

## III

(Other acts)

## EUROPEAN ECONOMIC AREA

## EFTA SURVEILLANCE AUTHORITY DECISION

No 206/11/COL

of 29 June 2011

on the Mortgage Loan Scheme (Iceland)

THE EFTA SURVEILLANCE AUTHORITY,

Having regard to the Agreement on the European Economic Area, and in particular Articles 61 and Protocol 26 thereof,

Having regard to the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice, and in particular Article 24 thereof,

Having regard to Article 1 of Part I and Article 7(5) of Part II of Protocol 3 to the Surveillance and Court Agreement ('Protocol 3'),

Having regard to the Authority's Decision of 14 July 2004 on the implementing provisions referred to under Article 27 of Part II of Protocol 3 <sup>(1)</sup>,

Having called on interested parties to submit their comments pursuant to Article 6(1) of Part II of Protocol 3 <sup>(2)</sup> and having regard to their comments,

WHEREAS:

I. FACTS

1. PROCEDURE

From October to December 2008, the EFTA Surveillance Authority (the 'Authority') and the Icelandic authorities had pre-notification discussions in relation to the introduction of a scheme for the purchase of mortgage loans (the 'Mortgage Loan Scheme'). In this context, the Icelandic authorities submitted three letters to the Authority, dated 14 October 2008 (Event No 494902), 3 November 2008 (Event No 496979) and 3 December 2008 (Event No 500670).

On 27 May 2009, the Icelandic authorities notified the Mortgage Loan Scheme to the Authority (Event No 519720).

By letter dated 25 June 2009 (Event No 520515) and e-mail dated 29 June 2009 (Event No 523605), the Authority

requested the Icelandic authorities to provide additional information. The Icelandic authorities replied by letter on 27 July 2009 (Event No 525671) and on 28 August 2009 (Event No 528493).

The case was also discussed during a conference call between the Authority and the Icelandic authorities on 1 July 2009, and again on 4 November 2009 in the context of the State Aid Package Meeting in Iceland.

By letter dated 16 November 2009 (Event No 536644), the Authority requested information to follow up on the discussions. The Icelandic authorities replied on 25 November 2009 (Event No 538088).

By letter dated 10 March 2010 (Event No 548915), the Authority informed the Icelandic authorities that it had decided to initiate the procedure laid down in Article 1(2) of Part I of Protocol 3 to the Surveillance and Court Agreement in respect of the Mortgage Loan Scheme.

The Authority's Decision No 76/10/COL to initiate that procedure was published in the *Official Journal of the European Union* and the EEA Supplement thereto on 14 October 2010 <sup>(3)</sup>. The Authority called on interested parties to submit comments but did not receive any such comments.

By letter received on 3 May 2010, the Icelandic authorities submitted comments in respect of the Authority's Decision No 76/10/COL to open the formal investigation procedure (Event Nos 555824 and 555999).

The Icelandic authorities submitted further information, including an expert opinion, on 25 May 2010 (Event Nos 558177 and 558531).

On 1 June 2010, the case was discussed between the Authority and the Icelandic authorities in the context of the State Aid Package Meeting in Iceland.

<sup>(1)</sup> Decision 195/04/COL of 14.7.2004, published in OJ L 139, 25.5.2006, p. 37, and EEA Supplement No 26, 25.5.2006, p. 1, as amended. A consolidated version of the Decision can be found on [www.eftasurv.int](http://www.eftasurv.int)

<sup>(2)</sup> OJ C 277, 14.10.2010, p. 4, and EEA Supplement No 57, 14.10.2010, p. 4.

<sup>(3)</sup> See footnote 2 above.

## 2. DESCRIPTION OF THE MEASURES

### 2.1. Background

As a result of turmoil in the global financial markets during 2008 and 2009, a number of Icelandic financial institutions faced a shortage of liquidity and a limited supply of credit. In response to the crisis, the Icelandic authorities adopted a series of measures aimed at securing the functioning of financial markets in Iceland.

One such measure was to introduce the Mortgage Loan Scheme, which authorises the Icelandic housing agency, the Housing Financing Fund (*Íbúðalánasjóður*), to take over mortgage loans from certain financial institutions in Iceland in exchange for Housing Financing Fund (HFF) bonds, a form of permanent asset swap. A financial institution may then use the HFF bonds as collateral in order to take cash loans from the Central Bank of Iceland <sup>(4)</sup>.

The overall objective of the Mortgage Loan Scheme is to provide liquid funds to eligible financial institutions and to ensure the availability of loans on the residential housing market (and thereby safeguard the interests of property owners) <sup>(5)</sup>.

The Icelandic authorities have explained that the Mortgage Loan Scheme is a follow up to an earlier scheme, approved by the Authority on 27 March 2009 (Decision No 168/09/COL), which authorised HFF to intervene on behalf of the Icelandic State in the context of the financial crisis by temporarily refinancing mortgage loans (the 'Temporary Mortgage Loan Scheme') <sup>(6)</sup>. Under the Temporary Mortgage Loan Scheme, mortgages could be swapped on a temporary basis. The Mortgage Loan Scheme allows for a permanent asset swap. Mortgages subject to the Temporary Mortgage Loan Scheme must be returned to the beneficiary prior to any swap agreement under the Mortgage Loan Scheme.

The Mortgage Loan Scheme is directed principally at small savings banks which are dependent on access to liquidity

from other domestic financial institutions also facing liquidity problems <sup>(7)</sup>. The savings banks mainly provide traditional banking services to local communities (individuals, corporate customers and local authorities), of which they form an integrated part. In many regional areas, the savings banks are the only financial institutions in operation <sup>(8)</sup>.

### 2.2. Legal basis

The Mortgage Loan Scheme is based on Chapter V of Act No 125/2008 of 6 October 2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc. (the 'Emergency Act') <sup>(9)</sup>, which amended, *inter alia*, Act No 44/1998 on Housing Affairs (the 'Housing Act'). Further detail is set out in Regulation No 1081/2008 of 26 November 2008 on the authority of the Housing Financing Fund to purchase bonds secured by mortgages in residential housing and issued by financial undertakings (the 'Regulation'). The Regulation was adopted and entered into force on 27 November 2008.

In addition, the Board of HFF has issued *Rules regarding the purchase of mortgage loans from financial undertakings* (the 'Supplementary Rules') <sup>(10)</sup>. Following approval by the Minister of Social Affairs and Social Security, the Supplementary Rules were published on 15 January 2009 and entered into force on the same day. The Mortgage Loan Scheme also entered into operation on that day.

