered the CBI's request carefully, but eventually declined to participate. A letter from the Bank of England governor, Mervyn King, to his Icelandic counterpart, Davíð Oddson, illustrates the views of the United Kingdom's central bank (letter of 23 April 2008):

“It is clear that the balance sheet of your three banks combined has risen to the level where it would be extremely difficult for you effectively to act as a lender of last resort. International financial markets are becoming more aware of this position and increasingly concerned about it. In my judgement, the only solution to this problem is a programme to be implemented speedily to reduce significantly the size of the Icelandic banking system. It is extremely unusual for such a small country to have such a large banking system. I know you will be disappointed. But among friends it is sometimes necessary to be clear about what we think. We have given much consideration to your proposal. In my judgement, only a serious attempt to reduce the size of the banking system would constitute a solution to the current problem. I would like to think that the international central banking community could find a way to offer effective help to enable you more easily to construct a programme to reduce the size of the banking system. I shall be willing to do all in our power to help you achieve that.”³³

Later efforts included contacts with Timothy F. Geithner, President and CEO of the Federal Reserve Bank of New York. The request was eventually declined on 3 October 2008. According to the SIC report the main reason given by the Federal Reserve was the size of the Icelandic banking system as for a currency swap agreement to be effective, it would have to be for a bigger amount than the Federal Reserve could accept.

The Icelandic authorities did consider dividing the bank into a “good bank” and a “bad bank” by transferring the healthy and valuable assets to a “good bank” that should generally be able to finance itself on the market and leaving the less valuable assets that are difficult to realise in a “bad bank” funded by the state. However, it was considered that due to the financial crisis, even “good” Icelandic banks would probably not have been able to seek sufficient capital to finance their operations despite a potentially healthy financial status. Another problem for Iceland in using the “good bank/bad bank” solution was that running a “bad bank” would require substantial equity contributions from the Government. Faced with a situation where aid was needed for three of the nation's biggest banks (over 80% of the nation's banking system), which had collective liabilities over 10 times Iceland's GDP, it was the conclusion of the Icelandic authorities that such an attempt would almost certainly lead to the state suffering major financial difficulties. In combination therefore it was felt that such a solution would have lacked the credibility necessary in a situation where the immediate problem faced by the banks was the run on their liabilities through the termination of credit facilities and massive deposit withdrawals.

³² See: <http://rna.althingi.is/pdf/RNABindi1.pdf> (see p. 167-181)

³³ Chapter 4.5.6.2, p. 172-3 of the SIC report.

4.3. Timescales

In so far as the period of time it has taken to reach this stage is concerned the Icelandic authorities argue that they faced severe and complex circumstances – a division of three commercial banks to save the domestic part of a banking system and through that the economy, had as far as they are aware never been done before. The task required the participation of many parties both domestic and foreign and in their view some aspects of the split proved more difficult than the “good bank/bad bank” method used in some other countries where banking systems have encountered serious problems.

The first problem encountered was a practical one. The intra-month transfer date for the assets and liabilities (21 October 2008) caused significant technical and audit complexities. The procedure used to split Kaupthing’s balance sheet in October 2008 was based on the bank’s interim accounts of 30 September 2008. All changes from that date until the date of division were estimated until 21 October 2008. It took until the beginning of 2009 for the division of the bank’s systems into the new and old banks to be reconciled. From that time, work was done on each bank separately, and clearing accounts were used for transactions between the two banks. The processing of clearing account transactions entailed substantial risk of error and great complexity, which was only completed by the summer of 2009.

Within a short period of time it became evident that the creditors of the old banks were very unhappy with the asset valuation process that had been established. They considered the process to be one-sided in that their input was not taken into account as a part of the valuation process. As a result the procedure was changed in February 2009 into a formal negotiating process with the participation of domestic and foreign creditors. This process proved time consuming as a large number of international creditors and their advisors needed to participate at the negotiation table³⁴.

