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Brussels, 10 December 2009
Case No: 66935
Event No: 539094

EFTA SURVEILLANCE AUTHORITY

Subject: Complaints against Iceland concerning the actions as regards the banking crisis – your ref:

1. Introduction

Reference is made to your letter of 30 July 2009 and our letter of 4 August 2009 (Event No: 526339).

The complainant is a credit institution which subscribed euro medium term notes issued by Landsbanki Íslands hf. ("Landsbanki") and Kaupthing bank hf. ("Kaupthing").

The complainant alleges that measures taken by the Icelandic authorities are in breach of:

1. The rule of non-discrimination, both as a general rule (Article 4 of the EEA Agreement) and as a rule specifically applicable to the free movement of capital (Article 40 of the EEA Agreement); and
2. The prohibition of restrictions to the principles of free movement of capital (Article 40 of the EEA Agreement) and of freedom to provide services (Article 36 of the EEA Agreement)

In this letter, the Authority will give its preliminary assessment of issues raised in the complaint.

The Authority sees two main measures taken by the Icelandic authorities relevant to the complainant's position. First, there is the legislative amendment of 6 October 2008 giving depositors priority over other unsecured creditors (see Article 6 of Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc.). Second, there are the various decisions of the Icelandic Financial Supervisory Authority ("the FME") to transfer assets and liabilities from the existing banks to newly established entities, taken on the basis of Article 5 of the said Act. Given that the measures are closely interlinked and form part of the Icelandic authorities' actions to save the

Icelandic financial system, in the following, the Authority will mostly examine them together.

As the complainant is not a depositor, this letter does not deal with the compatibility under EEA law of the difference in treatment, due to the Icelandic emergency measures, between domestic deposits and deposits held in branches of Icelandic banks in other EEA States.

2 The compatibility of the emergency measures with the EEA Agreement

2.1 Introduction

By Article 6 of the Icelandic Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc. ("the Emergency Act"), Article 103 of the Icelandic Act 161/2002 on Financial Undertakings was amended so that in dividing the estate of a bankrupt financial undertaking, claims for deposits, pursuant to the Icelandic Act on Deposit Guarantees and an Investor Compensation Scheme, shall have priority as provided for in Article 112, Paragraph 1 of the Icelandic Act No. 21/1991 on Bankruptcy etc. This implies that claims for deposits, together with claims for wages and some other claims, will be covered before unsecured general claims when the estate of a bankrupt financial undertaking is divided.

Based on Article 100a of the Icelandic Act on Financial Undertakings, as amended by Article 5 of the Emergency Act, the FME decided to transfer some assets, some liabilities and some guarantees from Kaupthing and Landsbanki to newly established entities. Similar action was taken as regards a third Icelandic bank; Glitnir. To ensure the viability of the new entities, the Icelandic authorities intended to transfer more assets than liabilities to the new banks. However, the old banks were to be compensated for the net value of the transferred assets. The compensation was to take the form of financial instruments issued by the new banks to the old banks.

2.2 Discrimination under Article 40 EEA

Article 125 EEA corresponds to Article 345 TFEU (ex 295 EC) and provides that the EEA "*[...] Agreement in no way prejudices the rules of the Contracting Parties governing the system of property ownership*". The Icelandic rules on insolvency proceedings concerning financial institutions can be seen as falling within the scope of Article 125 EEA. Even if this were to be the case, such national measures would, however, remain subject to the fundamental rules of EEA law, including those of non-discrimination and free movement of capital.[1]

With regard to discrimination, the complainant refers to both Articles 4 and 40 EEA. According to the case law of the EFTA Court, the general non-discrimination principle in Article 4 EEA applies independently only to situations governed by EEA law for which the EEA Agreement lays down no specific rules prohibiting discrimination. The principle of non-discrimination has been given effect in the field of free movement of capital by Article 40 EEA.[2] Consequently, as the case here concerns the free movement of capital the Authority has examined issues of alleged discrimination under Article 40 EEA.

[1] See to that effect Case C-452/01 *Ospelt and Schlössle Weissenberg* [2003] ECR I-9743, paragraph 24 and the case law cited and Case E-2/06 *the Authority v Norway* [2007] EFTA Ct. Rep.167, paragraph 62.
[2] Case E-1/00 *Íslandsbanki-FBA* [2000-2001] EFTA Ct. Rep. 8, paragraphs 35-36.

Articles 6 and 9 of the Emergency Act do not make any distinction on grounds of nationality and apply equally to Icelandic nationals (or entities) and nationals (or entities) of other States, including EEA States. They are therefore not, *a priori*, discriminatory in nature.[3] In addition, the measures apply in principle irrespective of the residence of the originator of the credit or of the place where the credit is provided.

In making the distinction between deposits and other unsecured creditors, the subsequent measures taken by Iceland, again, do not constitute direct discrimination on the grounds of nationality, residence or of the place where capital is invested as the measures were not expressly based on such grounds. The measures may, however, amount to indirect discrimination of other unsecured creditors. Such a conclusion presupposes that depositors and other unsecured creditors were in comparable situations with regard to the emergency measures.

It has been argued that this was the case as both deposits and unsecured credits constitute claims with the right to payment into, ultimately, the estate of the debtor without collateral. However, the underlying flow of capital is different for deposits, which can normally be withdrawn on a daily or short-term basis, than for loans to banks, which usually are agreed for medium or long terms. Moreover, there are considerable differences in the psychological role which depositors and, in particular, retail depositors play in terms of public perception as compared to that of professional financial institutions. The general confidence of retail depositors in the functioning and stability of banks with which they have entrusted their savings is an essential feature and prerequisite for the stability of both the banking and the financial system. Lack of confidence by retail depositors is likely to trigger a run on banks, potentially with severe consequences for the stability of the financial system. This danger was generally imminent in Europe, and in particular in Iceland, when the FME emergency measures were taken in October 2008. The Authority, therefore, takes the view that depositors and other unsecured creditors were not in comparable situations with regard to the FME emergency measures.

In the complaint it is also maintained that the so-called Icesave Agreements between Iceland and the UK and the Netherlands constitute undue discrimination between the creditors of Landsbanki based on nationality. It is the understanding of the Authority that the priority of depositors, including those who would be affected by such agreements, in principle, stems from the Emergency Act, which granted priority to all deposits. As has been concluded above, depositors and other unsecured creditors are not in a comparable situation and therefore treating them differently does not constitute discrimination.

The issue also arises whether unsecured creditors are in a comparable situation to guarantee holders. In relation to the split, the following liabilities and guarantees were, with some exceptions, transferred to New Landsbanki (later NBI) according to the

[3] See to that effect Case C-452/01 *Ospelt and Schlössle Weissenberg*, cited above, paragraph 37.

FME's decision of 9 October 2008, as amended on 12 and 19 October 2008:

- domestic deposits;
- export and import guarantees;
- guarantees due to discharge of contract by companies and individuals regarding regular activities; and
- debt backed by collateral which rested upon appropriated assets which were transferred to the new bank.