### 2.3. Applications under the Mortgage Loan Scheme

Under the Mortgage Loan Scheme, eligible financial institutions may apply to swap assets (mortgage loans) with HFF. A swap results in HFF permanently taking over the mortgage loans (or 'mortgage loan pool') of the applicant financial institution in exchange for existing HFF bonds, which are transferred to the applicant financial institution.

All banks, saving banks and credit institutions which have been granted a licence to operate in Iceland pursuant to Act No 161/2002 on Financial Undertakings may apply for an asset

<sup>(4)</sup> The Icelandic authorities have explained that it was not possible for financial institutions to raise liquid funds on the open market as, at the time, there was no functioning inter-bank market in Iceland due to the financial crisis, and that the smaller saving banks did not have assets which would qualify as collateral with the central bank.

<sup>(5)</sup> See Government Declaration of 19.6.2008 concerning measures relating to the real estate and financial markets, and the Government's press release of 18.7.2008. Due to the financial crisis in Iceland the length of the mortgage loans prolonged to 70 years.

<sup>(6)</sup> OJ C 241, 8.10.2009, p. 16, and EEA Supplement No 52, 8.10.2009, p. 1. The Decision is also available on the Authority's website: [http://www.eftasurv.int/fieldsOfWork/fieldStateAid/stateAidRegistry/sadecice09/168\\_09\\_col.pdf](http://www.eftasurv.int/fieldsOfWork/fieldStateAid/stateAidRegistry/sadecice09/168_09_col.pdf)

<sup>(7)</sup> Before the financial crisis, the Icelandic banking sector essentially consisted of two segments, the first comprising the three former major banks Glitnir, Landsbanki and Kaupthing, which had relatively large international exposure; and the second comprising small savings banks, which relied on financing from the bigger banks.

<sup>(8)</sup> See Decision No 168/09/COL, p. 3.

<sup>(9)</sup> Act No 125/2008 entered into force upon publication, i.e. on 7.10.2008.

<sup>(10)</sup> The amended Housing Act and the Regulation authorise HFF to purchase (or refinance) bonds secured by mortgages in residential housing. However, the Supplementary Rules concern the purchase of mortgage loans themselves. The Icelandic Authorities have explained that this was meant to refer to the same thing.

swap under the Mortgage Loan Scheme. This includes subsidiaries and branches of foreign banks established in Iceland.

In order to apply, a financial institution must send a written application, which includes information on the estimated size of the mortgage loan pool it wishes to swap with HFF. On this basis, HFF negotiates the terms of the transaction with the applicant financial institution. An important element in this process is the determination of the value of the mortgage loans (see section 2.4 below). If the application is accepted, HFF takes over the mortgage loan pool from the applicant financial institution without needing to seek permission for the transfer from the debtor (borrower).

Following the asset swap, HFF assumes the role of lender vis-à-vis the borrower under the mortgage loan, subject to formal transfer of the mortgage deeds.

The Icelandic authorities have informed the Authority that between 22 October 2008 and 18 December 2008 seven financial institutions submitted applications for an asset swap under the Mortgage Loan Scheme: Keflavik Savings Bank, BYR Savings Bank, Bolungarvik Savings Bank, Ólafsfjarðar Saving Bank, Mýrasýsla Saving Bank, Höfðhverfinga Saving Bank and SPRON.

Keflavik Savings Bank, BYR Savings Bank and Bolungarvik Savings Bank entered into swap agreements with HFF on 23 March 2009, 20 May 2009, and 3 July 2009 and 5 August 2009 <sup>(11)</sup> respectively.

The first agreement made under the Mortgage Loan Scheme was a mortgage loan transfer agreement signed on 23 March 2009 between HFF and Keflavik Savings Bank for a total value of ISK 9 959 972 471,00 <sup>(12)</sup>. The agreements with BYR Savings Bank and Bolungarvik Savings Bank were to the value of ISK 2 707 559 690,00 and ISK 477 141 823,00 and ISK 425 924 422,00, respectively.

The applications from the other four banks referred to above were rejected.

#### 2.4. Valuation of mortgage loans and HFF bonds under the Mortgage Loan Scheme

Under the Mortgage Loan Scheme, HFF is required to go through several steps in order to assess the value of the mortgage loan pool of an applicant financial institution and of the HFF bonds to be swapped.

<sup>(11)</sup> There were two agreements between HFF and Bolungarvik Savings Bank.

<sup>(12)</sup> According to the agreement between the parties to the swap, the final price was to be settled on 15.4.2009.

Article 3 of the Regulation <sup>(13)</sup> and Article 6 <sup>(14)</sup> of the Supplementary Rules provide that HFF 'shall perform the assessment of the value of the bonds offered to the Fund' and that 'the book value of the loan shall as a rule be the basis for their price.' In other words, HFF itself carries out an 'in-house' assessment of the value of the mortgage loans. It bases that assessment on the book value of the loans.

##### 2.4.1. Selection of mortgage loans by HFF <sup>(15)</sup>

Prior to estimating the value of a mortgage loan pool, HFF considers whether it has an interest in taking over the loans at all. For this purpose, HFF assesses the loans on the basis of the payment status of the debtor, the loan-to-value (LTV) ratio of the mortgage loan, its default status, and the terms of the mortgage loan contract. On this basis HFF divides the mortgage loans into three categories:

- (a) non-defaulted mortgage loans that meet all of HFF's general loan requirements;
- (b) other non-defaulted mortgage loans that do not meet all of HFF's general loan requirements;
- (c) defaulted mortgage loans.

<sup>(13)</sup> Regarding the pricing of bonds, Article 3 of the Regulation provides that: '[t]he Housing Financing Fund shall perform an independent assessment of the value of the bonds offered to the Fund. When assessing the value of bonds, the Fund shall, among other things, take account of the payment status of the debtor, the mortgage proportion of that residential housing when the bond is taken over, defaults of the bond and its terms so that the pricing of the bond reflects its market value. The contract terms and purchase price, moreover, shall be designed to minimise the credit risks of the Fund.'

<sup>(14)</sup> Article 6 of the Supplementary Rules, concerning the '[p]urchase price', provides that:

'[t]he purchase price of mortgage loans shall be based on their market value. In mortgage loan purchase agreements the book value of the loan shall as a rule be the basis for their price allowing for prepayment risk, operation costs and other factors. The final price of the mortgage pool is determined by its performance and the expected loss at the final settlement of the purchase price.

The purchase price amount paid at the time of signing the agreement shall never exceed 80 % of the pool's market price. This percentage shall decrease in proportion to an increased estimated loss, (EL) pursuant to Art.5. The retained portion of the purchase price shall always be higher than the estimated loss (EL). Mortgage loan purchase agreements shall specify the final settlement of the purchase price. As a rule, such a settlement shall take place 8 to 10 years after the purchase date. At the time of final settlement, HFF shall pay the seller the remainder of the purchase price less depreciation of the mortgage pool that has already taken place and the estimated loss (EL), of the pool throughout its duration pursuant to Art. 5.'