Another factor in the delay of the process was the development of each of the new banks’ initial business plans – a necessary element in the negotiations with the creditors. The banks were not ready to present their business plans until they had had the opportunity to go through the valuation of transferred assets prepared by Deloitte, as the opening balance sheet would be the foundation of such business plans. The banks presented 5 year business plans to the creditors in June 2009 following which the negotiations could begin. In their business plans the new banks put forward their own valuation of transferred assets which was not consistent with the Deloitte valuation. As the Deloitte valuation was not an exact number but a wide range, a Deloitte valuation number could not be entered into the opening balance sheet of the new banks. The new banks’ valuation of the assets transferred was at the low end or below the low end of the Deloitte valuation, while the creditors’ view stood at the high end or above the high end of the Deloitte valuation. A complex negotiation process followed in which both sides were far apart. In the end it became necessary to develop contingent compensation instruments to bridge the gap between the parties.

When the split was made between each old and new bank it became evident that there would be a massive currency mismatch in the new banks’ balance sheets. The deposits transferred were mainly ISK denominated and the loan assets mainly foreign currency denominated or linked. This created potentially major market risks in the new banks that

³⁴ It is also notable that during this period Iceland suffered political upheaval. A new minority government came to power in February 2009, a government which later became a majority government after Parliamentary elections in April the same year. The new government had in some cases different views to the former government and some changes to the process had to be made.

had to be addressed before the capitalisation could take place. The process of addressing this issue was time consuming and only partially successful.

During the negotiations it became evident that the creditors in two of the banks (Kaupthing and Glitnir) could possibly have an interest in capitalising the banks themselves and become majority owners. To respond to this possibility, two alternative positions had to be formulated during the negotiations. After the creditors had opted for ownership of the bank a due diligence had to be performed by the creditor advisors, which also was time-consuming.

Finally, the Icelandic authorities argue that account should be taken of the fact that from October 2008 until the autumn of 2009 the remainder of the financial sector in Iceland was far from stable, and in fact, during this period almost all financial undertakings in Iceland were taken over by the FME.

The Authority specifically requested information on why full business plans are still not available for the banks and why they have not been fully restructured. The Authority also requested information on why an assessment of the true value of the assets of the banks is yet to be completed. According to the Icelandic authorities, given the circumstances (in particular the impact on international creditors) it was considered important to abide by the principles of good public governance, including moderation. Specifically, it was thought that systematically and deliberately leaving damaged assets behind in the old banks (as would be the case in a “good bank/bad bank” scenario) would exceed what was strictly necessary to ensure the short to medium-term operability of the new banks. For this reason, insofar as the basic principle of a domestic-foreign split was considered sufficient to ensure operability of the new banks in the short to medium term, “cherry picking” of good assets was deliberately avoided. Another reason for doing so was that it was considered that successfully valuing the assets (and therefore their degree of impairment) was a highly complex exercise.

The above considerations were borne out by the events. Despite considerable time and resources allocated to the task, the professional firm engaged to assess the true net value of the assets transferred was unable to give a precise estimate. After months of negotiations, supported by some of the world’s most renowned professional firms and investment banks, the stakeholders eventually settled on contingent compensation instruments for all three banks due to this uncertainty. The likely implication is that although certain margins can be, and have already been, established regarding the lower limits of asset value, only time can tell with sufficient precision what the true value of the transferred asset portfolios will be. The Icelandic authorities also argue that it is clear that establishing the new banks without performing a “good bank/bad bank split” – i.e. without ensuring that the level of impairment in their portfolios was kept within very strict boundaries – meant that the entities were not inherently viable. According to the Icelandic authorities the long term viability of the banks cannot be achieved without first creating banks that are operable and functional in the short to medium-term before undertaking further restructuring. The process of assessing the viability of the Arion Bank is therefore ongoing but the Icelandic authorities have committed to providing a restructuring plan as soon as possible.

II. ASSESSMENT

1. The presence of state aid

State aid within the meaning of Article 61(1) EEA Agreement.