This approach was used also for Kaupthing and Glitnir (later Íslandsbanki).

This left foreign depositors, bondholders, lenders and other creditors in the old banks. As regards the three last groups of creditors, their nationality, domicile or place of establishment was of no significance. Also Icelandic bondholders and most of the creditors, other than depositors, were left in the old banks.

According to information provided by the Icelandic Government, none of the new entities have taken over debt backed by collateral which rested upon appropriated assets which were transferred to the new banks.

The guarantee holders are only potential creditors of the banks. Only if the underlying obligation is not honoured will the guarantee holders enter into creditor positions towards the banks. To the Authority, this strongly indicates that the position of the guarantee holders was not comparable to the position of the unsecured general creditors. More importantly, the Authority has no information indicating that the nationality or the place of residence of the guarantee holders or the place of the underlying claim was, directly or indirectly, decisive for whether the guarantees were transferred.

Based on the above, the Authority concludes that the equal treatment requirements of Article 40 EEA are fulfilled as regards the Icelandic emergency measures.

Paragraph 100 of the complaint refers to communications in the field of state aid issued by the Commission in relation to the financial crisis. Similar instruments have also been adopted by the Authority and have been applied in the Authority's decision making practice. The complaint (paragraphs 102-103) notes that the communications provide that the state aid measures shall be compatible with the principle of non-discrimination and the fundamental freedoms. These references (*e.g.* paragraph 16 of the Authority's guidelines *Temporary Rules Regarding Financial Crisis*) to the principle of non-discrimination are simply references to the general principle of EEA law and do not have any content beyond the application of that principle. It follows from the above that as regards the free movement of capital the principle is given effect by Article 40 EEA, which is for the reasons stated above not breached in this case.

2.3 Non-discriminatory restrictions

The complainant also alleges that the emergency measures constituted non-discriminatory restrictions on the free movement of capital and services, cf. Articles 40 and 36 EEA. According to the case law of the EFTA Court, it follows from the wording of these two provisions, as well as their placement in different chapters of the Agreement, that they are intended to regulate different situations. Articles 36 and 40 EEA are, as a rule, not

intended to apply simultaneously.[4] Potentially, the emergency measures might make it less attractive for Icelandic financial institutions to provide services in other EEA States, and customers of financial institutions from buying such services. However, in the case at hand, the main issue at stake is the negative effects the emergency measures have on holders of unsecured credit claims as is evident from the complaint itself. Therefore, the Authority considers that the *free movement of capital* is the predominant feature of the case and will accordingly examine the issue under Article 40 EEA. In any event the Authority is of the opinion that the conclusion reached would have been the same had the issue been analysed under Article 36 EEA.

The principle of free movement of capital can also preclude non-discriminatory measures which adversely affect the flow of capital.[5] In the case at hand, it could be argued that the changes introduced to the ranking order of unsecured credit claims against financial institutions in insolvency proceedings may dissuade the provision of unsecured credit by financial institutions to other financial institutions. Consequently, such measures could be considered to be restrictive of the free movement of capital.

In examining that issue the Authority considers it appropriate to start by examining secondary legislation.

The Winding-up Directive 2001/24/EC, which has been incorporated into the EEA Agreement, generally recognises that EEA States may rank creditors' claims on the estate of a bank in winding-up proceedings. According to Article 10(2) letter h of the Directive, the law of the credit institution's home EEA State shall determine, *inter alia*, "the ranking of claims".

Article 16(2) of the Directive states that: *"The claims of all creditors whose domiciles, normal places of residence or head offices are in Member States other than the home Member State shall be treated in the same way and <u>accorded the same ranking as claims of an equivalent nature</u> which may be lodged by creditors having their domiciles, normal places of residence, or head offices in the home Member State".*[6]

In December 2007, the European Commission issued a report on a public consultation on the reorganisation and winding-up of credit institutions.[7] The report recognises that some Member States have granted certain creditors priority rights in accordance with the Directive.[8] The same report also reveals that in the context of the Winding-up Directive, some Member States have introduced priority rights relating to deposit claims.[9]

The general Insolvency Proceedings Regulation (EC) No 1346/2002 determines the jurisdiction for insolvency proceedings, but covers only to a limited extent substantive law questions. Although this Regulation has not been incorporated into the EEA Agreement, it can nonetheless serve as a point of reference for the assessment of whether the Icelandic

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[4] Case E-1/00 *Íslandsbanki-FBA*, cited above, paragraphs 32-33.
[5] Case C-98/01 *Commission* v. *United Kingdom* [2003] ECR I-4641, paragraph 47, Case C-463/00 *Commission* v. *Spain* [2003] ECR I-4581, paragraph 61,
[6] Emphasis added; see also Recital 17 to the Directive.
[7] European Commission, Summary of the public consultation on the reorganisation and winding-up of credit institutions, December 2007. See: http://ec.europa.eu/internal_market/bank/docs/windingup/spc_en.pdf.
[8] Page 4 (point 11) and page 6 (point 23).
[9] Page 10 (points 50-52).

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emergency measures are restrictive of the free movement of capital within the EEA. Firstly, Regulation 1346/2002, does not preclude EU Member States from adopting national legislation granting certain creditors priority rights against the assets of the estate of the bankrupt company. Secondly, the Regulation expressly does not apply to providers of financial services, such as banks.[10] Indeed, Recital 9 to the Regulation states that such undertakings *"are subject to special arrangements and, to some extent, the national supervisory authorities may have extremely wide-ranging powers of intervention"*.

Therefore, provided that the measures are non-discriminatory, as is the case here, EEA States may enact national legislation that grants deposit claims a higher ranking, and thus preferential treatment, compared to claims of other creditors in winding-up proceedings. It is, therefore, the view of the Authority that EEA States can, as a matter of principle, enact such general legislation without it constituting a restriction for the purposes of Article 40 EEA.

However, the issue arises whether the Icelandic legislation could nevertheless be regarded as involving a restriction on the free movement of capital in light of the timing of the measure. The changes to the insolvency order came into effect without prior stakeholder consultation and at a time when the consequences of the new regime were not just of a theoretical nature, but entailed immediate effects on the unsecured claims affected, both positive (as regards deposits) and negative (as regards other unsecured credits). To the Authority's knowledge, there is no case law from the European Court of Justice or the EFTA Court to the effect that the timing or the procedure for adoption of a measure, that does not constitute a restriction, as such alter the classification of the measure into a restriction. To the extent that the measures come within the ambit of EEA law, these considerations are addressed under the principle of legal certainty.

