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Contents

[1] Text with EEA relevance

EN

Acts whose titles are printed in light type are those relating to day-to-day management of agricultural matters, and are generally valid for a limited period.

The titles of all other acts are printed in bold type and preceded by an asterisk.

II

(Non-legislative acts)

DECISIONS

COMMISSION DECISION

of 19 September 2012

on the measures in favour of *ELAN* d.o.o. SA.26379 (C 13/10) (ex NN 17/10) implemented by Slovenia

(notified under document C(2012) 6345)

(Only the Slovenian text is authentic)

(Text with EEA relevance)

(2014/273/EU)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union, and in particular the first subparagraph of Article 108(2) thereof,

Having called on interested parties to submit their comments pursuant to the provision cited above [1],

Whereas:

1. **PROCEDURE**

(1) On 10 July 2008, *Marker Völkl International GmbH* (hereinafter referred to as 'complainant'), a German ski producer, filed a complaint alleging that Slovenia had granted state aid to the company *Elan d.o.o.* (hereinafter referred to as '*Elan*'; at the time of the complaint it was known as *Skimar d.o.o.*). The Commission sent several requests for information to Slovenia, to which Slovenia replied with letters dated 14 October 2008, 30 January 2010 and 22 February 2010. In November 2009, the Commission also sent a request for information to the complainant, to which it replied on 5 March 2010.

(2) By letter dated 12 May 2010, the Commission informed Slovenia that it had decided to initiate the procedure laid down in Article 108(2) of the Treaty on the Functioning of the European Union in respect of the aid.

(3) The Commission decision to initiate the procedure was published in the *Official Journal of the European Union* [2]. The Commission invited interested parties to submit their comments on the measures. The Commission received no comments from interested third parties.

(4) Following the opening Decision, Slovenia submitted further information by letters dated 9, 10 and 16 June 2010 (the latter with annexes dated 26 May, 28 May, 31 May, 2 June and 14 June 2010). On 16 August 2011, the Commission sent an information request to the Slovenian authorities, to which they replied by letter of

[1] OJ C 223, 18.8.2010, p. 8.
[2] See footnote 1.

10 October 2011. Several annexes to that letter were submitted on 11 October 2011. Following a meeting between the Commission services and company's representatives, Slovenia submitted additional information by letters dated 6 March, 30 March, 13 April, 16 April, 23 April, 10 May, 15 May and 30 May 2012.

2. **DESCRIPTION OF THE AID**

2.1. THE BENEFICIARY

(5) *Elan*, a limited liability company is active in producing skiing equipment and marine oriented crafts such as yachts. The company is located in Begunje na Gorenjskem, Slovenia, which is in its totality eligible for regional aid under Article 107(3)(a) of the TFEU ([3]). At present, *Elan* employs approximately 460 staff and has two main divisions: a winter sport division and a marine division. The company has only one subsidiary in Slovenia, *Elan Inventa d.o.o.* (sport equipment), as well as several trading companies in other countries.

(6) Until June 2010, and when the measures under assessment took place, *Elan* was organised differently. It consisted of the parent company *Elan* which held shares in four subsidiaries:

— *Elan d.o.o.* (hereinafter referred to as '*Elan Winter sport*'), in which *Elan's* winter sport activities were organised. *Elan Winter sport* held in turn the shares in several trading companies.

— *Elan Marine* d.o.o. (hereinafter '*Elan Marine*'), in which *Elan's* marine activities were organised. *Elan Marine* in turn held shares in several subsidiaries such as 100 % in *Elan PBO*, 100 % in *Elan Marine Charter* and 100 % in *Elan Yachting d.o.o.*

— *Elan Inventa d.o.o.* (sport equipment division).

— *Marine Nova d.o.o.* (non-trading company).

(7) *Elan* is state owned. Currently, 66,4 % of its shares are held by *Posebna družba za podjetniško svetovanje, d.d.* (hereinafter referred to as '*PDP*'), a financial holding company owned by three state owned funds. Another 25 % of the shares in *Elan* are held by *Triglav Naložbe, finančna družba, d.d.* (hereinafter referred to as '*Triglav Naložbe*'), a financial company for a mainly state owned insurance company. The remaining 8,6 % are held by *Prvi pokojninski sklad*, which is a state owned pension fund (see Point 2.2 for a detailed description of *Elan's* shareholders). When the measures under investigation were taken, *Elan* was also mainly state owned. Its shareholder structure was, however, slightly different (see also Point 2.2).

(8) As regards the financial situation of *Elan*, following a difficult year in 2004, the company was profitable in 2005 and 2006 and turnover was growing. It was in 2007 when the company's situation started to worsen, which resulted in a declining turnover and net losses in the years 2007-2008. A more detailed assessment of *Elan's* financial situation is provided in recitals (68) to (74).

(9) At present, *Elan* is in the process of privatisation. The main shareholder *PDP* intends to sell its stake in the company and is currently negotiating with potential bidders.

2.2. THE SHAREHOLDERS OF THE BENEFICIARY AT PRESENT AND WHEN THE MEASURES WERE GRANTED

(10) As the ownership structure as well as the identity of *Elan's* owners and their corporate governance is relevant for the question of whether the measures in favour of *Elan* consist of state resources and are imputable to the State, in the following, a short description of each owner will be provided, followed by an overview of the shares in *Elan* held by each of them over time. It should be noted that *Elan's* ownership structure changed between the time of the first capital injection in 2007 (Measure 1) and the second capital injection in 2008 (Measure 2) and that further changes have occurred since then. Details are provided below (see recitals (19) to (22)).

([3]) Guidelines on national regional aid for 2007-2013, OJ C 54, 4.3.2006, p. 13.

2.2.1. **Description of Elan's shareholders**

KAD

(11) *Kapitalska družba pokojninskega in invalidskega zavarovanja, d.d.* (hereinafter referred to as '*KAD*') is a joint stock company whose sole shareholder is Slovenia. *KAD* manages state pension funds and assets for Slovenia. It is also responsible for the privatisation of state owned assets. *KAD* is subject to the Slovenian Company Act ('*ZGD-1, Zakon o gospodarskih družbah*'). Accordingly, *KAD* has an assembly, a supervisory board and a management board. The Slovenian government appoints all 15 members of the assembly (of which 5 represent pensioners and disabled workers, 5 represent employers and insured persons and 5 represent the Slovenian government) and all 9 members of the supervisory board. Representatives of the government are invited to the assembly meetings.

KAD-PPS

(12) *Prvi pokojninski sklad* is the First Pension Fund of the Republic of Slovenia, which means that it is 100 % state owned. *KAD* is managing this pension fund, and also controls the share that *PPS* holds in *Elan* (hereinafter referred to as '*KAD-PPS*').

DSU

(13) *Družba za svetovanje in upravljanje, d.o.o.* (hereinafter referred to as '*DSU*') is a limited liability management and consultancy company that is 100 % state owned. It is, inter alia, responsible for the privatisation of state owned assets. *DSU* has a supervisory council, consisting of three members. Two are appointed by the Slovenian government and one is appointed by the company's employees. Until the appointment of the employees' representative, Slovenia also appoints the third member. The supervisory council appoints a company director, who manages *DSU*'s business transactions.

Zavarovalnica Triglav

(14) *Zavarovalnica Triglav, d.d.*, (hereinafter referred to as '*Zavarovalnica Triglav*') is a company that offers all kinds of non-life and life, health and accident insurance. 67,7 % of its shares are held by companies who are in turn directly or indirectly majority owned by the State. At the time of granting, *Zavarovalnica Triglav's* main shareholders were: *Zavod za pokojninsko in invalidsko zavarovanje* (hereinafter referred to as '*ZIPZ*', the Pension and Disability Insurance Institute), 100 % state owned, holding a share of 34,5 % in *Zavarovalnica Triglav*; *Slovenska odškodninska družba, d.d.* (hereinafter referred to as '*SOD*', the Slovenian indemnity incorporation), 100 % state owned, holding a share of 28,1 % in *Zavarovalnica Triglav*; *NLB, d.d.*, 50 % state owned, holding a 3,1 % share in *Zavarovalnica Triglav* and *HIT d.d.*, 100 % state owned, holding a 1,1 % share in *Zavarovalnica Triglav*. None of the other shareholders of *Zavarovalnica Triglav* had a share that was higher than 1,8 % in the company.

(15) *Zavarovalnica Triglav* has a supervisory board consisting of 8 members and a management board. Five members of the supervisory board represent the interest of the shareholders and are elected by the general meeting of *Zavarovalnica Triglav*. The other three members are representing employees' interest.

Triglav Naložbe

(16) *Triglav Naložbe* is a financial company. At the time of the second capital injection, 80 % of the shares of *Triglav Naložbe* were owned by *Zavarovalnica Triglav*. The latter is in turn majority state owned (see recital (14)). The remaining capital of *Triglav Naložbe* is very dispersed among individual investors, none holding a share higher than 0,67 %. *Triglav Naložbe* has a supervisory board and a management board. The supervisory board consists of three members and is appointed by the general meeting of *Triglav Naložbe*.

PDP

(17) *PDP* is a financial holding company, which was established in June 2009. It is owned by three state owned funds, namely *KAD*, *DSU* and *SOD* and acts as a restructuring company on behalf of the Slovenian state. PDP may, under contract, take over the management of state owned enterprises in difficulty, exercise all voting rights, install a supervisory board and management board and carry out rehabilitation measures for the state ([4]). PDP holds shares in several Slovenian companies previously owned by para-state funds ([5]) and is searching strategic investors for some of them.

KD Kapital

(18) *KD Kapital, finančna družba, d.o.o.* (hereinafter referred to as '*KD Kapital*'), a company active in capital investment. *KD Kapital* belongs to *Skupina KD* group ([6]) and is in private ownership.

2.2.2. **Shares held in Elan at different points in time**

(19) In 2007, when the first measure was granted, the following companies held a share in *Elan*: *KAD* (30,48 %), *KAD-PPS* (10,3 %), *DSU* (17,34 %), *Triglav Naložbe* (13,16 %), *Zavarovalnica Triglav* (11,89 %) and *KD Kapital* (16,83 %).

(20) In April 2008, *KD Kapital* sold its share to *KAD*. Following this transaction, and at the time of the second capital injection, the following companies held a share in *Elan*: *KAD* (47,31 %), *KAD-PPS* (10,3 %), *DSU* (17,34 %), *Triglav Naložbe* (13,16 %) and *Zavarovalnica Triglav* (11,89 %).

(21) In 2010, *KAD* and *DSU* vested their *Elan* shares in the financial holding company *PDP*. Today, *PDP* holds 66,4 % of the shares in *Elan*. *KAD-PPS* holds 8,6 % and *Triglav Naložbe* 25 %.

(22) Table 1 provides an overview of the shares held by each respective shareholder at the time of Measure 1, Measure 2 and in May 2012:

Table 1

(in %)

Entity	Measure 1 (January 2007)	Measure 2 (August 2008)	May 2012
PDP (owned by *KAD*, *DSU* and SOD, which are in turn owned by the State)	0	0	66,4
KAD (100 % state owned)	30,48	47,31	0
KAD-PPS (100 % state owned)	10,30	10,30	8,6
DSU (100 % state owned)	17,34	17,34	0
Triglav Naložbe (80 % owned by *Zavarovalnica Triglav*)	13,16	13,16	25
Zavarovalnica Triglav (owned by ZIPZ and SOD, which are in turn owned by the State)	11,89	11,89	0
KD Kapital (private company)	16,83	0	0
Total state ownership	**83,17**	**100**	**100**

([4]) 'Structural Adjustments 2010 and 2011', Government of the Republic of Slovenia, October 2009, p. 12, at: http://www.svrez.gov.si/fileadmin/svez.gov.si/pageuploads/docs/strukturne_prilagoditve/Structural_adjustmements_SLO_EN.pdf
([5]) In December 2009 PDP held shares of 10 Slovenian companies previously owned by KAD, SOD and DSU; cf. 'Who we are' — PDP powerpoint presentation submitted by the Slovenian authorities.
([6]) http://www.kd-group.com/en/index.php.

2.3. DESCRIPTION OF THE MEASURES

2.3.1. **The capital injection in 2007 ('Measure 1')**

(23) In 2006, *Elan* envisaged an ambitious investment programme for the group concerning investments into buildings, equipment and brand marketing, based on a strategic development plan for the period 2006-2010 (drawn up by *Elan's* supervisory board in December 2005). For the years 2006-2007 investments of EUR 20,2 million were planned. In order to finance those investments, *Elan* proposed a capital increase of EUR 20,2 million to its shareholders. In the meantime, in the course of 2006, *Elan* started to purchase new production equipment, which was also foreseen by the strategic development plan.

(24) On 29 January 2007, *Elan* and *Elan's* shareholders signed a letter of intent, in which they agreed that the shareholders would inject EUR 10,225 million into *Elan* (about half of the EUR 20,2 million foreseen in the strategic development plan 2006-2010). Each shareholder agreed to participate in the capital increase in proportion to its share in *Elan*. The decision was taken on the basis of a company valuation from the independent consultancy […] (*) and several other documents drawn up by *Elan* itself as well as *KAD*, *Elan's* majority shareholder. […] calculation of the fair value of the company was made on the basis of the average of the calculation (for each division) of (i) the weighted average benchmarked price/sales ratio of recent deals done, (ii) the price/earnings ratios of applicable companies in 2005 and (iii) seven times the EBITDA value including 25 %of estimated cost-saving potential. From this average, the short-term interest-bearing debts and half of identified investments that could not be financed by the company's assumed cash-flow were deducted. *KAD's* flash estimate of *Elan's* value was elaborated on the basis of the discounted cash flow method, using business projections provided by *Elan* to its supervisory board.

(25) Prior to this, in May 2006, *Elan* had informed its shareholders that, although it was putting all free cash flows in investments foreseen in the Strategic development plan 2006-2010, additional capital would be needed to realise the necessary investments ([7]). In the following, in November 2006, *Elan* prepared a more detailed analysis of the effects of a capital increase ([8]), according to which the investments would lead to a cumulative net profit for the winter sport division of EUR 15,4 million over the period 2006-2010, compared to cumulative net losses without the capital increase of EUR 4,8 million. Also the cumulative net profit of the marine division for the period 2006-2010 would be higher if the capital increase took place (EUR 14,9 million compared to EUR 8 million). At the same time, *Elan's* majority shareholder *KAD* estimated the value of the group to be EUR 22,8 million. The supervisory boards of the shareholders *KAD*, *DSU*, *Zavarovalnica Triglav* and *Triglav Naložbe* approved the capital injection already in December 2006 and January 2007 respectively.

(26) Formally, the capital increase was confirmed in the shareholder assembly of 25 October 2007. The shareholder payments were carried out on 15 November 2007 in proportion to the respective shareholder's ownership share. The EUR 10,225 million were injected into *Elan*, which gave in turn a shareholder loan of EUR 5,8 million to *Elan Winter sport* and a shareholder loan of EUR 4,425 million to *Elan Marine*. Those shareholder loans were later converted into equity in *Elan Winter sport* and *Elan Marine*. As described above, *Elan Winter sport* and *Elan Marine* were merged into their parent company *Elan* in June 2010 (see recital (6)).

(27) One of the reasons for the time lag between the letter of intent and the formal agreement of the shareholders was that *KD Kapital*, the only private shareholder at that time in *Elan*, which had a blocking minority, blocked the formal decision for the capital increase. The reason for *KD Kapital's* blocking was a dispute between *KAD* and *KD Kapital* over changes in the supervisory board of *Elan*. As explained by Slovenia, *KD Kapital* was also 50 % shareholder of one of *Elan's* competitors, *Seaway Group d.o.o.* and intended to install a *KD Kapital* representative in the supervisory board of *Elan*. *KAD* considered this not to be acceptable in light of *KD Kapital's* shareholding in *Seaway*. In order to solve this issue, in the beginning of October 2007, *KAD* offered *KD Kapital* a put option, under the condition that *KD Kapital* voted in favour of *KAD's* proposal related to the dispute over the supervisory board members.

(*) Business secret.
([7]) A document done by the Management Board of *Elan*, dated 30 May 2006, on the capital increase of the companies in *Elan*.
([8]) Letter from *Elan*'s management board to KAD, dated 30 November 2006.

(28) Following this offer, *KD Kapital* finally agreed to the capital increase, and as described above, the shareholders took the formal decision in October 2007.

2.3.2. **The capital injection in 2008 ('Measure 2')**

(29) Despite the capital increase of November 2007, the bad winter season of 2007/2008 (affected by the previous 'green' winter of 2006/2007) led to further difficulties of the group. *Elan* was facing insolvency at the beginning of 2008.

(30) When *SKB banka d.d.* refused to further finance *Elan* in the beginning of 2008, *KD Kapital* exercised its put option in March 2008, with effect as of April 2008. *KAD* purchased the shares of *KD Kapital* and thus increased its share in *Elan*. Since then, *Elan* has been an entirely state owned company (see recital (20)).

(31) To cope with the difficult financial situation, *Elan's* shareholders appointed a new management board in April 2008. The management started talks with the banks to reach an agreement on rescheduling of the banks' claims against *Elan* and thus to avoid bankruptcy of the company. The banks were only willing to do so on condition that *Elan's* shareholders provided additional capital to the company.

(32) Against this background, in March 2008, *Elan* asked its shareholders for additional new capital. Based on a long-term plan for *Elan* for the period 2008-2012, drawn up by *Elan* in June 2008 (hereinafter 'long-term plan 2008-2012'), *Elan* asked its shareholders more concretely for EUR 25 million in June/July 2008. *Elan's* shareholders considered the long-term plan 2008-2012 as inadequate to inject EUR 25 million. In fact, the shareholders were only willing to inject EUR 10 million, and made this capital increase conditional on a prior agreement between *Elan* and its banks to reschedule *Elan's* debts. The shareholders also asked for a supplemented long-term plan for *Elan* ([9]). Following this request, *Elan* prepared an additional Rehabilitation plan, dated 8 August 2008 (hereinafter 'Rehabilitation plan'). *Elan* was, however, not able to reach an agreement with its banks on the debt rescheduling. On the contrary, one of *Elan's* creditors, namely *SKB banka d.d.*, started court proceedings to enforce its claims and in August 2008, the Court of Ljubljana served *Elan* a court order to pay its outstanding debts. The enforcement of this order would have led to bankruptcy of the company.

(33) In light of this, *Elan* called for an urgent meeting of the shareholders which took place on 28 August 2008. During this meeting, following a proposal from *KAD*, *Elan's* shareholders decided to inject EUR 10 million into *Elan*, although the condition that *Elan* reached an agreement with its banks on rescheduling the loans was not met.

(34) The supervisory board of KAD approved the capital injection already before the shareholders' meeting in August 2008; the supervisory board of the other shareholders approved the decision to inject EUR 10 million in *Elan* the latest in early September 2008.

(35) The shareholders' payments were carried out on 8 September 2008 in proportion to the respective shareholder's ownership share. As described in recital (6), *Elan's* winter sport and marine activities were organised in two subsidiaries at the time of granting, namely *Elan Winter sport* and *Elan Marine*. The EUR 10 million were injected into *Elan*, which then put EUR 5,924 million in *Elan Winter sport* and EUR 4,076 million in *Elan Marine*.

The long-term plan 2008-2012

(36) The long-term plan 2008-2012, drawn up in June 2008 by *Elan*, described first the economic and financial situation of *Elan group*. It proposed several restructuring measures on the level of *Elan Winter sport* (adjustment of investments in affiliated companies, inventory adjustments and termination benefits) and on the level of *Elan Marine* (inventory adjustments, termination benefits, write down of marine moulds). In addition to these restructuring measures, the following actions were foreseen for *Elan Winter sport*:

— Increase of the productivity of the employees; reduction of workforce from 340 to 230 employees;

— Reduction of number of trademarks;

([9]) See Minutes of the 134th meeting of *KAD*'s supervisory board, 4 July 2008, point 2 of the agenda, section 2.

— Improvements in product mix;

— Reorganisation of the administration.

(37) For *Elan Marine*, the long-term plan 2008-2012 foresaw the following actions:

— Investments in a new joint venture, called *Elan Yachts*, which should be active in sales and development of sailing boats;

— Sales of the power and yachting programmes (*Elan PBO*) for EUR [9,5-11,2] million in order to reduce *Elan Marine*'s debts.

(38) The long-term plan 2008-2012 then provided forecasts for the group and its subsidiaries, based on the assumption that the above described restructuring measures and actions were implemented. According to these forecasts, *Elan Winter sport* would be profit making from 2010 onwards, and *Elan Marine* would be profit making from 2011 onwards. The plan concluded that *Elan* needed additional capital of EUR [23-26] million in order to meet its liquidity needs. Only if such capital was provided, *Elan* could deliver adequate returns to its shareholders.

The Rehabilitation plan

(39) The Rehabilitation plan, drawn up in August 2008 by *Elan*, first presented the company structure of *Elan group* and the financial and economic situation of *Elan Winter sport* and *Elan Marine*, including a detailed analysis of liabilities, costs but also revenues. It then analysed the operations of *Elan Winter sport* and *Elan Marine* from January 2008-June 2008. Finally, the plan included a part on the rehabilitation of the company. According to the plan, the actions proposed in this part could only be realised if fresh capital was injected into *Elan* and the bank loans were rescheduled. The Rehabilitation plan did, however, not specify the amounts needed.

(40) The Rehabilitation plan foresaw the following measures for *Elan Winter sport*:

— […]

(41) The following measures were foreseen for *Elan Marine*:

— […]

(42) The Rehabilitation plan then provided business projections for the years 2008-2012, according to which *Elan Winter sport* would be profit making as from 2010 and *Elan Marine* would be profit making as from 2011 onwards.

3. **GROUNDS FOR INITIATING THE PROCEDURE**

(43) As described above in recitals (2)-(3), the Commission decided on 12 May 2010 to open a formal investigation procedure ('the opening decision'). In this opening decision, the Commission preliminarily considered that the two capital injections involved state aid in favour of *Elan Ski* and *Elan Marine*. It expressed doubts whether such state aid could be considered compatible with the Internal Market. As a preliminary point, the Commission examined whether the beneficiaries were companies in difficulty.

3.1. COMPANY IN DIFFICULTY

(44) Point 10 of the Rescue and Restructuring Guidelines lays down certain circumstances under which a company can be presumed to be in difficulties, such as a significant decrease in capital. In the opening decision, it was considered that *Elan Ski* and *Elan Marine* did not meet the criteria of Point 10 of the Rescue and Restructuring Guidelines. However, according to Point 11 of the Guidelines, a company may still be considered to be in difficulty where the usual signs of a company being in difficulty are present. In light of increasing losses, decreasing turnover and the difficult financial situation of the *Elan* group overall, the Commission considered that *Elan Ski* and *Elan Marine* could be seen as companies in difficulty at least in the years 2007 and 2008.

3.2. EXISTENCE OF STATE AID

(45) First, the Commission assessed whether the measures stem from state resources and whether they are imputable to the state. In light of the fact that *KAD* is 100 % owned by Slovenia, that Slovenia appoints all members of the assembly and the supervisory board, and that representatives of the Slovenian government take part in all assembly and supervisory board meetings, the Commission concluded preliminarily that the measures taken by

KAD stem from state resources and are imputable to the State. Concerning the measures granted by the other owners of *Elan*, which are *KAD-PPS*, *DSU*, *Triglav Naložbe* and *Triglav Insurance*, the Commission concluded that it had to be verified during the formal investigation procedure whether they also stemmed from state resources and were imputable to the State.

(46) Secondly, the Commission examined whether the measures conferred an advantage to the beneficiaries. It was doubted that the measures would meet the market economy investor test. In the first measure, the only private shareholder in *Elan*, *KD Kapital*, did not want to participate. It appeared that the measure was not based on a business plan or other information on potential return on the investment in the future. At the time of the capital injection, the beneficiaries seemed to have been in financial difficulties. In the second measure, no private company participated. While it was true that a long-term plan and a Rehabilitation plan were set up before the shareholders decided on the capital injection, there were indications that the shareholders of *Elan* considered those plans as inadequate. When the second measure was granted, *Elan Ski* and *Elan Marine* were still facing financial difficulties.

(47) Thirdly, the Commission considered that the measures taken by Slovenia were likely to distort competition and affect trade between the Member States, as there is indeed trade between Member States in skiing equipment and marine oriented crafts.

3.3. COMPATIBILITY OF THE AID

(48) The Commission preliminarily assessed whether the measures were compatible under the Rescue and Restructuring Guidelines. In light of their difficulties, and in the absence of other strong companies in the group, *Elan Ski* and *Elan Marine* are in principle eligible for rescue and restructuring aid. As the measures granted took the form of a capital increase, they could not be considered as rescue aid. As regards their compatibility as restructuring aid, it was unclear whether all the respective conditions were met. In particular, it was unclear whether the aid was limited to the minimum necessary and there was no indication of own contribution and compensatory measures.

(49) It was also preliminarily examined whether the measures could be compatible regional aid. While both beneficiaries are located in a region eligible for aid under Article 107(3)(a) TFEU, it was unclear, whether they were eligible for such aid, as both beneficiaries were in difficulty at the time of granting.

4. **COMMENTS FROM SLOVENIA**

(50) Slovenia submitted its comments with letters dated 9, 10 and 16 June 2010. Additional information was sent on 10 October 2011 and by letters dated 6 March, 30 March, 13 April, 16 April, 23 April, 10 May, 15 May and 30 May 2012 (see recital (4)).

(51) In summary, according to Slovenia the measures do not involve state aid, as they do not stem from state resources and are not imputable to the State. Even if they fulfilled these requirements, the measures would not give an advantage to the beneficiary, as Slovenia has acted in line with the market economy investor principle. Further, Slovenia puts forward that the measures did not affect trade nor distort competition given that, according to Slovenia, the winter sports hardgood market is highly consolidated with a trend of further consolidation. and that *Elan* was only a weak competitor to much larger players in that market.

(52) Slovenia brings no arguments forward as regards potential compatibility of Measure 1 with the Internal market, if the measure involved state aid. In Slovenia's view, measure 2 could be considered compatible according to the Rescue and Restructuring Guidelines.

4.1. EXISTENCE OF STATE AID

4.1.1. **State resources and imputability**

(53) Slovenia brings forward that it had no influence in the increase of share capital of *Elan*.

(54) It recalls that in order to be considered state aid, measures must be granted directly or indirectly through state resources and that the measures must be imputable to the State. It agrees that if a Member State has a dominant influence over an undertaking, the condition of 'state resources' is fulfilled. However, it cannot be automatically presumed if a Member State is in a position to exercise dominant influence over an undertaking, that it actually exercised such influence in a particular case. In this context, Slovenia refers to the *Stardust Marine* judgment ([10]) that set out a set of indicators to determine whether the State actually exercised such influence in a particular case. These indicators include the integration into the structures of the public administration, the nature of a company's activities and the exercise of the latter on the market in normal conditions of competition with private operators, the legal status of the undertaking, the intensity of the supervision exercised by the public authorities over the management of the undertaking. Slovenia points out that appropriate weight shall be given to the fact whether an undertaking was established under private law.

(55) In this context, Slovenia brings forward arguments for each entity involved in the capital injections, as follows:

(56) *KAD* is a private law entity that operates on the market under competitive conditions. Although *KAD* is state controlled, it cannot be concluded on that basis alone that the recapitalisations under assessment are imputable to the State. State involvement in the recapitalisations has not been demonstrated for the following reasons: *KAD's* actions are regulated by the Slovenian Company Act ('*ZGD-1, Zakon o gospodarskih družbah*'); disposal of its assets is not restricted by law; *KAD* is financed exclusively from dividends, interest and other revenues generated by investments and business operations; and the recapitalisation of *Elan* was decided by the supervisory board, which is independent in its decision making. While it is true that *KAD* is entrusted by the State with managing pension funds and concluding privatisations of companies, the public interest lying in those tasks cannot influence measures taken by *KAD* in a way that those actions should be considered as imputable.

(57) *DSU* is directly owned by the State, but it is not financed by the State and it aims at maximising the value of its investments. While it is true that *DSU* is entrusted by the State with managing pension funds and concluding privatisations of companies, the public interest involved in those tasks cannot influence measures taken by *DSU* in a way that those actions should be considered as imputable to the State.

(58) *Zavarovalnica Triglav* is only indirectly owned by the State and its activities are exclusively market based. The State has no direct influence on its operations. It is true that the supervisory board members of *Zavarovalnica Triglav* are elected by its shareholders; they are, however elected as private individuals and none of them had any position in the Slovenian government or administration.

(59) *Triglav Naložbe* is indirectly owned by the State via *Zavarovalnica Triglav*. Its purpose is to generate profit. The State has no direct influence *on Triglav Naložbe's* operations and its supervisory board consists of independent private individuals. In addition, *Triglav Naložbe* financed the recapitalisation by way of a commercial loan.

4.1.2. **Existence of advantage**

Measure 1

(60) According to Slovenia, Measure 1 did not give an advantage to *Elan* for the following reasons: In December 2005, *Elan* adopted a Strategic development plan 2006-2010, including detailed development plans for *Elan*'s subsidiaries at that time. The development plan 2006-2010 foresaw investments in both the winter sport and the marine division. In order to implement those investments, in May 2006, *Elan* proposed to its shareholders to increase the capital of *Elan* in the years 2006-2009 by EUR 20,2 million. The shareholders prudently assessed this proposal and *Elan* provided them with documents clearly showing that such a capital increase would be profitable for the shareholders. KAD, *Elan's* majority shareholder made its own assessment of the proposed capital

([10]) Case C-482/99 French Republic/Commission (*Stardust Marine*) [2002] ECR I-4397.

increase in November 2006, concluding that the capital increase would be a sound investment. *Triglav Naložbe* also reviewed *Elan's* forecasts and agreed to the capital injection on this basis. In addition, *Elan's* shareholders required an independent valuation of the group, a task for which […] was selected (see recital (24)). This valuation showed that investments were necessary, and that the investment could in any event be recovered by selling shares at a fair value to a strategic partner.

(61) Based on the above mentioned considerations, *Elan* and its shareholders concluded a letter of intent in January 2007, agreeing that the shareholders would inject EUR 10,225 million in the company. Also KD Kapital, *Elan's* only private shareholder, entered into the letter of intent without any conditions. Slovenia considers that this decision was taken by the shareholders with a view to getting a reasonable return on their invested capital and that they hence acted in line with the market economy investor principle.

(62) As regards the fact that the shareholder assembly only agreed formally to inject the capital in October 2007, Slovenia explains that the delay was due to a dispute between *KD Kapital*, the private minority shareholder in *Elan*, and *KAD*, the majority shareholder in *Elan*. *KD Kapital* was a 50 % shareholder in one of *Elan's* competitors named *Seaway group d.o.o*. *KD Kapital* intended to install a representative of its interests in the supervisory board of *Elan*, which the other shareholders did not want to accept in light of KD Kapital's shareholding in a competitor. The dispute was resolved when KAD offered *KD Kapital* a put option. Following this solution, all of *Elan's* shareholders, including *KD Kapital*, agreed formally to inject EUR 10,225 million in *Elan*.

Measure 2

(63) According to Slovenia, in the beginning of 2008, *Elan* was close to insolvency. The supervisory board and the shareholders reacted immediately by appointing new members to the management board of *Elan*, who started negotiations with *Elan's* banks on debt rescheduling. The banks, however, asked for an additional capital injection by the shareholders. In light of this, *Elan*, together with the assistance of an external adviser, prepared a turnaround strategy in May 2008; in June 2008, the long-term plan 2008-2012 was set up by *Elan* and in August 2008, *Elan's* management adopted a Rehabilitation plan. On 11 July 2008, the shareholders agreed to increase the capital under the condition that the banks first agreed to a debt rescheduling in light of these documents. In addition, according to Slovenia, the shareholders took the value of the company into account, as determined by an equity valuation of *Elan* by an independent audit company [11]. According to that valuation, *Elan's* market value as at 31 December 2007 was EUR 38 059 000. In addition, the shareholders considered a flash estimate of the value of *Elan* dated 1 July 2008. On 28 August 2008, the shareholders decided finally to inject the capital without a prior agreement from the banks to a debt rescheduling. Slovenia argues that otherwise, the shareholders might have lost their entire investment in *Elan*. In light of the above, Slovenia considers that *Elan's* shareholders acted in line with the market economy investor principle.

4.1.3. **Distortion of competition and effect on trade**

(64) According to Slovenia, the measures could not distort competition and they had no effect on trade either. First, *Elan* was a weak competitor for much larger players in the ski market at the time when the capital injections were granted. Second, also *Elan's* competitors needed action by their private shareholders to recover from losses in the years 2007-2008.

4.2. COMPATIBILITY

(65) Slovenia only brings forward compatibility arguments as regards Measure 2. It argues that this Measure was compatible according to the Rescue and Restructuring Guidelines, as *Elan* prepared a viable restructuring plan, including improvements in the group mainly from internal measures.

(11) […]

(66) Indeed, Slovenia argues that following the capital increase in 2008, *Elan* duly exercised its plans and managed to reschedule its short term loans. In January 2009, redundancy plans were adopted and in October 2009, *Elan* sold its subsidiary *Elan Yachting d.o.o.* and *Elan Marine Charter d.o.o.* In April 2010, *Elan Brod d.o.o.*, located in Obrovac, Croatia, was sold. Overall, the proceeds from these divestitures amounted to EUR [3,1-3,6] million. In May 2010, *Elan* was able to get new financing by entering into a long-term loan agreement with its banks amounting to EUR [21,5-25,5] million]. The new loan was used to reimburse old loans. Finally, on 1 June 2010, *Elan Winter sport* and *Elan Marine* were merged into the parent company *Elan*. Slovenia has also alleged a compensatory effect of the termination of its North American ski distribution joint venture with Dal Bello Sports. [...] the parties agreed on 14 December 2009 to terminate their joint venture agreement. The Canadian Distribution Agreement was terminated as of 1 January 2010, the US Distribution Agreement was subsequently terminated as of 1 January 2011.

5. **ASSESSMENT**

(67) The Commission examines whether the beneficiary received state aid in the meaning of Article 107(1) of the TFEU (see below point 5.2), and if so, whether such aid might be compatible with the internal market (see below point 5.3). To do so, it is necessary to define since when the potential beneficiary has to be considered a company in difficulty (see below point 5.1).

5.1. COMPANY IN DIFFICULTY

(68) According to point 10 of the R&R guidelines, a company is in difficulty if more than half of its capital has been lost over the 12 preceding months, or if it meets the criteria for being subject to collective insolvency proceedings under national law. As also concluded by the opening decision, neither the subsidiaries nor the group as a whole fulfilled point 10 of the R&R guidelines in 2007.

(69) According to point 11 of the R&R guidelines, a firm may still be considered to be in difficulties, in particular where the usual signs of a firm being in difficulty are present, such as increasing losses, diminishing turnover, growing stock inventories, excess capacity, declining cash flow, mounting debt, rising interest charges and falling or nil net asset value.

(70) In this context, it has to be noted that in the period 2003-2006 the turnover of the group grew from EUR 109,2 million to EUR 122,4 million. Moreover, with the exception of the year 2004, *Elan* group recorded net profits during this period. *Elan's* financial situation began to deteriorate in the course of the year 2007. The group's turnover decreased in 2007 by EUR 5 million to EUR 117,5 million and dropped to EUR 100 million in 2008. At the same time *Elan* group's result turned negative in 2007, dropping from EUR 0,6 million in 2006 to EUR – 8,4 million in 2007 and EUR – 12,7 million in 2008.

Table 2

Key financial indicators for *Elan group*

Figures in thousand EUR	2003	2004	2005	2006	2007	2008
Net sales revenue	109 165	103 262	109 216	122 404	117 455	99 995
Operating costs	114 280	108 310	113 244	127 689	132 919	117 197
Net profit/losses	3 480	– 9 430	3 996	596	– 8 432	– 12 695

(71) This can partly be explained by the mild winter season of 2006-2007 (the 'green' winter) which hit sales of the winter sport division. In fact, sales of *Elan* Ski dropped from EUR 48,1 million in 2006 to EUR 40,8 million in 2007 and further declined to EUR 37,7 million in 2008. At the same time *Elan* Ski's result deteriorated from EUR – 0,5 million in 2006 to EUR – 6,7 million in 2007 and EUR – 13,0 million in 2008.

Table 3

***Elan* Ski**

Figures in thousand EUR	2006	2007	2008
Net sales revenue	48 113	40 852	37 662
Net profit/losses	– 472	– 6 674	– 12 971

(72) *Elan's* marine division increased its sales revenue considerably in 2007 from EUR 31,8 million to EUR 38,6 million, but recorded a slight loss of EUR 0,3 million. However, the situation deteriorated in 2008, when sales dropped by one third from EUR 38,6 million to EUR 25,9 million and *Elan Marine* suffered a net loss of EUR 10,2 million.

Table 4

***Elan* Marine**

Figures in thousand EUR	2006	2007	2008
Net sales revenue	31 836	38 627	25 876
Net profit/losses	1 176	– 305	– 10 214

(73) In light of the financial figures presented in tables 2 to 4, it is clear that *Elan* was not in difficulty at the beginning of the year 2007, when Measure 1 was granted (see recitals (78) to (85)).

(74) However, as evidenced by the above financial information, in the course of 2007 *Elan's* financial situation began to deteriorate and became very serious in 2008. The company was suffering diminishing turnover and increasing losses and it was facing insolvency in the beginning of 2008 (see recitals (29)-(34) and recital (63)). It can be concluded that *Elan* has to be considered to have been a firm in difficulty under the rescue and restructuring guidelines at the time of granting of Measure 2. In fact, *Elan's* shareholders' agreement to go ahead with the capital injection was motivated by the fact that *Elan* would otherwise have had to go into bankruptcy (see recital (31) to (33)).

5.2. EXISTENCE OF STATE AID

(75) Article 107(1) of the TFEU lays down that any aid granted by a Member State 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 and affects trade among Member States is incompatible with the Internal Market.

(76) The conditions laid down in Article 107(1) of the TFEU are cumulative and thus for a measure to be qualified as state aid all the conditions must be fulfilled simultaneously.

5.2.1. **The capital injection in 2007 (Measure 1)**

(77) Slovenia mainly argues that Measure 1 was granted in line with the market economy investor principle and that there is hence no advantage for the beneficiary. In addition, it brings forward that in any event, the capital injection was not imputable to the State (see recitals (53)-(63)).

Date of granting

(78) First, it has to be determined when exactly Measure 1 was granted to *Elan*. In principle, a state measure is in any event considered to be granted as soon as the Member State committed to it, i.e. once the Member State is legally

bound to provide the measure. As described above (see recital (24)), *Elan's* shareholders and *Elan* signed a letter of intent on 29 January 2007, but the capital increase was only formally confirmed at *Elan's* shareholder assembly in October 2007. It therefore has to be determined whether the letter of intent can already be considered binding upon the shareholders in a way that allows to conclude that Measure 1 can be considered to have been granted on the date when the letter of intent was signed.

(79) In this context, the Commission notes that, according to a legal expertise provided by Slovenia ([12]) Slovenian law does not specifically regulate the nature of a letter of intent. Such a letter of intent could either be a mere non-binding record of ongoing negotiations, a pre-contractual agreement or an agreement. The legal nature of a letter of intent has to be established on a case by case basis, taking into account the wording of the letter of intent, the circumstances under which it was signed and the general rules of interpretation according to Slovenian law.

(80) According to Article 15 of the Slovenian Code of Obligations ([13]), an agreement is binding when the parties agree on the main elements of the agreement. In particular, the parties to the agreement must be specified and each agreement must have a 'causa'.

(81) In this context, the Commission notes that according to the wording of the letter of intent, the parties to the agreement were clearly specified; the total amount of the capital increase was already laid down in the letter of intent (EUR 10,225 million); the maximum nominal amount of the new capital issued and the minimum price per new capital share was set; each signatory shareholder agreed to participate proportionally to its shareholding at that time; the purpose of the capital injection was specified (mainly investments in *Elan Winter sport* and *Elan Marine*) and a control mechanism to monitor the use of the capital was laid down. In addition, it has to be considered that the letter of intent was not only made between *Elan's* shareholders, but between the shareholders and *Elan*. The former should inject capital in *Elan*, whereas the latter should register the new shares and use the capital injection in the manner specified in the letter of intent. In light of this, the Commission considers that the parties agreed to all main elements necessary to enter a binding agreement.

(82) Also the wording of the letter of intent indicates that the parties entered a binding agreement: the shareholders and *Elan* 'confirmed their intent to increase the capital'; the shareholders 'will support the capital injection'; the new shares 'will be paid in cash'.

(83) Furthermore, immediately after the letter of intent was signed, *Elan* concluded a contract for the delivery of a new production line, which can also be seen as an indication that *Elan* expected the shareholders to inject the capital in the company.

(84) Finally, the legal expertise submitted by Slovenia comes to the conclusion that the letter of intent had binding effects once it was signed, i.e. that the shareholders were obliged to adopt the decision to inject the capital and to pay in the capital after such a decision was taken. According to this expertise, the question whether the obligation to vote for the capital increase is enforceable has not yet been decided by the Slovenian courts; a party breaching such an agreement would however normally be liable for damages.

(85) In light of the arguments presented above, the Commission concludes that the date of signing the letter of intent, which was 29 January 2007, can be considered the date of granting of Measure 1.

Selective advantage to the beneficiary

(86) To be considered state aid, a measure must be specific or selective in that it favours only certain undertakings or the production of certain goods.

([12]) Done by the law firm Jadek&Pensa, www.jadek-pensa.si/en, dated 16 April 2012.
([13]) 'Obligacijski zakonik', Official Gazette of Slovenia 83/2001 with amendments.

Beneficiary of the aid

(87) Article 107(1) TFEU refers to the concept of undertaking in defining the beneficiary of the aid. As confirmed by the Union Courts, an undertaking for the purposes of that provision does not have to be a single legal entity, but may encompass a group of companies [14]. The key criterion in determining whether there is an undertaking within the meaning of that provision is whether an 'economic unit' is involved. An economic unit may be composed of several legal persons. In the present case, *Elan* was the legal entity into which the capital was injected. At the time of granting, *Elan* had four subsidiaries, namely *Elan Winter sport*, *Elan Marine*, *Elan* Inventa d.o.o. and *Marine Nova* d.o.o. (see recital (6)). Following the capital injection, *Elan* provided shareholder loans to *Elan Winter sport* and *Elan Marine*. Those shareholder loans were at a later stage converted into equity in the subsidiaries. It has hence to be considered whether the group as such or only *Elan Winter sport* and *Elan Marine* respectively benefitted from the capital injection.

(88) First, in terms of ownership relations, it is noted that *Elan* held 100 % of the shares in both subsidiaries, that is to say *Elan Winter sport* and *Elan Marine*. *Elan* therefore controls all the business activities of those subsidiaries.

(89) Secondly, *Elan Winter sport* and *Elan Marine* undertook the main activities of *Elan* at the time of granting, which were the production of skis and snowboards as well as the production of yachts. The other subsidiaries were either not active on the market (*Marine Nova d.o.o.*) or were active to support *Elan's* main activities (*Elan* Inventa d.o.o.). In fact, when *Elan* was restructured, *Elan Winter sport* and *Elan Marine* were merged into the parent company *Elan*, another element that indicates that the group can be considered the beneficiary.

(90) In light of the arguments set out above it is concluded that the entire *Elan* group must be regarded as beneficiary of the capital increase. As a next step, it has to be assessed whether the measure confers an advantage to the beneficiary.

Advantage

(91) If a measure meets the requirements of the private market economy investor principle, the existence of an advantage can be ruled out. According to case law, a market investor would attempt to maximise the return on his assets in accordance with the circumstances and his interests, even in the case of an investment in an undertaking in which he already has a shareholding [15]. In the case at hand, it has to be assessed whether the beneficiary's shareholders acted according to this principle, basing their investment decision *ex-ante* on information which allowed concluding that the transaction made economic sense.

(92) In this context, the Commission takes note of the circumstances that led to the capital injection and the information on which the shareholders' decision was based. As described above, at the time of granting, *Elan* was not a company in difficulty within the meaning of the Rescue and Restructuring Guidelines (see recitals (68) to (73)). The decision to inject new capital into *Elan* was taken on the basis of a company evaluation from the independent consultancy […] and several other documents drawn up by *Elan* itself as well as KAD, *Elan's* majority shareholder. *Elan's* detailed analysis of the effects of a capital increase indicated that the investments would lead to a cumulative net profit for the winter sport division of EUR 15,4 million over the period 2006-2010, compared to cumulative net losses without the capital increase of EUR 4,8 million. Also the cumulative net profit of the marine division for the period 2006-2010 would be higher if the capital increase took place (see recital (23) to (24)).

(93) In light of the above, it is considered that *Elan's* shareholders acted in line with the market economy investor principle when injecting money in the company and that Measure 1 hence does not confer an advantage to the beneficiary. As the presence of state aid can already be ruled out on that basis, it is not assessed whether Measure 1 is imputable to the State. The Commission concludes that Measure 1 does not involve state aid.

(14) See ECJ 323/82 *Intermills/Commission* [1984] ECR 3809, paras. 11 et seq.
(15) Case T-228/99, *WestLB/Commission*, ECR 2003, II-435.

5.2.2. **The capital injection in 2008 (Measure 2)**

(94) As for Measure 1, Slovenia mainly argues that Measure 2 was granted in line with the market economy investor principle and that there is hence no advantage for the beneficiary. In addition, it brings forward that in any event, the capital injection was not imputable to the State (see recitals (53)-(63)). Finally, it considers that the measure did not have any effect on trade and that there was no distortion of competition (see recital (64)).

State resources and imputability

(95) In order to be considered aid in the sense of Article 107(1) of the TFEU, a measure must be granted directly or indirectly from state resources and it must be imputable to the State.

(96) According to case law, resources of an undertaking are to be considered state resources if the State is capable, by exercising its dominant influence over such undertakings, to direct the use of their resources ([16]).

(97) However, the ability of the State to control the entities involved in granting the measures does not justify automatically the presumption that the entities' actions are imputable to the State. The Court has further explained the notion of imputability in *Stardust Marine* ([17]). It provided the following indicators for establishing imputability: integration of the public undertaking into the structures of the public administration; the nature of its activities and the exercise of the latter on the market in normal conditions of competition with private operators; the legal status of the undertaking (in the sense of its being subject to public law or ordinary company law); the intensity of the supervision exercised by the public authorities over the management of the undertaking; any other indicator showing, in the particular case, an involvement by the public authorities in the adoption of a measure or the unlikelihood of their not being involved, having regard also to the compass of the measure, its content or the conditions which it contains.

(98) As described in recital (54), Slovenia refers to the *Stardust Marine* judgment and argues that its ownership of *KAD* and *DSU* does not automatically imply imputability of their actions to the State. As regards *Triglav Naložbe* and *Zavarovalnica Triglav*, Slovenia considers that those companies are not controlled by the State and that in any event, their actions are not imputable to the State either. In the context of imputability, Slovenia particularly points out that all shareholders of *Elan* are incorporated under private law, which in its view alone offers a satisfactory level of independence of those companies from the State.

(99) As a preliminary remark, the Commission points out that the fact that a state owned company is incorporated under private law alone is not enough to exclude imputability of its actions to the State. No distinction should be drawn between cases where aid is granted directly by the State and cases where it is granted by public or private bodies established or appointed by the State to administer the aid. In addition, as described above, the Court has held that there are several indicators for imputability, of which the question of whether a company is subject to private law or public law is only one (see recital (97)). Therefore, it has to be examined whether there are other facts indicating that measure 2 is imputable to the State.

(100) In this regard, the Commission notes that there are several indications that the state was actively involved in the shareholders' decision to inject additional capital in the beneficiary. Although Slovenia has dismissed media reports pointing out the State's role in having to save *Elan* as 'hearsay' or 'a result of an excessive simplification', such reports demonstrate the public perception of the governments industrial policy approach at the time. As further explained below, the perception that the Slovenian government pursued an active industrial policy approach at the time in question is indeed supported by the OECD's review of corporate governance in Slovenia, which also highlights that an action plan for corporate governance reform in Slovenia was only adopted by the

([16]) Case C-482/99 French Republic/Commission (*Stardust Marine*) [2002] ECR I-4397.
([17]) Case C-482/99 French Republic/Commission (*Stardust Marine*) [2002] ECR I-4397, paragraphs 50-59.

government. nearly one year after measure 2 was put into place, namely in mid-2009 [18]. Thus, in June 2008 when Elan's precarious situation was apparent to the outside world the media reported about the potential State support to Elan. A German sports magazine wrote on 6 June 2008 that according to rumours the government intended to inject EUR 5,7 million into Elan to compensate for the past bad winter season [19]. Also the Slovenian media discussed Elan's situation, pointing out the significance of State support to save jobs. For instance the biggest commercial (independent) television PopTV reported on their website on 26 June 2008 that the management and the supervisory board of Elan were looking for the solution to the company's financial difficulties to come from the State, pointing out that if the State didn't help with a financial injection, more than 700 jobs were in danger [20].

(101) As discussed in more detail below, the public authorities' involvement or the unlikelihood of their not being involved is most obvious in the case of *Elan's* biggest shareholder KAD (that controlled 57,61 % of *Elan's* shares at the time of the capital injection) and of DSU (then accounting for 17,34 % of *Elan's* shares). Even the independent consultancy […] drew attention to the importance of political considerations for *KAD's* and *DSU's* decision making in its valuation report of 22 December 2006 [21]. In the context of an analysis of a possible privatisation of *Elan* (at the time known as *Skimar d.o.o.*), […] concluded that two of its owners, *KAD* and *DSU*, were 100 % government controlled and that consequently there was a probability that their decision to sell would be politically as well as economically motivated.

(102) The Commission verifies on the level of each shareholder whether it was controlled by the State and whether the funds used for the capital injection can be considered state resources. In addition, the Commission determines whether the decision to inject capital into *Elan* is imputable to the State. In this context, the Commission pays particular attention to the composition of the supervisory board of each shareholder and whether the supervisory board had to agree to the capital injection into *Elan* in 2008. The Commission then examines additional elements indicating an involvement by the public authorities in the adoption of the measure or the unlikelihood of their not being involved

K A D

(103) The Commission notes that Slovenia held 100 % of the shares in *KAD*, the majority shareholder of *Elan* at the time of granting. The Slovenian government appointed all the members of the assembly of *KAD* as well as the supervisory board (see recital (11)). According to *KAD*'s articles of association, the latter has to consent to the conclusion of a transaction whose value exceeds 1 % of the share capital of *KAD*. The capital injection under assessment was qualified as such a transaction, and in fact, *KAD*'s supervisory board discussed and agreed to the capital injection into *Elan* in its 134th meeting on 10 July 2008 and its 135th meeting in August 2008 [22].

(104) As Slovenia owns *KAD*, it can be assumed that it is in a position to control the company and that in principle, *KAD*'s resources can be considered state resources. Contrary to Slovenia's view, the fact that the funds used for the capital injection stem from dividends, interests and other revenues of *KAD*, does not change this conclusion. Using dividends, interests or other revenues, which could instead have been paid to the State as controlling shareholder of the company, is a decrease of state resources and can therefore be considered the use of state resources [23].

(105) Concerning the imputability of Measure 2, the Commission considers that *KAD* would not have injected the capital in the absence of the public authorities' influence on its decision making. The strong State influence

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(18) OECD review: Corporate Governance in Slovenia, p. 9, 28/3/2011, at: http://www.oecd.org/document/58/0,3746,en_2649_34813_47492282_1_1_1_1,00.html

(19) 'Gerüchten zufolge will die Regierung für Verluste nach dem schlechten Winter Elan eine Finanzspritze von EUR 5,7 Mio Euro zukommen lassen.' Sport Artikel Zeitung 'SAZsport', dated 9 June 2008: 'Zweiter Abgang an der Spitze'.

(20) https://24ur.com/novice/gospodarstvo/kriticne-razmere-v-elanu_comment_p1_a19.html?&page=1&p_all_items=19

(21) […], A Valuation of the Skimar Group, 22 December 2006, p. 28.

(22) See the minutes of the meeting: '[…] grants its approval of the management board taking all necessary steps to protect and maximise the value of the investment of *KAD* in the company Skimar, d.o.o., including the recapitalisation of the company, proportionate with the participating interest of Kapitalska družba, d.d. and Prvi pokojninski sklad RS (First Pension Fund), which amounts in total to 57,606 % in a maximum amount of EUR 5 761 000,00.'

(23) In Case C-6/97 Italy/Commission [1999] ECR I-2981, recital (22), the General Advocate argued that 'the decisive criterion is not the form that the intervention takes, nor of course, its legal nature or the aim it pursues but the result to which it leads. Any intervention which gives rise to an economic advantage, accompanied by a correlative decrease in state resources … is in principle state aid for the purposes of Article [107] of the Treaty'.

cannot only be derived from the fact that Slovenia was the sole shareholder of *KAD* at the time, that all members of *KAD's* supervisory board were appointed by Slovenia, and that the supervisory board actually had to agree to the transaction. An additional indicator of the State's close involvement in *KAD's* decision-making is the fact that representatives of the Slovenian government take part in all assembly and supervisory board meetings (see recital (45)).

(106) The government's influence on the decision making of *KAD* (and of another state-controlled fund, the restitution fund *SOD*) for the purpose of pursuing industrial policy objectives is also highlighted in the OECD's review of Corporate Governance in Slovenia: 'The two funds have provided the Government with a strong mechanism to influence the boards and management of privatised firms and, ultimately, to play an active role in determining ownership changes. In part this appears (at least initially) to have been motivated by a desire to manage the extent to which foreign firms gained control over important domestic firms and industries. The extent of direct and indirect ownership has allowed past governments to exercise a very significant, and sometimes opaque, role in influencing the operation of large sectors of Slovenia's commercial enterprises and in the market for corporate control ([24]).'

(107) The Slovenian government's document 'Structural Adjustments 2010 and 2011' ([25]) further highlights the role that *KAD* and the state-controlled restitution fund *SOD* had played in serving Slovenia's industrial policy purposes, for instance in providing assistance to *Elan*. Under Heading 2.1.1. '*Establishment of a public agency for governance of state-owned enterprises and the transformation of KAD and SOD*' the document states: 'Restructuring means that KAD and SOD must be relieved of all strategic investments: … — bad investments that have become strategic because the state wishes to provide assistance to them in overcoming their difficulties (Mura, Elan).' The characterisation that *KAD's* investment in *Elan* had become strategic 'because the state wishes to provide assistance' to *Elan* is in sharp contrast with Slovenia's assertion that *KAD* was independent in its decision making (see recital (56)). The government document goes on explaining that the transfer of bad strategic investments from the parastate directly to the state was a personnel-related task above all and that the *PDP* restructuring company, established by *KAD* and *SOD*, had been transferred directly to state ownership as the team could no longer be part of *KAD* and *SOD* ([26]).

(108) The Commission invited Slovenia to provide comments on the documents cited above. Slovenia affirmed that there was no government decision regarding *Elan's* recapitalisation. Slovenia pointed out that the OECD review, which describes how KAD and SOD have provided the government with a strong mechanism to influence the boards and management of privatised firms, did not mention DSU, Zavarovalnica Triglav and Triglav Naložbe and that the Slovenian government's document did not mention any direct or indirect state influence with respect to the assets held by Zavarovalnica Triglav or Triglav Naložbe. Furthermore, Slovenia draws attention to a passage in the OECD review mentioning that 'the lack of central coordination has created difficulties for effective management of the Government's ownership interests'. It goes on explaining that KAD had always been under the responsibility of the Ministry of Finance, whereas the Ministry of Economy had been responsible for the manufacturing sector, to which Elan belongs. With regard to the Slovenian government's document referring to bad investments that had become strategic, Slovenia points out that Mura, the second example of such investments cited in the document besides Elan, had been left to bankruptcy procedures in October 2009.

(109) The comments provided by Slovenia do not disprove the arguments set out above indicating the involvement by the public authorities in the adoption of the measure or the unlikelihood of their not being involved. The statement that the government was not involved in the recapitalisation decision is a mere affirmation. The fact that the OECD review does not specifically mention DSU, Zavarovalnica Triglav and Triglav Naložbe and that it speaks of a lack of central coordination does not alter the overall picture painted in the OECD review, namely that the Slovenian government was actively intervening in the economy and pursuing industrial policy purposes.

([24]) OECD review: Corporate Governance in Slovenia, p. 9, 28/3/2011, at: http://www.oecd.org/document/58/0,3746,en_2649_34813_47492282_1_1_1_1,00.html

([25]) 'Structural Adjustments 2010 and 2011', Government of the Republic of Slovenia, October 2009, p. 12, at: http://www.svrez.gov.si/fileadmin/svez.gov.si/pageuploads/docs/strukturne_prilagoditve/Structural_adjustmements_SLO_EN.pdf

([26]) 'Structural Adjustments 2010 and 2011', Government of the Republic of Slovenia, October 2009, p. 13, at: http://www.svrez.gov.si/fileadmin/svez.gov.si/pageuploads/docs/strukturne_prilagoditve/Structural_adjustmements_SLO_EN.pdf

With regard to the companies not specifically mentioned in the OECD review and in the Slovenian government's document, Zavarovalnica Triglav and Triglav Naložbe, details of the control exercised by the State are provided below. At the same time it has to be kept in mind that these companies were minority shareholders that held only 25 % of *Elan* shares. Finally, with regard to the government's document, the fact that another company in difficulties considered a 'strategic investment' went into bankruptcy is irrelevant for the assessment of the present case.

(110) In the light of the above, it is concluded that *KAD's* capital injection in 2008 into *Elan* consists of state resources and is imputable to Slovenia.

K A D - P P S

(111) As described in recital (12), *KAD* is managing *PPS* and controls its shareholdings. Therefore, the participation of *KAD-PPS* in the capital injection should be considered in the same light as *KAD's* participation. In fact, the consent of the supervisory board of *KAD* to the capital injection in its 134th meeting on 10 July 2008 also included the consent to inject capital on the behalf of *PPS* ([27]). The same is true for the decision taken during the 135th meeting of *KAD*'s supervisory board in August 2008.

(112) Therefore, it is concluded that *KAD-PPS* capital injection into *Elan* in 2008 consists of state resources and is imputable to Slovenia.

D S U

(113) The Commission notes that *DSU* was 100 % directly state owned at the time of granting. Its supervisory council consists of three members, two of which are appointed by the shareholder, i.e. Slovenia (see recital (13)). At the time of the capital injections, also the third member had been appointed by the State. According to the Articles of Association, the supervisory council adopts decisions by a majority of votes and it is supervising the management of *DSU*'s business. In fact, *DSU*'s supervisory council studied and approved the capital injection into *Elan* at an extraordinary session on 11 July 2008 and partially amended its decision at two extraordinary sessions on 26 August 2008 and 8 September 2008 ([28]).

(114) As Slovenia owns *DSU*, it can be assumed that it is in a position to control the company and that in principle, *DSU*'s resources can be considered state resources. Contrary to Slovenia's view, the fact that the funds used for the capital injection stem from dividends, interests and other revenues of *DSU*, does not change this conclusion, as explained in recital (104).

(115) Concerning the imputability of Measure 2, it has to be taken into account that all three members of the supervisory council at the time of granting were appointed by Slovenia, the sole shareholder of *DSU*, and that the supervisory council actually had to agree to the transaction. As set out above, the influence of political considerations on *DSU's* decision making is acknowledged in […] valuation report of 22 December 2006 ([29]). Also the fact that together with *KAD* in 2010 *DSU* transferred its *Elan* shares to the *PDP* holding company has to be seen in the light of the explanations provided above concerning the question of how the Slovenian government decided to deal with parastate investments that had become strategic because the state wished to provide assistance to them in overcoming their difficulties. In connection with the other over-arching circumstances speaking in favour of the public authorities' involvement in the adoption of the measure or the unlikelihood of their not being involved, the Commission considers that *DSU* would not have injected the capital in the absence of the public authorities' influence on its decision making.

(116) Therefore, it is concluded that the *DSU* capital injection in 2008 into *Elan* consists of state resources and is imputable to Slovenia.

([27]) See footnote 22.
([28]) See minutes of the meeting of 8 September 2008: […].
([29]) […], A Valuation of the Skimar Group, 22 December 2006, p. 28.

Z a v a r o v a l n i c a T r i g l a v

(117) *Zavarovalnica Triglav* is not directly owned by Slovenia. The Commission observes, however, that Slovenia indirectly owns two third of *Zavarovalnica Triglav* (see recital (14)). Its majority shareholders are *ZIPZ*, the Pension and Disability Insurance Institute and *SOD*, the Slovenian indemnity corporation. Both are 100 % state owned. None of the other shareholders has a share higher than 1,8 % in *Zavarovalnica Triglav*.

(118) Five of the eight members of the supervisory board of *Zavarovalnica Triglav*, including its president and vice-president, represent the shareholders and are appointed by them. As described in recital (14), the majority shareholders of *Zavarovalnica Triglav* are 100 % state owned companies. Therefore, it is in principle the State who appoints these five members of the supervisory board and the supervisory board members represent the State's interest. The Commission notes that it was the management board of *Zavarovalnica Triglav* which voted for the capital increase in *Elan's* general assembly on 28 August 2008, but it did so under the condition that the supervisory board would give its consent to the transaction. In fact, the supervisory board agreed to the capital injection on 4 September 2008 ([30]).

(119) As Slovenia owned indirectly two third of the shares in *Zavarovalnica Triglav*, it can be assumed that it is in a position to control the company and that in principle, *Zavarovalnica Triglav's* resources can be considered state resources.

(120) Attention has to be given to the fact that the State appoints the majority of the supervisory board members of *Zavarovalnica Triglav*, including the president and the vice-president, and that the supervisory board had to give its consent to the capital injection.

(121) In connection with the other over-arching circumstances discussed above that clearly speak in favour of the public authorities' involvement in the adoption of the measure or the unlikelihood of their not being involved, the measure is considered imputable to Slovenia,

T r i g l a v N a l o ž b e

(122) *Triglav Naložbe* is not directly owned by Slovenia. The Commission observes, however, that Slovenia indirectly owns the majority of *Triglav Naložbe* shares. At the time of granting the measure, *Zavarovalnica Triglav* owned effectively 80 % of the shares of *Triglav Naložbe*. *Zavarovalnica Triglav* is in turn indirectly majority owned by Slovenia (see recital (14)). Therefore, indirectly, Slovenia holds more than 51 % of the shares of *Triglav Naložbe*. None of the other shareholders has a share higher than 0,67 % in the company.

(123) The three members of the supervisory board represent the shareholders interest and are elected by them. As the State indirectly is the majority shareholder in *Triglav Naložbe*, it has to be considered that the State can decide who is nominated into the supervisory board to represent Slovenia's interest. The supervisory board of *Triglav Naložbe* had to agree to the capital injection into *Elan*, and did so on its 7th extraordinary meeting on 3 September 2008 ([31]).

(124) As Slovenia indirectly owned the majority of *Triglav Naložbe*, it can be assumed that it was in a position to control the company and that in principle, *Triglav Naložbe's* resources can be considered state resources. Contrary to Slovenia's view, the fact that the funds used for the capital injection stem from a loan does not change this conclusion, as explained in recital (104).

([30]) See minutes of the meeting dated 4 September 2008 'The supervisory board consents to the participation of *Zavarovalnica Triglav*, d.d., in the capital increase of Skimar, d.o.o., in the amount of EUR 1 200 000,0 […]'.

([31]) See minutes of this meeting: 'the supervisory board studied the report on the investment in Skimar d.o.o. and the resolutions of the last general meeting on 28 August 2008 and supports the management board in its active participation in the recovery process of the company and therefore also the required recapitalisation with a total value of EUR 10 million, in proportionate shares […]'.

(125) Keeping in mind that the State appoints all the supervisory board members of *Triglav Naložbe* and that the supervisory board had to give its consent to the capital injection, in connection with the other over-arching circumstances discussed above that clearly speak in favour of the public authorities' involvement in the adoption of the measure or the unlikelihood of their not being involved, the measure is considered imputable to Slovenia

Conclusion

(126) The composition of the supervisory boards of *Elan's* shareholders and the fact that the supervisory boards had to agree to the capital injection in 2008 already suggest that the measure in question is imputable to the State ([32]).

(127) Furthermore, the Commission has strong indications — as set out above — for the State's close involvement in the decision-making of *KAD* — *Elan's* by far most important shareholder that controlled 57,61 % of the capital at the time of the capital injection — and *DSU*. These indications derive from the OECD report, the report of […], documents published by the Slovenian government, and press reports.

(128) In addition, the parallel behaviour of *Elan's* five shareholders that were all controlled by the State gives an indication of the State's involvement in the shareholders' decision, as it seems unlikely that five private and independent operators would have agreed to inject capital in a company in difficulty at the same time and at the same conditions.

(129) In light of the above it is concluded that Measure 2 consists of state resources and was imputable to Slovenia.

Selective advantage to the beneficiary

(130) To be considered state aid, a measure must be specific or selective in that it favours only certain undertakings or the production of certain goods.

(131) It is considered that the entire *Elan* group must be regarded as beneficiary of the capital increase in 2008 for the same reasons as for Measure 1 (see recitals (87)-(90)). As a next step, it has to be assessed whether the measure confers an advantage to the beneficiary.

(132) If a measure meets the requirements of the private market economy investor principle, the existence of an advantage can be ruled out. As described above, a market investor would attempt to maximise the return on its assets (see recital (91)).

(133) In this context, the Commission first notes that *Elan* was facing difficulties in the meaning of the Rescue and Restructuring Guidelines when Measure 2 was granted (see recital (74)). In addition, according to Slovenia, *Elan* was facing insolvency in the beginning of 2008, and had a liquidity shortfall of EUR [12,6-15 million].

(134) Slovenia argues that *Elan's* shareholders based their decision to inject additional capital on several documents drawn up by *Elan* and external advisers, showing that the decision was justified.

(135) While it is true that *Elan* drew up a long-term plan 2008-2012 for the group, it has to be considered that this plan foresaw a capital increase of EUR 25 million as a basis for achieving adequate returns in the future and *Elan's* shareholders considered this long-term plan as inadequate for carrying out a capital injection of that amount. The Rehabilitation plan of August 2008 consisted mainly of forecasts and did not provide information on the planned capital increase. Both, the long-term plan 2008-2012 and the Rehabilitation plan were set up by

([32]) Commission Decision 2008/948/EC of 23 July 2008 on measures by Germany to assist DHL and Leipzig Halle Airport C 48/06 (ex N 227/06) (OJ L 326, 23.12.2008, p. 1), recitals (184)-186, (226), (227); Commission Decision 17 June 2008 on Frankfurt-Hahn airport — Alleged State aid to the airport and the agreement with Ryanair, C 29/2008, (OJ C 12, 7.1.2009, p. 6), recitals (212)-(218).

Elan, without the involvement of an external adviser. Another document provided by Slovenia in relation to the second capital increase was a flash estimate of the value of *Elan*, prepared by KAD, dated July 2008. This document does, however, not support Slovenia's argument that *Elan's* shareholders acted like prudent investors, as according to that estimate, if potential liabilities are taken into account *Elan* had a negative equity value amounting to EUR [29,5-34] million in July 2008. Moreover, the flash estimates points out that the projections in *Elan's* long term plan 2008-2012 may be greatly overoptimistic in view of previous experiences, in which case the company's value would be even lower.

(136) Slovenia also submitted an equity valuation of *Elan* following the discounted cash flow method. This equity valuation, prepared by […]. in June 2008, considered that *Elan's* market value at 31 December 2007 had still been positive, amounting to EUR [35-40] million. However, as described above (see recitals (70) to (74)), *Elan's* situation deteriorated drastically in the course of the year 2008. In the light of these developments the above equity valuation has to be considered outdated on 28 August 2008 when *Elan's* shareholders decided on the capital injection and cannot be relied on to show that *Elan's* shareholders acted like prudent market investors, in particular when considering the circumstances of the second capital injection.

(137) As described in recital (32), the shareholders made any capital increase conditional on the prior agreement of the banks to reschedule *Elan's* existing loans. Although such an agreement could not be reached prior to the capital increase, *Elan's* shareholders went ahead with the capital injection as *Elan* would otherwise have had to go into bankruptcy.

(138) If the banks had agreed to reschedule the loans prior to the capital increase, this could have been a sign that they believed in a return to viability of *Elan*. However, this was not the case, and on the contrary, one of the banks even asked for a court order to enforce outstanding debts against *Elan*. The bank's stance can be considered a sign that the market did not believe in *Elan's* return to viability.

(139) Moreover, it also has to be taken into account that already in 2007 the shareholders had injected EUR 10,225 million in *Elan*, without success. It should be clarified that, although the 2007 capital injection was based on a so-called strategic development plan under which *Elan* had originally asked for investments of EUR 20,2 million, the 2008 capital injection of EUR 10 million cannot be considered a second investment tranche pursuant to the original strategic development plan. The 2008 capital injection was necessary to avoid insolvency by covering *Elan's* liquidity shortfall and losses incurred, the capital was not devoted to the purposes set out in the strategic development plan (see recital (23)).

(140) Finally, the Commission notes that all shareholders at the time of granting the measure were state owned, i.e. that no private shareholder took part in the capital increase.

(141) In light of the above, the Commission concludes that Measure 2 was not granted in conformity with the private market economy investor principle and conferred an advantage to *Elan*.

Distortion of competition and effect on trade

(142) The Commission notes that the beneficiary is active on markets that are open to competition. Any state grant provided to such an undertaking might provide it with an advantage over other competitors not receiving such grants. Contrary to Slovenia's view it is not relevant in this context whether *Elan's* competitors had a bigger market share than *Elan* or whether those competitors also received funds from their shareholders.

(143) When aid granted by a Member State strengthens the position of an undertaking compared to other undertakings competing in intra-Union trade, the latter must be regarded as affected by that aid ([33]). Indeed, there is trade between Member States in skiing equipment and marine oriented crafts, which are the goods that the beneficiary manufactures and markets.

([33]) See, in particular, Case 730/79 *Philip Morris v Commission* [1980] ECR 2671, para. 11; Case C-53/00 *Ferring* [2001] ECR I-9067, para. 21; Case C-372/97 *Italy v Commission* [2004] ECR I-3679, paragraph 44.

(144) In light of the above, the Commission concludes that Measure 2 might distort competition and might have an effect on trade.

5.2.3. **Conclusion on the existence of State aid**

(145) On account of the arguments above, the Commission concludes that Measure 2 involves state aid within the meaning of Article 107(1) of the TFEU to *Elan*. Slovenia did not respect the stand-still obligation under Article 108(3) of the TFEU.

5.3. COMPATIBILITY OF THE AID

(146) Articles 107(2) and 107(3) of the TFEU provide for exemptions to the general rule that state aid is incompatible with the internal market as stated in Article 107(1) of the TFEU.

(147) In this context, it must be noted that the burden of proof of the compatibility of aid with the Internal Market, by way of derogation from Article 107(1) TFEU is borne principally by the Member State concerned, which must show that the conditions for that derogation are satisfied ([34]).

(148) The Commission assesses the compatibility of Measure 2 under those exceptions. Given that the measure in question was granted to a company in difficulty (see above point 5.1), the Commission first assesses the compatibility of the measure under the Rescue and Restructuring Guidelines. Second, it is considered whether the measure could be considered compatible on any other basis.

5.3.1. **Rescue and Restructuring Guidelines**

(149) According to Point 33 of the Rescue and Restructuring Guidelines, only companies in difficulty are eligible for rescue and restructuring aid. *Elan* is eligible, as it can be considered to have been a company in difficulty at the time of the second capital injection (see recital (74)).

(150) According to the Rescue and Restructuring Guidelines, a **rescue aid** has to meet certain requirements, which are not all fulfilled by the measure at stake:

(a) First, the measure was not granted in the form of a loan or a guarantee, but as capital injection (Point 25(a) of the Rescue and Restructuring Guidelines).

(b) Secondly, the measure did not come to an end within a period of not more than six months after the disbursement of the first instalment (Point 25(a) Rescue and Restructuring Guidelines).

(c) Thirdly, Slovenia did not communicate within six months after the first implementation of the measure a restructuring plan or liquidation plan or proof that the guarantee had been terminated (Point 25(c) Rescue and Restructuring Guidelines).

(151) Hence, the capital injections in question cannot be considered as rescue aid.

(152) The measure does not meet all the requirements for **restructuring aid** set out in the Rescue and Restructuring Guidelines either, as no compensatory measures were provided that could have offset the adverse effect of the aid on trading conditions.

(153) According to Points 38 to 42 of the Rescue and Restructuring Guidelines, restructuring must be accompanied by compensatory measures in proportion to the distortive effects of the aid and, in particular, to the size and the

([34]) E.g. Case T-68/03, *Olympiaki Aeroporia Ypiresies AE v Commission* [2007] ECR II-02911, paras. 34-37.

relative importance of the beneficiary firm on its market. Point 40 of the Guidelines stipulates that compensatory measures should in particular take place in the market(s) where the firm will have a significant market position after restructuring. Slovenia claims that certain divestments carried out by *Elan* in 2009 and 2010 had a compensatory effect.

(154) With regard to Elan's winter sport division, Slovenia describes *Elan* as 'one of last stand-alone winter sports hard-good brands' and refers to it as 'only a week [sic] competitor to much larger players in the market ([35])'. The latter characterisation is, however, not in line with the description that *Elan's* current majority shareholder gives of the firm. *PDP* points out that in 2010 *Elan* sold 448 000 pairs of skis and 217 000 snowboards, that *Elan* represented 13 % of global ski production and that it was the 7th global ski brand with the market share of its brand accounting for approximately 8 % of the global market.

(155) Slovenia does not propose any specific definition of the product or geographical market(s), in which *Elan's* winter sport division is active. As detailed below, taking into account the information provided by Slovenia and keeping in mind considerations with respect to market definition from past merger practice ([36]), it has to be concluded that Elan did indeed hold considerable market shares at least in some of the relevant markets concerned.