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

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

The Authority will assess the following measures below:

- The initial operating capital provided by the Icelandic state to the new bank;
- The (temporary) full state capitalisation of the new bank;
- The retention by the State of the 13% share capital remaining after 87% of the share capital in the new bank was transferred to the creditors of Kaupthing; and
- The provision by the State of Tier II capital to the new bank by way of subordinated debt.

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

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

1.1. Presence of state resources

It is clear that the capitalisation measures are financed through state resources provided by the Icelandic Treasury. State resources are also present in the provision of liquidity to the bank as part of the compensation for taking over the deposit liabilities of SPRON and otherwise.

The primary intention of the statement made by the Icelandic authorities safeguarding domestic deposits was to reassure deposit holders and to stop widespread run on deposits in the (old) banks. The deposit guarantee was implemented in practice through the use of powers under the Emergency Act to change the priority of deposit holders in bankruptcy proceedings and by transferring the liabilities for deposits to the newly established banks, which were initially fully capitalised by the state. According to statements made by the Icelandic authorities, however, a full guarantee of all deposits in Icelandic banks remains in place. The Authority wishes to further investigate whether the notice issued (and subsequent references to it) was a precise, firm, unconditional and legally binding statement such as to involve a commitment of state resources³⁵.

1.2. Favouring certain undertakings or the production of certain goods

Firstly, the aid measure must confer on the new bank advantages that relieve it of charges that are normally borne from its budget. The Authority is again of the view that each of the capitalisation measures confers an advantage on the new bank as the capital provided would not have been available to the bank without state intervention. The approach taken

³⁵ See in this respect the judgment of the General Court in joined Cases T-425/04, T-444/04, T-450/04 and T-456/04, *France and others v Commission*, judgment of 21.5.2010, not yet reported, paragraph 283 (on appeal).

both by the European Commission (in numerous cases since the financial crisis began³⁶) and by the Authority³⁷ in assessing whether state intervention to recapitalise banks amounts to state aid assumes that, given the difficulties faced by the financial markets, the state is investing because no market economy investor would be willing to invest on the same terms. The market economy investor principle is considered not to apply in cases involving the capitalisation of financial institutions affected by the crisis that are in difficulty. The Authority considers this to be the case notwithstanding the eventual transfer of 83% of the capital of the new bank to the (largely private sector) creditors. The private investor involvement in the capitalisation of the new Icelandic banks is made up entirely of creditors of the old banks who are not therefore investors acting freely in an open market but rather are seeking to minimise their losses in the most efficient manner³⁸.

Secondly, the aid measure must be selective in that it favours “*certain undertakings or the production of certain goods*”. The capitalisation measures are selective as they only benefit Arion Bank. Similar measures were also implemented in the cases of the other two failed banks, and several other Icelandic financial institutions have required assistance from the government. However, not all Icelandic banks have received state aid, and state support can in any event be selective in situations where one or more sectors of the economy benefit and others do not. This principle applies also to the state guarantee on deposits which benefits the Icelandic banking sector as a whole.

In so far as the liquidity facility is concerned, paragraph 51 of the Authority’s temporary rules on the “application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis” provides that, following the Commission’s decision-making practice³⁹, the Authority considers that the provision of a central bank’s funds to financial institutions will not constitute aid when the following conditions are met:

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

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

³⁶ See for example Commission decision of 10.10.2008 in case NN 51/2008 *Guarantee scheme for banks in Denmark*, at paragraph 32, and Commission decision of 21.10.2008 in case C 10/2008 *IKB*, at paragraph 74.

³⁷ See the Authority’s decision of 8.5.2009 on a scheme for temporary recapitalisation of fundamentally sound banks in order to foster financial stability and lending to the real economy in Norway (205/09/COL) available at: <http://www.eftasurv.int/?1=1&showLinkID=16694&1=1>

³⁸ 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).

³⁹ See for instance Northern Rock (OJ C 43, 16.2.2008, p. 1).