<sup>(15)</sup> Article 4 of the Supplementary Rules.

Mortgage loans falling into the first two categories are eligible for a swap under the Mortgage Loan Scheme. However, mortgage loans in category (c) are eligible only if the mortgage loan is removed from debt collection and all fees and expenses are paid prior to the swap.

#### 2.4.2. *Establishing the value of mortgage loans by HFF*

Article 3 of the Regulation and Article 6 of the Supplementary Rules provide that HFF is required to base the purchase price of mortgage loans on their market value. However, Article 6 also provides that HFF must base the market value on the book value of the mortgage loans (allowing for prepayment risk, operation costs and other factors). The latter has been confirmed to the Authority by the Icelandic authorities<sup>(16)</sup>. The Icelandic authorities have also confirmed that the book value of each individual loan is the principal amount lent to the borrower, without write-downs<sup>(17)</sup>. A financial institution applying to participate in the Mortgage Loan Scheme is required to provide to HFF the book value of each individual loan<sup>(18)</sup>.

#### 2.4.3. *Determining the credit risk and the 'credit buffer' by HFF*

The third step is to determine the credit risk associated with the mortgage loans at issue. Pursuant to Article 3 of the Regulation and Article 5 of the Supplementary Rules, HFF employs a credit risk model in that regard, provided by KPMG Iceland, pursuant to which the assessment of the credit risk of mortgage loan pools is carried out on the basis of the international standard, Basel II on the capital risk assessment of financial institutions. The assessment involves calculating the expected loss by multiplying the following three factors: probability of default, loss-given default and exposure to default. Each of those variables is assessed for each mortgage loan and for each year of the loan period.

The model is based on a number of parameters designed to assess the likely credit loss for individual loans, as well as on a number of macroeconomic factors likely to influence mortgage loans. The parameters used in the assessment of individual loans are: (i) loan to value; and (ii) payment history. The macroeconomic analysis is a medium-term forecast (until 2014) of real estate prices, inflation, wage developments, and other factors likely to impact upon the mortgage loan pool in a general way. After 2014, a flat credit loss figure is assumed based on historical experience.

<sup>(16)</sup> Letter from the Icelandic authorities to the Authority dated 27.8.2009.

<sup>(17)</sup> The Authority understands this to mean the outstanding principal amount lent to the borrower (without write-downs).

<sup>(18)</sup> According to Article 3 of the Supplementary Rules, '[t]he financial firm shall submit computer-readable information that HFF considers essential in order to assess the value and the credit risk of mortgage pools to be sold to HFF.'

Following determination of a credit risk by HFF, the book value is not immediately reduced by the value of the credit risk. The value of the credit risk is used only to determine the value of the bonds that the applicant financial institution will receive at the time of the swap.

Pursuant to Article 3 of the Regulation and Article 6 of the Supplementary Rules, HFF uses the expected credit risk to establish a 'credit buffer'. This means that the financial institution initially will only receive HFF bonds corresponding to a maximum of 80 % of the aggregated book value of the mortgage loan pool. The credit buffer may be more than that 20 % depending on the estimated loss (EL) in relation to the mortgage loan pool, and will increase by the amount of that estimated loss (Article 5 of the Supplementary Rules). The credit buffer will always be higher than the estimated loss. In practice, HFF calculates the credit buffer by adding an additional 10 % to the estimated loss.

Approximately 8 to 10 years after the initial agreement, the performance of the loan pool during that period is assessed. In addition, the forward-looking credit risk of the pool is assessed at that time. Depending on both of those elements, the financial institution will receive additional HFF bonds up to the value of the credit buffer. In other words, if, after 8 to 10 years, the credit risk has materialised only in part, that is, if the actual losses are less than estimated at the time of the agreement, HFF will transfer bonds up to the value of the credit buffer less the actual losses, subject to the forward-looking credit risk estimate. However, if the credit risk materialises in full, that is, if all expected losses materialise, HFF will not transfer any additional bonds to the financial institution. Finally, in the event that actual losses are greater than the credit buffer, HFF will bear such losses.

#### 2.4.4. *Establishing the corresponding amount of HFF bonds by HFF*

Pursuant to Article 5 of the Regulation and Article 7 of the Supplementary Rules<sup>(19)</sup>, HFF determines the value of HFF bonds to be transferred to the financial undertaking under the mortgage loan pool swap (subtracting the credit buffer).

HFF determines the value of the HFF bonds on the basis of the 'end-of-day dirty price' on the transaction day, as quoted by the OMX Iceland exchange. That price is adjusted by the weighted average interest rate of the mortgage loans (which has been

<sup>(19)</sup> Article 7 of the Supplementary Rules, concerning the '[p]ayment for mortgage bonds', provides that: 'HFF shall pay for the mortgage loans by handing over HFF bonds in exchange. The yield of HFF bonds shall be based on the duration and terms of the mortgage loans. Prepayment risk and operating costs shall be considered as well, in addition to other factors.'

reduced by the prepayment risk, operational costs and credit losses). Based on the information provided by the Icelandic authorities, it is unclear whether this implies a reduction or an increase in the value of the bonds.

#### 2.4.5. Settlement of the swap under the Mortgage Loan Scheme

When the value of the mortgage loan pool has been determined, it is transferred to HFF in exchange for HFF bonds, which are transferred to the financial institution <sup>(20)</sup>.

Final settlement takes place approximately 8 to 10 years after the agreement is entered into <sup>(21)</sup>. At that time, subject to the assessment described in section 2.4.3 above, HFF transfers additional bonds to the financial institution up to the value of the credit buffer (less any actual losses and less any estimated losses throughout the remainder of the period of the mortgage loan) <sup>(22)</sup>.

### 2.5. Duration and budget

The Mortgage Loan Scheme is not limited in time. That is, there is no final date for the application of the Scheme or a fixed period during which applications under the Scheme can be made. Currently, the Mortgage Loan Scheme is therefore still in force and applications may be made by eligible financial institutions.

As regards the budget, the Icelandic authorities have not provided the Authority with estimated annual or total expenditure under the Mortgage Loan Scheme.

### 2.6. Further relevant market information

On 22 April 2010, the Financial Supervisory Authority (FME) issued a decision on the transfer of the assets and liabilities of Keflavik Savings Bank to Spkef Savings Bank <sup>(23)</sup>. On 5 March 2011, the Financial Supervisory Authority issued a decision on the transfer of the assets and liabilities of Spkef Savings Bank to NBI hf. (New Landsbanki) <sup>(24)</sup>.