(156) To assess the firm's relative importance in the markets in which it is active, the Commission has examined available evidence, including strategic documents drawn up by *Elan* itself. Besides accessories, Elan manufactures in particular alpine skis and snowboards. On the one hand these are sold as *Elan* branded products to retailers (hereinafter referred to as 'the retail market'); on the other hand Elan acts as a so-called original equipment manufacturer and supplies skis and snowboards to other (rival) manufacturers (hereinafter referred to as 'the OEM market'). It should be noted that in case No COMP/M.3765 — AMER SALOMON the Commission considered in December 2005 for the purposes of that decision, inter alia, separate product markets for different types of winter sports hard goods, incl. separate relevant product markets for alpine skis, for snowboards and for the OEM market for alpine skis. The retail markets for winter sports hard goods were considered national, whereas the OEM markets were considered at least EEA wide in scope ([37]). In its *Development Plan Elan Ski OEM 2006-2010* the firm indicates its global market share of the 2005 OEM production of skis as 21 % and explains '[…]' The firm's *Development Plan Elan Sportartikel 2006-2010* indicates that *Elan* considered itself the worldwide leading producer of snowboards with a production output of 268 000 in 2005, equalling a share of 16 %. The vast majority of this output concerns the OEM business, while 30 000 snowboards were sold in 2005 under the *Elan* brand. With regard to *Elan* brand skis the *Development Plan Market and brand focused penetration strategy Elan Brand 2006-2010* indicates a worldwide market share of 7,5 %, ranking *Elan* No 7 in terms of market share. However, the document highlights that the firm believed it could reach a position under the top 5 brands in the mid-term, explaining that […].

(157) As the winter sport division accounts for the by far biggest part of Elan's revenue and given Elan's strong position detailed above, at least in certain sectors of the winter sports business, compensatory measures should in particular have taken place in this area. Examining the elements indicated by Slovenia as compensatory measures taken in the winter sport division, the only divestment was the sale of a [17,5 %-20 %] share of the capital that *Elan* held in its distribution Joint Venture partner *Dal Bello Sports (hereinafter referred to as 'Dal Bello'*) in the US. Elan's divestment was the consequence of the termination of the marketing and distribution Joint Venture with *Dal Bello* in North America. *Elan* argues that the termination of the cooperation led to a decrease of *Elan's* sales in Canada and in the US and sees in this a 'compensatory effect'.

(158) It should first be noted that neither the long-term plan 2008-2012 nor the Rehabilitation Plan mention the sale of the *Dal Bello* shares, and the sale can therefore not be seen as 'an integral part of the restructuring', as foreseen in Point 40 of the Rescue and Restructuring Guidelines. Indeed, closer examination of the transaction reveals that the marketing and distribution cooperation was terminated at *Dal Bello's* initiative. Slovenia conceded that 'Elan's

([35]) Letter of Jadek & Pensa on behalf of Elan, dated 2/12/2012.

([36]) See case No COMP/M.3765 — AMER SALOMON, at: http://ec.europa.eu/competition/mergers/cases/decisions/m3765_20051012_20212_en.pdf

([37]) See footnote 36.

problems in 2008 and Dal Bello's search for a more reliable partner in a long term led to discussion on termination of otherwise successful cooperation. Such discussions resulted in 14 December 2009 Joint Venture Termination Agreement …' In the light of the above *Elan's* divestment can already for these reasons not be qualified as a compensatory measure.

(159) Moreover, while the reduction of sales, leading to a decrease in the beneficiary's market share, may in other circumstances constitute a compensatory measure, the Commission notes that in the case at hand, the transaction concerned the retail market, which was previously considered national by the Commission ([38]), and that *Elan's* sales of skis were in any case only reduced in the North American market, but not in the European market(s) and therefore cannot compensate the distortions created in the EEA. Besides, the Joint Venture was active in the marketing and distribution of skis, and not their manufacturing. Elan's core activity is, however, the manufacturing of skis and snowboards. Only divestitures in a beneficiary's main market can be considered as appropriate compensatory measures.

(160) Slovenia has also argued that the reduction of employees active in the production of skis and the decrease of its marketing investments could be considered as compensatory measures.

(161) However, as also evidenced by *Elan's* Long Term Plan and by its *Rehabilitation Plan*, these measures have to be seen as simple rationalisation measures aimed at cutting costs and increasing efficiency in order to regain financial viability. The measures were not taken in order to reduce *Elan's* market presence or to offset any distortions of competition resulting from the aid received by *Elan*.

(162) In the marine sector, Slovenia argues that the following divestments had a compensatory effect: In 2009 *Elan* sold two companies involved in yacht chartering, *Elan Yachting d.o.o.* and *Elan Marine Charter d.o.o.* In 2010 *Elan Brod d.o.o.*, a company located in Croatia that was primarily involved in the production of motor boats, was sold. Slovenia asserts that the companies were not structurally loss making, that the charter activities carried out by *Elan Yachting d.o.o.* and *Elan Marine Charter d.o.o.* were supporting the penetration of *Elan's* yachts to *Elan's* main markets and that the withdrawal from the motor boat market segment substantially reduced *Elan's* market presence in the pleasure and sporting boat market.

(163) The Commission recalls that, according to Point 40 of the Rescue and Restructuring Guidelines, the compensatory measures should take place in particular in the market(s) where the firm will have a significant market position after restructuring. Write-offs and closure of loss-making activities which would at any rate be necessary to restore viability are not considered reduction of capacity for the purpose of the assessment of the compensatory measures.

(164) It needs to be kept in mind that the marine business does not constitute *Elan's* main activity. The company generates a considerably higher share of its turnover in the winter sport division. According to the financial forecast for 2011, the total revenue of the marine division was expected to reach only EUR [20-24] million, compared to EUR [58-68] million in the winter sport division. Moreover, the winter sport division also received the bigger part (EUR 5,924 million) of the EUR 10 million capital injection into *Elan*. In the light of Point 40 of the Rescue and Restructuring Guidelines it appears doubtful, if divestments in the marine division could at all be considered appropriate compensatory measures since, as also further detailed below, the marine business is not the market where the firm has the most significant market position after restructuring.

(165) In order to fully appreciate the arguments presented by Slovenia the Commission has nevertheless examined to which extent Slovenia could argue that appropriate compensatory measures were taken in the marine business. Before the restructuring *Elan's* maximum production capacity amounted to [280-330] sailing boats and [45-55] motor boats. Slovenia does not propose any specific definition of the marine product or geographic market(s), in

([38]) See footnote 36.

which its relative importance could be measured. In its submissions it speaks of a reduction of *Elan's* presence in the 'pleasure and sporting boat market', at the same time referring to its withdrawal from the 'motor boat market segment'.

(166) However, the analysis of available documents, including strategic documents drawn up by Elan itself, dealing with the competitive position of *Elan's* marine division provide further insights into the relative importance of the firm on the marine market. The *Development Plan Elan Marine Division 2006-2010* stated that the world market of all new boats was about EUR 25 billion, of which 80 % were power boats and 20 % sailing boats with the same ratio applying to Europe. *Elan* described the market as 'highly fragmented' and put the EU market share of its sail program at approximately [0-5] %, of its motor boat program at << 1 %. The Development Plan did, however, point to the existence of different market segments characterised by different competitive conditions, including entry barriers. *Elan's Long Term Plan of the Skimar Group 2008-2012* of June 2008 provided for a segmentation of the boat market by boat length and stated that competition was stiffest in the segment of small vessels (30 feet), whereas *Elan* manufactured and sold medium-category products of 30 to 50 feet in length and intended to develop new models […]. The clearest statement on *Elan's* market share in the segment in which it sees itself competing comes from a presentation of *Elan's* current majority shareholder *PDP* stating: 'In 2010 *Elan*, in a segment of sailing boats between 32 and 60 ft (that represents 20 % of the nautical market) sold 122 boats, getting a 5,2 % market share.' It appears plausible that market segmentation uses criteria such as type of power (sail, motor) and size as a starting point. In the absence of an opposing view, for the purpose of this decision the Commission can accept *PDP's* assessment that *Elan* held a market share of > 5 % in the fragmented sailing boat market.

(167) Based on the above, even if *Elan's* divestments in the marine division could be taken into account for the purpose of the Commission's compatibility assessment, within the marine sector any compensatory measures would have had to take place in the manufacturing of sailing boats, which was clearly the main activity of *Elan's* marine division and where, as discussed, the firm had a non-negligible share of the, according to *Elan*,'highly fragmented market'. The divestment of the charter activities that were at most indirectly supporting *Elan's* sales of yachts, and the divestment of the motor boat production, a sector which *Elan* exited through the sale of *Elan Brod d.o.o.* altogether, are therefore not in line with Point 40 of the Rescue and Restructuring Guidelines. As far as motor boats are concerned, *Elan* only started producing such boats in the year 2002, intending to use the reputation gained in the sailing boat sector also for production of motor boats. However, sales peaked at 50 motor boats in 2006 and 2007 and then decreased to [25-29] boats in 2008 and only [7-9] boats in 2009.

(168) Also Submissions from Slovenia highlight the fact that Elan's shareholders and the banks considered the divested activities to be non-core activities ([39]). It should also be noted that the sale of *Elan's* subsidiaries was not meant to offset any distortions of competition. All three subsidiaries were loss making at the time of the sale as well as in the years prior to the sale. Slovenia informed the Commission that the total (combined) net result of *Elan Yachting d.o.o.* and *Elan Marine Charter d.o.o.* was EUR – 157 000 in 2007, EUR – 100 000 in 2008 and EUR – 57 000 in 2009. Also *Elan Brod d.o.o.* recorded losses during the entire period, namely EUR – 58 000 in the year 2006, EUR – 436 000 in 2007, EUR – 1 million in 2008 and EUR – 1,5 million in 2009. In the light of these numbers Slovenia's statement that the companies were not structurally loss making appears to be a merely self-serving assertion. As set out above, pursuant to the Rescue and Restructuring Guidelines write-offs and closure of loss-making activities which would at any rate be necessary to restore viability are not considered reduction of capacity for the purpose of the assessment of the compensatory measures. The high losses recorded by the three marine subsidiaries sold and the severe continuous downward trend of *Elan Brod d.o.o.* however highlight that the divestments were indeed at any rate necessary to restore viability and can also for this reason not be considered to qualify as compensatory measures.

(169) The Commission therefore concludes that *Elan's* divestments and its reduction of employees and of its marketing expenditure cannot be qualified as compensatory measures. Since no appropriate compensatory measures were implemented, even taking into account Point 56 of the Rescue and Restructuring Guidelines, which stipulates

([39]) See submission from Slovenia, dated 10 October 2011, containing a letter from *KAD*, referring to the sell-off of companies in the marine division 'not considered as core business', or letter from the law firm Jadek & Pensa, acting on behalf of Elan, dated 26 April 2012, explaining that banks required the sale of non-core assets in Croatia for their entering into refinancing agreements.

that the conditions for authorising aid may be less stringent in assisted areas as regards the implementation of compensatory measures, the Commission has to conclude that the requirement of the Rescue and Restructuring Guidelines are not met with regard to the necessity to implement appropriate compensatory measures. As the requirements for compatible restructuring aid laid down in the Guidelines are cumulative, it is sufficient to exclude the applicability of the Guidelines if only one requirement is not met. The Commission does therefore not further assess whether the other requirements are met. In light of the above, it is concluded that Measure 2 cannot be considered compatible according to the Rescue and Restructuring Guidelines.

5.3.2. **Compatibility on another basis**

(170) The exemptions in Article 107(2) of the TFEU do not apply in the present case because this measure does not have a social character, has not been awarded to individual consumers, is not designed to make good damage caused by natural disasters or exceptional occurrences and has not been awarded to the economy of certain areas of the Federal Republic of Germany affected by the division of that country.

(171) Further exemptions are set out in Article 107(3) TFEU.

(172) Article 107(3)(a) of the TFEU states that 'aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment' may be declared compatible with the internal market. *Elan* is located in a region eligible for aid under Article 107(3)(a) of the TFEU ([40]). Compatibility of state aid to assisted areas is regulated by the Regional Aid Guidelines ([41]). Under the Regional Aid Guidelines, State aid can in principle only be granted to companies that are not in difficulty. *Elan* was however in difficulties at the time the measure was granted (see recital (74)). Therefore, Measure 2 cannot be considered as compatible regional aid.

(173) In view of the above, the Commission concludes that the aid is not eligible for the derogation provided for in Article 107(3)(a) of the TFEU.

(174) Article 107(3)(b) of the TFEU states that 'aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State' may be declared compatible with the internal market.

(175) The Commission notes that the aid in question was not designed to promote the execution of an important project of common European interest nor has the Commission found any evidence that it was designed to remedy a serious disturbance in the Slovenian economy.

(176) In view of the above, the Commission concludes that the aid does not qualify for the derogation set out in Article 107(3)(b) of the TFEU.

(177) Article 107(3)(d) of the TFEU states that aid to promote culture and heritage conservation may be declared compatible with the TFEU where such aid does not affect trading conditions and competition in the EU to an extent that is contrary to the common interest. This Article obviously does not apply to the current case.

(178) Article 107(3)(c) of the TFEU provides for the authorisation of state aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest. The Commission has developed several guidelines and communications that explain how it will apply the derogation contained in this Article. Given that the measures in question

([40]) Regional aid map of Slovenia approved by the Commission on 13 September 2006 and published in OJ C 256, 24.10.2006, p. 6.
([41]) OJ C 54, 4.3.2006, p. 13.

were granted to a company in difficulty, the Commission only assessed the compatibility of the measure under the Rescue and Restructuring Guidelines. None of the other guidelines and communications are applicable to the measure under assessment.

(179) Therefore, the aid under assessment constitutes incompatible state aid.

6. **RECOVERY**

(180) According to the TFEU and the Court of Justice's established case-law, the Commission is competent to decide that the state concerned must abolish or alter aid ([42]) when it has found that it is incompatible with the internal market. The Court has also consistently held that the obligation on a state to abolish aid regarded by the Commission as being incompatible with the internal market is designed to re-establish the previously existing situation ([43]). In this context, the Court has established that this objective is attained once the recipient has repaid the amounts granted by way of unlawful aid, thus forfeiting the advantage which it had enjoyed over its competitors on the market, and the situation prior to the payment of the aid is restored ([44]).

(181) Following the case-law, Article 14 of the Procedural Regulation laid down that '*where negative decisions are taken in respect of unlawful aid, the Commission shall decide that the Member State concerned shall take all necessary measures to recover the aid from the beneficiary.*'

(182) Thus, given that the measure at hand is to be considered as unlawful and incompatible aid, the aid must be recovered in order to re-establish the situation that existed on the market prior to the granting of the aid. Recovery shall hence cover the time from when the advantage occurred to the beneficiary, that is to say when the aid was put at the disposal of the beneficiary until effective recovery and shall bear recovery interest until effective recovery.

(183) The capital injection in 2008 needs to be recovered in its totality as the decisions of all five entities taking part in the operation are imputable to the State. The total amount of the capital injection was EUR 10 million, of which EUR 5,924 million were injected into *Elan Winter sport* and EUR 4,076 million into *Elan Marine*. Those two companies, were however, in June 2010 merged into their parent company *Elan*. The date from when the recovery interest has to be calculated is the date when the capital was actually put at the disposal of the beneficiary, which was 8 September 2008.

7. **CONCLUSION**

(184) The capital injection in favour of *Elan* decided in January 2007 (Measure 1) does not involve state aid, as the shareholders decision was in line with the market economy investor principle.

(185) The capital injection in favour of *Elan* decided in August 2008 (Measure 2) involves state aid. The state aid is not compatible with the internal market. It does not meet the requirements of the Rescue and Restructuring Guidelines. None of the provisions of Article 107(2) and (3) of the TFEU is met either. Therefore, the capital injection of EUR 10 million has to be recovered from *Elan* together with the recovery interests.

HAS ADOPTED THIS DECISION:

Article 1

The capital injection of January 2007 does not constitute aid within the meaning of Article 107(1) of the Treaty on the Functioning of the European Union.

([42]) See Case C-70/72 *Commission v Germany* [1973] ECR 00813, paragraph 13.
([43]) See Joined Cases C-278/92, C-279/92 and C-280/92 *Spain v Commission* [1994] ECR I-4103, paragraph 75.
([44]) See Case C-75/97 *Belgium v Commission* [1999] ECR I-030671 paragraphs 64-65.

Article 2

The state aid measure in favour of *Elan* in the form of a capital increase of EUR 10 million in 2008 was unlawfully put into effect by Slovenia in breach of Article 108(3) of the Treaty on the Functioning of the European Union and is incompatible with the internal market.

Article 3

1. Slovenia shall recover the aid referred to in Article 2 from the beneficiary *Elan*.

2. The sum to be recovered shall bear interest from the date on which it was put at the disposal of the beneficiary (8 September 2008) until its actual recovery.

3. The interest shall be calculated on a compound basis in accordance with Chapter V of Commission Regulation (EC) No 794/2004 ([45]).

4. Slovenia shall cancel all outstanding payments of the aid referred to in Article 2 with effect from the date of adoption of this Decision.

Article 4

1. Recovery of the aid referred to in Article 2 shall be immediate and effective.

2. Slovenia shall ensure that this decision is implemented within four months following the date of notification of this Decision.

Article 5

1. Within two months following notification of this Decision, Slovenia shall submit the following information to the Commission:

(a) the total amount (principal and recovery interests) to be recovered from the beneficiary;

(b) a detailed description of the measures already taken and planned to comply with this Decision;

(c) documents demonstrating that the beneficiary has been ordered to repay the aid.

2. Slovenia shall keep the Commission informed of the progress of the national measures taken to implement this Decision until recovery of the aid referred to in Article 2 has been completed. It shall immediately submit, on simple request by the Commission, information on the measures already taken and planned to comply with this Decision. It shall also provide detailed information concerning the amounts of aid and recovery interest already recovered from the beneficiary

Article 6

This Decision is addressed to the Republic of Slovenia.

Done at Brussels, 19 September 2012.

For the Commission

Joaquín ALMUNIA

Vice-President

([45]) OJ L 140, 30.4.2004, p. 1.

COMMISSION DECISION

of 20 March 2013

on State Aid No SA.23420 (11/C, ex NN40/10) implemented by Belgium for SA Ducroire/Delcredere NV

(notified under document C(2013) 1497)

(Only the Dutch and French texts are authentic)

(Text with EEA relevance)

(2014/274/EU)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union, and in particular the first subparagraph of Article 108(2) thereof ([1]),

Having regard to the Agreement on the European Economic Area, and in particular Article 62(1)(a) thereof,

Having called on interested parties to submit their comments pursuant to the above Articles ([2]),

Whereas:

I. PROCEDURE

(1) On 5 June 2007, [the complainant] (*) filed a complaint with the European Commission concerning the initial capital injection of EUR 150 million granted to the company SA Ducroire/Delcredere NV (hereinafter: 'Ducroire/Delcredere') when it was established in September 2004 by the Office National du Ducroire (hereinafter: 'the ONDD').

(2) By letter dated 7 December 2007, the Commission put detailed questions to the Belgian authorities. The Commission received the replies to these questions, which were accompanied by numerous documents and a business plan, on 12 February 2008.

(3) A meeting between the complainant and the Commission took place on 9 September 2008.

(4) The Commission sent the Belgian authorities a non-confidential version of the complaint on 4 December 2008.

(5) A non-confidential version of Belgium's observations and specific questions were sent to the complainant on 12 and 17 December 2008. The complainant replied by letter dated 6 November 2009.

(6) Additional questions were put to Belgium on 21 April 2010, to which Belgium replied on 23 July 2010.

(7) On 23 February 2011, the Commission decided to initiate the formal investigation procedure laid down in Article 108(2) of the Treaty on the Functioning of the European Union (hereinafter: 'TFEU') ([3]) into the following possible aid measures: (i) the Belgian State's guarantee to the ONDD in respect of its marketable risks; (ii) one or more internal transfers of resources for the benefit of the insurance of marketable risks, and (iii) the capital provided by the ONDD for the benefit of the insurance of marketable risks by Ducroire/Delcredere. The Commission invited interested parties to submit their comments on the measures in question.

([1]) With effect from 1 December 2009, Articles 87 and 88 of the EC Treaty have become Articles 107 and 108, respectively, of the Treaty on the Functioning of the European Union ('TFEU'). The two sets of provisions are, in substance, identical. For the purposes of this Decision, references to Articles 107 and 108 of the TFEU should be understood as references to Articles 87 and 88 respectively of the EC Treaty, where appropriate. The TFEU also introduced certain changes in terminology, such as the replacement of 'Community' by 'Union', 'common market' by 'internal market' and 'Court of First Instance' by 'General Court'. The terminology of the TFEU is used throughout this Decision.

([2]) OJ C 163, 1.6.2011, p. 1.

(*) Confidential information.

([3]) OJ C 163, 1.6.2011, p. 1.

(8) Two meetings between the Belgian authorities, the ONDD, Ducroire/Delcredere and the Commission were held on 17 March 2011 and 28 April 2011 respectively.

(9) On 4 May 2011, the Belgian authorities requested a four-week extension of the deadline for responding to the decision to open the formal investigation procedure (hereinafter: 'the opening decision'). On 5 May 2011, the Commission informed the Belgian authorities that it did not have any objections to the request for a deadline extension and asked for additional information relating to the meeting on 28 April 2011.

(10) On 1 June 2011, the Belgian authorities submitted their response to the observations and questions set out by the Commission in the opening decision. The annexes to their response were received on 9 and 10 June 2011.

(11) In the light of the response, on 27 July 2011 the Commission asked for further information.

(12) In order to prepare their response to the Commission's questions, the Belgian authorities held two technical meetings with the Commission and the aid beneficiary on 26 September and 18 October 2011 respectively. On 14 November 2011, Belgium provided additional information concerning the subjects discussed at those meetings.

(13) On 5 December 2011, the Belgian authorities sent their response to the questions from the Commission dated 27 July 2011.

(14) On 23 April 2012, the Commission asked for a number of clarifications on the information provided, which the Belgian authorities supplied on 16 May 2012.

(15) A meeting between the Belgian authorities, the ONDD, Ducroire/Delcredere and the Commission was held on 21 May 2012, following which the Belgian authorities provided further explanations by letter dated 31 May 2012. By letter dated 14 June 2012, the Belgian authorities reiterated their position concerning the capital allocation measure contested by the Commission.

II. **DETAILED DESCRIPTION OF THE AID**

II.1. THE BENEFICIARY AND ITS ACTIVITIES

(16) The ONDD is an 'autonomous public institution' operating in the credit insurance market and guaranteed by the Belgian State.

(17) Until 31 August 2013, all the insurance business transacted by the ONDD was for its own account, with the guarantee of the State. There were no separate accounts for short-term and long-term credit insurance, or for marketable and non-marketable risks. The Commission communication to the Member States pursuant to Article 93(1) of the EC Treaty applying Articles 92 and 93 of the Treaty to short-term export-credit insurance (hereinafter: 'the Communication on export-credit insurance') ([4]) defines as 'marketable' commercial and political risks of less than two years' duration on debtors ([5]) established in one of the EU Member States or in certain OECD member countries, namely Australia, Canada, Iceland, Japan, New Zealand, Norway, Switzerland and the United States of America ([6]).

(18) On 1 September 2003, the ONDD set up a 'commercial' account which, according to the Belgian authorities, was not guaranteed by the State, and which, from that date, was used for all insurance business relating to short-term risks. At the time, capital of EUR [45-70] million was allocated to this commercial account, which allowed authorisation to be obtained from the national insurance regulator, the Office de Contrôle des Assurances (hereinafter: 'the OCA'). Within this commercial account, there were no separate accounts for marketable and non-marketable risks.

([4]) OJ C 281, 17.9.1997, p. 4. With effect from 1 January 2013, the Commission has been applying the new Communication to the Member States on the application of Article 107 and 108 of the Treaty on the Functioning of the European Union to short-term export-credit insurance, which was published on 19 December 2012 (OJ C 392, 19.12.2012, p. 1).

([5]) Whether public or non-public.

([6]) See point 2.5 of the Communication on export-credit insurance.

(19) In May 2004 the ONDD decided to transfer its existing short-term credit insurance business to a subsidiary by setting up Ducroire/Delcredere. The Belgian authorities maintain that the decision to set up Ducroire/Delcredere was taken in order to comply with the Communication on export-credit insurance, which calls on the Member States to amend their export-credit insurance systems so that export-credit insurers no longer receive state support for risks defined as 'marketable'.

(20) The decision to set up Ducroire/Delcredere and to allocate it EUR 150 million in capital was taken by the Board of Directors on 11 May 2004 on the basis of a business plan for 2005-07 drawn up by the ONDD, which envisaged two scenarios: scenario (A), termed 'realistic', based on the economic situation and assuming 3 % growth in sums insured, and scenario (B), termed 'dynamic', based on a proactive approach in terms of winning markets and assuming twice the rate of growth under the realistic scenario, i.e. 6 % ([7]).

(21) Ducroire/Delcredere was set up on 23 September 2004, on which date the ONDD subscribed EUR 150 million to the company's capital, of which EUR 100 million was paid up immediately, while the remaining EUR 50 million was paid up in 2009.

(22) On 1 January 2005, the ONDD transferred its portfolio of short-term risks to Ducroire/Delcredere, which began its activities on that date. The ONDD continues to manage the long-term risks.

(23) Ducroire/Delcredere therefore manages all the marketable risks within the meaning of the Communication on export-credit insurance (which, by definition, are short term), and the non-marketable short-term risks, such as the risks of less than two years' duration on debtors established outside the OECD.

(24) In 2007 Ducroire/Delcredere acquired 33 % of the capital in Komerčni úvěrová pojišťovna EGAP (KUP) (the commercial arm of the Czech national agency for export-credit insurance) for EUR [12-14] million. This acquisition was made jointly with SACE BT, which had also acquired 33 % of KUP's capital. In 2009 Ducroire/Delcredere bought all of SACE BT's shareholding in the capital of KUP for EUR [0-20] million. Ducroire/Delcredere therefore acquired 66 % of the capital in KUP for a total of EUR [10-35] million. EUR 12 million of the latter amount was then written off as a loss on the shareholding (negative adjustment to the value of the investment).

II.2. THE COMPLAINT

(25) On 5 June 2007, a complaint was made to the Commission. The complainant alleges that the ONDD made the capital allocation on terms that a market economy investor would have found unacceptable. First, Ducroire/Delcredere's profitability anticipated at the time of the capital contribution was said to be lower than would be expected by a private investor. Second, the capital allocated to Ducroire/Delcredere was said to exceed the capital required, both in terms of the prudential rules on minimum adequate own funds and in relation to the average solvency ratio (net premiums/own funds) of the other operators in the sector. According to the complainant, it was solely thanks to their 'over-capitalisation' in 2004 that Ducroire/Delcredere and SACE BT had been able, during the second half of 2006, to table a joint offer to buy 66 % of KUP's shares that was 'impossible to match'.

II.3. GROUNDS FOR INITIATING THE PROCEDURE

(26) The investigation opened on 23 February 2011 concerns the following measures:

(a) The Belgian State's alleged guarantee to the ONDD in relation to its marketable risks (hereinafter: 'Measure 1');

(b) Possible internal transfers of resources (within the ONDD) from its insurance of non-marketable risks to its insurance of marketable risks (before the transfer of its insurance of short-term risks to Ducroire/Delcredere) (hereinafter: 'Measure 2');

([7]) See pages 60 and 69 of Annex 8 to the 'Observations by Belgium on the Decision by the European Commission of 24 February 2011', submitted by the Belgian authorities on 1 June 2011.

When the ONDD insured marketable risks, it had no separate management and accounts for (short-term) marketable and non-marketable risk insurance, contrary to the requirement in point 4.3 of the Communication on export-credit insurance. However, that point states that publicly supported export-credit insurers 'have to keep a separate administration and separate accounts for their insurance of marketable risks and non-marketable risks for the account or with the guarantee of the State, demonstrating that they do not enjoy State aid in their insurance of marketable risks'.

(c) The capital allocation (EUR 150 million of subscribed capital) by the ONDD in 2004 to its subsidiary, Ducroire/Delcredere (hereinafter: 'Measure 3').

(27) With regard to Measure 3, the opening decision came to the conclusion that the following parts of the capital allocation to Ducroire/Delcredere do not constitute aid [8]:

(a) the part of Ducroire/Delcredere's initial capital that can be regarded as supporting the insurance of non-marketable risks [9] does not constitute aid. Under the Communication on export-credit insurance, Member States are free to support export-credit insurance in the non-marketable risks sector. Since this activity is not supposed to be provided by market operators, state support is not likely to distort competition and cannot, therefore, constitute state aid within the meaning of Article 107(1) TFEU. The Commission therefore called on Belgium to clarify which part of Ducroire/Delcredere's capital supported its insurance of non-marketable risks.

(b) the part of Ducroire/Delcredere's capital that was already supporting the insurance of marketable risks within the ONDD and which was simply transferred to Ducroire/Delcredere with the corresponding insurance business does not constitute aid. It was solely a change in the legal form of an existing economic activity with the associated capital [10].

(28) The possible new aid in question (Measure 3) therefore concerns only that part of the capital allocated to Ducroire/Delcredere that does not support export-credit insurance of non-marketable risks and that exceeds the part of the capital that was already supporting the insurance of marketable risks within the ONDD on 31 December 2004 (just before the insurance of short-term risks was transferred to Ducroire/Delcredere).

(29) For the purposes of this Decision, the following definitions apply:

(a) '*additional capital*': the part of the capital allocated to Ducroire/Delcredere that exceeds the part of the capital that was already supporting the insurance of short-term risks (including marketable and non-marketable risks) within the ONDD on 31 December 2004 (just before the insurance of short-term risks was transferred to Ducroire/Delcredere);

(b) '*supplementary capital*': the part of the additional capital, as defined above, that supports the credit insurance of marketable risks (i.e. the capital allocated to Ducroire/Delcredere that supports the credit insurance of marketable risks and that exceeds the part of the capital that was already supporting the insurance of short-term risks within the ONDD on 31 December 2004).

(30) The additional capital therefore includes, inter alia, the supplementary capital (see the diagram in recital (141)).

(31) In the opening decision, the Commission assumed that there was substantial additional and supplementary capital, given the disproportion between the capital of EUR 150 million granted to Ducroire/Delcredere when it was set up and the EUR [45-70] million allocated within the ONDD to the commercial account used, from 1 September 2003 to 31 December 2004, for the insurance of short-term risks, including marketable risks. The Commission therefore stated that there appeared to be additional and supplementary capital and that the expected profitability seemed insufficient.

(8) See section 4.1.2.2.1 of the opening decision.

(9) This excluded capital, relating to non-marketable risks, includes the capital of Ducroire/Delcredere which, when the insurance of short-term risks was transferred to Ducroire/Delcredere, supported the insurance of risks on debtors established in Romania and Bulgaria because those risks were non-marketable at the time, those countries having joined the European Union on 1 January 2007, i.e. after the insurance business had been transferred to Ducroire/Delcredere.

(10) See the Commission Decision of 21 December 2005 in Case N 531/2005 'Measures relating to the creation and operation of the Banque Postale', paragraph 54 (OJ C 21, 28.1.2006, p. 2) available at: http://ec.europa.eu/eu_law/state_aids/comp-2005/n531-05.pdf.

(32) The failure of the ONDD and Ducroire/Delcredere to comply with point 4.3 of the Communication on export-credit insurance (see recitals (17) and (19)), i.e. the failure to set up a separate administration and separate accounts for marketable and non-marketable risks, meant that it was impossible for the Commission to clearly determine the amount of 'supplementary capital' when it opened the formal investigation procedure. In its opening decision, the Commission therefore asked the Belgian authorities to comply with point 4.3 of the Communication on export-credit insurance and to notify to it the parts of the capital that supported, respectively, the insurance of short-term non-marketable risks and the insurance of marketable risks, before and after the transfer to Ducroire/Delcredere.

III. **COMMENTS BY INTERESTED THIRD PARTIES**

(33) No comments by interested third parties were received with regard to the opening decision within the prescribed time limits.

IV. **COMMENTS BY BELGIUM**

On Measures 1 and 2: *State guarantee for marketable risks within the ONDD and internal transfers of resources for the benefit of the ONDD's marketable risks*

(34) Belgium stated that the ONDD has always focused on non-marketable risks and that the predominance of these risks in its portfolio was a constant. After 1993 ([11]) and before the accession of the ten new Member States of the European Union in May 2004, the insurance business relating to marketable risks within the ONDD was insignificant. At the end of 2003, the premiums relating to this insurance business accounted for only approximately [0-1 %] of the portfolio of short-term risks and the sums insured amounted to only some EUR […] million (see Table 1 below). It was pointed out that the percentage of marketable risks covered at that time was very low because of the link between these risks and a non-marketable risk ([12]).

(35) It was not until 1 May 2004, when the ten new Member States joined the European Union, that the balance between short-term marketable and non-marketable risks in the ONDD's portfolio was changed, the proportion of marketable risks in the ONDD's portfolio shifting from [0-1 %] (in terms of premiums) in 2003 to [15-20 %] in 2004 (see Table 1 below). This change was the result of an automatic shift from the class of non-marketable risks to the class of short-term marketable risks on debtors established in the ten new Member States of the European Union.

(36) With regard to Measure 1, the Belgian authorities also added that the guarantee by the Belgian State was terminated on 1 September 2003 in relation to marketable risks as these were transferred to the commercial account for which the ONDD had obtained authorisation from the OCA ([13]), precisely because this account was not guaranteed by the State (insurance business guaranteed by the State is not regulated by the OCA).

(37) With regard to the possible internal transfers of resources to marketable risks within the ONDD, the Belgian authorities argue that, given the insignificance of the insurance of marketable risks, any transfer of resources was inconceivable and would, in any event, be *de minimis* ([14]).

(38) The Belgian authorities conclude that the amounts at stake for Measure 1 and Measure 2 are, in any event, *de minimis* ([15]).

([11]) According to the Belgian authorities, the ONDD covered the risks on debtors in Zone 1 until 1993 ([…], see footnote 24) and has since stopped offering this cover. Even before 1993, the ONDD never had a large portfolio of marketable risks.

([12]) See the example given on pages 13-14 of the 'Observations by Belgium on the Decision by the European Commission of 24 February 2011', submitted by the Belgian authorities on 1 June 2011.

([13]) The Banking, Finance and Insurance Commission (Commission bancaire, financière et des assurances — CBFA) was created by integrating the Insurance Inspectorate (Office de contrôle des assurances — OCA) into the Banking and Finance Commission (Commission bancaire et financière — CBF) on 1 January 2004.

([14]) Clarification by the Commission: the Belgian authorities are referring to the *de minimis* rule. Article 108(3) TFEU lays down the obligation to notify state aid to the Commission to enable it determine whether the aid is compatible with the internal market, having regard to the criteria in Article 107(1) TFEU. Under the *de minimis* rule, aid granted over a period of three years and below a certain threshold is exempt from the obligation to notify. When Measure 1 and Measure 2 applied, the threshold was set at EUR 100 000 by Commission Regulation (EC) No 69/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to *de minimis* aid (OJ L 10, 13.1.2001, p. 30).

([15]) See footnote 14.

Table 1

Trend in premiums and sums insured for short-term marketable and non-marketable risks (whole turnover exporters policies — short-term)

(EUR thousand) (1)

	2000	2001	2002	2003	2004	2005	2006
marketable risks	**[…]**	**[…]**	**[…]**	**[…]**	**[…]**	**[…]**	**[…]**
marketable since 2004 (10 new Member States)					*[…]*	*[…]*	*[…]*
marketable since 2007 (2 new Member States)							
non-marketable risks	**[…]**	**[…]**	**[…]**	**[…]**	**[…]**	**[…]**	**[…]**
marketable since 2004 (10 new Member States)	*[…]*	*[…]*	*[…]*	*[…]*			
marketable since 2007 (2 new Member States)	*[…]*	*[…]*	*[…]*	*[…]*	*[…]*	*[…]*	*[…]*
Sums insured	**[…]**	**[…]**	**[…]**	**[…]**	**[…]**	**[…]**	**[…]**
marketable risks	**[…]**	**[…]**	**[…]**	**[…]**	**[…]**	**[…]**	**[…]**
marketable since 2004 (10 new Member States)					*[…]*	*[…]*	*[…]*
marketable since 2007 (2 new Member States)							
non-marketable risks	**[…]**	**[…]**	**[…]**	**[…]**	**[…]**	**[…]**	**[…]**
marketable since 2004 (10 new Member States)	*[…]*	*[…]*	*[…]*	*[…]*			
marketable since 2007 (2 new Member States)	*[…]*	*[…]*	*[…]*	*[…]*	*[…]*	*[…]*	*[…]*
Premiums	**[…]**	**[…]**	**[…]**	**[…]**	**[…]**	**[…]**	**[…]**
(%)							
	2000	2001	2002	2003	2004	2005	2006
marketable risks	**[0-1 %]**	**[0-1 %]**	**[0-1 %]**	**[0-1 %]**	**[20-25 %]**	**[20-25 %]**	**[25-30 %]**
marketable since 2004 (10 new Member States)					*[20-25 %]*	*[15-20 %]*	*[15-20 %]*
marketable since 2007 (2 new Member States)							
non-marketable risks	**[99-100 %]**	**[99-100 %]**	**[99-100 %]**	**[99-100 %]**	**[75-80 %]**	**[75-80 %]**	**[70-75 %]**
marketable since 2004 (10 new Member States)	*[20-25 %]*	*[15-20 %]*	*[20-25 %]*	*[20-25 %]*			
marketable since 2007 (2 new Member States)	*[0-5 %]*	*[0-5 %]*	*[0-5 %]*	*[0-5 %]*	*[0-5 %]*	*[0-5 %]*	*[0-5 %]*
Sums insured	**100,00 %**	**100,00 %**	**100,00 %**	**100,00 %**	**100,00 %**	**100,00 %**	**100,00 %**

(EUR thousand) ([1])

	2000	2001	2002	2003	2004	2005	2006
marketable risks	**[0-1 %]**	**[0-1 %]**	**[0-1 %]**	**[0-1 %]**	**[15-20 %]**	**[15-20 %]**	**[15-20 %]**
marketable since 2004 (10 new Member States)					*[15-20 %]*	*[10-15 %]*	*[10-15 %]*
marketable since 2007 (2 new Member States)							
non-marketable risks	**[99-100 %]**	**[99-100 %]**	**[99-100 %]**	**[99-100 %]**	**[80-85 %]**	**[80-85 %]**	**[80-85 %]**
marketable since 2004 (10 new Member States)	*[15-20 %]*	*[15-20 %]*	*[20-25 %]*	*[15-20 %]*			
marketable since 2007 (2 new Member States)	*[0-5 %]*	*[0-5 %]*	*[0-5 %]*	*[0-5 %]*	*[0-5 %]*	*[0-5 %]*	*[5-10 %]*
Premiums	**100,00 %**	**100,00 %**	**100,00 %**	**100,00 %**	**100,00 %**	**100,00 %**	**100,00 %**

([1]) See page 7 of the reply by Belgium to the letter from the European Commission dated 7 December 2007, submitted by the Belgian authorities on 12 February 2008 (the Belgian authorities refer to it on page 14 of their submission dated 1 June 2011).

On Measure 3: *Capital allocated to Ducroire/Delcredere by the ONDD*

(39) In order to establish that the capital allocated to Ducroire/Delcredere by the ONDD was necessary and fulfilled the criterion of the private market economy investor, the Belgian authorities put forward the following arguments: (1) the transaction must be seen in its context, namely the transfer of an existing activity to a new subsidiary; (2) the capital injection is justified under the solvency rules; (3) the expected profitability of Ducroire/Delcredere's insurance of marketable risks was sufficient to convince a private market economy investor to make this investment.

1. *The transaction is a transfer of an existing activity* ([16])

(40) The Belgian authorities take the view that the capital injection must be seen in its context, which is that of a transfer of an existing activity. All the insurance business housed in Ducroire/Delcredere when it was established merely corresponded to a transfer of the ONDD's portfolio of short-term insurance business.

(41) To this end, the Belgian authorities state that all the balance-sheet items in the commercial account **relating to commercial activity** were transferred to Ducroire/Delcredere's opening balance sheet. On the asset side, only the claims directly related to insurance policies already in the portfolio were transferred (investments were not transferred). On the liabilities side, the only items transferred were those relating to the existing insurance portfolio and therefore excluded capital, reserves and equalisation and catastrophe provisions ([17]). The Belgian authorities stress that the EUR [45-70] million allocated to the commercial account was not transferred to Ducroire/Delcredere since the identification of the amount of capital had been subject to a specific assessment.

(42) The Belgian authorities maintain that the capital allocated to the commercial account is not a relevant comparator for assessing Ducroire/Delcredere's capital requirements. The capital requirement for the commercial account was estimated by the mechanical application of the rules set out in Directive 2002/13/EC of the European Parliament and of the Council of 5 March 2002 amending Council Directive 73/239/EEC as regards the solvency margin requirements for non-life insurance undertakings ([18]) (hereinafter: 'the Solvency I Directive') corresponding to the prudential rules in order to obtain OCA authorisation for the short-term insurance business since it was no longer guaranteed by the State, but this capital does not correspond to the economic capital required to cover the risk profile of this insurance business.

(43) According to the Belgian authorities, there is a difference between the attitude of a private investor looking to the profitability of a new investment and a parent company that is transferring its existing activities to a subsidiary. The Belgian authorities maintain that to judge otherwise could force a public undertaking to transfer or cease an economic activity if it was not profitable enough for a private market economy investor, which would breach the principle of the neutrality of public capital laid down in Article 345 TFEU.

2. *The methods used to justify the amount of capital in Ducroire/Delcredere*

(44) The Belgian authorities maintain that in 2004 two methods could be envisaged for determining the capital requirements of credit insurance companies: (a) the classical method for the insurance sector in general, laid down by the Solvency I Directive and based on the remuneration of risk (premium-based approach) and (b) the method based on risks assumed (exposure-based approach), for example the method of the Basel rules applied to the banking sector and the Standard & Poor's method for determining the capital requirement of a credit insurance company.

([16]) See the 'Observations by Belgium on the Decision by the European Commission of 24 February 2011', submitted by the Belgian authorities on 1 June 2011, pp. 22-24.
([17]) The details of the items transferred were submitted by the Belgian authorities on 14 February 2007 on page 3 of their note in response to the Commission letter dated 17 January 2007 in Case CP 8/2007 (SA.22302) and are set out in recital 70 of the opening decision.
([18]) OJ L 77, 20.3.2002, p. 17.

Prudential rules in force: Solvency I

(45) In the case of Ducroire/Delcredere, the Belgian authorities take the view that the method laid down by the Solvency I Directive does not sufficiently reflect the overall financial profile of an insurer.

(46) Under the Solvency I Directive, the solvency margin requirement is equal to the higher of two amounts, one based on the annual amount of premiums or contribution income, the other on the average claims burden for the past three financial years. However, the absolute minimum threshold is EUR 3 million for 2004 to 2006 and EUR 3,2 million for 2007 to 2009.

(47) The application of these rules by the ONDD results in a minimum level of capital for Ducroire/Delcredere of approximately **EUR 3 to 3,3 million** ([19]) between 2005 and 2007, on the basis of the business plan (see Table 2 below).

(48) Belgium argues that credit insurers' capital requirements depend more on exposure than on risk remuneration (premiums) and that the methodologies based on risks assumed (exposure-based approach) (such as Article 8 of the 1939 Law on the ONDD, the Standard & Poor's method, or the method of the Basel rules applied to the banking sector) are more appropriate than the Solvency I Directive, which is based on the remuneration of risk (premium-based approach).

(49) The Belgian authorities maintain that the portfolio of risks insured by Ducroire/Delcredere is atypical in that, unlike most of its competitors, it covers for the most part non-marketable risks within the meaning of the Communication on export-credit insurance. The level of risk attached to such a portfolio is substantially higher than that associated with a portfolio composed exclusively or partially of marketable risks and, according to Belgium, justifies the use of more prudent rules.

Exposure-based approach: (i) Application to Ducroire/Delcredere of Article 8 of the 1939 Law on the ONDD

(50) The Belgian authorities consider the application of Article 8 of the 1939 Law on the ONDD ([20]) (hereinafter: 'the 1939 Law') to be appropriate in this case because it is based on the exposure-based approach. It is important to note that Article 8 of the 1939 Law is not relevant in regulatory terms for Ducroire/Delcredere because it applies only to the ONDD.

(51) Furthermore, although Article 8 stipulates the maximum amount of commitments by the ONDD resulting from its insurance business for its own account and guaranteed by the State, as well as for its insurance business for the account of the State, the Belgian authorities take the view that Article 8 of the 1939 Law constitutes a minimum benchmark for Ducroire/Delcredere, which does not enjoy the guarantee of the State.

(52) By applying Article 8(1) of the **1939 Law** ([21]), which states that commitments may not exceed 20 times the combined amount of the capital and the general reserve, the Belgian authorities estimate ([22]) Ducroire/Delcredere's capital requirement at approximately **EUR 92 to 106** million between 2005 and 2007, on the basis of the business plan (see Table 2 below).

Exposure-based approach: (ii) model developed by Standard & Poor's

(53) In their observations, the Belgian authorities refer to the method developed by Standard & Poor's to determine the capital requirement of a credit insurer.

([19]) See the reply to the questionnaire from the European Commission dated 28 July 2011, submitted by the Belgian authorities on 5 December 2011, pp. 9-11 (the detailed calculations were submitted on 14 November 2011).
([20]) Belgian Official Gazette, 4 October 1939.
([21]) In relation to the ONDD's business transacted for its own account with the guarantee of the State.
([22]) See the reply to the questionnaire from the European Commission dated 28 July 2011 submitted by the Belgian authorities on 5 December 2011, p. 16.

(54) In order to establish the level of capital [23], Standard & Poor's uses a model based on risks assumed (exposure-based approach), accompanied by an assessment of the insurer's reinsurance. The capital required is determined by a methodology which compares gross claims with gross sums insured (the gross loss over gross exposure method) over (usually) a ten-year period. The highest ratio during this period is multiplied by a factor of 1,25 and applied to the projected sums insured and adjusted for reinsurance. The model is based on the assumption that the insurer's portfolio is reasonably well diversified geographically and by line of business.

(55) Although the Belgian authorities refer to the Standard & Poor's method, they did not use it to determine the capital requirement for Ducroire/Delcredere.

Exposure-based approach: (iii) Application of the Basel I rules to credit insurers (Cooke ratio)

(56) The Belgian authorities argue that the Basel rules are more suited to assessing the solvency of credit insurers than the current prudential rules, i.e. the Solvency I Directive. The nature of credit insurance and the precautionary principle justify use of the Basel rules. According to the Belgian authorities, credit insurance is similar to the credit business of banks at the level of counterparty risk (principally the risk of non-payment by the debtor). Furthermore, Ducroire/Delcredere's insurance business, unlike that of other private credit insurers, comprises essentially credit risks on debtors established in less developed or emerging countries (risks in Zone 2 [24]).

(57) According to the Belgian authorities, therefore, the Cooke ratio under the Basel I prudential rules, which requires minimum capitalisation of 8 % of net commitments, is more appropriate for assessing the solvency of credit insurers.

(58) The minutes of the meeting of the ONDD Board of Directors held on 20 April 2004 show that the ONDD used the Cooke ratio to determine Ducroire/Delcredere's capital requirement, while taking into account the need to provide the company with enough credibility in the eyes of its competitors.

(59) The ratio used by the Belgian authorities in the calculations is not 8 %, as laid down by the Basel I rules, but 10 % in order to provide a safety buffer.

(60) The capital thus determined by the ONDD for Ducroire/Delcredere and stated in the financial plans submitted to the regulator and in the information memo dated 20 April 2004 [25], on the basis of which the Board of Directors agreed in principle to set up Ducroire/Delcredere with a subscribed capital of EUR 150 million, was approximately **EUR 68 to 74 million** for the end of 2006 (see Table 2 below). The underlying assumptions included solely cover of the risks located in Zone 2 and in the 10 countries that joined the European Union in May 2004.

(61) However, in the strategy paper dated 28 September 2004 [26], the capital estimated by the ONDD using the Cooke ratio (10 % of net commitments) between 2005 and 2007 was approximately **EUR 74 to 101 million**. Contrary to the financial projections in the information memo of April 2004, the financial projections of September 2004 included the cover of all short-term risks, thereby encompassing all of Zones 1 and 2. The conclusion in this paper was that paid-up capital of EUR 100 million was enough to carry on the business of short-term whole turnover export policies until 2007, but would have to be reviewed at the end of the period.

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[23] See Annex B14 to the reply to the questionnaire from the European Commission dated 28 July 2011, submitted by the Belgian authorities on 5 December 2011.

[24] See the document submitted by the Belgian authorities on 1 June 2011 'Observations by Belgium on the Decision by the European Commission of 24 February 2011', p. 10: 'Selon les catégories utilisées par l'ONDD, […]'.

[25] See Annexes 8 (p. 70) and 13 to the 'Observations by Belgium on the Decision by the European Commission of 24 February 2011', submitted by the Belgian authorities on 1 June 2011.

[26] See page 28 of the strategy paper dated 28 September 2004 entitled 'Strategy guidelines for the ONDD and its subsidiary' (*Lignes directrices stratégiques pour l'ONDD et sa SA*) presented to the ONDD Board of Directors and set out in Annex 10 to the 'Observations by Belgium on the Decision by the European Commission of 24 February 2011', submitted by the Belgian authorities on 1 June 2011.

(62) The Belgian authorities take the view that the application of the Cooke ratio is not an appropriate method for dividing the capital requirements between the marketable and the non-marketable insurance business because the method using the Cooke ratio, which is applied to the amount of commitments, results, they believe, in a certain linearity in that it does not take adequate account of the varied nature of the different underlying risks.

Application of the Solvency II Directive methodology with internal modelling for political risks

(63) The Solvency II rules fall within the scope of Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of insurance and reinsurance ([27]) (hereinafter: 'the Solvency II Directive').

(64) In 2011 the ONDD developed **a methodology** that it considers more appropriate for dividing the capital requirements between the marketable and the non-marketable insurance business. It consists of the standard formula under Solvency II ([28]), developed as part of Quantitative Impact Study 5 (QIS5), accompanied by internal modelling of the capital requirement to cover political risk and calibrated to meet a degree of solvency corresponding to an A rating and applied using the parameters for 2004.

(65) The Belgian authorities argue that it can reasonably be supposed that a prudent private investor would have used this methodology in 2004.

(66) The Solvency II standard formula QIS5 was applied by the ONDD for all risks except political risks. The Belgian authorities consider that political risk in credit insurance may be likened to catastrophe risk. They believe that catastrophe risk for credit insurance is currently poorly covered by the Solvency II standard formula QIS5. They take the view that it is therefore justified to use an internal model to estimate the capital requirement in relation to political risks.

(67) Using this method, Ducroire/Delcredere's capital requirement is estimated ([29]) at approximately **EUR 80 to 99 million** between 2005 and 2007 and approximately EUR [125-150] million in 2009 on the basis of the business plan (see Table 2 below). The majority of this capital requirement arises from the cover of political risk.

(68) Following a request by the Commission, the Belgian authorities estimated Ducroire/Delcredere's capital requirement by applying the Solvency II standard formula QIS5 for all types of risk (including political risk). In that case, Ducroire/Delcredere's capital requirement is said ([30]) to be **below EUR 23 to 25 million** between 2005 and 2007 and below EUR [25-50] million for 2009 (see Table 2 below).

([27]) OJ L 335, 17.12.2009, p. 1. The Solvency II Directive entered into force on 6 January 2010.

([28]) Solvency II is a European regulatory reform of the insurance sector. Like Basel II, its objective is to better adapt the own funds required of insurance and reinsurance companies to the risks they are subject to in their business. After Solvency I, which provided for a solvency margin determined according to percentages of premiums and claims, insurance regulation moved to more complex rules that incorporate risk, either by applying a standard formula, or by taking account of an internal model. The standard formula approach is currently being designed and calibrated through Quantitative Impact Studies (hereinafter: 'QIS'). These consultations will enable the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) to test the proposed formulae and calibrations. Companies wishing to opt for an internal model must obtain validation from the supervisory authority before the solvency capital requirement (SCR) is actually determined using their internal model.

([29]) See the reply to the questionnaire from the European Commission dated 28 July 2011, submitted by the Belgian authorities on 5 December 2011, p. 22.

([30]) See the reply to the questionnaire from the European Commission dated 28 July 2011, submitted by the Belgian authorities on 5 December 2011, p. 22.

Table 2

Determination of Ducroire/Delcredere's capital by the ONDD/Belgian authorities for 2005, 2007 and 2009 under two growth scenarios and using different methods

(EUR million)

	Methodology	Scenario (1)	Period considered	Capital require-ment for marketable risks	Capital requirement for non-marketable risks	Total
On the basis of the business plan	Solvency I in line with the comments in December 2011	A (3 %)	End 2005	3,0	3,0	3 (2)
			End 2007	3,2	3,2	3,2 (2)
		B (6 %)	End 2005	3,0	3,0	3,0 (2)
			End 2007	3,2	3,2	3,3 (2)
	Article 8 of 1939 Law in line with the comments in December 2011	A (3 %)	End 2005			92
			End 2007			97
			End 2009			[100-125]
		B (6 %)	End 2005			95
			End 2007			106
			End 2009			[100-125]
	Cooke ratio/Basel I (10 % of net commitments) in line with the minutes of the board meeting on 20.4.2004 and as submitted to the regulator	A (3 %)	End 2006			68,2
		B (6 %)	End 2006			74,3
	Cooke ratio/Basel I (10 % of net commitments) in line with the strategy paper dated 28.9.2004	A (3 %)	End 2005			73,5
			End 2007			92,2
		B (6 %)	End 2005			77,4
			End 2007			100,7
	Cooke ratio/Basel I (10 % of net commitments) in line with the comments in December 2011	A (3 %)	End 2009			[100-125]
		B (6 %)	End 2009			[125-150]
	Solvency II, standard method (from 2011) in line with the comments in December 2011, Annex B10	A (3 %)	End 2005	7,0	48,0	55,0
			End 2007	9,0	56,0	65,0
			End 2009	[10-20]	[65-80]	[75-100]
		B (6 %)	End 2005	8,0	51,0	59,0
			End 2007	10,0	64,0	74,0
			End 2009	[5-15]	[70-85]	[75-100]
	Solvency II with internal modelling for political risks in line with the comments in December 2011	A (3 %)	End 2005	7,0	73,0	80,0
			End 2007	9,0	81,0	90,0
			End 2009	[5-15]	[110-135]	[125-150]
		B (6 %)	End 2005	8,0	74,0	82,0
			End 2007	10,0	89,0	99,0
			End 2009	[5-15]	[120-135]	[125-150]
	Adjusted capital (QIS5 + internal model) (see recital 76), including accumulated profit (3)	A (3 %)	End 2005	9,8	90,2	100,0
			End 2007	10,8	91,7	102,5
			End 2009	[5-15]	[130-145]	[135-160]
		B (6 %)	End 2005	9,8	90,2	100
			End 2007	11	92,3	103,3
			End 2009	[10-20]	[140-155]	[150-175]

(EUR million)

	Methodology	Scenario (1)	Period considered	Capital require-ment for marketable risks	Capital requirement for non-marketable risks	Total
On the basis of actual figures	Allocated paid-up capital in line with the comments of 31 May 2012		End 2011	[40-80]	[70-110]	150,0

(1) In brackets: expected annual growth rate of the business under the scenario in question.
(2) The capital requirements for marketable and non-marketable risks are not added to produce the total because there is an absolute minimum threshold of EUR 3 million for 2004 to 2006 and EUR 3,2 million for 2007 to 2009.
(3) See the documents submitted by the Belgian authorities on 14 November 2011 (Excel files, 'Capital' sheet) The QIS5 plus internal modelling method was used solely to determine the capital allocated to marketable and non-marketable risks in 2005. For the years after 2005, the capital was determined in […]. It should be noted that […], which is why the results are identical for scenarios 1A and 1B for 2005. The Belgian authorities did not take into account the unpaid capital of EUR 50 million until 2009. It is these figures that were used in the calculations of the return on equity in the following section.

(69) In its comments dated 16 and 31 May 2012, the ONDD pointed out that, following strategic decisions taken between 2007 et 2009 (for example, change in the reinsurance strategy, shift in the risk parameters of the portfolio of non-marketable risks) that were not included in its strategic plan from 2004, internal transfers of capital took place from the non-marketable to the marketable insurance business.

3. *Principle of a private investor in a market economy*

(70) The Belgian authorities take the view that the initial capital injection by the ONDD when Ducroire/Delcredere was set up satisfies the criterion of the private investor in a market economy.

Profitability according to the projections of 2004

(71) In the memo of April 2004, under scenario 1B, which assumed 6 % growth in business, the ONDD was anticipating a return on equity (ROE) of 1,3 % to 1,5 % for Ducroire/Delcredere's first three years of activity (2005, 2006 and 2007) by including the equalisation provisions, and of 2,2 % to 2,9 % for the same years by excluding the equalisation provisions.

Table 3

Financial projections of April 2004 (scope: Zone 1 '10 accession countries' + Zone 2)

(EUR thousand)

	Scenario 1A: growth 3 %			Scenario 1B: growth 6 %		
	Budget 2005	Budget 2006	Budget 2007	Budget 2005	Budget 2006	Budget 2007
Result from insurance business	– 527	– 536	– 543	47	389	763
Result from management business	1 643	1 692	1 742	1 749	1 885	2 029
Technical result	1 116	1 156	1 199	1 797	2 274	2 792

(EUR thousand)

	Scenario 1A: growth 3 %			Scenario 1B: growth 6 %		
	Budget 2005	Budget 2006	Budget 2007	Budget 2005	Budget 2006	Budget 2007
Transfer to equalisation provision	– 837	– 867	– 899	– 1 347	– 1 706	– 2 094
Technical result after equal. provision	279	289	300	449	569	698
Financial result	2 360	2 468	2 577	2 369	2 499	2 641
Tax	– 871	– 910	– 949	– 930	– 1 012	– 1 102
Result	1 768	1 847	1 927	1 888	2 055	2 237
Capital	150 000	150 000	150 000	150 000	150 000	150 000
Return on equity (result/capital)	1,2 %	1,2 %	1,3 %	1,3 %	1,4 %	1,5 %
Result + equal. provision	2 605	2 715	2 826	3 235	3 761	4 331
Return on equity before equal. provision (result + equal. provision)/capital	1,7 %	1,8 %	1,9 %	2,2 %	2,5 %	2,9 %
Cash flow	5 744	5 190	5 803	6 634	6 557	7 742
Capital required by the business			68 186			74 319

Source: the ONDD: These are the financial projections set out in Annex 8, p. 70 (paper entitled 'Setting up a limited company' — *Création d'une société anonyme* — presented to the ONDD Board of Directors on 20 April 2004) to the observations by the Belgian authorities dated 1 June 2011.

(72) In the paper presented to its Board of Directors on 28 September 2004 — after Ducroire/Delcredere was set up on 23 September 2004 — the ONDD anticipated, under the 'dynamic scenario — 6 % growth', an ROE of 1,3 % to 1,9 % for the three years 2005, 2006 and 2007 by including the equalisation provisions, and of 2,8 % to 4,3 % for the same years by excluding the equalisation provisions. The financial projections of September 2004 present slightly different results to those of April 2004 because the September 2004 projections are based on a more extensive business scope (all of Zone 1). Furthermore, certain assumptions were revised in September 2004.

Table 4

Financial projections — September 2004 (scope: all of Zone 1 and Zone 2)

(EUR thousand)

	Scenario 1A: growth 3 %			Scenario 1B: growth 6 %		
	Budget 2005	Budget 2006	Budget 2007	Budget 2005	Budget 2006	Budget 2007
Result from insurance business (1)	**– 229**	**49**	**292**	**330**	**924**	**1 504**
non-marketable risks (Zone 2)	*378*	*688*	*970*	*918*	*1 537*	*2 148*
marketable risks (Zone 1 '10 accession countries')	*– 619*	*– 579*	*– 545*	*– 600*	*– 553*	*– 511*
other marketable risks (Zone 1 'other countries')	*13*	*– 12*	*3*	*31*	*43*	*109*
Result from management business	1 662	1 734	1 805	1 768	1 924	2 086
Technical result	**1 433**	**1 783**	**2 096**	**2 097**	**2 848**	**3 590**

(EUR thousand)

	Scenario 1A: growth 3 %			Scenario 1B: growth 6 %		
	Budget 2005	Budget 2006	Budget 2007	Budget 2005	Budget 2006	Budget 2007
Transfer to equalisation provision	– 1 066	– 1 383	– 1 672	– 1 564	– 2 182	– 2 392
Technical result after equal. provision	**367**	**400**	**425**	**533**	**667**	**1 197**
Financial result	1 366	1 470	1 581	1 375	1 500	1 642
Tax	– 568	– 637	– 706	– 626	– 735	– 981
Result	**1 165**	**1 233**	**1 300**	**1 282**	**1 432**	**1 858**
Capital	100 000	100 000	100 000	100 000	100 000	100 000
Return on equity (result/capital)	**1,2 %**	**1,2 %**	**1,3 %**	**1,3 %**	**1,4 %**	**1,9 %**
Result + equal. provision	2 231	2 616	2 972	2 846	3 614	4 251
Return on equity before equal. provision (result + equal. provision/capital)	**2,2 %**	**2,6 %**	**3,0 %**	**2,8 %**	**3,6 %**	**4,3 %**
Cash flow	5 358	5 152	6 080	6 233	6 471	7 796
Capital required by the business	73 506	82 798	92 150	77 419	88 931	100 696

Source: the ONDD: These are the financial projections set out on page 28 and in Annex 9 to the paper entitled 'Strategic guidelines for the ONDD and its subsidiary' (*Lignes directrices stratégiques pour l'ONDD et sa SA*) presented to the ONDD Board of Directors on 28 September 2004, submitted by the Belgian authorities on 1 June 2011 in Annex 10 to their observations.

[1] The Commission has identified calculation errors in the financial projections. In particular, the sum of the results from the insurance business for the different business scopes differs from the total result from the insurance business for Ducroire/Delcredere. Errors in the sums were made in the calculation of the result from the insurance business for Ducroire/Delcredere as a whole. However, these differences do not have a material effect on the estimate of the ROE.

(73) Unlike in the memo of April 2004, the ROE is calculated on the basis of EUR 100 million in paid-up capital, without taking into account the supplementary EUR 50 million invested but not paid up.

(74) With regard to the ROE anticipated for the marketable risks insurance business, the Belgian authorities explained that the breakdown as set out in the strategy paper presented to the Board of Directors on 28 September 2004 ([31]) should not be taken into account when analysing the profitability of marketable and non-marketable risks insurance. They explained ([32]) that these projections are absurd since the level of claims was grossly overestimated for the risks that became marketable in 2004, while no account was taken of the possibility for an insurer to adjust premiums in the event of a high claims experience actually being recorded. They point out that the ONDD Board of Directors did not base its decision concerning Ducroire/Delcredere's level of capitalisation on the division set out in Annex 9 to the strategy paper.

Profitability according to the projections drawn up ex post in 2011

(75) The projections of 2004 did not, therefore, serve as the basis for the division of the projections for marketable and non-marketable risks submitted to the Commission in June 2011. The observations of June 2011 were, in turn, based on the actual figures before 2004 and on the performance of Ducroire/Delcredere's competitors at the time. Belgium takes the view that the approach used in the observations of June 2011 best reflects the reasoning that a private investor would have followed in 2004, while remaining consistent with the consolidated result.

([31]) See the 'Observations by Belgium on the Decision by the European Commission of 24 February 2011', submitted by the Belgian authorities on 1 June 2011, Annex 10.

([32]) See the reply to the questionnaire from the European Commission dated 28 July 2011, submitted by the Belgian authorities on 5 December 2011, p. 33.

(76) In their observations of June 2011, the Belgian authorities estimated the profitability of the marketable risk insurance business in relation to the capital allocated to this business using the Solvency II model (standard formula QIS5 and internal model), a method developed ex post at the Commission's request. It should be noted that the difference between the minimum amount of capital under this model, i.e. EUR 82 million, and the actual paid-up capital of EUR 100 million, was allocated to marketable and non-marketable risk insurance in proportion to their respective share of the minimum capital of EUR 82 million. As a result, the 'adjusted' capital estimated by the ONDD for the marketable risks is EUR 9,8 million for 2005 ([33]) (see Table 5 below).

(77) On the basis of the revised financial projections submitted by the Belgian authorities in 2011 and their estimates of the capital allocated to the marketable risk insurance business, as explained in recital 76, the profitability of the marketable risk insurance business for 2005-07, as determined by the Belgian authorities, is set out below:

Table 5

Financial projections recalculated in 2011 ([1])

(EUR thousand)

	Scenario 1B: growth 6 % marketable risks			Scenario 1B: growth 6 % non-marketable risks		
Financial projections	Budget 2005	Budget 2006	Budget 2007	Budget 2005	Budget 2006	Budget 2007
Result from insurance business	656	516	596	– 326	408	908
Result from management business	292	329	363	1 476	1 596	1 723
Technical result before provisions	**948**	**845**	**959**	**1 150**	**2 004**	**2 631**
Transfer to equalisation provision	– 328	– 347	– 368	– 1 236	– 1 835	– 2 024
Technical result after equal. provision	**620**	**497**	**591**	**-86**	**170**	**607**
Financial result	280	347	374	1 095	1 153	1 268
Tax	– 297	– 279	– 318	– 330	– 456	– 664
Profit after tax	**603**	**566**	**646**	**679**	**866**	**1 212**
Adjusted capital (QIS5 + internal model) ([2])	9 756	10 322	10 969	90 244	91 110	92 321
Adjusted capital + equal. provision	9 756	10 437	11 205	90 244	91 743	93 671
ROE (result/capital)	**6,2 %**	**5,5 %**	**5,9 %**	**0,8 %**	**1,0 %**	**1,3 %**
Result + equal. provision	**823**	**799**	**893**	**1 511**	**2 068**	**2 519**
ROE before equal. provision	**8,4 %**	**7,7 %**	**8,0 %**	**1,7 %**	**2,3 %**	**2,7 %**

([1]) See the observations submitted by the Belgian authorities on 14 November 2011 (Excel files '201105 P&L et Bilan Business Plan Scenario 1B', sheets 'P&L_cessibles' and 'PL_non_cessibles').
([2]) The QIS 2005 plus internal modelling method was used solely to determine the capital allocated to marketable and non-marketable risks in 2005. The capital for 2006 and 2007 was determined on the basis of the capital for 2005 plus the forecast accumulated profit for the period.

([33]) Belgium's calculation for the marketable risks is as follows: EUR 8 million + [(EUR 100 million — EUR 82 million) × (EUR 8 million/EUR 82 million)]. The same applies to the non-marketable risks.

(78) The ROE is calculated by the Belgian authorities on the basis of EUR 100 million in paid-up capital, without taking into account the supplementary EUR 50 million invested but not paid up until 2009.

(79) In response to the doubt raised in the opening decision about whether a private investor would require remuneration on the unpaid capital, given that he would lose it in the event of bankruptcy, the Belgian authorities observed that they maintained their position, i.e. that the EUR 50 million capital should not be taken into account in the calculation of profitability until it had actually been paid up. They believe that the only effect of bankruptcy (assuming that it would result in a call on the balance of the subscribed capital) would be to reduce the duration of such an investment. They further added that, until the capital was paid up in 2009, the ONDD was able to invest this capital of EUR 50 million freely on the market in order to benefit from a corresponding return.

(80) Moreover, the Belgian authorities maintain that an investment rate of 2 % used in the 2004 projections and taken into account in the calculations set out in Table 5 is below what a private investor would probably have used. By using an investment rate of 3,5 %, the Belgian authorities established that the projected profitability of marketable risk insurance (ROE adjusted for the equalisation provision) would reach a level of approximately 9,7 % to 10,4 % between 2005 and 2007 (against approximately 7,7 % to 8,4 % with an investment rate of 2 %) ([34]).

Use of the ROR ratio

(81) The Belgian authorities consider that the most appropriate rate for assessing the expected profitability of the investment is the Economic Return on Revenue (hereinafter: 'ROR'), although this rate was not used in the ex ante financial projections (ONDD business plan). This rate is calculated by comparing technical income (before allocation to the equalisation reserve) with turnover (insurance premiums). The Belgian authorities consider ROR to be the most appropriate method because:

(a) it is calculated before the equalisation provision, imposed by the Belgian prudential authorities, which is intended to balance out the results over time and to cover potential future losses resulting from future business;

(b) it accurately reflects the profitability of credit insurance by isolating it from purely financial profitability. It therefore demonstrates the profitability connected with the 'core' of the credit insurance activity.

(82) An ROR of 16,5 % and 18,5 % in 2005 and 2006 respectively showed Ducroire/Delcredere to be more profitable ([35]) than the three biggest names in the credit insurance world, i.e. Coface, Euler Hermes and Atradius, whose ROR in 2005 and 2006 stood at 9,7 % and 10,9 %, 16,0 % and 16,9 %, and 9,3 % and 11,9 % respectively.

Determining the expected profitability

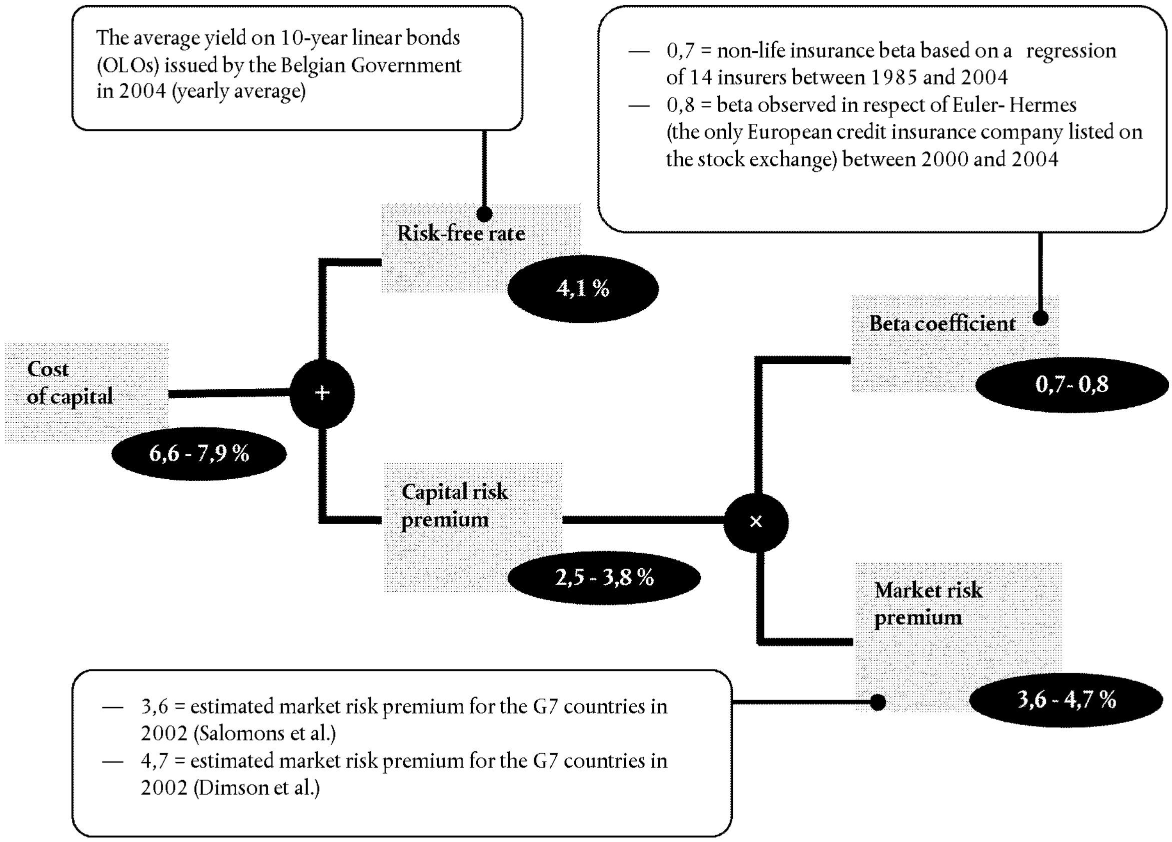
(83) In response to a remark by the Commission that it was unlikely that a private investor would use ROR as the sole basis for assessing the profitability of a prospective investment, the Belgian authorities proposed two new methodologies to show that Ducroire/Delcredere was sufficiently profitable when it was capitalised: (a) the 'capital asset pricing model' (hereinafter: 'CAPM') ([36]), by means of which the rate of return expected by the market for a given financial asset can be estimated on the basis of risk; and (b) benchmarking of the profitability of credit insurers.

([34]) See the document submitted by the Belgian authorities on 5 December 2011, 'Reply to the questionnaire from the European Commission dated 28 July 2011', pp. 38 and 39.
([35]) See the 'Observations by Belgium on the Decision by the European Commission of 24 February 2011', submitted by the Belgian authorities on 1 June 2011, p. 38.
([36]) Capital asset pricing model (CAPM).

(84) According to the CAPM model, the cost of capital is calculated using the following formula:

Cost of capital = risk-free rate + capital risk premium
Cost of capital = risk-free rate + beta coefficient of the assets* [market risk premium]
Where the beta coefficient of the assets represents the volatility of the profitability of the assets in question compared with that of the market.

(85) Estimates by the Belgian authorities of the cost of the Ducroire/Delcredere capital are set out in the diagram below.



(86) According to ONDD estimates based on the CAPM, a private investor in the Belgian non-life insurance sector would have demanded a minimum profitability of 7-8 % in 2004.

(87) To achieve the historical profitability benchmark, the Belgian authorities drew up a sample of insurers by selecting those that met the following criteria: (a) European players, (b) whose main business is credit insurance, (c) who are active mainly in the marketable risk sector but are also active in the non-marketable risk sector, excluding companies subject to a state aid procedure or established after 2004 and subsidiaries of companies included in the sample. The sample comprises 11 insurers. According to the Belgian authorities, the average ROE for credit insurance companies active mainly in the marketable risk sector is 6-7,5 % depending on the period under consideration (i.e. including or excluding the crisis years). The average ROE for these 11 insurers in 2004 was 7,8 % compared with the 13,3 % average ROE of the three market reference players (see Table 6).