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

The Authority also considers that it is possible that the bank has benefitted (indirectly) from the statements made by the Government safeguarding all domestic deposits, as in the absence of the guarantee the new bank could have suffered from a run on its deposits like its predecessor⁴⁰. Accordingly, the Authority has doubts as to whether the guarantee entailed an advantage for the bank.

1.3. Distortion of competition and effect on trade between Contracting Parties

The measures strengthen the position of the new bank in comparison to competitors (or potential competitors) in Iceland and other EEA States and must therefore be regarded as distorting competition and affecting trade between the Contracting Parties to the EEA Agreement⁴¹.

1.4. Conclusion

The Authority's preliminary conclusion, therefore, is that the measures taken by the Icelandic State to capitalise the new bank, as well as the liquidity facility, involve state aid within the meaning of Article 61(1) of the EEA Agreement. It also cannot exclude that aid to Arion Bank may be present in the transfer to it of SPRON's assets and liabilities and as a result of the government's notice safeguarding deposits.

2. Procedural requirements

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

The Icelandic authorities did not notify the aid measures to the Authority in advance of their implementation. The Authority therefore concludes that the Icelandic authorities have not respected their obligations pursuant to Article 1(3) of Part I of Protocol 3. The granting of aid was therefore unlawful.

3. Compatibility of the aid

Assessment of the aid measures under Article 61(3) of the EEA Agreement is set out below.

⁴⁰ 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

⁴¹ See in this respect Case 730/79 *Phillip Morris v Commission* [1980] ECR 2671

3.1. The necessity, proportionality and appropriateness of the aid

In the Authority's view it is beyond dispute that Iceland faced, and still faces, a serious disturbance in its economy and that Kaupthing Bank was of structural importance. In consequence the Authority will assess the potential compatibility of the aid under Article 61(3)(b) of the EEA Agreement and the guidelines based upon that sub-paragraph.

The Authority considers that this case, although not necessarily unique, is difficult to assess using the traditional and commonly understood notions of on the one hand "rescue" aid and the other "restructuring" aid. For instance the restoration of the bank as an emergency measure in October 2008 involved both rescue aid and immediately enforced restructuring. Through this decision the Authority intends to assess, retrospectively, the measures undertaken to restore the bank both through its initial creation and subsequent capitalisation as rescue measures. Such aid can only, however, be approved on a temporary and conditional basis. In the absence of a restructuring plan, the Authority is unable to fully assess the case and reach a conclusion and in consequence the measures will be assessed once again – on this occasion as structural measures, upon receipt of the restructuring plan⁴². The Authority will at that stage assess the viability of the bank and the requirement that the aid provided was the minimum necessary to ensure its viability. The restructuring plan should include a full comparison of the old and new banks (for the purposes of demonstrating that previous problems should not re-occur), as well as an assessment of how ongoing restructuring should secure the long term viability of the bank.

In line with the general principles underlying the state aid rules of the EEA Agreement, which require that the aid granted does not exceed what is strictly necessary to achieve its legitimate purpose and that distortions of competition are avoided or minimised as far as possible, and taking due account of the current circumstances, support measures must be:

- well-targeted in order to be able to achieve effectively the objective of remedying a serious disturbance in the economy,
- proportionate to the challenge faced, not going beyond what is required to attain this objective, and
- designed in such a way as to minimise negative spill over effects on competitors, other sectors and other EEA States.

In assessing the rescue measures undertaken to date, therefore, the Authority takes into account the following.

3.1.1. *The necessity of the measures.*

Again the Authority accepts the argumentation of the Icelandic authorities, and believes that it is largely self-evident, that the state had to intervene in order to restore certain operations of Kaupthing Bank as well as the other two banks and guarantee deposits and avoid a systemic failure of the Icelandic financial system. The Authority also notes the views of the CBI in this respect. It also accepts, given the run on the banks and the instability of the financial system, that a state guarantee of deposits was required⁴³.

⁴² This approach is similar to the one taken by the European Commission in the case of Emergency aid for Ethias – Belgium – case no NN57/2008.