Following the collapse of Byr Savings Bank (Old Byr) in April 2010, the Icelandic State founded Byr hf (New Byr), a fully State-owned limited liability company. Old Byr is now in a winding-up procedure. New Byr will take over all assets and certain liabilities and operations of Old Byr <sup>(25)</sup>.

<sup>(20)</sup> Article 5 of the Regulation provides that: '[c]ompensation for bonds purchased by the Housing Financing Fund shall generally be in the form of HFF bonds.' On this basis, the Regulation allows, in principle, for other forms of compensation, such as cash payments. However, to date, only compensation in the form of HFF bonds has been used.

<sup>(21)</sup> The actual time of final settlement is normally specified in the agreement.

<sup>(22)</sup> Article 3 of the Regulation and Article 6 of the Supplementary Rules.

<sup>(23)</sup> See <http://www.fme.is/lisalib/getfile.aspx?itemid=7199>

<sup>(24)</sup> See <http://www.fme.is/lisalib/getfile.aspx?itemid=7997>

<sup>(25)</sup> See ESA decision No 126/11/COL of 13.4.2011 regarding State aid for the establishment and capitalisation of Byr hf., not yet published, available on the Authority's website: <http://www.eftasurv.int/media/decisions/126-11-COL.pdf>

### 3. GROUNDS FOR INITIATING THE FORMAL INVESTIGATION PROCEDURE

In March 2010, the Authority decided to initiate the formal investigation procedure in this case because it had doubts in relation to whether transactions carried out under the Mortgage Loan Scheme were made on market terms, and therefore, whether the Scheme might involve elements of State aid within the meaning of Article 61(1) of the EEA Agreement <sup>(26)</sup>.

The Authority also had doubts as to whether the potential aid could be regarded as compatible with the State aid provisions of the EEA Agreement and considered that the appropriate framework for assessing the compatibility of the measure was the Impaired Assets Guidelines (IAG) <sup>(27)</sup>. On the basis of the IAG, the Authority had doubts as to whether (i) the market value of the assets had been calculated correctly (and reflected in the transfer price); and (ii) the swap agreements included sufficient remuneration for the State, ensuring proper burden sharing between the parties.

Finally, the Authority objected to the fact that the Icelandic authorities had not limited the time period ('entrance window') during which eligible financial institutions could apply under the Mortgage Loan Scheme, or specified the amount of the total or annual budget of the Scheme. In other words, the Mortgage Loan Scheme was unlimited in terms of its budget and its duration.

### 4. COMMENTS FROM THIRD PARTIES

The Authority did not receive any comments from third parties following publication of Decision No 76/10/COL to initiate the formal investigation procedure.

### 5. COMMENTS BY THE ICELANDIC AUTHORITIES

The Icelandic authorities have argued that the transfer of mortgage loans under the Mortgage Loan Scheme takes place on market terms, thereby ensuring that no State aid is involved in the transfer of HFF bonds to applicant financial institutions.

The Icelandic authorities also question whether it is correct to assess the Mortgage Loan Scheme under the IAG, on the basis that the mortgage loans to be swapped under the Scheme are not impaired. The Icelandic authorities argue that the reason for offering the savings banks the possibility to swap their mortgage loans for HFF bonds is not that the assets are impaired, but rather that they are not sufficiently liquid <sup>(28)</sup>.

<sup>(26)</sup> See footnote 2 above.

<sup>(27)</sup> The updated version of the State Aid Guidelines is published on the Authority's website: <http://www.eftasurv.int/state-aid/legal-framework/state-aid-guidelines/>

<sup>(28)</sup> The Authority notes that this is in contrast to the notification of the Mortgage Loan Scheme to the Authority on 27.5.2009 (Event No 519720), where the Icelandic authorities argue that the IAG would be the correct guidelines under which to assess the Scheme (in the event that the Authority were to come to the conclusion that the Scheme involved aid).

In the event that the Authority nevertheless concludes that the Mortgage Loan Scheme involves State aid and must be assessed under the IAG, the Icelandic authorities argue that the aid is compatible with the criteria of using an independent expert. They explain that the credit risk model used in the valuation of mortgage loans carried out by HFF is based on a credit risk model designed by KPMG Iceland, an independent expert valuator. The Icelandic authorities also argue that the inclusion of a 'credit buffer' ensures that the book value of the mortgage loans is adjusted to their market value <sup>(29)</sup>.

After the Authority's decision to initiate the formal investigation procedure, the Icelandic authorities also submitted a valuation prepared by an independent financial expert (ALM Finance Ltd (ALM) <sup>(30)</sup> of the mortgage loan pool and HFF bonds already subject to the Scheme. The ALM valuation relies on a probability weighted cash flow model and on the risk-free rate of return in order to calculate the present value (real economic value) of the mortgage loan pools subject to the Scheme. The calculation of the real economic value of the loan pools was performed for two economic scenarios: an expected scenario and a stressed scenario. The ALM valuation approximately confirms the valuation carried out by HFF.

The Icelandic authorities also argue that the Mortgage Loan Scheme includes remuneration for the granting authority, HFF, on the basis that HFF adjusts the value of the HFF bonds to cover operating costs, prepayment risk and credit losses <sup>(31)</sup>.

The Icelandic authorities also argue that the Mortgage Loan Scheme should be regarded as part of a wider plan for the restructuring of savings banks in Iceland, and that it should therefore be assessed under the Authority's restructuring guidelines <sup>(32)</sup>. Both the Ministry of Finance and the Central Bank of Iceland have initiated measures designed to recapitalise savings banks in Iceland. As part of that wider restructuring plan, the FME has been overseeing the restructuring of the savings banks and has laid down certain requirements in that regard.

<sup>(29)</sup> As regards compatibility of the Mortgage Loan Scheme, the Icelandic authorities also refer to previous arguments made to the Authority regarding the systemic importance of the savings banks in Iceland – see, for example, a letter from the Central Bank of Iceland dated 19.5.2009, confirming the necessity of the measures (Annex 5 to the notification). In support, the Icelandic authorities have submitted a study by the Centre for European Policy Studies (CEPS) ('Investigating Diversity in the Banking Sector in Europe: The Performance and Role of Savings Banks', CEPS, 26.6.2009).

<sup>(30)</sup> The report was prepared by Hjörtur H. Jónsson of ALM.

<sup>(31)</sup> The premium charged in respect of Spkef was 95 basis points (bp) to cover prepayment risk, operational costs and excess credit losses. 95 bp is the current premium that HFF generally charges customers: 25 bp for operating costs, 50 bp for prepayment risk and 20 bp for credit losses.