The question also needs to be addressed whether the FME measures themselves can be regarded as non-discriminatory restrictions under Article 40 EEA. The case law of the European Court of Justice concerning such restrictions, generally referred to as the "golden share" case law, has primarily been limited to measures concerning limitation of state privileges regarding shareholdings in previously state-owned companies.[11] The rationale behind concluding that these measures constituted restrictions was that the measures hindered shareholders from other EEA States from fully exercising their influence on the company corresponding to their portion of the shareholding in the company. In addition, the Court of Justice has concluded that prior authorisation schemes for the acquisition of real estate constitute restrictions for the purposes of Article 63 TFEU (ex 56 EC).[12]

The FME measures concern the splits between the existing assets and liabilities of the Icelandic banks into new banks and old banks. The effect of the transfers of assets will be outlined in detail below. Any detrimental effect on the claims of the creditors is first and foremost a consequence of the change in the order of ranking in insolvency proceedings, which does not constitute a restriction on the free movement of capital. In the Authority's opinion, the logic underlying the restrictions identified in the golden shares case law referred to above cannot be transposed to a situation such as is at stake here.

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[10] Article 1(2) and Recital 9.

[11] See.e.g. Case C-98/01 *Commission v United Kingdom*, cited above; Case C-463/00 *Commission v Spain*, cited above; Joined Cases C-282/04 and C-283/04 *Commission v the Netherlands* [2006] ECR I-9141; C-112/05 *Commission v Germany* [2007] ECR I-8995.

[12] See e.g. Case C-300/01 *Salzmann* [2003] ECR I-4899; Case C-370/05 *Festersen* [2007] ECR I-1129.

If the old banks had insufficient assets to cover the deposits and other claims with priority, nothing would have been left for the other unsecured creditors. In such circumstances, the latter's position would not have been influenced by the transfer of assets.

However, even in a situation where there are assets enough to cover all prioritised claims and parts of the claims of unsecured general creditors, the Authority finds that the latter creditors' coverage is not affected by the transfer of assets when the transferred liabilities are taken into account. The Authority would like to illustrate this with examples.

Let us take an example of a simplified balance sheet for a bank with more liabilities than assets:

Assets	Liabilities	
800	Domestic deposits	100
	Non-domestic deposits	200
	Unsecured liabilities with normal priority	700
	Equity	
		-200

If this bank were wound up according to the Icelandic legislation as per 6 October 2008, the depositors would get full coverage of their claims. The other creditors would get (800-300) / 700 = 500 / 700 = 71.4 % coverage of their claims.

Let us now assume that the bank is split in the way that all the domestic deposits are transferred to a new entity together with 150 of the assets and the new bank issues a bond of 50 to the old bank to compensate for the net value of the transferred assets. The balance sheet of the old bank would be:

Assets	Liabilities	
650	Non-domestic depositors	200
50	Unsecured liabilities with normal priority	700
	Equity	
		-200

A winding-up in this situation would lead to 100 % coverage of the non-domestic deposits. The rest of the assets, 500, would be shared between the other creditors. This would give them a coverage of 500/700 = 71.4 % of their claims.

The simplified examples are of course theoretical. The valuation of the assets is a complex process. There is a margin for error, but that can as well be to the benefit of the other creditors if the transferred assets are estimated to be of a higher value than the real one.

Against this background, the Authority takes the view that, in principle, the coverage of the complainant was not affected by the transfers of assets.

Based on all of the above, the Authority considers that the measures do not constitute a restriction under Article 40 EEA.

2.4 Justification

Although having reached the above conclusion, the Authority has, for the sake of completeness, examined whether a hypothetical restriction on the free movement of capital in the EEA would be justified. Article 40 EEA is essentially identical in substance to provisions under EU law prohibiting restrictions on the movement of capital in relations between Member States.[13] The EFTA Court, in determining whether restrictions can be justified, has held that the rules of the EEA Agreement governing the free movement of capital are essentially identical in substance to those in the TFEU. Consequently, national rules restricting the free movement of capital in the EEA may, as in EU law, be justified on grounds such as those stipulated in Article 65 TFEU (ex 58 EC) or on considerations of overriding public interest. In order to be so justified, the national rules must be suitable for securing the objective that they pursue and must not exceed what is necessary in order to achieve it, so as to accord with the principle of proportionality.[14] Deviations from the fundamental principles and freedoms of the EEA Agreement must be construed narrowly and justification can only be accepted in the case of a *genuine and sufficiently serious threat affecting one of the fundamental interests of society.*[15]

The Authority takes the view that the Icelandic emergency measures changing the ranking of creditors were taken in extreme circumstances entailing a real risk of a collapse of the whole Icelandic banking system. Depositors in Europe (and elsewhere) feared for the solvency of commercial banks, for the stability of the financial systems and for the safety of their deposits. The ability of deposit guarantee schemes to pay out deposits was questioned.

It was against this background that Articles 6 and 9 of the Emergency Act were intended by Iceland to enhance protection of depositors with the aim of safeguarding the functioning of the Icelandic domestic banking system. The purpose of the amendments can be seen as conveying to depositors the message that even in the worst case (insolvency of the affected banks), deposits would be safe and would not have to be withdrawn in an uncontrollable manner. The psychological importance of such reassurances for the overall domestic confidence in the functioning of the Icelandic banking system should, in the view of the Authority, not be underestimated.

In *Campus Oil* the European Court of Justice considered, as regards petroleum supply, that petroleum products are of fundamental importance for a country's existence since not only its economy but above all its institutions, its essential public services and even the survival of its inhabitants, depend upon them. An interruption of supplies of petroleum products, with the resulting dangers for the country's existence, could therefore seriously affect the public security that the [ex EC] Treaty allows states to protect. The aim of ensuring a minimum supply of petroleum products at all times transcends purely economic interests.[16]

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[13] Case E-1/04 *Fokus Bank* [2004] EFTA Ct. Rep. 11, paragraph 23 with reference to Case C-452/01 *Ospelt and Schlössle Weissenberg*, cited above, paragraph 28.
[14] Case E-10/04 *Piazza* [2005] EFTA Ct. Rep. 76, paragraph 39 with reference to Case C-174/04 *Commission v Italy* [2005] ECR I-4933, paragraph 35.
[15] See Case E-10/04 *Piazza*, cited above, paragraph 42; Case E-3/98 *Rainford-Towning* [1998] EFTA Ct. Rep. 205, paragraph 42.
[16] Case 72/83 *Campus Oil and Others* [1984] ECR 2727, paragraphs 34 and 35.

The same reasons apply, in the view of the Authority, to the functioning of a country's banking system and the systemic significance of the banking system for the proper functioning of the state's real overall economy as well as the security of the general public and the functioning of society. The existence of a banking system is of vital importance not only for the economy of the state but also from a public security point of view, since the payment systems of the country depend thereon. Conversely, the collapse of these systems would result in immediate bank runs and could potentially lead to the collapse of the whole economic system and jeopardise the functioning of society at large.