Table 6

Profitability benchmark for credit insurers submitted by Belgium

Methodology for defining the sample for benchmarking the marketable ROE		ROE (2), 2000-09, percentage																		
						ROE											Averages		
Filter criteria	Sample size	Companies	Head Office	Estimated share of marketable risk (3) %	Gross premiums EUR million, 2004	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2001-04	2003-04	2001-09
• Credit insurers who are members of ICISA and the Berne Union (4)	115	Cesce	Spain	60	51 (5)			2,3	5,2	7,3	6,0	3,5	8,3	2,3	− 24,0	10,4	4,1	4,5	1,8
		KUKE	Poland	60	7			− 9,0	0,5	1,9	5,5	7,9	4,9	5,3	8,1	− 14,6	− 0,3	3,7	1,2
• European credit insurers (7)	47	COSEC	Portugal	90	37			1,5	1,7	− 5,1	8,1	7,3	2,2	6,0	− 9,0	1,8	1,5	1,5	1,6
		Prisma	Germany	100	36	0,0	4,8	6,8	4,7	5,6	9,3	12,9	17,1	9,5	15,9	7,6	6,6	7,5	9,9
• Companies whose main activity is credit insurance and who are active mainly in marketable risks (1)	19	Crédito y Caución	Spain	100	341	9,0	13,7	14,3	16,0	21,1	17,6	14,3	13,7	15,2	53,7	0,5	17,3	19,4	18,5
		Baez	Bulgaria	60	0,5						4,7	8,7	5,3	11,5	10,6	14,2	4,7	4,7	9,2
• Exclusion of companies that are subject to a state aid procedure (i.e. SACE and SACE BT)	16	Garant	Austria	50	4						− 7,3	− 5,6	0,6	1,3	3,2	-10,7	-7,3	-7,3	-3,1
		Mehib	Hungary	90	6 (5)				0,2	0,8	2,2	0,8	-2,3	0,4	5,7	8,2			

Methodology for defining the sample for benchmarking the marketable ROE		ROE (2), 2000-09, percentage																	
		Companies	Head Office	Estimated share of marketable risk (3) %	Gross premiums EUR million, 2004	ROE											Averages		
Filter criteria	Sample size					1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2001-04	2003-04	2001-09
• Exclusion of companies established after 2004 and/ or a subsidiary of another company already on the list	11	Atradius	Netherlands	90	1079			1,8	− 17,5	3,4	10,1	16,8	14,5	19,4	− 22,1	− 12,5	− 0,5	6,8	1,5
		Euler Hermes:	France	96	1567		13,7	13,2	16,7	14,5	18,4	17,7	17,3	21,8	4,5	1,3	15,7	16,4	13,9
		COFACE	France	83	903	11,3	11,8	9,2	3,2	13,2	11,5	13,4	11,2	15,1	3,7	− 15,0	9,3	12,4	7,3
		Average (6)					11,0	5,0	3,4	7,0	7,8	8,9	8,4	9,8	4,6	-0,8	5,8	7,4	6,0
		Average (6) of the 3 reference players						8,1	0,8	10,4	13,3	16,0	14,3	18,8	-4,6	-8,7	8,2	11,9	7,6
		Average (6) for players of a similar size						3,1	4,7	5,3	5,8	6,2	6,2	6,4	8,0	2,2	4,7	5,5	5,3

(1) Only those players whose key activity is deemed to be in the marketable risk sector (i.e. is above 50 % in terms of premiums or total exposure according to the available information) were selected.
(2) Adjusted for the equalisation provision.
(3) On the basis of the geographical information communicated, e.g. exposure, premiums (varies from company to company).
(4) International associations of credit insurers.
(5) Net premiums.
(6) Non-weighted average.
(7) In 2004 or shortly thereafter.

(88) According to the Belgian authorities, the expected profitability of the marketable risk business before the equalisation provision (ROE before equalisation provision), on the basis of the financial projections recalculated by the Belgian authorities in 2011 under scenario 1B (see Table 5), is in line with the profitability which a private investor would have expected to achieve in 2004 (Belgian authority estimates based on the cost of capital using the CAPM model and on the benchmarking of the profitability of credit insurers; see recitals (86) and (87) respectively).

Separation of accounts

(89) Following the Commission's request expressed in its opening decision regarding compliance with point 4.3 of the Communication on export-credit insurance, which imposes a separate administration and separate accounts for the insurance of marketable risks and non-marketable risks, the Belgian authorities replied that such separation of accounts was not necessary. After 1 January 2005, short-term activities (marketable and non-marketable risks) were carried on within Ducroire/Delcredere as part of the transfer of an existing activity. According to the Belgian authorities, there is no need to draw up separate accounts since Ducroire/Delcredere no longer receives state aid, even for its activities in the non-marketable risk sector.

V. **ASSESSMENT OF THE AID**

V.1. EXISTENCE OF STATE AID

(90) Article 107(1) of the TFEU provides that, save as otherwise provided in the Treaties, any aid granted by a Member State 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 Member States, be incompatible with the internal market.

(91) The Commission's first step should be to assess the measures in question to determine whether they constitute state aid within the meaning of Article 107(1) of the TFEU. Consequently, in the sections below, it analyses the measures in relation to the different criteria which constitute aid.

V.1.1. **Existence of an advantage**

V.1.1.1 *Existence of an advantage deriving from the state guarantee (Measure 1) and possible internal transfers of resources for the benefit of marketable risks within the ONDD (Measure 2)*

(92) According to points 3.1 and 3.2 of the Communication on export-credit insurance, state guarantees provided to export-credit insurance companies are likely to give the beneficiaries a financial advantage over their competitors. Therefore, the investigation launched on 23 February 2011 (see recital (26)) concerned in particular the Belgian state guarantee accorded to the ONDD for its activity relating to marketable risks.

(93) From 1 September 2003, a 'commercial' account which, according to the Belgian authorities, was not guaranteed by the State was assigned to ONDD activities in the area of short-term risks, including marketable risks.

(94) Since within the ONDD there were no separate accounts enabling a distinction to be made between the marketable and non-marketable risk insurance activities, the Belgian authorities were asked to provide details of the part of the state guarantee which could be considered to have been allocated, until 31 August 2003, to marketable risk activities. They were also asked to produce evidence that this guarantee did indeed expire on 31 August 2003 and not at the time when Ducroire/Delcredere was established, i.e. 1 January 2005.

(95) The Belgian authorities affirmed that the ONDD stopped offering risk cover to debtors in 'Zone 1' ([37]) in 1993. After 1993, the ONDD's business was focused exclusively on non-marketable risks. The ONDD provided cover for marketable risks on a purely exceptional basis.

([37]) See footnote 21.

(96) As set out in recital (34), Belgium explained that the amount of marketable risk business within the ONDD prior to May 2004 was insignificant. Moreover, the reason why the percentage of marketable risks covered at the time was so low was because of the link between these risks and a non-marketable risk. The example provided ([38]) is as follows: '*An insured person X sold goods to an intermediary A located in zone 1, who sold the goods on to the final customer B, located in zone 2. In most cases, the goods were delivered direct to final customer B. The payment of the invoice of the insured party X by the intermediary A was linked, de facto, to the payment of the invoice of intermediary A by the final customer B. The insured parties could not usually obtain cover from another credit insurer because the operations in question were exposed to political risks in the country where the final customer B was located*.'

(97) The Belgian authorities reaffirmed that cover for these risks were not available from other private credit insurers.

(98) Regarding the elements set out in recitals (93) to (95), it is estimated that these risks, though theoretically classed as marketable (given the principal relation between the insured exporter X and the intermediary A), are to be considered in practice non-marketable in view of the market conditions at the time. Moreover, before May 2004, these risks were covered by the ONDD quite exceptionally since they represented less than [0-2 %] of the premiums (from 2000 to 2004) of the ONDD's short-term portfolio (see recital (34)).

(99) The Belgian authorities also provided proof that the state guarantee granted to the ONDD for its marketable risk business expired on 1 September 2003. This guarantee expired the moment the marketable risks were transferred to the commercial account; the ONDD obtained authorisation from the OCA ([39]) for this account precisely because it was not covered by the state guarantee. The Royal Decree defining the activities carried on by the ONDD for its own account without the state guarantee, published on 1 September 2003 (the date on which it entered into force), details the operations to be entered in this account. Following the entry into force of the Royal Decree ([40]), any coverage of risks by an export policy of less than two years' duration is governed by Article 3(2) of the 1939 Law (business for the account of the ONDD without the state guarantee).

(100) In conclusion, the doubts raised by the Commission in its opening decision concerning the existence of an advantage for the marketable risk insurance activity due to the state guarantee are dispelled. The state guarantee accorded to the ONDD until August 2003 for its activity relating to marketable risks is considered not to have conferred on this activity a competitive advantage over competitors since no actual marketable risk activity existed. Moreover, no attempt was made to develop an actual marketable risk activity on the strength of the state guarantee. The conclusion can also be drawn that the entire business relating to short-term risks ceased to benefit from the state guarantee from 1 September 2003.

(101) There were no internal transfers of resources in favour of marketable risks within the ONDD, given that there was no actual business activity in this area. There was no attempt to develop an actual marketable risk activity on the basis of a transfer of resources from the non-marketable risk business (see recital (98)). In conclusion, there is no evidence to support the existence of transfers of resources to the marketable risk sector within the ONDD or of any advantage conferred on the ONDD as a result of such transfers.

(102) In conclusion, Measure 1 and Measure 2 do not confer an advantage within the meaning of Article 107 of the TFEU. Consequently, they do not constitute state aid.

(103) This being the case, an analysis of the other criteria which constitute aid (state resources, selectivity, distortion of competition) will not be carried out for Measures 1 and 2 in the sections below.

([38]) See the 'Observations by Belgium on the Decision by the European Commission of 24 February 2011', submitted by the Belgian authorities on 1 June 2011, pp. 13-14.

([39]) On the basis of Article 2(2)(d) of Council Directive 73/239/EEC (in force at the time), the ONDD did not need to be authorised by the OCA in so far as its operations were covered by the Belgian state guarantee. By proceeding to carry on, via the 'commercial' account, activities which were not guaranteed by the Belgian State, the ONDD no longer benefited from the exemption laid down in Article 2(2)(d) and needed to obtain authorisation from the OCA.

([40]) See page 15 of the document submitted by the Belgian authorities on 1 June 2011.

V.1.1.2. *Existence of an advantage deriving from the allocation of capital to Ducroire/Delcredere (Measure 3)*

Scope of the assessment to determine whether the allocation of capital to Ducroire/Delcredere constitutes aid

(104) According to the opening decision (see recitals (27) and (28) of this Decision), the following two amounts must be deducted from the initial capital allocation to Ducroire/Delcredere as they do not constitute aid:

(a) the part of the capital supporting non-marketable risk insurance (first exclusion criterion);

(b) the part of the capital that was already supporting the insurance of marketable risks within the ONDD and which was simply transferred to Ducroire/Delcredere with the corresponding insurance business. This was solely a change in the legal form of a pre-existing economic activity together with the relevant capital. Based on the approach followed in the decision on the creation of the Banque Postale ([41]), such a transfer of capital does not confer a new advantage on the economic activity in question and cannot therefore be considered aid as such (second exclusion criterion).

(105) In line with the approach developed in the opening decision, the Commission ought to begin by applying these two exclusion criteria.

(106) However, Belgium advanced an argument based on the second exclusion criterion which, if it were correct, would make it possible to exclude immediately any categorisation of the whole of Measure 3 as aid. The Commission will therefore demonstrate in the first instance that this argument is invalid, before applying the two exclusion criteria set out in the opening decision.

Rejection of Belgium's claim that the total amount of EUR 150 million was linked to the business transferred in 2004

(107) In response to the opening decision, Belgium invoked to its advantage and expanded on the second exclusion criterion according to which the capital which, within the ONDD, already supported the existing marketable business just before its transfer to Ducroire/Delcredere on 1 January 2005 does not constitute aid. More precisely, Belgium considers that all of the initial capital of EUR 150 million allocated to Ducroire/Delcredere constituted the economic capital associated with the short-term insurance business (**marketable and non-marketable**) transferred. It considers that the creation of Ducroire/Delcredere with its initial capital of EUR 150 million was simply a change in the legal form of an existing business and of the relevant capital. This meant that none of initial capital allocation constituted aid. Consequently, Belgium maintains that there is no need to verify how this capital was used subsequently by Ducroire/Delcredere (i.e. whether it was used for marketable or non-marketable risks — first exclusion criterion) given that it could not constitute aid.

(108) In support of their assertion, the Belgian authorities emphasised that the Ducroire/Delcredere capital subscription of EUR 150 million was necessary from the beginning of 2005. The Belgian authorities justified this level of capitalisation on the basis of the 'current standards' developed within the framework of the adoption of the Solvency II Directive ([42]) (the so-called 'standard' method in accordance with technical parameters such as those established in an impact study — 'QIS 5' for Belgium — dating from March 2011) for all the risks to which Ducroire/Delcredere was exposed, except for political risks for which internal modelling was used to determine the capital required to cover these risks. As indicated in the section 'Solvency II with internal modelling for political risks' of Table 2, EUR [125-150] million of capital was required to cover the expected level of activity in 2009.

([41]) See the Commission Decision of 21 December 2005 in Case N 531/2005 'Measures relating to the creation and operation of the Banque Postale' (OJ C 21, 28.1.2006, p. 2) available at: http://ec.europa.eu/eu_law/state_aids/comp-2005/n531-05.pdf.

([42]) See footnote 28.

(109) The Commission observes that the concept of 'capital connected with transferred activities' is defined in the Commission decision of 21 December 2005, 'Measures relating to the creation and operation of the Banque Postale' ([43]). In that case, it was found that the transfer did not involve any new capital as only the own funds attached to the financial service activities of La Poste were transferred to the newly created legal entity, 'La Banque Postale'. In other words, these were exclusively own funds which already existed and which had clearly been allocated previously to the assets, rights and obligations transferred. Thus, the analysis related to the capital which was already formally attached to the business activities transferred and not to a prospective estimation of the capital which it would have been appropriate to assign to the new entity to support its future development.

(110) As explained previously, the activity relating to short-term (marketable and non-marketable) risks transferred to Ducroire/Delcredere had been managed within the ONDD through the commercial account since 1 September 2003. Capital of EUR [45-70] million had been assigned to this account. Moreover, as set out in recital (99), the ONDD obtained authorisation from the national insurance regulator (the OCA) specifically and solely for the commercial account (and the related capital of EUR [45-70] million). The rules and oversight of the OCA concerned, *inter alia*, compliance with the solvency rules (minimum guarantee fund, solvency margin to be constituted) ([44]). Accordingly, on the basis of the prudential rules in force at the time, these short-term activities assigned to the commercial account were sufficiently capitalised.

(111) In this regard, the Commission observes that, according to the internal memo of 20 April 2004 ([45]) on the basis of which the decision was taken to set up Ducroire/Delcredere and allocate to it a capital of EUR 150 million, the capital strictly allocated to the activity relating to short-term risks was the capital registered in the commercial account plus the profit for a period of 16 months (from 1 September 2003 to 31 December 2004) estimated at EUR [0-5] million. The memo states that '*of the company's EUR 150 million capital, EUR* [45-70] *million originated from the transfer of own funds from the commercial account*'. The Commission concludes, therefore, that, when the decision was taken to set up Ducroire/Delcredere, the capital that could be considered to be formally allocated to short-term activities on 31 December 2004 amounted to only EUR [45-75] million (EUR [45-70] million plus the estimated profit of EUR [0-5] million). Therefore, only the transfer of this capital for an amount of EUR [45-75] million constituted the part of the capital already allocated to the short-term risk activity within the ONDD and simply transferred to Ducroire/Delcredere. This transfer cannot therefore constitute a new advantage for this activity and cannot therefore constitute aid.

(112) The Commission therefore rejects Belgium's assertion that all of the initial capital of an amount of EUR 150 million constitutes the capital which was simply transferred and which was already allocated within the ONDD to the activity transferred and therefore cannot be considered an advantage. The Commission considers that the difference between the EUR [45-75] million and the capital actually subscribed to the tune of EUR 150 million therefore constitutes additional capital representing a new advantage for this activity.

(113) In the alternative, the Commission would observe that the internal memos of 2004 which underpinned the ONDD's decision to grant Ducroire/Delcredere EUR 150 million of capital (greatly exceeding the EUR [45-75] million allocated to the commercial account) show that the ONDD considered different scenarios for the **growth** of business within the future Ducroire/Delcredere. The need for EUR 150 million of capital was therefore determined on the basis of hypotheses regarding the future growth of the activities of Ducroire/Delcredere. It can therefore be concluded that the approach of the Belgian authorities is akin to excluding from the scope of the analysis to determine the existence of an overall advantage the entirety of the capital which the new entity could be assumed to require in order to support its future development. This approach cannot be accepted. Only the capital from which the activities transferred within the existing legal entity already formally benefited (short-term insurance activities within the ONDD) does not constitute a new advantage since the activities in question already benefited therefrom. Conversely, any additional capital constitutes a new advantage since the activity in question did not benefit from this capital before the transfer. The decision to create Ducroire/Delcredere and allocate to it a capital of EUR 150 million cannot therefore be considered a simple change of legal form of an existing activity with a simple transfer of capital allocated to the activity transferred. Therefore, the Belgian authorities' assertion that from 2004 it could be anticipated that Ducroire/Delcredere would need a capital of EUR 150 million in 2009 on the basis of the expected growth of its business is irrelevant. The Belgian authorities do not in any way demonstrate that this capital of EUR 150 million was already allocated to short-term activities within the ONDD before their transfer to Ducroire/Delcredere and that this capital of EUR 150 million does not therefore constitute a new advantage for these activities.

([43]) See footnote 10.
([44]) See Annex 4 to the observations of the Belgian authorities of 1 June 2011.
([45]) See pages 62 and 70 of the said memo (submitted as Annex 8 to the observations of the Belgian authorities of 1 June 2011).

(114) Purely in the alternative, even if the capital required to support the expected growth of the business was a pertinent criterion for the present analysis (which the Commission contests), the Commission would make the following observations:

(a) First, the financial projections existing in 2004 covered only the period 2005-07. Accordingly, even if the capital required to support the growth of business was a relevant criterion for the present analysis (which the Commission contests), it cannot be accepted that it be based on the expected level of activity in 2009 since this level of activity had not even been estimated in 2004.

(b) Secondly, the methodology of the Solvency II Directive accompanied by internal modelling for political risks, proposed by Belgium to estimate the capital required, cannot be accepted. This method was absent from the 2004 internal memos which formed the basis for the decision taken by the ONDD Board of Directors on 20 April 2004 to establish Ducroire/Delcredere and endow it with a certain amount of capital since this method was non-existent at the time (it is not due to enter into force until 1 January 2014). It was applied by the ONDD for the first time in 2011 and is still being developed. Consequently, the internal modelling for political risks has not yet been validated by the Belgian insurance regulator, contrary to the requirements of the Solvency II Directive ([46]). The use of a methodology which did not exist in 2004, such as Solvency II, for which numerous calculation parameters and an implementation timetable have not yet been finalised (they are still at QIS stage) is inappropriate. To consider that the economic capital required by Ducroire/Delcredere when it was set up in 2005 to continue the activity pre-existing within the ONDD must be determined on the basis of the requirements of the Solvency II Directive which did not even exist at the time and for which the regulators would in any case have planned transitional arrangements, seems excessive. Moreover, to draw any other conclusion would be tantamount to contradicting the validation of the level of capital (solvency margin) ([47]) of the commercial account (EUR [45-70] million) by the regulator, who at the time had considered this capital sufficient in the light of the prudential rules in force.

(115) The ONDD Board of Directors, meeting on 20 April 2004, used another method, i.e. the Cooke ratio, to determine Ducroire/Delcredere's capital requirement, while taking into account the need to provide Ducroire/Delcredere with sufficient credibility in the eyes of its competitors. The ratio used in the calculations is not 8 %, as prescribed by the Basel I rules, but 10 %. Hence, the calculations of capital requirements made in 2004 included a 2 % safety buffer. It should be noted that the capital thus determined for the end of 2004 amounted to EUR 66 million ([48]) and is therefore well below the EUR 150 million of subscribed capital.

(116) As for using the Cooke ratio to determine the capital required, the Commission criticised, in its opening decision, the appropriateness of applying banking rules (such as the Cooke ratio) to credit insurers, given the many differences between the risks assumed by credit insurers and by banks (see recital (90) of the opening decision). In this regard, Belgium has not proved that the Basel rules (Cooke ratio) — which, in law, apply **exclusively** to the banking sector — would in practice be applied by credit insurance bodies or be recommended by rating agencies or insurance supervisory bodies.

(117) Regarding the application of Article 8 of the 1939 Law on the ONDD, the Belgian authorities have confirmed that this law does not apply to Ducroire/Delcredere. Moreover, this article concerns only the ONDD's own-account activities guaranteed by the State and activities for the account of the State.

(118) Although Belgium refers to the Standard & Poor's method, which existed at the time to determine the capital requirements of credit insurers, it should be noted that the Belgian authorities have not submitted any capital estimate using this method. Nor was the method used by the ONDD in 2004.

([46]) The Solvency 2 QIS 5 report of the CBFA (March 2011) states on page 17 that very few participants have been capable of providing information on their use and the characteristics of internal models because these models are still at the development stage. Moreover, the CBFA decided not to draw any conclusions at this stage. This suggests that even private insurance companies still find it difficult to produce internal models for calculating the capital required to cover certain risks.

([47]) See pages 11 and 13-16 of Annex 4 to the Belgian authorities' observations of 1 June 2011.

([48]) Calculated according to the method used in 2004 on the basis of projected net commitments for the end of 2004. The data used to perform the calculation are provided on page 16 of Annex 13 to the observations of the Belgian authorities of 1 June 2011.

(119) In conclusion, even supposing that the capital required to support the expected growth of Ducroire/Delcredere's business was a relevant criterion for the present analysis (a fact contested by the Commission), the Belgian authorities have not provided any fresh evidence to demonstrate conclusively that the capital requirement relating to short-term risks transferred to Ducroire/Delcredere had to be greater than the existing capital on the ONDD commercial account at the end of 2004.

(120) In this section, the Commission has demonstrated that it was necessary to reject the Belgian authorities' assertion that the allocation of an initial capital of EUR 150 million to Ducroire/Delcredere in 2004 constituted only the transfer of the capital which had already been provided to support the activity relating to short-term risks within the ONDD. The Commission has in fact concluded that the capital which already supported the activity relating to short-term risks within the ONDD before the transfer of this activity to Ducroire/Delcredere amounted to EUR [45-75] million and that therefore additional capital of EUR [75-100] million was allocated to this activity.

(121) It is now appropriate to examine the application of the two exclusion criteria described in the opening decision. The second exclusion criterion will be dealt with before the first.

Part of the capital already supporting the insurance of marketable risks within the ONDD and which was simply transferred to Ducroire/Delcredere with the corresponding insurance activities (second exclusion criterion detailed in the opening decision)

(122) In recital (111), the Commission concluded that, within the ONDD, EUR [45-75] million of capital was allocated to the activity relating to short-term risks as at 31 December 2004. To apply the second exclusion criterion, it is necessary, therefore, to estimate, of the EUR [45-75] million allocated to the short-term risk business at the end of 2004, the part of the capital relating to marketable risks ([49]). As described above, these marketable risks were composed exclusively of risks relating to debtors located in the ten States which acceded to the European Union in May 2004.

(123) As also described above, the commercial account, which consisted of a capital of EUR [45-75] million at the end of 2004, did not contain separate accounts making it possible to identify precisely the capital supporting only the activity relating to marketable risks. It is therefore necessary to estimate the part of the EUR [45-75] million which can reasonably be regarded as supporting the activity relating to marketable risks.

(124) According to the data submitted to the regulator in 2004, the amounts of net commitments were EUR 141,6 million for risks relating to the ten new Member States and EUR 661,4 million for all short-term export policies at the end of 2004 ([50]). On the basis of a pro rata breakdown of the EUR [45-75] million based on net commitments, EUR [10-25] million can therefore be regarded as constituting the capital linked to risks relating to the ten new Member States before their transfer from the ONDD's commercial account to Ducroire/Delcredere.

(125) The Commission notes that such a distribution of the capital in accordance with net commitments is in line with the approach followed by the ONDD itself in 2004 ([51]).

([49]) As is explained in recital (140), an alternative approach would be to exclude the entire amount of EUR [45-75] million. However, in order to be able to calculate the part of the capital supporting the activity relating to marketable risks within the additional capital of EUR [75-100] million, it is necessary to break down the pre-existing capital between marketable and non-marketable risks. This is due to the fact that the separation of the capital supporting the activity relating to marketable and non-marketable risks is carried out on the entire capital (see Table 2 and recital (135)).

([50]) The figures were obtained by multiplying commitments at the end of 2004 by the retention rate (or 100 % minus the reinsurance cession rate). The figures come from Annex 13 (*Financial Plan 2005, 2006 and 2007 submitted to the CBFA*) to the document submitted by the Belgian authorities on 1 June 2011 (*Observations by Belgium on the Decision by the European Commission of 24 February 2011*).

([51]) As previously indicated, the method used by the ONDD in 2004 to estimate the capital needs of Ducroire/Delcredere was based on the amount of net commitments multiplied by a certain percentage (Cooke ratio). When applying this method, the ONDD did not distinguish between net commitments relating to risks connected with debtors located in the ten countries which acceded to the Union in 2004 and net commitments relating to other non-marketable risks. Consequently, the application of the method for the pro rata calculation based on net commitments (after cession) is in line with the approach followed by the ONDD.

(126) The Commission also observes that the Belgian authorities and the ONDD/Ducroire/Delcredere consistently maintained during the procedure that non-marketable risks required, for a given sum insured, more capital than marketable risks. Therefore, the amount of EUR [10-25] million represents more of a ceiling than a floor. The Commission considers, however, that it is reasonable to retain this figure as it is in line with the approach followed by the ONDD itself in 2004.

(127) The Commission concludes from this that, of the initial capital amount of EUR 150 million, the amount of EUR **[10-25]** million can be considered not to constitute an advantage for the marketable risk business as it already supported this activity within the ONDD ([52]). What was involved in this case was simply a change in the legal form of the same economic activity and of the related capital. The transfer to Ducroire/Delcredere of this capital with the activity in question cannot therefore constitute aid.

(128) By analogy, the same reasoning must be applied to the amount of the capital associated with risks relating to debtors located in Romania and Bulgaria. In 2007, non-marketable risks relating to debtors located in Romania and Bulgaria were recategorised as marketable risks owing to the accession of these States to the European Union. The capital which already supported these risks when they were not marketable cannot therefore constitute a fresh advantage merely on the ground that these risks became marketable subsequently. It is therefore appropriate to exclude this capital also from categorisation as state aid.

(129) Therefore, the capital relating to non-marketable risks which became marketable is excluded from the analysis of the existence of an advantage. In their comments of 16 May 2012, the Belgian authorities estimated the capital associated with risks relating to debtors located in Romania and Bulgaria at EUR [0-2] million, based on the assumption that these risks were marketable in 2005. On the other hand, they did not provide an estimate of the capital associated with these risks on 31 December 2006. Since the risks in question were indeed not marketable in 2005, the Belgian authorities' estimate of the capital allocated to these risks is likely to be too low. The separate accounts recreated retrospectively by the ONDD as part of this procedure (comments of 16 May 2012), show that the capital allocated to non-marketable risks was EUR [0-5] million less in 2007 than in 2006. This decrease can be explained by the change in the categorisation of risks relating to Romania and Bulgaria (considered marketable risks from 2007), but also by other factors, such as the change in policy with regard to reinsurance. On the basis of all of the information available, it can reasonably be considered that the capital supporting risks relating to Bulgaria and Romania before they became marketable amounted to EUR [0-5] million.

(130) In the light of the foregoing, the Commission concludes that an amount of EUR [**10-25**] million already supported marketable risks before 1 January 2005 and that the transfer of this capital with the activities in question cannot therefore constitute an advantage. Similarly, an amount of EUR [0-5] million already supported risks which became marketable on 1 January 2007 (Romania and Bulgaria) before they became marketable.

Part of the capital supporting the non-marketable risk activity (first exclusion criterion described in the opening decision)

(131) As described above, EUR [45-75] million of capital was already supporting short-term risks before their transfer to the ONDD (see recital (120)). Of this EUR [45-75] million, it has been concluded above that one can reasonably estimate the share of marketable risks at EUR [**10-25**] million. Consequently, one can reasonably estimate the share of non-marketable risks at EUR [35-50] million (including EUR [0-5] million for risks relating to Bulgaria and Romania which became marketable in 2007).

(132) For the same reasons as those set out in recital (127), since the transfer of the whole of the EUR [45-75] million (including the share of non-marketable risks estimated at EUR [35-50] million) does not constitute an advantage, the latter is excluded from the analysis of the existence of aid.

(133) In conclusion, of the initial capital of EUR 150 million allocated to Ducroire/Delcredere, only EUR [75-100] million constitutes additional capital, that is to say fresh capital. Only the granting of this EUR [75-100] million could therefore constitute an advantage (see recital (120)).

([52]) As can be seen from Table 1 and recitals (96)-(98), this capital supported only risks relating to debtors established in the ten countries that acceded to the European Union on 1 May 2004 and other risks considered in practice to be non-marketable risks.

(134) As was pointed out in recital (65) of the opening decision, Member States are free to support the non-marketable risk insurance business, since the Commission considers that there is no market for these risks. There can therefore be no distortion of competition vis-à-vis other insurers. However, the Commission notes that Ducroire/Delcredere did not keep separate accounts for marketable and non-marketable risk activities. **Formally, no capital was allocated to the non-marketable risk activity.** No part of the EUR 150 million of capital was earmarked for the financing of non-marketable risks. Accordingly, a purely formal approach could result in none of the additional capital of EUR [75-100] million being excluded. Such an approach would be all the more justified as the obligation to introduce separate accounts is expressly provided for in point 4.3 of the Communication on export-credit insurance which has been in force since 1998. However, it is clear that a large part of the activities of Ducroire/Delcredere concerns the insurance of non-marketable risks. Ducroire/Delcredere could not have insured these risks without adequate capital. Therefore, in addition to the EUR [45-75] million (including EUR [35-50] million for non-marketable risks), the Commission can agree to exclude also from categorisation as state aid that part of the capital which can reasonably be demonstrated to have been used to support the activity of insuring non-marketable risks.

(135) In the opening decision, Belgium was invited to develop a method for determining the part of the capital of Ducroire/Delcredere which can be regarded as supporting the marketable risk activity and that supporting the non-marketable risk activity. Following this request from the Commission, the Belgian authorities submitted, for the period 2005-2011, a separate balance sheet and profit and loss account for the marketable risk and the non-marketable risk activity. The balance sheet for non-marketable risks at 31 December 2011 included EUR [70-110] million of capital and that for marketable risks EUR [40-80] million of capital. Although the separation of the accounts is based on certain hypotheses or data which are partially verifiable by means of retrospective reconstruction, the levels of capital for the marketable and the non-marketable risk activities at 31 December 2011 are considered by the Commission to be reasonable.

(136) The Commission agrees, therefore, to exclude from categorisation as state aid EUR [70-110] million because it supports, de facto, an activity which, according to the Communication on export-credit insurance, is not subject to competition.

(137) Thus, the capital supporting short-term non-marketable risks rose from EUR [35-50] million at the end of 2004 to EUR [70-110] million at the end of December 2011, i.e. an increase of EUR [35-60] million. Since the amount of EUR [35-50] million of capital linked to the non-marketable risk activity includes the EUR [0-5] million for risks relating to Romania and Bulgaria, recategorised as marketable in 2007, the gross increase in capital supporting non-marketable risks is EUR [35-65] million. In other words, of the additional capital of EUR [75-100] million, EUR [35-65] million supported, de facto, the non-marketable risk activity.

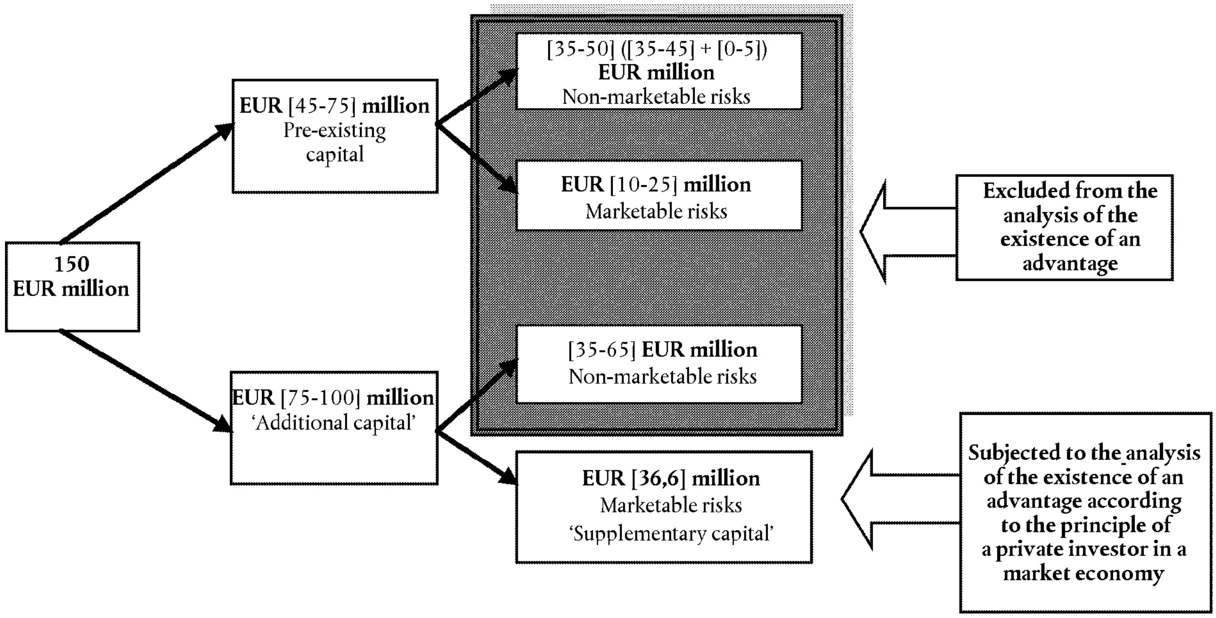
Conclusion on the application of the two exclusion criteria and on the amount of additional capital

(138) An amount of EUR [70-110] million has been excluded from categorisation as aid because it has been possible to regard this amount as supporting the non-marketable risk activity as at 31 December 2011 (first exclusion criterion). An amount of EUR **[10-25]** million has also been excluded from categorisation as aid because it has been possible to regard it as not constituting an advantage given that it already supported marketable risks before those risks were transferred to Ducroire/Delcredere on 31 December 2004 (second exclusion criterion). Furthermore, an amount of EUR [0-5] million must also be excluded since it already supported risks relating to Bulgaria and Romania before they became marketable on 1 January 2007.

(139) In conclusion, only EUR 36,6 million of the initial capital allocation of EUR 150 million might constitute an advantage and state aid within the meaning of Article 107(1) of the TFEU.

(140) Another way of presenting the result of EUR 36,6 million is **to subtract, from the initial capital of EUR 150 million** granted to Ducroire/Delcredere, (1) the EUR [45-75] million in support already provided for short-term risks before their transfer to Ducroire/Delcredere (including the EUR [0-5] million for risks relating to debtors established in Romania and Bulgaria which became marketable on 1 January 2007); and (2) the additional EUR [35-65] million which supported, de facto, non-marketable risks. This leaves us with an amount of **EUR 36,6 million.**

(141) This analysis of the breakdown of the capital is presented in the following table:



(142) In the alternative, the Commission would make the following observations. The Belgian authorities assert that, with the exception of approximately EUR 7 to 13 million (see Table 2), the entire capital of EUR 150 million was implicitly allocated in 2004 to non-marketable risks. On the basis of this first assertion, Belgium maintains that it was only later (in 2007 and 2008) that a part of the capital initially allocated to non-marketable risks was transferred to marketable risks. Belgium maintains, therefore, that only these capital transfers could constitute aid and that the private investor test must be applied to these amounts *at the time of their internal transfer* and not at the time of the initial capital allocation in 2004. This reasoning cannot be accepted.

(143) When Ducroire/Delcredere was set up and in the years that followed, the EUR 150 million of capital was never formally allocated to the activity relating to marketable risks and to that relating to non-marketable risks respectively. This capital could be used freely to support the activity relating to marketable risks or that relating to non-marketable risks (in undefined proportions) depending on market opportunities and the strategic choices of Ducroire/Delcredere. The capital allocation between the activity of marketable risks and that of non-marketable risks was recreated only retroactively within the framework of the present procedure. The 2004 documents, as submitted by the Belgian authorities, did not show any allocation of capital between the different activities. The Commission cannot therefore agree to exclude from the analysis of the existence of aid a part of the EUR [75-100] million of additional capital of Ducroire/Delcredere on the sole basis that at that time this amount might have been used to support the non-marketable risk activity. As already indicated, only that part of the additional capital of EUR [75-100] million which can be shown to have actually supported the non-marketable risk activity can be excluded from the analysis of the existence of aid.

(144) Purely in the alternative, the Commission would observe that, even if one were to accept Belgium's argument that part of the initial capital of Ducroire/Delcredere was allocated to non-marketable risks and therefore could not come within the scope of Article 107(1) of the TFEU, this argument would apply to the amount of EUR 36,36 million only if Belgium managed to demonstrate that the capital allocated to non-marketable risks was higher than EUR [70-110] million. (To calculate the EUR 36,6 million, an amount of EUR [70-110] million supporting the activity relating to non-marketable risks has already been deducted from the EUR 150 million.) It is clear that such an amount was never allocated to non-marketable risks in 2004, as internal documents indicate that EUR 100 million of capital was sufficient to cover all short-term risks (both non-marketable and marketable) until 2007.

Application of the principle of a private investor in a market economy

(145) According to settled case law, in order to establish that a measure grants an economic advantage, it is necessary to consider whether, in similar circumstances, a market economy investor of a size comparable to that of the undertaking concerned would have made a capital contribution of the same amount ([53]), particularly in the light of the available information and foreseeable developments at the time of the investment.

(146) In the present case, an analysis must be carried out as to whether the supplementary capital of EUR 36,6 million granted in 2004 would have been sufficiently profitable to convince a private market economy investor. However, the profitability of this supplementary capital cannot be examined separately from the capital as a whole as the supplementary capital results from an artificial division of the capital of EUR 150 million subscribed in 2004. It is impossible to identify any precise flow of income coming from this EUR 36,6 million. In other words, no profit from a specific activity was attributed to this EUR 36,6 million since separate accounts did not exist. The Commission therefore considers that, in order to apply the private investor test correctly, the expected profitability of the entire capital of EUR 150 million must be verified to see whether it was sufficient. If not, the conclusion will have to be drawn that the EUR 36,6 million constitutes an advantage.

(147) Purely in the alternative, another possibility would be to apply a pro rata method to the overall profit generated, which would produce the same result.

(148) Nor does the Commission consider that the profitability of the additional capital of EUR [75-100] million alone should be examined, excluding the EUR [45-75] million allocated to the short-term risk activity before its transfer to Ducroire/Delcredere. The ONDD could in fact have decided to terminate its short-term risk activity and recover the amount of capital allocated to this activity at the time, namely EUR [45-75] million ([54]). This EUR [45-75] million cannot, therefore, be regarded as a sunk cost.

(149) In the recitals that follow, the Commission will demonstrate that the expected profitability of the EUR 150 million was insufficient to convince a private investor to make such an investment. In the alternative, it will show that, even if one considers that the marketable risk activity benefited virtually from a capital of EUR [45-65] million (EUR 36,6 million plus EUR **[10-25]** million) and from the expected profits from this specific activity, the expected profitability of this activity was also insufficient.

(150) The criterion of a private investor in a market economy must be applied ***ex ante***. The appropriate time for assessing whether a private investor would have made such a contribution is the time when the capital contribution was made. When assessing the private investor criterion, developments subsequent to the capital contribution must not be taken into account. Moreover, compliance with the principle of a private investor in a market economy can be demonstrated by an *ex ante* business plan on the basis of which the decision to invest was made ([55]). According to recent case law ([56]), a Member State can only invoke objective and verifiable elements taken into account prior to or at the same time as the decision to make an investment. Thus elements may be

([53]) Judgment in Case C 261/89 *Italy* v *Commission* [1991] ECR I-4437, paragraph 8; judgment in Joined Cases C-278/92 to C-280/92 *Spain* v *Commission* [1994] ECR I-4103, paragraph 21; judgment in Case C-42/93 *Spain* v *Commission* [1994] ECR I-4175, paragraph 13.

([54]) Excluding the limited costs of terminating this activity, such as […]. The potential scale of such costs is not such as to affect the Commission's conclusions.

([55]) See the Commission Decision 2000/600/EC of 10 November 1999 conditionally approving the aid granted by Italy to the public banks *Banco di Sicilia* and *Sicilcassa* (OJ L 256, 10.10.2000, p. 21, recitals 58–61).
See the Commission decisions of 2005 on the recapitalisation of the German *Landesbanken*, for instance NN 71/2005, *HSH Nordbank* (OJ C 241, 6.10.2006, p. 12) and NN 72/2005, *Bayern LB* (OJ C 242, 7.10.2006, p. 18).
See also the decision in the Shetland Shellfish case (Commission Decision 2006/226/EC, OJ L 81, 18.3.2006, p. 36), in which the Commission rejected two reports produced by the Shetland Islands authorities containing a projected profit-and-loss account, a projected balance sheet and a projected cash-flow statement for 2000, 2001 and 2002. The United Kingdom contended that the studies were *ex ante* and that the assumptions on which they were based were 'conservative and prudent', but the Commission concluded that they would have been considered insufficient by a market economy investor despite the fact that relatively small amounts were involved.

([56]) Judgment in Case C-124/10 P *Commission* v *EDF* [2012] ECR I-0000, paragraphs 82-86 and105.

required that show that this decision is based on comparable economic assessments to those that a rational private investor in a comparable situation would have made before such an investment in order to determine its future profitability. However, it is not enough to rely on economic assessments made after the advantage was conferred, on a retrospective finding that the investment made was actually profitable or on subsequent justifications of the course of action actually chosen to conclude that a Member State had decided on the investment in the same way as a private shareholder in a market economy.

(151) Since no private investors took part in the measure at issue and Ducroire/Delcredere is not listed on the stock exchange, the parameter whose validity must be assessed is the expected profitability of the investment as could be reckoned on from the available information and the developments that were foreseeable at the time (as featured, in principle, in the business plan drawn up by the ONDD in 2004). According to the case law of the Court of Justice ([57]) and the Commission's decision-making practice ([58]), the fact that a capital contribution is allegedly necessary for the undertaking to continue its operations or to ensure the adequate capitalisation of the business, in accordance with prudential rules or an estimation of the risks involved, is not sufficient grounds on which to consider that the market economy investor principle has been satisfied. A private investor operating under normal market conditions would make such a capital contribution only if the expected profitability was sufficient, at the time of the contribution, based on the available information and the developments that were foreseeable at that particular time ([59]). The Commission would therefore point out that Belgium's arguments to justify its assertion that a capital of EUR 150 million was 'necessary' for economic reasons and/or because of prudential rules cannot be relied on to demonstrate that this investment was sufficiently profitable for a market investor.

(152) The Belgian authorities based their analysis of profitability on the business plan of 28 September 2004. Ducroire/Delcredere was in fact incorporated on 23 September 2004. However, it did not actually start operating until 1 January 2005, given that the short-term risk portfolio continued to belong to the ONDD until 31 December 2004, the date on which it was transferred. It can therefore be considered that, until shortly before that date, the ONDD could have gone back on its investment decision by not transferring the risks in question and by liquidating the newly created legal entity. It is therefore acceptable to take into account the ONDD's business plan of 28 September 2004 as requested by the Belgian authorities.

(153) It emerges from the notes and minutes of 2004 that the ONDD's decision to endow Ducroire/Delcredere with a capital of EUR 150 million to Ducroire was essentially due to the ONDD's wish to endow its subsidiary with 'sufficient' initial capital to enable it to develop its business and […] — '*a paid-up capital of EUR 100 million is sufficient to carry on the short-term exporters' global policies business until 2007 but this should be reviewed after that date*' ([60]), however it was not actually and precisely demonstrated that the expected future profitability was satisfactory from a private investor's point of view. In terms of expected profitability analysis, a positive result anticipated for all activities in the first three years seems to have been enough to convince the ONDD to make the investment.

(154) According to the projections in scenario B of the business plan of 28 September 2004, the ONDD was counting on an ROC for all activities of 1,3 % to 1,9 % for 2005, 2006 and 2007 in line with the '6 % growth process' scenario in the business plan (the ROC before the equalisation provision was 2,8-4,3 %) (see Table 4). It must be explained that this profitability is based on a capital of EUR 100 million and does not take account of the EUR 50 million not paid up, which makes the profitability result more favourable than it is in reality. The expected profitability rate in the financial projections of 20 April 2004 was not higher (see Table 3).

(155) In the light of the above, it seems that the expected profitability of the future Ducroire/Delcredere was insufficient to convince a private investor in a market economy to make such an investment. The expected profitability for

([57]) See, for instance, the *West LB* judgment in Joined Cases T-228/99 and T-223/99, *Westdeutsche Landesbank Girozentrale* v *Commission* [2003] ECR II-435, paragraph 255.
([58]) See, for instance, the Commission Decision concerning the restructuring of *Dexia* (decision of 26 February 2010 in Case C 9/2009, OJ L 274, 19.10.2010, p. 54, recital 127) in which the Commission rejected the argument put forward by the Member States concerned whereby the principle of a private investor in a market economy should be applied less strictly since the authorities that had recapitalised Dexia were the bank's 'historical' shareholders.
([59]) See the judgment in Case T-16/96 *Cityflyer Express* v *Commission* [1998] ECR II-757, paragraph 76.
([60]) See page 28 of the strategy paper of 28 September 2004, '*Strategic guidelines for the ONDD and its SA*', presented to the ONDD board of directors, in Annex 10 to the document submitted by the Belgian authorities on 1 June 2011: 'Observations by Belgium on the Decision by the European Commission of 24 February 2011'.

the first three years was less than the risk-free rate (long-term Belgian government bonds). The average rate for long-term Belgian government bonds in 2004 was 4,15 % ([61]). Even taking the equalisation provision into account, the expected profitability rate reached only the risk-free rate.

(156) A private investor in a market economy would not accept such a low profitability during the first few years unless he could reasonably count on being compensated later by profits significantly higher than the average for the industry, so that the total return on investment (after applying an appropriate discount rate) would be sufficient ([62]).

(157) There was no serious study in 2004 that could lead one to consider that this low initial profitability would be compensated by an increased profitability in later years. The Commission would also point out that the financial projections available at the time showed that performance remained at the same level between 2005 and 2007, or at least that there was only sluggish growth (see Table 4), therefore there was nothing to indicate that results would improve rapidly in the years beyond 2007. In this connection, it must be noted that the conversion of Ducroire/Delcredere into a subsidiary cannot be regarded as being the same thing as a start-up since it was envisaged at the time that it would continue with the activities previously carried on by the parent company, and the assets and liabilities were simply transferred from the ONDD to Ducroire/Delcredere for this purpose. This conclusion is also based on the way in which financial projections were produced at the time. It emerges that the ONDD, making financial projections for the future Ducroire/Delcredere in 2004, based them on the past performance of the activity in question (short-term risks, including marketable risks) as carried on by the ONDD. Assumptions regarding premiums and costs were also based mainly on historical financial data from the previous five years, apart from a few adjustments linked to changes in market circumstances, such as a reduction applied to premiums for risks that became marketable in 2004 following the accession of ten new Member States to the European Union.

(158) Moreover, it is clear from internal memos that it was envisaged that the entire paid-up capital of EUR 100 million should be absorbed mainly through the gradual growth until the end of 2007 (see recital (61)) of the activities performed by the ONDD in the past, in other words organic growth of existing activities (no expansion into other, more profitable activities was planned in 2004).

(159) No plans were drawn up at the time for the use of the subscribed capital that had not been paid up (EUR 50 million), hence no projection was produced on the expected profitability of this capital. Moreover, neither the acquisition of KUP nor a broader acquisition strategy was taken into account when transferring the capital to Ducroire/Delcredere.

(160) The projections for the period 2005-2014 were produced only *ex post*, after the Commission had launched the formal investigation procedure. The only *ex ante* financial projections produced by the ONDD were confined to a three-year period (the first three years of operation of the future Ducroire/Delcredere, namely 2005, 2006 and 2007), a relatively short period from the point of view of a private investor.

(161) The Commission concludes that the expected profitability of the capital was insufficient, and that therefore the EUR 36,6 million constitutes an advantage for Ducroire/Delcredere's marketable risk activity.

(162) In the alternative, the Commission will analyse the expected profitability of the marketable risk activity in the recitals that follow.

(163) The Commission would point out that, according to Annex 9 to the strategy paper of 28 September 2004, the financial projections drawn up by the ONDD envisaged **a negative result for the marketable risk activity (in other words, for the marketable risk countries according to the Communication on export-credit**

([61]) Source: Eurostat.

([62]) In its judgment in Joined Cases T-129/95, T-2/96 and T-97/96 *Neue Maxhütte Stahlwerke GmbH* and *Lech-Stahlwerke GmbH* v *Commission* [1999] ECR II-17, paragraphs 116 to 121, the Court of First Instance stated that, while it was true that a parent company could bear the losses of one of its subsidiaries, there should be sufficient probability of a return to profitability by the subsidiary. A private investor could not reasonably allow himself, after years of continuous losses, to contribute additional capital if this proved to be costlier than selling the subsidiary.

See also the *Banco di Sicilia* and *Sicilcassa* decision cited above, recitals 63 to 66.

insurance) ([63]) for the entire period projected from 2005 to 2007, so that the non-marketable risk activity was subsidising the marketable risk activity. It can be deduced, therefore, that the estimated profitability of marketable risks was lower than the estimation for all activities, which in itself was insufficient for a private investor. The Commission therefore concludes that, even if the expected profitability of the marketable risk activity is analysed separately on the basis of the financial projections existing in 2004 ([64]), the conclusion would still be that the expected profitability was negative, and thus obviously insufficient to convince a private investor to proceed with such an investment.

(164) The Belgian authorities point out, for the reasons stated in recital (74), that the September 2004 projections must not be taken into account when analysing the profitability of marketable and non-marketable activities because 'they produce absurd results'. The Belgian authorities say that the method developed in 2011 to separate marketable and non-marketable risks is a better reflection of the reasoning that a private investor might have followed when taking a decision in 2004. They seem to be saying, therefore, **retroactively**, that the 2004 projections for marketable risks ([65]) were based on wrong assumptions. In fact, the forecast claims experience was high but constant, whereas the forecast level of premiums (intended to remunerate the risks incurred) was very low. The result was a loss ratio of 94 %. The Commission cannot accept a retrospective modification of the projected profitability of a business activity (see recital (150)). In the alternative, the Commission would point out that this argument by the Belgian authorities is tantamount to confirming that no serious separate analysis had been carried out of the expected profitability of marketable risks and that, therefore, in order to correctly apply the private investor test, the profitability of the entire capital granted to Ducroire/Delcredere should be examined.

(165) The Commission observes, purely in the alternative, that, even if account were taken of the projections for the result of the marketable risk activity as reviewed and submitted by the Belgian authorities in 2011 ([66]) — which the Commission does not accept since they did not exist at the time of the investment — and if this result were divided by the capital relating to marketable risks as estimated by the Commission (in other words EUR [45-65] million), the estimated ROC for 2005-07 would still be below the risk-free rate.

(166) Contrary to the ONDD's calculations of profitability, the estimation of expected profitability, as indicated in the previous recital, is based on the entire estimated capital for marketable risks, including **the non-paid-up part of the capital**. The Belgian authorities' argument (see recital (79)) whereby the part of the capital subscribed in 2004 but paid up in 2009 should not be taken into account in the estimated profitability calculations before 2009, cannot be accepted. While this capital was not paid up in 2004, it could in fact be called upon at any time since it had been subscribed when Ducroire/Delcredere was set up. A private investor in a market economy would demand remuneration for the risks incurred in relation to this investment, since he could lose part or all of his investment in the event of bankruptcy. Thus the calculations produced by the Belgian authorities cannot be accepted.

(167) However, it must be recognised that this investor can invest the amount of the non-paid-up capital corresponding to his investment, so long as this capital is not called in, in risk-free investments that can be cashed-in in the short or medium term, thereby benefiting from the profitability rate applicable to this type of investment. As a result, such an investor would be able to rely on remuneration for a non-paid-up capital investment corresponding only to the risk premium of the company in which he is investing (in other words, the difference between the expected profitability rate of a capital investment in a similar undertaking and the profitability rate of risk-free investments that can be cashed-in in the short or medium term) ([67]).

([63]) See footnote 24.

([64]) The minutes of the meeting of the ONDD Board of Directors of 20 April 2004 state that the respective contributions of each sector of activity to the overall result had been requested by the Board (see p. 4 of Annex 9 to the submission of 1 June 2011).

([65]) Specifically the risks relating to the ten accession countries.

([66]) For marketable risks, the premium rate was revised upwards (from an initial 0,2 % to 0,3 % of sums insured), thus raising the company's income from insurance by one third. The projections concerning claims experience were, for their part, revised downwards.

([67]) A similar division of remuneration can be found in other Commission decisions concerning state aid. See, for instance, the Commission decision of 11 February 2009 in Case NN 3/2009 'Modifications to the Public support measures to JSC Parex Banka', recitals 36-40, OJ C 147, 27.6.2009, p. 2. The risk premium depends on the investment risk.

(168) Consequently, the expected profitability of a partly paid-up capital investment must be estimated by taking account of the entire capital subscribed, adjusting the result of the expected return rate for the capital that is not paid up. The Commission has simulated various scenarios, including the most favourable case for expected profitability, namely that which consists in accepting that, of the EUR [45-65] million supporting the marketable risk activity, only EUR **[10-25]** million was paid up in 2004 (in other words, the capital already supporting marketable risks in the ONDD), and regarding the remaining EUR 36,6 million as capital that was not paid-up, which therefore required only a risk premium. In carrying out this simulation, the income corresponding to the return on a risk-free medium-term investment of EUR 36,6 million was added to the expected profitability of marketable activities. More precisely, the part of the capital not paid up multiplied by the expected profitability rate at the time for risk-free medium-term liquid investments ([68]) was added to the provisional result for marketable activities ([69]). Next, this sum is divided by the average capital supporting the marketable risk activity. The result is the expected return on average equity (ROAE), which is estimated at approximately 4 % for the investment in 2005-07. The expected profitability calculated in this way is scarcely equal to the average rate for long-term Belgian government bonds in 2004 (see recital (155)).

(169) Even using an investment rate of 3,5 %, as suggested by the Belgian authorities (see recital (80)), the expected profitability would not change significantly and would not achieve the estimated capital cost calculated by Belgium itself.

(170) The estimated profitability (as referred to in recital (168)) takes account of contributions to the equalisation provision, contrary to what is advocated by the Belgian authorities. Since the constitution of this provision, required by the Belgian prudential authorities, is intended to ensure a balance in results over time and to cover future potential losses resulting from future activities, it is more appropriate to take account of it when calculating profitability. The Commission's approach is in line with the accounting approach, where such a provision is regarded as a cost that reduces profit. Even if the provision was not taken into account (as a cost when estimating profit), the expected profitability would not equal the capital cost estimated by the Belgian authorities themselves (in this Decision, the Commission does not comment on the validity of the Belgian authorities' estimate of the capital cost since the reasoning in this Decision is not based on that figure).

(171) It seems, therefore, that, even when the elements put forward by the Belgian authorities are applied (elements which the Commission regards as wrong), the expected profitability of the marketable risk activity was insufficient to convince a private investor in a market economy to proceed with such an investment.

(172) In the alternative, as regards the method *advocated* by the Belgian authorities in their reply to the Commission's request for information in December 2007, in order to estimate profitability or the ROC ratio, the Commission would point out that this ratio was not used in the ONDD's *ex ante* financial projections (business plan). Moreover, such a ratio highlights the technical income on turnover, does not take account of the capital invested and does not state the profitability in relation to it. Nor does it take account of the result of purely financial activities, which, however, forms part of the accounting profit that can be distributed to shareholders. A private equity investor (such as a shareholder) would not therefore have used this rate only (which does not indicate the return on equity or on invested amounts) in order to assess the profitability of the investment he was considering.

(173) In conclusion, the EUR 36,6 million constitutes an advantage which the ONDD granted to Ducroire/Delcredere in the form of capital which it could not have obtained on the market on the same conditions.

V.1.2. **Imputability and state resources**

(174) The granting of capital to Ducroire/Delcredere is a decision of the ONDD imputable to the Belgian State since the ONDD is an '*autonomous public institution*' under Belgian public law, incorporated by an Organic Law of 31 August 1939. The members of its Board of Directors are appointed (by decree decided by the Belgian Council

([68]) After adjusting the financial result upwards because the estimated paid-up capital relating to marketable risks is slightly higher than that estimated by the Belgian authorities (EUR [10-25] million compared with EUR 9,8 million respectively).

([69]) Allowing for the benefit of the doubt, it is considered that the profitability rate expected at the time for risk-free medium-term liquid investments corresponded to the average profitability rates in 2004, in the secondary market, of government bonds with four to six years remaining to maturity, in other words 3,5 %.
See: http://www.nbb.be/belgostat/GlobalDispatcher?TARGET=/TreeviewLinker&rowID=2685&prop=treeview&action=open&Lang=F#2685.

of Ministers) and can be dismissed by the King of the Belgians (who also sets their salaries and allowances) on a proposal, in most cases, from the supervising Federal Ministers and Regional Ministers from the three regions of Belgium ([70]). Known as 'ministerial delegates', the members of the Board of Directors appointed on a proposal from the supervising ministers can, during the deliberations of the Board, suspend decisions they deem contrary to the interests of the State. In this case, the ministerial delegate who suspended the decision must report to the minister who entrusted him with his mandate as Board member. Lastly, the ONDD benefits from a Belgian State guarantee and can act on behalf of the Belgian State.

(175) The Belgian State, represented on the Board of Directors of the ONDD and informed of the decisions taken by it, was therefore directly involved in the ONDD's allocation of capital to Ducroire/Delcredere. The Belgian authorities have not contested the imputability to the Belgian State of the capital allocation measure.

(176) The allocation of capital to Ducroire/Delcredere by the ONDD, a public body whose conduct is imputable to the Belgian State, therefore constitutes a state resource within the meaning of Article 107 of the TFEU.

V.1.3. **Selectivity**

(177) The capital allocation made in 2004 is selective inasmuch as it benefits Ducroire/Delcredere directly and exclusively.

V.1.4. **Distortion of competition**

(178) Once the ONDD made the capital allocation in question without expecting sufficient profitability, Ducroire/Delcredere benefited from a competitive advantage compared with private credit insurance organisations whose shareholders expect a return on their investment of the same level as the return they could obtain from comparable investments.

(179) In particular, Ducroire/Delcredere would have been unable to obtain such capital on the market since the return on the investment was insufficient. This means that without the capital provided by the State via the ONDD, Ducroire/Delcredere would have been unable to extend its activities on the market as it did.

(180) In this respect, point 3.2 of the Communication on export-credit insurance states that the provision of capital by the State to certain undertakings, which constitutes state aid if the State is not acting in accordance with the market economy investor principle, distorts competition.

(181) According to the case law of the Court of Justice, an improvement in the competitive position of an undertaking as a result of state aid generally constitutes proof that competition with other undertakings which have not received similar aid is being distorted ([71]).

(182) The support given by the State to the ONDD in the form of a capital contribution for marketable risks distorts or threatens to distort competition.

V.1.5. **Effect on trade between Member States**

(183) Ducroire/Delcredere is in competition with other European Union undertakings in the credit insurance market. The same applied to the ONDD as far as marketable risks were concerned before it transferred its credit insurance business for short-term risks, including marketable risks, to Ducroire/Delcredere.

(184) Moreover, the ONDD and Ducroire/Delcredere operate in the other Member States, mainly as a result of the acquisition of KUP, the commercial arm of the Czech national export-credit insurance agency.

([70]) Brussels-Capital Region, Flemish Region and Walloon Region.
([71]) Judgment of the Court of Justice in Case C-730/79 *Philip Morris* [1980] ECR 2671, paragraphs 11 and 12.

(185) Point 3.2 of the Communication on export-credit insurance states that, when the State gives a guarantee or capital to an export credit insurance organisation, in relation to marketable risks, without behaving as a private investor would in a market economy, that guarantee or capital constitutes aid which distorts intra-Community trade.

(186) According to settled case law, there is an effect on trade between Member States where the undertaking in receipt of aid carries on its activities in a sector which is open to competition and in which there is trade between Member States ([72]).

(187) The fact that, at the start of this procedure, a competitor from a Member State other than Belgium complained about the distortion of competition as a result of Ducroire/Delcredere's actions in a third Member State (the Czech Republic) simply confirms that Ducroire/Delcredere is active in a sector subject to trade between Member States.

(188) Trade between Member States is therefore sufficiently affected by Measure 3.

V.2. THE ILLEGALITY OF THE POTENTIAL AID

(189) In the light of the above, Measure 3 constitutes aid.

(190) The Commission considers that this aid is new aid which was not notified to it beforehand and is, therefore, illegal.

(191) The ONDD subscribed the capital in question in September 2004 and the short-term risk activity (including marketable risks) was transferred to Ducroire/Delcredere on 1 January 2005.

(192) This measure:

— is therefore later than the date of 17 September 1998, after which Belgium is required not to grant new aid as a result of its acceptance of the Communication on export-credit insurance, and

— does not qualify for the limitation period set out in Article 15 of Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty since it was adopted less than ten years ago.

(193) The part of the capital granted by the ONDD to Ducroire/Delcredere (EUR 36,6 million) which was not notified to the Commission beforehand, thus constitutes illegal new aid from the beginning.

V.3. ASSESSMENT OF THE COMPATIBILITY OF THE POTENTIAL AID WITH THE INTERNAL MARKET

(194) The Commission has verified the compatibility of Measure 3 in accordance with the provisions in the Communication on export-credit insurance applicable at the time. The new Communication to Member States concerning the application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to short-term export-credit insurance (hereinafter: 'the new Communication on export-credit insurance'), published on 19 December 2012, applies from 1 January 2013.

(195) In principle, according to points 3.2 and 4.1 of the Communication on export-credit insurance, the exemptions set out in the Treaty provisions on state aid do not apply to aid granted for the insurance of marketable risks. This aid clearly distorts competition between insurers, but above all leads to '*variations in the insurance cover available for marketable risks in different Member States, thereby distorting competition between companies in Member States and having secondary effects on intra-Community trade regardless of whether intra-Community exports outside the*

([72]) Judgment of the Court of Justice in Case C-102/87 *France* v *Commission* [1988] ECR I-4067, paragraph 19.

Community are concerned. The exceptions provided for in Article 92 of the Treaty do not apply to aid for the insurance of marketable risks. The distorting effects of such aid in the Community outweigh any possible national or Community interest in supporting exports' ([73]). In other words, this aid is not in principle eligible for any of the exemptions set out in Article 107(3) of the TFEU, in particular that provided for in Article 107(3)(c), because it constitutes too great a distortion of competition in the internal market.

(196) Moreover, the aid in question does not meet the conditions of eligibility for one or more of the exemptions provided for in Article 107(3) of the TFEU. In particular, as stated in the opening decision, the aid in question cannot constitute rescue or restructuring aid according to the Community guidelines on state aid for rescuing and restructuring firms in difficulty ([74]), essentially for the following reasons:

1) The Belgian authorities have not proved that Ducroire/Delcredere was eligible for such aid, for instance that it was in difficulty within the meaning of the guidelines on state aid for rescuing and restructuring firms in difficulty. It should also be noted that, according to point 12 of those guidelines, a newly created firm is not eligible for rescue or restructuring aid.

2) The aid was not confined to the minimum necessary. In particular, the capital allocation to Ducroire/Delcredere was sufficiently large to enable it to carry out acquisitions. The business plan presented in 2004 in the form of internal memos did not envisage an own contribution by the beneficiary.

3) The business plan for Ducroire/Delcredere did not contain any measures to limit distortions of competition.

(197) There is nothing in the provisions of the new Communication on export-credit insurance that would change the Commission's assessment.

(198) Consequently, the measure at issue cannot be declared compatible with the internal market pursuant to Article 107(3) of the TFEU.

V.4. THE OBLIGATION TO ESTABLISH AND MAINTAIN A SEPARATE ADMINISTRATION AND SEPARATE ACCOUNTS

(199) According to point 4.3 of the Communication on export-credit insurance, where a non-marketable risk activity receives state support, the company will have to keep a separate administration and separate accounts for its insurance of marketable risks and non-marketable risks so as to ensure that the capital allocated to the non-marketable risk activity does not benefit the marketable risk activity, thereby distorting competition.

(200) According to the Belgian authorities, Ducroire/Delcredere has been engaged in the short-term risk business since 1 January 2005, based on the transfer of an existing business with its existing capital (without an additional capital allocation). In the alternative, Belgium considers that the capital was granted on terms acceptable to a private investor. Since, according to the Belgian authorities, Ducroire/Delcredere does not receive state support — even for the non-marketable risk activity it operates — it is, according to those authorities, not necessary to establish separate accounts.

(201) In section V.1.1.2 it was concluded that the capital allocated to the transferred activity amounted to EUR [45-75] million and that there was therefore an additional capital of EUR [75-100] million, of which EUR [35-65] million de facto benefited the non-marketable risk activity. For this reason, this amount of EUR [35-65] million was excluded from classification as aid. The Belgian authorities' argument that the non-marketable risk activity does not receive state support must therefore be rejected since the existence of additional capital which partly benefited

([73]) See the second and third sentences of the third paragraph of point 3.2. of the Communication on export-credit insurance. See also point 4.1 of the Communication on export-credit insurance which states that '*State aid of the types listed in paragraph 3.1, … would therefore be ineligible for exemption under the State aid rules of the Treaty*'.

([74]) OJ C 244, 1.10.2004, p. 2.

the non-marketable risk activity has been proven. In addition, the 2004 financial projections for Ducroire/Delcredere's entire business envisaged an expected profitability lower than the risk-free rate at the time ([75]). The expected profitability was therefore insufficient to satisfy the requirements of a private investor in a market economy. It can therefore be concluded that the non-marketable risk activity has continued to benefit from state support.

(202) Since the non-marketable risk activity has received and is receiving state support, Ducroire/Delcredere should from its establishment have complied with point 4.3 of the Communication on export-credit insurance imposing a separate administration and separate accounts making it possible to distinguish between the activities relating to non-marketable risks and those relating to marketable risks, and this as long as it carries on its activity relating to marketable risks. This obligation is maintained in the provisions of the new Communication on export-credit insurance (see point 15 of the new Communication on export-credit insurance).

(203) Ducroire/Delcredere was and therefore still is bound by this obligation. A separate administration and separate accounts for the non-marketable and the marketable risk activities must therefore be introduced immediately. Otherwise, the support amounting to EUR [35-65] million granted to the non-marketable risk activity would no longer escape from classification as aid. The conclusion of this Decision that this amount of EUR [35-65] million supports the non-marketable risk activity is based on certain assumptions that are in some cases impossible to verify in a context of retrospective reconstruction of separate accounts (there is no formal separation of accounts within Ducroire/Delcredere). The Commission will no longer accept such a retrospective reconstruction if it must again examine the use of Ducroire/Delcredere's capital in future. The purpose of the obligation to keep a separate administration and separate accounts is precisely to avoid having to resort to such retrospective reconstruction which is, by necessity, based on a number of assumptions that are partially unverifiable.

(204) This Decision and in particular the calculation of the amount of EUR 36,6 million are based on separate accounts (balance sheet and profit and loss accounts) for marketable and non-marketable risks at 31 December 2011 as submitted by the Belgian authorities in May 2012. It would not be acceptable, therefore, if the introduction of a separate administration and separate accounts were to be based on assumptions and methods other than those used to determine the amounts submitted in the context of this procedure. In particular, it would not be acceptable to allocate less capital to the non-marketable risk activity (and thus more capital to the marketable risk activity) than that set out in the separate balance sheet at 31 December 2011 submitted by the Belgian authorities in May 2012.

(205) In the alternative, the Commission would emphasise that the absence of separate accounts since the establishment of Ducroire/Delcredere has made the examination of Measure 3 considerably more complicated and forced the Commission to conduct its analysis on the basis of certain assumptions. Given that the obligation to keep separate accounts lay with Ducroire/Delcredere, it can hardly reproach the Commission for having made certain assumptions or having developed a complex approach as part of its analysis. In the absence of such a complex approach, the Commission could simply have considered that the entire EUR [75-100] million constituted an advantage within the meaning of Article 107(1) of the TFEU.

V.5. THE OBLIGATION THAT THE NON-MARKETABLE ACTIVITY SHOULD NOT CONTRIBUTE TO REPAYING THE AID

(206) In this Decision, the Commission has excluded from qualification as aid that part of the capital which de facto benefits the non-marketable risk activity, even though this part of the capital constituted support that did not meet the requirements of a private investor. The amount of the incompatible aid therefore does not include the support for non-marketable activities. Following the logic of this Decision, the repayment of the incompatible aid should therefore be financed strictly by the marketable activity and the related capital, as this is the only way of restoring the competitive situation in the market for marketable risks that existed before the incompatible aid was granted. As indicated above, this recovery must be made on the basis of separate accounts in a manner consistent with the comments by the Belgian authorities of May 2012.

([75]) Even if the non-marketable risk activity is considered in isolation, the profitability would still be well below the capital cost estimated by the Belgian authorities themselves.

VI. **CONCLUSIONS**

(207) The Commission finds that, of the three measures which were the subject of the formal investigation procedure, Measures 1 and 2 (the state guarantee and the potential internal transfers of resources to marketable risks within the ONDD) do not constitute state aid within the meaning of Article 107(1) of the TFEU. However, the analysis of Measure 3 makes it possible to conclude as to the existence of state aid within the meaning of Article 107(1) of the TFEU amounting to EUR 36,6 million. Since the ONDD (for the account of the Belgian State) illegally implemented Measure 3 in breach of Article 108(3) of the TFEU and since this aid is incompatible with the internal market, it must be recovered. The repayment of this aid must be financed by Ducroire/Delcredere's marketable risk activity,

HAS ADOPTED THIS DECISION:

Article 1

Since the guarantee granted by Belgium to the ONDD did not benefit the ONDD's marketable risk activity, it does not constitute aid.

Article 2

Any internal transfers of resources to the marketable risk activity within the ONDD, the existence of which has not been proved, do not constitute aid.

Article 3

The initial capital allocation granted by the ONDD to Ducroire/Delcredere amounting to EUR 113,4 million does not constitute aid.

Article 4

The initial capital allocation granted by the ONDD to Ducroire/Delcredere amounting to EUR 36,6 million, implemented on 23 September 2004 in breach of Article 108(3) of the Treaty on the Functioning of the European Union, constitutes illegal aid incompatible with the internal market within the meaning of that Treaty.

Article 5

1. Belgium, through the ONDD, shall recover from Ducroire/Delcredere the aid referred to in Article 4. Belgium shall provide detailed evidence — including certification issued by an independent firm auditing these accounts — that the repayment has been financed exclusively by Ducroire/Delcredere's marketable risk activity.

2. The sums to be recovered shall include the interest which has accrued between the date on which they were made available to Ducroire/Delcredere (1 January 2005) and the date on which they are actually recovered.

3. The interest shall be calculated on a compound basis in accordance with Chapter V of Commission Regulation (EC) No 794/2004 ([76]).

4. Recovery of the aid shall be immediate and effective.

Article 6

A separate administration and separate accounts must be introduced without delay for the non-marketable risk activity and the marketable risk activity, and maintained for as long as the non-marketable risk activity receives state support. The separation of the accounts must take account of the financial data furnished by the Belgian authorities in May 2012. In particular, the resulting breakdown of the capital must be done in the same way as in May 2012.

([76]) OJ L 140, 30.4.2004, p. 1.

Article 7

1. Within two months following notification of this Decision, Belgium shall communicate the following information to the Commission:

(a) the total amount (principal and interest) of the aid to be recovered from Ducroire/Delcredere;

(b) a detailed description of the measures already taken and planned to comply with this Decision;

(c) the documents proving that Ducroire/Delcredere has been served with formal notice to repay the aid.

2. Belgium shall keep the Commission informed of the progress of the national measures taken to implement this Decision until recovery of the aid referred to in Article 4 has been completed. It shall immediately submit, on simple request by the Commission, any information on the measures already taken and planned to comply with this Decision. It shall also provide detailed information on the amounts of aid and interest already recovered from Ducroire/Delcredere.

Article 8

Belgium shall take the measures necessary to implement this Decision within four months following the date of its notification.

Article 9

This Decision is addressed to the Kingdom of Belgium.

Done at Brussels, 20 March 2013.

For the Commission

Joaquín ALMUNIA

Vice-President

ANNEX

INFORMATION ON AMOUNTS RECEIVED, TO BE RECOVERED AND ALREADY RECOVERED

Identity of the beneficiary	Total amount of aid received under the scheme [1]	Total amount of aid to be recovered [1] (Principal)	Total amount already repaid [1]	
			Principal	Interest

[1] Million national currency

III

(Other acts)

EUROPEAN ECONOMIC AREA

Public version of [1] EFTA SURVEILLANCE AUTHORITY DECISION No 244/12/COL of 27 June 2012 on restructuring aid granted to Íslandsbanki (Iceland)

The EFTA Surveillance Authority ('the Authority'),

HAVING REGARD to the Agreement on the European Economic Area ('the EEA Agreement'), in particular to Article 61(3)(b) and Protocol 26 thereof,

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

HAVING REGARD to Protocol 3 to the Surveillance and Court Agreement ('Protocol 3'), in particular to Article 1(3) of Part I, Article 7(3) of Part II, and Article 13 of Part II,

Whereas:

I. FACTS

1. PROCEDURE

(1) Following informal correspondence in October 2008, and the passing on 6 October by the Icelandic Parliament (the Althingi) of Act No 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc. (referred to as the 'Emergency Act'), which gave the Icelandic state wide-ranging powers to intervene in the banking sector, the President of the Authority wrote on 10 October 2008 to the Icelandic authorities and requested that state aid measures taken under the Emergency Act be notified to the Authority. Further contact and correspondence followed periodically including notably a letter sent by the Authority on 18 June 2009 reminding the Icelandic authorities of the need to notify any state aid measures, and of the stand-still clause in Article 3 of Protocol 3. Following further correspondence state aid involved in the restoration of certain operations of Glitnir and the establishment and capitalisation of a new Glitnir Bank (by then re-named 'Íslandsbanki') was eventually notified retrospectively by the Icelandic authorities on 15 September 2010 [2].