<sup>(32)</sup> The Authority assumes that the Icelandic authorities are referring to the Authority's Guidelines on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules.

Finally, as regards the proportionality of the measure, the Icelandic authorities note that they are willing to take the necessary steps to meet the Authority's concerns regarding limiting the duration and budgetary scope of the Mortgage Loan Scheme.

## II. ASSESSMENT

### 1. THE PRESENCE OF STATE AID WITHIN THE MEANING OF ARTICLE 61(1) OF THE EEA AGREEMENT

Article 61(1) of the EEA Agreement provides 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.'

In order for a measure to constitute aid within the meaning of Article 61(1) of the EEA Agreement, the following four cumulative criteria must be met: the measure must (i) confer on recipients an economic advantage which is not received in the normal course of business; (ii) be granted by the State or through State resources; (iii) be selective by favouring certain undertakings or the production of certain goods; and (iv) distort competition and affect trade between Contracting Parties.

#### 1.1. Presence of State resources

The measure must be granted by the State or through State resources.

In line with settled case law, aid may be granted directly by the State or by public or private bodies established or appointed by the State to administer the aid <sup>(33)</sup>.

In exchange for mortgage loans, the applicant financial institutions receive HFF bonds. HFF was established by the Housing Act as a State housing agency, wholly owned by the Icelandic State and under the administrative surveillance of the Minister of Welfare. The Minister of Welfare appoints HFF's five-member Board of Directors. The tasks of HFF (to give loans to individuals, municipalities and companies for financing the acquisition or construction of residential housing) are laid down and regulated in statutory rules: the Housing Act and secondary legislation (for example, Regulation No 57/2009 on the loan categories of HFF).

<sup>(33)</sup> Case 78/76 *Steinike and Weinlig v Federal Republic of Germany* [1977] ECR 595, paragraph 21.

The measures at issue in this case were therefore executed through a public agency, HFF, which is subject to the full control of the State. The actions of HFF are therefore imputable to the State. Therefore, the transfer of HFF bonds to financial institutions involves State resources.

## 1.2. Favouring undertakings or the production of goods

### 1.2.1. *Economic advantage*

The measure must confer on beneficiaries advantages that relieve them of charges that are normally borne from their budgets.

As explained by the Icelandic authorities, the Mortgage Loan Scheme was established in order to enable certain financial institutions to obtain financing from sources other than inter-bank loans due to the fact that inter-bank lending was drying up as a result of global difficulties in the financial sector.

The Authority considers it unlikely that, in the financial crisis, financing would have been provided by a market economy investor on a comparable scale and on similar conditions to financial institutions eligible to participate in the Mortgage Loan Scheme. Therefore, the transaction as such gives the participating banks an economic advantage which would not have been available to them under the market conditions at the time.

The Mortgage Loan Scheme improves the position of beneficiary financial institutions by increasing the liquidity of their assets and removing a source of volatility on their balance sheets. That, in turn, improves their position on the market.

### 1.2.2. *Selectivity*

To constitute State aid, the measure must favour certain undertakings, the production of certain goods or the provision of certain services.

The Mortgage Loan Scheme is selective in that it favours only certain financial institutions. The fact that all undertakings in a given sector may benefit from a measure does not lead to the conclusion that the measure is of a general nature. On the contrary, the measure is selective in that it favours only one sector of the economy<sup>(34)</sup>.

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

The Mortgage Loan Scheme is liable to distort competition and affect trade between the Contracting Parties. The Scheme improves the position of beneficiary financial institutions by

increasing the liquidity of their assets and removing a source of volatility on their balance sheets, thereby strengthening their position compared to their competitors in other EEA countries.

All banks, saving banks and credit institutions which have been granted a licence to operate in Iceland, whatever their size, are in principle eligible to apply for support under the Mortgage Loan Scheme. Services and products in the banking and financial sectors are traded internationally. In that light also, the Mortgage Loan Scheme is liable to distort competition and affect trade between Contracting Parties.

## 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 notified the Mortgage Loan Scheme to the Authority by letter dated 27 May 2009 (Event No 519720). However, the Supplementary Rules of the Board of HFF regarding the purchase of mortgage loans from financial undertakings entered into force on 15 January 2009, that is, before the Authority had taken a final decision in respect of the notification.

In that light, the Icelandic authorities have not respected their obligations pursuant to Article 1(3) of Part I of Protocol 3.

## 3. COMPATIBILITY OF THE AID

Support measures designated as State aid under Article 61(1) of the EEA Agreement are generally incompatible with the functioning of the EEA Agreement, unless one of the exemptions in Articles 61(2) or (3) of the EEA Agreement applies. The derogation in Article 61(2) is not applicable to the aid at issue in this case, which is not designed to achieve any of the aims listed in that Article. Similarly, the derogations in Articles 61(3)(a) and (c) of the EEA Agreement do not apply to the aid measure under investigation. In particular, the aid measure is not granted with the aim of promoting or facilitating the economic development of certain areas or of certain economic activities.

The aid at issue is not linked to any investment in production capital. It merely reduces the costs which companies would normally have to bear in the course of pursuing their day-to-day business activities, and must, therefore, be classified as operating aid. Operating aid is normally not considered suitable to facilitate the development of certain economic activities or of certain regions as provided for in Article 61(3)(c) of the EEA Agreement. Operating aid is only allowed under special circumstances (for example, for certain types of environmental or regional aid), when the relevant Guidelines of the Authority provide for such an exemption.

<sup>(34)</sup> Joined Cases E-5/04, E-6/04 and E-7/04 *Fesil and Finnjford* [2005] EFTA Court Report p. 117, paragraph 77. This judgment confirms the case law of the European Court of Justice as laid down in Case C-75/97 *Belgium v Commission* [1999] ECR I-3671, paragraph 33. See also Case C-66/02 *Italy v Commission* [2005] ECR I-10901, paragraph 95.

Article 61(3)(b) of the EEA Agreement enables the Authority to declare aid compatible with the functioning of the EEA Agreement if it is designed 'to remedy a serious disturbance in the economy of an EC Member State or an EFTA State'. The Authority recalls that, in line with the case law of the European Court of Justice and the decision-making practice of the Authority and the European Commission (the 'Commission'), Article 61(3)(b) is to be applied restrictively and the measures at issue must tackle a disturbance in the entire national economy <sup>(35)</sup>.

The Authority acknowledges that the Mortgage Loan Scheme was adopted during and in response to the current international financial crisis. In Iceland, small saving banks in particular have faced liquidity problems as a result of the financial difficulties suffered by the larger banks, which have traditionally provided funding to small savings banks. Unlike the larger financial undertakings, the savings banks do not have direct access to funding from the Icelandic Central Bank.