It is settled case law of the European Court of Justice that mere economic grounds cannot serve as justification for obstacles prohibited by the Treaty.[17] However, with reference to the above, the Authority considers that the objective of the emergency measures was not merely economic. The objective of safeguarding the functioning of the domestic banking system and the real overall economy constitutes, as a matter of principle, an overriding public interest consideration because this objective aims at warding off a genuine and sufficiently serious threat affecting one of the fundamental interests of society. The pursuit of such an aim is capable of justifying restrictions on the free movement of capital within the EEA, provided that the measures taken can be regarded as proportionate to the attainment of the objective pursued.

The Authority considers that the emergency measures can be seen as suitable for the attainment of the aim of safeguarding the functioning of the Icelandic domestic banking system. Giving depositors higher ranking in insolvency proceedings and the transfer of domestic deposits to the new banks contributed to rebuilding confidence of the domestic depositors in the safety of their deposits.

Further, the changes in the ranking order did not go beyond what was necessary in order to attain the legitimate aim. The Authority notes that confidence, in particular that of depositors is of systemic importance for the functioning of any banking system. This justifies measures to protect depositors. Conversely, financial institutions and large economic operators as investors do not need the same level of protection. Moreover, it is the view of the Authority that equally suitable, but less restrictive, measures which the Icelandic authorities could have taken are not apparent.

The proportionality of the emergency measures has to be considered against the background that, at the time these measures were taken, almost the entire banking sector in Iceland was on the brink of collapse. According to the International Monetary Fund (IMF)[18], Iceland's economy was in the midst of a banking crisis of such extraordinary proportions that it was expected to lead to a deep recession, a sharp rise in the fiscal deficit, and a dramatic surge in public sector debt, reflecting a very high fiscal cost of restructuring the banking system. The virtual collapse of the on-shore foreign exchange market posed, in view of the IMF, a serious and immediate risk to the economy considering its very high import dependence. The Central Bank of Iceland and the State had suffered a loss in creditworthiness in the eyes of the international financial community. This situation in which Iceland suddenly found itself was an unprecedented calamity for a developed country.

[17] See, in relation to the free movement of capital, Case C-367/98, *Commission* v *Portugal* [2002] ECR I-4731, paragraph 52.
[18] http://www.imf.org/external/pubs/ft/scr/2008/cr08362.pdf and http://www.imf.org/external/pubs/ft/survey/2008/123108.pdf

The functioning of a country's banking system is of systemic significance for the proper functioning of the state's real overall economy and the functioning of society. The existence of a banking system is of vital importance not only for the economy of the state but also for society as a whole, since payment systems of the country depend thereon. Consequently, the measures taken by the Icelandic authorities were aimed to remedy a real and imminent danger of total collapse of the domestic banking system. Similarly, the Icelandic measures were designed to safeguard the functioning of the economy as such rather than the interests of individual depositors.

Conversely, the success of the emergency measures depended largely on the credibility of the action taken. Measures taken to back up the Icelandic banks as a whole would probably have lacked the necessary credibility. In its budget for 2008, Iceland's total State revenue was estimated at ISK 460 billion. The deposits in the Icelandic banks alone were at the time of their collapse around ISK 2.800 billion, thereof the equivalent of ISK 1.600 billion in foreign currencies in the foreign branches of the banks. The foreign currency reserves of Iceland consisted of ISK 410 billion in October 2008, i.e. approximately 1/4 of deposits in the non-domestic branches. In comparison, according to publicly available information, the total credit claims against Glitnir, Kaupthing and Landsbanki accounted for ISK 13.597 billion by June 2008.

In contrast, the three banking groups covered by the measures taken under the Icelandic emergency legislation in October 2008, together, played a predominant role in the Icelandic banking sector both numerically and in terms of significance. In particular, and according to the Icelandic authorities, by October 2008, the total operations of Glitnir, Kaupthing and Landsbanki accounted for over 85% of retail banking in Iceland. Consequently, practically the entire payments systems of the country depended upon them. Almost every family and business in Iceland is said to have been a customer, holding cheque and savings accounts with these banks. The Icelandic authorities claim that deposits with banks are not just savings; the current accounts are used by the bank's customers for their regular financial transactions. Limits in accessing such accounts would have instantly risked causing a full run on the banks with consequent serious risks for public security. Businesses could not have used funds to pay for their resources and to pay wages to employees; retail suppliers could not have imported necessities for the public, drugs and food etc; lawyers' trust accounts and other similar forms of deposits would have been non-operable with dire consequences. The general public would not have been able to access money deposited at the banks, e.g. proceeds from sales of real-estate, to finance the purchase of a new home. Money could not have been withdrawn to honour large payment obligations to banks and other institutions. This would have increased the already existing risk of systemic financial collapse.

It does not appear that equally suitable but less restrictive measures could have been taken by the Icelandic authorities; for example imposing limits on deposit withdrawals or access to savings accounts. Such measures would have implied a considerable risk of triggering a run on the new banks as well as the few remaining solvent banks. The Authority recalls that the very objective of the measures taken by the Icelandic authorities was to restore the confidence in the banking system in order to prevent a full bank run.

The complaint (paragraph 83) refers to some alternative measures that could have been taken by the Icelandic Government, which the complainant considers would be less restrictive means to achieve the Government's aim, such as recapitalisation of the banks without performing a split, issuing a state guarantee for the banks or transfer some selected liabilities into a specific vehicle without differentiating between categories of creditors.

The Authority considers that it follows from the above that a recapitalisation of the banks was not an option that was open to the Icelandic Government given the amount of money that would have been needed to credibly undertake that operation. Similarly, granting them a state guarantee would, given their size in relation to the Icelandic State, not have been a credible alternative. These alternatives would, to the extent the Icelandic Government could have taken them, therefore, not have been likely to achieve the aim of the safeguarding the functioning of the Icelandic banking system. As regards differentiation between categories of creditors, the Authority has stated above that measures to ensure the confidence of depositors are justified in view of the systemic importance of their confidence for the functioning of any banking system.

It is therefore the view of the Authority that on the assumption that the measures were a restriction under Article 40 EEA they would have been justified as safeguarding the functioning of the Icelandic banking system. Moreover, that the emergency measures were proportionate to the objective to remedy a genuine and sufficiently serious threat to the domestic banking system, the functioning of which constitutes one of the fundamental interests of society. An assessment under Article 36 EEA will not lead to another conclusion.

2.5 The principle of legal certainty

In relation to the claim that the measures are discriminatory, the complainant also states that his legitimate expectations were breached contrary to general principles of law. The protection of legitimate expectations and the principle of non-retroactivity both form part of the principle of legal certainty, which is recognised as a general principle of EEA law.[19] As stated above, the general principles of EEA law are not applicable with regard to those measures of national law that do not come within the scope of EEA law. Therefore, the Authority considers that the EEA principle of legal certainty is not applicable in the case under examination. However, in light of the complainant's submissions the Authority will, nevertheless, briefly comment on the matter.

As regards the principle of legitimate expectations, the Authority notes that prior to the enactment of the emergency measures, there was no State action which could have made unsecured creditors believe that the Icelandic authorities would not make changes to the insolvency order for financial institutions, even in times of crisis.