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

[2] See for a more thorough description of the procedure the opening decision, referred to in footnote 3.

(2) By letter dated 15 December 2010 ([3]) the EFTA Surveillance Authority (the Authority) informed the Icelandic authorities that it had decided to initiate the procedure laid down in Article 1(2) of Part I of Protocol 3 in respect of the measures undertaken by the Icelandic State to restore certain operations of (old) Glitnir Bank hf and establish and capitalise New Glitnir Bank hf, now renamed Íslandsbanki (the opening decision) ([4]). The Authority also required that a detailed restructuring plan for Íslandsbanki be submitted within six months.

(3) By e-mail of 24 March 2011 ([5]), the Authority received one comment from interested parties, which was forwarded to the Icelandic authorities on 25 May 2011. The Icelandic authorities did not respond to this comment.

(4) By letter of 31 March 2011, the Icelandic authorities submitted a restructuring plan for Íslandsbanki. Following the acquisition of Byr in November 2011, the Icelandic authorities submitted a new restructuring plan for Íslandsbanki on 22 February 2012 ([6]).

(5) The Authority requested information with regards to the restructuring plan on 11 July 2011 and 13 February 2012. The request for information was answered by the Icelandic Authorities on 17 October 2011 and 13 March 2012. The final versions of the commitments were submitted on 16 May 2012 and on 6 June 2012 ([7]).

(6) In addition, the Authority met with the Icelandic authorities on 7 June 2011 and 27-28 February 2012.

2. BACKGROUND

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

2.1. **The collapse of Glitnir Bank**

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

(9) Elsewhere, one of the United Kingdom's biggest banks, HBOS, had to be taken over by Lloyds TSB. Glitnir meanwhile, was experiencing major difficulties in financing its activities. A bond issue had had to be cancelled due to a lack of interest, an asset sale was not completed, and a German bank refused to extend two loans estimated at 150 million euros. Market conditions also worsened dramatically after the fall of Lehman Brothers.

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

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

([5]) Corrected by the interested parties on 25 May 2012.

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

([7]) Regarding the competitive situation in the Icelandic banking sector and possible competition remedies, the Authority has cooperated with the Icelandic Competition Authority (ICA).

(10) On 25 September 2008, the Chairman of Glitnir's Board contacted the Central Bank of Iceland (CBI) to inform them that as a result of loans that had to be repaid in October, the bank had an immediate shortfall of 600 million euros. On 29 September it was announced that the Icelandic government would provide Glitnir with 600 million euros in return for 75 % of its equity. The fact that 600 million euros amounted to nearly a quarter of Iceland's foreign currency reserves, and that Glitnir had experienced refinancing problems for some time and had debt estimated at 1,4 billion euros to repay over the following six months, according to publicly available information, suggested, however, that the proposal was not credible ([8]). As it turned out, the value of issued Glitnir shares collapsed from over 200 billion ISK to 26 billion ISK in one day.

(11) The Icelandic banks experienced massive withdrawals of deposits not only abroad but also within Iceland. Domestic withdrawals became so large that at one stage the Icelandic banks and the CBI were close to experiencing a shortage of cash. On 30 September 2008, the credit agency Moody's lowered Glitnir's credit rating, triggering repayment obligations for further loans. Margin calls of over a billion euros also followed. On 7 October 2008 Glitnir was required to ask the Icelandic Financial Supervisory Authority (FME) to be taken under its control ([9]).

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

(12) In their notification of the aid granted to New Glitnir Bank (later Íslandsbanki), the Icelandic authorities explained that the reasons for the collapse of the Icelandic banking sector and their need to intervene were set out in considerable detail in a report prepared by a Special Investigation Commission (SIC) established by the Icelandic Parliament ([10]), whose remit was to investigate and analyse the processes leading to the collapse of the three main banks. The Authority summarises below the conclusions of the Commission concerning the causes of failure most relevant to the demise of Glitnir Bank. The information is drawn from Chapters 2 (Executive Summary) and 21 (Causes of the Collapse of the Icelandic Banks — Responsibility, Mistakes and Negligence) of the SIC report.

(13) The global reduction in liquidity in financial markets that began in 2007 eventually led to the collapse of the three main Icelandic banks, whose business operations had become increasingly dependent on raising funding through international markets. The reasons for the demise of the Icelandic banks were however complex and numerous. The SIC investigated the reasons which led to the collapse of the main banks, and it is notable that the majority of the conclusions applied to all three banks and many are inter-related. Causes of failure related to the banks' activities are briefly summarised below.

Excessive and unsustainable expansion

(14) The SIC concluded that in the years leading up to the collapse the banks had expanded their balance sheets and lending portfolios beyond their own operational and managerial capacity. The combined assets of the three banks had increased exponentially from 1,4 trillion ISK ([11]) 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 2007 ([12]), most notably after the beginning of the international liquidity

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

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

([10]) The SIC's members were Supreme Court Judge, Mr Páll Hreinsson; Parliamentary Ombudsman of Iceland, Mr 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/

([11]) Icelandic *króna*.

([12]) Lending to foreign parties increased by 11,4 billion euros from 9,3 billion euros to 20,7 billion euros in six months.

crisis. This led the SIC to conclude that much of this increase in lending resulted from loans made to undertakings that had been refused credit elsewhere. The report also concluded that inherently riskier investment banking had become an ever increasing feature of the banks' activities and growth had contributed to the problems.

The reduction in finance available on the international markets

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

The gearing of the banks' owners

(16) In the case of each major Icelandic bank, the principal owners were among the biggest debtors ([13]). Glitnir's loans to major shareholders of the Baugur Group and related parties, in particular the FL Group, were substantial. In the spring of 2007 a new Glitnir board was appointed after the Baugur and FL Groups significantly increased their shareholdings in the bank. Over the latter part of 2007 and beginning of 2008 loans to Baugur and companies related to Baugur nearly doubled, and at its peak lending to this group amounted to 80 % of the bank's equity ([14]). This increase in lending to major shareholders occurred despite the fact that Glitnir was starting to face liquidity and refinancing problems. The SIC was of the view that certain shareholders had abnormally easy access to borrowing from the banks in their capacity as owners. It also concluded that there were strong indications that Baugur and the FL Group had tried to exert undue influence on the bank's management, and that the boundaries between the interests of the largest shareholders and the interest of the bank were blurred. The emphasis on the major shareholders was therefore to the detriment of other shareholders and creditors. When the bank collapsed its outstanding loans to the Baugur Group and affiliated companies was approximately 2 billion euros, around 70 % of its equity. The SIC also questioned the operation of money market funds operated by subsidiaries of the banks, which invested heavily in securities connected to the owners of the banks. Glitnir Funds, a subsidiary of Glitnir, lent around 300 million euros to Baugur and the FL Group by investing 20 % of its total capital in their securities.

Concentration of risk

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

Weak equity

(18) Although the capital ratio of Glitnir and the other two major Icelandic banks was always reported to be slightly higher than the statutory minimum, the SIC concluded that the capital ratios did not accurately reflect the financial strength of the banks. This was due to risk exposure of the banks' own shares through primary collaterals and forward contracts on the shares. Share capital financed by the companies themselves, referred to by the SIC as 'weak equity' ([15]), represented more than 25 % of the banks' capital bases (or over 50 % when assessed against the core component of the capital, i.e. shareholders' equity less intangible assets). Added to this were problems caused by the risk that the banks were exposed to by holding each other's shares. By the middle of 2008 direct financing by the banks of their own shares, as well as cross-financing of the other two banks' shares, amounted

([13]) Chapter 21.2.1.2 (page 6) of the Report.

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

([15]) Chapter 21.2.1.4 of the Report.

to approximately 400 billion ISK, around 70 % of the core component of the capital. The SIC was of the opinion that the extent of financing of shareholders' equity by borrowing from the system itself was such that the system's stability was threatened. The banks held a substantial amount of their own shares as collateral for their lending and therefore as share prices fell the quality of their loan portfolios declined. This affected the banks' performance and put further downward pressure on their share prices; in response to which (the SIC assumed from the information in their possession), the banks attempted to artificially create abnormal demand for their own shares.

The size of the banks

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

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

(20) The SIC concluded that the relevant supervisory bodies in Iceland lacked the credibility that was necessary in the absence of a sufficiently resourced lender of last resort. The report concludes that the FME and CBI lacked the expertise and experience to regulate the banks in difficult economic times, but that they could have taken action to reduce the level of risk that the banks were incurring. The FME, for example, did not grow in the same proportion as the banks and the regulator's practices did not keep up with the rapid developments in the banks' operations. The report is also critical of the government, 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 abroad ([16]).

Imbalance and overexpansion of the Icelandic economy as a whole

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

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

([17]) Chapter 2, page 5 of the report.

The Icelandic króna, external imbalances and CDS spreads

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

2.3. **Measures taken to reconstruct the banking sector**

(23) Following the collapse of the three biggest commercial banks in October 2008 (including Glitnir) the Icelandic authorities were faced with the unprecedented challenge of safeguarding continued banking operations in Iceland ([18]). The policy followed by the Icelandic government is primarily laid down in the Emergency Act ([19]) adopted by the Icelandic Parliament on 6 October 2008. The law grants extraordinary powers to the FME to take control of financial undertakings and to dispose of their assets and liabilities as required. The Minister of Finance was authorised, on behalf of the Treasury, to disburse funds in order to establish new financial undertakings. Moreover, in bankruptcy proceedings of financial undertakings, deposits would be given priority over other claims. The government declared that deposits in domestic commercial and savings banks and their branches in Iceland would be fully protected.

(24) Policy priorities focused initially on securing the basic functioning of the domestic banking, payment and settlement systems. In the first weeks after the crash, the Icelandic Government also prepared an economic program in collaboration with the International Monetary Fund (the IMF), leading to the approval on 20 November 2008 of Iceland's request for a two year stand-by-arrangement from the Fund, which included a 2,1 billion USD loan from the IMF aimed at strengthening Iceland's currency reserves. Additional loans of up to 3 billion USD were secured from other Nordic countries as well as certain other trading partners. Of the IMF loan, 827 million USD was made available immediately, while the remaining amount was disbursed in eight equal instalments, subject to quarterly reviews of the program.

(25) The IMF Program was a broad-based stabilisation program focusing on three key objectives. Firstly, to stabilise and restore confidence in the króna so as to contain the negative impact of the crisis on the economy. The measures included the introduction of capital controls aimed at stemming capital flight. Secondly, the program included a comprehensive bank restructuring strategy, ultimately aimed at rebuilding a viable financial system in Iceland as well as safeguarding the country's international financial relations. Among subsidiary goals was to ensure fair valuation of the banks' assets, maximise asset recovery and strengthen supervisory practices. Thirdly, the program aimed at ensuring sustainable public finances, by limiting the socialisation of losses in the failed banks and implementing a medium-term fiscal consolidation program.

(26) The Icelandic authorities have underlined that due to the exceptional circumstances linked to the large size of the banking system in relation to the financial capacity of the Treasury, the policy options available to the authorities were limited. The solutions relied upon were therefore in many ways different to the measures taken by the governments of other countries facing threats to financial stability.

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

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

(27) On the basis of the Emergency Act, the three large commercial banks, Glitnir Bank, Landsbanki Íslands and Kaupthing Bank, were split into 'old' and 'new' banks. The Minister of Finance founded three limited liability companies to take over the domestic operations of the old banks and appointed them boards of directors. The FME took control of the old banks, allocated essentially their domestic assets and liabilities (deposits) to the new banks which continued banking operations in Iceland, while the old banks were placed under the supervision of their respective resolution committees ([20]). Foreign assets and liabilities were in the main placed in the old banks, which were later submitted to winding-up procedures and the eventual closure of all foreign operations ([21]).

(28) In the provisional opening balance sheets of the three new banks of 14 November 2008 it was estimated that the banks' combined total assets would amount to 2 886 billion ISK, with an equity to be provided by the State of 385 billion ISK. The total amount of bonds to be issued by the new banks in favour of the old banks as payment for the value of the assets transferred in excess of liabilities was estimated at 1 153 billion ISK. The FME appointed Deloitte LLP to perform assessments of the value of transferred assets and liabilities. In this process it transpired that the independent assessment would not result in fixed values of net assets transferred but valuations within certain ranges. It also emerged that the banks' creditors raised disagreements concerning the valuation process, which they considered not to be impartial, and complained that they were unable to protect their interests. These complications resulted in a change of policy for settling the accounts between the old and the new banks, entailing that instead of relying on valuations by an independent expert, the parties would try through negotiations to reach agreements on the value of the net assets transferred.

(29) It was clear that it would be difficult for the parties to reach agreements on the valuations as they were evidently subject to numerous assumptions on which the parties were likely to disagree. The state aimed to reach agreements on base evaluations providing a firm foundation for the initial capitalisation of the new banks. Price performance of assets in excess of the base evaluation could be attributed to the creditors in the form of contingent bonds or increases in the value of the banks' share capital, as it had emerged in the negotiations that the resolution committees of Glitnir and Kaupthing and a majority of their creditors could be interested to acquire holdings in the new banks, and this would allow them to benefit from potential increases in the values of the assets transferred.

(30) The full capitalisation of the three new banks and the basis of agreements with the creditors of the old banks were announced on 20 July 2009. The Government, as the sole owner of the three new banks, reached heads of agreements with the resolution committees of the old banks in relation to how compensation for the transfer of net assets into the new banks would be achieved and paid for. With regard to two of the new banks, Íslandsbanki and New Kaupthing (later named Arion Bank), this included conditional agreements for the old banks to subscribe for majority equity interests in the new banks.

(31) On the basis of the above tentative agreements, the resolution committees of the old banks decided in October 2009 (Glitnir) and December 2009 (Kaupthing Bank and Landsbanki Islands) to exercise the negotiated options and subscribe to shareholding in the new banks. On 18 December 2009 the Government announced that bank reconstruction had been concluded and that agreements had been reached between the Icelandic authorities and the new banks, on the one hand, and the resolution committees of Glitnir Bank, Landsbanki Íslands and Kaupthing Bank on behalf of their creditors, on the other hand, on settlements concerning assets which were transferred from the old banks to the new ones, and that the new banks were then fully financed.

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

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

(32) As it turned out, the Treasury's contribution to the new banks' equity was reduced substantially, from 385 billion ISK as originally envisaged to 135 billion ISK in the form of share capital and, in the case of two of the three banks, Íslandsbanki and Arion Bank, approximately 55 billion ISK of Tier II capital in the form of subordinated loans or a total of 190 billion ISK. In addition, the Treasury provided Íslandsbanki and Arion Bank with certain liquidity facilities. The share capital provided by the old banks to the new ones amounted in total to approximately 156 billion ISK. Total capitalisation of the new banks therefore amounted to approximately 346 billion ISK. Thus, instead of maintaining full ownership of the three banks, the agreements implied that the state's holdings would be reduced to approximately 5 % in the case of Íslandsbanki, 13 % in the case of Arion Bank and 81 % in the case of Landsbankinn.

(33) While this takeover of two of the three banks by the creditors of the old banks resolved major issues in the rebuilding of the financial sector and established firmer capital foundation for the new banks, numerous weaknesses remained which needed to the addressed. Since the autumn of 2009, the banks have concentrated their efforts mostly on internal issues, determining the overall strategy for their operations and in particular restructuring their loan portfolios, which represent the greatest risk factor to their operations and long-term viability. The restructuring process has been complex due to various complicating factors, including Supreme Court rulings on illegality of loans granted in ISK but indexed to foreign currencies. As for Íslandsbanki, in so far as relevant for its restructuring, these matters are discussed further below.

Macroeconomic environment

(34) Major economic turbulence followed the collapse of the banking system in October 2008. The difficulties in Iceland's financial system were coupled with a breakdown of confidence in its currency. The króna depreciated sharply in the first quarter of 2008 and again in the autumn, before and after the failure of the three commercial banks. Despite capital controls imposed in the autumn of 2008, currency volatility prevailed in the course of 2009 ([22]). This turmoil resulted in a severe recession in Iceland's economy, with a contraction of GDP by 6,8 % in 2009 and 4 % in 2010.

(35) Among the implications of the economic crisis was a sudden increase in unemployment from 1,6 % in 2008 to 8 % in 2009, a hike in inflation and a drop in real wages. Moreover, there was a sharp rise in corporate and household debt and of the share of non-performing loans in the banks' loan portfolios as well as a large scale takeover by the new banks of businesses in financial distress. At the same time the high fiscal cost of restructuring the banking system led to a sharp rise in the fiscal deficit and a major surge in public sector debt.

(36) Following the deep recession provisional data from Statistics Iceland indicates a turnaround in the second half of 2011 and for the whole year a growth of GDP of 3.1 % compared to the previous year.

(37) Economic growth in 2011 was mostly due to an increase in domestic demand, particularly a 4 % rise in private household consumption. This was supported by increases in wages and social benefits as well as certain policy initiatives undertaken to ease the payment burden of household debt, including a temporary interest rate subsidy, the freezing of payments on loans and the early reimbursement of private pension savings. Provisional data for 2011 also indicate a slow increase in investments, however from a particularly low level ([23]). Public consumption has remained at a subdued level during the past three years.

(38) The general macroeconomic data disguise more significant sectoral differences. In addition to the collapse in the financial sector a major contraction has taken place in construction and many other domestic production and service activities. Growth has on the other hand taken place in certain export sectors. Due to the low exchange rate of the króna and relatively stable prices in foreign currency for both marine and aluminium products, export revenue rose following the onset of the economic crisis, also with respect to tourism and other services exports.

([22]) As an example of the scale of the sharp depreciation, the monthly average exchange rate of the euro to the Icelandic króna rose from 90,71 ISK in December 2007 to 184,64 ISK November 2009.

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

At the same time, imports fell sharply, turning the trade balance ([24]) temporarily to a surplus of approximately 10 % of GDP in 2010. However, with increased domestic demand in 2011, imports have grown again, leading to an overall smaller trade surplus of 8,2 % of GDP.

(39) Statistics Iceland forecast for 2012-2017 assumes that gradual economic recovery will continue with 2,6 % growth in 2012. A similar growth rate is expected throughout the forecast period. This forecast is however subject to several uncertainties. Planned large scale industrial investments might be further delayed. Iceland's terms of trade would be negatively affected by a prolonged recession in the main trading countries, implying a lower growth rate in Iceland. Slower progress than anticipated in tackling the debt burden of households and corporates would furthermore restrain domestic demand and the growth prospects of the economy. Growth could also be threatened by continued price instability linked to currency volatility in the context of removal of capital controls.

2.4. **Financial supervision and improvements in regulatory framework**

(40) Following the FME's initial work linked to the foundation of the new banks and the assessment of the value of the net assets transferred from the old banks, the FME conducted in the spring of 2009 an audit of the new banks and their business plans, financial strength and capital requirements in a so-called sign-off project. This was done with the assistance of the international management consultant firm Oliver Wyman.

(41) Having concluded the above process, the FME granted the banks operating licenses subject to various conditions. In view of the quality of the asset portfolios and the anticipated economic uncertainty, it was considered necessary to place higher capital requirements on the three banks than the statutory minimum. The FME therefore set the minimum capital adequacy (CAD) ratio for the three banks at 16 %, thereof a minimum of 12 % for the Tier I capital ratio. The requirements were applicable for at least 3 years unless reviewed by the FME. Liquidity conditions were also specified, requiring that available liquid funds should at any point amount to a minimum of 20 % of deposits and that cash or cash equivalents should amount to at least 5 % of deposits. Furthermore, requirements were made regarding other matters such as restructuring of loan portfolios, risk assessment, corporate governance and ownership. Comparable capital requirements were introduced by the FME regarding other financial undertakings.

(42) The economic stabilisation program established in consultation with the IMF provided for a review of the entire regulatory framework of financial services and supervision to improve defence against future financial crisis. The Government invited the former Director-General of the Finnish Financial Supervisory Authority, Mr Kaarlo Jännäri, to carry out an assessment of the existing regulatory framework and supervisory practices. Among the improvements proposed by Mr Jännäri was the creation of a National Credit Registry at the FME to diminish credit risks in the system. His report also suggested to lay down tougher rules and a stricter practice on large exposures and connected lending as well as to conduct more on-site inspections to verify off-site supervision and reports, particularly on credit risk, liquidity risk and foreign exchange risk. It was also recommended to review and improve the deposit guarantee system, following closely the developments within the EU.

(43) The Government subsequently proposed a bill of law to the Althingi, based, inter alia, on proposals made by Jännäri as well as amendments made to EEA law on financial activities from 2009 onwards, which was adopted and entered into force on 1 July 2010, as Act No 75/2010. With the new law, extensive amendments were made to the Act on Financial Undertakings. Several other amendments were later introduced to the law on financial undertakings as well as of regulation and supervision of financial services. These regulatory amendments are considered in more detail in the Annex.

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

2.5. **Main challenges ahead** [25]

(44) Despite major achievements in rebuilding a financial sector, Iceland continues to strive with the repercussions of the financial and currency crisis in the autumn of 2008. The financial crisis has revealed various flaws and deficiencies in the financial system, which must be addressed, if public confidence is to be restored. It seems evident that Iceland — as many other countries hard hit by the financial crisis — faces numerous challenges in adapting the legal and operating environment of financial services to support a viable and efficient financial system in the future and reduce as much as possible the risk of further systemic shocks to reoccur.

(45) The most immediate challenges currently facing Icelandic financial undertakings are linked to the fact that the banks are operating in a sheltered environment with capital controls and a blanket deposit guarantee. The banks now need to prepare themselves to operate in a more exposed environment, when the capital controls are removed and deposit guarantees revert to the arrangement set out in the relevant EU/EEA directives [26]. The Icelandic authorities have underlined that extreme caution must be exercised when introducing new rules in this regard.

(46) Another major challenge is the need to adapt further the legal and regulatory framework to support a solid and efficient financial system which is also consistent with EEA and international law developments [27].

2.6. **The state of competition in the Icelandic financial sector**

(47) According to recent information from the Icelandic authorities [28], competition on the financial market has changed radically since the banking collapse. The number of financial undertakings has decreased, as several savings banks, commercial banks and specialised lenders are either being wound up or have been merged with other undertakings [29]. The number of financial undertakings is still decreasing, most recently with the mergers of Landsbankinn and SpKef in March 2011, of Íslandsbanki and Byr in December 2011 and the merger of Landsbankinn and Svarfdaelir Savings Bank, approved by the Authority on 20 June 2012 in Decision

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

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

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

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

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

No 226/12/COL. With the reductions in the number of financial undertakings and the larger banks taking over deposits from the banks closing down, concentration in the domestic market has increased. The overall presence of the new banks on the EEA financial markets is on the other hand much smaller than that of their predecessors, as international banking operations have been closed down.

(48) In addition, the domestic market has shrunk considerably as certain sub-markets have disappeared or are largely subdued. The near disappearance of the stock market and the introduction of capital controls have reduced operations in the stock and currency markets and resulted in limited investment options. With the level of investments in the economy at a historically low level and households and companies generally highly leveraged, demand for credit is low. Since the collapse, the banks have concentrated their efforts on internal issues and restructuring of their loan portfolios as well as the restructuring of some of their major corporate clients.

(49) Before the financial crisis, the savings banks accounted collectively for a market share of approximately 20-25 % in deposits. This has now collapsed to approximately 2-4 %. The market shares lost by the savings banks and commercial banks exiting the market have been gained by the three major commercial banks, Arion Bank, Íslandsbanki and Landsbanki. Combined the three big banks now account for approximately 90-95 % of the market instead of 60-75 % earlier on, where Landsbankinn's market share is marginally highest. Apart from the 10 regional savings banks, currently accounting for approximately 2-4 % of the market, the only other market player is the restructured MP Bank ([30]), with a market share of approximately 1-5 %.

(50) The Icelandic financial market is thus clearly oligopolistic and the three largest companies could collectively achieve a dominant market position. According to the Icelandic Competition Authority (ICA), which the Authority had asked for its views on the state of competition in Iceland and potential remedies, there are significant entry barriers to the Icelandic banking market. This has detrimental effects on competition. There are also certain impediments for consumers to switch banks. The Icelandic authorities furthermore acknowledged that the exchange rate risks associated with Iceland's small and non-traded currency, the Icelandic króna, has further restricted competition and deterred foreign banks and companies from entering the Icelandic market.

(51) ICA has lately focused on a specific issue regarding IT infrastructure for the banks' operations and their cooperation in that regard. This relates to the financial institutions' jointly owned IT service provider, *Reiknistofa bankanna* (the Icelandic Banks' Data Centre; RB). This matter is of relevance for the assessment of the case at hand and was among the issues discussed by the Authority with the Icelandic authorities and the banks.

(52) RB is jointly owned by the three main Icelandic banks, two saving banks, the Icelandic Savings Bank Association and the three main payment card processors in Iceland. Landsbankinn owns 36,84 % of the shares in RB, Íslandsbanki holds 29,48 % and Arion Bank 18,7 %. Combined the three commercial banks therefore own 85,02 % of shares in RB. RB's clients are the owners, the Central Bank of Iceland and other financial institutions as well as the government and public entities. The banks' cooperation in this area is extensive, as RB has developed the clearing and settlement system in Iceland. It also provides a number of core banking solutions which are multi-tenant solutions, used by most of the Icelandic banks. RB furthermore operates an e-invoicing and e-payment system for corporates and consumers.

(53) According to ICA, the collapse in 2008 has made the smaller banks and savings banks particularly vulnerable. For the smaller financial undertakings, the required IT services were of crucial importance, as they can be viewed as one of the entry barriers for new market participants. The platform for IT services has been provided to a

([30]) On 11 April 2011, a contract for the sale of (old) MP bank's operations in Iceland and Lithuania was approved at the bank's shareholder meeting, when over 40 new shareholders invested 5,5 billion ISK in new shares in the bank. Other operations of the old bank remained with the previous owners and were transferred to a new legal entity, EA fjárfestingarfélag hf. For further details, see MP bank's press releases of 11 April 2011 available at https://www.mp.is/um-mp-banka/utgefid-efni/frettir/nr/1511 and https://www.mp.is/um-mp-banka/utgefid-efni/frettir/nr/1510 significant extent by RB as regards the bigger financial undertakings and, as regards the savings banks and smaller market players, by Teris. Following the closure of many smaller financial undertakings in recent years, Teris lost a significant share of its income, leading in January 2012 to the sale of some of its IT solutions to RB. According to RB and Teris, this transaction was, inter alia, aimed at securing continued provision of IT services to smaller financial undertakings.

(54) The ICA has been investigating two cases regarding RB. Firstly, whether the joint ownership and cooperation of the banks and other financial undertakings in the RB forum should be considered to be a breach of the ban on restrictive practices under Article 10 of the Icelandic Competition Act. Secondly, the compatibility of RB's purchase of Teris's major assets is being assessed under the merger provisions of the same act. However, in May 2012 these two cases were concluded with a settlement between RB and its owners, on the one hand, and the ICA on the other hand ([31]).

(55) Aside from the above concerns that relate directly to the Icelandic financial market, the ICA has in particular pointed to the need for the sale and restructuring of operating companies ([32]) to be completed without undue delay. Many operating companies have been taken over by the banks (being creditors of those companies) due to over indebtedness following the economic crash in 2008. According to ICA, it may create a conflict of interest when banks provide financial services to companies and own the companies at the same time. The ICA is of the opinion that the banks' direct and indirect ownership ([33]) is the most wide-spread and dangerous competition problem in the aftermath of the financial crisis, as this has an effect on almost every company and industry in Iceland. In ICA's view, faster restructuring of companies would improve competition in the financial market. When the banks' involvement in the restructuring of their corporate clients has been subject to the notification requirements under national merger control, the ICA has in this regard often set conditions regarding the banks' ownership. However, a comprehensive solution to the problem appears to be difficult, as it relates essentially to the high leverage of the Icelandic business sector.

(56) In their submission to the Authority, the three commercial banks, Arion Bank, Íslandsbanki and Landsbankinn, have all expressed the view that no major changes have taken place in the conditions of competition in the Icelandic financial market since autumn 2008 which should give cause for concerns. Effective competition prevailed in the market, without any evidence of collusive behaviour of the three biggest players. When examining the conditions of competition in the market, the ICA had overlooked certain key factors, such as the fact that foreign banks have for long and still are actively competing with Icelandic banks for the provision of financial services to the biggest clients, such as undertakings in export-based activity (fisheries, power-intensive industry, etc.) as well as state and municipal activity.

(57) However, this view is contrary to the view expressed in the submission of the Icelandic authorities, as set out in the report referred to above by the Minister of Economic Affairs to the Althingi and to the views of ICA. Moreover, as will be outlined below, Íslandsbanki has, despite certain reservations regarding analysis of competition conditions, decided to provide certain commitments aimed at limiting distortion of competition linked to the aid measures concerned. Those commitments are reported in the Annex.

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

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

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

3. DESCRIPTION OF THE MEASURES

3.1. **The beneficiary**

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

3.1.1. *Glitnir Bank*

(59) Prior to the financial crisis of 2008 Glitnir Bank was the third largest bank in Iceland. Just before its collapse, at the end of June 2008 its balance sheet amounted to 3 862 billion ISK. The bank's main markets were in Iceland and Norway where it offered a range of financial services, including corporate banking, investment banking, capital markets, investment management and retail banking. Glitnir also had operations in Finland, Sweden, Denmark, UK, Luxembourg, US, Canada, China and Russia. It held a number of subsidiary companies, the most significant being: Glitnir AB (Sweden); Glitnir Bank Oyi (Finland); Glitnir Bank ASA (Norway); Glitnir Bank Luxembourg SA; and Gltinir Asset Management Luxembourg. The bank's international expansion was based on two specialised industry sectors; seafood and sustainable energy ([34]). Shares in the bank were listed on the Icelandic OMX.

3.1.2. *Íslandsbanki*

(60) Glitnir's successor, Íslandsbanki, is a universal bank offering a comprehensive set of financial services to individuals, households, corporations and professional investors in Iceland, specialising in two industry sectors; seafood and geothermal energy. Following the merger with Byr, the bank's assets now amount to approximately ISK 800 billion. It has about 1 100 employees, and is Iceland's third largest bank when measured in terms of total assets. The banking products and services fall into four divisions: Retail banking, Corporate Banking, Markets and Wealth Management. According to Íslandsbanki, it has a market share of between [20] and [40] % in all those business segments.

3.1.2.1. Retail banking — Iceland

(61) Retail Banking provides banking services to individuals, households and small- to medium-sized companies (SMEs). The division comprises Íslandsbanki's branch network, the Bank's Asset-Based Financing division and an independently operated subsidiary, Kreditkort, a leading credit card issuer in Iceland.

(62) The latest available figures, show that Íslandsbanki has a market share of [> 30] % in the retail sector.

3.1.2.2. Corporate banking — Iceland

(63) Corporate Banking (CB) provides lending and other credit services to medium-size and large companies in Iceland, usually called 'the largest 300'. Furthermore, Corporate Solutions, a division within CB, manages and leads the restructuring of the distressed large corporate portfolio.

(64) The latest available figures, show that Íslandsbanki has a market share of [> 30] % in the corporate banking market.

([34]) Glitnir's Annual Report for 2007, p. 40. The report is available here: http://tools.euroland.com/arinhtml/is-isb/2007/ar_eng_2007/ Glitnir's Consolidated Financial Statements 2007 are available here: http://en.sff.is/media/auglysingar/Glitnir_-Annual_Report_2007.pdf

3.1.2.3. Markets

(65) The markets division offers full range services in corporate finance, securities, and foreign exchange and money market products in Iceland as well as corporate finance advisory in the geothermal energy and seafood sectors in the USA.

(66) The latest available figures, show that Íslandsbanki has a market share of [> 5] % of the equity market ([35]), [> 20] % of the bonds market, [> 30] % of the foreign exchange (FX) market and around [35-45] % of the Corporate Finance market ([36]).

3.1.2.4. Wealth Management — VÍB

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

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

3.2. **Comparing the old and new bank**

3.2.1. *A comparison of Glitnir and Íslandsbanki (2008)*

Table 1

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

	Islandsbanki hf.	Glitnir banki hf.	
(ISK m)	15.10.2008	30.6.2008	Δ %
Cash and balances with Central Bank	53 829	37 550	43 %
Derivatives	0	278 404	– 100 %
Bonds and debt instruments	3 762	217 873	– 98 %
Shares and equity instruments	3 944	71 767	– 95 %
Securities used for hedging	0	162 332	– 100 %
Loans to banks	10 597	328 027	– 97 %
Loans to customers	482 536	2 548 164	– 81 %
Investments in associates	296	540	– 45 %
Investment property	1 589	5 539	– 71 %
Property and equipment	1 773	4 897	– 64 %
Intangible assets	107	63 218	– 100 %
Deferred tax assets	34	2 018	– 96 %
Non-current assets held for sale	1 894	908	109 %

([35]) Íslandsbanki has the second highest market share on the NASDAQ OMX ICE, fixed income market according to turnover figures for 2011.
([36]) However, as most of the transactions that determine the market share of the bank in this business segment are not publicly reported, these are just best estimates submitted by the Icelandic authorities.
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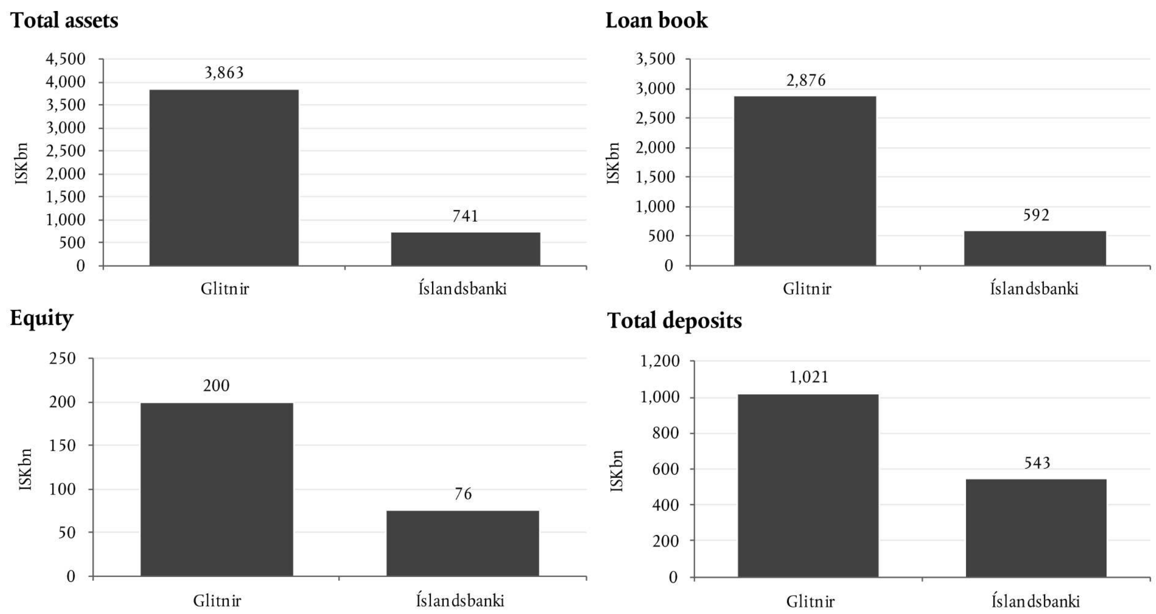
	Islandsbanki hf.	Glitnir banki hf.	
(ISK m)	15.10.2008	30.6.2008	Δ %
Share subscription	64 225	0	100 %
Other assets	5 279	141 560	– 96 %
Total Assets	**630 965**	**3 862 797**	**– 84 %**
Short positions	0	23 312	– 100 %
Derivatives	0	109 903	– 100 %
Deposits from Central Bank & banks	134 303	311 775	– 57 %
Deposits from customers	361 302	709 584	– 49 %
Debt issued and other borrowed funds	53 808	2 241 976	– 98 %
Subordinated loans	103	145 902	– 100 %
Post-employment obligations	0	696	– 100 %
Current tax liabilities	34	812	– 96 %
Deferred tax liabilities	0	4 937	– 100 %
Non-current liabilities held for sale	1 285	0	100 %
Other liabilities	14 471	113 465	– 87 %
Total Liabilities and Equity	**565 306**	**3 662 362**	**– 85 %**
Share capital	10 000	14 547	– 32 %
Share premium	55 000	53 174	3 %
Other reserves		37 143	– 100 %
Retained earnings		94 744	– 100 %
Minority interest	660	727	– 9 %
Total Equity	**68 030**	**200 435**	**– 66 %**
Total Liabilities and Equity	**630 965**	**3 862 797**	**– 84 %**

(69) There are major differences between the new and old bank both in terms of their operations and scale. Íslandsbanki is predominantly a domestic bank without any licensed banking operations overseas whereas Glitnir was an international bank with operations in 11 countries. Íslandsbanki has four business segments; Commercial/Retail Banking, Asset Management, Corporate and Investment Banking, and Treasury and Capital Markets, all of which are focused on the domestic market. Most notably the scale of Íslandsbanki's operations are substantially smaller than that of Glitnir; the old bank's balance sheet of 3 862 billion ISK compared to the new bank's 631 billion ISK amounts to a reduction of 84 %. A comparison of the old bank's balance sheet at June 2008 with the new bank's opening balance sheet can be found at Table 1 above.

(70) Glitnir had a diverse funding mix and was a large issuer of bonds sold worldwide. Íslandsbanki, on the other hand, relies mainly on deposits for funding. This, together with the likely inability for the bank to have access to similar funding sources to its predecessor bank (in the short term at least), limits the bank's ability to grow. The comparison in Graph 1 of key indicators of the two banks shows considerable differences ([38]):

Graph 1

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



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

3.3. **National legal basis for the aid measure**

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

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

— *Supplementary State Budget Act for 2008 (Article 4)*

— *State Budget Act for 2009 (Article 6)*

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

3.4. **The aid measures**

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

(74) The following section is limited to describing those aspects of the State's intervention that constitute aid measures relevant for assessment under Article 61 of the EEA Agreement.

3.4.1. *Tier I capital*

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

3.4.1.1. Initial capital

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

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

(77) On 20 July 2009, the Government of Iceland and the Resolution Committee of Glitnir concluded an agreement on the initial capitalisation of Íslandsbanki and the basis for the compensation payable to the creditors of Glitnir in return for the transfer of mostly domestic assets and deposits from Glitnir ([39]). On the basis of this agreement, the State committed on 14 August 2009 to provide Íslandsbanki with additional equity capital of 64,2 billion ISK, bringing the bank's total equity to 65 billion ISK, which was required for it to meet the FME's requirement of a Tier-I ratio of 12 %. The agreement provided for two possible options regarding payment of net assets transferred and equity participation; either that Glitnir would subscribe for majority shareholding in Íslandsbanki and be paid for the assets transferred with shares in the bank or, if that subscription was not completed, that the government capitalisation would remain in place and the government would continue to own Íslandsbanki. Glitnir was given time until 30 September 2009 to decide which option to select; this deadline was later extended until 15 October 2009. On 15 October 2009 it was announced that Glitnir's Resolution Committee had decided, on behalf of its creditors, to take 95 % of the share capital in Íslandsbanki as compensation for the assets that had been transferred from the old to the new bank. The state retained the remaining 5 %.

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

(78) As part of the deal it was agreed that the Resolution Committee (creditors) would remunerate the state for total interest accrued on its investment over the period the government held the bank to the sum of 8,3 billion ISK. This amounted to a yield of 12,8 %, which annualised to 13,9 %, and concluded the settlement concerning those assets transferred from Glitnir to Íslandsbanki upon the collapse of the banks in October 2008.

3.4.2. *Tier II capital contribution*

(79) On 15 October 2009 the Government also provided the bank with a subordinated loan to strengthen its equity and liquidity position in order to comply with the capital requirements of the FME. The subordinated loan is available in euros and amounts to 25 billion ISK of Tier II capital in a form of an instrument providing for Íslandsbanki to issue unsecured subordinated notes. The term of the notes is 10 years as of 30 December 2009. The instrument has built-in incentives for exit in the form of a step-up of interest after five years. Under the agreement the interest rate per annum for the first five years is 400 basis points above EURIBOR ([40]) and in the period from five to 10 years after the completion of the agreement the interest rate per annum is 500 basis points above EURIBOR.

(80) In conjunction with the Tier I capital measures described above, the Tier II capital contribution ensured that Íslandsbanki complied with the FME's CAD requirement of 16 % on 15 October 2009.

3.4.3. *Deposit guarantee*

(81) In order to comply with Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes ([41]) and Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit guarantee schemes ([42]), Iceland adopted Act No 98/1999 on deposit guarantees and investor-compensation scheme and thereby set up the so-called Depositors' and Investors' Guarantee Fund ('TIF'), which has been funded by annual contributions from the banks, calculated in relation to the total deposits of that bank.

(82) According to the Icelandic authorities, and so as to provide further assurance and comfort to the general public on the safety of their deposits when the crisis struck, the bank rescue measures of the Icelandic Government of autumn 2008 also entailed an additional state backing of deposits in domestic commercial and savings banks, outside the scope of Act No 98/1999 implementing the deposit guarantee Directive 94/19/EC and the investor-compensation Directive 97/9/EC.

(83) An announcement from the Prime Minister's Office of 6 October 2008 stated that the '*Government of Iceland underlines that deposits in domestic commercial and savings banks and their branches in Iceland will be fully covered*' ([43]). This announcement has since been repeated by the Office of the current Prime Minister in February and December 2009 ([44]). 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

([40]) Euro Interbank Offered Rate.
([41]) OJ L 84, 26.3.1997, p. 22.
([42]) OJ L 135, 31.5.1994, p. 5.
([43]) The English translation of the announcement is available at: http://eng.forsaetisraduneyti.is/news-and-articles/nr/3033
([44]) 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).

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' ([45]). 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 ([46]).

(84) A recent statement of the current Minister of Economic Affairs and former Minister of Finance (2009-2011), Steingrímur Sigfússon in a debate in the Icelandic Parliament regarding the government's cost related to Landsbankinn's taking over SpKef, illustrates the above further: According to the Minister, one must keep in mind regarding this matter the State's declaration in the autumn of 2008 that all deposits in savings banks and commercial banks would be safe and protected. 'Work has since in all instances been based on this (i.e. the declaration) and it is unfortunately correct that this (i.e. payments due to SpKef) will be one of the bigger bills footed directly by the state as costs for securing the deposits of all inhabitants of Suðurnes … and all SpKef's clients in the West Fjords and the West and North-West area … I do not expect that anyone has thought that deposit holders in those areas would be treated differently from other inhabitants, so the state did not have much of a choice in this matter' ([47]).

(85) According to the Icelandic government, the additional deposit guarantee will be lifted before the capital controls are fully abolished, which according to the Icelandic authorities is currently foreseen for the end of 2013.

3.4.4. *Special Liquidity Facility*

(86) In addition, as a condition for the creditors taking equity in the new bank, the Icelandic government concluded a further agreement with Íslandsbanki on 11 September 2009 that would come into force if Glitnir's Resolution Committee decided to exercise its option to become the majority owner of the bank ([48]). Under the agreement the Ministry of Finance commits to lend repo-able government bonds in exchange for specifically defined assets on terms and conditions specified in the agreement up to a value of 25 billion ISK.

(87) The main terms of the agreement to provide liquidity are as follows:

Max. loan amount:	25 billion ISK
Term:	Until September 2012
Remuneration:	3,0 % on first 8 billion ISK; 3,5 % on next 8 billion ISK; 4,0 % for amounts above 16 billion ISK
Fee:	Íslandsbanki is required to pay 0,5 % of the loan amount on each occasion new securities are provided
Counter-security:	Íslandsbanki is required to provide counter-security for the loan of Treasury securities, which can be financial assets in various forms.

([45]) 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
([46]) http://hamar.stjr.is/Fjarlagavefur-Hluti-II/GreinargerdirogRaedur/Fjarlagafrumvarp/2011/Seinni_hluti/Kafli_8.htm [Mbl 10.6.2012].
([47]) Unofficial translation by the Authority of a statement reported in Morgunblaðið (www.mbl.is) on 10 June 2012.
([48]) An addendum was also signed on 13.1.2010 and a new agreement was concluded on 19.7.2010 in response to certain remarks submitted by the FME.

(88) According to the Icelandic authorities, this liquidity facility is required because the creditors' decision to take ownership of Íslandsbanki significantly reduced the bank's holding of repo-able assets and threatened its ability to comply with supervisory requirements regarding liquidity reserves ([49]). According to the Icelandic authorities the facility is intended to be an additional measure to be used only when other sources of liquidity are insufficient. The pricing and terms of the facility contain incentives to discourage its use if other options are available. To date, the facility has never been drawn upon.

3.4.5. *Straumur securities lending agreement*

(89) On 9 March 2009 the FME, acting under the authority conferred upon it by the Emergency Act, assumed the powers of the shareholders of Straumur–Burdaras Investment Bank hf. ('Straumur') and appointed a Resolution Committee to replace its Board of Directors ([50]). After consultation with the Resolution Committee, creditors, the CBI and the Ministry of Finance, on 17 March 2009, the FME transferred the liabilities for deposits of Straumur to Íslandsbanki ([51]). In return Straumur issued a bond collateralised against its assets, as repayment for assuming the deposit obligations. The bond was issued on 3 April 2009 for the amount of 43 679 014 232 ISK for a term up to 31 March 2013. The bond bears interest on the amount of REIBOR ([52]) plus 190 basis points in the first 12 months before reducing to REIBOR plus 100 basis points thereafter until maturity. Simultaneously, Íslandsbanki and the Ministry of Finance entered into a securities lending agreement, in which the government effectively pledges repo-able government notes as security for the Straumur claim, in return for which Íslandsbanki can obtain liquidity from the CBI to the extent that liquidity is required as a result of Íslandsbanki assuming the liability for Straumur's deposits.

(90) In the agreement Íslandsbanki is committed to returning to the state the amount of the government bonds that equal the payments the bank receives under the bond issued by Straumur. The parties also agreed that in the event that Íslandsbanki does not receive full payment under the bond, and in the event that the state had not paid the remaining debt, Íslandsbanki would retain the outstanding government bonds. In essence, therefore, Íslandsbanki assumed Straumur's liabilities for deposits in return for a matching amount of government guaranteed assets.

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

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

(92) As described in detail in Decision No 126/11/COL of 13 April 2011 ('the Byr Decision') the Icelandic government granted state aid in the form of capital and a subordinated loan facility for the establishment of Byr, which continued the operations of its predecessor, Byr savings bank ('Old Byr'). In this process the creditors of Old Byr became the shareholders of (new) Byr, along with the Icelandic State which had provided capital for the establishment of the new company.

(93) When the Byr Decision was adopted on 13 April 2011, the annual accounts for the year 2010 were still unavailable. However, at that point the management of Byr was confident that the rescue measures that were temporarily approved by the Authority in the Byr Decision would suffice to secure the operations of the bank at least until a restructuring plan establishing long term viability could be submitted to the Authority. In the course of auditing the bank's accounts for the first half of 2011, it became evident that further write-downs of Byr's assets were necessary which in turn decreased the CAD ratio of the bank.

([49]) As mentioned above, one of the FME's conditions required that cash or cash-like assets should amount to 5 % of on-demand deposits and the banks should be able to withstand a 20 % instantaneous outflow of deposits.
([50]) The decision is available in English at: http://fme.is/lisalib/getfile.aspx?itemid=6055
([51]) The decision is available in English at: http://fme.is/lisalib/getfile.aspx?itemid=6077
([52]) REIBOR denotes Reykjavik Interbank Offered Rate, representing the interbank market rate for short term loans at Icelandic commercial and savings banks. The approach is similar to how many countries use LIBOR as the base rate for variable rate loans, but Icelandic banks use REIBOR (plus a premium) as the basis for supplying variable interest rate loans in the Icelandic currency, the króna.

(94) As described in detail in Decision No 325/11/COL of 19 October 2011 ('the second Byr Decision'), the resulting capital shortage could not be remedied, and Byr was put up for sale. The subsequent acquisition, in particular the potential use of state aid for this purpose by Íslandsbanki, was approved by the Authority in the second Byr Decision, without prejudice to the Authority's formal investigation procedure on whether the aid granted to Íslandsbanki was compatible with the EEA Agreement, which is assessed in the decision at hand.

(95) In addition, the Authority considered the continued availability of the subordinated loan facility for the interim period until the formal merger between Byr and Íslandsbanki could take place, i.e. for as long as Byr was a separate legal entity under national law, to be compatible with the functioning of the EEA Agreement. According to the Icelandic authorities, neither Byr nor Íslandsbanki have ever drawn on the subordinated loan facility.

(96) The Authority indicated that the outcome of the final assessment of these measures depended on the information in the restructuring plan for the merged entity of Íslandsbanki and Byr that the Icelandic government had committed to submit no later than 3 months after the execution of the envisaged transaction. Indeed, as described above, a restructuring plan for the merged entity was submitted in time, which the Authority will assess below.

The restructuring plan

(97) The Icelandic authorities submitted a restructuring plan for Íslandsbanki on 31 March 2011. Following the acquisition of Byr, the plan was amended, updated and resubmitted by the Icelandic authorities on 22 February 2012 (hereinafter the 'restructuring plan'). The restructuring plan was supplemented with a 5-year business plan dated 14 January 2012 ([53]) and an Internal Capital Adequacy Assessment Process (ICAAP) report (submitted to the FME on 1 April 2012).

(98) The restructuring plan, together with the 5-year business plan, addresses the substantive issues of viability, burden-sharing and limitation of distortions of competition. According to the restructuring plan, Íslandsbanki will focus on its core business and the restructuring of the household and corporate loan portfolios.

(99) In addition, the Icelandic authorities have submitted an ICAAP report for 2012 to demonstrate Íslandsbanki's ability to withstand stress.

(100) As indicated above, the Authority considers the restructuring period to last until 15 October 2014.

3.4.7. *Description of the restructuring plan*

(101) The Icelandic authorities and the Bank consider that the restructuring of Íslandsbanki will ensure its return to being a solid, well-funded bank with sound capital ratios so that it can maintain its role as a supplier of credit to the real economy. They submit that this will be achieved through the following steps:

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

(ii) Establishing and maintaining a strong capital ratio position

(iii) Achieving satisfactory profitability

(iv) Establishing and maintaining a strong liquidity position

(v) Restructuring the loan portfolio, both for households and businesses.

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

(vi) Improving the funding strategy

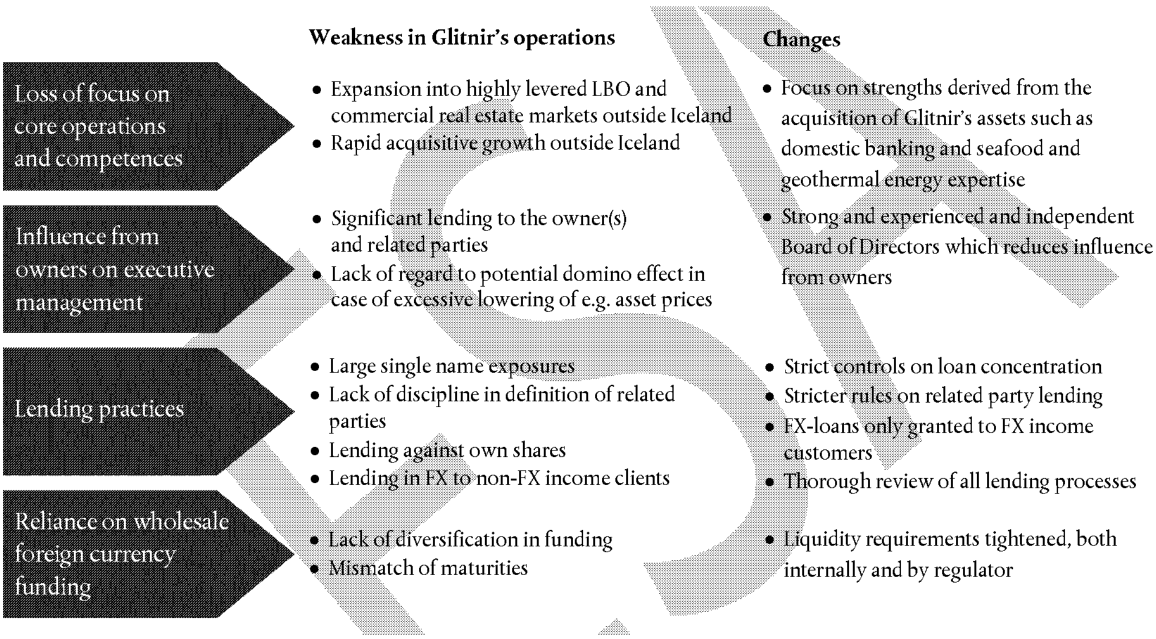
(vii) Achieving cost efficiency

(viii) Improving the corporate governance

(102) Before describing each of the above points in more detail, the bank's view on how the weaknesses that contributed to Glitnir's demise are being addressed in the restructuring plan for Íslandsbanki, is briefly set out below. It is underlined that although Íslandsbanki is based on the domestic operations of Glitnir, it is a different bank. It is also submitted that material changes have been made to address weaknesses that are thought to have contributed to the collapse of the predecessor. Among the most important changes are amendments to rules on related party lending, abolishment of lending with stock as collateral and FX-lending ([54]) to non-FX income clients and otherwise stricter discipline on loan approvals. While Íslandsbanki just as Glitnir intends to provide a broad range of financial services in the Icelandic market, the difference between pre- and post-crisis banking for Íslandsbanki is more visible in 'how' the bank does business (processes, procedures, documentation, rules and regulation) rather than 'what' service and product range it offers. Íslandsbanki's views on this matter are otherwise summarised in the graph 2 below:

Graph 2

Past weaknesses and the changes addressing these weaknesses



(103) The restructuring plan, as well as the 5-year business plan, is based on a set of general and economic assumptions ([55]). These assumptions constitute the economic underpinning of the base scenario, as referred to below.

(104) The general assumptions include that:

— restructuring will be completed by year-end […] in Corporate Banking and […] in Retail Banking. Interest reset on mortgages will be completed at year-end […]. The amortisation of the discount, further described below, on the portfolio acquired from Glitnir will be distributed accordingly;

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

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

— the bank will have ISK […] billion of additional gain on […];

— the capital controls will be lifted in stages

— there will be no limits to lending based funding in ISK. It is not assumed that lending based funding in FX will exceed repayments of currently outstanding FX denominated loans in 2012; access to FX funding is assumed to become more easily available from 2012 and onwards.

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

— Return on Equity (ROE): Risk free rate + […] %. The risk free rate is considered to be the Central Bank current account rate (3,75 % at December 2011). The target assumes a Tier 1 ratio of […] %

— CAD Capital Ratio: […] % […]

— Tier 1 ratio: […] % […]

(106) The macroeconomic assumptions include

— Economic growth will continue in 2012 and beyond although at a slower pace than anticipated earlier. Households will be in a better economic position as purchasing power increases with falling unemployment.

— Inflation will remain just above the CBI's target i.e. just below 3 % from 2013 onwards. This is based on a stable ISK exchange rate (with modest strengthening at the beginning of the period) and a balanced labour market with moderate wage increases and gradual house price rises.

Change between years average (%)	2012	2013	2014	2015	2016
GDP growth	2,2	2,1	3,4	2,3	3,0
Unemployment	6,6	6,0	5,4	5,0	4,4
Inflation	4,4	2,9	2,8	2,7	2,6
Wages	6,7	4,7	4,8	5,0	4,8

Short-term interest rates will stay unchanged around 5 % ([56]) in 2012 but gradually rise as the economy recovers.

— While conditions in the labour market will improve, unemployment will still remain somewhat higher than before the financial crisis. Wage growth will pick up as the unemployment rate falls.

— Finally, it is assumed that the ISK will continue to be Iceland's currency throughout the restructuring period. Currency controls will be lifted in steps from 2012 and onwards. Some restrictions on capital flows will remain throughout the decade.

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

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

([56]) As from 16.5.2012, the CBI seven-day collateralised lending rate has been 5,5 %.

(ii) Establishing and maintaining a strong capital ratio position

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

Table 2

Capital ratios during 2008-2011, amounts in million ISK

	31.12.2008	31.12.2009	31.12.2010	31.12.2011 (*)
Tier 1 capital	68 030	91 996	120 993	120 530
Tier 2 capital	—	24 843	21 251	21 937
Total capital	68 030	116 839	142 244	142 234
Risk-Weighted Assets (RWA)	656 713	589 819	534 431	629 419
Tier 1 ratio	10,4 %	15,6 %	22,6 %	19,1 %
CAD ratio	10,4 %	19,8 %	26,6 %	22,6

(*) At the time the restructuring plan was submitted, the financial reporting for 2011 was not completed, and the data from 30.9.2011 was used in the final restructuring plan. After the publication of Íslandsbanki's financial statement for 2011, the Authority up-dated the figures.

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

Table 3

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

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

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

(iii) Achieving a satisfactory profitability

(111) According to the restructuring plan, and as illustrated below in Table 4, the return on equity of Íslandsbanki has been healthy since the establishment of the bank in 2008 (with the exception of 2011) ([57]).

([57]) The reason given for the fall in ROE in 2011 was the Supreme Court ruling on FX-leading of 15.2.2012 and the writing off of goodwill following the merger with Byr.

Table 4

Past Return on Equity (ROE)

(%)

	2008	2009	2010	2011
ROE	17,2	30,0	28,5	1,5

Moreover, the restructuring plan predicts the following return on capital during the course of the restructuring and beyond (Table 5).

Table 5

Return on Equity (ROE) forecast

(%)

	2012	2013	2014	2015	2016
ROE	[5-15]	[10-20]	[5-15]	[5-15]	[5-15]

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

— Profit from the most important business segments is expected to […]; this is mainly due to an increase in funding cost and the absence of a 'discount revenue' from 2014 onwards.

— Profit in the markets business segment are forecasted to increase from […] to […] ISK until 2016, predominately due to greater fee and commission income.

— The net interest margin is expected to […] in 2014 and then expected to stay stable.

— The number of employees is expected to decrease by […]

— The cost/income ratio is expected to fall from 75 % in 2011 to […] % in 2014.

(113) According to the Icelandic authorities, the very solid performance of Íslandsbanki since its establishment is to a certain extent due to the fact that the loan portfolio was acquired by the bank from Glitnir at deep discount ([58]). The discount has been and will remain an important part of the Bank's revenues while the loan portfolio is being restructured. However, according to the forecast, the discount will have been amortised in full when the restructuring will be completed.

(114) In support of this view the Icelandic authorities have submitted a calculation (Table 6) indicating what the annual results would have been without the discount and other 'irregular items', such as the writing off of goodwill resulting from the Byr transaction.

Table 6

Profits net of irregular items

ISK m

	Profit for the year	'irregular items'	Profit net of 'irregular items'
2008	2 366	− 1 543	14 909
2009	23 982	801	23 181

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

ISK m

	Profit for the year	'irregular items'	Profit net of 'irregular items'
2010	29 369	14 507	14 862
2011	9 613	– 11 074	20 687
2012	[…]	[…]	[…]
2013	[…]	[…]	[…]
2014	[…]	—	[…]
2015	[…]	—	[…]
2016	[…]	—	[…]

(115) According to this data, the bank would still have made and will during the restructuring period make profits even in the absence of the discount ([59]). It is not clear however, if both aspects of the 'deep discount' mentioned above are reflected in these figures.

(iv) Establishing and maintaining a strong liquidity position

(116) Regarding liquidity, the FME requires that that cash or cash-like assets should amount to 5 % of on-demand deposits and the banks should be able to withstand a 20 % instantaneous outflow of deposits. In addition, the Central Bank of Iceland sets rules on credit institutions' liquidity ([60]) according to which credit institutions' liquid assets and liabilities are classified by type and maturity and assigned weights according to risk. Credit institutions must have liquid assets in excess of the next three months' liabilities. The rules also entail a certain stress test where a discount is applied to various equity items, but where it is assumed, on the one hand, that all obligations must be paid upon maturity, and on the other, that a portions of other obligations, such as deposits, must be paid at short notice or none at all.

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

Figures A and B

Íslandsbanki's compliance with supervisory liquidity requirements

Central Bank liquidity ratios if government liquidity facility is excluded			
Requirement to be above 100 % for 0-1 and 0-3 months			
	31.12.2009	31.12.2010	31.12.2011
ON - 1 m	2,34	2,73	1,32
0-3 m	2,41	2,73	1,31
A change in classification results in a significant drop in the ratios between year-end 2010 and 2011			

FME liquidity ratios if government liquidity facility is excluded			
Requirement to be above 20 % in liquid assets ratio and above 5 % in the cash ratio			
	31.12.2009	31.12.2010	31.12.2011
Liquid assets ratio	N/A	33 %	31 %
Cash ratio	N/A	17 %	12 %
Not implemented until after year-end 2009			

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

([60]) See the CBI's Rules on Liquidity Ratios No 317 of 25 April 2006, available at http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=4713

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

[…]

[Graph showing Íslandsbanki's liquidity ratios

Values not disclosed for reasons of professional secrecy]

Figure C

Historical liquidity ratios:

— Liquidity ratio A shows the coverage of liabilities maturing within the next 3 months

— Liquidity ratio B shows the coverage of liabilities maturing within the next 6 months

— Liquidity ratio C shows the coverage of liabilities maturing within the next 12 months

(119) The expected development of Íslandsbanki's liquidity position, in particular in case of a stress event, is further discussed below.

(v) Finalising the restructuring of the loan portfolio, both for private households and for businesses.

(120) Prior to the financial crises in 2008, both the bank's private and commercial customers took on a high level of debt. When the economy and, in particular, real estate prices fell in the wake of the crisis, the suddenly over-leveraged customers could often not service their debt any longer, and held negative equity. Aside from the general threat to the economic welfare of Iceland, the sudden deterioration in the bank's lending portfolio became a major risk for the banks future viability. For this reason the restructuring of the private and commercial loan portfolios (deleveraging), as reflected in the restructuring plan, has become a priority for Íslandsbanki.

(121) According to the Icelandic authorities, Íslandsbanki has developed specific debt relief programmes and cooperated with the state and other banks on general debt relief measures (e.g. the 110 % mortgage adjustment) ([61]).

(122) Íslandsbanki has submitted an outline of the restructuring methods it uses to the Authority, based on information compiled in November 2010. The methods distinguish between debt restructuring for companies and for households and individuals. Tailor made solutions are designed for larger companies, whereas SMEs are offered an adjustment of the principal, and/or adjustment of the outstanding debt/interest to either the value of the assets in the company or the free cash flow.

(123) Households and individuals are offered a variety of restructuring options, such as payment holidays, extension of terms and flexible payment schemes.

(124) In order to monitor and ensure the progress in restructuring, Íslandsbanki has also developed a so-called 'Restructuring Dashboard', which has been submitted to the Authority.

(125) According to the Icelandic authorities, and in spite of some unexpected events such as the recent ruling of the Icelandic Supreme Court on FX-loans, Íslandsbanki will complete the restructuring of its corporate loan portfolio by year-end 2012 and in 2013 in Retail Banking. The resetting of interest rates on mortgages is forecasted to be completed at year-end 2014.

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

(vi) Improvement of the funding strategy;

(126) Íslandsbanki's deposit base has remained fairly stable at around ISK 400 billion since the establishment and increased to ISK 535 billion at year end 2011 due to Íslandsbanki's merger with Byr. Deposits currently amount to almost 80 % of total liabilities.

(127) The Bank's deposit/loan ratio has been around and above 80 % during 2010 and 2011. Íslandsbanki assumes that the current low deposit rates will encourage investors to move some of their funds into higher yielding investments as the economy recovers and risk appetite increases. As a result, the bank foresees that the deposit/loan ratio may fall to around […] % by 2016. Moreover, foreign currency deposits are expected to […]. Íslandsbanki aims at gradually diversifying its funding mix.

(128) […] ([62]).

(129) As for the funding needs in ISK, […]. On the other hand, Íslandsbanki was the first Icelandic bank to issue a covered bond. The first issuance was in December 2011, a CPI ([63])-linked ISK 4 billion issue. The issuance was well received by institutional investors and oversubscribed. Íslandsbanki expects to be able to issue short-term paper in 2012 as well as expanding the current covered bond issuance at a rate of ISK 10 billion per year. […].

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

(vii) Cost efficiency

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

(viii) Improvements to the corporate governance and risk management

(132) Íslandsbanki has informed the Authority that one of their priorities is to bring its corporate governance structures and processes in line with national and international best practices. In this regard, Íslandsbanki has established a Risk Management and Credit Control division. The division oversees risk management and credit control issues; work that is linked into everyday processes in every division throughout the Bank. In 2011 Íslandsbanki published for the first time a comprehensive Risk Book ([64]) together with the Annual Report. The Risk Book, which will be published annually, provides additional information about the Bank's risk management framework, capital structure and adequacy, material risk exposures and risk assessment processes.

([62]) Íslandsbanki has stressed that the deposit priority in Iceland limits the ability to issue unsecured debt […]
([63]) Consumer Price Index.
([64]) The Risk Book is available on the Bank's website www.Íslandsbanki.is/riskbook.

3.4.8. *Ability to reach viability under a base and stress scenario*

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

3.4.8.1. The base scenario

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

3.4.8.2. The stress scenario

(135) In chapter 5.9.3 of the restructuring plan, Íslandsbanki has made reference to a stress scenario presented in the ICAAP report, submitted to the Icelandic Financial Authority on 1 April 2012.

(136) The main findings of the 2012 ICAAP report are that the capitalisation of Íslandsbanki is well above both internal and external minimum requirements and in excess of what can be viewed as a long-term target for a Bank operating under 'normal' business conditions. According to the report, the internal minimum capital requirements and the results from the stress tests conducted in the current ICAAP indicate that the foreseen dividend payments in the 5-year business plan appear reasonable.

(137) According to the ICAAP report, decisions on each year's dividend payment should be based on up to date capital adequacy analysis and also take into account the Bank's liquidity position.

(138) According to the ICAAP report the minimum capital ratio for the Bank is in the range of […] % — […] % of RWA. At year-end 2012, the minimum amount of capital needed is estimated to be ISK […] billion, whereof ISK […] billion is required under Pillar 2a, due to risk factors that are not covered or are underestimated under Pillar 1. In reality, however, the capital ratio of the Bank was 22,6 % at the end of 2011. Results from stress tests indicate that part of the excess capital is needed to meet possible adverse events to the Bank's operations but a gradual payment of excess capital in the form of dividends is reasonable. The capital estimated necessary to meet stress events amounts to ISK […]billion at the beginning of 2012 and excess capital at the end of 2012 is […] billion, as illustrated below in Table 7:

Table 7

Overview ICAAP report

ISK billion

	Pillar 1 (*)	Pillar 2a (**)	Pillar 2b	CAD required
	Minimum requirement	Add-on	Stress testing	All levels combined
Credit risk	[…]	[…]		[…]
Market risk	[…]	[…]		[…]
Operational risk	[…]			[…]

ISK billion

	Pillar 1 (*)	Pillar 2a (**)	Pillar 2b	CAD required
	Minimum requirement	Add-on	Stress testing	All levels combined
Concentration risk		[…]		[…]
Minimum capital required under Pillar (1 and 2a)	[…]	[…]		[…]
Stress testing			[…]	[…]
CAD required	[…]	[…]	[…]	[…]
CAD as of (year-end 2012)				[…]
Capital surplus				[…]

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

(139) In the ICAAP report, Íslandsbanki has assessed the aggregated possible losses due to credit risk, market risk (in trading book and in banking book), operational risk, business risk (impact of increased funding costs and less reduction in operational cost, and the impact of […] % less growth in market revenues), as well as legal and political risk (e.g. the impact of the recent Supreme Court ruling on FX-loans, no additional recovery for the corporate (seafood) portfolio and other legal and political risk factors.

(140) In addition, Íslandsbanki has performed stress testing of the liquidity ratio of the bank. Here, Íslandsbanki has made one base stress scenario ([65]) and a more severe stressed scenario, where the different sources of cash inflows and cash outflows are stressed to varying degrees. The result indicates that the Bank is well positioned to meet unexpected liquidity disruptions.

3.4.9. *Exit strategy/repayment of the State*

(141) As already described above, the Tier II capital contribution has 10 year duration from December 2009. As for the remuneration, there is a built in step-up clause after 5 years (i.e. 2014), from 400bp to 500bp over EURIBOR. According to the Icelandic authorities, this step-up should act as an incentive for the bank to pay back this capital as from this time.

([65]) The Bank's internal liquidity ratio represents a stressed situation rather than normal business conditions.

(142) As for the 5 % equity stake that the State retains in Íslandsbanki, the government's holdings in financial undertakings are managed by the Icelandic State Financial Investments (the ISFI) ([66]). According to the State Budget for 2012, the government has been authorised to sell the stakes that it currently holds in savings banks, but no decision has yet been made regarding sale of state's holdings in the three major commercial banks. A working group has however been established by the responsible ministers to explore possible ways of disposing of shareholdings in the commercial banks. The government has indicated that while it has no intention of reducing its holdings in Landsbankinn below two-thirds of the bank's share capital, the stakes in Íslandsbanki and Arion Bank could soon be offered for sale or sold with the banks in their entirety if their majority owners decide to sell, subject to certain prerequisites being resolved ([67]).

(143) The special liquidity facility is only available until September 2012 and has never been used. The Icelandic authorities envisage to remove the government's declaration on a blanket deposit guarantee in the near future, before the capital controls are lifted.

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

4. GROUNDS FOR INITIATING THE FORMAL INVESTIGATION PROCEDURE AND THE MEASURES TEMPORARILY APPROVED IN THE BYR DECISIONS

(145) In the opening decision, the Authority preliminarily concluded that the measures by the Icelandic State to capitalise Íslandsbanki, as well as the liquidity facility, entail state aid pursuant to Article 61 EEA. Furthermore it could not exclude that state aid was present in the deposit guarantee and the Straumur agreement. The opening decision did not cover the aid measures related to the acquisition of Byr, which were temporarily approved by the Authority in the Byr decisions. The Authority will take a final view on these measures, which continue to have a bearing on the assessment at hand, in the present decision.

(146) As for the compatibility of the measures assessed in the opening Decision, the Authority considered that a final view could only be taken on the basis of a restructuring plan, which had not been submitted when the Authority opened the formal investigation procedure on 15 December 2010. It was in particular due to the absence of a restructuring plan more than one year after the establishment of Íslandsbanki that the Authority expressed doubts about the compatibility of the aid.

4.1. **Comments from interested parties**

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

4.2. **Comments from the Icelandic authorities**

(148) The Icelandic authorities accept that measures undertaken in establishing New Glitnir Bank, now Íslandsbanki, constitute state aid. In the view of the Icelandic authorities, the measures are however compatible with the functioning of the EEA Agreement on the basis of Article 61(3)(b) of the Agreement, as they are necessary, proportionate and appropriate to remedy a serious disturbance in the Icelandic economy. In the view of the Icelandic authorities the measures taken are in all aspects in line with the principles set out in the Authority's state aid guidelines, and submit that the aid is necessary and limited to the minimum amount necessary.

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

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

(149) Moreover, the Icelandic authorities emphasise that the former shareholders of Glitnir Bank have lost all their shares and received no compensation from the state, that the aid is well designed to minimize negative spill-over effect on competitors and that the terms of the loans (the Tier II capital) are comparable to market rates.

(150) The Icelandic authorities do not regard the deposit guarantee as entailing state aid.

4.3. **Commitments by the Icelandic authorities**

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

II. **ASSESSMENT**

1. THE PRESENCE OF STATE AID

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

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

(153) The Authority will assess the following measures ([68]) below:

— The initial operating capital provided by the Icelandic State to the new bank;

— The (temporary) full state capitalisation of the new bank;

— The retention by the State of the 5 % share capital remaining after 95 % of the share capital in the new bank was transferred to the creditors of Glitnir; and

— The provision by the State of Tier-II capital to the new bank by way of subordinated debt.

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

— The special liquidity facility agreement;

— The Icelandic Government's statement to guarantee domestic deposits in all Icelandic banks in full; and

— The Straumur agreement.

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

1.1. **Presence of state resources**

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

([68]) Described in detail in Chapter 3 of the present decision.

(156) Regarding the deposit guarantee, the Authority emphasises at the outset that its assessment is limited to the additional deposit guarantee described above, consisting in essence of the statements made by the Icelandic government that deposits in domestic commercial and savings banks and their branches in Iceland will be fully covered.

(157) This assessment is without prejudice to the Authority's view on the compatibility of Act No 98/1999 and the actions of the Icelandic Government and the TIF during the financial crisis with EEA law, in particular Directive 94/19/EC. As regards the implementation of Directives 97/9/EC and 94/19/EC the Authority is of the view that to the extent such measures constitute state aid, the use of state resources to comply with obligations under EEA law would generally not raise concerns under Article 61 EEA. The present decision is therefore not concerned with those measures.

(158) The Authority stated in the opening decision that it would investigate further whether the statements by the Icelandic State described above are sufficiently precise, firm, unconditional and legally binding such as to involve a commitment of state resources [69]. In assessing whether these criteria are met, the Authority notes that the declarations entailed an irrevocable commitment of public resources as shown by the fact that the Icelandic state has done its utmost to protect depositors: Not only has it changed the priority of deposit holders in insolvent estates (which would not entail the use of state resources), but it has also made it clear that it would not allow depositors to suffer any losses. The Government's blanket guarantee of all deposits in domestic commercial and savings banks is furthermore distinct from any deposit guarantee scheme based on EEA acts due to the fact that the protection is unlimited in amount and no financial contribution is made by the banks benefitting from the measure.

(159) The Icelandic government's understanding of its declaration is illustrated by the state interventions in the financial sector that have occurred sector since October 2008 which have been motivated by the intention to honour this declaration. Those interventions have included measures to cover deposits of financial undertakings, such as the foundation of the three commercial banks, the transfer of SPRON deposits to Arion Bank, the transfer of Straumur deposits to Íslandsbanki, the CBI takeover of the deposits of 5 savings banks in Sparisjódabanki Íslands, the transfer of deposits in Byr Savings Bank to Byr hf, the transfer of deposits from Keflavík Savings Bank to SpKef and the State's responsibility for deposits in SpKef following the forced merger with Landsbankinn.

(160) In fact, the Icelandic authorities have argued in several state aid cases that the Authority is currently investigating, some of which were mentioned above, that the respective chosen measure was the financially least burdensome option for the Icelandic state to comply with its pledge to protect depositors in full.