⁴³ See paragraph 19 of the Authority's temporary rules on the application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis: <http://www.eftasurv.int/?1=1&showLinkID=16604&1=1>

3.1.2. *The method of restoring the bank – the appropriateness of the means employed to achieve the objective.*

The Authority accepts in principle the views of the Icelandic authorities that given the circumstances, the approach taken of restoring domestic operations of the banks and guaranteeing domestic deposits was likely to be the only credible and effective means of safeguarding an Icelandic banking sector and the interests of the wider economy.⁴⁴ Bank rescue measures of the kind adopted elsewhere in the EEA; recapitalisation, restructuring, relief for impaired assets, or a combination of each were unlikely to succeed. The scale of the problem and the sums of public money that would have been necessary to remedy it, the disproportionate size of the three main Icelandic banks, and the realistic threat that the entire system could collapse meant that the state's options were limited.

The measures however involved wide-ranging restructuring of the bank's operations through the effective divestiture of foreign operations, and potential further restructuring of domestic operations. The measures can only therefore finally be considered to be appropriate if it can be demonstrated through the means of a detailed restructuring plan that the bank is viable in the medium to long term.

3.1.3. *The proportionality of the measures - limiting aid and distortions of competition to the minimum necessary.*

The Authority is conscious in this context that in light of the foreign operations of the Icelandic banks remaining in the old banks, which are under administration; and in light of the Icelandic authorities adopting similar measures to restore each of the three main banks in Iceland which make up over 80% of the domestic market⁴⁵, the impact on competition and trade across the EEA is minimal. The Authority is also of the view that the state intervention in the case of Arion Bank is *prima facie* proportionate as the process of ensuring that the creditors of the old bank became the majority shareholders of the new bank meant that the Icelandic authorities were able to ensure:

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

Although, due to the circumstances involved, this was not achieved through a tendering procedure, the Authority is of the view that it would not have been realistic to expect any private sector investors to have invested other than those already involved as creditors of the collapsed bank.

⁴⁴ This decision does not relate to any aspects of the internal market rules of the EEA Agreement that may apply in so far as the division of foreign and domestic assets and liabilities is concerned.

⁴⁵ A number of other financial institutions have also required state assistance. In 22.4.2010 the FME decided to take control of BYR Savings Bank, to establish on its foundation a new limited liability company BYR hf. and to transfer to BYR hf. assets and liabilities of the failed savings bank. At the same time FME decided to take control of Keflavik Savings Bank and establish on its foundation SpKef Savings Bank to take over assets and liabilities of the failed Keflavik Savings Bank. Measures for recapitalization of these two savings banks are under way and the Authority awaits notification from the Icelandic authorities. On 21.6.2010 the Authority approved for a period of six months a rescue scheme in support of five smaller savings banks in Iceland through settlement of claims owned by the Central Bank of Iceland on the savings banks concerned.

The amount of the capital provided is the minimum necessary in order to enable Arion Bank to comply with the minimum capital adequacy ratio set by the FME of 12% Tier I capital and 4% Tier II capital. The liquidity facility is also considered to be necessary by the regulator.

In so far as the remuneration of the capital is concerned, paragraphs 26 to 30 of the Authority's rules on the recapitalisation of financial institutions specifies a method of calculating an "entry level" price for capitalising fundamentally sound banks. Capitalisation of banks that are not fundamentally sound are subject to stricter requirements and in principle the remuneration paid by such banks should exceed the entry level. Although the remuneration payable in the case of Arion Bank most likely does not comply with these requirements it is clear that (as envisaged by paragraph 44 of the rules) the bank has experienced far-reaching restructuring including a change in management and corporate governance.

The Authority will further assess the aid granted through the remuneration payable for the capital and the terms of the liquidity facility, as well as any aid paid through the transfer of liabilities and guaranteed assets of SPRON savings bank, as part of its full assessment of the restructuring of the bank. It will also assess the duration of the state guarantee in this context.