Regarding non-retroactivity, the emergency measures did not take effect prior to their enactment. Thus, these measures had no effect for the past. They were, however, immediately applicable and thus affected past transactions, which still had effects. When reviewing Community measures, the Court of Justice has generally considered that immediate application requires justification by an overriding public interest consideration. On the assumption that such a test would be applicable to the emergency measures the

[19] Case E-1/04, *Fokus Bank*, cited above, paragraph 37; Joined Cases E-5/04, E-6/04, E-7/04 *Fesil ASA and others v the Authority* [2005] EFTA Ct. Rep. 121 paragraph 163.

Authority considers that the result of its application would not lead to a different outcome from that of the proportionality conducted above.

3. Final remarks

The Authority invites the complainant to provide his views on the preliminary findings of the Authority and any other information deemed relevant to the case by **15 January 2010**.

Yours sincerely,

Hallgrímur Ásgeirsson
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Brussels, 10 December 2009
Case No: 66797
Event No: 539093

EFTA SURVEILLANCE AUTHORITY

Subject: Complaints against Iceland concerning the actions as regards the banking crisis – your ref:

1. Introduction

Reference is made to your letter of 24 June 2009 and our letter of 14 July 2009 (Event No: 524508).

The complainant is a bank that subscribed bonds and participates in syndicated loans issued by Glitnir bank hf. ("Glitnir"), Landsbanki Íslands hf. ("Landsbanki") and Kaupthing bank hf. ("Kaupthing").

The complainant alleges that measures taken by the Icelandic authorities are in breach of:

1. The rule of non-discrimination, both as a general rule (Article 4 of the EEA Agreement) and as a rule specifically applicable to the free movement of capital (Article 40 of the EEA Agreement); and
2. The prohibition of restrictions to the principles of free movement of capital (Article 40 of the EEA Agreement) and of freedom to provide services (Article 36 of the EEA Agreement)

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The Authority sees two main measures taken by the Icelandic authorities relevant to the complainant's position. First, there is the legislative amendment of 6 October 2008 giving depositors priority over other unsecured creditors (see Article 6 of Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc.). Second, there are the various decisions of the Icelandic Financial Supervisory Authority ("the FME") to transfer assets and liabilities from the existing banks to newly established entities, taken on the basis of Article 5 of the said Act. Given that the measures are closely interlinked and form part of the Icelandic authorities' actions to save the

Icelandic financial system, in the following, the Authority will mostly examine them together.

As the complainant is not a depositor, this letter does not deal with the compatibility under EEA law of the difference in treatment, due to the Icelandic emergency measures, between domestic deposits and deposits held in branches of Icelandic banks in other EEA States.

2 The compatibility of the emergency measures with the EEA Agreement

2.1 Introduction

By Article 6 of the Icelandic Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc. ("the Emergency Act"), Article 103 of the Icelandic Act 161/2002 on Financial Undertakings was amended so that in dividing the estate of a bankrupt financial undertaking, claims for deposits, pursuant to the Icelandic Act on Deposit Guarantees and an Investor Compensation Scheme, shall have priority as provided for in Article 112, Paragraph 1 of the Icelandic Act No. 21/1991 on Bankruptcy etc. This implies that claims for deposits, together with claims for wages and some other claims, will be covered before unsecured general claims when the estate of a bankrupt financial undertaking is divided.

Based on Article 100a of the Icelandic Act on Financial Undertakings, as amended by Article 5 of the Emergency Act, the FME decided to transfer some assets, some liabilities and some guarantees from Kaupthing, Landsbanki and Glitnir to newly established entities. To ensure the viability of the new entities, the Icelandic authorities intended to transfer more assets than liabilities to the new banks. However, the old banks were to be compensated for the net value of the transferred assets. The compensation was to take the form of financial instruments issued by the new banks to the old banks.

2.2 Discrimination under Article 40 EEA

Article 125 EEA corresponds to Article 345 TFEU (ex 295 EC) and provides that the EEA "*[...] Agreement in no way prejudices the rules of the Contracting Parties governing the system of property ownership*". The Icelandic rules on insolvency proceedings concerning financial institutions can be seen as falling within the scope of Article 125 EEA. Even if this were to be the case, such national measures would, however, remain subject to the fundamental rules of EEA law, including those of non-discrimination and free movement of capital.[1]

With regard to discrimination, the complainant refers to both Articles 4 and 40 EEA. According to the case law of the EFTA Court, the general non-discrimination principle in Article 4 EEA applies independently only to situations governed by EEA law for which the EEA Agreement lays down no specific rules prohibiting discrimination. The principle of non-discrimination has been given effect in the field of free movement of capital by Article 40 EEA.[2] Consequently, as the case here concerns the free movement of capital the Authority has examined issues of alleged discrimination under Article 40 EEA.

[1] See to that effect Case C-452/01 *Ospelt and Schlössle Weissenberg* [2003] ECR I-9743, paragraph 24 and the case law cited and Case E-2/06 *the Authority v Norway* [2007] EFTA Ct. Rep.167, paragraph 62.

[2] Case E-1/00 *Íslandsbanki-FBA* [2000-2001] EFTA Ct. Rep. 8, paragraphs 35-36.

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Articles 6 and 9 of the Emergency Act do not make any distinction on grounds of nationality and apply equally to Icelandic nationals (or entities) and nationals (or entities) of other States, including EEA States. They are therefore not, *a priori*, discriminatory in nature.[3] In addition, the measures apply in principle irrespective of the residence of the originator of the credit or of the place where the credit is provided.

In making the distinction between deposits and other unsecured creditors, the subsequent measures taken by Iceland, again, do not constitute direct discrimination on the grounds of nationality, residence or of the place where capital is invested as the measures were not expressly based on such grounds. The measures may, however, amount to indirect discrimination of other unsecured creditors. Such a conclusion presupposes that depositors and other unsecured creditors were in comparable situations with regard to the emergency measures.

It has been argued that this was the case as both deposits and unsecured credits constitute claims with the right to payment into, ultimately, the estate of the debtor without collateral. However, the underlying flow of capital is different for deposits, which can normally be withdrawn on a daily or short-term basis, than for loans to banks, which usually are agreed for medium or long terms. Moreover, there are considerable differences in the psychological role which depositors and, in particular, retail depositors play in terms of public perception as compared to that of professional financial institutions. The general confidence of retail depositors in the functioning and stability of banks with which they have entrusted their savings is an essential feature and prerequisite for the stability of both the banking and the financial system. Lack of confidence by retail depositors is likely to trigger a run on banks, potentially with severe consequences for the stability of the financial system. This danger was generally imminent in Europe, and in particular in Iceland, when the FME emergency measures were taken in October 2008. The Authority, therefore, takes the view that depositors and other unsecured creditors were not in comparable situations with regard to the FME emergency measures.