(161) In the light of the above the Authority considers that there is a legally binding, precise, unconditional and firm measure in place. On this basis, the Authority therefore concludes that the statements by the Icelandic state according to which deposits are fully guaranteed entail a commitment of state resources in the meaning of Article 61 EEA

1.2. **Favouring certain undertakings or the production of certain goods**

1.2.1. *Advantage*

(162) First, the aid measures must confer on the new bank advantages that relieve it of charges that are normally borne from its budget. In line with the preliminary conclusion it reached in the opening decision, the Authority remains of the view that each of the capitalisation measures confers an advantage on the new bank as the capital provided would not have been available to the bank without state intervention.

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

(163) In determining whether an investment in an undertaking, for example by means of a capital injection, entails an advantage, the Authority applies the market economy investor principle, and assesses whether a private investor of a comparable size to that of the public body operating in normal market conditions would have made such an investment ([70]). As regards capitalisation measures for the benefit of banks in difficulties, since the onset of the financial crisis, the approach taken both by the European Commission (in numerous cases since the financial crisis began ([71]) and by the Authority ([72]) has been in general that state recapitalisations of banks amount to state aid given the turmoil and uncertainty that have characterised financial markets since the autumn of 2008. This general consideration applies in particular to the Icelandic financial markets in 2008 and 2009, when the entire system collapsed. Thus the Authority considers the capitalisation measures to confer an advantage on Íslandsbanki notwithstanding the eventual transfer of 95 % of the capital of the new bank to the (largely private sector) creditors. The private sector involvement in the capitalisation of Íslandsbanki is made up entirely of creditors of the old bank who are solely seeking to minimise their losses ([73]).

(164) Similar consideration apply in so far as the special liquidity facility is concerned, which was negotiated as part of a package of state assistance measures aiming to restore operations of a failed bank in a newly formed bank and to encourage equity participation in the new bank by the creditors of the failed bank. It is evident that the State stepped in as it was not clear if sufficient liquidity could be obtained by Íslandsbanki on the market. Thus, rather than acting as a private investor, the State replaced the role of private market participants who shied away from lending to financial undertakings. Therefore the Authority confirms the preliminary conclusion that it reached in the opening decision and considers the special liquidity facility as conferring an advantage on Íslandsbanki.

(165) Regarding the transfer of assets and liabilities of Straumur Bank — the Straumur agreement, the Authority notes positively that the overall transaction aims at providing Íslandsbanki with compensation equalling solely the amount of the transferred liabilities. However, the entire risk of the assets of Straumur being of less value than the transferred deposits, and the obligation to make up for any potential shortfall, is allocated to the State. It thus seems that Íslandsbanki, aside from receiving some revenue (through interest payments on the bond) is able to acquire goodwill and additional market shares, without taking on any risk. The Authority concludes that this constitutes an advantage.

(166) Finally, the Authority also needs to assess whether the additional deposit guarantee conveys an advantage on Íslandsbanki and Icelandic banks in general. In this regard, the Authority notes that when the statement that deposits would be guaranteed were first made by the Icelandic authorities, it was not entirely clear how this guarantee would work in practice, in particular what effect such intervention would have on the bank that could not live up to its financial obligations vis-à-vis its depositors anymore. In the meanwhile, it appears that such a bank would be allowed to fail, but that the Icelandic state would ensure — for example by transferring deposits to another bank and making up for the shortfall in assets — that deposits could be paid in full, and the depositors would never lose access to the full amount of their deposits.

(167) The Authority considers that it is of secondary importance how exactly the State would act in complying with the unlimited guarantee on domestic deposits. What matters is that it has assumed the obligation to step in if a bank would fail to pay out deposits, to an unlimited extent.

([70]) See for example T-228/99 WestLB [2003] ECR II-435.

([71]) See for example Commission decision of 10 October 2008 in case NN 51/2008 *Guarantee scheme for banks in Denmark*, at paragraph 32, and Commission decision of 21.10.2008 in case C 10/2008 *IKB*, at paragraph 74.

([72]) 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

([73]) 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).

(168) This unlimited guarantee has, in the Authority's view, favoured Íslandsbanki: First, as it provides a valuable competitive advantage — an unlimited state guarantee, and hence a significant safety net — over alternative investment options and providers. This is illustrated for example by a recent report of the Minister of Economic Affairs which states that: 'Icelandic financial undertakings are currently operating in a sheltered environment with capital controls and a blanket deposit guarantee. Under such conditions, bank deposits are practically the only secure option for Icelandic savers' ([74]).

(169) Second, it seems clear that in the absence of the guarantee Íslandsbanki could have more easily suffered from a run on its deposits like its predecessor ([75]). Thus the bank would likely have had to pay higher interest rates (to compensate for the risk) in order to attract or even simply retain the same amount of deposits were it not for the additional unlimited deposit guarantee that the Icelandic state has taken upon itself. Accordingly, the Authority concludes that the deposit guarantee entails an advantage for the bank.

1.2.2. *Selectivity*

(170) Second, the aid measure must be selective in that it favours *'certain undertakings or the production of certain goods'*. The capitalisation measures, the liquidity facility and the Straumur agreement are selective as they only benefit Íslandsbanki.

(171) Moreover, as state support can be selective even in situations where one or more sectors of the economy benefit and others do not, the Authority also considers the state guarantee on deposits which benefits the Icelandic banking sector as a whole as selective. This conclusion also follows from the considerations set out above according to which banks are favoured over other undertakings that offer possibilities to save and invest money.

1.3. **Distortion of competition and affection of trade between Contracting Parties**

(172) The measures strengthen the position of Íslandsbanki in comparison to competitors (or potential competitors) in Iceland and other EEA States. Íslandsbanki is an undertaking which is active, as described above, on financial markets, which are open for international competition in the EEA. Whilst the Icelandic financial markets are currently, particularly due to the capital controls, rather isolated, (a potential for) cross-border trade still exists, which will increase as soon as the capital controls are lifted. All measures under assessment must therefore be regarded as distorting competition and affecting trade between the Contracting Parties to the EEA Agreement ([76]).

1.4. **Conclusion**

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

([74]) Report of the Minister of Economic Affairs to the Althingi (March 2012), 'The Future Structure of the Icelandic Financial System', Ch. 9.6, available at http://eng.atvinnuvegaraduneyti.is/media/Acrobat/Future-Structure.pdf

([75]) 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

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

2. PROCEDURAL REQUIREMENTS

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

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

3. COMPATIBILITY OF THE AID

(176) As a preliminary remark, the Authority notes that whilst Íslandsbanki is a new legal entity that was established in 2008, it is — as regards domestic operations — evidently the economic successor of Glitnir, in the sense that there is an economic continuity between those two entities. As those economic operations that were carried out by Íslandsbanki from the autumn of 2008 onwards could not have continued in the absence of the aid, the Authority considers the bank as an undertaking in difficulties.

(177) Moreover, the measures under assessment are at the same time rescue and restructuring measures. As stated in the opening decision, the Authority would probably have temporarily approved the measures as compatible rescue aid had they been notified before their implementation, before then taking a final view on them on the basis of a restructuring plan. However, in the absence of a timely notification, the Authority initiated the formal investigation procedure and requested the submission of a restructuring plan. As indicated above, the final compatibility of these measures depends on whether the restructuring plan meets the criteria of the Authority's applicable state aid guidelines for undertakings in difficulties.

3.1. **Legal basis for assessment of compatibility: Article 61(3) of the EEA Agreement and the Authority's Restructuring Guidelines**

(178) While state aid to undertakings in difficulties such as Íslandsbanki is normally assessed under Article 61(3)(c) of the EEA Agreement, the Authority may, under Article 61(3)(b) of the Agreement allow state aid 'to remedy a serious disturbance in the economy of an EC Member State or an EFTA State'. As is stated in paragraph 8 of the Banking Guidelines ([77]), the Authority reaffirms that, in line with the case law and the European Commission's decision making practice, Article 61(3)(b) of the EEA Agreement necessitates a restrictive interpretation of what can be considered a serious disturbance of an EFTA State's economy.

(179) The Icelandic authorities have explained, as described in detail above, that Iceland's financial system entered into a state of systemic crisis in October 2008, leading to the collapse of its major banks as well as major savings banks within a time span of a few days. The combined market share of the collapsed financial institutions exceeded 90 % in most segments of the Icelandic financial market. The difficulties were coupled with a breakdown of confidence in the country's currency. Iceland's real economy has been severely hit by the financial crisis. Although more than three years have passed since the onset of the crisis, the Icelandic financial system is still in a state of turmoil. Even if the situation has eased significantly since 2008, it is evident that at the time that the measures were taken, they were intended to remedy a serious disturbance in the Icelandic economy.

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

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

The application of the Restructuring Communication

(181) The Authority's State Aid Guidelines on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules ([78]) ('the Restructuring Guidelines') sets out the state aid rules applicable to the restructuring of financial institutions in the current crisis. According to the Restructuring Guidelines, in order to be compatible with Article 61(3)(b) EEA, the restructuring of a financial institution in the context of the current financial crisis has to:

(i) Lead to a restoration of the viability of the bank;

(ii) Include sufficient own contribution by the beneficiary (burden-sharing);

(iii) Contain sufficient measures limiting the distortion of competition.

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

3.2. **Restoration of viability**

(183) Restoring the long-term viability of a beneficiary in receipt of restructuring aid is the main objective of such aid, and the assessment of whether restructuring aid will attain this, is an important aspect in determining its compatibility.

(184) As indicated above, the turmoil in the Icelandic economy in the wake of autumn 2008, the presence of extraordinary measures such as the capital controls, an evolving regulatory environment and a macroeconomic outlook that, in spite of some recent stabilisation, remains somewhat uncertain, given in particular the ongoing economic woes of the euro zone, make it challenging to operate a bank profitably and ensure its long-term viability. The Authority emphasises at the outset that this consideration needs to be borne in mind in the below assessment.

(185) Section 2 of the Restructuring Guidelines sets out that the EEA State should provide a comprehensive and detailed restructuring plan which provides complete information on the business model and which restores the bank's long-term viability. Paragraph 10 of the Restructuring Guidelines requires that the restructuring plan identifies the causes of the bank's difficulties and the bank's own weaknesses, and outlines how the proposed restructuring measures remedy the bank's underlying problems.

(186) The causes of Íslandsbanki's difficulties are, as described above, spelt out both in the restructuring plan, but also in the report of the Special Investigation Commission. Amongst the main causes identified at the bank's level in the latter were the excessive and unsustainable expansion, the gearing of the bank's owners, the concentration of risk, weak equity and the size of the banks as compared to the Icelandic economy. Moreover, Glitnir had expanded into highly leveraged LBOs ([79]) and commercial real estate markets outside Iceland. It also relied predominately on short-term wholesale funding and took on major risk by lending to its owners, and the bank had large single exposures.

Regulatory viability measures

(187) Whilst the Íslandsbanki's restructuring plan addresses many of the bank's weaknesses as identified above, the Authority considers that the failure of Glitnir, and the collapse of the Icelandic financial industry, was also caused by a number of factors specific to Iceland, relating to its small size and the regulatory and supervisory shortcomings highlighted by the Special Investigation Commission. The long-term viability of Íslandsbanki, such as that of any other Icelandic bank, thus does not depend solely on the measures taken at the bank's level, but also on whether those supervisory and regulatory shortcomings have been remedied.

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

([79]) Leveraged Buyouts.

(188) In this regard the Authority notes positively the amendments to the regulatory and supervisory framework that the Icelandic authorities have made, as explained in the Annex.

(189) First, the powers and competences of the FME have been enhanced, inter alia, with new responsibilities regarding large single exposures and the risks related thereto, which in the Authority's view addresses one of the factors that led to the financial collapse.

(190) Second, the temporary high CAD ratio requirements, and a number of provisions relating to collateralisation, in particular the prohibition of extending credit against pledges of own shares, aims at ensuring that Icelandic banks cannot once again build up a weak capital position. The Authority considers that these measures will contribute to the resilience of the Icelandic banks.

(191) Third, a range of measures have been implemented relating to the eligibility of directors and board members, as well as their remuneration. Moreover, lending to related parties (such as owners) has been subjected to stricter rules, and the FME can now prohibit a bank from performing specific activities, if it sees reason to do so. External and internal accounting rules have also been amended, for example the duration for which an external accountant can work for the same bank has been shortened. The Authority notes positively that these measures are aimed at preventing a repetition of events in so far as the owners and high executives are concerned. The measures also increase external risk monitoring, both of which reduces threats to the banks' viability.

(192) Fourth, according to the Icelandic authorities, the already mentioned possibility for the FME to limit a bank's activities, is also prompted by the large-scale deposit taking by Icelandic commercial banks before the crisis, which seems to at least have accelerated their demise. Moreover, the new rules on liquidity and foreign exchange balance ([80]) also appear, in the Authority's understanding, to entail certain restrictions as regards the banks' possibility to attract disproportionately large amounts of foreign deposits if that were to make the bank's business more fragile and vulnerable to foreign currency exchange and liquidity risks. The Authority welcomes that the Icelandic authorities have responded to this aspect of regulatory failure.

Íslandsbanki's restructuring plan

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

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

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

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

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

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

(198) As regards the assets side of the balance sheet, the most risky, international assets — such as the commercial real estate securities abroad — were also kept in Glitnir's estate. As a result, the balance sheet has shrunk by 85 %. A main weakness of Glitnir's business model — the reliance on risky international assets without appropriate risk assessment and limited market knowledge — has thus been remedied. The Authority welcomes that pursuant to the restructuring plan, the bank will not engage in similar business in the future, but rather focus on its traditional core business.

(199) Evidently, the bank has grown since its establishment, in particular through the acquisition of Byr. However, according the restructuring plan, this does not have a major impact on the business model of Íslandsbanki, as Byr mainly disposed of domestic assets of similar characteristics as those in Íslandsbanki's portfolio. In any event, the Authority considers that the committed divestments, further discussed below, will contribute to letting Íslandsbanki focus on its core business.

(200) A considerable challenge for the bank as regards its asset portfolio remains the restructuring of the loans that were transferred from Glitnir. In this regard the Authority notes positively that this restructuring process is a priority for the bank, as illustrated by the many generic and tailor-made proposals that the bank has made to its overleveraged customers. Whilst the process has not progressed as swiftly as was initially planned, much has been already achieved. For example, on 8 February 2012, 2 680 companies had undergone some form of restructuring, and according to the Icelandic authorities, the vast majority of those were able to service their debt post restructuring.

(201) The Authority considers this to be an indicator of the soundness of Íslandsbanki's restructuring methods. Moreover, based on the data in the banks' restructuring dashboard, it appears realistic that the bank can meet its target of completing the restructuring of its corporate debt by year-end 2012 and of retail debt by 2013. Overall, barring unexpected developments in the macroeconomic environment in Iceland or abroad, this would mean that at the latest at the end of the restructuring period, Íslandsbanki will, in the Authority's view, have a relatively healthy balance sheet and well-performing loan portfolios.

(202) As indicated above, the weak capitalisation of Glitnir was one of the factors that lead to its downfall. Íslandsbanki's restructuring plan predicts that the bank will stay well above the minimum CAD ratio of 16 % required by the FME throughout the restructuring period. This ratio is well above the future Basel III minimum of 10,5 %. Even pursuant to the stress case, which Íslandsbanki has submitted in conjunction with this year's ICAAP report attached to the restructuring plan, the CAD ratio would not fall below this high benchmark. In fact, according to the restructuring plan, Íslandsbanki will gradually reduce its capital ratio in order to increase profitability by

starting to pay out dividends ([81]). The Authority considers it prudent and comforting that even in the stress case submitted by Íslandsbanki, which seems to be based on sensible parameters, a capital surplus of over ISK […] billion remains, which, in an operating environment as described above, provides Íslandsbanki with a significant capacity to deal with unexpected adversities.

(203) As for the bank's liquidity position, the Authority notes that the current situation, pursuant to the restructuring plan, appears sufficiently robust, and that there are no indications that the situation could deteriorate substantially during the restructuring period. Moreover, the Authority considers that stress testing the bank's liquidity ratio in the context of the ICAAP report, according to which the bank is well prepared for adverse events, suggests that Íslandsbanki's liquidity situation is sound.

(204) The Authority also welcomes the changes to Íslandsbanki's corporate governance and risk management, as described above, which address a weakness in Glitnir's business and will contribute to a more objective and professional risk assessment in the bank's operation.

(205) As regards profitability, the Restructuring Guidelines also provide that the restructuring plan should demonstrate how the bank will restore its long-term viability without State aid as soon as possible. In particular, the bank should be able to generate an appropriate return on equity, while covering all costs of its normal operation and complying with the relevant regulatory requirements. In particular, point 13 of the Restructuring Guidelines indicates that long-term viability is achieved when a bank is able to cover all its costs including depreciation and financial charges and provide an appropriate return on equity, taking account of the risk profile of the bank.

(206) At this point, the Authority recalls what was already mentioned above, namely that the economic environment in which Íslandsbanki operates would be challenging for any bank. With this in mind, the Authority is satisfied with the restructuring plan's forecasted profitability, which, in spite of the high capital ratio, will be adequate and mostly above Íslandsbanki's own profitability targets throughout most of the restructuring period and beyond. Between 2009 and 2014, the ROE fluctuates between […] % and […] %. However, as described above, […]fluctuation is mainly due to irregular situations and events, such as the valuation gains from the assets transferred from Glitnir on one hand, and the write-downs caused by the recent Supreme Court ruling on FX-loans and the acquisition of Byr on the other hand. According to the restructuring plan, such irregular events are not foreseen to occur beyond 2013, and from 2014 to 2016 the ROE is expected to increase from […] % to […] %. The calculation submitted by the Icelandic authorities in which the Profit and Loss Statement (P&L) has been cleansed of those irregular items indicates that the bank has made and will continue to make relatively stable profits from 2008 to 2016. The report by the Icelandic State Financial Investments ('ISFI') referred to above would seem to support this conclusion. Whilst it is not clear if these calculations fully reflect the gains stemming from the deep discount, the Authority notes that after 2013, when the discount is forecasted to be fully absorbed, the bank will make profits of between […]and […]billion ISK annually according to the restructuring plan.

(207) Some of the most relevant and more detailed aspects of the financial planning on which the restructuring plan is based were mentioned above, such as the decreasing income from core business segments corporate and retail bank during the restructuring period. It appears to the Authority that this is mainly a result of the discount being absorbed, and reflects the increasing funding costs (resulting from greater diversification on the liabilities side, with a larger share of debt with longer maturities) as well as a decrease in the net interest margin from currently 4,4 % to […] %. The Authority is of the view that it is prudent to not rely on increasing revenue in these segments. Indeed, it appears probable that funding costs will increase slightly (according to the restructuring plan, by up to […]bp). As regards the interest rate margin, the Authority notes that even after the anticipated decrease

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

to […] %, it would be rather high in international comparison ([82]). According to the Icelandic authorities, the margin has been approximately at that level or higher throughout the last decades, and is due, amongst other factors, to the high-interest rate environment in Iceland, the lower share of mortgages in the loan portfolio and the smaller size of the banks. The Authority considers these explanations reasonable, and therefore finds this aspect of the financial planning to be sufficiently plausible.

(208) Another important driver of future profitability according to the restructuring plan is a greater fee and commission income, which is forecasted to increase […] over the planning period […]. This increase would then yield profits of ISK […] in 2016. The Icelandic authorities submit that these projections are plausible, as commission fee yielding business such as stock market related transactions and foreign currency trade have practically come to a standstill after the collapse and as a result of the capital controls. However, as it is, according to the Icelandic authorities, realistic to expect a substantial increase in stock exchange activity, and the capital controls are supposed to be lifted at the end of 2013, the Authority does not question the plausibility of these figures.

(209) The revenue side of the P&L forecast aside, the bank has taken a number of initiatives, as described above, to increase efficiency and reduce cost, amongst others a reduction of staff by almost 10 %, which should overall reduce the cost to income ratio from 75 % to […] % in 2014. The Authority welcomes these efforts, as the current ratio appears quite high in international comparison. The Authority also considers it, based on the restructuring plan, plausible that this target can be reached, as indeed the finalisation of the restructuring of the portfolio inherited from Glitnir and anticipated reduction of supervisory work should make it possible to trim down the bank's head count, and efficiency gains still appear attainable in the bank's operation.

(210) In addition to the above, it is evident that the restructuring plan is based on a large number of other assumptions. The Authority has aimed to scrutinise those that seem most pertinent and of greatest influence to the future viability of Íslandsbanki. As regards the macroeconomic assumptions, they appear broadly in line with the forecasts of the IMF and Statistics Iceland, for example as regards GDP growth and unemployment. Overall the assumptions on which the restructuring plan is based appear to be sufficiently prudent to allow, in conjunction with the considerations set out by the Authority above, the conclusion that the restructuring measures undertaken by the bank are sufficient to ensure its long-term viability, barring unexpected adverse events of unforeseen scale and consequences.

(211) Taking into account the above elements, the Authority considers that the restructuring plan comprises sufficient elements contributing to the restoration of the long-term viability of the bank for the Authority to conclude that the provisions of section 2 of the Restructuring Guidelines are complied with.

3.3. **Own contribution/burden-sharing**

(212) Paragraph 22 of the Restructuring Guidelines reads as follows: 'In order to limit distortions of competition and address moral hazard, aid should be limited to the minimum necessary and an appropriate own contribution to restructuring costs should be provided by the aid beneficiary. The bank and its capital holders should contribute to the restructuring as much as possible with their own resources. This is necessary to ensure that rescued banks bear adequate responsibility for the consequences of their past behaviour and to create appropriate incentives for their future behaviour'.

(213) The Authority recalls in this regard a decisive aspect of the case at hand. When Íslandsbanki was established on the basis of the domestic operations of Glitnir, the shareholders in Glitnir Bank were fully wiped out and have thus contributed the maximum possible to the restructuring of Íslandsbanki. Moreover, the creditors of Glitnir had to take considerable losses ([83]), or at least had to take on the risk of their investment depending on the profitability of Íslandsbanki. Therefore, as far as the owners and creditors of Glitnir are concerned, the criterion of burden-sharing is optimally satisfied and the issue of moral hazard addressed.

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

([83]) According to current estimates, the losses could amount to 70-75 % of the loans they had granted to Glitnir; see for example http://glitnirbank.com/press-room/tilkynningar-a-islensku/448-athugasemdfraslidastjorn.html

(214) In addition to the above, the Authority needs to assess whether the state aid that Íslandsbanki has received was limited to the minimum necessary.

(215) As regards the capitalisation measures, the initial capitalisation of Íslandsbanki, until the agreement with the creditors of Glitnir reduced the State's stake to 5 %, was just sufficient to meet the FME's capital requirements. In 2009, after the agreement on Glitnir's acquisition of Íslandsbanki had been reached, and the Tier-II capital had been granted to Íslandsbanki, the CAD ratio reached approximately 19 %, 3 percentage point more than the minimum ratio set forth by the FME. In this context, the Authority notes that the capital ratio depended mainly on whether valuation of the assets that had been transferred from Glitnir to Íslandsbanki had been done accurately. Moreover, it has to be borne in mind that at the time the economic outlook for Iceland was cast in uncertainty. In view of the foregoing, the Authority considers that the amount of capital provided by the Icelandic state to Íslandsbanki was limited to the minimum necessary, as it amounted to nothing more than the regulatory minimum plus a reasonable buffer.

(216) This conclusion is not undone by the fact that Íslandsbanki's CAD ratio subsequently grew strong enough to allow it to absorb a severely undercapitalised bank — Byr — in 2011. The increase of the CAD ratio was almost exclusively due to the writing up of the book value of the assets that had been transferred from Glitnir to Íslandsbanki. It could not have been predicted with any certainty that this would happen, and the fact that the CAD ratio developed so strongly later is in the Authority's view no reason to consider that Íslandsbanki was overcapitalised by the State at the outset ([84]).

(217) Paragraph 26 of the Restructuring Guidelines provides that banks in receipt of restructuring aid 'should be able to remunerate capital, including in the form of dividends and coupons on outstanding subordinated debt, out of profits generated by their activities'.

(218) In this context, it is worth recalling that the State made an annualised return of almost 14 % on the capital which was redeemed already in the autumn of 2009. The prospect of a satisfactory return for the 5 % stake that the State retained appear promising too, given the overall good performance of Íslandsbanki since its establishment.

(219) However, it also should be stressed that the remuneration for the Tier-II capital deviates from the Authority's Recapitalisation Guidelines ([85]). As correctly submitted by the Icelandic authorities, the required remuneration pursuant to the Recapitalisation Guidelines amounts to approximately 15,7 % (consisting of the government's funding cost of 8 %, Glitnir's pre-crisis CDS-spread of 5,7 % and an add-on fee of 2 %). The remuneration that Íslandsbanki pays, EURIBOR plus 4 % add-on falls significantly short of this benchmark. According to paragraph 25 of the Restructuring Guidelines, such derogation from adequate *ex-ante* burden-sharing (i.e. appropriate remuneration) can, inter alia, be justified by farther-reaching restructuring, including measures to limit distortions of competition. As will be shown below, the Authority considers that the restructuring of Íslandsbanki is sufficiently far-reaching for this condition to be met.

(220) Whilst the Straumur agreement, as described above, entails elements of state aid, the Authority considers that it is constructed in a manner that aims at limiting if not excluding a direct financial advantage for Íslandsbanki. The agreement constitutes in essence a negotiated compensation for Íslandsbanki in exchange for taking on the deposit liabilities of Straumur, and it is likely that Íslandsbanki obtains matching assets for the transferred liabilities. The Authority does not consider that this aid is of great significance for its burden-sharing assessment.

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

([85]) The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition ('the Recapitalisation Guidelines'), OJ L 17, 20.1.2011 and EEA Supplement No 3. The guidelines are also available on the Authority's website at: http://www.eftasurv.int/state-aid/legal-framework/state-aid-guidelines/

(221) Finally, as regards the deposit guarantee, the Authority has already indicated in the opening decision that — in light of the extraordinary circumstances at the time — it might constitute a proportionate means to safeguard financial stability in Iceland. It is evident however that such aid cannot be approved indefinitely.

(222) Thus, in order for this state aid to be considered as limited to the minimum necessary, the Authority is of the view that it needs to be terminated as soon as possible. The Authority therefore welcomes the intention of the Icelandic authorities to abolish the deposit guarantee before the capital controls are lifted, thus, pursuant to current planning, no later than the end of 2013.

(223) So as to cater for delays in the lifting of the capital controls, and to reflect the Authority's view that a viable bank should be able to compete on the market without the protection of such a blanket guarantee on deposits, it will therefore authorise the deposit guarantee until the end of 2014 ([86]). After that time, protection of deposits should be governed only by the applicable EEA legislation regarding deposit guarantees.

(224) On the basis of the above elements, the Authority concludes that the restructuring plan of Íslandsbanki ensures that the aid is limited to the minimum necessary and that the beneficiary, the shareholders and debt holders of its predecessor bank have participated significantly in the burden-sharing. The restructuring aid thus complies with section 3 of the Restructuring Guidelines.

3.4. **Limiting distortions of competition**

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

> 'Financial stability remains the overriding objective of aid to the financial sector in a systemic crisis, but safeguarding systemic stability in the short-term should not result in longer-term damage to the level playing field and competitive markets. In this context, measures to limit distortions of competition due to state aid play an important role. […] Measures to limit the distortion of competition should be tailor-made to address the distortions identified on the markets where the beneficiary bank operates following its return to viability post restructuring, while at the same time adhering to a common policy and principles. The Authority takes as a starting point for its assessment of the need for such measures, the size, scale and scope of the activities that the bank in question would have upon implementation of a credible restructuring plan as foreseen in Section 2 of this Chapter. […] The nature and form of such measures will depend on two criteria: first, the amount of the aid and the conditions and circumstances under which it was granted and, second, the characteristics of the market or markets on which the beneficiary bank will operate.
>
> As regards the first criterion, measures limiting distortions will vary significantly according to the amount of the aid as well as the degree of burden sharing and the level of pricing. Generally speaking, where there is greater burden sharing and the own contribution is higher, there are fewer negative consequences resulting from moral hazard.
>
> As regards the second criterion, the Authority will analyse the likely effects of the aid on the markets where the beneficiary bank operates after the restructuring. First of all, the size and the relative importance of the bank on its market or markets, once it is made viable, will be examined. The measures will be tailored to market characteristics to make sure that effective competition is preserved. […] Measures limiting distortions of competition should not compromise the prospects of the bank's return to viability.'

(226) It follows from the above that the size of the aid, particularly in relative terms, and the market characteristics are decisive in the Authority's assessment of the appropriateness of measures to limit distortions of competition. At the same time, it is evident that such measures must not jeopardise the viability of the beneficiary of restructuring aid, and competition concerns must be addressed with a view to the overriding goal of financial stability in the present crisis.

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

(227) Against the background of the above legal framework, the Authority will set out below the considerations that it deems essential for its assessment of the measures limiting distortions of competition.

(228) First and foremost the Authority considers that given the particular situation on the Icelandic financial markets and the economic conditions, as described in previous chapters, a careful assessment of the market conditions and the competitive environment is necessary. The measures limiting the distortion of competition should reflect the currently difficult circumstances, while ensuring that the distortions of competition are limited to a minimum both in the short-term and the long-term.

(229) Second, as set out above in the section on burden-sharing, the greatest possible contribution from the former owners of Glitnir, and to some extent, of Glitnir's creditors has been addressed. Consequently, the need for additional competition measures has been limited.

(230) Third, as regards the characteristics of the relevant market and as described above, the collapse of the financial system in Iceland, followed by the interventions of the Icelandic authorities, including the establishment of Íslandsbanki on the basis of Glitnir's domestic operations, led to a greater concentration in the Icelandic market for financial services, and substantially increased the market share by the three major banks — Íslandsbanki, Arion Bank and Landsbankinn. Beside these, only a few small market players remain, and the immediate prospect of a new entry is extremely slim, not only due to the already mentioned barriers to entry and the small size of the market, but in particular also due to the capital controls. Íslandsbanki enjoys a very significant position on this concentrated market, with a market share of over […] % in the most relevant and economically important segments.

(231) Fourth, the crisis led to a number of very specific problems, such as the extremely high degree of direct and indirect ownership of the large banks in the real economy, and the existence of a de-facto monopoly for banking IT-services (RB), majority owned by the three major banks.

(232) Fifth, the relative size of aid that Íslandsbanki has received is significant. In this regard, the Authority notes that at the outset the entire capital of the bank was provided by the State. In addition, the bank has benefited from a variety of aid measures — the Straumur agreement, the special liquidity facility and the deposit guarantee. At the same time, Íslandsbanki remains a small bank, at least by international standards.

(233) Sixth, the bank's acquisition of Byr calls for additional competition measures. In the second Byr decision, the Authority required that the forthcoming restructuring plan should comprise measures which would ensure that the Icelandic financial market would benefit from effective competition in the future, so as to address the concerns that the Authority raised about the state of competition in the Icelandic financial market.

(234) Against this background, the Authority notes that a number of measures have been or will be taken that limit the distortions of competition resulting from the state aid granted to Íslandsbanki.

(i) Measures and regulatory developments undertaken or committed to by the Icelandic authorities

(235) The Icelandic government has specifically made two commitments (see Annex) which in the Authority's view can contribute to creating a regulatory environment that favours competition in financial markets:

(236) First, by appointing a working group that will review Act No 36/1978 on Stamp Duty, and by examining in particular whether to abolish stamp duties for bonds issued by individuals when transferred between creditors (e.g. when individuals transfer their loans from one loan institution to another). The Authority considers that the current law — which, inter alia, obliges customers to pay stamp duty on the amount of the respective bond ([87]) when switching lenders — may be capable of constituting an impediment to competition, as it may lock customers to existing contracts on long term loans. The Authority thus welcomes the commitment for this law to be reviewed.

(237) Second, the Authority takes note that, in accordance with a resolution passed by the Icelandic parliament on 21 March 2012, a committee will be appointed by the government with the mandate to review consumer protection in the financial market. This will include a specific mandate for the review of switching facilitation and switching costs reduction, and for the committee to work closely with the ICA as regards that issue. The Committee shall present its report no later than 15 January 2013. The Authority is of the opinion that a closer assessment could be of benefit for competition in the long-run. In the meantime the bank-specific commitment by Íslandsbanki discussed below should contribute to making switching easier, and thereby will increase competition.

(238) As for the competition concerns identified by the Authority regarding RB, the Authority welcomes the settlement that ICA and the owners of RB, including the three major banks, have reached on this issue. This endeavours to ensure access to essential IT-infrastructure on a non-discriminatory basis and at reasonable cost for small competitors and potential new market entrants. The Authority is of the view that its concerns, as voiced, inter alia, in the second Byr decision, have been addressed in a satisfactory manner by this settlement, and that there is no need for the Authority to further address this issue in the current decision.

(239) Finally, the Authority takes note of the regulatory amendments that have been made since 2008, as discussed in the Annex. As regards competition concerns, the introduction of Article 22 in the Act on financial undertakings No 161/2002 is of particular relevance in this regard. It includes provisions which limit the participation of financial undertakings in activities falling outside the scope of their operating licenses. According to this new rule, such activities may only be pursued on a temporary basis and for the purpose of concluding transactions or reorganising the activities of customers. A reasoned notification to this effect must be sent to the FME, and time limits have been introduced for financial undertakings to complete reorganisation of their customers and dispose of appropriated assets.

(240) The Authority regards this change as an appropriate regulatory response to the issue of the disproportionately large ownership by financial institutions in the real economy. This provision appears to at least remedy this situation — which is a direct result of debt-to-equity-swaps (and similar transactions) involving over-indebted companies in the wake of the crisis — from becoming a permanent one. As it addresses one of the most pressing competition issues that is linked to the state aid to the three banks, the Authority takes it duly into account in its assessment.

(ii) Measures specific to Íslandsbanki

(241) The Authority emphasises that Íslandsbanki's market presence and size is only a fraction of that of Glitnir — as total assets have been reduced by 84 %, as described above and unlike Glitnir, Íslandsbanki is only active in the Icelandic market. Whilst most of this reduction is evidently a result of the winding up of Glitnir's international operations, the Authority is of the view that this process is of particular relevance as regards the distortions of competition, as it was in particular Glitnir's risky overseas strategy that led to its collapse and caused distortions in the EEA financial markets in the past ([88]).

([87]) The stamp duty varies depending on the type of legal document concerned, but is normally 15 ISK for each started thousand ISK (i.e. approximately 1,5 %) on the amount of interest-bearing bonds secured by a mortgage or other security.

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

(242) In addition, the Authority welcomes Íslandsbanki's commitments (see Annex) to reduce its domestic market presence further by […] divestments relating to […]. On the basis of the final restructuring plan, and recalling that Íslandsbanki is a small bank by EEA standards, the Authority agrees with Íslandsbanki that further structural measures could endanger the bank's prospects of restoring long-term viability [89].

(243) The Authority takes note of the commitment that Íslandsbanki will not acquire financial institutions until 15 October 2014, except if it obtains the Authority's approval beforehand. This means, unless further mergers would be necessitated by financial stability considerations, that further concentration of the Icelandic financial market through acquisitions by Íslandsbanki can be prevented. This commitment also ensures that the aid that has been granted to Íslandsbanki is used for restoring its viability rather than it being used to consolidate and further expand its market presence in Iceland. The same is true for Íslandsbanki's commitment pursuant to which it will, until 15 October 2014, neither enforce contract clauses nor introduce new contract clauses which make special terms on interest rates contingent upon maintaining a minimum range of business with the bank, as well as for the commitment not to invoke state involvement as a source of a competitive advantage when marketing its services.

(244) As described above, the Icelandic financial market currently presents a challenging operating environment for any bank, which is reflected also by the almost complete absence of interest from abroad to enter this market at the present time. The Authority thus welcomes the commitments by Íslandsbanki relating to facilitating the switching between banks and providing basic payment processing as well as money distribution services. The Authority is of the view that those measures, in conjunction with the agreement between the three major banks and ICA on RB mentioned above ensure that smaller market participants can access the most essential infrastructure and services at reasonable prices without the larger players being able to block their access. The Authority is of the view that this will reduce the barriers to entry for future (potential) market participants, and could allow existing smaller players to expand their market shares if they are able to offer better services than their larger competitors. Moreover, the measures aimed at facilitating switching will contribute to more fierce competition between the existing large players, and could contribute to prevent or dissolve a situation of potential collective dominance.

(245) Lastly, Íslandsbanki commits to sell, as soon as possible, shareholdings in operating companies which have been taken over due to restructuring in line with Article 22 of the Act on financial undertakings No 161/2002, commits to follow the procedure and time-limits which are set out in this provision, and will maintain up-to-date information on its website or of a subsidiary on subsidiaries and shareholdings that are held for sale. The Authority welcomes Íslandsbanki's commitment to divest as soon as possible all companies and shareholdings that are not related to its core business, not the least because of viability concerns. Whilst the Authority is of the view that it is self-evident that the bank needs to respect domestic legal obligations such as Article 22 of the Act on financial undertaking, it takes note of this commitment and draws the Icelandic authorities' and beneficiaries' attention to the fact that in this regard a breach of national law might also entail a misuse of aid. The Authority moreover considers that by having to include information about foreseen divestments and sales on its website, more transparency about the current ownership situation in the Icelandic economy is introduced. This remedies, at least to some extent, this particular competition concern that currently characterises Iceland's markets.

(246) On the basis of all of the above, given in particular the specific situation in Iceland and the fact that the Authority considers that the above measures address the main competition issues that the Authority has identified in collaboration with the ICA, and taking into account the overriding objective of financial stability, the Authority concludes that the commitments limit distortions of competition to a satisfactory degree. The restructuring aid therefore complies with section 4 of the Restructuring Guidelines.

(89) For the same reasons the Authority accepts the divestments are subject to the condition that […].

4. CONCLUSION

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

HAS ADOPTED THIS DECISION:

Article 1

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

Article 2

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

Article 3

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

Article 4

This Decision is addressed to the Republic of Iceland.

Article 5

Only the English language version of this decision is authentic.

Done at Brussels, 27 June 2012.

For the EFTA Surveillance Authority

Oda Helen SLETNES

President

Sabine MONAUNI-TÖMÖRDY

College Member

ANNEX

COMMITMENTS AND RELEVANT CHANGES TO THE LEGAL FRAMEWORK FOR BANKING

1. COMMITMENTS BY THE ICELANDIC AUTHORITIES

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

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

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

Measures to facilitate switching and reduce switching costs

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

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

Limitation of acquisitions

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

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

Divestment of […]

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

[…] e […]

[…].

Divestment of shares in companies under restructuring

Íslandsbanki commits itself to sell, as soon as possible, shareholdings in operating companies which have been taken over due to restructuring, cf. Article 22 of the Act on financial undertakings No 161/2002. Furthermore, the bank commits itself to follow the procedure and time-limits, which are set out in the above-mentioned legal provision. Finally, the bank will maintain up-to-date information on its website (or website of a relevant subsidiary, e.g. Midengi ehf.) on such shareholdings that are held for sale.

Measures benefitting new and small competitors

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

(a) Íslandsbanki will, until 15 October 2014, neither enforce contract clauses nor make new contract clauses which make special terms on interest rates contingent upon maintaining a minimum range of business with the bank.

(b) Íslandsbanki will provide for easily accessible information, at the bank's website, on the process of switching banking services to another financial institution. Furthermore, the website will make easily accessible the necessary documents to switch between financial institutions. Finally, the same information and business-transfer forms will be available at the branches of the bank.

(c) Íslandsbanki will execute all requests for transfer of banking services in a swift manner.

(d) Íslandsbanki will not invoke state involvement as a source of competitive advantage when marketing.

(e) Provided that competitive service offers are not available, Íslandsbanki is willing to offer the following services at a price that will be based on cost plus reasonable margin:

(f) Payment processing services for ISK.

   (i) Payment processing services for FX.

   (ii) Distribution of bank notes and coins.

      I. Sale and delivery of bank notes and coins to the premises of the service recipient.

      II. Maintaining a stock of special cassettes containing bank notes which are placed inside ATM machines. However, a security firm contracted by the new/small party would 'feed' the folders into the ATM's.

2. RELEVANT ADAPTATIONS AND CHANGES TO THE REGULATORY AND SUPERVISORY FRAMEWORK FOR FINANCIAL MARKETS IN ICELAND ADOPTED AFTER THE CRISIS

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

— FME's (The Icelandic Financial Supervisory Authority) authorisations to intervene (to take over the powers of shareholders' meetings and dispose of assets, cf. the emergency legislation) have been increased; FME has been given expanded supervisory authorisations; additional provisions have been adopted enabling FME to evaluate the operations or behaviour of individual supervised parties. These include both decision-making authorisations, such as on the closing of establishments or termination of specific activities without actual revocation of operating licences, as well as a more detailed definition of concepts whose interpretation has been disputed by FME and supervised entities or appellate bodies.

— Rules on individual large exposures have been clarified and made more specific; both the role and responsibility of risk management have been increased and FME authorised to accord risk management higher status in the organisation of financial undertakings; provisions on the application of stress tests have been tightened.

— Provisions for a special registry of larger borrowers have been legalised, in order to provide better overview of large, individual exposures to two or more financial undertakings. The registry is important for linking exposures together and assessing their systemic impact if difficulties should arise in the borrowers' operations. Entities not subject to FME supervision, but which are listed in the registries of financial undertakings, must provide FME with information on all their obligations. FME can prohibit the provision of services to such parties should they refuse to provide the information requested.

— Provisions on sound business practices have been reinforced and the existence of the Complaints Committee on Transactions with Financial Undertakings enshrined in law; detailed information must be disclosed on all major owners of financial undertakings.

— The time limits allowing financial undertakings to dispose of appropriated assets have been shortened.

— Provisions on financial undertakings' holdings in own shares have been tightened and defined in more detail. Holdings of subsidiaries are now considered own shares, as are off-balance-sheet contracts concerning own shares.

— Financial undertakings have been prohibited from extending credit against pledges of their own shares or guarantee capital certificates.

— FME is now to lay down rules as to how loans secured by a mortgage on the shares of other financial undertakings are to be calculated in the risk base and capital base.

— Both the responsibility and role of internal auditing section has been increased. There are detailed rules concerning the balance between the size and diversity of the activities of the financial undertaking concerned and the scope of its internal auditing section.

— Five-year limits have been placed on the period for which an auditing firm may carry out the audit of the same financial undertaking; financial undertakings' ability to dismiss a 'difficult' auditor is reduced.

— All provisions on calculation of equity and various other technical aspects have been reviewed.

— Rules on exercising qualifying holdings, i.e. 10 % or more of voting rights, have been reviewed. FME is authorised to reverse the onus of proof in assessing parties intending on acquiring or adding to qualifying holdings, e.g. when it is uncertain who is/are the beneficial owner/-s of a holding company with a qualifying holding.

— Additional demands on eligibility have now been made of directors, their responsibility for supervision or operations have been increased and executive chairmen of the Board are prohibited; FME has been assigned a greater supervisory role for Boards of Directors; personally identifiable information must be disclosed on remuneration to senior management.

— Rules have been set concerning credit transactions of financial undertakings with directors, managing directors, key employees and owners of qualifying holdings in the financial undertaking concerned. Similar rules apply to parties closely connected with the above-mentioned. FME has adopted rules as to what is considered satisfactory collateral for such transactions.

— Rules concerning arrangements for incentive schemes and bonuses to management and employees and on termination contracts have been adopted.

— Provisions on the reorganisation and winding-up of financial undertakings have been tightened.

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

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

— FME is authorised to restrict the activities of individual establishments of financial undertakings, if it sees reason to do so. Furthermore, it is authorised to set special requirements for individual establishments of financial undertakings to continue their activities. FME may also limit provisionally the activities which a financial undertaking may pursue, in full or in part, whether subject to license or not, if the Authority sees reason to do so. This is naturally prompted not least by the activities of branches and deposit accounts established by them in other European states until 2008 (Icesave, Edge and Save-and-Save).

— Considerably more detailed provisions are set concerning the role of internal audit in Icelandic law than in the EU directives.

— Considerably more detailed provisions are set on how stress tests are to be carried out than in the EU directives.

— Financial undertakings must keep a special registry (a credit registry) of all parties to whom they extend credit and submit an updated list to FME at the end of each month. Furthermore, a similar list shall be sent on parties closely connected with financial undertakings, their Boards of Directors and managers and groups of connected clients, to the extent that these parties are not on the above-mentioned list. This list will provide a better opportunity to monitor inter-linkages between financial undertakings, their directors and management.

— If FME is of the opinion that the borrowing of a single party on the credit registry, which is not subject to official supervision of financial activities, could have a systemic impact, it may demand information from the party concerned on its obligations.

— Should a party not subject to official supervision listed on the credit registry refuse to disclose information to FME, the Authority may order supervised entities to refrain from providing the said party with further service. The same applies if the information disclosure of the party concerned is unsatisfactory. The provisions on a credit registry and extensive authorisations to supervisors concerning parties not subject to official supervision are not in EU/EEA rules.

— There are considerably more detailed and restrictive provisions on related party lending and collateral than in EU/EEA rules.

— FME must refuse the owner of a qualifying holding the right to exercise the holding if there is doubt as to who is or will be its beneficial owner.

— The maximum length of time external auditors can work for the same financial undertaking is shorter than in EU/EEA rules.

— There are considerably more detailed provisions on the eligibility of directors in financial undertaking than in the EU directives.

— Provisions are adopted on arrangements for bonus schemes and termination contracts.

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

On 23 March 2012, the Minister of Economic Affairs presented a report on the Future Structure of the Icelandic Financial System and its regulation and supervision. The Minister furthermore appointed an expert group to review the legal and regulatory framework for all financial activities in Iceland.

Public version of [1]

EFTA SURVEILLANCE AUTHORITY DECISION

No 290/12/COL

of 11 July 2012

on restructuring aid granted to Landsbankinn (Iceland)

The EFTA Surveillance Authority ('the Authority')

HAVING REGARD to the Agreement on the European Economic Area ('the EEA Agreement'), in particular to Article 61(3)(b) and Protocol 26 thereof,

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

HAVING REGARD to Protocol 3 to the Surveillance and Court Agreement ('Protocol 3'), in particular to Article 1(3) of Part I, Article 7(3) of Part II, and Article 13 of Part II,

Whereas:

I. **FACTS**

1. PROCEDURE

(1) Following informal correspondence in October 2008, and the passing of Act No 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc. (referred to as the 'Emergency Act'), which gave the Icelandic state wide-ranging powers to intervene in the banking sector, on 6 October by the Icelandic Parliament (the Althingi), the President of the EFTA Surveillance Authority ('Authority') wrote on 10 October 2008 to the Icelandic authorities and requested that state aid measures taken under the Emergency Act be notified to the Authority.

(2) 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 stand-still clause in Article 3 of Protocol 3. State aid involved in the restoration of certain operations of Landsbanki and the establishment and capitalisation of a new Landsbanki Bank ('NBI', later renamed Landsbankinn) was eventually notified retrospectively by the Icelandic authorities on 15 September 2010. [2]

(3) By letter dated 15 December 2010 [3] the Authority informed the Icelandic authorities that it had decided to initiate the procedure laid down in Article 1(2) of Part I of Protocol 3 in respect of the measures undertaken by the Icelandic State to restore certain operations of (old) Landsbanki Islands hf and establish and capitalise New Landsbanki Islands (NBI hf) (the opening decision). The Authority also required that a detailed restructuring plan for Landsbankinn be submitted within 31 March 2011.

(4) By e-mail of 24 March 2011, the Authority received one comment from interested parties, which was forwarded to the Icelandic authorities on 25 May 2011. The Icelandic authorities did not respond to this comment.

[1] This document is made available for information purposes only. In this public version, some information has been omitted so as not to divulge confidential information. This is denoted by […] or a range in square brackets providing for a non-confidential approximation of the relevant figure.
[2] Please see a more thorough description in the opening decision, referred to in footnote 3.
[3] The Authority's Decision No 493/10/COL, opening the formal investigation procedure into state aid granted opening the formal investigation procedure into state aid granted in the restoration of certain operations of (old) Landsbanki Islands hf and the establishment and capitalisation of New Landsbanki Islands (NBI hf) (now renamed Landsbankinn), OJ C 41, 10.2.2011, p. 31 and EEA Supplement to the *Official Journal to the EU* No 7, 10.2.2011, p. 26.

(5) By letter of 31 March 2011, the Icelandic authorities submitted a restructuring plan for Landsbankinn. A revised restructuring plan, reflecting, inter alia, the non-notified transfer of deposits and assets from Spkef Savings Bank (SpKef) effectuated on 22 April 2010 and taking into account the acquisition of Sparisjodur Svarfdaela ('SpSv') was submitted by letter dated 23 May 2012.

(6) The Authority requested information with regards to the restructuring plan on 11 July 2011 and 13 February 2012. The request for information was answered by the Icelandic authorities on 17 October 2011 and 13 March 2012. The final versions of the commitments were submitted on 6 June 2012 and 13 June 2012.

(7) On 20 June 2012, the Authority approved the potential use of state aid granted to Landsbankinn for the acquisition of SpSv in Decision No 212/12/COL ('the SpSv Decision'). The Authority had by its Decision No 253/10/COL, of 21 June 2011, temporarily approved a rescue aid scheme involving settlement of claims owned by the Central Bank of Iceland ('CBI') on savings banks, including SpSv. By decision 127/11/COL of 13 April 2011 the Authority had approved amendments to the rescue aid scheme ('the Savings Banks Decisions')

(8) In addition, the Authority met with the Icelandic authorities on 7 June 2011 and 27-28 February 2012.

2. BACKGROUND

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

2.1. **The collapse of Landsbanki**

(10) Icelandic banks experienced massive withdrawals of deposits not only abroad but also within Iceland in autumn 2008. Domestic withdrawals became so large that at one stage the Icelandic banks and the CBI were close to experiencing a shortage of cash.

(11) Access to foreign debt securities markets had been the main source of the Icelandic banks' growth, in particular between 2003 and 2006. This source of financing however began to diminish, and foreign credit-rating agencies also expressed concern that the ratio of the banks' lending to deposits was low in comparison to other (foreign) banks.

(12) The Icelandic commercial banks (in particular Landsbanki) responded by accumulating deposits abroad. From the end of the third quarter of 2006 to the middle of 2007, customer deposits in Landsbanki tripled — an increase of almost 10 billion Euros. The largest proportion of this were accounts opened in the Landsbanki UK branch, in which retail deposits had grown from nothing to 6,6 billion Euros, while wholesale deposits (in branches in the UK and the Netherlands) had grown to 2,5 billion Euros.

(13) On 3 October 2008 the European Central Bank issued a margin call to Landsbanki to the amount of 400 million Euros and although this was later withdrawn the bank's UK branch had begun to experience a run on its deposits, meaning that it had to make available large amounts in pounds sterling. Landsbanki's request for the assistance of the CBI was turned down on 6 October. When the bank failed to make the funds demanded by the UK Financial

Services Authority available the UK authorities closed the branch. The following day the Dutch Central Bank requested that an insolvency practitioner be appointed for Landsbanki's Amsterdam branch. Also that day the FME suspended the board of directors of Landsbanki, took over the power of shareholders' meetings and appointed a Resolution Committee in its place using its powers under the Emergency Act ([4]).

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

(14) The Icelandic authorities explained in their submissions to the Authority 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 Parliament ([5]), whose remit was to investigate and analyse the processes leading to the collapse of the three main banks. The Authority summarises below the conclusions of the SIC concerning the causes of failure most relevant to the demise of Landsbanki. 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.

(15) The global reduction in liquidity in financial markets that began in 2007 eventually led to the collapse of the three main Icelandic banks, whose business operations had become increasingly dependent on raising funding through international markets. The reasons for the demise of the Icelandic banks were however complex and numerous. The SIC investigated the reasons which led to the collapse of the main banks, and it is notable that the majority of the conclusions applied to all three banks and many are inter-related. Causes of failure related to the banks' activities are briefly summarised below.

Excessive and unsustainable expansion

(16) 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 ISK ([6]) 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 2007 ([7]), most notably after the beginning of the international liquidity crisis. This led the SIC to conclude that much of this increase in lending resulted from loans made to undertakings that had been refused credit elsewhere. The report also concluded that inherently riskier investment banking had become an ever increasing feature of the banks' activities and growth had contributed to the problems.

The reduction in finance available on the international markets

(17) 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

([4]) Glitnir Bank was also placed in receivership on the same day and Kaupthing Bank followed two days later on 9.10.2008. The SIC report (see paragraph 14 and footnote 4 of the present Decision) concluded (at page 86 of Chapter 21) that a key issue was that notwithstanding Landsbanki's liquidity in ISK, the bank had insufficient foreign currency at its disposal to honour its foreign obligations. The report also considered it noteworthy that the loan of 153 million Euros to its principal owner (referred to above) had taken place only days earlier, stating that it was therefore '*apparent that the principal owners of Landsbanki were not interested in or capable of helping the bank out of the difficult position that had arisen*'.

([5]) 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/

([6]) Icelandic *króna*.

([7]) Lending to foreign parties increased by 11,4 billion Euros from 9,3 billion Euros to 20,7 billion Euros in six months.

European debt securities markets became more limited, the banks financed their activities on US markets, with Icelandic debt securities packaged into collateralised debt obligations. In the period before the collapse, the banks were increasingly reliant on short-term borrowing, leading to major and, according to the SIC, foreseeable re-financing risks.

The gearing of the banks' owners

(18) In the case of each major Icelandic bank, the principal owners were among the biggest debtors ([8]). Samson Holding Company ('Samson') was the biggest shareholder in the Landsbanki since its privatisation. When Landsbanki collapsed Samson's co-owner Björgólfur Thor Björgólfsson and companies affiliated to him were the bank's largest debtors, while his father and co-owner of Samson, Björgólfur Guðmundsson was the bank's third largest debtor. In total their obligations to the bank exceeded 200 billion ISK, which was greater than the bank's equity. The SIC was of the view that certain shareholders had abnormally easy access to borrowing from the banks in their capacity as owners. This was notable in the case of Landsbanki from the fact that as late as 30 September 2008, when it was clear that Landsbanki did not have sufficient foreign currency to honour its obligations abroad, the bank provided a loan of 153 million Euros to a company owned by Björgólfur Thor Björgólfsson. It also concluded that that there were strong indications that in the case of each bank the boundaries between the interests of the largest shareholders and the interest of the bank were blurred. The emphasis on the major shareholders was therefore to the detriment of other shareholders and creditors.

Concentration of risk

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

Weak equity

(20) Although the capital ratio of Landsbanki (and the other two major 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 the risk exposure of the bank's own shares through primary collaterals and forward contracts on the shares. Share capital financed by the company itself, referred to by the SIC as 'weak equity' represented more than 25 % of the banks' capital bases (or over 50 % when assessed against the core component of the capital, shareholders' equity less intangible assets). Added to this were problems caused by the risk 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 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 portfolio declined. This affected the banks' performance and put further downward pressure on their share prices; in response to which (the SIC assumed from the information in their possession), the banks attempted to artificially create abnormal demand for their own shares.

The size of the banks

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

([8]) Chapter 21.2.1.2 (page 6) of the Report.

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

(22) 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 that they could have taken action to reduce the level of risk that the banks were incurring. The FME, for example, did not grow in the same proportion as the banks and the regulator's practices did not keep up with the rapid developments in the banks' operations. The report is also critical of the government, 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 abroad ([9]).

Imbalance and overexpansion of the Icelandic economy as a whole

(23) 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' ([10]). The report is also critical of the ease with which the banks were able to borrow from the CBI, with the stock of CBI short-term collateral loans increasing from 30 billion ISK in the autumn of 2005 to 500 billion ISK by the beginning of October 2008.

The Icelandic króna, external imbalances and CDS spreads

(24) 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.

2.3. **Measures taken to reconstruct the banking sector**

(25) Following the collapse of the three biggest commercial banks in October 2008 (including Landsbanki) the Icelandic authorities were faced with the unprecedented challenge of safeguarding continued banking operations in Iceland ([11]). The policy followed by the Icelandic Government is primarily laid down in the Emergency Act ([12]) adopted by the Icelandic Parliament on 6 October 2008. The law grants extraordinary powers to the FME to take control of financial undertakings and to dispose of their assets and liabilities as required. The Minister of Finance was authorised, on behalf of the Treasury, to disburse funds in order to establish new financial undertakings. Moreover, in bankruptcy proceedings of financial undertakings, deposits would be given priority over other claims. The Government declared that deposits in domestic commercial and savings banks and their branches in Iceland would be fully protected.

(26) Policy priorities focused initially on securing the basic functioning of the domestic banking, payment and settlement systems. In the first weeks after the crash, the Icelandic Government also prepared an economic program in collaboration with the International Monetary Fund (the IMF), leading to the approval on 20 November 2008 of Iceland's request for a two year stand-by-arrangement from the Fund, which included a 2,1 billion USD loan

([9]) 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.

([10]) Chapter 2, page 5 of the report.

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

([12]) Act No 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc.

from the IMF aimed at strengthening Iceland's currency reserves. Additional loans of up to 3 billion USD were secured from other Nordic countries as well as certain other trading partners. Of the IMF loan, 827 million USD was made available immediately, while the remaining amount was disbursed in eight equal instalments, subject to quarterly reviews of the program.

(27) The IMF Program was a broad-based stabilisation program focusing on three key objectives. Firstly, to stabilise and restore confidence in the króna so as to contain the negative impact of the crisis on the economy. The measures included the introduction of capital controls aimed at stemming capital flight. Secondly, the program included a comprehensive bank restructuring strategy, ultimately aimed at rebuilding a viable financial system in Iceland as well as safeguarding the country's international financial relations. Among subsidiary goals was to ensure fair valuation of the banks' assets, maximise asset recovery and strengthen supervisory practices. Thirdly, the program aimed at ensuring sustainable public finances, by limiting the socialisation of losses in the failed banks and implementing a medium-term fiscal consolidation program.

(28) The Icelandic authorities have underlined that due to the exceptional circumstances linked to the large size of the banking system in relation to the financial capacity of the Treasury, the policy options available to the authorities were limited. The solutions relied upon were therefore in many ways different to the measures taken by the governments of other countries facing threats to financial stability.

(29) On the basis of the Emergency Act, the three large commercial banks, Glitnir Bank, Landsbanki Íslands and Kaupthing Bank, were split into 'old' and 'new' banks. The Minister of Finance founded three limited liability companies to take over the domestic operations of the old banks and appointed them boards of directors. The FME took control of the old banks, allocated essentially their domestic assets and liabilities (deposits) to the new banks which continued banking operations in Iceland. The old banks were placed under the supervision of their respective resolution committees. ([13]) Foreign assets and liabilities were in the main placed in the old banks, which were later submitted to winding-up procedures and the eventual closure of all foreign operations. ([14])

(30) In the provisional opening balance sheets of the three new banks of 14 November 2008 it was estimated that the banks' combined total assets would amount to 2 886 billion ISK, with an equity to be provided by the State of 385 billion ISK. The total amount of bonds to be issued by the new banks in favour of the old banks as payment for the value of the assets transferred in excess of liabilities was estimated at 1 153 billion ISK. The FME appointed Deloitte LLP to perform assessments of the value of transferred assets and liabilities. In this process it transpired that the independent assessment would not result in fixed values of net assets transferred but valuations within certain ranges. It also emerged that the banks' creditors raised disagreements concerning the valuation process, which they considered not to be impartial, and complained that they were unable to protect their interests. These complications resulted in a change of policy for settling the accounts between the old and the new banks. Instead of relying on valuations by an independent expert, the parties would try through negotiations to reach agreements on the value of the net assets transferred.

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

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

(31) It was clear that it would be difficult for the parties to reach agreements on the valuations as they were evidently subject to numerous assumptions on which the parties were likely to disagree. The state aimed to reach agreements on base evaluations providing a firm foundation for the initial capitalisation of the new banks. Price performance of assets in excess of the base evaluation could be attributed to the creditors in the form of contingent bonds or increases in the value of the banks' share capital, as it had emerged in the negotiations that the resolution committees of Glitnir and Kaupthing and a majority of their creditors could be interested to acquire holdings in the new banks, and this would allow them to benefit from potential increases in the values of the assets transferred.

(32) The full capitalisation of the three new banks and heads of agreements with the creditors of the old banks on how compensation for the transfer of net assets into the new banks would be paid was announced on 20 July 2009. With regard to two of the new banks, New Glitnir (later named Íslandsbanki) and New Kaupthing (later named Arion Bank), this included conditional agreements for the old banks to subscribe for majority equity interests in the new banks.

(33) On the basis of the heads of agreements, the resolution committees of the old banks decided in October 2009 (Glitnir) and December 2009 (Kaupthing Bank and Landsbanki Islands) to subscribe to shareholding in the new banks. On 18 December 2009 the Government announced that bank reconstruction had been concluded and that agreements had been reached between the Icelandic authorities and the new banks, on the one hand, and the resolution committees of Glitnir Bank, Landsbanki Íslands and Kaupthing Bank on behalf of their creditors, on the other hand. The agreements contained settlements concerning assets which were transferred from the old banks to the new ones, and that the new banks were then fully financed.

(34) The Treasury's contribution to the new banks' equity was reduced substantially, from 385 billion ISK as originally envisaged to 135 billion ISK in the form of share capital and, in the case of two of the three banks, Íslandsbanki and Arion Bank, approximately ISK 55 billion of Tier II capital in the form of subordinated loans or a total of 190 billion ISK. In addition, the Treasury provided Íslandsbanki and Arion Bank with certain liquidity facilities. The share capital provided by the old banks to the new ones amounted in total to approximately 156 billion ISK. Total capitalisation of the new banks therefore amounted to approximately 346 billion ISK. Thus, instead of maintaining full ownership of the three banks, the agreements implied that the state's holdings would be reduced to approximately 5 % in the case of Íslandsbanki, 13 % in the case of Arion Bank and 81 % in the case of Landsbankinn.

(35) While this takeover of two of the three banks by the creditors of the old banks resolved major issues in the rebuilding of the financial sector and established firmer capital foundation for the new banks, numerous weaknesses remained which needed to the addressed. Since the autumn of 2009, the banks have concentrated their efforts mostly on internal issues, determining the overall strategy for their operations and in particular restructuring their loan portfolios, which represent the greatest risk factor to their operations and long-term viability. The restructuring process has been complex due to various complicating factors, including Supreme Court rulings on illegality of loans granted in ISK but indexed to foreign currencies. As for Landsbankinn, in so far as relevant for its restructuring, these matters are discussed further below.

2.4. **Macroeconomic environment**

(36) Major economic turbulence followed the collapse of the banking system in October 2008. The difficulties in Iceland's financial system were coupled with a breakdown of confidence in its currency. The króna depreciated sharply in the first quarter of 2008 and again in the autumn, before and after the failure of the three commercial banks. Despite capital controls being imposed in the autumn of 2008, currency volatility prevailed in the course of 2009. ([15]) This turmoil resulted in a severe recession in Iceland's economy, with a contraction of Gross Domestic Product (GDP) by 6,8 % in 2009 and 4 % in 2010.

([15]) As an example of the scale of the sharp depreciation, the monthly average exchange rate of the Euro to the Icelandic króna rose from 90,71 ISK in December 2007 to 184,64 ISK November 2009.

(37) Among the implications of the economic crisis was a sudden increase in unemployment from 1,6 % in 2008 to 8 % in 2009, a hike in inflation and a drop in real wages. Moreover, there was a sharp rise in corporate and household debt and of the share of non-performing loans in the banks' loan portfolios as well as a large scale takeover by the new banks of businesses in financial distress. At the same time the high fiscal cost of restructuring the banking system led to a sharp rise in the fiscal deficit and a major surge in public sector debt.

(38) Following the deep recession provisional data from Statistics Iceland indicates a turnaround in the second half of 2011 and for the whole year a growth of GDP of 3,1 % compared to the previous year.

(39) Last year's economic growth was mostly due to an increase in domestic demand, particularly a 4 % rise in private household consumption. This was supported by increases in wages and social benefits as well as certain policy initiatives undertaken to ease the payment burden of household debt, including a temporary interest rate subsidy, the freezing of payments on loans and the early reimbursement of private pension savings. Provisional data for 2011 also indicate a slow increase in investments, however from a particularly low level ([16]), whereas public consumption has remained at a subdued level during the past three years.

(40) The general macroeconomic data disguise more significant sectoral differences. In addition to the collapse in the financial sector a major contraction has taken place in construction and many other domestic production and service activities. Growth has on the other hand taken place in certain export sectors. Due to the low exchange rate of the króna and relatively stable prices in foreign currency for both marine and aluminium products, export revenue rose following the onset of the economic crisis, also with respect to tourism and other services exports. At the same time, imports fell sharply, turning the trade balance ([17]) temporarily to a surplus of approximately 10 % of GDP in 2010. However, with increased domestic demand in 2011, imports have grown again, leading to an overall smaller trade balance of 8,2 % of GDP.

(41) Statistics Iceland forecast for 2012-2017 assumes that gradual economic recovery will continue with 2,6 % growth in 2012. A similar growth rate is expected throughout the forecast period. This forecast is however subject to several uncertainties. Planned large scale industrial investments might be further delayed. Iceland's terms of trade would be negatively affected by a prolonged recession in the main trading countries, implying a lower growth rate in Iceland. Slower progress than anticipated in tackling the debt burden of households and corporates would furthermore restrain domestic demand and the growth prospects of the economy. Growth could also be threatened by continued price instability linked to currency volatility in the context of removal of capital controls.

2.5. **Financial supervision and improvements in regulatory framework**

(42) Following the FME's initial work linked to the foundation of the new banks and the assessment of the value of the net assets transferred from the old banks, the FME conducted in the spring of 2009 an audit of the new banks and their business plans, financial strength and capital requirements in a so-called sign-off project. This was done with the assistance of the international management consultant firm Oliver Wyman.

([16]) During the years 2009-2011, the share of investments in GDP has been only 13-14 %.

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

(43) Having concluded the above process, the FME granted the banks operating licenses subject to various conditions. In view of the quality of the asset portfolios and the anticipated economic uncertainty, it was considered necessary to place higher capital requirements on the three banks than the statutory minimum. The FME therefore set the minimum capital adequacy ('CAD') ratio for the three banks at 16 %, thereof a minimum of 12 % for the Tier I capital. The requirements were applicable for at least 3 years unless reviewed by the FME. Liquidity conditions were also specified, requiring that available liquid funds should at any point amount to a minimum of 20 % of deposits. Cash or cash equivalents should amount to at least 5 % of deposits. Furthermore, requirements were made regarding other matters such as restructuring of loan portfolios, risk assessment, corporate governance and ownership. Comparable capital requirements were introduced by the FME regarding other financial undertakings.

(44) The economic stabilisation program established in consultation with the IMF provided for a review of the entire regulatory framework of financial services and supervision to improve defence against future financial crisis. The Government invited the former Director-General of the Finnish Financial Supervisory Authority, Mr Kaarlo Jännäri, to carry out an assessment of the existing regulatory framework and supervisory practices. Among the improvements proposed by Mr Jännäri was the creation of a National Credit Registry at the FME to diminish credit risks in the system. His report also suggested to lay down tougher rules and a stricter practice on large exposures and connected lending as well as to conduct more on-site inspections to verify off-site supervision and reports, particularly on credit risk, liquidity risk and foreign exchange risk. It was also recommended to review and improve the deposit guarantee system, following closely the developments within the EU.

(45) The Government subsequently proposed a bill of law to the Althingi which was adopted and entered into force on 1 July 2010, as Act No 75/2010. With the new law, extensive amendments were made to the Act on Financial Undertakings. Several other amendments were later introduced to the law on financial undertakings as well as of regulation and supervision of financial services. These regulatory amendments are considered in more detail in the Annex.

2.6. **Main challenges ahead** [18]

(46) Despite major achievements in rebuilding a financial sector, Iceland continues to strive with the repercussions of the financial and currency crisis in the autumn of 2008. The financial crisis has revealed various flaws and deficiencies in the financial system, which must be addressed, if public confidence is to be restored. It seems evident that Iceland — as many other countries hard hit by the financial crisis — faces numerous challenges in adapting the legal and operating environment of financial services to support a viable and efficient financial system in the future and reduce as much as possible the risk of further systemic shocks to reoccur.

(47) The most immediate challenges currently facing Icelandic financial undertakings are linked to the fact that the banks are operating in a sheltered environment with capital controls and a blanket deposit guarantee. The banks now need to prepare themselves to operate in a more exposed environment, when the capital controls are removed and deposit guarantees revert to the arrangement set out in the relevant EU/EEA directives [19]. The Icelandic authorities have underlined that extreme caution must be exercised when introducing new rules in this regard.

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

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

(48) Another major challenge is the need to adapt further the legal and regulatory framework to support a solid and efficient financial system which is also consistent with EEA and international law developments ([20]).

2.7. **The state of competition in the Icelandic financial sector**

(49) According to recent information from the Icelandic authorities ([21]), competition on the financial market has changed radically since the banking collapse. The number of financial undertakings has decreased, as several savings banks, commercial banks and specialised lenders are either being wound up or have been merged with other undertakings ([22]). The number of financial undertakings is still decreasing, most recently with the mergers of Landsbankinn and SpKef in March 2011, of Íslandsbanki and Byr in December 2011 and the forthcoming merger of Landsbankinn and Svarfdaelir Savings Bank, approved by the Authority in the SpSv Decision on 20 June 2012. With the reductions in the number of financial undertakings and the larger banks taking over deposits from the banks closing down, concentration in the domestic market has increased. The overall presence of the new banks on the EEA financial markets is on the other hand much smaller than that of their predecessors, as international banking operations have been closed down.

(50) In addition, the domestic market has shrunk considerably as certain sub-markets have disappeared or are largely subdued. The near disappearance of the stock market and the introduction of capital controls have reduced operations in the stock and currency markets and resulted in limited investment options. With the level of investments in the economy at a historically low level and households and companies generally highly leveraged, demand for credit is low. Since the collapse, the banks have concentrated their efforts on internal issues and restructuring of their loan portfolios as well as the restructuring of some of their major corporate clients.

(51) Before the financial crisis, the savings banks accounted collectively for a market share of approximately 20-25 % in deposits. This has now collapsed to approximately 2-4 %. The market shares lost by the savings banks and commercial banks exiting the market have been gained by the three major commercial banks, Arion Bank, Íslandsbanki and Landsbankinn. Combined the three big banks now account for approximately 90-95 % of the market instead of 60-75 % earlier on, where Landsbankinn's market share is marginally highest. Apart from the 10 regional savings banks, currently accounting for approximately 2-4 % of the market, the only other market player is the restructured MP Bank ([23]), with a market share of approximately 1-5 %.

(52) The Icelandic financial market is thus clearly oligopolistic and the three largest companies could collectively achieve a dominant market position. According to the Icelandic Competition Authority ('ICA') there are significant entry barriers to the Icelandic banking market. This has detrimental effects on competition. There are also certain

([20]) See Chapter 9 of the report of the Minister of Economic Affairs referred to in footnote 18. When presenting that report, the Minister of Economic Affairs also appointed a group of banking experts, with participation of foreign experts, to prepare proposals on a comprehensive legal and regulatory framework for the financial market in Iceland as a whole. According to the same report, the Icelandic authorities also foresee to study other future options, including the possible separation of investment and commercial banking activities, the adoption of a financial stability legislation and possible amendment of the division of responsibility of financial services regulatory bodies. It is also clear from the statements of the Icelandic authorities that a review of the monetary policy framework remains on the agenda, with or without the possibility that Iceland will become a member of the European Union, as well as other possible means to improve economic management and ensure that regulators 'see the forest for the trees' and effectively apply the most appropriate macro-prudential tools.

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

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

([23]) On 11.4.2011, a contract for the sale of (old) MP bank's operations in Iceland and Lithuania was approved at the bank's shareholder meeting, when over 40 new shareholders invested 5,5 billion ISK in new shares in the bank. Other operations of the old bank remained with the previous owners and were transferred to a new legal entity, EA fjárfestingarfélag hf. For further details, see MP bank's press releases of 11.4.2011 available at https://www.mp.is/um-mp-banka/utgefid-efni/frettir/nr/1511 and https://www.mp.is/um-mp-banka/utgefid-efni/frettir/nr/1510 impediments for consumers to switch banks. The Icelandic authorities furthermore acknowledged that the exchange rate risks associated with Iceland's small and non-traded currency, the Icelandic króna, has further restricted competition and deterred foreign banks and companies from entering the Icelandic market.

(53) ICA has lately focused on a specific issue regarding IT infrastructure for the banks' operations and their co-operation in that regard. This relates to the financial institutions' jointly owned IT service provider, *Reiknistofa bankanna* (the Icelandic Banks' Data Centre; RB). This matter is of relevance for the assessment of the case at hand and was among the issues discussed by the Authority with the Icelandic authorities and the banks.

(54) RB is jointly owned by the three main Icelandic banks, two savings banks, the Icelandic Savings Bank Association and the three main payment card processors in Iceland. Landsbankinn owns 36,84 % of the shares in RB, Íslandsbanki holds 29,48 % and Arion Bank 18,7 %. Combined the three commercial banks therefore own 85,02 % of shares in RB. RB's clients are the owners, the Central Bank of Iceland and other financial institutions as well as the government and public entities. The banks' cooperation in this area is extensive, as RB has developed the clearing and settlement system in Iceland. It also provides a number of core banking solutions which are multi-tenant solutions, used by most of the Icelandic banks. RB furthermore operates an e-invoicing and e-payment system for corporations and consumers.

(55) According to ICA, the collapse in 2008 has made the smaller banks and savings banks particularly vulnerable. For the smaller financial undertakings, the required IT services were of crucial importance, as they can be viewed as one of the entry barriers for new market participants. The platform for IT services has been provided to a significant extent by RB as regards the bigger financial undertakings and, as regards the savings banks and smaller market players, by Teris. Following the closure of many smaller financial undertakings in recent years, Teris lost a significant share of its income, leading in January 2012 to the sale of some of its IT solutions to RB. According to RB and Teris, this transaction was, inter alia, aimed at securing continued provision of IT services to smaller financial undertakings.