As stated in its decision to open the formal investigation procedure, the Authority considers that the appropriate framework for assessing the compatibility of the Mortgage Loan Scheme is the Impaired Assets Guidelines (IAG), which are based on Article 61(3)(b) of the EEA Agreement. The Mortgage Loan Scheme must therefore be assessed under Article 61(3)(b) of the EEA Agreement and the IAG.

Prior to determining whether the Mortgage Loan Scheme is compatible under the IAG, it is relevant, in the present case, to determine whether the Scheme qualifies as a 'scheme' within the meaning of Protocol 3 to the Surveillance and Court Agreement. Article 1(d) of Part II of Protocol 3 provides that:

“aid scheme” shall mean any act on the basis of which, without further implementing measures being required, individual aid awards may be made to undertakings defined within the act in a general and abstract manner and any

<sup>(35)</sup> Joined Cases T-132/96 and T-143/96 *Freistaat Sachsen and Volkswagen AG v Commission* [1999] ECR II-3663, paragraph 167. See the Commission's Decisions in Case NN 70/07 *Northern Rock* (OJ C 43, 16.2.2008, p. 1), and in Case NN 25/08 *Rescue aid to WestLB* (OJ C 189, 26.7.2008, p. 3); and Commission's Decision of 4.6.2008, C 9/08 *SachsenLB* (OJ L 104, 24.4.2009). See also the Authority's Decision No. 36/09/COL of 30.1.2009 on the Agreement between the Norwegian State and Eksportfinans ASA concerning State funding of Eksportfinans (OJ C 156, 9.7.2009, p. 17, and EEA Supplement No 36, 9.7.2009, p. 9); Decision No 205/09/COL of 8.5.2009 on the scheme for temporary recapitalisation of fundamentally sound banks in order to foster financial stability and lending to the real economy (OJ L 29, 3.2.2011, p. 36, and EEA Supplement No 6, 3.2.2011, p. 1); Decision 235/09/COL of 20.5.2009 on the Norwegian Temporary Small Aid Scheme (OJ L 46, 19.2.2011, p. 59, and EEA Supplement No 8, 17.2.2011, p. 1); Decision No. 168/09/COL of 27.3.2009 on an additional loan category of the Icelandic Housing Financing Fund on lending to banks, saving banks and other financial institutions for the purpose of temporarily refinancing mortgage loans (OJ C 241, 8.10.2009, p. 16, and EEA Supplement No 52, 8.10.2009, p. 1).

act on the basis of which aid which is not linked to a specific project may be awarded to one or several undertakings for an indefinite period of time and/or for an indefinite amount'.

The Authority has taken the view (which has not been disputed by the Icelandic authorities) that the Mortgage Loan Scheme is based on rules — the Housing Act, the Regulation and the Supplementary Rules — on the basis of which, without further implementing measures being required, individual aid awards may be made to undertakings defined in those rules in a general and abstract manner. The Mortgage Loan Scheme therefore qualifies as an aid scheme within the meaning of Article 1(d) of Part II of Protocol 3. In that regard, the Authority recalls that in Case C-310/99, the European Court of Justice held that: 'There was no need for the contested decision to include an analysis of the aid granted in individual cases on the basis of the scheme. It is only at the stage of recovery of the aid that it is necessary to look at the individual situation of each undertaking concerned.' <sup>(36)</sup>.

In line with that case law, the Authority has assessed the Mortgage Loan Scheme on the basis of the characteristics of the Scheme (as opposed to the specifics of individual awards made under the Scheme).

As described above, the Icelandic authorities have argued that the Authority should consider the Mortgage Loan Scheme as part of the ongoing restructuring of the Icelandic savings banks sector and that it should be assessed under the Authority's restructuring guidelines applicable to financial institutions under the financial crisis (the 'banking restructuring guidelines') <sup>(37)</sup>. However, the swap under the Mortgage Loan Scheme does not require any general restructuring of the financial institutions benefiting from the Scheme. The Mortgage Loan Scheme may be applied to any financial institution irrespectively of whether such financial institutions are being restructured. In such circumstances the Authority considers that the appropriate guidelines applicable to the measure are not the banking restructuring guidelines. As established above, the characteristics of the Mortgage Loan Scheme are such that the conditions are in place for applying the IAG.

### 3.1. Application of the IAG — eligibility of assets

In order to be declared compatible with Article 61(3)(b) of the EEA Agreement, the aid must be granted on the basis of non-discriminatory criteria, be appropriate in terms of being well

<sup>(36)</sup> Case C-310/99 *Italy v Commission* [2002] ECR I-2289, paragraph 91. In Case C-66/02 *Italy v Commission* [2005] ECR I-10901, paragraph 91, the Court stated 'In the case of an aid scheme, the Commission may confine itself to examining the general characteristics of the scheme in question without being required to examine each particular case in which it applies [...] in order to establish whether the scheme involves elements of aid.'. See also Case E-2/05 *ESA v Iceland* [2005] EFTA Court Report p. 202, paragraph 24 and Case C-71/09 P, C-73/09 P and C-76/09 P, *Comitato Venezia vuole vivere v Commission*, not yet reported, paragraphs 63-64.

<sup>(37)</sup> See footnote 32.



targeted to remedy a serious disturbance in the economy, and be necessary and proportionate thereto, limiting negative spill-over effects for competitors. The IAG translate these general principles into specific conditions for impaired asset relief.

As already mentioned, the Icelandic authorities have questioned the applicability of the IAG to the asset swap provided for under the Mortgage Loan Scheme on the basis that the mortgage loans subject to the swap agreements are not impaired assets. The Icelandic authorities argue that the mortgage loans represent the most financially attractive assets possessed by the banks and are not therefore impaired.

The IAG define impaired assets as: 'assets commonly referred to as 'toxic assets' (e.g. US mortgage backed securities and associated hedges and derivatives), which have triggered the financial crisis and have largely become illiquid or subject to severe downward value adjustments...'. The IAG also provide that when determining whether assets are impaired it is necessary to take a pragmatic approach and allow for some flexibility<sup>(38)</sup>.

As already noted, the savings banks currently taking part in the Mortgage Loan Scheme normally finance their activities through customer deposits and taking loans from the principal Icelandic banks. If that does not prove sufficient, in order to continue operations, the normal course of business for a savings bank would be to sell some of its assets (for example, mortgage loans).

However, the Icelandic authorities have explained that the principal Icelandic banks are bankrupt and undergoing restructuring, which rules out loans from those banks. In addition, customer deposits alone are not sufficient to cover the financing needs of the savings banks. The Icelandic authorities have informed the Authority that the third possibility — of selling assets — has not been possible due to the financial crisis. It was against this background that the Mortgage Loan Scheme was introduced.