In the complaint it is also maintained that the so-called Icesave Agreements between Iceland and the UK and the Netherlands constitute undue discrimination between the creditors of Landsbanki based on nationality. It is the understanding of the Authority that the priority of depositors, including those who would be affected by such agreements, in principle, stems from the Emergency Act, which granted priority to all deposits. As has been concluded above, depositors and other unsecured creditors are not in a comparable situation and therefore treating them differently does not constitute discrimination.

The issue also arises whether unsecured creditors are in a comparable situation to guarantee holders. In relation to the split, the following liabilities and guarantees were, with some exceptions, transferred to New Glitnir (later Íslandsbanki) according to the

[3] See to that effect Case C-452/01 *Ospelt and Schlössle Weissenberg*, cited above, paragraph 37.

FME's decision of 14 October 2008, as amended on 19 October 2008:

- domestic deposits;
- export and import guarantees;
- guarantees due to discharge of contract by companies and individuals regarding regular activities; and
- debt backed by collateral which rested upon appropriated assets which were transferred to the new bank.

This approach was used also for Kaupthing and Landsbanki.

This left foreign depositors, bondholders, lenders and other creditors in the old banks. As regards the three last groups of creditors, their nationality, domicile or place of establishment was of no significance. Also Icelandic bondholders and most of the creditors, other than depositors, were left in the old banks.

According to information provided by the Icelandic Government, none of the new entities have taken over debt backed by collateral which rested upon appropriated assets which were transferred to the new banks.

The guarantee holders are only potential creditors of the banks. Only if the underlying obligation is not honoured will the guarantee holders enter into creditor positions towards the banks. To the Authority, this strongly indicates that the position of the guarantee holders was not comparable to the position of the unsecured general creditors. More importantly, the Authority has no information indicating that the nationality or the place of residence of the guarantee holders or the place of the underlying claim was, directly or indirectly, decisive for whether the guarantees were transferred.

Based on the above, the Authority concludes that the equal treatment requirements of Article 40 EEA are fulfilled as regards the Icelandic emergency measures.

Paragraph 100 of the complaint refers to communications in the field of state aid issued by the Commission in relation to the financial crisis. Similar instruments have also been adopted by the Authority and have been applied in the Authority's decision making practice. The complaint (paragraphs 102-103) notes that the communications provide that the state aid measures shall be compatible with the principle of non-discrimination and the fundamental freedoms. These references (*e.g.* paragraph 16 of the Authority's guidelines *Temporary Rules Regarding Financial Crisis*) to the principle of non-discrimination are simply references to the general principle of EEA law and do not have any content beyond the application of that principle. It follows from the above that as regards the free movement of capital the principle is given effect by Article 40 EEA, which is for the reasons stated above not breached in this case.

2.3 Non-discriminatory restrictions

The complainant also alleges that the emergency measures constituted non-discriminatory restrictions on the free movement of capital and services, cf. Articles 40 and 36 EEA. According to the case law of the EFTA Court, it follows from the wording of these two provisions, as well as their placement in different chapters of the Agreement, that they are intended to regulate different situations. Articles 36 and 40 EEA are, as a rule, not

intended to apply simultaneously.[4] Potentially, the emergency measures might make it less attractive for Icelandic financial institutions to provide services in other EEA States, and customers of financial institutions from buying such services. However, in the case at hand, the main issue at stake is the negative effects the emergency measures have on holders of unsecured credit claims as is evident from the complaint itself. Therefore, the Authority considers that the *free movement of capital* is the predominant feature of the case and will accordingly examine the issue under Article 40 EEA. In any event the Authority is of the opinion that the conclusion reached would have been the same had the issue been analysed under Article 36 EEA.

The principle of free movement of capital can also preclude non-discriminatory measures which adversely affect the flow of capital.[5] In the case at hand, it could be argued that the changes introduced to the ranking order of unsecured credit claims against financial institutions in insolvency proceedings may dissuade the provision of unsecured credit by financial institutions to other financial institutions. Consequently, such measures could be considered to be restrictive of the free movement of capital.

In examining that issue the Authority considers it appropriate to start by examining secondary legislation.

The Winding-up Directive 2001/24/EC, which has been incorporated into the EEA Agreement, generally recognises that EEA States may rank creditors' claims on the estate of a bank in winding-up proceedings. According to Article 10(2) letter h of the Directive, the law of the credit institution's home EEA State shall determine, *inter alia*, "the ranking of claims".

Article 16(2) of the Directive states that: "*The claims of all creditors whose domiciles, normal places of residence or head offices are in Member States other than the home Member State shall be treated in the same way and <u>accorded the same ranking as claims of an equivalent nature</u> which may be lodged by creditors having their domiciles, normal places of residence, or head offices in the home Member State*".[6]

In December 2007, the European Commission issued a report on a public consultation on the reorganisation and winding-up of credit institutions.[7] The report recognises that some Member States have granted certain creditors priority rights in accordance with the Directive.[8] The same report also reveals that in the context of the Winding-up Directive, some Member States have introduced priority rights relating to deposit claims.[9]

The general Insolvency Proceedings Regulation (EC) No 1346/2002 determines the jurisdiction for insolvency proceedings, but covers only to a limited extent substantive law questions. Although this Regulation has not been incorporated into the EEA Agreement, it can nonetheless serve as a point of reference for the assessment of whether the Icelandic

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[4] Case E-1/00 *Íslandsbanki-FBA*, cited above, paragraphs 32-33.
[5] Case C-98/01 *Commission* v. *United Kingdom* [2003] ECR I-4641, paragraph 47, Case C-463/00 *Commission* v. *Spain* [2003] ECR I-4581, paragraph 61,
[6] Emphasis added; see also Recital 17 to the Directive.
[7] European Commission, Summary of the public consultation on the reorganisation and winding-up of credit institutions, December 2007. See: http://ec.europa.eu/internal_market/bank/docs/windingup/spc_en.pdf.
[8] Page 4 (point 11) and page 6 (point 23).
[9] Page 10 (points 50-52).

emergency measures are restrictive of the free movement of capital within the EEA. Firstly, Regulation 1346/2002, does not preclude EU Member States from adopting national legislation granting certain creditors priority rights against the assets of the estate of the bankrupt company. Secondly, the Regulation expressly does not apply to providers of financial services, such as banks.[10] Indeed, Recital 9 to the Regulation states that such undertakings *"are subject to special arrangements and, to some extent, the national supervisory authorities may have extremely wide-ranging powers of intervention"*.

Therefore, provided that the measures are non-discriminatory, as is the case here, EEA States may enact national legislation that grants deposit claims a higher ranking, and thus preferential treatment, compared to claims of other creditors in winding-up proceedings. It is, therefore, the view of the Authority that EEA States can, as a matter of principle, enact such general legislation without it constituting a restriction for the purposes of Article 40 EEA.