(56) The ICA has been investigating two cases regarding RB. Firstly, whether the joint ownership and cooperation of the banks and other financial undertakings in the RB forum should be considered to be a breach of the ban on restrictive practices under Article 10 of the Icelandic Competition Act. Secondly, the compatibility of RB's purchase of Teris's major assets is being assessed under the merger provisions of the same act. However, in May 2012 these two cases were concluded with a settlement between RB and its owners, on the one hand, and the ICA on the other hand. ([24])

(57) Aside from the above concerns that relate directly to the Icelandic financial market, the ICA has in particular pointed to the need for the sale and restructuring of operating companies ([25]) to be completed without undue delay. Many operating companies have been taken over by the banks (being creditors of those companies) due to over indebtedness following the economic crash in 2008. According to ICA, it may create a conflict of interest when banks provide financial services to companies and own the companies at the same time. The ICA is of the

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

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

opinion that the banks' direct and indirect ownership ([26]) is the most wide-spread and dangerous competition problem in the aftermath of the financial crisis, as this has an effect on almost every company and industry in Iceland. In ICA's view, faster restructuring of companies would improve competition in the financial market. When the banks' involvement in the restructuring of their corporate clients has been subject to the notification requirements under national merger control, the ICA has in this regard often set conditions regarding the banks' ownership. However, a comprehensive solution to the problem appears to be difficult, as it relates essentially to the high leverage of the Icelandic business sector.

(58) In their submission to the Authority, the three commercial banks, Arion Bank, Íslandsbanki and Landsbankinn, have all expressed the view that no major changes have taken place in the conditions of competition in the Icelandic financial market since autumn 2008 which should give cause for concerns. Effective competition prevailed in the market, without any evidence of collusive behaviour of the three biggest players. When examining the conditions of competition in the market, the ICA had overlooked certain key factors, such as the fact that foreign banks have for long and still are actively competing with Icelandic banks for the provision of financial services to the biggest clients, such as undertakings in export-based activity (fisheries, power-intensive industry, etc.) as well as state and municipal activity.

(59) However, this view is contrary to the view expressed in the submission of the Icelandic authorities, as set out in the report referred to above by the Minister of Economic Affairs to the Althingi and to the views of ICA. Moreover, as will be outlined below, Landsbankinn has, despite certain reservations regarding analysis of competition conditions, decided to provide certain commitments aimed at limiting distortion of competition linked to the aid measures concerned. Those commitments are reported in the Annex.

3. DESCRIPTION OF THE MEASURES

3.1. **The beneficiary**

(60) As described above, Landsbanki collapsed in 2008, as did the two other large Icelandic commercial banks, Glitnir and Kaupthing. So as to ensure the continuing operation of the domestic banking sector, the Icelandic authorities undertook certain measures, and to restore certain operations of (old) Landsbanki, they established and capitalised New Landsbanki (now renamed Landsbankinn), described in more detail below.

3.1.1. *Landsbanki*

(61) Prior to the financial crisis of 2008 Landsbanki was the second largest bank in Iceland. At the end of the second quarter of 2008 its balance sheet amounted to 3 970 billion ISK and it made a pre-tax profit during the first half of that year of 31 billion ISK. The published business strategy ([27]) of the bank was to transform the bank from a local commercial bank, operating exclusively in Iceland, 'into a highly profitable corporate and investment banking operation stretching eastward from Iceland across Europe and westward over the Atlantic'. In 2000 Landsbanki began its activities abroad by acquiring a 70 % holding in the Heritable Bank in London and over the

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

([27]) Annual Report 2007, page 10. Available here: http://www.lbi.is/library/Opin-gogn/pdf/landsbanki_annual_report_2007.pdf?bcsi_scan_A7E1E556D7B2F94D=aB9LkrKRu+y0xx3fim/JyUDnRB0bAAAANp6SAg==&bcsi_scan_filename=landsbanki_annual_report_2007.pdf

following years the bank grew substantially both through acquisitions and the establishment of foreign branches. Prior to its collapse the bank held 7 main subsidiaries in the UK, Ireland, Luxembourg, France/Germany and Iceland itself. It also had branches in the UK (which in turn had offices in the Netherlands, Germany and the United States), Canada, Norway and Finland, and a sales office in Hong Kong.

3.1.2. *Landsbankinn*

(62) Landsbanki's successor, Landsbankinn, is a universal bank offering a comprehensive set of financial services to individuals, households, corporations and professional investors in Iceland. Landsbankinn is the largest bank in Iceland. Total assets amounted to 1 135 billion ISK at the end of 2011, and it has 1142 employees. According to the restructuring plan, Landsbankinn is mainly active in the following areas:

3.1.2.1. Retail banking

(63) The Retail Banking division handles all general service to individuals and small and medium sized companies. With 520 employees, 410 working out of the various branches, this is the Bank's largest division. According to the information provided by the Icelandic authorities, Landsbankinn has a market share of [> 25] % in the retail sector.

3.1.2.2. Corporate banking

(64) Corporate Banking deals with large companies and municipalities and larger financing projects. Three departments within the Corporate Banking division handle lending: Industry, Trade & Services, Fisheries & Seafood and Construction & General Credit Management. The division has 40 employees. According to the information provided by the Icelandic authorities, Landsbankinn has a market share of [> 30] % in this market segment.

3.1.2.3. Markets, Treasury and Asset Management

(65) The Treasury is responsible for the Bank's liquidity and funding, manages market risk, market making in the foreign exchange ('FX') market, money market and listed securities. The Markets division handles FX sales and securities brokerage in bonds, equities and derivatives to professional clients.

(66) Asset management consist of three sub-departments, namely third-party asset management, private banking and financial advisory services.

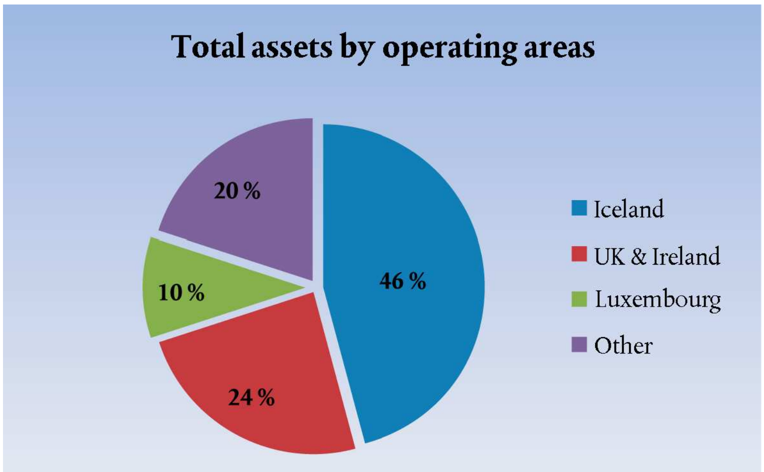
3.2. **Comparing the old and new bank**

(67) The Icelandic authorities have 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.

(68) As referred to above Landsbanki's business strategy involved expansion of its business internationally, and from 2004 the main goal of the bank was to grow in international investment and corporate banking markets focusing on services to small to medium sized corporate enterprises. A branch was opened in London in 2005, initially focused on leverage finance and asset based loans. Later branches, opened in Canada, Finland, Norway and the sales office in Hong Kong, were initially focused on asset-based lending and trade finance. The aim of this strategy [28] was to diversify the loan portfolio across countries and sectors. Due to this strategy lending to non-Icelandic companies accounted for an ever-larger share of the bank's operations. Nearly half of the 2 644 people employed by Landsbanki and its subsidiaries in September 2008 were based outside Iceland.

Chart 1

Distribution of assets by region — Q1 and Q2 2008

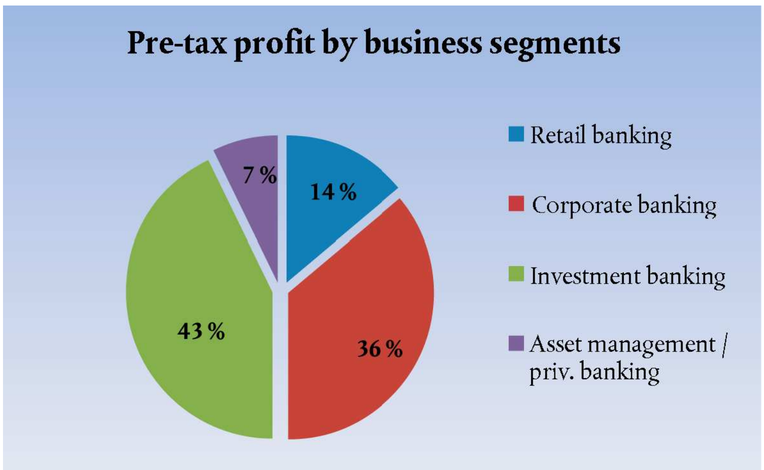


(69) When examined geographically, 54 % of total assets (of 3 970 billion ISK for Q1-Q2 2008), as shown in the chart above, were located outside Iceland. Moreover, 41 % of revenues in the first half of 2008 originated in Iceland, 34 % in the UK and Ireland, 6 % in Luxembourg and 15 % other areas.

(70) The chart below shows that for the first half of 2008 (the last available numbers for the bank) the largest part of Landsbanki's pre-tax profit of 31 billion ISK came from investment banking and corporate banking. In the years following the privatisation of the bank (in 2002) the share of retail banking in pre-tax profits had been steadily declining.

Chart 2

Distribution of profits by business segment — Q1 and Q2 2008



([28]) Annual report 2007, p. 61.

(71) The new bank, Landsbankinn focuses solely on activities in Iceland. It is not an internationally oriented bank as its predecessor, and contrary to Landsbanki, which based its growth on a diverse funding mix, heavily relying on unsecured bonds sold worldwide, it relies mainly on deposits as a funding base. This limits Landsbankinn's potential to grow.

(72) Moreover, the splitting between foreign and domestic assets meant a significant reduction in the size of the balance sheet of Landsbankinn when compared to Landsbanki:

Table 1

Balance sheet of Landsbanki (LBI) and Landsbankinn

Balance sheet LBI and Landsbankinn comparison (m. ISK)	30.6.2008	9.10.2008
Loans and advances to customers	2 571 470	655 725
Loans and advances to financial institutions	337 003	5 291

(73) As illustrated above by reference to the two most significant items on the asset side, the opening balance sheet of Landsbankinn was only about 25 % of Landsbanki's balance sheet for 30 June 2008. At the end of 2011, Landsbankinn's total assets amount to 1 135 billion ISK.

(74) In terms of employees, there has been a reduction of more than 55 % (from 2 644 to 1 142).

3.3. **National legal basis for the aid measure**

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

(75) 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 aid measures**

(76) The Icelandic authorities' intervention following the failure of Landsbanki has been described above, and was set out in more detail in the opening decision. The essence of the interventions can be summarised in the following manner:

(77) The FME took control of Landsbanki on 7 October 2008, and domestic liabilities and (most) domestic assets were transferred to New Landsbanki on 9 October 2008. The estate of the old bank and its creditors were to be compensated for this transfer by receiving the sum of the difference between assets and liabilities. However, determining this difference proved to be difficult and time-consuming, and the State provided some initial capital, as well as a commitment to contribute further capital if need be. On 15 December 2009 an agreement was reached between the State and the creditors of the old bank, pursuant to which the State took a 81,33 % stake in the bank (by injecting 121,225 billion ISK) whilst the creditors of Landsbanki subscribed to 18,67 % of the new shares. The compensation of the creditors for the transferred assets depends, according to the agreement between the State and the creditors, mainly on a contigent bond, further described below. The Authority considers the date on which the agreement was reached — 15 December 2009 — to mark the beginning of the 5 year restructuring period, which will consequently last until 15 December 2014.

(78) The following section is limited to describing those aspects of the State's intervention that constitute aid measures relevant for assessment under Article 61 of the EEA Agreement.

3.4.1. *Tier I capital*

(79) The State provided Tier I capital twice — once, when New Landsbanki was created in 2008, and then again when the bank was fully capitalised in 2009, after an agreement with the creditors of the old bank had been reached.

3.4.1.1. Initial capital

(80) The state provided 775 million ISK ([29]) (5 million Euros) in cash as initial capital to the new bank. In addition it issued a commitment to contribute up to 200 billion ISK to the new bank in return for all of its equity. This figure was calculated as 10 % of an initial assessment of the likely size of the bank's risk weighted asset balance, and was formally included in the state budget for the year 2009 as an allocation of government funds to address the extraordinary circumstances in financial markets. This allocation of capital was intended to provide an adequate guarantee of the operability of the bank until issues relating to its final re-capitalisation could be resolved, including the size of its opening balance based on the valuation of compensation payable to the old bank for assets transferred from it.

3.4.1.2. The final capitalisation of Landsbankinn

(81) On 20 July 2009 the Icelandic Government announced that it had determined the basis for the capitalisation of Landsbankinn and reached an agreement on a process for how the old banks would be compensated for the transfer of net assets. It also announced that the state would capitalise the new bank. Final agreement on the capitalisation was reached on 15 December 2009 (eventually to the total sum of 150 billion ISK, of which the state provided 121,225 billion ISK) when agreement was reached on compensation to creditors for the net value of the assets and liabilities transferred to Landsbankinn. As described above, the capital requirements imposed by the FME stipulated that Landsbankinn should hold at least 12 % Core Tier I Capital ([30]) and an additional 4 % of Tier II Capital as a ratio of risk-weighted assets. When Landsbankinn was formally capitalised on 20 January 2010, the Core Tier I Capital ratio of the bank was approximately 15 %. The FME granted temporary relief from the (overall) 16 % requirement conditional upon the submission of an acceptable plan illustrating how the full amount would be achieved. In June 2010 the bank reported that its Core Tier I exceeded 16 % and on that basis the FME permanently exempted Landsbankinn from the requirement to hold Tier II capital as long as its Core Tier I ratio remains above 16 %.

([29]) 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.

([30]) 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.

(82) This agreement followed a lengthy and complex negotiation process resulting in an outline agreement among the parties in a heads of terms on 10 October 2009 and more detailed sets of term sheets in relation to the debt instruments on 20 November 2009. There were also a number of subsequent meetings and discussions between the parties during which the outlined terms were modified and reflected in documentation. The resulting agreement comprises the issuance of three bonds denominated in Euros, Pound Sterling and US Dollars, respectively, having an aggregate principal amount equivalent to 260 billion ISK, and also involves Landsbanki (or in effect the old bank's creditors) taking an initial (and potentially temporary) 18,67 % ownership stake in Landsbankinn. ([31])

(83) In addition, given the considerable uncertainty about the value of the transferred assets, Landsbankinn agreed to issue to Landsbanki a contingent bond (linked to its equity participation), the principal amount of which will not be determined until on or after 31 March 2013. Following the determination of the principal amount of the contingent bond, all or part of the shareholding held by Landsbanki may be surrendered to the Icelandic government. ([32])

3.4.2. *Deposit guarantee*

(84) In order to comply with Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes ([33]) and Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit guarantee schemes ([34]), Iceland adopted Act No 98/1999 on deposit guarantees and investor-compensation scheme and thereby set up the so-called Depositors' and Investors' Guarantee Fund ('TIF'). The fund has been financed by annual contributions from the banks, calculated in relation to the total deposits of that bank.

(85) According to the Iceland authorities in addition to the bank rescue measures of the Icelandic Government of autumn 2008 they intended to give further assurance and comfort to the general public on the safety of their deposits when the crisis struck. Thus they provided an additional state backing of deposits in domestic commercial and savings banks, outside the scope of Act No 98/1999 implementing the deposit guarantee Directive 94/19/EC and the investor-compensation Directive 97/9/EC.

(86) An announcement from the Prime Minister's Office of 6 October 2008 stated that the 'Government of Iceland underlines that deposits in domestic commercial and savings banks and their branches in Iceland will be fully covered' ([35]). This announcement has since been repeated by the Office of the current Prime Minister in February and December 2009. ([36]) 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

([31]) On 15.6.2012, Landsbankinn announced that it would start paying back (parts of) those bonds Landsbanki earlier than expected. See http://www.landsbankinn.com/news-and-notifications/2012/06/15/Landsbankinn-starts-to-repay-bond-before-schedule/.

([32]) The contingent bond is linked to the valuation and performance of certain reference assets. To the extent that the values of these assets are higher on 31.12.2012 as estimated when the agreement was concluded, the contingent bond is intended to compensate the old bank for this difference. If the difference between the valuation on these two dates is zero or a negative amount, the new principal balance will be deemed to be zero and the contingent bond will be cancelled. However, if the value is positive the contingent bond will issued at this value and Landsbanki will surrender its shareholding to Landsbankinn, or part of its shareholding to the extent that the positive value is less that the value of the shareholding.

([33]) OJ L 84, 26.3.1997, p. 22.

([34]) OJ L 135, 31.5.1994, p. 5.

([35]) The English translation of the announcement is available at: http://eng.forsaetisraduneyti.is/news-and-articles/nr/3033.

([36]) 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).

(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.' ([37]) 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. ([38])

(87) A recent statement of the current Minister of Economic Affairs and former Minister of Finance (2009-2011), Steingrímur Sigfússon in a debate in the Icelandic Parliament regarding the government's cost related to Landsbankinn's taking over SpKef, illustrates the above further: According to the Minister, one must keep in mind regarding this matter the State's declaration in the autumn of 2012 that all deposits in savings banks and commercial banks would be safe and protected. 'Work has since in all instances been based on this (i.e. the declaration) and it is unfortunately correct that this (i.e. payments due to SpKef) will be one of the bigger bills footed directly by the state as costs for securing the deposits of all inhabitants of Suðurnes … and all SpKef's clients in the West Fjords and the West and North-West area … I do not expect that anyone has thought that deposit holders in those areas would be treated differently from other inhabitants, so the state did not have much of a choice in this matter'. ([39])

(88) According to the Icelandic government, the additional deposit guarantee will be lifted before the capital controls are fully abolished, which according to the Icelandic authorities is currently foreseen for the end of 2013.

3.4.3. *Rescue and transfer of operations from Spkef to Landsbankinn*

(89) In March 2009 the capital position of Keflavik Savings Bank fell short of the statutory required minimum. According to the Icelandic authorities, this was caused in parts by spill-over effects of the financial turmoil that was described above, and also by particular strong impact of the economic crisis on the regions in which the bank was active.

(90) This bank had offered savings accounts and loans to retail customers and small and medium-sized enterprises. It had also offered asset management and securities brokerage in addition to traditional financial services such as payment services, collection services, banking services for housing associations, premium banking, online banking and ATM services. Its headquarters were located in Keflavik and the bank operated sixteen branches in the Suðurnes Area, the West Fjords, Hvammstangi and Ólafsvik. The bank had about 3 % market share measured in total deposits in financial institutions in Iceland.

(91) After the CAD ratio had fallen below the required minimum, the FME granted repeated extension periods for the bank to reorganise its finances in collaboration with its creditors and bring its capital base to the minimum of 16 %. The final deadline for increasing Keflavik Savings Bank's capital base expired on 21 April 2010. In a letter dated 22 April 2010 Keflavik Savings Bank informed the FME that part of the savings bank's creditors had rejected proposals on financial reorganisation and, given the situation of the bank at the time, it was requested that the FME took over the bank's operations.

([37]) 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
([38]) http://hamar.stjr.is/Fjarlagavefur-Hluti-II/GreinargerdirogRaedur/Fjarlagafrumvarp/2011/Seinni_hluti/Kafli_8.htm [Mbl 10.6.2012].
([39]) Unofficial translation by the Authority of a statement reported in Morgunblaðið (www.mbl.is) on 10.6.2012.

(92) The next day, the Minister of Finance established a new financial undertaking, Spkef, which took over the operations of Keflavik Savings Bank in accordance with a Decision by the FME. The deposits, part of other liabilities and most of the assets of the savings bank were transferred to the new undertaking which commenced operations immediately.

(93) Initially, according to the Icelandic authorities, it had been intended to restore the viability of Spkef by injecting capital and making it viable on a stand-alone basis. However, in February 2011, and following further deterioration of the economic conditions in the areas in which Spkef was active, the management and board of Spkef estimated the financial difference in the respective values of deposits and assets to be 11,2 billion ISK, which meant that 19,4 billion ISK were needed to meet the FME's CAD ratio requirements. According to the Icelandic authorities, this estimation was by far worse than what previous assessments had indicated and other, less costly means to remedy the situation were therefore considered.

(94) On 5 March 2011 an agreement was reached between Landsbankinn and the Icelandic authorities whereby the operations, assets and liabilities of Spkef would be merged with Landsbankinn. According to the Icelandic authorities, this was considered to be the best course of action to safeguard financial stability and the interest of customers, creditors and the Icelandic state as Landsbankinn's capital adequacy ratio had become sufficient to take over Spkef without the need for an additional state contribution. The Icelandic authorities submit that offsetting the negative asset position (against commitments in deposits) of Spkef was in any event necessary, due to the deposit guarantee. Thus the agreement on the takeover between Landsbankinn and the Icelandic State entailed a commitment by the State to set off the negative asset position of Spkef. A special mechanism to determine this difference — and hence the scope of the State's obligation — was included, according to which, in the absence of a mutually agreed outcome of the valuation exercise, the dispute would be put before an arbitration committee.

(95) As the parties to the agreement could not agree on the difference between transferred assets and liabilities, the aforementioned arbitration committee was charged with this task. On 8 June 2012 it concluded its work, and decided that the compensation due to Landsbankinn following the takeover of deposits and assets of Spkef amounts to 19,2 billion ISK. ([40]) According to the Icelandic authorities, the settlement will be made in the form of treasury bonds.

3.4.4. *The rescue and acquisition of Sparisjodur Svarfdaela*

(96) As for Sparisjodur Svarfdaela, the events leading up to April 2011 that describe its financial difficulties and the intervention by the Icelandic State were set out in the Savings Banks Decisions referred to above. The subsequent acquisition by Landsbankinn was described and approved by the Authority in the SpSv Decision referred to above.

(97) The Icelandic government granted state aid to SpSv by issuing a subordinated loan in April 2011 as well as by settling claims owned by CBI against SpSv. These claims were converted to guarantee capital transferred to the Icelandic State Financial Investments ('the ISFI'). These rescue measures were held to be temporarily compatible with the EEA Agreement based on the Savings Banks Decisions, subject to the submission of a restructuring plan for SpSv. As Landsbankinn has taken over all assets and operations of the SpSv, which amount to approximately 0,311 % of the assets of Landsbankinn on that same date, the Authority considers Landsbankinn's restructuring plan as the restructuring plan for the merged entity.

3.5. **The restructuring plan**

(98) The Icelandic authorities submitted a restructuring plan for Landsbankinn on 31 March 2011. The plan was amended, updated and resubmitted by the Icelandic authorities on 23 May 2012 (hereinafter the 'restructuring plan').

([40]) See http://www.fjarmalaraduneyti.is/frettatilkynningar/nr/15527.

(99) The restructuring plan addresses the substantive issues of viability, burden-sharing and limitations of distortions of competition. According to the restructuring plan, Landsbankinn will focus on its core business and the restructuring of the household and corporate loan portfolios.

(100) As indicated above, the Authority considers the restructuring period to last until 15 December 2014.

3.5.1. *Description of the restructuring plan*

(101) The Icelandic authorities and the Bank consider that the restructuring of Landsbankinn will ensure its return to being a solid, well-funded bank with sound capital ratios so that it can maintain its role as a supplier of credit to the real economy. Based on the information in the restructuring plan and the written answers to questions by the Authority, this will be achieved in particular through:

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

(ii) Establishing and maintaining a strong capital ratio position and a healthy balance sheet;

(iii) Achieving satisfactory profitability;

(iv) Establishing and maintaining a strong liquidity position;

(v) Finalising the restructuring of the loan portfolio, both for private households and for businesses;

(vi) Improving the funding strategy;

(vii) Improving cost efficiency;

(viii) Improving risk management.

(102) Before describing each of the above points in more detail, the bank's view on how the weaknesses that contributed to Landsbanki's demise are being addressed in the restructuring plan, is briefly set out below. The bank claims that although Landsbankinn is based on the domestic operations of Landsbanki, it is a different bank.

(103) The Icelandic authorities submit that weaknesses that characterised Landsbanki prior to the collapse of the banking system are discussed in detail in the report of the Special Investigation Commission, described earlier. In addition, the bank emphasises that in particular poor risk management, excessive risk appetite, the unusually close relation between owners and largest borrowers, too much growth over too short a period, the lack of experience in global markets, lenient lending rules, the lack of internal checks and controls and a flawed corporate culture and strategy were factors that led to the collapse. It also submits that key changes have been made to the bank's business model since Landsbankinn commenced operations in fall 2008 and that the above mentioned factors served as a guidance for implementation of the Bank's new strategy and governance.

(104) Aside from a long list of measures to re-organise internal work processes and replace key staff, the most relevant changes seem to be the following: A greater focus on domestic operations, in particular on retail banking and the branch network, strongly reduced investment banking activities, an emphasis on restructuring the loan portfolio, revised risk management and a greater significance of corporate responsibility and compliance with high ethical standards.

(105) Thus, whilst Landsbankinn just as its predecessor provides a broad range of financial services in the Icelandic market, the difference between pre- and post-crisis banking for Landsbankinn is more visible in 'how' the bank does business (processes, procedures, documentation, rules and regulation) rather than 'what' service and product range it offers in Iceland.

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

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

(ii) Establishing and maintaining a strong capital ratio position and a healthy balance sheet

(107) As a result of the capitalisation measures described above, and the developments since the bank's establishment, particularly the re-evaluation of assets (further elaborated on below), Landsbankinn has achieved CAD ratios well above the capital requirements of the FME. The CAD ratio increased from 13,0 % at the end of 2008 to 15,0 % at the end of 2009, 19,5 % at the end of 2010 and 21,4 % at the end of 2011.

(108) According to the restructuring plan, this ratio is forecasted to increase further during the course of the restructuring period, to reach [> 20] % at the end of 2014. Landsbankinn thus anticipates to stay well above the capital requirements of the FME during the restructuring period and beyond. […].

(109) During this period the balance sheet is expected to shrink slightly, from approximately 1 135 billion ISK to […] billion ISK. On the assets side of the balance sheet, the significance of equities and equity instruments will decrease strongly, presumably due to the intended sale of operating companies. Likewise, the amount of loans to financial institutions is expected to decrease by approx. […] % until 2014. On the other hand, loans to customers will increase by roughly […] % to approx. […] billion ISK according to the restructuring plan.

(110) On the liabilities side, the significance of deposits will increase (from currently approx. 444 billion ISK to […] billion ISK, whilst the share of secured bonds and liabilities due to financial institutions and the CBI will diminish.

(iii) Achieving a satisfactory profitability

(111) According to the restructuring plan, and as illustrated below in table 2, the return on equity of Landsbankinn has been healthy since 2009.

Table 2

Past ROE

(%)

	2009	2010	2011
Return on Equity (ROE) (*)	9,5	15,9	8,8

(*) When referring to 'Return on Equity/ROE' the ROE after taxes is meant.

Moreover, the restructuring plan predicts the following ROE for the remaining restructuring period (Table 3).

Table 3

ROE forecast

(%)

	2012	2013	2014
Return on Equity (ROE)	[5-15]	[5-15]	[5-15]

(112) This forecast is the result of more detailed financial planning entailed in the restructuring plan:

— Operating income will increase from about 30 billion ISK to […] billion ISK, whereas profits will remain relatively stable, fluctuating around […] billion ISK annually;

— Net interest income will fluctuate between […] and […] billion ISK;

— Fee and commission income is expected to increase by about […] %, from approximately 4 billion ISK to […] billion ISK;

— The net interest margin is expected to fall from […] % in 2012 to […] % in 2014;

— The number of employees is expected to decrease by about […], from 1158 to […] in 2016;

— The cost/income ratio is expected to fall from 57,2 % in 2011 to […] % in 2014.

(113) According to the Icelandic authorities, the solid performance of Landsbankinn since its establishment is to a certain extent due to the fact that assets in the loan portfolio that was acquired by the bank from Landsbanki have been written up significantly since then. Whilst these valuation gains are to some extent offset by the contingent bond, the 'discount' has been and will remain an important part of the bank's revenues while the loan portfolio is being restructured.

(114) In support of this view the Icelandic authorities have submitted a calculation (table 4) indicating what the annual results would have been without the discount and other 'irregular items'.

Table 4

Profits net of irregular items

	7.10.2008 - 31.12.2008	2009	2010	2011	Budget 2012	Budget 2013	Budget 2014	Budget 2015
Profit for the year	– 6 936	14 332	27 231	16 957	[…]	[…]	[…]	[…]
Adjustments to profitability:								
Re-evaluation of transferred assets		– 23 772	– 49 702	– 58 489	[…]	[…]	[…]	[…]

	7.10.2008 - 31.12.2008	2009	2010	2011	Budget 2012	Budget 2013	Budget 2014	Budget 2015
Fair value changes of contingent bond		10 241	16 269	34 316				
FX verdicts		0	18 158	40 726				
Equity and Bonds		– 7 983	– 7 318	– 18 017				
FX gain / loss		3 000	– 14 623	759				
Discontinued operations		– 693	– 2 769	– 6 255				
Funding cost of equity positions		2 804	1 019	1 223				
Adjusted profitability		– 2 072	– 11 735	11 221	[…]	[…]	[…]	[…]
Adjusted ROE		– 1,4 %	– 6,9 %	5,8 %	[5-10]%	[5-10]%	[5-10]%	[5-10]%

(115) According to this data, the bank would from 2010 onwards still have made profits, and would during the remainder of the restructuring period make profits even in the absence of the discount. ([41])

(iv) Establishing and maintaining a strong liquidity position

(116) Regarding liquidity, the FME requires that cash or cash-like assets should amount to 5 % of on-demand deposits and the banks should be able to withstand a 20 % instantaneous outflow of deposits. In addition, the Central Bank of Iceland sets rules on credit institutions' liquidity ([42]) according to which credit institutions' liquid assets and liabilities are classified by type and maturity and assigned weights according to risk. Credit institutions must have liquid assets in excess of the next three months' liabilities. The rules also entail a certain stress test where a discount is applied to various equity items, but where it is assumed, on the one hand, that all obligations must be paid upon maturity, and on the other, that a portions of other obligations, such as deposits, must be paid at short notice or none at all. According to the Icelandic authorities, Landsbankinn complies with the above rules. In fact, according to the restructuring plan, it currently holds 42,5 % liquid assets against total deposits.

(117) Moreover, according to the Icelandic government, Landsbankinn has recently changed its liquidity policy in order to monitor and ensure compliance with the requirements of Basel III. Currently its liquidity coverage ratio (LCR) is […] %.

(118) The impact on the liquidity position of the bank in case of stress, such as an immediate removal of the capital controls, is further described below.

([41]) The ISFI's report for 2011 (on the banks' operations in 2010) comes to a similar conclusion; the 'core profitability' of Landsbankinn according to this report is even higher. See http://www.banka-sysla.is/files/SkyrslaBR_2011_net_74617143.pdf

([42]) See the CBI's Rules on Liquidity Ratios No 317 of 25.4.2006, available at http://www.sedla-banki.is/lisalib/getfile.aspx?itemid=4713

(v) Finalising the restructuring of the loan portfolio, both for private households and for businesses.

(119) Prior to the financial crises in 2008, both the bank's private and commercial customers took on a high level of debt. When the economy and, in particular, real estate prices fell in the wake of the crisis, the suddenly over-leveraged customers could often not service their debt any longer, and held negative equity. Aside from the general threat to the economic welfare of Iceland, the sudden deterioration in the bank's lending portfolio became a major risk for the bank's future viability. For this reason the restructuring of the private and commercial loan portfolios (deleveraging), as reflected in the restructuring plan, has become a priority for Landsbankinn.

(120) According to the Icelandic authorities, Landsbankinn has developed specific debt relief programmes and cooperated with the state and other banks on general debt relief measures (e.g. the 110 % mortgage adjustment). ([43])

(121) By 30 March 2012 the financial restructuring of more than 75 % of over indebted companies with obligations towards the bank in excess of 100 million ISK and more than 75 % of the total debt had been restructured. The restructuring plan assumes that by the end of 2012 this figure will have increased to 92 %. Moreover, already restructured loans are to a large extent performing. For example, only 2,6 % of the total loan value of already restructured companies is more than 30 days overdue.

(vi) Improving the funding strategy

(122) According to the Icelandic authorities, Landsbankinn's funding profile is sufficiently well diversified, and no major refinancing need is expected for the short or medium term. The current composition of funding is approximately as follows: 10 % deposits from financial institutions, 40 % deposits from customers (of which 80 % are on-demand and 20 % are term deposits of up to 5 years), 30 % secured borrowing, maturing in 2014-2018 and 20 % equity.

(123) As indicated above, deposits are Landsbankinn's most important source of funding. According to the restructuring plan, the significance of deposits will even increase during the restructuring period. At the same time, Landsbankinn intends to increase the share of term deposits so as to make them 'stickier'.

(124) Secured borrowings will remain an important source of funding. Such are also the most likely refinancing option when the current secured borrowings mature, whereas unsecured bond issuance is not a likely funding option for Landsbankinn for the short or medium term. The bank intends to fund long-term assets such as mortgages with secured bonds in the future and this could represent up to 5 % of the bank's total funding in the future. However, this is not assumed to materialise in the time period covered by the restructuring plan submitted to the Authority.

(vii) Improving cost efficiency

(125) According to the restructuring plan, Landsbankinn continues to focus on efficient and streamlined operations in order to counter increased infrastructure cost following from tighter regulatory controls, increased taxation and the expenses linked to the restructuring work.

(126) The restructuring plan assumes that general operating cost will decrease by […] % (taking into account inflation), mainly as a result of being able to merge Spkef and other subsidiaries with the bank. According to Landsbankinn, this provides an opportunity to reduce cost, in particular by reducing staff ([…] % of full-time employees over the next 3 years). Moreover, the bank submits that a major project has been launched which aims at streamlining Landsbankinn's service chain. Finally, the bank has committed to close […] branches in the course of the restructuring period. Those measures, as well as a reduction in staff, are expected to lead to the cost/income ratio falling from 57,2 % in 2011 to […] % in 2014.

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

(viii) Improving risk management

(127) Landsbankinn has informed the Authority that one of their priorities is to improve its risk management practices. In this regard, Landsbankinn has established a Risk Management division. The division is responsible for all traditional risk management, measuring and assessing market risk, liquidity risk, operational and credit risk. According to Landsbankinn, risk management has been greatly enhanced through the Bank's new organisational structure. The division has 44 employees.

3.5.2. *Ability to reach viability under a base and stress scenario*

(128) In the restructuring plan the Icelandic authorities have submitted a base and 3 stress scenarios for Landsbankinn with the aim of demonstrating Landsbankinn's ability to achieve long-term viability, and its resilience to adverse macroeconomic developments.

3.5.2.1. The base scenario

(129) The restructuring plan as described above constitutes the base case. According to the Icelandic authorities, the underlying macroeconomic indicators are similar to those of the CBI's baseline forecast for the next years, and are reflected below in table 5:

Table 5

Macroeconomic forecast, base scenario

Key indicator	Forecast			
	2011	2012	2013	2014
GDP	3,2 %	1,7 %	2,3 %	3,9 %
Private consumption	3,4 %	1,5 %	3,4 %	3,2 %
Public consumption	-0,2 %	1,3 %	1,5 %	1,0 %
Total investment	6,6 %	23,9 %	6,4 %	13,4 %
Exports	2,7 %	2,0 %	2,0 %	2,5 %
Imports	4,1 %	3,4 %	4,9 %	3,1 %
Output Gap	-2,7 %	-1,6 %	-0,8 %	1,1 %
Short Term IR	4,5 %	4,9 %	6,4 %	6,9 %
Unemployment	7,4 %	6,2 %	5,0 %	4,0 %
ISK/EUR exchange rate	162,6	163,5	163,5	163,5
Inflation	4,0 %	4,6 %	3,0 %	2,6 %

3.5.2.2. The stress scenarios

(130) The restructuring plan includes 3 stress scenarios — mild recession, international economic depression and króna depreciation, including the methodology used to build those scenarios, and the impact on the capital position of the bank. The scenarios are designed against the background of unlikely but plausible severe changes in the economic environment in which the bank operates. For example, the international economic depression scenario is based on a potential break-up of the Euro zone and the resulting effects on the European economy. The resulting macro economic variables for this scenario would be the following:

Table 6

Macro-indicators in the international economic depression scenario

Scenario 3 – International Depression						
Key indicator	2012		2013		2014	
GDP	-3,5 %	-5,2 %	-3,6 %	-5,9 %	-0,8 %	-4,7 %
Private consumption	-5,6 %	-7,1 %	-3,9 %	-7,3 %	3,6 %	0,4 %
Public consumption	1,3 %	0,0 %	1,5 %	0,0 %	1,0 %	0,0 %
Total investment	-15,7 %	-39,6 %	-1,4 %	-7,8 %	0,6 %	12,8 %
Exports	-5,8 %	-7,8 %	-4,0 %	-6,0 %	2,8 %	0,3 %
Imports	-16,3 %	-19,7 %	0,4 %	-4,5 %	13,7 %	10,6 %
Output Gap	-4,0 %	-2,5 %	-9,7 %	-9,0 %	-12,8 %	-13,9 %
Short Term IR	4,8 %	-0,1 %	4,0 %	-2,4 %	2,3 %	-4,6 %
Unemployment	6,9 %	0,7 %	7,3 %	2,3 %	7,7 %	3,7 %
ISK/EUR exchange rate	196,2	32,7	196,2	32,7	196,2	32,7
Inflation	6,7 %	2,1 %	3,8 %	0,8 %	1,3 %	-1,3 %
(*) Figures in grey show difference from baseline forecast.						

(131) In the stress test exercise that Landsbankinn has submitted, different methods are used to translate these 3 scenarios into an impact measurement on the bank's financial statements, the loan loss and the economic capital. By means of example, the below chart 3 demonstrates how loss given default (LGD) is related to GDP performance.

Chart 3

GDP-LDG correlation

[Graph on the correlation between loss given default and GDP

Values not disclosed for reasons of professional secrecy]

(132) The main finding of the stress tests is that the capitalisation of Landsbankinn is such that it stays above both internal and external minimum CAD requirements in all scenarios, and according to the restructuring plan, has in fact […] % excess capital.

(133) In addition, Landsbankinn's restructuring plan includes a quasi-stress test of the liquidity ratio of the bank. In this case, the bank assumes that all deposits held by financial institutions would be withdrawn immediately, following for example the removal of the capital controls. According to the information submitted by the Icelandic authorities, even in such a case Landsbankinn's liquidity position would stay strong, in particular because it could liquidate additional assets relatively quickly and without overly detrimental effect on the balance sheet, such as for example its ISK denominated mortgage book (through lending operations with the CBI). Chart 4 below illustrates this scenario:

Chart 4

Core liquidity position after withdrawals of all institutional deposits and varying withdrawals from customers

[Graph on Landsbankinn's liquidity position

Values not disclosed for reasons of professional secrecy]

(134) According to this calculation, the bank could withstand an additional withdrawal of […] % of customer deposits without having to start liquidating assets. This result indicates that the Bank is well positioned to meet unexpected liquidity disruptions.

4. GROUNDS FOR INITIATING THE FORMAL INVESTIGATION PROCEDURE, THE SPKEF TRANSACTION AND THE MEASURES TEMPORARILY APPROVED IN THE SAVINGS BANKS DECISIONS

(135) In the opening decision, the Authority preliminarily concluded that the measures by the Icelandic State to capitalise Landsbankinn entail state aid pursuant to Article 61 EEA. Furthermore it could not exclude that state aid was present in the unlimited deposit guarantee. The opening decision did not cover the aid measures related to the acquisition of SpSv, which were temporarily approved by the Authority in the Savings Banks Decisions. The Authority will take a final view on these measures, which continue to have a bearing on the assessment at hand, in the present decision. Finally, the measures related to the transfer of operations from Spkef to Landsbankinn were not covered by the opening decision, and the Authority will thus also assess them below.

(136) As for the compatibility of the measures assessed in the opening decision, the Authority considered that a final view could only be taken on the basis of a restructuring plan, which had not been submitted when the Authority opened the formal investigation procedure on 15 December 2010. It was in particular due to the absence of a restructuring plan more than two years after the establishment of Landsbankinn and one year after the agreement with Landsbanki's creditors that the Authority expressed doubts about the compatibility of the aid.

4.1. **Comments from interested parties**

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

4.2. **Comments from the Icelandic authorities**

(138) The Icelandic authorities accept that measures undertaken in establishing NBI, now Landsbankinn, constitute state aid. In the view of the Icelandic authorities, the measures are however compatible with the functioning of the EEA Agreement on the basis of Article 61(3)(b) of the Agreement, as they are necessary, proportionate and appropriate to remedy a serious disturbance in the Icelandic economy. In the view of the Icelandic authorities the measures taken are in all aspects in line with the principles set out in the Authority's state aid guidelines, and submit that the aid is necessary and limited to the minimum amount necessary.

(139) Moreover, the Icelandic authorities emphasise that the former shareholders of Landsbanki have lost all their shares and received no compensation from the state and that the aid is well designed to minimize negative spill-over effect on competitors.

(140) As for the transfer of operations from Spkef to Landsbankinn, they Icelandic authorities acknowledge that the State's obligation to make up for a shortfall in transferred assets (compared to the amount of transferred liabilities) constitute state aid pursuant to Article 61(1) of the EEA Agreement, even though they are of the view that the nature of the agreement precludes Landsbankinn from receiving a direct financial advantage. They concede, however, that the measure could strengthen Landsbankinn's position as it enlarges its customer base and might provide opportunities to streamline operations.

(141) In any event, the Icelandic authorities maintain that the aid is compatible with Article 61(3)(b) of the Agreement. As they state's contribution is limited to covering precisely the difference between assets and liabilities, and that difference is determined by an independent committee, they submit that the aid is limited to the minimum necessary. They submit that the aid was also proportionate, as Landsbankinn was the only bank that could take on the operations of Spkef at the time, and that alternatives, such as a forced merger by the FME, would have been more disruptive and potentially more costly for the State.

(142) The Icelandic authorities do not regard the deposit guarantee as entailing state aid.

4.3. **Commitments by the Icelandic authorities**

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

II. **ASSESSMENT**

1. THE PRESENCE OF STATE AID

(144) 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.'

(145) The Authority will assess the following measures ([44]) below:

— The initial operating capital provided by the Icelandic State to the new bank;

— The (initial) full state capitalisation of the new bank; and the retention of a majority shareholding by the State.

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

— The Icelandic Government's guarantee to domestic deposits in all Icelandic banks and

— The transfer of operations from Spkef to Landsbankinn ('the Spkef transaction').

(146) The Authority also recalls that the temporarily approved rescue measures for SpSv, which will now be merged with Landsbankinn, constitute state aid, the final compatibility of which depends on the restructuring plan for the merged entity.

1.1. **Presence of state resources**

(147) As the Authority already preliminarily concluded in the opening decision, it is clear that the capitalisation measures are financed through state resources provided by the Icelandic Treasury. As for the Spkef transaction, the State assumed the risk that the assets of Spkef would be insufficient to cover the transferred liabilities (deposits) of Spkef bank. In essence, it guaranteed to make up for the shortfall, which entailed a (potential) transfer of state resources. As indicated above, the arbitration committee decided recently that the State had to pay Landsbankinn 19,2 billion ISK. It is therefore evident that this measure entails a transfer of state resources.

([44]) Described in detail in Chapter 3 of the present decision.

(148) Regarding the deposit guarantee, the Authority emphasises at the outset that its assessment is limited to the additional deposit guarantee described above, consisting in essence of the statements made by the Icelandic government that deposits in domestic commercial and savings banks and their branches in Iceland will be fully covered.

(149) This assessment is without prejudice to the Authority's view on the compatibility of Act No 98/1999 and the actions of the Icelandic Government and the TIF during the financial crisis with EEA law, in particular Directive 94/19/EC. As regards the implementation of Directives 97/9/EC and 94/19/EC the Authority is of the view that to the extent such measures constitute state aid, the use of state resources to comply with obligations under EEA law would generally not raise concerns under Article 61 EEA. The present decision is therefore not concerned with those measures.

(150) The Authority stated in the opening decision that it would investigate further whether the statements by the Icelandic Government described above are sufficiently precise, firm, unconditional and legally binding such as to involve a commitment of state resources ([45]). In assessing whether these criteria are met, the Authority notes that the declarations entailed an irrevocable commitment of public resources as shown by the fact that the Icelandic state has done its utmost to protect depositors: Not only has it changed the priority of deposit holders in insolvent estates (which would not entail the use of state resources), but it has also made it clear that it would not allow depositors to suffer any losses. The Government's blanket guarantee of all deposits in domestic commercial and savings banks is furthermore distinct from any deposit guarantee scheme based on EEA acts due to the fact that the protection is unlimited in amount and no financial contribution is made by the banks benefitting from the measure.

(151) The Icelandic Government's understanding of its declaration is illustrated by the state interventions in the financial sector that have occurred sector since October 2008 which have been motivated by the intention to honour this declaration. Those interventions have included measures to cover deposits of financial undertakings, such as the foundation of the three commercial banks, the transfer of SPRON deposits to Arion Bank, the transfer of Straumur deposits to Íslandsbanki, the CBI takeover of the deposits of 5 savings banks in Sparisjódabanki Íslands the transfer of deposits in Byr Savings Bank to Byr hf, the transfer of deposits from Keflavík Savings Bank to SpKef and the State's responsibility for deposits in SpKef following the merger with Landsbankinn.

(152) In fact, the Icelandic authorities have argued in several state aid cases that the Authority is currently investigating, some of which were mentioned above, that the respective chosen measure was the financially least burdensome option for the Icelandic state to comply with its pledge to protect depositors in full.

(153) In the light of the above the Authority considers that there is a legally binding, precise, unconditional and firm measure in place. On this basis, the Authority therefore concludes that the statements by the Icelandic state according to which deposits are fully guaranteed entail a commitment of state resources in the meaning of Article 61 EEA.

1.2. **Favouring certain undertakings or the production of certain goods**

1.2.1. *Advantage*

(154) First, the aid measures must confer on the new bank advantages that relieve it of charges that are normally borne from its budget. In line with the preliminary conclusion it reached in the opening decision, the Authority remains of the view that each of the capitalisation measures confers an advantage on Landsbankinn as the capital provided would not have been available to the bank without state intervention.

([45]) 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, ECR [2010] II-02099, paragraph 283 (on appeal) as well as the Opinion delivered by AG Mengozzi in the appeal case, i.e. Case C-399/10 *Bouygues*, paragraph 47, considering these conditions as too restrictive for the finding of state aid.

(155) In determining whether an investment in an undertaking, for example by means of a capital injection, entails an advantage, the Authority applies the market economy investor principle, and assesses whether a private investor of a comparable size to that of the public body operating in normal market conditions would have made such an investment. ([46]) Since the onset of the financial crisis, the approach taken both by the European Commission (in numerous cases since the financial crisis began ([47])) and by the Authority ([48]) has been that state recapitalisations of banks amount to state aid given the turmoil and uncertainty that have characterised financial markets since the autumn of 2008. This general consideration applies in particular to the Icelandic financial markets in 2008 and 2009, when the entire system collapsed. Thus the Authority considers the capitalisation measures to confer an advantage on Landsbankinn notwithstanding the eventual transfer of a minority shareholding to the (largely private sector) creditors. The private sector involvement in the capitalisation of Landsbankinn is made up entirely of creditors of the old banks who are solely seeking to minimise their losses ([49]). Moreover, given the contingent bond mechanism described above, they cannot be considered to have invested at the same terms as the State.

(156) Regarding the Spkef transaction, the Authority notes that the transaction aimed at providing Landsbankinn with compensation equalling solely the difference between transferred assets and liabilities. Moreover, the mechanism to determine this difference, with an independent arbitration committee as the final arbiter, ensured a high degree of objectivity in this process. However, the entire risk of the assets of Spkef being of less value than the transferred deposits, and the obligation to make up for any potential shortfall, was allocated to the State. It follows that Landsbankinn was able to acquire goodwill and additional market shares, without taking on any risk. The Authority concludes that this constitutes an advantage.

(157) Finally, the Authority also needs to assess whether the additional deposit guarantee conveys an advantage on Landsbankinn and Icelandic banks in general. In this regard, the Authority notes that when the statement that deposits would be guaranteed were first made by the Icelandic authorities, it was not entirely clear how this guarantee would work in practice, in particular what effect such intervention would have on a failing bank. Today it appears that such a bank would be allowed to fail, but that the Icelandic state would ensure — for example by transferring deposits to another bank and making up for the shortfall in assets — that deposits could be paid in full, and the depositors would never lose access to the full amount of their deposits.

(158) The Authority considers that it is of secondary importance how the State would act in complying with the unlimited guarantee on domestic deposits. What matters is that it has assumed the obligation to step in if a bank would fail to pay out deposits, to an unlimited extent.

(159) This unlimited guarantee has, in the Authority's view, favoured Landsbankinn: First, as it provides a valuable competitive advantage — an unlimited state guarantee, and hence a significant safety net — over alternative investment options and providers. This is illustrated for example by a recent report of the Minister of Economic Affairs

([46]) See for example T-228/99 *WestLB* [2003] ECR II-435.
([47]) 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.
([48]) 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
([49]) 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).

which states that: 'Icelandic financial undertakings are currently operating in a sheltered environment with capital controls and a blanket deposit guarantee. Under such conditions, bank deposits are practically the only secure option for Icelandic savers'. ([50])

(160) Second, it seems clear that in the absence of the guarantee Landsbankinn could have more easily suffered from a run on its deposits like its predecessor ([51]). Thus the bank would likely have had to pay higher interest rates (to compensate for the risk) in order to attract or even simply retain the same amount of deposits. Accordingly, the Authority concludes that the deposit guarantee entails an advantage for the bank.

1.2.2. *Selectivity*

(161) Second, the aid measure must be selective in that it favours '*certain undertakings or the production of certain goods*'. The capitalisation measures and the Spkef transaction are selective as they only benefit Landsbankinn.

(162) Moreover, as state support can be selective even in situations where one or more sectors of the economy benefit and others do not, the Authority also considers the state guarantee on deposits which benefits the Icelandic banking sector as a whole as selective. This conclusion also follows from the considerations set out above according to which banks are favoured over other undertakings that offer possibilities to save and invest money.

1.3. **Distortion of competition and affection of trade between Contracting Parties**

(163) The measures strengthen the position of Landsbankinn in comparison to competitors (or potential competitors) in Iceland and other EEA States. Landsbankinn is an undertaking which is active, as described above, on financial markets, which are open for international competition in the EEA. Whilst the Icelandic financial markets are currently, particularly due to the capital controls, rather isolated, (a potential for) cross-border trade still exists, which will increase as soon as the capital controls are lifted. All measures under assessment must therefore be regarded as distorting competition and affecting trade between the Contracting Parties to the EEA Agreement. ([52])

1.4. **Conclusion**

(164) The Authority, therefore, comes to the conclusion that the measures taken by the Icelandic State to capitalise the new bank, the deposit guarantee and the Spkef transaction involve state aid within the meaning of Article 61(1) of the EEA Agreement. The Authority recalls that it reached the same conclusion regarding the capitalisation measures granted to SpSv in the Savings banks decisions.

2. PROCEDURAL REQUIREMENTS

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

([50]) Report of the Minister of the Minister of Economic Affairs to the Althingi (March 2012), 'The Future Structure of the Icelandic Financial System', Ch. 9.6, available at: http://eng.atvinnuvegaraduneyti.is/media/Acrobat/Future-Structure.pdf

([51]) 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

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

(166) The Icelandic authorities did not notify the aid measures covered by the opening decision to the Authority in advance of their implementation. The same applies to the Spkef transaction The Authority therefore concludes that the Icelandic authorities have not respected their obligations pursuant to Article 1(3) of Part I of Protocol 3. The granting of those aid measures was therefore unlawful.

3. COMPATIBILITY OF THE AID

(167) As a preliminary remark, the Authority notes that whilst Landsbankinn is a new legal entity that was established in 2008, it is — as regards domestic operations — evidently the economic successor of Landsbanki, in the sense that there is an economic continuity between those two entities. In fact, the Icelandic authorities have explained that the similarity of names of old and new bank are intended to allow Landsbankinn to capitalise on the goodwill still associated with the name 'Landsbanki' in Iceland. As those economic operations that were carried out by Landsbankinn from the autumn of 2008 onwards could not have continued in the absence of the aid, the Authority considers the bank as an undertaking in difficulties.

(168) Moreover, the measures under assessment are at the same time rescue and restructuring measures. As stated in the opening decision, the Authority would probably have temporarily approved the measures as compatible rescue aid had they been notified before their implementation, before then taking a final view on them on the basis of a restructuring plan. However, in the absence of a timely notification, the Authority initiated the formal investigation procedure and requested the submission of a restructuring plan. As indicated above, the final compatibility of these measures depends on whether the restructuring plan meets the criteria of the Authority's applicable state aid guidelines for undertakings in difficulties.

3.1. **Legal basis for assessment of compatibility: Article 61(3)(b) of the EEA Agreement and the Authority's Restructuring Guidelines**

(169) While state aid to undertakings in difficulties such as Landsbankinn is normally assessed under Article 61(3)(c) of the EEA Agreement, Article 61(3)(b) of the Agreement allows state aid 'to remedy a serious disturbance in the economy of an EC Member State or an EFTA State'. As is stated in paragraph 8 of the Banking Guidelines ([53]), the Authority reaffirms that, in line with the case law and the European Commission's decision making practice, Article 61(3)(b) of the EEA Agreement necessitates a restrictive interpretation of what can be considered a serious disturbance of an EFTA State's economy.

(170) The Icelandic authorities have explained, as described in detail above, that Iceland's financial system entered into a state of systemic crisis in October 2008, leading to the collapse of its major banks as well as major savings banks within a time span of a few days. The combined market share of the collapsed financial institutions exceeded 90 % in most segments of the Icelandic financial market. The difficulties were coupled with a breakdown of confidence in the country's currency. Iceland's real economy has been severely hit by the financial crisis. Although more than three years have passed since the onset of the crisis, the Icelandic financial system is still vulnerable. Even if the situation has eased significantly since 2008, it is evident that at the time that the measures were taken, they were intended to remedy a serious disturbance in the Icelandic economy.

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

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

The application of the Restructuring Communication

(172) The Authority's State Aid Guidelines on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules ([54]) ('the Restructuring Guidelines') set out the state aid rules applicable to the restructuring of financial institutions in the current crisis. According to the Restructuring Guidelines, in order to be compatible with Article 61(3)(b) EEA, the restructuring of a financial institution in the context of the current financial crisis has to:

(i) Lead to the restoration of the viability of the bank;

(ii) Include sufficient own contribution by the beneficiary (burden-sharing);

(iii) Contain sufficient measures limiting the distortion of competition.

(173) The Authority will thus assess below, based on the restructuring plan submitted for Landsbankinn whether these criteria are met and if the aid measures described above constitute compatible restructuring aid.

3.2. **Restoration of viability**

(174) Restoring the long-term viability of a beneficiary in receipt of restructuring aid is the main objective of such aid, and the assessment of whether restructuring aid will attain this, is an important aspect in determining its compatibility.

(175) As indicated above, the turmoil in the Icelandic economy in the wake of autumn 2008, the presence of extraordinary measures such as the capital controls, an evolving regulatory environment and a macroeconomic outlook that remains somewhat uncertain, make it challenging to operate a bank profitably and ensure its long-term viability. The Authority emphasises at the outset that this consideration needs to be borne in mind in the below assessment.

(176) Section 2 of the Restructuring Guidelines sets out that the EEA State should provide a comprehensive and detailed restructuring plan which provides complete information on the business model and which restores the bank's long-term viability. Paragraph 10 of the Restructuring Guidelines requires that the restructuring plan identifies the causes of the bank's difficulties and the bank's own weaknesses, and outlines how the proposed restructuring measures remedy the bank's underlying problems.

(177) The causes of Landsbanki's difficulties are, as described above, spelt out both in the restructuring plan, but also in the report of the Special Investigation Commission. Amongst the main causes identified at the bank's level in the latter were poor risk management, excessive risk appetite, the inordinately close relation between owners and largest borrowers, too much growth over too short a period, the lack of experience in global markets, lenient lending rules, the lack of internal checks and controls and a flawed corporate culture and strategy were factors that led to the collapse.. The bank also relied heavily on short-term wholesale funding and had to obtain large amount of deposits abroad to be able to fund its operations. This aggravated the already existing currency imbalances.

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

Regulatory viability measures

(178) The Authority considers that the failure of Landsbanki, and the collapse of the Icelandic financial industry, was also caused by a number of factors specific to Iceland, relating to its small size and the regulatory and supervisory shortcomings highlighted by the Special Investigation Commission. The long-term viability of Landsbankinn, such as that of any other Icelandic bank, thus also depends on whether those supervisory and regulatory shortcomings have been remedied.

(179) In this regard the Authority notes positively the amendments to the regulatory and supervisory framework that the Icelandic authorities have made, as explained in the Annex.

(180) First, the powers and competences of the FME have been enhanced, inter alia, with new responsibilities regarding large single exposures and the risks related thereto, which in the Authority's view addresses one of the factors that led to the financial collapse.

(181) Second, the temporary high CAD ratio requirements, and a number of provisions relating to collateralisation, in particular the prohibition of extending credit against pledges of own shares, aims at ensuring that Icelandic banks cannot once operate on a weak capital position. The Authority considers that these measures will contribute to the resilience of the Icelandic banks.

(182) Third, a range of measures have been implemented relating to the eligibility of directors and board members, as well as their remuneration. Moreover, lending to related parties (such as owners) has been subjected to stricter rules, and the FME can now prohibit a bank from performing specific activities. External and internal accounting rules have also been amended. For example the duration for which an external accountant can work for the same bank has been shortened. The Authority notes positively that these measures are aimed at preventing a repetition of events in so far as the owners and high executives are concerned. The measures also increase external risk monitoring, both of which reduce threats to the banks' viability.

(183) Fourth, according to the Icelandic authorities, the already mentioned possibility for the FME to limit a bank's activities, is also prompted by the large-scale deposit taking by Icelandic commercial banks before the crisis. Moreover, the new rules on liquidity and foreign exchange balance [55] also appear, in the Authority's understanding, to entail certain restrictions as regards the banks' possibility to attract disproportionately large amounts of foreign deposits if that were to make the bank's business more fragile and vulnerable to foreign currency exchange and liquidity risks. The Authority welcomes that the Icelandic authorities have responded to this aspect of regulatory failure.

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

Landsbankinn's restructuring plan

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

(185) As indicated above, Landsbankinn was — if compared to its predecessor — from the moment of its establishment substantially less leveraged. As most wholesale debt remained in the estate of Landsbanki, it will, according to the restructuring plan, not have to rely on refinancing by issuing unsecured bonds on international markets, which, in the current climate, would likely be a challenging prospect.

(186) In fact, the reliance on wholesale markets and later on foreign deposits for refinancing turned out to be one of the main reasons for Landsbanki's demise. Landsbankinn's funding, on the other hand, has so far been based to a large extent on deposits and equity (over 70 %), and the restructuring plan foresees a slight increase in the share of deposits of total liabilities. The restructuring plan shows that no major refinancing need arises in the course of the restructuring period […], and the Authority notes positively that neither a successful return to international markets for unsecured debt nor the less challenging issuance of secured bonds form part of the assumptions on which the funding forecast is based.

(187) As regards the aforementioned possibility of successfully issuing unsecured bonds, the bank submits that the currently limited appetite of investors for such debt could pick up again once the unlimited deposit guarantee — in particular the deposit priority — is lifted, which currently decreases the attractiveness of other forms of debt.

(188) Based on the facts submitted by the Icelandic authorities, the Authority considers that the bank's funding situation appears to be sound until the end of the restructuring period. Given the uncertainties surrounding the deposit guarantee and the capital controls, as well as the ambiguous future developments of (sovereign) debt markets, it cannot conclude on whether Landsbankinn's long term funding strategy will materialise as foreseen in the long run. However, given the stability of the funding prospects, in particular the strong reliance on deposits and equity during the restructuring period, and the large share of those types of debt on the balance sheet, the Authority concedes that slight variations to the funding strategy would not threaten the bank's viability.

(189) As regards the assets side of the balance sheet, most of the risky, international assets were also kept in Landsbanki's estate. As a result, the balance sheet has shrunk by approximately 75 %. A main weakness of Landsbanki's business model — the reliance on risky international assets, and in particular the strong dependence on profits from investment banking (43 % of pre-crisis profits) without appropriate risk assessment and limited market knowledge — has thus been remedied. The Authority welcomes that pursuant to the restructuring plan, the bank will not engage in similar business in the future, but rather focus on its traditional core business.

(190) Evidently, the bank has grown since its establishment, in particular through the acquisitions of Spkef and SpSv as described above. However, according to the restructuring plan, this does not have a major impact on the business model of Landsbankinn, as SpKef and SpSv mainly disposed of domestic assets of similar characteristics as those in Landsbankinn's portfolio. In any event, the Authority considers that the committed divestments, further discussed below, will contribute to letting Landsbankinn focus on its core business. The committed closure of […] branches during the restructuring period will contribute to letting Landsbankinn realise efficiency gains.

(191) A considerable challenge for the bank is the restructuring of the loans that were transferred from Landsbanki. In this regard the Authority notes positively that this restructuring process is a priority for the bank, as illustrated by the many generic and tailor-made proposals that the bank has made to its overleveraged customers. It has also created a well-staffed restructuring division. Whilst the process has not progressed as swiftly as initially planned, much has been already achieved. For example, by 30 March 2012, 75 % of the total debt in need of restructuring had undergone some form of debt-adjustment. Moreover according to the figures submitted by the Icelandic authorities, the vast majority of those were able to service their debt post restructuring.

(192) The Authority considers this to be an indicator of the soundness of Landsbankinn restructuring methods, and as evidence that the bank has indeed made the restructuring of its loan portfolio a priority. Moreover, based on the progress made so far, it appears realistic that the bank can meet its target of completing 92 % of the restructuring (in terms of total loan volume) by year-end 2012.

(193) The Authority also notes positively that the restructuring plan only predicts an increase of […] % in terms of loans to customers over the restructuring period. This seems plausible in the current economic environment. It also considers that the decreased significance of equities and equity instruments, and in particular the committed sale of […] (see Annex), will further reduce the riskiness of Landsbankinn's assets portfolio.

(194) Overall, barring unexpected developments in the macroeconomic environment in Iceland or abroad, this would appear to suggest that at the latest at the end of the restructuring period, Landsbankinn will have a relatively healthy balance sheet and well-performing loan portfolios.

(195) As indicated above, the weak capitalisation of Landsbanki was one of the factors that lead to its downfall. Landsbankinn's restructuring plan predicts that the bank will stay well above the minimum CAD ratio of 16 % throughout the restructuring period. This ratio is also well above the future Basel III minimum requirement of 10,5 %. Even in the sufficiently severe stress tests which Landsbankinn has performed and which are in line with the Restructuring Guidelines' requirement of a 'a combination of stress events, including a protracted global recession' (cf. paragraph 13 thereof), the CAD ratio would not fall below this high benchmark. The Authority considers it prudent and comforting that even in the stress case with the strongest impact on Landsbankinn capital base — essentially a disintegration of the Euro zone — the bank would retain […] % excess capital, which, in an operating environment as described above, provides Landsbankinn with a significant buffer to deal with unexpected adversities.

(196) Moreover, Landsbankinn's CAD ratio will continue to gradually increase during the restructuring period. On this basis the Authority considers that the capitalisation of Landsbankinn makes the bank sufficiently resilient.

(197) As for the banks' liquidity position, the Authority notes that it currently appears to be sufficiently robust, and that there are no indications that the situation should deteriorate substantially during the restructuring period. The Authority notes positively that the bank has already started to adapt its liquidity policy to comply with the future Basel III requirement. It considers that the bank's current LCR of […] % is a comforting indicator, in particular compared to the average of 83 % that was determined in a study comprising over 200 banks by the Bank for international settlements ([56]). Moreover, the Authority considers that the stress testing of the bank's liquidity ratio that Landsbankinn's liquidity situation is sound.

([56]) Cf. http://www.bis.org/press/p120412a.htm.

(198) The Authority also welcomes the changes to Landsbankinn's corporate governance and the replacement of key staff. In the same vein, the greater role of risk management, as described above, addresses in the Authority's view a weakness in Landsbankinn's business model and will contribute to a more objective and professional risk assessment in the bank's operations.

(199) The Restructuring Guidelines also provide that the restructuring plan should demonstrate how the bank will restore its long-term viability without state aid as soon as possible. In particular, the bank should be able to generate an appropriate return on equity, while covering all costs of its normal operation and complying with the relevant regulatory requirements. In particular, point 13 of the Restructuring Guidelines indicates that long-term viability is achieved when a bank is able to cover all its costs including depreciation and financial charges and provide an appropriate return on equity, taking account of the risk profile of the bank.

(200) At this point, the Authority recalls that the economic environment in which Landsbankinn operates would be challenging for any bank. Moreover, the Authority considers that a difficult balance has to be struck for any bank in Iceland at the moment between the goal of increasing profitability and maintaining a safe (i.e. high) capital balance. With this in mind, the Authority is satisfied with the restructuring plan's forecasted profitability, which, in spite of the high capital ratio, will be adequate throughout the restructuring period. Between 2009 and 2014, the ROE fluctuates between [> 5] % and [> 15] %.

(201) However, as described above, this fluctuation is also due to irregular situations and events, such as for example the valuation gains from the assets transferred from Landsbanki. One-off events such as unexpectedly successful sales of subsidiaries on one hand, and the write-downs caused by the recent Supreme Court ruling on FX-loans on the other hand, may also have an impact. The calculation submitted by the Icelandic authorities in which the Profit and Loss Statement (P&L) has been cleansed of those irregular items indicates that the bank has made and will continue to make relatively stable profits from 2011 onwards. The report by the Icelandic State Financial Investments ('ISFI') referred to above would seem to support this conclusion. It is not clear if these calculations are such as to solely reflect the 'core profitability' of the bank. However, the Authority notes that the significance of the discount decreases rapidly over the restructuring period, and the bank expects to report 'core' profits between approx. […] and […] billion ISK annually according to the restructuring plan in the period between 2012 and 2014.

(202) Some of the most relevant and more detailed aspects of the financial planning were mentioned above. The Authority is of the view that these assumptions overall seem sufficiently prudent, given the challenging operating environment. As regards the interest rate margin, the Authority notes that even after the anticipated decrease to […] %, it would be rather high in international comparison. ([57]) According to the Icelandic authorities, the margin has been approximately at that level or higher throughout the last decades This is due, amongst other factors, to the high-interest rate environment in Iceland, the lower share of mortgages in the loan portfolio and the smaller size of the banks. The Authority considers these explanations reasonable, and therefore finds this aspect of the financial planning to be sufficiently plausible.

(203) Another important driver of future profitability is greater fee and commission income, which is forecasted to increase by approximately […] %. This increase would then yield profits of over […] billion ISK in 2014. The Icelandic authorities submit that these projections are plausible, as business such as stock market related transactions and foreign currency trade have practically come to a standstill after the collapse and the introduction of the capital controls.

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

(204) The bank has taken a number of initiatives, as described above, to increase efficiency and reduce cost, amongst others the planned reduction of staff described above, the committed closure of […] branches and a general streamlining of operations. These measures should overall reduce the cost to income ratio from 57,2 % to […] % in 2014. The Authority welcomes these efforts, as the current ratio appears quite high in international comparison. The Authority also considers it to be plausible that this target can be reached.

(205) In addition to the above, it is evident that the restructuring plan is based on a large number of other assumptions. The Authority has aimed to scrutinise those that seems most pertinent and of greatest influence to the future viability of Landsbankinn. The macroeconomic assumptions appear to be in line with the forecasts of the CBI. Overall the assumptions on which the restructuring plan is based appear to be sufficiently prudent to allow the conclusion that the restructuring measures undertaken by the bank are sufficient to ensure its long-term viability, barring unexpected adverse events of unforeseen scale and consequences.

(206) Taking into account the above elements, the Authority considers that the restructuring plan demonstrates the restoration of the long-term viability of the bank. The Authority therefore concludes that the provisions of section 2 of the Restructuring Guidelines are complied with.

3.3. **Own contribution/burden-sharing**

(207) Paragraph 22 of the Restructuring Guidelines reads as follows: 'In order to limit distortions of competition and address moral hazard, aid should be limited to the minimum necessary and an appropriate own contribution to restructuring costs should be provided by the aid beneficiary. The bank and its capital holders should contribute to the restructuring as much as possible with their own resources. This is necessary to ensure that rescued banks bear adequate responsibility for the consequences of their past behaviour and to create appropriate incentives for their future behaviour'.

(208) The Authority recalls in this regard a decisive aspect of the case at hand. When Landsbankinn was established on the basis of the domestic operations of Landsbanki, the investments of the shareholders in Landsbanki were fully wiped out and have thus contributed to the maximum possible to the restructuring of Landsbankinn. Moreover, the creditors of Landsbanki had to take considerable losses ([58]), or at least they had to take on the risk of their investment depending on the performance of the assets transferred to Landsbankinn (via the contingent bond). Therefore, as far as the owners and creditors of Landsbanki are concerned, the criterion of burden-sharing is satisfied and the issue of moral hazard addressed.

(209) In addition to the above, the Authority needs to assess whether the state aid that Landsbankinn has received was limited to the minimum necessary.

(210) As regards the capitalisation measures, the initial capitalisation of Landsbankinn at its establishment was below the FME's capital requirements (13 % instead of 16 %). In 2009, after the agreement with Landsbanki had been reached the CAD ratio reached 15 %, 1 percentage point short of the minimum ratio set forth by the FME, which granted a temporary exemption. In this context, the Authority notes that the (future) capital ratio depended mainly on whether valuation of the assets that had been transferred from Landsbanki to Landsbankinn had been done accurately. The fact that Landsbankinn's CAD ratio subsequently grew strong enough to allow it to absorb the operations of Spkef, and later SpSv, has been explained with the writing up of the book value of the assets that had been transferred That the CAD ratio developed so strongly later is in the Authority's view no reason to consider that Landsbankinn was overcapitalised by the State at the outset.

([58]) The exact extent of the losses is still uncertain, and varies according to the ranking. An indication of the losses, according to current estimates, can be inferred from http://www.lbi.is/library/Opin-gogn/skyrslan/Opna%20netið%20-%20CreditorsMeeting_31Mai2012%20-%20íslenskaME.pdf, according to which liabilities are approx 3 times greater than assets in the estate.

(211) Paragraph 26 of the Restructuring Guidelines provides that banks in receipt of restructuring aid 'should be able to remunerate capital, including in the form of dividends and coupons on outstanding subordinated debt, out of profits generated by their activities'.

(212) The Authority clarified its State aid guidelines with regard to capital injections made through shares in 2012. Paragraphs 7-8 of the 2012 Financial Crisis Guidelines provide: 'In view of the regulatory changes and the changing market environment, the Authority anticipates that State capital injections may in the future more commonly take the form of shares bearing a variable remuneration. Clarification of the rules on pricing of capital injections is desirable given that such shares are remunerated in the form of (uncertain) dividends and capital gains, making it difficult to assess directly *ex ante* the remuneration on such instruments. The Authority will therefore assess the remuneration of such capital injections on the basis of the issue price of the shares. Capital injections should be subscribed at a sufficient discount to the share price (after adjustment for the "dilution effect") immediately prior to the announcement of the capital injection to give a reasonable assurance of an adequate remuneration for the State' ([59])

(213) In the Authority's view, this provision is not directly applicable to the case at hand, as, technically, the State capitalised a new bank. Thus it could not dilute the old shareholders in the exact sense of the word. However, the rationale underlying the provision is that sufficient diluted ownership and future profits would be allocated to the State who had to take on risk by injecting capital in a company in difficulty.

(214) In the case at hand, it is evident that the State obtained most (81,33 %) of Landsbankinn's ownership and will consequently receive the same share of future profits, whereas former shareholders receive none. The current minority shareholders who are former creditors will participate to some extent in future profits. However, they will in all likelihood still have to bear significant losses, as set out above.

(215) In addition, Landsbankinn's performance since its establishment has been adequate, and the restructuring plan predicts stable profits for the next years. Therefore the Authority considers that the requirement of Paragraph 26 of the Restructuring Guidelines, in conjunction with Paragraph 8 of the 2012 Financial Crisis Guidelines has been complied with.

(216) Whilst the Spkef transaction, as described above, entails elements of state aid, the Authority considers that it is constructed in a manner that aims at excluding a direct financial advantage for Landsbankinn. In this regard, it recalls that the final compensation for taking on Spkef's deposits was determined by an independent arbitration committee. Therefore, this transaction constitutes in essence a negotiated compensation for Landsbankinn in exchange for taking on the deposit liabilities of Spkef. The Authority does not consider that this aid is of great significance for its burden-sharing assessment. However, the additional goodwill and market share that Landsbankinn acquired through the transaction has a more significant bearing on the assessment of the distortions of the competition below.

([59]) Financial crisis Guidelines 2012, adopted by the Authority on 14.12.2011 under chapter VII: Temporary Rules regarding the Financial Crises. Available at the Authority's website at: http://www.eftasurv.int/media/state-aid-guidelines/Part-VIII—Financial-Crisis-Guidelines-2012.pdf. Emphasis added.

(217) Finally, as regards the deposit guarantee, the Authority has already indicated in the opening decision that — in light of the extraordinary circumstances at the time — it might constitute a proportionate means to safeguard financial stability in Iceland. It is evident however that such aid cannot be approved indefinitely.

(218) Thus, in order for this state aid to be considered as limited to the minimum necessary, the Authority is of the view that it needs to be terminated as soon as possible. The Authority therefore welcomes the intention of the Icelandic authorities to abolish the deposit guarantee before the capital controls are lifted, thus, pursuant to current planning, no later than the end of 2013.

(219) So as to cater for delays in the lifting of the capital controls, and to reflect the Authority's view that a viable bank should be able to compete on the market without the protection of such a blanket guarantee on deposits, it will therefore authorise the deposit guarantee until the end of 2014. ([60]) After that time, protection of deposits should be governed only by the applicable EEA legislation regarding deposit guarantees.

(220) The Authority concludes that the restructuring plan of Landsbankinn ensures that the aid is limited to the minimum necessary and that the beneficiary, the shareholders and debt holders of its predecessor bank have participated significantly in the burden-sharing. The restructuring aid thus complies with section 3 of the Restructuring Guidelines.