The Authority considers that the fact that the savings banks have been unable to sell their mortgage loans on the market implies that those assets are illiquid and, therefore, impaired. Annex 3 of the IAG contains a list of categories of impaired assets which are considered eligible for asset relief measures. The list includes housing mortgages.

In that light, in order to be found compatible with the EEA Agreement, the Mortgage Loan Scheme must fulfil the conditions for the compatibility of asset relief as set out in the IAG. The relevant conditions are considered in sections 3.2-3.6 below.

<sup>(38)</sup> See paragraph 32 of the IAG.

### 3.2. Valuation of the mortgage loan — independent expert

Paragraph 20, 1st bullet point, of the IAG provides that: 'Applications for aid should be [...] based on adequate valuation, certified by recognised independent experts [...].'

Article 3 of the Regulation provides that HFF must perform an assessment of the value of the mortgage loans assets offered to the Fund. This is also what happens in practice: the assets swapped under the Mortgage Loan Scheme are valued by HFF. Thus, the assets swapped under the Mortgage Loan Scheme are not valued by an independent expert, contrary to the requirements of the IAG.

The fact that one element of the valuation assessment — the credit risk method — has been prepared by an independent expert (KPMG Iceland) does not automatically mean that the entire assessment must be deemed to be carried out by an independent expert. Other important element of the assessment, namely determining the basis for the assessment (i.e. the choice of eligible mortgage loans, the basis for the value (book value), the performance of the credit risk assessment, and the decision on how to calculate the credit buffer and determine the corresponding amount due in HFF bonds) is determined by regulation or by HFF alone. The fact that an independent expert has provided a method for assessing the credit risk does not alter the fact that HFF itself actually applies that method; in other words, it performs the valuation itself. There is no scrutiny over whether, and if so, how HFF applies the method.

In such circumstances, the Authority concludes that the asset valuation carried out under the Mortgage Loan Scheme is not in accordance with paragraph 20 of the IAG.

As already described, during the formal investigation, the Icelandic authorities put forward an asset valuation report carried out by independent financial expert, ALM, in respect of mortgage loans already subject to swaps under the Mortgage Loan Scheme. However, that does not change the fact that under the Mortgage Loan Scheme itself, as well as pursuant to the relevant legal provisions, HFF itself must carry out the valuation of mortgage loans taken over by it under the Scheme.

As stated in Part II, Section 3 above, the Authority will only consider the Mortgage Loan Scheme as an 'aid scheme' within the meaning of Article 1(d) of Part II of Protocol 3. Thus, without prejudice to the valuation carried out in individual cases under the Scheme, the Mortgage Loan Scheme itself does not fulfil the conditions laid down in the IAG.

On the basis of the above, the Authority concludes that the system for valuing the mortgage loans does not satisfy the conditions laid down in the IAG.

### 3.3. Valuation of the mortgage loan — basis for valuation

The IAG also sets out a method for the valuation of impaired assets in the context of an asset-relief measure. Paragraphs 39 and 40 of the IAG and annex 3 introduce the concepts of 'cost', 'current market value', 'real economic value' and 'transfer value'. Those concepts are defined in the IAG as follows <sup>(39)</sup>:

- Cost means the carrying amount or nominal value of the loans minus impairment.
- Current market value is the value the impaired assets could have obtained in the market.
- The real economic value is the underlying long-term economic value of the assets on the basis of underlying cash flows and broader time horizons. This should be calculated both for a base case scenario and a stress case scenario.
- The transfer value is the value attributed to impaired assets in the context of an asset-relief programme.

Normally, the IAG provide that if the transfer value is higher than the current market value, State aid is involved. In order for the aid to be declared compatible, the transfer value must be less than or equal to the real economic value.

Article 6 of the Supplementary Rules states that the value of the mortgage loan pools is based on the book value of each individual mortgage. The book value is normally not the same as the real economic value of the assets, which is based on underlying cash flows and broader time horizons.

In the light of the above, the Authority considers that the Icelandic Government has failed to show (or calculate) that the transfer value is based on the real economic value. The

<sup>(39)</sup> Paragraph 39 provides that: '[a]s a first stage, assets should be valued on the basis of their current market value, whenever possible. In general, any transfer of assets covered by a scheme at a valuation in excess of the market price will constitute State aid. The current market value may, however, be quite distant from the book value of those assets in the current circumstances, or non-existent in the absence of a market (for some assets the value may effectively be as low as zero).'

Paragraph 40 provides that: '[a]s a second stage, the value attributed to impaired assets in the context of an asset-relief programme (the "transfer value") will inevitably be above current market prices in order to achieve the relief effect. To ensure consistency in the assessment of the compatibility of aid, the Authority would consider a transfer value reflecting the underlying long-term economic value (the "real economic value") of the assets, on the basis of underlying cash flows and broader time horizons, an acceptable benchmark indicating the compatibility of the aid amount as the minimum necessary.'

In addition, Table 1, Non-securitised loans, introduces the concepts of 'Cost', 'Economic Value' and 'Transfer Value' as the basis for valuation under the Scheme.

arguments of the Icelandic authorities to the effect that the inclusion of a 'credit buffer' ensures that the book value is adjusted to a market value cannot be accepted. First, the 'credit buffer' is only designed to protect HFF against a credit risk (by postponing part of the consideration for the mortgage loans), and not to establish a market value. Secondly, upon final settlement, financial institutions will receive HFF bonds corresponding to the book value of the mortgage loans less any realised and future expected impairment, and not corresponding to the actual economic value of the mortgage loans.

Therefore, on the basis of the available information, and in accordance with the principles set out in the IAG, the Authority cannot exclude that incompatible State aid is involved in the Mortgage Loan Scheme.

### 3.4. Burden sharing

As regards burden sharing, the IAG set out, in paragraphs 21 to 25, a general principle that financial institutions ought to bear the losses associated with impaired assets to the maximum extent possible. That implies that they should bear the loss resulting from the difference between the current market value and the real economic value of impaired assets.

As HFF has not carried out a valuation in accordance with the IAG, it is not possible to assess to what extent eligible financial institutions bear a share of the burden as required by the IAG.

### 3.5. Remuneration

The Authority notes that that the EFTA States must also ensure that 'any pricing of asset relief must include remuneration for the State that adequately takes account of the risks of future losses exceeding those that are projected in determination of the 'real economic value' and any additional risk stemming from a transfer value above the real economic value' <sup>(40)</sup>.