3.2. Timescales

While the Authority regrets that the normal time scales for the duration of rescue measures have been exceeded, a need for longer periods to restructure financial institutions was envisaged by the European Commission and Authority when adopting guidelines for the assessment of rescue and restructuring aid granted as a result of the financial crisis⁴⁶. The Authority accepts in particular that for the various reasons put forward by the Icelandic authorities, delays were inevitable at least until the assets of the bank could be valued and its ownership and capitalisation could be resolved. The Authority is also aware of domestic litigation in Iceland concerning loans linked to foreign currencies which has had the potential to have a major impact on the value of each bank's assets, and led to considerable uncertainty for many months⁴⁷. It also notes the content of the CBI's financial stability report for 2010/2⁴⁸ which refers among other matters to the fact that non-performing loans (90 days or more in default) of the Icelandic commercial banks now total 39% of all loans - a major political and economic issue given that many loans have already been written down. The Authority is therefore willing to accept that given the exceptional circumstances the rescue measures could be authorised and remain in place for a longer period than is normally allowed. However, whilst the Authority accepts that there are also justifiable reasons for further delay since the recapitalisation of the banks, the Authority is concerned at the lack of progress since the summer of 2009 in concluding a detailed restructuring plan. In the absence of the restructuring plan, therefore, the Authority has doubts concerning the compatibility of the measures with the EEA Agreement.

⁴⁶ See paragraphs 10 and 24, and footnote 13, of the Authority's guidelines:

<http://www.eftasurv.int/?l=1&showLinkID=16604&l=1>

⁴⁷ The issue is referred to in the CBI's Financial Stability Report for the second half of 2010 (p. 18-21), <http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=8260> and the Annual Report of the FME for 2010 (currently only available in Icelandic, p. 31-32): <http://www.fme.is/lisalib/getfile.aspx?itemid=7604>. See also the following news reports:

<http://www.businessweek.com/news/2010-07-29/iceland-debt-outlook-cut-to-negative-at-moody-s-on-bank-ruling.html>

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

⁴⁸ <http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=8260>

4. Conclusion

On the basis of the foregoing assessment, had the Icelandic authorities notified the capitalisation measures and deposit guarantee involved in Phases 1 and Phase 2 of the process of restoring and restructuring Arion Bank in advance, the Authority would in all probability have temporarily approved the measures as aid compatible with the functioning of the EEA Agreement. The aid granted could, however, only have been considered compatible on a temporary basis, conditional upon the submission of a detailed restructuring plan for the bank and a satisfactory assessment by the Authority of its future viability. Although the Icelandic authorities have committed to submit a restructuring plan for the Authority's assessment, in view of the time period that has elapsed since the aid was granted, the Authority is required to open a formal investigation procedure into the measures adopted. The decision to open a formal investigation procedure is without prejudice to the final decision of the Authority, which may conclude that the measures in question do not constitute state aid or are compatible with the functioning of the EEA Agreement.

The Authority also regrets that the Icelandic authorities did not respect their obligations pursuant to Article 1(3) of Part I of Protocol 3. The Icelandic authorities are therefore reminded that any plans to grant further restructuring or other aid to the bank must be notified to the Authority and approved in advance.

HAS ADOPTED THIS DECISION:

Article 1

The formal investigation procedure provided for in Article 1(2) of Part I of Protocol 3 to the Surveillance and Court Agreement is opened into the measures undertaken by the Icelandic State to restore certain operations of (old) Kaupthing Bank hf and establish and capitalise New Kaupthing Bank hf (now renamed Arion Bank).

Article 2

The Authority requires that a detailed restructuring plan for Arion Bank be submitted as soon as possible and in any event no later than 31 March 2011.

Article 3

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

Article 4

The Icelandic authorities are requested to provide within one month from notification of this decision, all documents, information and data needed for assessment of the compatibility of the aid measure.

Article 5

This Decision is addressed to the Republic of Iceland.

Article 6

Only the English language version of this decision is authentic.

Decision made in Brussels, on 15 December 2010.

For the EFTA Surveillance Authority

Per Sanderud
President

Sverrir Haukur Gunnlaugson
College Member