3.4. **Limiting distortions of competition**

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

> 'Financial stability remains the overriding objective of aid to the financial sector in a systemic crisis, but safeguarding systemic stability in the short-term should not result in longer-term damage to the level playing field and competitive markets. In this context, measures to limit distortions of competition due to state aid play an important role. […] Measures to limit the distortion of competition should be tailor-made to address the distortions identified on the markets where the beneficiary bank operates following its return to viability post restructuring, while at the same time adhering to a common policy and principles. The Authority takes as a starting point for its assessment of the need for such measures, the size, scale and scope of the activities that the bank in question would have upon implementation of a credible restructuring plan as foreseen in Section 2 of this Chapter. […] The nature and form of such measures will depend on two criteria: first, the amount of the aid and the conditions and circumstances under which it was granted and, second, the characteristics of the market or markets on which the beneficiary bank will operate.
>
> As regards the first criterion, measures limiting distortions will vary significantly according to the amount of the aid as well as the degree of burden sharing and the level of pricing. Generally speaking, where there is greater burden sharing and the own contribution is higher, there are fewer negative consequences resulting from moral hazard.
>
> As regards the second criterion, the Authority will analyse the likely effects of the aid on the markets where the beneficiary bank operates after the restructuring. First of all, the size and the relative importance of the bank on its market or markets, once it is made viable, will be examined. The measures will be tailored to market characteristics to make sure that effective competition is preserved. […] Measures limiting distortions of competition should not compromise the prospects of the bank's return to viability.'

(222) It follows from the above that the size of the aid, particularly in relative terms, and the market characteristics are essential in the Authority's assessment of the appropriateness of measures to limit distortions of competition. At the same time, it is evident that such measures must not jeopardise the viability of the beneficiary of restructuring aid, and competition concerns must be addressed with a view to the overriding goal of financial stability in the present crisis.

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

(223) Against the background of the above legal framework, the Authority will set out below the considerations that it deems essential for its assessment of the measures limiting distortions of competition.

(224) First and foremost the Authority considers that given the particular situation on the Icelandic financial markets a careful assessment of the market conditions and the competitive environment is necessary. The measures limiting the distortion of competition should reflect the current difficult circumstances, while ensuring that the distortions of competition are limited to a minimum both in the short-term and the long-term.

(225) Second, as set out above in the section on burden-sharing, the greatest possible contribution from the former owners of Landsbanki, and to some extent, of Landsbanki's creditors has been addressed. Consequently, the need for additional competition measures has been limited.

(226) Third, as regards the characteristics of the relevant market, the collapse of the financial system in Iceland, followed by the interventions of the Icelandic authorities, led to a greater concentration in the Icelandic market for financial services, and substantially increased the market share by the three major banks — Íslandsbanki, Arion Bank and Landsbankinn. Beside these, only a few small market players remain, and the immediate prospect of a new entry is slim, due to the already mentioned barriers to entry and the small size of the market and in particular due to the capital controls. Landsbankinn enjoys a very significant position on this concentrated market, with a market share of over 30 % in the most segments. It is the largest Icelandic bank in terms of balance sheet.

(227) Fourth, the crisis led to a number of very specific problems, such as the extremely high degree of direct and indirect ownership of the large banks in the real economy, and the emergence of a de-facto monopoly for banking IT-services (RB), majority owned by the three banks.

(228) Fifth, the relative size of aid that Landsbankinn has received is significant. In this regard, the Authority notes that at the outset the entire capital of the bank was provided by the State. In addition, the bank has benefited from other of aid measures — the Spkef transaction and the deposit guarantee. Moreover, SpSV has received aid before it was taken over by Landsbankinn. At the same time, Landsbankinn remains a small bank, at least by international standards.

(229) Sixth, the bank's takeovers of Spkef and SpSv call for additional competition measures. In the SpSv decision, the Authority emphasised that Landsbankinn's restructuring plan needs to comprise such measures.

(230) Against this background, the Authority notes that a number of measures have been or will be taken that limit the distortions of competition resulting from the state aid granted to Landsbankinn.

(i) Measures and regulatory developments undertaken or committed to by the Icelandic authorities

(231) The Icelandic government has specifically made two commitments (see Annex) which in the Authority's view can contribute to creating a regulatory environment that favours competition in financial markets:

(232) First, by appointing a working group that will review Act No 36/1978 on Stamp Duty, and by examining in particular whether to abolish stamp duties for bonds issued by individuals when transferred between creditors (e.g. when individuals transfer their loans from one loan institution to another). The Authority considers that the current law — which, inter alia, obliges customers to pay stamp duty on the amount of the respective bond [61] when switching lenders — may be capable of constituting an impediment to competition, as it may lock customers to existing contracts on long term loans. The Authority thus welcomes the commitment for this law to be reviewed.

(233) Second, the Authority takes note of that in accordance with a resolution passed by the Icelandic parliament on 21 March 2012, a committee will be appointed by the government with the mandate to review consumer protection in the financial market. This will include a specific mandate for the review of switching facilitation and switching costs reduction, and for the committee to work closely with the ICA as regards that issue. The Committee shall present its report no later than 15 January 2013. Such a closer assessment could be of benefit for competition in the long-run. In the meantime the bank-specific commitment by Landsbankinn discussed below should contribute to making switching easier, and thereby will increase competition.

(234) The Authority welcomes the settlement that ICA and the owners of RB, including the three major banks, have reached on this issue as it endeavours to ensure access to essential IT-infrastructure on a non-discriminatory basis and at reasonable cost for small competitors and potential new market entrants. The Authority is of the view that its concerns, as voiced, inter alia, in the second Byr [62] decision, have been addressed in a satisfactory manner by this settlement. Thus, there is no need for the Authority to further address this issue in the current decision.

(235) Finally, the Authority takes note of the regulatory amendments that have been made since 2008, as discussed in the Annex. As regards competition concerns, the introduction of Article 22 in Act on financial undertakings No 161/2002 is of particular relevance. This provision limits the participation of financial undertakings in activities falling outside the scope of their operating licenses. According to this new rule, such activities may only be pursued on a temporary basis and for the purpose of concluding transactions or reorganising the activities of customers. A reasoned notification to this effect must be sent to the FME, and time limits have been introduced for financial undertakings to complete reorganisation of their customers and dispose of appropriated assets.

(236) The Authority regards this change as an appropriate regulatory response to the issue of the disproportionately large ownership by financial institutions in the real economy. This provision appears to prevent that this situation — which is a direct result of debt-to-equity-swaps with becomes a permanent one.

(ii) Measures specific to Landsbankinn

(237) The Authority emphasises that Landsbankinn's market presence and size is only a fraction of that of Landsbanki — as total assets have been reduced by 75 %, as described above. Moreover, unlike Landsbanki, Landsbankinn is only active in the Icelandic market. Whilst most of this reduction is a result of the winding up of Landsbanki's international operations, the Authority is of the view that this process is of particular relevance as regards the distortions of competition, as it was in particular Landsbanki's risky overseas strategy that led to its collapse and caused distortions in the EEA financial markets in the past. [63]

[61] The stamp duty varies depending on the type of legal document concerned, but is normally 15 ISK for each started thousand ISK (i.e. approximately 1,5 %) on the amount of interest-bearing bonds secured by a mortgage or other security.
[62] Decision No 325/11/COL of 19.10.2011.
[63] Cf. for example Commission Decision in Case SA.28264, Restructuring aid for Hypo Real Estate, in which the Commission accepted the separation of a large part of the Hypo Real Estate's overseas business as a measure to limit distortions of competition for the bank's successor PBB.

(238) In addition, the Authority welcomes Landsbankinn's commitments (see Annex) to reduce its domestic market presence further by […] divestment relating to […]. Moreover, the Authority notes positively that Landsbankinn has committed to close […] branches during the restructuring period. On the basis of the final restructuring plan, and recalling that Landsbankinn is a small bank by EEA standards, the Authority agrees with Landsbankinn that further structural measures could endanger the bank's prospects of restoring long-term viability. ([64])

(239) The Authority takes note of the commitment that Landsbankinn will not acquire financial institutions until 15 December 2014, except if it obtains the Authority's approval beforehand. This means that further concentration of the Icelandic financial market through acquisitions by Landsbankinn can be prevented. This commitment also ensures that the aid that has been granted to Landsbankinn is used for restoring its viability rather than being used to consolidate and further expand its market presence in Iceland. The same is true for Landsbankinn's commitment pursuant to which it will, until 15 October 2014, neither enforce contract clauses nor introduce new contract clauses which make special terms on interest rates contingent upon maintaining a minimum range of business with the bank, as well as for the commitment not to invoke state involvement as a source of a competitive advantage when marketing its services.

(240) As described above, the Icelandic financial market currently presents a challenging operating environment for any bank. The Authority thus welcomes the commitments by Landsbankinn relating to facilitating the switching between banks and providing basic payment processing as well as money distribution services. The Authority is of the view that those measures, in conjunction with the agreement between the three major banks and ICA on RB mentioned above, ensure that smaller market participants can access the most essential infrastructure and services at reasonable prices without the larger players being able to block their access. The Authority is of the view that this will reduce the barriers to entry for future (potential) market participants. The measures could also allow existing smaller players to expand their market shares if they are able to offer better services than their larger competitors. Moreover, the measures aimed at facilitating switching will contribute to more fierce competition between the existing large players, and could contribute to prevent or dissolve a situation of potential collective dominance.

(241) Lastly, Landsbankinn commits to sell, as soon as possible, shareholdings in operating companies which have been taken over due to restructuring in line with Article 22 of the Act on financial undertakings No 161/2002. It commits to follow the procedure and time-limits which are set out in this provision, and will maintain up-to-date information on its website (or that of a subsidiary) on subsidiaries and shareholdings that are held for sale. Moreover, Landsbankinn has committed to sell […] by certain deadlines within the restructuring period.

(242) The Authority welcomes Landbankinn's general commitment to divest as soon as possible all companies and shareholdings that are not related to its core business. This will not only address the potentially competition concerns that could arise from the being such a dominant owner in the Icelandic real economy, but will also prevent putting the bank's viability at risk.

(243) This draws the Icelandic authorities' and Landsbankinn's attention to the fact that due to the commitments breach of national law might also entail a misuse of aid. The Authority moreover considers that by having to include information about foreseen divestments and sales on its website, more transparency about the current ownership situation in the Icelandic economy is introduced. This remedies, at least to some extent, this particular competition concern that currently characterises Iceland's markets.

(244) On the basis the above the Authority considers that the above measures address the main competition issues that the Authority has identified in collaboration with the ICA. Taking into account the overriding objective of financial stability, the Authority concludes that the commitments limit distortions of competition to a satisfactory degree. The restructuring aid therefore complies with section 4 of the Restructuring Guidelines.

([64]) For the same reasons the Authority accepts the divestments are subject to the condition that […].

III. **CONCLUSION**

(245) On the basis of the foregoing assessment and in the light of the restructuring plan submitted by the Icelandic authorities for Landsbankinn, the Authority's doubts expressed in the opening decision as regards the nature and the compatibility of the aid measures for Landsbankinn are allayed. Moreover, the Authority raises no objections to the Spkef transaction and authorises the aid that SpSv has received. The Authority therefore approves the aid measures as restructuring aid compatible with the functioning of the EEA Agreement pursuant to Article 61(3)(b) EEA subject to Iceland and Landsbankinn adhering to the commitments as set out in the Annex.

HAS ADOPTED THIS DECISION:

Article 1

The initial operating capital and the final state capitalisation granted to Landsbankinn as well as the Spkef transaction and the deposit guarantee constitute state aid within the meaning of Article 61(1) of the EEA Agreement.

Article 2

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

Article 3

The measures enumerated in Article 1 as well as the measures for SpSv described in the Savings Banks decisions are compatible with the functioning of the EEA agreement pursuant to Article 61(3)(b) EEA subject adhering to the commitments as set out in the Annex. The authorisation for the deposit guarantee is limited to the end of 2014.

Article 4

This Decision is addressed to the Republic of Iceland.

Article 5

Only the English language version of this decision is authentic.

Done at Brussels, 11 July 2012.

For the EFTA Surveillance Authority

Oda Helen SLETNES	Sverrir Haukur GUNNLAUGSSON
President	*College Member*

ANNEX

COMMITMENTS AND RELEVANT CHANGES TO THE LEGAL FRAMEWORK FOR BANKING

1. COMMITMENTS BY THE ICELANDIC AUTHORITIES

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

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

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

Measures to facilitate switching and reduce switching costs

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

Moreover, the Icelandic authorities have endorsed the following commitments by Landsbankinn:

Limitation on acquisitions

Landsbankinn commits itself not to acquire financial institutions until 15 December 2014. Notwithstanding this commitment, Landsbankinn may, after obtaining the Authority's approval, acquire financial institutions, in particular if this is necessary in order to safeguard financial stability.

Divestment of […] and closure of branches

Landsbankinn commits itself to divest of its shareholding in […] before [date]. […]

Moreover, Landsbankinn commits to close […] of its branches [date].

Divestment of shares in companies under restructuring

Landsbankinn commits itself in general to sell, as soon as possible, shareholdings in operating companies, which have been taken over due to restructuring, cf. Article 22 of the Act on Financial Undertakings No 161/2002. Furthermore, the bank commits itself to follow the procedure and time-limits, which are set out in the above-mentioned legal provision. Finally, the bank will maintain up-to-date information on its website (or website of a relevant subsidiary) on such shareholdings that are held for sale.

In particular, Landsbankinn commits to offer for sale its shareholdings in the following companies, provided that the companies, including their financial positions, operations and future prospects, will not be subject to significant legal/litigation risk or comparable uncertainties:

[…]

Measures benefitting new and small competitors

Landsbankinn commits itself to undertake the following measures for the benefit of new and small competitors:

(a) Landsbankinn will, until the end of 2014, neither enforce contract clauses nor make new contract clauses, which make special terms on interest rates contingent upon maintaining a minimum range of business with the bank.

(b) Landsbankinn will provide for easily accessible information, at the Bank's website, on the process of switching banking services to another financial institution. Furthermore, the website will make easily accessible the necessary documents to switch between financial institutions. The same information and business-transfer forms will be available at the branches of the bank.

(c) Landsbankinn will execute all requests for transfer of banking services in a swift manner.

(d) Landsbankinn will not invoke state involvement as a source of competitive advantage when marketing.

(e) Provided that competitive service offers are not available, Landsbankinn is willing to offer the following services at a price that will be based on cost plus reasonable margin:

(i) Payment processing services for ISK.

(ii) Payment processing services for FX.

(iii) Distribution of bank notes and coins.

2. RELEVANT ADAPTATIONS AND CHANGES TO THE REGULATORY AND SUPERVISORY FRAMEWORK FOR FINANCIAL MARKETS IN ICELAND ADOPTED AFTER THE CRISIS

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

— FME's (The Icelandic Financial Supervisory Authority) authorisations to intervene (to take over the powers of shareholders' meetings and dispose of assets, cf. the emergency legislation) have been increased; FME has been given expanded supervisory authorisations; additional provisions have been adopted enabling FME to evaluate the operations or behaviour of individual supervised parties. These include both decision-making authorisations, such as on the closing of establishments or termination of specific activities without actual revocation of operating licences, as well as a more detailed definition of concepts whose interpretation has been disputed by FME and supervised entities or appellate bodies.

— Rules on individual large exposures have been clarified and made more specific; both the role and responsibility of risk management have been increased and FME authorised to accord risk management higher status in the organisation of financial undertakings; provisions on the application of stress tests have been tightened.

— Provisions for a special registry of larger borrowers have been legalised, in order to provide better overview of large, individual exposures to two or more financial undertakings. The registry is important for linking exposures together and assessing their systemic impact if difficulties should arise in the borrowers' operations. Entities not subject to FME supervision, but which are listed in the registries of financial undertakings, must provide FME with information on all their obligations. FME can prohibit the provision of services to such parties should they refuse to provide the information requested.

— Provisions on sound business practices have been reinforced and the existence of the Complaints Committee on Transactions with Financial Undertakings enshrined in law; detailed information must be disclosed on all major owners of financial undertakings.

— The time limits allowing financial undertakings to dispose of appropriated assets have been shortened.

— Provisions on financial undertakings' holdings in own shares have been tightened and defined in more detail. Holdings of subsidiaries are now considered own shares, as are off-balance-sheet contracts concerning own shares.

— Financial undertakings have been prohibited from extending credit against pledges of their own shares or guarantee capital certificates.

— FME is now to lay down rules as to how loans secured by a mortgage on the shares of other financial undertakings are to be calculated in the risk base and capital base.

— Both the responsibility and role of internal auditing section has been increased. There are detailed rules concerning the balance between the size and diversity of the activities of the financial undertaking concerned and the scope of its internal auditing section.

— Five-year limits have been placed on the period for which an auditing firm may carry out the audit of the same financial undertaking; financial undertakings' ability to dismiss a 'difficult' auditor is reduced.

— All provisions on calculation of equity and various other technical aspects have been reviewed.

— Rules on exercising qualifying holdings, i.e. 10 % or more of voting rights, have been reviewed. FME is authorised to reverse the onus of proof in assessing parties intending on acquiring or adding to qualifying holdings, e.g. when it is uncertain who is/are the beneficial owner/-s of a holding company with a qualifying holding.

— Additional demands on eligibility have now been made of directors, their responsibility for supervision or operations have been increased and executive chairmen of the Board are prohibited; FME has been assigned a greater supervisory role for Boards of Directors; personally identifiable information must be disclosed on remuneration to senior management.

— Rules have been set concerning credit transactions of financial undertakings with directors, managing directors, key employees and owners of qualifying holdings in the financial undertaking concerned. Similar rules apply to parties closely connected with the above-mentioned. FME has adopted rules as to what is considered satisfactory collateral for such transactions.

— Rules concerning arrangements for incentive schemes and bonuses to management and employees and on termination contracts have been adopted.

— Provisions on the reorganisation and winding-up of financial undertakings have been tightened.

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

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

— FME is authorised to restrict the activities of individual establishments of financial undertakings, if it sees reason to do so. Furthermore, it is authorised to set special requirements for individual establishments of financial undertakings to continue their activities. FME may also limit provisionally the activities which a financial undertaking may pursue, in full or in part, whether subject to license or not, if the Authority sees reason to do so. This is naturally prompted not least by the activities of branches and deposit accounts established by them in other European states until 2008 (Icesave, Edge and Save-and-Save).

— Considerably more detailed provisions are set concerning the role of internal audit in Icelandic law than in the EU directives.

— Considerably more detailed provisions are set on how stress tests are to be carried out than in the EU directives.

— Financial undertakings must keep a special registry (a credit registry) of all parties to whom they extend credit and submit an updated list to FME at the end of each month. Furthermore, a similar list shall be sent on parties closely connected with financial undertakings, their Boards of Directors and managers and groups of connected clients, to the extent that these parties are not on the above-mentioned list. This list will provide a better opportunity to monitor inter-linkages between financial undertakings, their directors and management.

— If FME is of the opinion that the borrowing of a single party on the credit registry, which is not subject to official supervision of financial activities, could have a systemic impact, it may demand information from the party concerned on its obligations.

— Should a party not subject to official supervision listed on the credit registry refuse to disclose information to FME, the Authority may order supervised entities to refrain from providing the said party with further service. The same applies if the information disclosure of the party concerned is unsatisfactory. The provisions on a credit registry and extensive authorisations to supervisors concerning parties not subject to official supervision are not in EU/EEA rules.

— There are considerably more detailed and restrictive provisions on related party lending and collateral than in EU/EEA rules.

— FME must refuse the owner of a qualifying holding the right to exercise the holding if there is doubt as to who is or will be its beneficial owner.

— The maximum length of time external auditors can work for the same financial undertaking is shorter than in EU/EEA rules.

— There are considerably more detailed provisions on the eligibility of directors in financial undertaking than in the EU directives.

— Provisions are adopted on arrangements for bonus schemes and termination contracts.

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

On 23 March 2012 the Minister of Economic Affairs introduced a report on the future structure of the Icelandic financial system and. The Minister has further appointed an expert group to prepare a legislative frame for all financial activities in Iceland.

Public version of ([1])

EFTA SURVEILLANCE AUTHORITY DECISION

No 291/12/COL

of 11 July 2012

on restructuring aid to Arion Bank (Iceland)

The EFTA Surveillance Authority ('the Authority')

HAVING REGARD to the Agreement on the European Economic Area ('the EEA Agreement'), in particular to Article 61(3)(b) and Protocol 26 thereof,

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

HAVING REGARD to Protocol 3 to the Surveillance and Court Agreement ('Protocol 3'), in particular to Article 1(3) of Part I, Article 7(3) of Part II, and Article 13 of Part II,

Whereas:

I. **FACTS**

1. PROCEDURE

(1) Following informal correspondence in October 2008, and the passing on 6 October by the Icelandic Parliament (the Althingi) of Act No 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc. (referred to as the 'Emergency Act'), which gave the Icelandic state wide-ranging powers to intervene in the banking sector, the President of the Authority wrote on 10 October 2008 to the Icelandic authorities and requested that state aid measures taken under the Emergency Act be notified to the Authority. Further contact and correspondence followed periodically including notably a letter sent by the Authority on 18 June 2009 reminding the Icelandic authorities of the need to notify any state aid measures, and of the stand-still clause in Article 3 of Protocol 3. Following further correspondence and meetings, state aid involved in the restoration of certain operations of (old) Kaupthing Bank and the establishment and capitalisation of New Kaupthing Bank (renamed Arion Bank as from 21 November 2009) was eventually notified retrospectively by the Icelandic authorities on 20 September 2010.

(2) By letter dated 15 December 2010 ([2]) the EFTA Surveillance Authority ('the Authority') informed the Icelandic authorities that it had decided to initiate the procedure laid down in Article 1(2) of Part I of Protocol 3 in respect of the measures undertaken by the Icelandic State to restore certain operations of (old) Kaupthing Bank hf and establish and capitalise New Kaupthing Bank hf, now renamed Arion Bank (the opening decision) ([3]). The Authority also required that a detailed restructuring plan for Arion Bank be submitted within six months.

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

([2]) The Authority's Decision No 492/10/COL, 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) OJ C 41, 10.2.2011, p. 7 and EEA Supplement to the *Official Journal* No 7, 10.2.2011, p. 1.

([3]) Further information on the procedure leading up to the Authority's Decision No 492/10/COL, can be found in the procedure part of the decision.

(3) By letter dated 24 March 2011 [4], the Authority received one comment from interested parties, which was forwarded to the Icelandic authorities on 25 May 2011. The Icelandic authorities did not respond to this comment.

(4) By letter of 31 March 2011, the Icelandic authorities submitted a restructuring plan for Arion Bank. An updated restructuring plan was submitted by e-mail on 30 April 2012.

(5) The Authority requested information with regards to the restructuring plan on 11 July 2011 and 13 February 2012. Replies to the requests for information were received from the Icelandic Authorities on 26 October 2011, 16 April 2012, 30 April 2012, 21 May 2012 and 6 July 2012. The final versions of the commitments made by the Icelandic authorities and Arion Bank were submitted on 3 July 2012 [5].

(6) In addition, the Authority's representatives met with the Icelandic authorities and representatives of Arion Bank on 7 June 2011 and 27-28 February 2012.

2. BACKGROUND

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

2.1. **The collapse of Kaupthing Bank**

(8) In September 2008 a number of major global financial institutions began to experience severe difficulties. In the midst of the turbulence in global financial markets, 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.

(9) 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 takeover 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.

(10) 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 500 million euros 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.

(4) Corrected by the interested parties on 25 May 2012.
(5) Regarding the competitive situation in the Icelandic banking sector and possible competition remedies, the Authority has cooperated with the Icelandic Competition Authority (ICA).

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

(11) In their notification of the aid granted to 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 Parliament ([6]), whose remit was to investigate and analyse the processes leading to the collapse of the three main banks. The Authority summarises below the conclusions of the Commission concerning the causes of failure most relevant to the demise of 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.

(12) The global reduction in liquidity in financial markets that began in 2007 eventually led to the collapse of the three main Icelandic banks, whose business operations had become increasingly dependent on raising funding through international markets. The reasons for the demise of the Icelandic banks were however complex and numerous. The SIC investigated the reasons which led to the collapse of the main banks, and it is notable that the majority of the conclusions applied to all three banks and many are inter-related. Causes of failure related to the banks' activities are briefly summarised below.

Excessive and unsustainable expansion

(13) 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 ISK ([7]) 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 2007 ([8]), most notably after the beginning of the international liquidity crisis. This led the SIC to conclude that much of this increase in lending resulted from loans made to undertakings that had been refused credit elsewhere. The report also concluded that inherently riskier investment banking had become an ever increasing feature of the banks' activities and growth had contributed to the problems.

The reduction in finance available on the international markets

(14) 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 refinancing risks.

The gearing of the banks' owners

(15) In the case of each major Icelandic bank, the principal owners were among the biggest debtors ([9]). 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 parties ([10]) 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

([6]) 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/

([7]) Icelandic *króna*.

([8]) Lending to foreign parties increased by 11,4 billion euros from 9,3 billion euros to 20,7 billion euros in six months.

([9]) Chapter 21.2.1.2 of the Report.

([10]) Exista, Exista Trading, Bakkavör Group, Bakkavor Finance Ltd, Bakkabraedur Holding B.V., Lýsing, Síminn, Skipti and other related companies.

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 collateral ([11]). 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 related parties had received from Kaupthing Bank's parent company at the collapse of the bank amounted to around 2 billion euros ([12]).

Concentration of risk

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

Weak equity

(17) 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' ([13]), represented more than 25 % of the banks' capital bases (or over 50 % when assessed against the core component of the capital, i.e. shareholders' equity less intangible assets). Added to this were problems caused by the risk that the banks were exposed to by holding each other's shares. By the middle of 2008 direct financing by the banks of their own shares, as well as cross-financing of the other two banks' shares, amounted to approximately 400 billion ISK, around 70 % of the core component of the capital. The SIC was of the opinion that the extent of financing of shareholders' equity by borrowing from the system itself was such that the system's stability was threatened. The banks held a substantial amount of their own shares as collateral for their lending and therefore as share prices fell the quality of their loan portfolios declined. This affected the banks' performance and put further downward pressure on their share prices; in response to which (the SIC assumed from the information in their possession), the banks attempted to artificially create abnormal demand for their own shares.

The size of the banks

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

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

(19) The SIC concluded that the relevant supervisory bodies in Iceland lacked the credibility that was necessary in the absence of a sufficiently resourced lender of last resort. The report concludes that the FME and CBI lacked the expertise and experience to regulate the banks in difficult economic times, but that they could have taken action

([11]) More than half of such loans granted from the beginning of 2007 until the collapse of the bank, were granted without collateral.
([12]) 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.
([13]) Chapter 21.2.1.4 of the Report.

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 abroad [14].

Imbalance and overexpansion of the Icelandic economy as a whole

(20) 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' [15]. The report is also critical of the ease with which the banks were able to borrow from the CBI, with the stock of CBI short-term collateral loans increasing from 30 billion ISK in the autumn of 2005 to 500 billion ISK by the beginning of October 2008.

The Icelandic króna, external imbalances and CDS spreads

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

2.3. **Measures taken to reconstruct the banking sector**

(22) Following the collapse of the three biggest commercial banks in October 2008 (including Kaupthing) the Icelandic authorities were faced with the unprecedented challenge of safeguarding continued banking operations in Iceland [16]. The policy followed by the Icelandic Government is primarily laid down in the Emergency Act [17] adopted by the Icelandic Parliament on 6 October 2008. The law grants extraordinary powers to the FME to take control of financial undertakings and to dispose of their assets and liabilities as required. The Minister of Finance was authorised, on behalf of the Treasury, to disburse funds in order to establish new financial undertakings. Moreover, in bankruptcy proceedings of financial undertakings, deposits would be given priority over other claims. The Government declared that deposits in domestic commercial and savings banks and their branches in Iceland would be fully protected.

(23) Policy priorities focused initially on securing the basic functioning of the domestic banking, payment and settlement systems. In the first weeks after the crash, the Icelandic Government also prepared an economic program in collaboration with the International Monetary Fund ('IMF'), leading to the approval on 20 November 2008 of Iceland's request for a two year stand-by-arrangement from the Fund, which included a 2,1 billion USD loan from the IMF aimed at strengthening Iceland's currency reserves. Additional loans of up to 3 billion USD were secured from other Nordic countries as well as certain other trading partners. Of the IMF loan, 827 million USD was made available immediately, while the remaining amount was disbursed in eight equal instalments, subject to quarterly reviews of the program.

(14) 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.
(15) Chapter 2, page 5 of the report.
(16) For further general details of the measures taken by the Icelandic authorities see the report of the Minister of Finance to the Parliament on the resurrection of the commercial banks of May 2011 (Skýrsla fjármálaráðherra um endurreisn viðskiptabankanna), available at http://www.althingi.is/altext/139/s/pdf/1213.pdf
(17) Act No 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc.

(24) The IMF Program was a broad-based stabilisation program focusing on three key objectives. Firstly, to stabilise and restore confidence in the króna so as to contain the negative impact of the crisis on the economy. The measures included the introduction of capital controls aimed at stemming capital flight. Secondly, the program included a comprehensive bank restructuring strategy, ultimately aimed at rebuilding a viable financial system in Iceland as well as safeguarding the country's international financial relations. Among subsidiary goals was to ensure fair valuation of the banks' assets, maximise asset recovery and strengthen supervisory practices. Thirdly, the program aimed at ensuring sustainable public finances, by limiting the socialisation of losses in the failed banks and implementing a medium-term fiscal consolidation program.

(25) The Icelandic authorities have underlined that due to the exceptional circumstances linked to the large size of the banking system in relation to the financial capacity of the Treasury, the policy options available to the authorities were limited. The solutions relied upon were therefore in many ways different to the measures taken by the governments of other countries facing threats to financial stability.

(26) On the basis of the Emergency Act, the three large commercial banks, Glitnir Bank, Landsbanki Íslands and Kaupthing Bank, were split into 'old' and 'new' banks. The Minister of Finance founded three limited liability companies to take over the domestic operations of the old banks and appointed them boards of directors. The FME took control of the old banks, allocated essentially their domestic assets and liabilities (deposits) to the new banks which continued banking operations in Iceland, while the old banks were placed under the supervision of their respective resolution committees ([18]). Foreign assets and liabilities were in the main placed in the old banks, which were later submitted to winding-up procedures and the eventual closure of all foreign operations ([19]).

(27) In the provisional opening balance sheets of the three new banks of 14 November 2008 it was estimated that the banks' combined total assets would amount to 2 886 billion ISK, with an equity to be provided by the State of 385 billion ISK. The total amount of bonds to be issued by the new banks in favour of the old banks as payment for the value of the assets transferred in excess of liabilities was estimated at 1 153 billion ISK. The FME appointed Deloitte LLP to perform assessments of the value of transferred assets and liabilities. In this process it transpired that the independent assessment would not result in fixed values of net assets transferred but valuations within certain ranges. It also emerged that the banks' creditors raised disagreements concerning the valuation process, which they considered not to be impartial, and complained that they were unable to protect their interests. These complications resulted in a change of policy for settling the accounts between the old and the new banks, entailing that instead of relying on valuations by an independent expert, the parties would try through negotiations to reach agreements on the value of the net assets transferred.

(28) It was clear that it would be difficult for the parties to reach agreements on the valuations as they were evidently subject to numerous assumptions on which the parties were likely to disagree. The state aimed to reach agreements on base evaluations providing a firm foundation for the initial capitalisation of the new banks. Price performance of assets in excess of the base evaluation could be attributed to the creditors in the form of contingent bonds or increases in the value of the banks' share capital, as it had emerged in the negotiations that the resolution committees of Glitnir and Kaupthing and a majority of their creditors could be interested to acquire

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

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

holdings in the new banks, and this would allow them to benefit from potential increases in the values of the assets transferred.

(29) The full capitalisation of the three new banks and the basis of agreements with the creditors of the old banks was announced on 20 July 2009. The Government, as the sole owner of the three new banks, reached heads of agreements with the resolution committees of the old banks in relation to how compensation for the transfer of net assets into the new banks would be achieved and paid for. With regard to two of the new banks, Íslandsbanki and Arion Bank, this included conditional agreements for the old banks to subscribe for majority equity interests in the new banks.

(30) On the basis of the above tentative agreements, the resolution committees of the old banks decided in October 2009 (Glitnir) and December 2009 (Kaupthing Bank and Landsbanki Islands) to exercise the negotiated options and subscribe to shareholding in the new banks. On 18 December 2009 the Government announced that bank reconstruction had been concluded and that agreements had been reached between the Icelandic authorities and the new banks, on the one hand, and the resolution committees of Glitnir Bank, Landsbanki Íslands and Kaupthing Bank on behalf of their creditors, on the other hand, on settlements concerning assets which were transferred from the old banks to the new ones, and that the new banks were then fully financed.

(31) As it turned out, the Treasury's contribution to the new banks' equity was reduced substantially, from 385 billion ISK as originally envisaged to 135 billion ISK in the form of share capital and, in the case of two of the three banks, Íslandsbanki and Arion Bank, approximately 55 billion ISK of Tier II capital in the form of subordinated loans or a total of 190 billion ISK. In addition, the Treasury provided Íslandsbanki and Arion Bank with certain liquidity facilities. The share capital provided by the old banks to the new ones amounted in total to approximately 156 billion ISK. Total capitalisation of the new banks therefore amounted to approximately 346 billion ISK. Thus, instead of maintaining full ownership of the three banks, the agreements implied that the state's holdings would be reduced to approximately 5 % in the case of Íslandsbanki, 13 % in the case of Arion Bank and 81 % in the case of Landsbankinn.

(32) While this takeover of two of the three banks by the creditors of the old banks resolved major issues in the rebuilding of the financial sector and established firmer capital foundation for the new banks, numerous weaknesses remained which needed to the addressed. Since the autumn of 2009, the banks have concentrated their efforts mostly on internal issues, determining the overall strategy for their operations and in particular restructuring their loan portfolios, which represent the greatest risk factor to their operations and long-term viability. The restructuring process has been complex due to various complicating factors, including Supreme Court rulings on illegality of loans granted in ISK but indexed to foreign currencies. As for Arion Bank, in so far as relevant for its restructuring, these matters are discussed further below.

2.4. **Macroeconomic environment**

(33) Major economic turbulence followed the collapse of the banking system in October 2008. The difficulties in Iceland's financial system were coupled with a breakdown of confidence in its currency. The króna depreciated sharply in the first quarter of 2008 and again in the autumn, before and after the failure of the three commercial banks. Despite capital controls imposed in the autumn of 2008, currency volatility prevailed in the course of 2009 ([20]). This turmoil resulted in a severe recession in Iceland's economy, with a contraction of GDP by 6,8 % in 2009 and 4 % in 2010.

(34) Among the implications of the economic crisis was a sudden increase in unemployment from 1,6 % in 2008 to 8 % in 2009, a hike in inflation and a drop in real wages. Moreover, there was a sharp rise in corporate and household debt and of the share of non-performing loans in the banks' loan portfolios as well as a large scale takeover by the new banks of businesses in financial distress. At the same time the high fiscal cost of restructuring the banking system led to a sharp rise in the fiscal deficit and a major surge in public sector debt.

([20]) As an example of the scale of the sharp depreciation, the monthly average exchange rate of the euro to the Icelandic króna rose from 90,71 ISK in December 2007 to 184,64 ISK November 2009.

(35) Following the deep recession provisional data from Statistics Iceland indicates a turnaround in the second half of 2011 and for the whole year a growth of GDP of 3,1 % compared to the previous year.

(36) Economic growth in 2011 was mostly due to an increase in domestic demand, particularly a 4 % rise in private household consumption. This was supported by increases in wages and social benefits as well as certain policy initiatives undertaken to ease the payment burden of household debt, including a temporary interest rate subsidy, the freezing of payments on loans and the early reimbursement of private pension savings. Provisional data for 2011 also indicate a slow increase in investments, however from a particularly low level ([21]). Public consumption has remained at a subdued level during the past three years.

(37) The general macroeconomic data disguise more significant sectoral differences. In addition to the collapse in the financial sector a major contraction has taken place in construction and many other domestic production and service activities. Growth has on the other hand taken place in certain export sectors. Due to the low exchange rate of the króna and relatively stable prices in foreign currency for both marine and aluminium products, export revenue rose following the onset of the economic crisis, also with respect to tourism and other services exports. At the same time, imports fell sharply, turning the trade balance ([22]) temporarily to a surplus of approximately 10 % of GDP in 2010. However, with increased domestic demand in 2011, imports have grown again, leading to an overall smaller trade surplus of 8,2 % of GDP.

(38) Statistics Iceland forecast for 2012-2017 assumes that gradual economic recovery will continue with 2,6 % growth in 2012. A similar growth rate is expected throughout the forecast period. This forecast is however subject to several uncertainties. Planned large scale industrial investments might be further delayed. Iceland's terms of trade would be negatively affected by a prolonged recession in the main trading countries, implying a lower growth rate in Iceland. Slower progress than anticipated in tackling the debt burden of households and corporations would furthermore restrain domestic demand and the growth prospects of the economy. Growth could also be threatened by continued price instability linked to currency volatility in the context of removal of capital controls.

2.5. **Financial supervision and improvements in regulatory framework**

(39) Following the FME's initial work linked to the foundation of the new banks and the assessment of the value of the net assets transferred from the old banks, the FME conducted in the spring of 2009 an audit of the new banks and their business plans, financial strength and capital requirements in a so-called sign-off project. This was done with the assistance of the international management consultant firm Oliver Wyman.

(40) Having concluded the above process, the FME granted the banks operating licenses subject to various conditions. In view of the quality of the asset portfolios and the anticipated economic uncertainty, it was considered necessary to place higher capital requirements on the three banks than the statutory minimum. The FME therefore set the minimum capital adequacy (CAD) ratio for the three banks at 16 %, thereof a minimum of 12 % for the Tier I capital ratio. The requirements were applicable for at least 3 years unless reviewed by the FME. Liquidity conditions were also specified, requiring that available liquid funds should at any point amount to a minimum of 20 % of deposits and that cash or cash equivalents should amount to at least 5 % of deposits. Furthermore, requirements were made regarding other matters such as restructuring of loan portfolios, risk assessment, corporate governance and ownership. Comparable capital requirements were introduced by the FME regarding other financial undertakings.

([21]) During the years 2009-2011, the share of investments in GDP has been only 13-14 %.

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

(41) The economic stabilisation program established in consultation with the IMF provided for a review of the entire regulatory framework of financial services and supervision to improve defence against future financial crisis. The Government invited the former Director-General of the Finnish Financial Supervisory Authority, Mr Kaarlo Jännäri, to carry out an assessment of the existing regulatory framework and supervisory practices. Among the improvements proposed by Mr Jännäri was the creation of a National Credit Registry at the FME to diminish credit risks in the system. His report also suggested to lay down tougher rules and a stricter practice on large exposures and connected lending as well as to conduct more on-site inspections to verify off-site supervision and reports, particularly on credit risk, liquidity risk and foreign exchange risk. It was also recommended to review and improve the deposit guarantee system, following closely the developments within the EU.

(42) The Government subsequently proposed a bill of law to the Althingi, based, inter alia, on proposals made by Jännäri as well as amendments made to EEA law on financial activities from 2009 onwards, which was adopted and entered into force on 1 July 2010, as Act No 75/2010. With the new law, extensive amendments were made to the Act on Financial Undertakings. Several other amendments were later introduced to the law on financial undertakings as well as of regulation and supervision of financial services. These regulatory amendments are considered in more detail in the Annex.

2.6. **Main challenges ahead** [23]

(43) Despite major achievements in rebuilding a financial sector, Iceland continues to strive with the repercussions of the financial and currency crisis in the autumn of 2008. The financial crisis has revealed various flaws and deficiencies in the financial system, which must be addressed, if public confidence is to be restored. It seems evident that Iceland — as many other countries hard hit by the financial crisis — faces numerous challenges in adapting the legal and operating environment of financial services to support a viable and efficient financial system in the future and reduce as much as possible the risk of further systemic shocks to reoccur.

(44) The most immediate challenges currently facing Icelandic financial undertakings are linked to the fact that the banks are operating in a sheltered environment with capital controls and a blanket deposit guarantee. The banks now need to prepare themselves to operate in a more exposed environment, when the capital controls are removed and deposit guarantees revert to the arrangement set out in the relevant EU/EEA directives [24]. The Icelandic authorities have underlined that extreme caution must be exercised when introducing new rules in this regard.

(45) Another major challenge is the need to adapt further the legal and regulatory framework to support a solid and efficient financial system which is also consistent with EEA and international law developments [25].

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

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

[25] See Chapter 9 of the report of the Minister of Economic Affairs referred to in footnote 23. When presenting that report, the Minister of Economic Affairs also appointed a group of banking experts, with participation of foreign experts, to prepare proposals on a comprehensive legal and regulatory framework for the financial market in Iceland as a whole. According to the same report, the Icelandic authorities also foresee to study other future options, including the possible separation of investment and commercial banking activities, the adoption of a financial stability legislation and possible amendment of the division of responsibility of financial services regulatory bodies. It is also clear from the statements of the Icelandic authorities that a review of the monetary policy framework remains on the agenda, with or without the possibility that Iceland will become a member of the European Union, as well as other possible means to improve economic management and ensure that regulators 'see the forest for the trees' and effectively apply the most appropriate macro-prudential tools.

2.7. **The state of competition in the Icelandic financial sector**

(46) According to recent information from the Icelandic authorities ([26]), competition on the financial market has changed radically since the banking collapse. The number of financial undertakings has decreased, as several savings banks, commercial banks and specialised lenders are either being wound up or have been merged with other undertakings ([27]). The number of financial undertakings is still decreasing, most recently with the mergers of Landsbankinn and SpKef in March 2011, of Íslandsbanki and Byr in December 2011 and the merger of Landsbankinn and Svarfdaelir Savings Bank, approved by the Authority on 20 June 2012. With the reductions in the number of financial undertakings and the larger banks taking over deposits from the banks closing down, concentration in the domestic market has increased. The overall presence of the new banks on the EEA financial markets is on the other hand much smaller than that of their predecessors, as international banking operations have been closed down.

(47) In addition, the domestic market has shrunk considerably as certain sub-markets have disappeared or are largely subdued. The near disappearance of the stock market and the introduction of capital controls have reduced operations in the stock and currency markets and resulted in limited investment options. With the level of investments in the economy at a historically low level and households and companies generally highly leveraged, demand for credit is low. Since the collapse, the banks have concentrated their efforts on internal issues and restructuring of their loan portfolios as well as the restructuring of some of their major corporate clients.

(48) Before the financial crisis, the savings banks accounted collectively for a market share of approximately 20-25 % in deposits. This has now collapsed to approximately 2-4 %. The market shares lost by the savings banks and commercial banks exiting the market have been gained by the three major commercial banks, Arion Bank, Íslandsbanki and Landsbanki. Combined the three big banks now account for approximately 90-95 % of the market instead of 60-75 % earlier on, where Landsbankinn's market share is marginally highest. Apart from the 10 regional savings banks, currently accounting for approximately 2-4 % of the market, the only other market player is the restructured MP Bank ([28]), with a market share of approximately 1-5 %.

(49) The Icelandic financial market is thus clearly oligopolistic and the three largest companies could collectively achieve a dominant market position. According to the Icelandic Competition Authority (ICA), which the Authority had asked for its views on the state of competition in Iceland and potential remedies, there are significant entry barriers to the Icelandic banking market. This has detrimental effects on competition. There are also certain impediments for consumers to switch banks. The Icelandic authorities furthermore acknowledged that the exchange rate risks associated with Iceland's small and non-traded currency, the Icelandic króna, has further restricted competition and deterred foreign banks and companies from entering the Icelandic market.

(50) ICA has lately focused on a specific issue regarding IT infrastructure for the banks' operations and their cooperation in that regard. This relates to the financial institutions' jointly owned IT service provider, *Reiknistofa bankanna* (the Icelandic Banks' Data Centre; RB). This matter is of relevance for the assessment of the case at hand and was among the issues discussed by the Authority with the Icelandic authorities and the banks.

(51) RB is jointly owned by the three main Icelandic banks, two saving banks, the Icelandic Savings Bank Association and the three main payment card processors in Iceland. Landsbankinn owns 36,84 % of the shares in RB, Íslandsbanki holds 29,48 % and Arion Bank 18,7 %. Combined the three commercial banks therefore own 85,02 % of

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

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

([28]) On 11 April 2011, a contract for the sale of (old) MP bank's operations in Iceland and Lithuania was approved at the bank's shareholder meeting, when over 40 new shareholders invested 5,5 billion ISK in new shares in the bank. Other operations of the old bank remained with the previous owners and were transferred to a new legal entity, EA fjárfestingarfélag hf. For further details, see MP bank's press releases of 11 April 2011 available at https://www.mp.is/um-mp-banka/utgefid-efni/frettir/nr/1511 and https://www.mp.is/um-mp-banka/utgefid-efni/frettir/nr/1510 shares in RB. RB's clients are the owners, the Central Bank of Iceland and other financial institutions as well as other public entities. The banks' cooperation in this area is extensive, as RB has developed the clearing and settlement system in Iceland. It also provides a number of core banking solutions which are multi-tenant solutions, used by most of the Icelandic banks. RB furthermore operates an e-invoicing and e-payment system for corporates and consumers.

(52) According to ICA, the collapse in 2008 has made the smaller banks and savings banks particularly vulnerable. For the smaller financial undertakings, the required IT services were of crucial importance, as they can be viewed as one of the entry barriers for new market participants. The platform for IT services has been provided to a significant extent by RB as regards the bigger financial undertakings and, as regards the savings banks and smaller market players, by Teris. Following the closure of many smaller financial undertakings in recent years, Teris lost a significant share of its income, leading in January 2012 to the sale of some of its IT solutions to RB. According to RB and Teris, this transaction was, inter alia, aimed at securing continued provision of IT services to smaller financial undertakings.

(53) The ICA has been investigating two cases regarding RB. Firstly, whether the joint ownership and cooperation of the banks and other financial undertakings in the RB forum should be considered to be a breach of the ban on restrictive practices under Article 10 of the Icelandic Competition Act. Secondly, the compatibility of RB's purchase of Teris's major assets is being assessed under the merger provisions of the same act. However, in May 2012 these two cases were concluded with a settlement between RB and its owners, on the one hand, and the ICA on the other hand ([29]).

(54) Aside from the above concerns that relate directly to the Icelandic financial market, the ICA has in particular pointed to the need for the sale and restructuring of operating companies ([30]) to be completed without undue delay. Many operating companies have been taken over by the banks (being creditors of those companies) due to over indebtedness following the economic crash in 2008. According to ICA, it may create a conflict of interest when banks provide financial services to companies and own the companies at the same time. The ICA is of the opinion that the banks' direct and indirect ownership ([31]) is the most wide-spread and dangerous competition problem in the aftermath of the financial crisis, as this has an effect on almost every company and industry in Iceland. In ICA's view, faster restructuring of companies would improve competition in the financial market. When the banks' involvement in the restructuring of their corporate clients has been subject to the notification requirements under national merger control, the ICA has in this regard often set conditions regarding the banks' ownership. However, a comprehensive solution to the problem appears to be difficult, as it relates essentially to the high leverage of the Icelandic business sector.

(55) In their submission to the Authority, the three commercial banks, Arion Bank, Íslandsbanki and Landsbankinn, have all expressed the view that no major changes have taken place in the conditions of competition in the Icelandic financial market since autumn 2008 which should give cause for concerns. Effective competition

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

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

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

prevailed in the market, without any evidence of collusive behaviour of the three biggest players. When examining the conditions of competition in the market, the ICA had overlooked certain key factors. Foreign banks, although without presence in Iceland, have for long and still are actively competing with Icelandic banks for the provision of corporate loans and other financial services to the biggest clients, such as undertakings in export-based activity (fisheries, power-intensive industry, etc.) as well as state and municipal activity.

(56) However, this view is contrary to the view expressed in the submission of the Icelandic authorities, as set out in the report referred to above by the Minister of Economic Affairs to the Althingi and to the views of ICA. Moreover, as will be outlined below, Arion Bank has, despite certain reservations regarding analysis of competition conditions, decided to provide certain commitments aimed at limiting distortion of competition linked to the aid measures concerned. Those commitments are reported in the Annex.

3. DESCRIPTION OF THE MEASURES

3.1. **The beneficiary**

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

3.1.1. *Kaupthing Bank*

(58) 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). Kaupthing was primarily a northern European bank operating in 13 countries. Kaupthing offered integrated financial services to companies, institutional investors and individuals, divided into five business segments: Corporate and Retail Banking, Capital Markets, Treasury, Investment Banking and 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 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 16 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 Reykjavík and in Stockholm.

3.1.2. *Arion Bank*

(59) Kaupthing's successor, Arion Bank, is an Icelandic bank offering universal financial services to companies, institutional investors and individuals. The Bank aims to be a relationship bank with a focus on larger corporations and individuals seeking a broad range of financial solutions.

(60) The Arion Bank Group consists of the parent company and eight core subsidiaries which are an integral part of the Bank's operations ([32]).

([32]) The core subsidiaries are (main operation and the Bank's holdings are indicated in brackets): AFL-sparisjóður (savings bank; 94,45 %), Verdis hf. (securities custodian; 100 %), KB ráðgjöf ehf. (sells insurance and pension products; 100 %), Gen hf. (holding in international enterprise funds; 100 %), Okkar Líftryggingar hf. (insurance company — individual and life insurance; 100 %), Sparisjóður Ólafsfjarðar (savings bank; 99,99 %), Stefnir hf. (management company for UCITS; 100 %) and Valitor Holding hf. (payment service company; 52,94 %).

(61) In relation to the recent and ongoing restructuring of its loan book, the Bank has taken over assets that are categorised as held for sale or if the recovery work is not finished, temporary operations. According to the Bank, it nevertheless endeavours to sell such assets without undue delay ([33]).

(62) Other key shareholdings are in Auðkenni (a holding company managing security keys for online banking; 20 %) and Reiknistofa bankanna (the Icelandic Banks' Data Centre, RB; 18,05 %). Arion Bank has closed down or is in the process of closing down a total of 15 companies, where the Bank has held equity interests. These companies are either in liquidation or have no assets or no operations.

(63) The main banking products fall into four categories: Asset Management, Investment Banking, Corporate Banking and Retail Banking, as further outlined below.

Asset Management

(64) This division consists of Sales and Services, Private Banking, and Institutional Asset Management. The Bank's subsidiary, *Stefnir* Asset Management Company, operates the fund management business and Arion Bank Asset Management is the main fund distributor. Asset Management is a leading participant in the Icelandic market with assets under management at Arion Bank and subsidiaries in excess of 659 billion ISK at the end 2011.

(65) Asset Management is responsible for managing assets on behalf of its clients, including institutional investors, corporations, high net worth clients and retail investors. It serves clients with differing investment objectives, offering a broad range of services. In addition to a variety of mutual funds, alternative investment vehicles and pension plan schemes, the division offers customised asset allocation strategies and managed accounts. The division also offers funds from other leading global fund management companies.

Investment Banking

(66) Investment Banking provides various services to corporate clients through its four main product areas:

— M&A advisory

— Capital market transactions

— Acquisition and leverage finance

— Principal investments.

(67) The division aims to combine advisory with the Bank's financing capabilities, creating an integrated solution for clients, in close cooperation with other divisions of the Bank, in particular Capital Markets and Corporate Banking.

([33]) In this regard, the Bank distinguishes between three types of assets. Firstly, the Bank's asset management company Eignabjarg ehf., which manages shares in viable operating companies that the Bank has taken over. This comprises shareholdings in the following companies (main operation and the Bank's shareholding indicated in brackets): Hagar hf. (a commercial enterprise operating in Iceland; 5,98 %), Penninn á Íslandi ehf. (a retail company specialising in stationery and office supplies; 100 %), Reitir fasteignafélag hf. (associate company of Eignabjarg hf. specialising in real estate; 42,65 %) and Fram Foods ehf. (food industry; 100 %). Secondly, other assets held for sale, comprising shareholdings in the following companies: Langalína 2 ehf. (holding company; 100 %), Umtak fasteignafélag ehf. (real estate; 100 %), EAB 2 ehf. (food industry; 100 %), Farice ehf. (operation of submarine data cable to neighbouring countries; 43,47 %), Sementsverksmiðjan ehf. (produce and import of cement; 33 %), HB Grandi hf. (fishing company; 33 %) and GO fjárfestingar ehf. (mushroom production; 30 %). Thirdly, assets are held as temporary operations as shareholdings in the following companies: Landey (holding company dealing with non-revenue generating properties; 100 %), Landfestar (operating company around commercial real estate acquired by Arion Bank from financially distressed clients; 100 %), Rekstrarfélagið Braut ehf. (pork farm; 100 %), NS 1 ehf. (owns land and leases out lots for holiday homes; 100 %), Módelhús ehf. (property and real estate; 100 %), EAB 1 ehf. (land and properties; 100 %), Andvaka ehf. (business and management consulting; 50,11 %), Klakki ehf. (former Exista — holding company; 44,9 %), Ölgerðin Egill Skallagrímsson ehf. (production, distribution and sale of soft drinks and some other drinks; 20 %) and SMI ehf. (property and real estate; 39,1 %).

Corporate Banking

(68) Corporate Banking is organized into 7 departments: Corporate Lending; Specialised Lending; Legal & Documentation; Portfolio Management; Corporate Services; Recovery; and Factoring. Corporate Banking offers a range of financing services and products for its corporate clients, from medium-sized businesses to large corporations. The prime focus of the division is to maintain long-term relationships with its clients as well as deliver tailor-made solutions and personalised services.

(69) Arion Bank considers that it is at the forefront in resolving corporate debt issues and has made considerable progress with the restructuring of companies. The Recovery unit within Corporate Banking is responsible for the Bank's debt recovery, i.e. the restructuring of companies which are experiencing payment difficulties. The work has progressed well and is close to completion.

Retail Banking

(70) Retail Banking has a 30 % market share in Iceland. There are 24 branches throughout Iceland and over 100 000 customers. The branches provide a comprehensive range of services, including advice on deposits and loans, payment cards, pension savings, insurance, funds and securities.

(71) The branch network is divided into seven clusters, each with its own business manager. Smaller branches capitalise on the strength of larger units within each cluster. More executive authority and responsibility is transferred to the branches and therefore closer to the customers. According to the Bank, this arrangement helps coordinate procedures and fully harness the expertise within the branches. Four of these business managers work in the greater Reykjavík area and three in larger urban areas. This structure is designed to reinforce the links between branches in the same part of the country.

Indications of market shares

(72) According to Arion Bank's calculations, its market share in deposits, based on the annual reports of Icelandic banks and savings banks, is [> 30] % or marginally lower than the shares of Landsbankinn ([> 30 %]) and Íslandsbanki ([> 30 %]). Other market players with only minor significance are MP Bank ([< 5 %]) and savings banks (collectively [< 5 %]).

(73) Arion Bank's share in loans to customers is approximately [15-25] % or similar to that of Íslandsbanki and slightly lower than Landsbankinn. The Housing Financing Fund has the biggest share in this market, [> 25] %. When counted collectively, pension funds also have a significant share in this market or [5-10] %, while the shares of other market players are insignificant.

(74) Arion Bank's market share in trade on the Icelandic Stock Exchange measured by turnover in the first 14 weeks in 2012 was [10-20] %, but the shares of each of the other commercial banks, Íslandsbanki, Landsbankinn and MP Bank, were [20-25] %.

3.2. **Comparing the old and the new bank**

(75) An indicative comparison of key financials in the old and new banks' balance sheets presented in Table 1 reveals a vast difference in the size and scope of the two operations ([34]). Arion Bank's total assets 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

([34]) Significant changes have occurred in Arion Bank's key financial indicators since its inception, but it is nevertheless appropriate to compare the two banks with reference to data close in time. It is recalled that Kaupthing was an international bank with operations in various countries, but Arion Bank was established to take over certain domestic operations and assets of Kaupthing Bank.

category. The book value of Kaupthing Bank's loan portfolio at the end of June 2008 was 4 169 billion ISK compared to Arion Bank's loan portfolio of 358 billion ISK at the end of 2009, 8,6 % of that of Kaupthing. There is also a significant change in securities holdings of Arion Bank compared to Kaupthing Bank. Shares and derivatives are reduced by 96-100 %. The reduction is smaller as regards bonds, as bonds held by Arion Bank amounted to 25,7 % of Kaupthing Bank's holdings.

Table 1

Comparison of Arion Bank and Kaupthing Bank balance sheets, amounts in billion ISK

	Kaupthing 30.6.2008	Arion 31.12.2009	Arion as % of Kaupthing
Total assets	6 603	757	11,5
— Loans and receivables to customers	4 169	358	8,6
— Bonds and debt instruments	676	173	25,7
— Shares and equity instruments	172	7	4,1
Total liabilities	6 166	667	10,8
— Deposits	1 848	495	26,8
Total equity	438	90	20,6

(76) The income statements of the two entities display a similar difference is 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 and net fee and commission income of Arion was 10,7 % of that of Kaupthing. 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 ([35]). Comparing the Icelandic operations of both banks, Kaupthing 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.

Table 2

Comparison of Arion Bank and Kaupthing Bank income statements, amounts in billion ISK

	Kaupthing 2007	Arion 2009	Arion as % of Kaupthing
Net interest income	80	12	15,2
Net fee and commission income	55	6	10,7
Operating income	166	50	29,9
Earnings before income tax	81	15	19,0

([35]) 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 %.

3.3. **National legal basis**

(77) The national legal basis for the aid measures is as follows:

— *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 aid measures**

(78) The Icelandic authorities' intervention following the failure of Kaupthing Bank has been described above, and was set out in more detail in the opening decision. The essence of the interventions can be summarised as follows: The FME took control of Kaupthing on 9 October 2008, and domestic liabilities and (most) domestic assets were transferred to New Kaupthing. The old bank's estate was to be compensated for this transfer by receiving the sum of the difference between assets and liabilities. As determining this difference proved to be difficult and time-consuming, the State provided some initial capital and a commitment to contribute further capital if need be. It then capitalised the bank, before finally an agreement was reached between the State and the old bank on 1 December 2009, which led to the State's stake in the bank being reduced from 100 % to 13 % [36]. The Authority considers this date — 1 December 2009 — to mark the beginning of the 5 year restructuring period, which will consequently last until 1 December 2014.

(79) The following section is limited to describing those aspects of the State's intervention that constitute measures relevant for assessment under Article 61 of the EEA Agreement.

3.4.1. *Tier I capital*

(80) The State provided Tier I capital twice — once, when New Kaupthing was created, and then again when it capitalised the bank fully (and retroactively); followed by an agreement with the old bank on behalf of its creditors according to which the State retained a 13 % stake in the bank.

3.4.1.1. Initial capital

(81) Following the establishment of New Kaupthing Bank in October 2008, the State provided 775 million ISK [37] (5 million Euros) in cash as initial capital to the new bank and in addition issued a commitment to contribute

[36] However, it was only on 8 January 2010 that the agreements were formalised, when Kaupthing, on behalf of its creditors, through its subsidiary Kaupskil ehf. took ownership of Arion Bank, following approval by the FME and the Icelandic Competition Authority. Kaupskil holds 87 % of common equity and the Icelandic State Financial Investments (the ISFI) 13 %. Kaupskil has a call option to buy the government's stake at a later point.

[37] 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.

up to 75 billion ISK in total as Tier I risk capital to the new bank in return for its entire equity. The former figure corresponds to the minimum capital required under Icelandic law for the foundation of a bank. The latter 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 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.

3.4.1.2. Capital injection and retention of a 13 % stake as a part of the settlement with the creditors of the old bank

(82) 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 New Kaupthing Bank (renamed Arion Bank as from 21 November 2009) and the basis for the compensation payable between the two parties. 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 Kaupthing Bank would not complete the subscription for shares in Arion Bank, the Government would retain full ownership.

(83) 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 bank a Core Tier I ratio of approximately 12 %. 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. Total Government share capital was therefore 72 billion ISK. In addition, the accrued interest on the government bond amounted to 9,2 billion ISK.

(84) On 4 September 2009 the Government announced that definitive agreements had been reached regarding the capitalisation of Arion Bank and the basis for compensation. In line with the heads of agreement of 20 July 2009, the agreement principally contained provisions for two alternative agreements: capitalisation under old bank (creditor) ownership (Joint Capitalisation Agreement) or capitalisation under Government ownership (Alternative Capitalisation Agreement) ([38]). Under the former agreement, the creditors of Kaupthing had an opportunity to acquire (through the Resolution Committee) control of Arion Bank by subscribing to new share capital. As the value of the liabilities transferred to Arion Bank exceeded the value of the assets transferred, Kaupthing was to pay for the new share capital from the old bank's own assets. 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. The Government would hold minority ordinary share capital, amounting to 13 % 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 ISK.

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

([38]) Under the Government ownership agreement — which did not materialise — the Government would continue to fully own the bank, in the event that Kaupthing's Resolution Committee decided not to acquire control of Arion Bank. The compensation would also in this case come from Kaupthing to Arion Bank and in the same form as under the Joint Capitalisation Agreement, i.e. a compensation instrument calculated at 38 billion ISK. 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.

(86) Kaupthing paid for the acquisition 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.

(87) 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 12,2 billion ISK for its 13 % share in Arion.

3.4.2. *Tier II capital contribution*

(88) The state also provided the new bank with two subordinated loans in order to strengthen its equity and liquidity position. Instrument A, denominated in foreign currency, corresponded at the time to an amount of 29,5 billion ISK. The loan was in the form of a capital instrument providing for Arion Bank to issue unsecured subordinated notes. Instrument B was in the amount of 6,5 billion ISK, and was used by Arion Bank for payment to the State of retained earnings (dividends) over the period until the Joint Capitalisation Agreement took effect. The Tier II instruments provided by the Government were based on a need to ensure a strong capital structure and were in accordance with the requirements of the FME.

(89) The term of instrument A is 10 years as of 30 December 2009. It 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 10 years the interest rate is 500 basis points above EURIBOR. The terms of instrument B are the same, except that for the first three years, the interest rate is 300 basis points above EURIBOR.

3.4.3. *Deposit guarantee*

(90) In order to comply with Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes ([39]) and Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit guarantee schemes ([40]), Iceland adopted Act No 98/1999 on deposit guarantees and investor-compensation scheme and thereby set up the so-called Depositors' and Investors' Guarantee Fund ('TIF'), which has been funded by annual contributions from the banks, calculated in relation to the total deposits of that bank.

(91) According to the Icelandic authorities, and so as to provide further assurance and comfort to the general public on the safety of their deposits when the crisis struck, the bank rescue measures of the Icelandic Government of autumn 2008 also entailed an additional state backing of deposits in domestic commercial and savings banks, outside the scope of Act No 98/1999 implementing the deposit guarantee Directive 94/19/EC and the investor-compensation Directive 97/9/EC.

(92) An announcement from the Prime Minister's Office of 6 October 2008 stated that the 'Government of Iceland underlines that deposits in domestic commercial and savings banks and their branches in Iceland will be fully covered'. This announcement has since been repeated by the Office of the current Prime Minister in February and

([39]) OJ L 84, 26.3.1997, p. 22.
([40]) OJ L 135, 31.5.1994, p. 5.

December 2009. 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.' 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 ([41]).

(93) A recent statement of the current Minister of Economic Affairs and former Minister of Finance (2009-2011), Steingrímur Sigfússon in a debate in the Icelandic Parliament regarding the Government's cost related to Landsbankinn's taking over the savings bank SpKef, illustrates the above further. According to the Minister, one must keep in mind regarding this matter the State's declaration in the autumn of 2008 that all deposits in savings banks and commercial banks would be safe and protected. 'Work has since in all instances been based on this (i.e. the declaration) and it is unfortunately correct that this (i.e. payments due to SpKef) will be one of the bigger bills footed directly by the state as costs for securing the deposits of all inhabitants of Suðurnes … and all SpKef's clients in the West Fjords and the West and North-West area … I do not expect that anyone has thought that deposit holders in those areas would be treated differently from other inhabitants, so the state did not have much of a choice in this matter' ([42]).

(94) According to the Icelandic Government, the additional deposit guarantee will be lifted before the capital controls are fully abolished, which according to the Icelandic authorities is currently foreseen for the end of 2013.

3.4.4. *Special Liquidity Facility*

(95) 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, 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. 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 the SPRON swap arrangement described below.

3.4.5. *The SPRON swap agreement*

(96) On 21 March 2009, using it 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

([41]) See the relevant section of the bill for the Budget Act 2011 available at: http://hamar.stjr.is/Fjarlagavefur-Hluti-II/GreinargerdirogRaedur/Fjarlagafrumvarp/2011/Seinni_hluti/Kafli_8.htm

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

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. However, the parties have so far been unable to reach an agreement on the interest to be paid on the bond [43].

(97) In heads of terms signed on 17 July 2009 the Government agreed to hold Arion Bank harmless with respect to the value of the SPRON bond. The parties further agreed to work towards the SPRON bond being made eligible as collateral for funding from the CBI.

(98) 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 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. This commitment by the Government was later formalised in an agreement dated 21 September 2010 on the loan of government bonds to Arion Bank to be used as collateral [44]. This 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 [45].

3.5. **The restructuring plan**

(99) The Icelandic authorities submitted a restructuring plan for Arion Bank on 31 March 2011 and an amendment of that plan on 26 October 2011. An updated restructuring plan was submitted on 30 April 2012 together with a 5 year business plan and an Internal Capital Adequacy Assessment Process (ICAAP) report dated April 2012. The ICAAP report was submitted to the FME in April 2012.

([43]) The disagreement between the parties regarding the interest rate on the bond was initially referred to the FME. The FME decided on 5 June 2009 that under the circumstances a rate of REIBOR + 1,75 % was an appropriate rate. In its decision, the FME declared that it would review its decision every six months at the request of the parties. However, the dispute was later brought to court and is unsettled at the time of writing. According to Arion Bank's annual report 2011, Drómi requested, in a letter dated 2 December 2009, that the FME review its former interest rate decision. On 4 February 2011 the FME decided that the debt should bear annual interest rate which should be the original given interest rate plus the original given interest premium from the takeover date until 30 June 2010, but without an interest premium from that time until the debt has been paid in full. The Arion Bank has brought legal action against the FME and Drómi in an attempt to annul the FME's decision of 4 February 2011. On 4 May 2011, Drómi brought legal action against the FME and Arion Bank, demanding principally the annulment of all decisions by the FME on interest rates and secondly demanding a different interest rate from the outset.

([44]) 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.

([45]) 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.

(100) The restructuring plan addresses the substantive issues of viability, burden-sharing and limitation of distortions of competition. According to the restructuring plan, Arion Bank has solely operations in Iceland and aims to focus on traditional universal banking services.

3.5.1. *Description of the restructuring plan*

(101) The Icelandic authorities and the Bank consider that the restructuring of Arion Bank will ensure its return to being a solid, well-funded bank with sound capital ratios so that it can maintain its role as a supplier of credit to the real economy. Based on the information in the restructuring plan and the answers to questions from the Authority, this will be achieved through the following steps:

(i) Setting the long-term strategic direction, scaling down the operations and limiting risk exposure

(ii) Achieving and maintaining a strong capital position and satisfactory profitability

(iii) Maintaining a solid liquidity position and improving the funding structure

(iv) Restructuring of household and corporate loan portfolios

(v) Limiting foreign exchange imbalances

(vi) Rationalising the branch network and achieving cost efficiency

(102) Before describing the restructuring plan in more detail, it is appropriate to set out briefly the Bank's view on how the flaws that contributed to Kaupthing's demise are being addressed in the restructuring plan for Arion Bank. In this regard, it has been underlined that while Arion Bank's operations are based on the domestic operations and assets of Kaupthing Bank, it is nevertheless a new bank, with different commercial objectives and ownership, board of directors and management different from that of Kaupthing. The current management of Arion Bank has in fact stated that it considers itself not to be in a position to speculate on the specific weaknesses or the collapse of Kaupthing. Otherwise, Arion Bank refers firstly to the SIC report discussed above regarding the causes for the collapse of Kaupthing Bank. Secondly, it is pointed out that following the collapse of Kaupthing, actions has been taken to strengthen the infrastructure after an assessment of risk management and governance made by the FME.

(103) According to Arion Bank, two projects are particularly relevant regarding actions taken at the Bank in response to the above assessment. Firstly, regarding large and connected exposures. It has been alleged that Kaupthing held a 'legalistic' view of the treatment of connected exposures, allowing it to engage in lending to connected or related parties in excess of the legal limit of 25 % of risk capital. Through this project Arion Bank has extended its definitions of connected parties, and applies stricter processes in this regard, where Arion Bank's Risk Management has the ultimate authority if disputes arise. Large exposures are rigorously monitored and reported and as part of the credit granting process, a special report is given when the granting of credit would result in a large exposure. Changes to Icelandic legislation on financial institutions made following the crisis have significantly curtailed the ability of banks to lend to related parties. Lending to owners or key employees can no longer exceed 1 % of risk capital and can only be made against quality collateral.

(104) Secondly, more scrutiny is applied to cross-ownership and indirect exposures. Kaupthing Bank allegedly engaged in lending against its own shares which was certainly risky and possibly beyond the limits set by the Icelandic companies act. Changes to Icelandic legislation now make it impossible to engage in any lending against own shares or to engage in contracts where own shares are the underlying risk.

Assumptions of the restructuring plan

(105) The restructuring plan is prepared for the parent company as a part of the ICAAP process and also takes into account the effects of the subsidiaries. It is based on a set of general and economic assumptions, constituting the economic underpinning of the base case and stress case scenarios set out below.

(106) The assumptions include the following:

— Economic, legal, political and regulatory uncertainties are still considerable in the Bank's operating environment and do affect its long-term forecast. For these reasons, no major changes are assumed in the Bank's operating activities.

— Macroeconomic assumptions are based on a forecast prepared by Arion Bank's Research division, which includes the following key variables:

Table 3

From Arion Bank Research Division economic forecast

Percentage change from previous year	2012	2013	2014
GDP growth	3,0	3,9	3,5
Unemployment	6,2	5,3	4,9
Inflation	5,5	6,1	5,9
Reibor (*)	4,9	5,8	5,6
Libor	0,5	0,5	0,5
Euribor	1,0	1,0	1,0
Wages	9,2	9,7	8,4
ISK exchange rate index (TWI) (**)	4,9	5,0	5,0

(*) REIBOR (Reykjavik interbank offered rate) is the interbank rate used by commercial and savings banks in Iceland and is applied to short term loans.
(**) Trade-weighted exchange rate index of the Icelandic króna.

— The Bank also makes assumptions in relation to for instance its market position, opportunities and threats, internal data and market development, including so-called key beliefs ([46]).

— On-going growth is expected, driven mainly by consumption ([47]).

— Consumption will continue to be driven by special measures (pension withdrawals and recalculations of foreign exchange loans, etc.). In addition, increasing housing prices will contribute to household wealth. A decrease in unemployment will also help to boost consumption.

— During the financial crisis since 2008, investment as a percentage of GDP has been below past 50 years' minimum, but is expected to gradually pick up for the remainder of the restructuring period.

— In line with the forecast increase in investment activity, the Bank expects demand for new loans to increase and its loan book to grow in the restructuring period.

— Imports will increase more than exports but will reach a balanced level at the end of the forecast period.

— Inflation and interest rates play a key role in the Bank's business and restructuring plan ([48]). It is assumed that inflation will remain high throughout the forecast period.

— A 5 % weakening of the króna is expected, on average, throughout the forecast.

— Arion Bank expresses doubts about the strategy related to the lifting of the capital controls and assumes that they will remain in place during the forecast period ([49]).

(i) Setting the long-term strategic direction, scaling down the operations and limiting risk exposure

(107) With a swift transformation from a Northern European bank with operations in 13 countries to a bank that has solely operation in Iceland, Arion Bank was faced with countless challenges, both internal and external, that needed to be addressed and overcome. The revaluation of transferred assets from Kaupthing to Arion Bank was

([46]) Among the Bank's key beliefs is that […].

([47]) Despite various difficult issues remaining unresolved, the Icelandic economy has, according to Arion Bank, shown clear signs of recovery in the past year, with the economy growing for the first time since the start of the financial crisis and the unemployment rate dropping.

([48]) The Bank notes that in 2011 the depreciation of the ISK, high global commodities prices in the first half of the year and contractual wage increases all contributed to an annual rate of inflation of 5,3 % at the end of the year. The inflation outlook for the next few years is not promising and inflation is likely to exceed the CBI's target of 2,5 %. In response to increasing economic activity and the deteriorating inflation outlook the CBI raised interest rates twice during 2011 by a total of 50 basis points and by a total of 75 basis points in the first half of 2012. The business plan assumes this development to continue in 2012-2014.

([49]) In this regard, Arion Bank states that although there are signs of a recovery in the Icelandic economy, there are a number of problems still to be resolved; one of the problems being the lifting of the capital controls. The lifting of capital controls has progressed slowly although the CBI announced a liberalization schedule in March 2011 which listed a number of measures aimed at lifting controls over the next four years. However, later in the year the Icelandic parliament decided merely to extend the laws on foreign currency (and thus the capital controls) until 2013. The CBI has therefore been given little room for manoeuvre by the parliament if the controls are to be lifted over the next two years. As a matter of fact, the capital controls were tightened in March 2012, with amendments to the Foreign Exchange Act. The strategy related to the lifting of the capital control is not clear and therefore it is assumed that the capital controls will remain in place during the forecast period.

one of them. Additionally the Bank's infrastructure had to be scaled down, and the Bank had to adjust to the new economic reality where many corporations, individuals and households found themselves with a severely diminished ability to service their debt.

(108) Many of the numerous challenges faced by the new bank were thus directly related to the circumstances surrounding its establishment. The transfer of domestic assets and liabilities from the estate of Kaupthing to Arion Bank created some unfavourable risk exposures for the Bank. However, in the broad efforts made to aligning the Bank's operations to a new economic reality, considerable success has been achieved in bringing the Bank's risk exposure down to a controllable level. The focus has been on:

— Debt recovery of distressed loans ([50]).

— Reducing the currency imbalance ([51]).

— Reducing the credit concentration towards large and connected clients ([52]).

— Increasing the capital level ([53]).

— Increasing term deposits and securing alternative funding sources ([54]).

— Reducing the inflation risk due to the Consumer Price Index (CPI) imbalance ([55]).

(109) During 2010, the long-term strategic direction for the Bank was set. According to Arion Bank, its customer portfolio is already leaning towards its goal of becoming a relationship bank and it is believed that this kind of banking model can be fully achieved.