The IAG suggest that such remuneration may be provided by setting the transfer value of assets sufficiently below the 'real economic value' so as to provide for adequate compensation for the risk taken on by the State <sup>(41)</sup>. Any pricing system would have to ensure that the overall contribution of beneficiary financial institutions reduces the extent of net State intervention to the minimum necessary. However, as the Mortgage Loan Scheme does not meet the requirements of the IAG with regard to valuation, it is not possible to assess whether the Icelandic authorities have complied with the remuneration requirement.

<sup>(40)</sup> Annex 4.II to the IAG.

<sup>(41)</sup> Annex 4.II to the IAG.

As already described, the Icelandic authorities have argued that beneficiary financial institutions are charged a fee of 95 basis points (bp), which is added to HFF's cost of capital, when entering into an agreement pursuant to the Mortgage Loan Scheme. However, according to the information available to the Authority, 95 bp is the current premium that HFF generally charges customers to cover operating costs (25 bp), prepayment risk (50 bp) and credit losses (20 bp) for regular mortgage loans.

Thus, while the Authority understands that this will affect the value of HFF bonds transferred to a beneficiary financial institution; however, HFF will incur such costs in connection with management of the transferred mortgages loans in the course of the term of the mortgages. To date, the Authority has not received any documentary evidence to the contrary<sup>(42)</sup>. In that light, the 95 bp charge cannot be considered as remuneration paid by beneficiary financial institutions to the State.

### 3.6. Unlimited scope and duration

The Icelandic authorities have neither specified any time-limit for the Mortgage Loan Scheme, nor specified any time-limit within which the financial institutions can apply to enter the Mortgage Loan Scheme (the so-called 'entrance window')<sup>(43)</sup>.

The IAG require, in order for asset relief measures to be found compatible with the EEA Agreement, that their duration must not go beyond the period of the financial crisis<sup>(44)</sup>. Asset relief measures are not approved for an unlimited period of time.

Based on the decisional practice of the European Commission, the entrance window of asset relief measures is usually approved for a maximum of six months. Any extensions to the duration of the entrance window (usually for an additional six months) must be re-notified well in advance and take account of the evolution of the situation on the relevant financial markets. Asset relief schemes may be approved for a period of up to two years, provided that biannual reports are submitted to the Authority<sup>(45)</sup>.

<sup>(42)</sup> Even if the 95 bp charge were to be accepted as remuneration for the asset swap, the question remains as to whether the level of that charge is sufficient to represent appropriate remuneration, see Annex 4.II of IAG.

<sup>(43)</sup> The argument of the Icelandic authorities that the nature of the Emergency Act is temporary and thus that schemes implemented under it are by definition not of a permanent nature cannot be accepted. There is no provision in any of the relevant legislation which would prevent the Icelandic authorities from continuing the Mortgage Loan Scheme indefinitely. This contradicts the general principle of proportionality and necessity at the core of the guidelines concerning State aid during the financial crisis. The fact that the Icelandic Parliament intended to review the Emergency Act by 1.1.2010 does not alter that conclusion. In any event, according to information available to the Authority, to date, the Icelandic Parliament has not carried out such a review.

<sup>(44)</sup> The Authority's Guidelines on financial institutions, paragraph 12.

<sup>(45)</sup> The Authority's Guidelines on financial institutions, paragraph 24.

Similarly, the Icelandic authorities have not specified a total budget for the Mortgage Loan Scheme, or estimated annual expenditure under the Scheme. They have not submitted an estimated number of beneficiaries or a limit to the value of the assets potentially eligible for an asset swap pursuant to the Scheme. Thus, the Mortgage Loan Scheme appears to be unlimited in scope, and, therefore, is not proportionate, as required pursuant to the IAG.

## 4. CONCLUSION

Based on the information submitted by the Icelandic authorities, the Authority concludes that the Mortgage Loan Scheme involves the grant of State aid within the meaning of Article 61(1) of the EEA Agreement which is not compatible with the functioning of the EEA Agreement for the reasons set out above. However, individual aid grants awarded under the Mortgage Loan Scheme which fulfil the criteria laid down in the State Aid Guidelines on impaired assets, are compatible with the functioning of the EEA Agreement<sup>(46)</sup>.

The Mortgage Loan Scheme was notified to the Authority after it entered into force and before the Authority had taken a final decision in respect of the notification. Thus, the Icelandic authorities have unlawfully implemented the aid at issue in breach of Article 1(3) of Part I of Protocol 3.

It follows from Article 14 of Part II of Protocol 3 that unlawful aid which is incompatible with the State aid rules under the EEA Agreement must be recovered from the beneficiaries,

HAS ADOPTED THIS DECISION:

### Article 1

The Mortgage Loan Scheme constitutes State aid which is incompatible with the functioning of the EEA Agreement within the meaning of Article 61(1) of the EEA Agreement.

### Article 2

In view of the failure by the Icelandic authorities to comply with the requirement to notify the EFTA Surveillance Authority before implementing the Mortgage Loan Scheme, in accordance with Article 1(3) of Part I of Protocol 3, the Mortgage Loan Scheme involves unlawful State aid.

<sup>(46)</sup> See, for example, Commission Decision of 16.12.2003 on the aid scheme implemented by France for the takeover of firms in difficulty (OJ L 108, 16.4.2004, p. 38), and Commission Decision of 20 December 2001 on a State aid scheme implemented by Spain in 1993 for certain newly established firms in Vizcaya (Spain) (OJ L 40, 14.2.2003, p. 11). See also ESA Decision 754/08/COL of 3 December 2008 on the Wood-based Innovation Scheme (OJ C 58, 12.3.2009, p. 12, and EEA Supplement No 14, 12.3.2009, p. 5).

*Article 3*

The Icelandic authorities shall abolish the Mortgage Loan Scheme with immediate effect and take all necessary measures to recover any incompatible and unlawful aid granted under the Mortgage Loan Scheme, as referred to in Article 1 and Article 2.

*Article 4*

By 30 August 2011, the Icelandic authorities shall inform the EFTA Surveillance Authority of the measures taken to comply with this decision.

*Article 5*

Recovery shall be effected without delay, and in any event not later than 30 October 2011. Recovery shall be effected in accordance with the procedures of national law provided that they allow for the immediate and effective execution of the Decision. The aid to be recovered shall include interest (including compound interest) from the date on which it was

at the disposal of the beneficiaries until the date of its recovery. Interest shall be calculated on the basis of Article 9 of Decision No 195/04/COL.

*Article 6*

This Decision is addressed to the Republic of Iceland.

*Article 7*

Only the English language version of this Decision is authentic.

Done at Brussels, 29 June 2011.

*For the EFTA Surveillance Authority*

Per SANDERUD  
*President*

Sabine MONAUNI-TÖMÖRDY  
*College Member*