However, the issue arises whether the Icelandic legislation could nevertheless be regarded as involving a restriction on the free movement of capital in light of the timing of the measure. The changes to the insolvency order came into effect without prior stakeholder consultation and at a time when the consequences of the new regime were not just of a theoretical nature, but entailed immediate effects on the unsecured claims affected, both positive (as regards deposits) and negative (as regards other unsecured credits). To the Authority's knowledge, there is no case law from the European Court of Justice or the EFTA Court to the effect that the timing or the procedure for adoption of a measure, that does not constitute a restriction, as such alter the classification of the measure into a restriction. To the extent that the measures come within the ambit of EEA law, these considerations are addressed under the principle of legal certainty.

The question also needs to be addressed whether the FME measures themselves can be regarded as non-discriminatory restrictions under Article 40 EEA. The case law of the European Court of Justice concerning such restrictions, generally referred to as the "golden share" case law, has primarily been limited to measures concerning limitation of state privileges regarding shareholdings in previously state-owned companies.[11] The rationale behind concluding that these measures constituted restrictions was that the measures hindered shareholders from other EEA States from fully exercising their influence on the company corresponding to their portion of the shareholding in the company. In addition, the Court of Justice has concluded that prior authorisation schemes for the acquisition of real estate constitute restrictions for the purposes of Article 63 TFEU (ex 56 EC).[12]

The FME measures concern the splits between the existing assets and liabilities of the Icelandic banks into new banks and old banks. The effect of the transfers of assets will be outlined in detail below. Any detrimental effect on the claims of the creditors is first and foremost a consequence of the change in the order of ranking in insolvency proceedings, which does not constitute a restriction on the free movement of capital. In the Authority's opinion, the logic underlying the restrictions identified in the golden shares case law referred to above cannot be transposed to a situation such as is at stake here.

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[10] Article 1(2) and Recital 9.

[11] See.e.g. Case C-98/01 *Commission v United Kingdom*, cited above; Case C-463/00 *Commission v Spain*, cited above; Joined Cases C-282/04 and C-283/04 *Commission v the Netherlands* [2006] ECR I-9141; C-112/05 *Commission v Germany* [2007] ECR I-8995.

[12] See e.g. Case C-300/01 *Salzmann* [2003] ECR I-4899; Case C-370/05 *Festersen* [2007] ECR I-1129.

If the old banks had insufficient assets to cover the deposits and other claims with priority, nothing would have been left for the other unsecured creditors. In such circumstances, the latter's position would not have been influenced by the transfer of assets.

However, even in a situation where there are assets enough to cover all prioritised claims and parts of the claims of unsecured general creditors, the Authority finds that the latter creditors' coverage is not affected by the transfer of assets when the transferred liabilities are taken into account. The Authority would like to illustrate this with examples.

Let us take an example of a simplified balance sheet for a bank with more liabilities than assets:

Assets	Liabilities	
800	Domestic deposits	100
	Non-domestic deposits	200
	Unsecured liabilities with normal priority	700
	Equity	
		-200

If this bank were wound up according to the Icelandic legislation as per 6 October 2008, the depositors would get full coverage of their claims. The other creditors would get (800-300) / 700 = 500 / 700 = 71.4 % coverage of their claims.

Let us now assume that the bank is split in the way that all the domestic deposits are transferred to a new entity together with 150 of the assets and the new bank issues a bond of 50 to the old bank to compensate for the net value of the transferred assets. The balance sheet of the old bank would be:

Assets	Liabilities	
650	Non-domestic depositors	200
50	Unsecured liabilities with normal priority	700
	Equity	
		-200

A winding-up in this situation would lead to 100 % coverage of the non-domestic deposits. The rest of the assets, 500, would be shared between the other creditors. This would give them a coverage of 500/700 = 71.4 % of their claims.

The simplified examples are of course theoretical. The valuation of the assets is a complex process. There is a margin for error, but that can as well be to the benefit of the other creditors if the transferred assets are estimated to be of a higher value than the real one.

Against this background, the Authority takes the view that, in principle, the coverage of the complaining bank was not affected by the transfers of assets.

Based on all of the above, the Authority considers that the measures do not constitute a restriction under Article 40 EEA.

2.4 Justification

Although having reached the above conclusion, the Authority has, for the sake of completeness, examined whether a hypothetical restriction on the free movement of capital in the EEA would be justified. Article 40 EEA is essentially identical in substance to provisions under EU law prohibiting restrictions on the movement of capital in relations between Member States.[13] The EFTA Court, in determining whether restrictions can be justified, has held that the rules of the EEA Agreement governing the free movement of capital are essentially identical in substance to those in the TFEU. Consequently, national rules restricting the free movement of capital in the EEA may, as in EU law, be justified on grounds such as those stipulated in Article 65 TFEU (ex 58 EC) or on considerations of overriding public interest. In order to be so justified, the national rules must be suitable for securing the objective that they pursue and must not exceed what is necessary in order to achieve it, so as to accord with the principle of proportionality.[14] Deviations from the fundamental principles and freedoms of the EEA Agreement must be construed narrowly and justification can only be accepted in the case of a *genuine and sufficiently serious threat affecting one of the fundamental interests of society.*[15]

The Authority takes the view that the Icelandic emergency measures changing the ranking of creditors were taken in extreme circumstances entailing a real risk of a collapse of the whole Icelandic banking system. Depositors in Europe (and elsewhere) feared for the solvency of commercial banks, for the stability of the financial systems and for the safety of their deposits. The ability of deposit guarantee schemes to pay out deposits was questioned.

It was against this background that Articles 6 and 9 of the Emergency Act were intended by Iceland to enhance protection of depositors with the aim of safeguarding the functioning of the Icelandic domestic banking system. The purpose of the amendments can be seen as conveying to depositors the message that even in the worst case (insolvency of the affected banks), deposits would be safe and would not have to be withdrawn in an uncontrollable manner. The psychological importance of such reassurances for the overall domestic confidence in the functioning of the Icelandic banking system should, in the view of the Authority, not be underestimated.

In *Campus Oil* the European Court of Justice considered, as regards petroleum supply, that petroleum products are of fundamental importance for a country's existence since not only its economy but above all its institutions, its essential public services and even the survival of its inhabitants, depend upon them. An interruption of supplies of petroleum products, with the resulting dangers for the country's existence, could therefore seriously affect the public security that the [ex EC] Treaty allows states to protect. The aim of ensuring a minimum supply of petroleum products at all times transcends purely economic

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[13] Case E-1/04 *Fokus Bank* [2004] EFTA Ct. Rep. 11, paragraph 23 with reference to Case C-452/01 *Ospelt and Schlössle Weissenberg*, cited above, paragraph 28.

[14] Case E-10/04 *Piazza* [2005] EFTA Ct. Rep. 76, paragraph 39 with reference to Case C-174/04 *Commission v Italy* [2005] ECR I-4933, paragraph 35.