(110) The organizational structure of the Bank has been simplified since its establishment ([56]) and corporate governance standards have been introduced, ensuring disclosure and transparency and increased accountability. The role and functions of support divisions, in particular the Risk Management division, have been enhanced. The division is independent and centralised and reports directly to the CEO. The CEO and the Board of Directors are responsible for defining and articulating a risk appetite for the Bank's operations. Risk appetite is translated into exposure limits and targets that are monitored by Risk Management, which reports its findings regularly to the CEO and the Board of Directors.

(111) The FME chose Arion Bank to take over all of the deposit obligations of Reykjavík Savings Bank (SPRON). In April 2009, the Bank acquired the regional Mýrasýsla Savings Bank (SPM), including all its assets and certain

([50]) Efforts regarding the restructuring of the loan book have resulted in a reduction of the non-performing ratio from 37 % at the end of 2010 to 13 % at the end of 2011. This progress made in the resolution of distressed borrowers, decreases substantially the uncertainty linked to the assessment of the loan book's carrying value.
([51]) The currency imbalance has decreased from 300 % of the Bank's capital base at the end of 2008, to 30 % of the capital base at the end of 2011.
([52]) The Bank had […] groups exceeding 10 % of capital base end of year 2009. These groups summed up to 175 % of the capital base. At the end of year 2011 the Bank had […] groups exceeding 10 % of the capital base totalling 87 % of capital base.
([53]) The total capital base has increased by 20,7 billion ISK from 2009 to 2011.
([54]) Term deposits have increased from 10 % to 23 % from the end of year 2009 to end of year 2011.
([55]) The CPI balance has been reverted from minus 17 % of the Bank's capital base at the end of 2009 to plus 9 % of capital base at the end of 2011.
([56]) After the intervention of the FME in October 2008, structural changes were made. Internal audit and Compliance were strengthened and Private Banking was merged with Asset Management and Treasury with Capital Markets. Following the new strategic direction and with new management joining the Bank in the fall of 2011 further substantial changes were made to the organizational structure to ensure that it better reflects and supports the Bank's new strategy, simplifies operations and increase synergies between divisions.

liabilities such as deposits ([57]). These actions brought 22 000 new customers to the Bank without expanding its existing branch network.

(112) On 22 December 2011 Arion Bank acquired the former Kaupthing Mortgages Institutional Investor Fund, KMIIF (now named Arion Bank Mortgages Institutional Investor Fund, AMIIF) ([58]).

(113) In 2012, the securities custodian Verdis, a fully owned subsidiary of the Bank, will be merged with the Bank. […].

(ii) Achieving and maintaining a strong capital position and satisfactory profitability

(114) As can be seen in Table 4, Arion Bank has been profitable since establishment, with return on equity (ROE) ranging between 10,5 and 16,7 %.

Table 4

Financial overview 2009-2011 and forecast 2012-2014

(The data is for the parent company. Effects of subsidiaries are taken through other income. Amounts in million ISK)

	2009	2010	2011	2012	2013	2014
Net interest income	14 258	24 440	25 480	[…]	[…]	[…]
Valuation change in loans	9 642	29 722	20 037	[…]	[…]	[…]
Commission income	3 914	3 379	4 454	[…]	[…]	[…]
Net financial income	13 460	– 5 681	1 223	[…]	[…]	[…]
Other income	1 713	1 047	4 364	[…]	[…]	[…]
Total income	42 988	52 908	55 559	[…]	[…]	[…]
Operating expenses	– 13 133	– 14 226	– 15 791	[…]	[…]	[…]

([57]) SPM had been experiencing financial distress for several months, seeking composition agreements with its creditors under the bankruptcy law, as its CAD ratio was below legal requirements. These efforts failed, however, and on 3 April 2009, an agreement was concluded between SPM and New Kaupthing, according to which New Kaupthing bought all assets of SPM, including the branch in Borgarnes, Iceland, as well as SPM's subsidiaries, including two savings banks in Northern Iceland, Afl Savings Bank and Ólafsfjörður Savings Bank (SPÓL). At the same time, New Kaupthing took over certain liabilities of SPM, including deposits and borrowings, as set out in the agreement. On the same day the FME took a decision on the disposal of assets and liabilities of SPM. The FME decision does not indicate any government intervention in the form of capital injection, commitments or declarations provided. It has furthermore been confirmed to the Authority by the Bank and the Icelandic authorities that no financial commitments were made by the state in this context. See the FME's decision of 3 April 2009, available at http://www.fme.is/media/akvardanir/3.-april-2009.pdf

([58]) The background to this transaction is that Kaupthing issued four series of covered bonds in 2006-2008, guaranteed by the Kaupthing's subsidiary KMIIF. Through KMIIF, Kaupthing owned a portfolio of Icelandic residential mortgages in excess of 120 billion ISK. The purpose of the covered bond was to fund a large part of Kaupthing's mortgage portfolio. According to the agreement of 22 December 2011, Arion Bank has acquired this mortgage portfolio. The deal was funded mostly by the acquisition of covered bonds in the amount of 117,7 billion ISK, as Arion Bank has assumed Kaupthing's liabilities under the covered bond programme. In the Arion Bank's opinion, the acquisition of AMIIF can neither be categorised as a 'normal' acquisition nor as an acquisition related to the restructuring work. The acquisition was related to the setup of the Bank where AMIIF was not transferred to Arion Bank when it was established. Before the transfer Arion Bank provided services to borrowers without having control over the loans. In addition, the borrowers with mortgages in the fund believed they were customers of Arion Bank. After the transfer the loans are owned by Arion Bank. As stated, the agreement on the above transaction was concluded between Kaupthing and Arion Bank and was without any involvement or commitment made by the Icelandic state.

	2009	2010	2011	2012	2013	2014
Impairment	− 14 470	− 23 067	− 26 582	[…]	[…]	[…]
Net earnings before taxes	15 384	15 614	13 186	[…]	[…]	[…]
Taxes and bank levy	− 2 414	− 2 897	− 2 692	[…]	[…]	[…]
Net earnings	12 971	12 717	10 494	[…]	[…]	[…]
Return on equity (ROE)	16,7 %	13,4 %	10,5 %	[10-20] %	[5-15] %	[5-15] %
Net interest margin	…	…	3,6 %	[…] %	[…] %	[…] %
Cost-to-income ratio	…	…	44,8 %	[…] %	[…] %	[…] %

(115) During 2009-2011, irregular items have had a major impact on the profit and loss account, in particular as concerns valuation change in loans. The Icelandic authorities have provided information on the total loans and discounts obtained from the old bank ([59]). The total face value of the loans transferred was 1 230 billion ISK and the book value 459 billion ISK. The total discount was thus approximately ISK 771 billion. When conditions have permitted, the loans have been re-valued, leading to a valuation change in loans, as indicated in Table 4 ([60]). However, for the remainder of the restructuring period, valuation change in loans are forecasted to be unsubstantial. The Bank's profitability will therefore not any longer depend on this irregular item.

(116) The capital requirements set by the FME as a condition for granting an operating license to Arion Bank was 12 % for the Tier 1 capital and 16 % for the total capital (CAD ratio). The Bank's capital policy is to maintain a strong capital base to support business development and to meet regulatory capital requirements, even in times of stress. Long-term capital planning at the Bank is currently based on a benchmark minimum of […] % for Tier 1 capital and a total CAD ratio of […] %. The capital position of the Bank has been strengthening gradually during 2009-2011 and has exceeded both the FME capital requirements and the Bank's internal targets. At the end of 2011, the Bank's CAD ratio was 20,5 %, with a Tier 1 ratio of 15,7 %.

Table 5

Capital ratios year-end 2009-2011 and forecast 2012-2014

(The data is for the parent company. Effects of subsidiaries are taken through other income. Amounts in million ISK)

	2009	2010	2011	2012	2013	2014
Tier 1 capital	88 302	98 715	106 459	[…]	[…]	[…]
Tier 2 capital	29 543	26 257	32 105	[…]	[…]	[…]
Total capital	117 845	124 972	138 564	[…]	[…]	[…]

([59]) These loans are grouped into mortgage loans and other loans from individuals and loans to corporate. The discounts differed depending on the types of loans as well as whether they were denominated in króna or foreign currency.

([60]) The increase in valuation of loans was, however, bigger in 2009-2011 than indicated in Table 4, as part of it was allocated to the compensation instrument, a total of 38 billion ISK. The compensation instrument was closed in the first quarter of 2011, as the valuation gap between assets and liabilities transferred from Kaupthing to Arion Bank was paid up in full.

	2009	2010	2011	2012	2013	2014
Risk-weighted assets	685 702	678 563	675 998	[…]	[…]	[…]
Tier 1 ratio	12,9 %	14,5 %	15,7 %	[15-20] %	[15-20] %	[15-20] %
CAD ratio	17,2 %	18,4 %	20,5 %	[20-25] %	[20-25] %	[20-25] %

(117) The Bank's assessment, according to the ICAAP report of April 2012, is that a capital of […] billion ISK is needed to cover its risk exposure. The Bank has a capital base of […] billion ISK and thus holds a capital buffer of […] billion ISK. Based on the current Risk Weighted Amount this translates to a capital ratio of […] %.

(118) It has been the policy of Arion Bank to refrain from paying dividends until 2013. This policy will only be altered in cooperation with the FME and only if Arion Bank and the FME jointly determine that a sustainable turnaround of the Icelandic economy has been achieved.

(iii) Maintaining a solid liquidity position and improving the funding structure

(119) Regarding liquidity, the FME requires that the bank must hold secured liquidity reserves of at least 20 % of deposits and cash reserves of 5 % of on-demand deposits. In addition, the Central Bank of Iceland sets rules on credit institutions' liquidity ([61]) according to which credit institutions' liquid assets and liabilities are classified by type and maturity and assigned weights according to risk. Credit institutions must have liquid assets in excess of liabilities within one month and after one month and up to three months. The rules also entail a certain stress test where a discount is applied to various equity items, but where it is assumed, on the one hand, that all obligations must be paid upon maturity, and on the other, that a portions of other obligations, such as deposits, must be paid at short notice or none at all.

(120) The Bank's liquidity ratios during 2011-2012 are set out in the graph below. It is apparent that the Bank has maintained a solid liquidity position, surpassing the requirements of the FME both with respect to the cash ratio requirement and the broader requirement of secured liquidity. According to the Bank's plans for 2012-2014, it will maintain a cash ratio between […] — […] % and a liquidity ratio of […] — […] %. The Bank has also complied with the CBI liquidity rules as its liquidity ratios (more than 1 and up to 3 months) at year end 2009-2011 have been in the range of 1,5-2,1.

Chart 1

Arion Bank's liquidity ratios 2011-2012

[***Graph on Arion Bank's liquidity ratios under FME rules***

Values not disclosed for reasons of professional secrecy]

(121) While the Basel III liquidity requirements are not yet mandatory, Arion Bank has begun voluntary monitoring of the Liquidity Coverage Ratio (LCR) ([62]) according to those rules, and at year end 2011 its LCR was […] %.

(122) Arion Bank is to a large degree deposit-funded, but steps have been taken to diversify the funding by issuing covered bonds. In November 2011, Arion Bank was granted a license by the FME to issue statutory covered bonds. In February 2012, a EUR 1 billion covered bond program was completed. The funds will be used to finance Arion Bank's mortgage lending. It is recalled that at the end of 2011, Arion Bank bought the KMIIF mortgage fund, taking over the outstanding amount 127 billion ISK in covered bonds and continued as the issuer of covered bonds. The Bank deems that issuance of covered bonds in the domestic markets will meet the refinancing needs of the Bank and funding of new loans in the period 2012-2016.

([61]) See the CBI's Rules on Liquidity Ratios No 317 of 25 April 2006, available at http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=4713
([62]) The LCR requires banks to maintain a stock of high quality liquid assets that is sufficient to cover net cash outflows for a 30-day period under a stress scenario. The LCR benchmark is thus 100 %.

(iv) Restructuring of household and corporate loan portfolios

(123) One of the most important tasks facing the Icelandic financial sector was the restructuring of household and corporate debt. This is a complex and sensitive issue with a number of financial, economic and ethical considerations.

(124) According to Arion Bank's submission, restructuring of the loan book has been a high priority and the Bank considers that it has been at the forefront in resolving corporate and household's debt issues and achieved good progress in that regard. A corporate recovery unit was set up at the Bank in 2009 and asset management companies were established for the management of foreclosed assets. The Bank has introduced a range of customized solutions designed to help households and individual borrowers tackle their debts.

(125) Corporate clients who have been unable to meet their obligations have entered the Bank's debt recovery process. The objective is to turn insolvent companies into solvent companies with a healthy balance sheet, thus enabling them to take on future business and contribute to the development of the economy. At the end of 2011, 986 companies had entered the Bank's corporate recovery programs, and conclusion was reached in 871 instances. In the Bank's view, the corporate debt restructuring is expected to be largely completed by the end of 2012.

(126) As for the restructuring of household debt, more than 14 000 personal customers have taken advantage of the Bank's debt solution packages, including the special debt relief programme. At the end of 2010, the Bank has also set up a dedicated debt advisory service for personal customers. In the Bank's view, this arrangement was important, given the high number of difficult debt recovery cases to be dealt with. The Bank aims to complete its household debt restructuring in 2012.

(127) The goal of the debt recovery programs is to improve asset quality. The share of non-performing loans has fallen from 37 % at the end of 2010 to 13 % at the end of 2011. At the end of 2011, 56 % of the loans in the loan book were categorised as performing, 18 % were 'on watch', 13 % sub-performing and 13 % non-performing.

(v) Measures to limit foreign exchange imbalances

(128) Foreign exchange (FX) loans in the loan portfolio are divided into FX/FX loans and FX/ISK loans. FX/FX loans are loans where the customers generate FX income but the FX/ISK loans are loans in FX where the customers generate ISK income. The Bank's FX imbalance is mainly due to the FX/ISK part. During 2010 and 2011 the Bank has made progress toward lowering its FX imbalance. The imbalance will continue to decrease during 2012 with redenomination of foreign currency loans to individuals into ISK as well as actions taken to encourage companies with limited foreign currency income to re-denominate their loans into ISK. There is still a legal uncertainty regarding the FX loans, but the Bank aims to reduce the FX/ISK imbalance so that by the end of 2012 the imbalance will be within CBI requirements.

(vi) Rationalization of the branch network and achieving cost efficiency

(129) In Arion Bank's view, the Icelandic market is 'over banked' in comparison with comparable economies. Banks will be forced to reduce cost to remain competitive. Arion Bank has focused on controlling its cost levels and considers that it has been at the forefront of the much needed rationalization within the financial sector.

(130) Arion Bank has streamlined the business by reducing the number of employees and rationalising the branch network. In March 2011 the rationalisation of the branch network was completed when three branches in the Reykjavík area were merged into one. A total of 15 branches have been closed and the remaining network of

24 branches is, according to the Bank, cost efficient while maintaining a high level of attention to customer needs. In relation to the above changes the Bank has reduced its workforce by approximately 10 % during 2011. Cost levels have been kept under firm control and the cost-to-income ratio is already down to 45 % at parent company level in 2011 and will be improved slightly further in 2012-2014, down to […] %.

3.5.2. *Ability to reach viability under a base and stress scenario*

(131) In the restructuring plan, with reference made to the ICAAP report, a stress scenario has been submitted for Arion Bank examining the Bank's ability to achieve long-term viability under different scenarios and risk exposures.

3.5.2.1. The base scenario

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

3.5.2.2. The stress case scenario

(133) The restructuring plan includes a stress case scenario where the base case is run under the 'Prolonged Deep Recession' (PDR) assumptions, which are based on guidelines from FME. The objective of the stress test is to examine how earnings, credit losses, capital requirements, available capital/capital buffers and liquidity positions of the Bank would evolve under stressed economic conditions. The difference is that assumptions in the PDR scenario for 2009 are now assumptions for the year 2012 and so on. The assumptions are summarised in Table 6 below.

Table 6

Main assumptions in Prolonged Deep Recession scenario (*)

(%)

	2012	2013	2014
GDP growth	– 16,0	– 3,9	– 2,8
Unemployment rate	10,6	16,6	16,9
Inflation	9,7	0,1	0,3
REIBOR	10,0	7,0	8,0

(*) This scenario is also based on further adverse assumptions. Housing prices are presumed to fall by 10 % in 2012, 18 % in 2013 and 16 % in 2014. An outflow of retail deposit of 30 % is assumed in 2012, 20 % of corporate deposits and 80 % of deposit from credit institutions. Commission income is assumed to be reduced by 50 % from the base case in 2012-2014. Lending impairment rate is assumed to be reduced by 1-3 % and lending spread by 0,5-1 %, but deposit spread will increase by 0,5-1 %. Operating expenditure is assumed to be 10 % higher than in the base case. The exchange rate of the króna is assumed to depreciate, with an increase of the trade-weighted index (TWI) of 4 % in 2013 and 11 % in 2014.

(134) The stress scenario is designed against the background of unlikely but potentially plausible changes in the economic environment in which the Bank operates. The Bank's profitability is certainly adversely affected by the severe conditions of the prolonged deep recession scenario, as its return on equity will be significantly reduced [63]. It will nevertheless make small profits and as the Bank's loan book and risk-weighted assets will shrink at the same time, its capital position will not be adversely affected [64]. The Bank's liquidity position would also remain well above the minimum requirements.

(135) The ICAAP report is based on financial figures from 31 December 2011. Its main result is that it is the Bank's assessment that a capital of […] billion ISK is needed to cover the Bank's risk exposure, based on Pillar I and II.

[63] ROE would drop down to [0-5] % in 2012, [0-5] % in 2013 and [5-10] % in 2014.
[64] The Bank's CAD-ratio will be [20-25] % in 2012, [20-25] % in 2013 and [25-30] % in 2014.

16 % of risk-weighted assets (RWA) amounts to […] billion ISK. The Bank has a capital base of […] billion ISK and therefore holds a capital buffer of […] billion ISK. The capital assessment takes into consideration stress related factors, including the impact on the Bank's loan book. According to the ICAAP report, the Bank's Risk Management focuses on identifying, assessing and measuring all material risks faced by the Bank, where the risks are grouped into four classes: credit risk (including concentration risk), market risk, operational risk and other risks (including liquidity risk, business risk and political and legal risk). Table 7 displays the various risk factors taken into account in the capital assessment.

Table 7

ICAAP results regarding capital assessment, amounts in billion ISK

	ICAAP 31.12.2011
Capital Requirement (Pillar I)	[…]
Single name concentration	[…]
Sector concentration	[…]
Interest rate risk in the banking book	[…]
Foreign exchange risk class C,D,E	[…]
Tax authorities	[…]
Valuation risk — unlisted equities	[…]
Valuation risk — loan book	[…]
Pillar II Capital Assessment	[…]
Total capital adequacy assessment (Pillar I+II)	[…]
16 % of RWA	[…]
Total Capital Base	[…]
Capital Buffer	[…]

(136) The ICAAP report states that although much progress has been made in curtailing the large imbalance between foreign currency denominated loans to customers and Icelandic currency denominated deposits, work remains in order to eliminate the remaining imbalance in 2012. At the end of 2011, the imbalances still exceeded the legal limit and dispensation from the CBI was necessary. The Bank's strategy for reducing its currency imbalance is on the one hand the systemic ISK redenomination of currency loans to customers who have income in ISK, and on the other hand the hedging of currency imbalances through agreements with the CBI and through currency swaps with Icelandic customers.

(137) Liquidity risk is one of the Bank's most important risk factors. This stems from the fact that the maturity of loans exceeds the maturity of deposits. It is the Bank's strategy to closely monitor its liquidity position and to lengthen the maturity on the liability side, through careful analysis of the stickiness of deposits ([65]) and diversification of its funding. According to the Bank's internal requirements, the secured liquidity ratio should not go under […] % of deposits and the minimum cash ratio should be […] % or slightly above the FME requirements, which are 20 % for the secured liquidity ratio and 5 % for the cash ratio. As can be seen on Chart 1 above, the Bank has remained well above the FME and internal benchmarks. Through an analysis of its deposit base, where deposits are rated into seven groups according to stickiness, the Bank has stress tested its liquidity. Assuming that the capital controls would be lifted immediately, the Bank's secured liquidity ratio would […]. The cash ratio would […]. However, the Bank has formulated contingency plans to address a potential funding crisis, and would among other things […].

3.5.3. *Exit strategy/repayment of the State*

(138) As already described above, the Tier II capital contribution has 10 year duration from 30 December 2009. As for the remuneration, there is a built in step-up clause after 5 years (i.e. 2014), from 400bp to 500bp over EURIBOR. According to the Icelandic authorities, this step-up should act as an incentive for the bank to pay back this capital as from this time.

(139) As for the 13 % equity stake that the State retains in Arion Bank, the Government's holdings in financial undertakings are managed by the Icelandic State Financial Investments (the ISFI) ([66]). According to the State Budget for 2012, the Government has been authorised to sell the stakes that it currently holds in savings banks, but no decision has yet been made regarding sale of state holdings in the three major commercial banks. A working group has however been established by the responsible ministers to explore possible ways of disposing of shareholdings in the commercial banks. The Government has indicated that while it has no intention of reducing its holdings in Landsbankinn below two-thirds of the bank's share capital, the stakes in Arion Bank and Íslandsbanki could soon be offered for sale or sold with the banks in their entirety if their majority owners decide to sell, subject to certain prerequisites being resolved.

(140) The special liquidity facility is only available until 31 December 2014, which coincides with the maturity of the SPRON bond.

4. GROUNDS FOR INITIATING THE FORMAL INVESTIGATION PROCEDURE

(141) In the opening decision, the Authority preliminarily concluded that the measures by the Icelandic State to capitalise Arion Bank, as well as the liquidity facility, entail state aid pursuant to Article 61 EEA. Furthermore it could not exclude that state aid was present in the deposit guarantee. The Authority will take a final view on these measures, which continue to have a bearing on the assessment at hand, in the present decision.

(142) As for the compatibility of the measures assessed in the opening decision, the Authority considered that a final view could only be taken on the basis of a restructuring plan, which had not been submitted when the Authority opened the formal investigation procedure on 15 December 2010. It was in particular due to the absence of a restructuring plan more than one year after the establishment of Arion Bank that the Authority expressed doubts about the compatibility of the aid.

([65]) The term 'stickiness of deposits' refers to the past stability of deposits and the projected behaviour over time.

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

4.1. **Comments from interested parties**

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

4.2. **Comments from the Icelandic authorities**

(144) The Icelandic authorities accept that measures undertaken in establishing New Kaupthing Bank, now Arion Bank, constitute state aid. In the view of the Icelandic authorities, the measures are however compatible with the functioning of the EEA Agreement on the basis of Article 61(3)(b) of the Agreement, as they are necessary, proportionate and appropriate to remedy a serious disturbance in the Icelandic economy. In the view of the Icelandic authorities the measures taken are in all aspects in line with the principles set out in the Authority's state aid guidelines. They also submit that the aid is necessary and limited to the minimum amount necessary.

(145) Moreover, the Icelandic authorities emphasise that the former shareholders of Kaupthing Bank have lost all their shares and received no compensation from the state, that the aid is well designed to minimize negative spill-over effect on competitors and that the terms of the loans (the Tier II capital) are comparable to market rates.

(146) The Icelandic authorities do not regard the deposit guarantee as entailing state aid.

4.3. **Commitments by the Icelandic authorities**

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

II. **ASSESSMENT**

1. THE PRESENCE OF STATE AID

(148) 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.'

(149) The Authority will assess the following measures ([67]) 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'. In addition, the Authority will assess:

— The special liquidity facility agreement;

— The SPRON swap agreement;

— The Icelandic Government's statement to guarantee domestic deposits in all Icelandic banks in full.

([67]) Described in detail in Chapter 3 of the present decision.

1.1. **Presence of state resources**

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

(151) Regarding the deposit guarantee, the Authority emphasises at the outset that its assessment is limited to the additional deposit guarantee described above, consisting in essence of the statements made by the Icelandic Government that deposits in domestic commercial and savings banks and their branches in Iceland will be fully covered.

(152) This assessment is without prejudice to the Authority's view on the compatibility of Act No 98/1999 and the actions of the Icelandic Government and the TIF during the financial crisis with EEA law, in particular Directive 94/19/EC. As regards the implementation of Directives 97/9/EC and 94/19/EC, the Authority is of the view that to the extent such measures constitute state aid, the use of state resources to comply with obligations under EEA law would generally not raise concerns under Article 61 EEA. The present decision is therefore not concerned with those measures.

(153) The Authority stated in the opening decision that it would investigate further whether the statements by the Icelandic State described above are sufficiently precise, firm, unconditional and legally binding such as to involve a commitment of state resources ([68]). In assessing whether these criteria are met, the Authority notes that the declarations entailed an irrevocable commitment of public resources as shown by the fact that the Icelandic state has done its utmost to protect depositors: Not only has it changed the priority of deposit holders in insolvent estates (which would not entail the use of state resources), but it has also made it clear that it would not allow depositors to suffer any losses. The Government's blanket guarantee of all deposits in domestic commercial and savings banks is furthermore distinct from any deposit guarantee scheme based on EEA acts due to the fact that the protection is unlimited in amount and no financial contribution is made by the banks benefitting from the measure.

(154) The Icelandic Government's understanding of its declaration is illustrated by the state interventions in the financial sector that have occurred sector since October 2008 which have been motivated by the intention to honour this declaration. Those interventions have included measures to cover deposits of financial undertakings, such as the foundation of the three commercial banks, the transfer of SPRON deposits to Arion Bank, the transfer of Straumur deposits to Íslandsbanki, the CBI takeover of the deposits of 5 savings banks in Sparisjódabanki Íslands, the transfer of deposits in Byr Savings Bank to Byr hf, the transfer of deposits from Keflavík Savings Bank to SpKef and the State's responsibility for deposits in SpKef following forced merger with Landsbankinn.

(155) In fact, the Icelandic authorities have argued in several state aid cases that the Authority is currently investigating, some of which were mentioned above, that the respective chosen measure was the financially least burdensome option for the Icelandic state to comply with its pledge to protect depositors in full.

(156) In the light of the above the Authority considers that there is a legally binding, precise, unconditional and firm measure in place. On this basis, the Authority therefore concludes that the statements by the Icelandic state according to which deposits are fully guaranteed entail a commitment of state resources in the meaning of Article 61 EEA.

([68]) 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 May 2010, ECR [2010] II-02099, paragraph 283 (on appeal) as well as the Opinion delivered by AG Mengozzi in the appeal case, i.e. Case C-399/10, *Bouygues*, paragraph 47, considering these conditions as too restrictive for the finding of state aid.

1.2. **Favouring certain undertakings or the production of certain goods**

1.2.1. *Advantage*

(157) First, the aid measures must confer on the new bank advantages that relieve it of charges that are normally borne from its budget. In line with the preliminary conclusion it reached in the opening decision, the Authority remains of the view that each of the capitalisation measures confer an advantage on the new bank as the capital provided would not have been available to the bank without state intervention.

(158) In determining whether an investment in an undertaking, for example by means of a capital injection, entails an advantage, the Authority applies the market economy investor principle, and assesses whether a private investor of a comparable size to that of the public body operating in normal market conditions would have made such an investment ([69]). As regards capitalisation measures for the benefit of banks in difficulties, since the onset of the financial crisis, the approach taken both by the European Commission (in numerous cases since the financial crisis began ([70]) and by the Authority ([71]) has been in general that state recapitalisations of banks amount to state aid given the turmoil and uncertainty that have characterised financial markets since the autumn of 2008. This general consideration applies in particular to the Icelandic financial markets in 2008 and 2009, when the entire system collapsed. Thus the Authority considers the capitalisation measures to confer an advantage on Arion Bank notwithstanding the eventual transfer of 87 % of the capital of the new bank to the (largely private sector) creditors. The private sector involvement in the capitalisation of Arion Bank was made up entirely of creditors of the old bank who were solely seeking to minimise their losses ([72]).

(159) Similar consideration apply in so far as the special liquidity facility is concerned, which was negotiated as part of a package of state assistance measures aiming to restore operations of a failed bank in a newly formed bank and to encourage equity participation in the new bank by the creditors of the failed bank. It is evident that the State stepped in as it was not clear if sufficient liquidity could be obtained by Arion Bank on the market. Thus, rather than acting as a private investor, the State replaced the role of private market participants who shied away from lending to financial undertakings. Therefore the Authority confirms the preliminary conclusion that it reached in the opening decision and considers the special liquidity facility as conferring an advantage on Arion Bank.

(160) Regarding the transfer of deposits from SPRON and the payment by the bond issued by Drómi — the SPRON swap agreement, the Authority notes positively that the overall transaction aims at providing Arion Bank with compensation equalling solely the amount of the transferred liabilities. However, the entire risk of the Drómi bond being of less value than the transferred deposits, and the obligation to make up for any potential shortfall, is allocated to the State. It thus seems that Arion Bank, aside from receiving revenue through interest payments on the bond, is able to acquire goodwill and additional market shares, without taking on any risk. The Authority concludes that this constitutes an advantage ([73]).

(161) Finally, the Authority also needs to assess whether the additional deposit guarantee conveys an advantage on Arion Bank and Icelandic banks in general. In this regard, the Authority notes that when the statement that deposits would be guaranteed were first made by the Icelandic authorities, it was not entirely clear how this guarantee would work in practice, in particular what effect such intervention would have on the bank that could not

([69]) See for example T-228/99 *WestLB* [2003] ECR II-435.

([70]) See for example Commission Decision of 10 October 2008 in case NN 51/2008 *Guarantee scheme for banks in Denmark*, at paragraph 32, and Commission Decision of 21 October 2008 in case C 10/2008 *IKB*, at paragraph 74.

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

([72]) 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).

([73]) This conclusion is not affected by the disagreement and legal dispute between the parties to the Drómi bond regarding the interest rate on the bond.

live up to its financial obligations vis-à-vis its depositors anymore. In the meanwhile, it appears that such a bank would be allowed to fail, but that the Icelandic State would ensure — for example by transferring deposits to another bank and making up for the shortfall in assets — that deposits could be paid in full, and the depositors would never lose access to the full amount of their deposits.

(162) The Authority considers that it is of secondary importance how exactly the State would act in complying with the unlimited guarantee on domestic deposits. What matters is that it has assumed the obligation to step in if a bank would fail to pay out deposits, to an unlimited extent.

(163) This unlimited guarantee has, in the Authority's view, favoured Arion Bank: First, as it provides a valuable competitive advantage — an unlimited state guarantee, and hence a significant safety net — over alternative investment options and providers. This is illustrated for example by a recent report of the Minister of Economic Affairs which states that: 'Icelandic financial undertakings are currently operating in a sheltered environment with capital controls and a blanket deposit guarantee. Under such conditions, bank deposits are practically the only secure option for Icelandic savers' ([74]).

(164) Second, it seems clear that in the absence of the guarantee, Arion Bank could have more easily suffered from a run on its deposits like its predecessor ([75]). Thus the bank would likely have had to pay higher interest rates (to compensate for the risk) in order to attract or even simply retain the same amount of deposits, were it not for the additional unlimited deposit guarantee that the Icelandic state has taken upon itself. Accordingly, the Authority concludes that the deposit guarantee entails an advantage for the bank.

1.2.2. *Selectivity*

(165) Second, the aid measure must be selective in that it favours *'certain undertakings or the production of certain goods'*. The capitalisation measures, the liquidity facility and the SPRON swap agreement are selective as they only benefit Arion Bank.

(166) Moreover, as state support can be selective even in situations where one or more sectors of the economy benefit and others do not, the Authority also considers the state guarantee on deposits which benefits the Icelandic banking sector as a whole as selective. This conclusion also follows from the considerations set out above according to which banks are favoured over other undertakings that offer possibilities to save and invest money.

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

(167) The measures strengthen the position of Arion Bank in comparison to competitors (or potential competitors) in Iceland and other EEA States. Arion Bank is an undertaking which is active, as described above, on financial markets, which are open for international competition in the EEA. Whilst the Icelandic financial markets are currently rather isolated, particularly due to the capital controls, cross-border trade and potential for it still exist, and trade will likely increase as soon as the capital controls are lifted. All measures under assessment must therefore be regarded as distorting competition and affecting trade between the Contracting Parties to the EEA Agreement ([76]).

([74]) Report of the Minister of the Minister of Economic Affairs to the Althingi (March 2012), 'The Future Structure of the Icelandic Financial System', Ch. 9.6, available at: http://eng.atvinnuvegaraduneyti.is/media/Acrobat/Future-Structure.pdf

([75]) 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

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

1.4. **Conclusion**

(168) The Authority, therefore, comes to the conclusion that the measures taken by the Icelandic State to capitalise the new bank, as well as the liquidity facility, the deposit guarantee and the SPRON swap agreement involve state aid within the meaning of Article 61(1) of the EEA Agreement.

2. PROCEDURAL REQUIREMENTS

(169) 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'.

(170) The Icelandic authorities did not notify the aid measures covered by the opening decision to the Authority in advance of their implementation. The Authority therefore concludes that the Icelandic authorities have not respected their obligations pursuant to Article 1(3) of Part I of Protocol 3. The granting of those aid measures was therefore unlawful. With respect to the acquisition of SPM savings Bank by Arion Bank, which the Authority has not found to involve state aid, it is nevertheless noted that according to paragraph 41 of the Authority's restructuring guidelines, and in order to avoid anti-competitive use of state aid, acquisitions by a bank of competing business can only be made in exceptional circumstances and upon notification to the Authority.

3. COMPATIBILITY OF THE AID

(171) As a preliminary remark, the Authority notes that whilst Arion Bank is a new legal entity that was established in 2008, it is — as regards domestic operations — evidently the economic successor of Kaupthing Bank, in the sense that there is an economic continuity between those two entities. As those economic operations that were carried out by Arion Bank from the autumn of 2008 onwards could not have continued in the absence of the aid, the Authority considers the Bank as an undertaking in difficulties.

(172) Moreover, the measures under assessment are at the same time rescue and restructuring measures. As stated in the opening decision, the Authority would probably have temporarily approved the measures as compatible rescue aid, had they been notified before their implementation, before then taking a final view on them on the basis of a restructuring plan. However, in the absence of a timely notification, the Authority initiated the formal investigation procedure and requested the submission of a restructuring plan. As indicated above, the final compatibility of these measures depends on whether the restructuring plan meets the criteria of the Authority's applicable state aid guidelines for undertakings in difficulties.

3.1. **Legal basis for assessment of compatibility: Article 61(3) of the EEA Agreement and the Authority's Restructuring Guidelines**

(173) While state aid to undertakings in difficulties is normally assessed under Article 61(3)(c) of the EEA Agreement, the Authority may, under Article 61(3)(b) of the Agreement allow state aid to remedy a serious disturbance in the economy of an EC Member State or an EFTA State'. As is stated in paragraph 8 of the Banking Guidelines ([77]), the Authority reaffirms that, in line with the case law and the European Commission's decision making practice, Article 61(3)(b) of the EEA Agreement necessitates a restrictive interpretation of what can be considered a serious disturbance of an EFTA State's economy.

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

(174) The Icelandic authorities have explained, as described in detail above, that Iceland's financial system entered into a state of systemic crisis in October 2008, leading to the collapse of its major banks as well as major savings banks within a time span of a few days. The combined market share of the collapsed financial institutions exceeded 90 % in most segments of the Icelandic financial market. The difficulties were coupled with a breakdown of confidence in the country's currency. Iceland's real economy has been severely hit by the financial crisis. Although more than three years have passed since the onset of the crisis, vulnerability still remains in the Icelandic financial system. Even if the situation has eased significantly since 2008, it is evident that at the time that the measures were taken, they were intended to remedy a serious disturbance in the Icelandic economy.

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

The application of the Restructuring Guidelines

(176) The Authority's State Aid Guidelines on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules ([78]) ('the Restructuring Guidelines') sets out the State aid rules applicable to the restructuring of financial institutions in the current crisis. According to the Restructuring Guidelines, in order to be compatible with Article 61(3)(b) EEA, the restructuring of a financial institution in the context of the current financial crisis has to:

(i) Lead to a restoration of the viability of the bank;

(ii) Include sufficient own contribution by the beneficiary (burden-sharing);

(iii) Contain sufficient measures limiting the distortion of competition.

(177) The Authority will thus assess below, based on the restructuring plan submitted for Arion Bank, whether these criteria are met, and if therefore the aid measures described above constitute compatible restructuring aid.

3.2. **Restoration of viability**

(178) Restoring the long-term viability of a beneficiary in receipt of restructuring aid is the main objective of such aid, and the assessment of whether restructuring aid will attain this, is an important aspect in determining its compatibility.

(179) As indicated above, the turmoil in the Icelandic economy in the wake of autumn 2008, the presence of extraordinary measures such as the capital controls, an evolving regulatory environment and a macroeconomic outlook that, in spite of some recent stabilisation, remains somewhat uncertain, given in particular the ongoing economic woes of the euro zone, make it challenging to operate a bank profitably and ensure its long-term viability. The Authority emphasises at the outset that this consideration needs to be borne in mind in the below assessment.

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

(180) Section 2 of the Restructuring Guidelines sets out that the EEA State should provide a comprehensive and detailed restructuring plan which provides complete information on the business model and which restores the bank's long-term viability. Paragraph 10 of the Restructuring Guidelines requires that the restructuring plan identifies the causes of the bank's difficulties and the bank's own weaknesses, and outlines how the proposed restructuring measures remedy the bank's underlying problems.

(181) The causes of Arion Bank's difficulties are, as described above, spelt out both in the restructuring plan, but also in the SIC report, related to the circumstances surrounding the establishment of the Bank and the problems of its predecessor. Among the main causes identified in the latter at the level of the predecessor bank were the excessive and unsustainable expansion, the gearing of the bank's owners, the concentration of risk, weak equity and the size of the banks as compared to the Icelandic economy. Kaupthing Bank had large single exposures and took on major risk by lending to its owners. It also relied predominately on short-term wholesale funding.

Regulatory viability measures

(182) Whilst the Arion Bank's restructuring plan addresses many of the bank's weaknesses as identified above, the Authority considers that the failure of Kaupthing, and the collapse of the Icelandic financial industry, was also caused by a number of factors specific to Iceland, relating to its small size and the regulatory and supervisory shortcomings highlighted by the Special Investigation Commission. The long-term viability of Arion Bank, such as that of any other Icelandic bank, thus does not depend solely on the measures taken at the bank's level, but also on whether those supervisory and regulatory shortcomings have been remedied.

(183) In this regard the Authority notes positively the amendments to the regulatory and supervisory framework that the Icelandic authorities have made, as explained in the Annex.

(184) First, the powers and competences of the FME have been enhanced, inter alia, with new responsibilities regarding large single exposures and the risks related thereto, which in the Authority's view addresses one of the factors that led to the financial collapse.

(185) Second, the temporary high CAD ratio requirements, and a number of provisions relating to collateralisation, in particular the prohibition of extending credit against pledges of own shares, aim at ensuring that Icelandic banks cannot once again build up a weak capital position. The Authority considers that these measures will contribute to the resilience of the Icelandic banks.

(186) Third, a range of measures have been implemented relating to the eligibility of directors and board members, as well as their remuneration. Moreover, lending to related parties (such as owners) has been subjected to stricter rules, and the FME can now prohibit a bank from performing specific activities, if it sees reason to do so. External and internal accounting rules have also been amended, for example the duration for which an external accountant can work for the same bank has been shortened. The Authority notes positively that these measures are aimed at preventing a repetition of events in so far as the owners and high executives are concerned, and the measures also increase external risk monitoring, both of which reduce threats to the banks' viability.

(187) Fourth, according to the Icelandic authorities, the already mentioned possibility for the FME to limit a bank's activities, is also prompted by the large-scale deposit taking by Icelandic commercial banks before the crisis, which seems to at least have accelerated their demise. Moreover, the new rules on liquidity and foreign exchange

balance ([79]) also appear, in the Authority's understanding, to entail certain restrictions as regards the banks' possibility to attract disproportionately large amounts of foreign deposits if that were to make the banks' business more fragile and vulnerable to foreign currency exchange and liquidity risks. The Authority welcomes that the Icelandic authorities have responded to this aspect of regulatory failure.

Arion Bank's restructuring plan

(188) As for the restructuring plan and the measures at the bank's level, Arion Bank has in essence reverted to a more traditional banking model, focusing on relationship banking for the Icelandic market. The Bank will be predominately funded through customer deposits and equity, with a gradual increase in borrowing mostly through covered bonds.

(189) Moreover, as indicated above, Arion Bank was — if compared to Kaupthing — from the moment of its establishment substantially less leveraged, and as most wholesale debt remained in the estate of Kaupthing, it will, according to the restructuring plan, have to rely on refinancing on international markets for unsecured debt only to a very limited extent. For the same reason, the issue of deleveraging the balance sheet of the Bank was in essence resolved already in October 2008. Nevertheless, the Authority concurs with the assessment of Arion Bank and the Icelandic authorities of the need for the various measures outlined in the restructuring plan as regards the scaling down of the Bank's operations to a new economic reality and limiting risk exposure. The deficiencies addressed by those measures (such as concentration of large and connected exposures, severe currency imbalances, etc.) are mostly inherited from the old bank. For Arion Bank's future viability it is of paramount importance that these deficiencies are adequately addressed in the restructuring plan.

(190) The reliance on wholesale markets for refinancing turned out to be one of the main reasons for Kaupthing's demise. Arion Bank's funding has so far been largely based on deposits and equity, but the restructuring plan foresees a slight reduction in the significance of deposits from 68 % to 61 % of total liabilities, based, inter alia, on the Bank's analysis of its deposits base. Arion Bank intends to make up for this by means of issuing covered bonds on the domestic market. It is recalled that Arion Bank has been granted a license to issue covered bonds and subsequently completed a EUR 1 billion covered bond program. In February 2012 Arion Bank completed its first covered bond offering, issuing 2,5 billion ISK worth of bonds, and in May 2012, the Bank completed its first non-indexed fixed rate covered bond offering, to the value of 1,2 billion ISK ([80]). For the remainder of the restructuring period, the bank intends to issue bonds in various formats, including covered bonds and senior unsecured bonds.

(191) The Authority considers that, based on the facts submitted by the Icelandic authorities, the Bank's funding situation appears to be sound until the end of the restructuring period. Given the uncertainties surrounding the deposit guarantee and the capital controls, as well as the ambiguous future developments of (sovereign) debt

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

([80]) In the context of the Bank's acquisition at the end of 2011 of the former Kaupthing Mortgage Institutional Investor Fund, the Bank also took on responsibility for covered bonds in the amount of 117,7 billion ISK.

markets, it cannot conclude on whether Arion Bank's funding strategy will materialise as foreseen in the long run. However, given the strong reliance on deposits and covered bonds during the restructuring period, and the large share of those types of debt on the balance sheet, the Authority concedes that slight variations to the funding strategy that might subsequently be necessary would not threaten the Bank's viability.

(192) As regards the assets side of the balance sheet, the international assets remain in Kaupthing's estate. As a result, the balance sheet has shrunk by 88 %. A main weakness of Kaupthing's business model — the reliance on risky international assets without appropriate risk assessment — has thus been remedied. The Authority welcomes that pursuant to the restructuring plan, the Bank will not engage in similar business in the future, but rather focus on its traditional core business.

(193) A considerable challenge for the Bank as regards its asset portfolio remains the restructuring of the loans that were transferred from Kaupthing. In this regard the Authority notes positively that this restructuring process has been and remains a key priority for the Bank, as illustrated by the many generic and tailor-made proposals that the Bank has made to its overleveraged customers. While work still remains to finalise the restructuring progress, information from the Bank appears to confirm that good progress has been made, particularly as from 2011, as is demonstrated by the fact that of the 986 companies which had entered recovery programs at the Bank, conclusion was reached at the end of 2011 in 871 cases, whereas conclusions had only been reached for 416 companies at the end of the first quarter in 2011. Good progress has also lately been achieved with regard to restructuring of household debt, and the Bank aims to complete its corporate and individual debt recovery projects by the end of 2012.

(194) The Authority considers the above to be an indicator of the soundness of Arion Bank's restructuring methods. Moreover, based on the data submitted by Arion Bank, it appears realistic that the bank can meet its target of completing the restructuring of its corporate and household loan portfolios by year-end 2012. Overall, barring unexpected developments in the macroeconomic environment in Iceland or abroad, this would mean that at the latest at the end of the restructuring period, Arion Bank will, in the Authority's view, have a relatively healthy balance sheet and well-performing loan portfolios.

(195) As indicated above, the weak capitalisation of Kaupthing was one of the factors that lead to its downfall. Arion Bank's restructuring plan predicts that the bank will stay well above the minimum CAD ratio of 16 % required by the FME throughout the restructuring period. This ratio is well above the future Basel III minimum of 10,5 %. Even pursuant to the stress case, which Arion Bank has submitted, the CAD ratio will continue to remain significantly above this high benchmark, at [> 20] %. As for the capital assessment of this year's ICAAP report which Arion Bank has submitted in conjunction with the restructuring plan, the Authority considers it prudent and comforting that having taken into account the various risk factors, the Bank holds a capital buffer of […] billion ISK, which, in an operating environment as described above, provides Arion Bank with a significant capacity to deal with unexpected adversities.

(196) As for the bank's liquidity position, the Authority notes that the current situation, pursuant to the restructuring plan, appears sufficiently robust, and that there are no indications that the situation could deteriorate substantially during the restructuring period. Moreover, the Authority considers that stress testing the bank's liquidity ratio in the context of the ICAAP report, suggests that while the Bank is exposed to liquidity risks which could materialise in the case of abrupt lifting of capital controls, its liquidity situation is monitored closely, measures are under way to limit the risk and contingency plans have been made to prepare the Bank for unexpected and adverse events. This is also of high significance, given the fact that it was necessary for the state in 2010 to provide the Bank with a special liquidity facility in order for it to comply with the FME's liquidity requirements and that this liquidity facility terminates at the end of 2014.

(197) The Authority also welcomes the changes to Arion Bank's organisational structure and risk management, as described above, which address a weakness in Kaupthing's business and will contribute to a more objective and professional risk assessment in the Bank's operation.

(198) As regards profitability, the Restructuring Guidelines also provide that the restructuring plan should demonstrate how the bank will restore its long-term viability without state aid as soon as possible. In particular, the bank should be able to generate an appropriate return on equity, while covering all costs of its normal operation and complying with the relevant regulatory requirements. In particular, point 13 of the Restructuring Guidelines indicates that long-term viability is achieved when a bank is able to cover all its costs including depreciation and financial charges and provide an appropriate return on equity, taking account of the risk profile of the bank.

(199) At this point, the Authority recalls what was already mentioned above, namely that the economic environment in which Arion Bank operates would be challenging for any bank. With this in mind, the Authority is satisfied with the restructuring plan's forecast profitability, which, in spite of the high capital ratio, will be adequate throughout most of the restructuring period and beyond. The return on equity, which was particularly high in 2009-2010, will vary between [> 10] % and [< 15] %. Irregular items in the profit and loss account, in particular substantial valuation gains from the loan portfolios transferred from Kaupthing and the write-downs caused by the recent Supreme Court ruling on FX-loans, which have had major impact on the Bank's financial results in past three years, are expected to recede. According to the restructuring plan, such irregular events are foreseen to have only a minor impact in 2012-2013 and not foreseen to occur beyond 2013.

(200) An important driver of future profitability according to the restructuring plan is greater fee and commission income, which is forecast to […] over the planning period. Commission fee yielding business such as stock market related transactions and foreign currency trade virtually came to a standstill after the collapse and as a result of the capital controls. However, once the restructuring of the corporate sector nears completion and capital controls will be lifted, it appears realistic to expect a substantial increase in stock exchange activity and currency trade. Hence, the Authority does not question the plausibility of these figures.

(201) The Bank has taken a number of initiatives, as described above, to achieve cost efficiency, amongst others to rationalise its branch network and has closed a total of 15 branches. According to the Bank's commitments, […]. A reduction of staff by approximately 10 % took place in 2011. The Authority welcomes these efforts as they imply that the Bank has already managed to contain its costs and maintain its cost-to-income ratio at 45 % in 2011. According to the restructuring plan, the Bank intends to ensure that this ratio will be reduced slightly further to […] % for the remainder of the restructuring period.

(202) In addition to the above, it is evident that the restructuring plan is based on a large number of other assumptions. The Authority has aimed to scrutinise those that seem most pertinent and of greatest influence to the future viability of Arion Bank. As regards the macroeconomic assumptions, they appear broadly in line with the forecasts of Statistics Iceland and the CBI, although the Bank predicts slightly stronger growth and higher inflation. Overall the assumptions on which the restructuring plan is based appear to be sufficiently prudent to allow, in conjunction with the considerations set out by the Authority above, the conclusion that the restructuring measures undertaken by the Bank are sufficient to ensure its long-term viability, barring unexpected adverse events of unforeseen scale and consequences.

(203. Taking into account the above elements, the Authority considers that the restructuring plan comprises sufficient elements contributing to the restoration of the long-term viability of the bank for the Authority to conclude that the provisions of section 2 of the Restructuring Guidelines are complied with.

3.3. **Own contribution/burden-sharing**

(204) Paragraph 22 of the Restructuring Guidelines reads as follows: 'In order to limit distortions of competition and address moral hazard, aid should be limited to the minimum necessary and an appropriate own contribution to restructuring costs should be provided by the aid beneficiary. The bank and its capital holders should contribute to the restructuring as much as possible with their own resources. This is necessary to ensure that rescued banks bear adequate responsibility for the consequences of their past behaviour and to create appropriate incentives for their future behaviour'.

(205) The Authority recalls in this regard a decisive aspect of the case at hand. When Arion Bank was established on the basis of the domestic operations of Kaupthing, the investments of shareholders in Kaupthing Bank were fully wiped out and have thus contributed the maximum possible to the restructuring of Arion Bank. Moreover, the creditors of Kaupthing had to take considerable losses ([81]), or at least had to take on the risk of their investment depending on the profitability of Arion Bank. Therefore, as far as the owners and creditors of Kaupthing are concerned, the criterion of burden-sharing is optimally satisfied and the issue of moral hazard addressed.

(206) In addition to the above, the Authority needs to assess whether the state aid that Arion Bank has received was limited to the minimum necessary.

(207) As regards the capitalisation measures, the initial capitalisation of Arion Bank, until the agreement with the creditors of Kaupthing reduced the State's stake to 13 %, was just sufficient to meet the FME's capital requirements. In 2009, after the agreement on Kaupthing's acquisition of Arion Bank had been reached, and the Tier-II capital had been granted to Arion Bank, the CAD ratio reached approximately 18 %, 2 percentage point more than the minimum ratio set forth by the FME. In this context, the Authority notes that the capital ratio depended mainly on whether valuation of the assets that had been transferred from Kaupthing to Arion Bank had been done accurately. Moreover, it has to be borne in mind that at the time the economic outlook for Iceland was cast in uncertainty. In view of the foregoing, the Authority considers that the amount of capital provided by the Icelandic state to Arion Bank was limited to the minimum necessary, as it amounted to nothing more than the regulatory minimum plus a reasonable buffer.

(208) This conclusion is not undone by the fact that Arion Bank's CAD ratio has subsequently grown somewhat, to 19 % in 2010 and 21 % in 2011. The increase of the CAD ratio was to a significant extent due to the writing up of the book value of the assets that had been transferred from Kaupthing to Arion Bank. It could not have been predicted with any certainty that this would happen, and the fact that the CAD ratio developed so favourably later is in the Authority's view no reason to consider that Arion Bank was overcapitalised by the State at the outset ([82]).

(209) Paragraph 26 of the Restructuring Guidelines provides that banks in receipt of restructuring aid 'should be able to remunerate capital, including in the form of dividends and coupons on outstanding subordinated debt, out of profits generated by their activities'.

(210) In this context, it is worth recalling that at the time when agreements were concluded on the takeover of Kaupskil of 87 % of shareholdings in Arion Bank, it was agreed that the Government would be paid a fair share of the bank's returned earnings over the period until the new agreement on ownership took effect. The amount agreed upon was 6,5 billion ISK ([83]), corresponding to an annualised return for the State of almost 9 % on the capital which was redeemed already in the autumn of 2009. It is clear that this amount falls 2,3 billion ISK short of the accrued interest on the government bond for this time and is also significantly below the ECB benchmark interest of 15,3 % for this period as set out in the Authority's Recapitalisation Guidelines. ([84]) However, as for the 13 % stake that the State retained in Arion Bank, the prospect of a satisfactory return appears promising, given the overall good performance of Arion Bank since its establishment.

([81]) As Kaupthing is still in a winding-up procedure, the precise losses are not yet known. According to information presented at the Kaupthing creditors' meeting on 31 May 2012, Kaupthing's total assets at year end 2011 were 874 billion ISK (5,2 billion EUR), and the current accepted claims under Article 113 of the Icelandic bankruptcy act (non-priority claims) amounted to 2 873 billion ISK (17 billion EUR). For further information see http://www.kaupthing.com/lisalib/getfile.aspx?itemid=21204.

([82]) In fact, the state capitalisation of Arion Bank was based directly on the difference between the initial valuation of assets and liabilities transferred, and the capital requirement of the FME.

([83]) The Icelandic authorities have explained that a fixed sum of 6,5 billion ISK was agreed upon as remuneration for the state in this context, as financial information was changing over the time when the negotiations took place and the true profitability of the bank in this period was difficult to determine.

([84]) The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition ('the Recapitalisation Guidelines'), OJ L 17, 20.1.2011 and EEA Supplement No 3. The guidelines are also available on the Authority's website at: http://www.eftasurv.int/state-aid/legal-framework/state-aid-guidelines/.

(211) However, it also should be stressed that the remuneration for the Tier-II capital deviates from the Authority's Recapitalisation Guidelines. As correctly submitted by the Icelandic authorities, the required remuneration pursuant to the Recapitalisation Guidelines consists of the government's funding cost of 8 %, Kaupthing's pre-crisis CDS-spread and an add-on fee of 2 %. Given Kaupthing's high pre-crisis CDS-spreads, the remuneration that Arion Bank pays, EURIBOR plus 4 % add-on, would appear to fall significantly short of this benchmark.

(212) According to paragraph 25 of the Restructuring Guidelines, derogation from adequate *ex-ante* burden-sharing (i.e. appropriate remuneration) can, inter alia, be justified by farther-reaching restructuring, including measures to limit distortions of competition. As will be shown below, the Authority considers that the restructuring of Arion Bank is sufficiently far-reaching for this condition to be met.

(213) Whilst the SPRON swap agreement, as described above, entails elements of state aid, the Authority considers that it is constructed in a manner that aims at limiting if not excluding a direct financial advantage for Arion Bank. The agreement constitutes in essence a negotiated compensation for Arion Bank in exchange for taking on the deposit liabilities of SPRON, and it is likely that Arion Bank obtains matching assets for the transferred liabilities. The Authority does not consider that this aid is of great significance for its burden-sharing assessment.

(214) Finally, as regards the deposit guarantee, the Authority has already indicated in the opening decision that — in light of the extraordinary circumstances at the time — it might constitute a proportionate means to safeguard financial stability in Iceland. It is evident however that such aid cannot be approved indefinitely.

(215) Thus, in order for this state aid to be considered as limited to the minimum necessary, the Authority is of the view that it needs to be terminated as soon as possible. The Authority therefore welcomes the intention of the Icelandic authorities to introduce a different deposit guarantee system, which is currently envisaged to be set up before the capital controls are lifted, thus no later than the end of 2013.

(216) In addition, the Authority is of the view that a viable bank should be able to compete on the market without the protection of such a blanket guarantee on deposits, and will therefore authorise the deposit guarantee only until the end of 2014 ([85]). After that time, protection of deposits should be governed only by the applicable EEA legislation regarding deposit guarantees.

(217) On the basis of the above elements, the Authority concludes that the restructuring plan of Arion Bank ensures that the aid is limited to the minimum necessary and that the beneficiary, the shareholders and debt holders of its predecessor bank have participated significantly in the burden-sharing. The restructuring aid thus complies with section 3 of the Restructuring Guidelines.

3.4. **Limiting distortions of competition**

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

'Financial stability remains the overriding objective of aid to the financial sector in a systemic crisis, but safeguarding systemic stability in the short-term should not result in longer-term damage to the level playing field and competitive markets. In this context, measures to limit distortions of competition due to state aid play an important role. […] Measures to limit the distortion of competition should be tailor-made to address the distortions identified on the markets where the beneficiary bank operates following its return to viability post restructuring, while at the same time adhering to a common policy and principles. The Authority takes as a starting point for its assessment of the need for such measures, the size, scale and scope of the activities that the bank in question would have upon implementation of a credible restructuring plan as foreseen in Section 2 of this Chapter. […] The nature and form of such measures will depend on two criteria: first, the amount of the aid and the conditions and circumstances under which it was granted and, second, the characteristics of the market or markets on which the beneficiary bank will operate.

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

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

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

(219) It follows from the above that the size of the aid, particularly in relative terms, and the market characteristics are decisive in the Authority's assessment of the appropriateness of measures to limit distortions of competition. At the same time, it is evident that such measures must not jeopardise the viability of the beneficiary of restructuring aid, and competition concerns must be addressed with a view to the overriding goal of financial stability in the present crisis.

(220) Against the background of the above legal framework, the Authority will set out below the considerations that it deems essential for its assessment of the measures limiting distortions of competition.

(221) First and foremost the Authority considers that given the particular situation on the Icelandic financial markets and the economic conditions, as described in previous chapters, a careful assessment of the market conditions and the competitive environment is necessary. The measures limiting the distortion of competition should reflect the currently difficult circumstances, while ensuring that the distortions of competition are limited to a minimum both in the short-term and the long-term.

(222) Second, as set out above in the section on burden-sharing, the greatest possible contribution from the former owners of Kaupthing, and to some extent, of Kaupthing's creditors has been addressed. Consequently, the need for additional competition measures has been limited.

(223) Third, as regards the characteristics of the relevant market and as described above, the collapse of the financial system in Iceland, followed by the interventions of the Icelandic authorities, including the establishment of Arion Bank on the basis of Kaupthing's domestic operations, led to a greater concentration in the Icelandic market for financial services, and substantially increased the market share by the three major banks — Landsbankinn, Íslandsbanki and Arion Bank. Beside these, only a few small market players remain, and the immediate prospect of a new entry is extremely slim, not only due to the already mentioned barriers to entry and the small size of the market, but in particular also due to the prevailing capital controls. Arion Bank enjoys a very significant position on this concentrated market, with a market share of 30 % or over in the most relevant and economically important segments.

(224) Fourth, the crisis led to a number of very specific problems, such as the extremely high degree of direct and indirect ownership of the large banks in the real economy. A further competition concern is the existence of a de-facto monopoly for banking IT-services (RB), majority owned by the three major banks.

(225) Fifth, the relative size of aid that Arion Bank has received is significant. In this regard, the Authority notes that at the outset the entire capital of the bank was provided by the State. In addition, the bank has benefited from a variety of aid measures — the special liquidity facility, the SPRON swap agreement and the blanket deposit guarantee. At the same time, Arion Bank remains a small bank, at least by international standards.

(226) Against this background, the Authority notes that a number of measures have been or will be taken that limit the distortions of competition resulting from the state aid granted to Arion Bank.

(i) Measures and regulatory developments undertaken or committed to by the Icelandic authorities

(227) The Icelandic Government has specifically made two commitments (see Annex) which in the Authority's view can contribute to creating a regulatory environment that favours competition in financial markets:

(228) First, by appointing a working group that will review Act No 36/1978 on Stamp Duty, and by examining in particular whether to abolish stamp duties for bonds issued by individuals when transferred between creditors (e.g. when individuals transfer their loans from one loan institution to another). The Authority considers that the current law — which, inter alia, obliges customers to pay stamp duty on the amount of the respective bond ([86]) when switching lenders — may be capable of constituting an impediment to competition, as it may lock customers to existing contracts on long term loans. The Authority thus welcomes the commitment for this law to be reviewed.

(229) Second, the Authority takes note of that, in accordance with a resolution passed by the Icelandic parliament on 21 March 2012, a committee will be appointed by the Government with the mandate to review consumer protection in the financial market. This will include a specific mandate for the review of switching facilitation and switching costs reduction, and for the committee to work closely with the Icelandic Competition Authority (the ICA) as regards that issue. The Committee shall present its report no later than 15 January 2013. The Authority is of the opinion that a closer assessment could be of benefit for competition in the long-run. In the meantime the bank-specific commitment by Arion Bank discussed below should contribute to making switching easier, and thereby will increase competition.

(230) As for the competition concerns identified by the Authority regarding RB, the Authority welcomes the settlement that ICA and the owners of RB, including the three major banks, have reached on this issue. This endeavours to ensure access to essential IT-infrastructure on a non-discriminatory basis and at reasonable cost for small competitors and potential new market entrants. The Authority is of the view that its concerns have been addressed in a satisfactory manner by this settlement, and that there is no need for the Authority to further address this issue in the current decision.

(231) Finally, the Authority takes note of the regulatory amendments that have been made since 2008, as discussed in the Annex. As regards competition concerns, the introduction of Article 22 in the Act on financial undertakings No 161/2002 is of particular relevance in this regard. It includes provisions which limit the participation of financial undertakings in activities falling outside the scope of their operating licenses. According to this new rule, such activities may only be pursued on a temporary basis and for the purpose of concluding transactions or reorganising the activities of customers. A reasoned notification to this effect must be sent to the FME, and time limits have been introduced for financial undertakings to complete reorganisation of their customers and dispose of appropriated assets.

(232) The Authority regards this change as an appropriate regulatory response to the issue of the disproportionately large ownership by financial institutions in the real economy. This provision appears to at least mitigate this situation — which is a direct result of debt-to-equity-swaps (and similar transactions) involving over-indebted companies in the wake of the crisis — from becoming a permanent one. As it addresses one of the most pressing competition issues that is linked to the state aid to the three banks, the Authority takes it duly into account in its assessment.

([86]) The stamp duty varies depending on the type of legal document concerned, but is normally 15 ISK for each started thousand ISK (i.e. approximately 1,5 %) on the amount of interest-bearing bonds secured by a mortgage or other security.

(ii) Measures specific to Arion Bank

(233) The Authority emphasises that Arion Bank's market presence and size is only a fraction of that of Kaupthing — as total assets have been reduced by 88 %, as described above. Unlike Kaupthing, Arion Bank is only active in the Icelandic market. Whilst most of this reduction is evidently a result of the winding up of Kaupthing's international operations, the Authority is of a view that this process is of particular relevance as regards the distortions of competition, as it was in particular Kaupthing's risky overseas strategy that led to its collapse and caused distortions in the EEA financial markets in the past ([87]).

(234) The Authority takes note of Arion Bank's commitments set out in the Annex, according to which Arion Bank will not acquire financial institutions until 1 December 2014, except if it obtains the Authority's approval beforehand. This means, unless further mergers would be necessitated by financial stability considerations, that further concentration of the Icelandic financial market through acquisitions by Arion Bank can be prevented. This commitment also ensures that the aid that has been granted to Arion Bank is used for restoring its viability rather than it being used to consolidate and further expand its market presence in Iceland. Arion Bank's commitment to […] is also to be welcomed as it […] and supports the policy to achieve necessary cost reductions. The same is true for Arion Bank's commitment pursuant to which it will, until 1 December 2014, neither enforce contract clauses in housing mortgage agreements for individuals ([88]) nor introduce new contract clauses which make special terms on interest rates contingent upon maintaining a minimum range of business with the bank.

(235) As described above, the Icelandic financial market currently represents a challenging operating environment for any bank, which is reflected also by the almost complete absence of interest from abroad to enter this market at the present time. The Authority thus welcomes the commitments by Arion Bank relating to facilitating the switching between banks and providing basic payment processing services. The Authority is of the view that those measures, in conjunction with the agreement between the three major banks and ICA on RB mentioned above ensure that smaller market participants can access the most essential infrastructure and services at reasonable prices without the larger players being able to block their access. The Authority is of the view that this will reduce the barriers to entry for future (potential) market participants, and could allow existing smaller players to expand their market shares if they are able to offer better services than their larger competitors. Moreover, all the measures aimed at facilitating switching will contribute to fiercer competition between the existing large players, and could contribute to prevent or dissolve a situation of potential collective dominance.

(236) Lastly, Arion Bank commits to sell, as soon as possible, shareholdings in operating companies which have been taken over due to restructuring in line with Article 22 of the Act on financial undertakings No 161/2002, commits to follow the procedure and time-limits which are set out in this provision and as interpreted by the FME, and will maintain up-to-date information on its website or of a subsidiary on subsidiaries and shareholdings that are held for sale. The Authority welcomes Arion Bank's commitment to divest as soon as possible all companies and shareholdings that are not related to its core business, not at least because of viability concerns. Whilst the Authority is of the view that it is self-evident that the Bank needs to respect domestic legal obligations such as Article 22 of the Act on financial undertaking, it takes note of this commitment and draws the Icelandic authorities' and beneficiaries' attention to the fact that in this regard a breach of national law might also entail a misuse of aid. The Authority moreover considers that by having to include information about foreseen divestments and sales on its website, more transparency about the current ownership situation in the Icelandic economy is introduced. This remedies, at least to some extent, this particular competition concern that currently characterises Iceland's markets.

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

([88]) The Bank has confirmed that it is not aware of any clauses in any other types of lending agreements that allow the Bank to raise the interest rate if the customer does not maintain a minimum range of business with the Bank. If such clauses can be found within the Bank, the Bank will not enforce them until December 2014.

(237) On the basis of all of the above, given in particular the specific situation in Iceland and the fact that the Authority considers that the above measures address the main competition issues that the Authority has identified in collaboration with the ICA, and taking into account the overriding objective of financial stability, the Authority concludes that the commitments limit distortions of competition to a satisfactory degree. The restructuring aid therefore complies with section 4 of the Restructuring Guidelines.

III. **CONCLUSION**

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

HAS ADOPTED THIS DECISION:

Article 1

The initial operating capital, the (temporary) full state capitalisation, the retention by the State of the 13 % share capital and the Tier-II capital granted to Arion Bank as well as the special liquidity facility, the SPRON swap agreement and the unlimited deposit guarantee constitute state aid within the meaning of Article 61(1) of the EEA Agreement.

Article 2

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

Article 3

The measures enumerated in Article 1 are compatible with the functioning of the EEA agreement pursuant to Article 61(3)(b) EEA subject to adhering to the commitments as set out in the Annex. The authorisation for the unlimited deposit guarantee expires at the end of 2014.

Article 4

This Decision is addressed to the Republic of Iceland.

Article 5

Only the English language version of this decision is authentic.

Done at Brussels, 11 July 2012.

For the EFTA Surveillance Authority

Oda Helen SLETNES	Sverrir Haukur GUNNLAUGSSON
President	*College Member*

ANNEX

COMMITMENTS AND RELEVANT CHANGES TO THE LEGAL FRAMEWORK FOR BANKING

1. COMMITMENTS BY THE ICELANDIC AUTHORITIES

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

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

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

Measures to facilitate switching and reduce switching costs

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

Moreover, the Icelandic authorities have endorsed the following commitments by Arion Bank:

Limitation on acquisition

Arion Bank commits itself not to acquire financial institutions until 1 December 2014. Notwithstanding this commitment, Arion Bank may, after obtaining the Authority's approval, acquire such undertakings, in particular if this is necessary in order to safeguard financial stability.

[…]

Arion Bank commits itself to […].

Divestment of shares in companies under restructuring

Arion Bank commits itself, to sell, as soon as possible, shareholdings in operating companies, which have been taken over due to restructuring, cf. Article 22 of the Act on Financial Undertakings No 161/2002. Furthermore, the bank commits itself to follow the procedure and time-limits, in the above-mentioned legal provision as interpreted by the FME. Finally, the bank will maintain up-to-date information on its website (or website of a relevant subsidiary) on such shareholdings that are held for sale.

Measures benefitting new and small competitors

Arion Bank commits itself to enact the following measures for the benefit of new and small competitors, until 1 December 2014:

(a) Arion Bank will not enforce contract clauses, nor introduce new contract clauses, on interest rates in housing mortgage agreements for individuals that make special terms on interest rates contingent upon maintaining a minimum range of business with the bank.

(b) Arion Bank will provide for easily accessible information, at the bank's website, on the process of switching banking services to another financial institution. Furthermore, the website will make easily accessible the necessary documents to switch between financial institutions. The same information and business-transfer forms will be available at the branches of the bank.

(c) Arion Bank will execute all requests for transfer of banking services in a swift manner.

(d) Arion Bank will not invoke state involvement as a source of competitive advantage when marketing.

(e) Provided that competitive service offers are not available, Arion Bank is willing to offer the following services at a price that will be based on cost plus a reasonable margin, as decided by the Bank at any given time:

(i) Payment processing services for ISK.

(ii) Payment processing services for FX.

2. RELEVANT ADAPTATIONS AND CHANGES TO THE REGULATORY AND SUPERVISORY FRAMEWORK FOR FINANCIAL MARKETS IN ICELAND ADOPTED AFTER THE CRISIS

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

— FME's (The Icelandic Financial Supervisory Authority) authorisations to intervene (to take over the powers of shareholders' meetings and dispose of assets, cf. the emergency legislation) have been increased; FME has been given expanded supervisory authorisations; additional provisions have been adopted enabling FME to evaluate the operations or behaviour of individual supervised parties. These include both decision-making authorisations, such as on the closing of establishments or termination of specific activities without actual revocation of operating licences, as well as a more detailed definition of concepts whose interpretation has been disputed by FME and supervised entities or appellate bodies.

— Rules on individual large exposures have been clarified and made more specific; both the role and responsibility of risk management have been increased and FME authorised to accord risk management higher status in the organisation of financial undertakings; provisions on the application of stress tests have been tightened.

— Provisions for a special registry of larger borrowers have been legalised, in order to provide better overview of large, individual exposures to two or more financial undertakings. The registry is important for linking exposures together and assessing their systemic impact if difficulties should arise in the borrowers' operations. Entities not subject to FME supervision, but which are listed in the registries of financial undertakings, must provide FME with information on all their obligations. FME can prohibit the provision of services to such parties should they refuse to provide the information requested.

— Provisions on sound business practices have been reinforced and the existence of the Complaints Committee on Transactions with Financial Undertakings enshrined in law; detailed information must be disclosed on all major owners of financial undertakings.

— The time limits allowing financial undertakings to dispose of appropriated assets have been shortened.

— Provisions on financial undertakings' holdings in own shares have been tightened and defined in more detail. Holdings of subsidiaries are now considered own shares, as are off-balance-sheet contracts concerning own shares.

— Financial undertakings have been prohibited from extending credit against pledges of their own shares or guarantee capital certificates.

— FME is now to lay down rules as to how loans secured by a mortgage on the shares of other financial undertakings are to be calculated in the risk base and capital base.

— Both the responsibility and role of internal auditing section has been increased. There are detailed rules concerning the balance between the size and diversity of the activities of the financial undertaking concerned and the scope of its internal auditing section.

— Five-year limits have been placed on the period for which an auditing firm may carry out the audit of the same financial undertaking; financial undertakings' ability to dismiss a 'difficult' auditor is reduced.

— All provisions on calculation of equity and various other technical aspects have been reviewed.

— Rules on exercising qualifying holdings, i.e. 10 % or more of voting rights, have been reviewed. FME is authorised to reverse the onus of proof in assessing parties intending on acquiring or adding to qualifying holdings, e.g. when it is uncertain who is/are the beneficial owner/-s of a holding company with a qualifying holding.

— Additional demands on eligibility have now been made of directors, their responsibility for supervision or operations have been increased and executive chairmen of the Board are prohibited; FME has been assigned a greater supervisory role for Boards of Directors; personally identifiable information must be disclosed on remuneration to senior management.

— Rules have been set concerning credit transactions of financial undertakings with directors, managing directors, key employees and owners of qualifying holdings in the financial undertaking concerned. Similar rules apply to parties closely connected with the above-mentioned. FME has adopted rules as to what is considered satisfactory collateral for such transactions.

— Rules concerning arrangements for incentive schemes and bonuses to management and employees and on termination contracts have been adopted.

— Provisions on the reorganisation and winding-up of financial undertakings have been tightened.

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

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

— FME is authorised to restrict the activities of individual establishments of financial undertakings, if it sees reason to do so. Furthermore, it is authorised to set special requirements for individual establishments of financial undertakings to continue their activities. FME may also limit provisionally the activities which a financial undertaking may pursue, in full or in part, whether subject to license or not, if the Authority sees reason to do so. This is naturally prompted not least by the activities of branches and deposit accounts established by them in other European states until 2008 (Icesave, Edge and Save-and-Save).

— Considerably more detailed provisions are set concerning the role of internal audit in Icelandic law than in the EU directives.

— Considerably more detailed provisions are set on how stress tests are to be carried out than in the EU directives.

— Financial undertakings must keep a special registry (a credit registry) of all parties to whom they extend credit and submit an updated list to FME at the end of each month. Furthermore, a similar list shall be sent on parties closely connected with financial undertakings, their Boards of Directors and managers and groups of connected clients, to the extent that these parties are not on the above-mentioned list. This list will provide a better opportunity to monitor inter-linkages between financial undertakings, their directors and management.

— If FME is of the opinion that the borrowing of a single party on the credit registry, which is not subject to official supervision of financial activities, could have a systemic impact, it may demand information from the party concerned on its obligations.

— Should a party not subject to official supervision listed on the credit registry refuse to disclose information to FME, the Authority may order supervised entities to refrain from providing the said party with further service. The same applies if the information disclosure of the party concerned is unsatisfactory. The provisions on a credit registry and extensive authorisations to supervisors concerning parties not subject to official supervision are not in EU/EEA rules.

— There are considerably more detailed and restrictive provisions on related party lending and collateral than in EU/EEA rules.

— FME must refuse the owner of a qualifying holding the right to exercise the holding if there is doubt as to who is or will be its beneficial owner.

— The maximum length of time external auditors can work for the same financial undertaking is shorter than in EU/EEA rules.

— There are considerably more detailed provisions on the eligibility of directors in financial undertaking than in the EU directives.

— Provisions are adopted on arrangements for bonus schemes and termination contracts.

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

On 23 March 2012, the Minister of Economic Affairs introduced a report on the future structure of the Icelandic financial system. The Minister has further appointed an expert group to prepare a legislative frame for all financial activities in Iceland.

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