[15] See Case E-10/04 *Piazza*, cited above, paragraph 42; Case E-3/98 *Rainford-Towning* [1998] EFTA Ct. Rep. 205, paragraph 42.

interests.[16]

The same reasons apply, in the view of the Authority, to the functioning of a country's banking system and the systemic significance of the banking system for the proper functioning of the state's real overall economy as well as the security of the general public and the functioning of society. The existence of a banking system is of vital importance not only for the economy of the state but also from a public security point of view, since the payment systems of the country depend thereon. Conversely, the collapse of these systems would result in immediate bank runs and could potentially lead to the collapse of the whole economic system and jeopardise the functioning of society at large.

It is settled case law of the European Court of Justice that mere economic grounds cannot serve as justification for obstacles prohibited by the Treaty.[17] However, with reference to the above, the Authority considers that the objective of the emergency measures was not merely economic. The objective of safeguarding the functioning of the domestic banking system and the real overall economy constitutes, as a matter of principle, an overriding public interest consideration because this objective aims at warding off a genuine and sufficiently serious threat affecting one of the fundamental interests of society. The pursuit of such an aim is capable of justifying restrictions on the free movement of capital within the EEA, provided that the measures taken can be regarded as proportionate to the attainment of the objective pursued.

The Authority considers that the emergency measures can be seen as suitable for the attainment of the aim of safeguarding the functioning of the Icelandic domestic banking system. Giving depositors higher ranking in insolvency proceedings and the transfer of domestic deposits to the new banks contributed to rebuilding confidence of the domestic depositors in the safety of their deposits.

Further, the changes in the ranking order did not go beyond what was necessary in order to attain the legitimate aim. The Authority notes that confidence, in particular that of depositors is of systemic importance for the functioning of any banking system. This justifies measures to protect depositors. Conversely, financial institutions and large economic operators as investors do not need the same level of protection. Moreover, it is the view of the Authority that equally suitable, but less restrictive, measures which the Icelandic authorities could have taken are not apparent.

The proportionality of the emergency measures has to be considered against the background that, at the time these measures were taken, almost the entire banking sector in Iceland was on the brink of collapse. According to the International Monetary Fund (IMF)[18], Iceland's economy was in the midst of a banking crisis of such extraordinary proportions that it was expected to lead to a deep recession, a sharp rise in the fiscal deficit, and a dramatic surge in public sector debt, reflecting a very high fiscal cost of restructuring the banking system. The virtual collapse of the on-shore foreign exchange market posed, in view of the IMF, a serious and immediate risk to the economy considering its very high import dependence. The Central Bank of Iceland and the State had suffered a loss in creditworthiness in the eyes of the international financial

[16] Case 72/83 *Campus Oil and Others* [1984] ECR 2727, paragraphs 34 and 35.

[17] See, in relation to the free movement of capital, Case C-367/98, *Commission* v *Portugal* [2002] ECR I-4731, paragraph 52.

[18] http://www.imf.org/external/pubs/ft/scr/2008/cr08362.pdf and http://www.imf.org/external/pubs/ft/survey/2008/123108.pdf

community. This situation in which Iceland suddenly found itself was an unprecedented calamity for a developed country.

The functioning of a country's banking system is of systemic significance for the proper functioning of the state's real overall economy and the functioning of society. The existence of a banking system is of vital importance not only for the economy of the state but also for society as a whole, since payment systems of the country depend thereon. Consequently, the measures taken by the Icelandic authorities were aimed to remedy a real and imminent danger of total collapse of the domestic banking system. Similarly, the Icelandic measures were designed to safeguard the functioning of the economy as such rather than the interests of individual depositors.

Conversely, the success of the emergency measures depended largely on the credibility of the action taken. Measures taken to back up the Icelandic banks as a whole would probably have lacked the necessary credibility. In its budget for 2008, Iceland's total State revenue was estimated at ISK 460 billion. The deposits in the Icelandic banks alone were at the time of their collapse around ISK 2.800 billion, thereof the equivalent of ISK 1.600 billion in foreign currencies in the foreign branches of the banks. The foreign currency reserves of Iceland consisted of ISK 410 billion in October 2008, i.e. approximately 1/4 of deposits in the non-domestic branches. In comparison, according to publicly available information, the total credit claims against Glitnir, Kaupthing and Landsbanki accounted for ISK 13.597 billion by June 2008.

In contrast, the three banking groups covered by the measures taken under the Icelandic emergency legislation in October 2008, together, played a predominant role in the Icelandic banking sector both numerically and in terms of significance. In particular, and according to the Icelandic authorities, by October 2008, the total operations of Glitnir, Kaupthing and Landsbanki accounted for over 85% of retail banking in Iceland. Consequently, practically the entire payments systems of the country depended upon them. Almost every family and business in Iceland is said to have been a customer, holding cheque and savings accounts with these banks. The Icelandic authorities claim that deposits with banks are not just savings; the current accounts are used by the bank's customers for their regular financial transactions. Limits in accessing such accounts would have instantly risked causing a full run on the banks with consequent serious risks for public security. Businesses could not have used funds to pay for their resources and to pay wages to employees; retail suppliers could not have imported necessities for the public, drugs and food etc; lawyers' trust accounts and other similar forms of deposits would have been non-operable with dire consequences. The general public would not have been able to access money deposited at the banks, e.g. proceeds from sales of real-estate, to finance the purchase of a new home. Money could not have been withdrawn to honour large payment obligations to banks and other institutions. This would have increased the already existing risk of systemic financial collapse.

It does not appear that equally suitable but less restrictive measures could have been taken by the Icelandic authorities; for example imposing limits on deposit withdrawals or access to savings accounts. Such measures would have implied a considerable risk of triggering a run on the new banks as well as the few remaining solvent banks. The Authority recalls that the very objective of the measures taken by the Icelandic authorities was to restore the confidence in the banking system in order to prevent a full bank run.

The complaint (paragraph 83) refers to some alternative measures that could have been taken by the Icelandic Government, which the complainant considers would be less restrictive means to achieve the Government's aim, such as recapitalisation of the banks without performing a split, issuing a state guarantee for the banks or transfer some selected liabilities into a specific vehicle without differentiating between categories of creditors.

The Authority considers that it follows from the above that a recapitalisation of the banks was not an option that was open to the Icelandic Government given the amount of money that would have been needed to credibly undertake that operation. Similarly, granting them a state guarantee would, given their size in relation to the Icelandic State, not have been a credible alternative. These alternatives would, to the extent the Icelandic Government could have taken them, therefore, not have been likely to achieve the aim of the safeguarding the functioning of the Icelandic banking system. As regards differentiation between categories of creditors, the Authority has stated above that measures to ensure the confidence of depositors are justified in view of the systemic importance of their confidence for the functioning of any banking system.

It is therefore the view of the Authority that on the assumption that the measures were a restriction under Article 40 EEA they would have been justified as safeguarding the functioning of the Icelandic banking system. Moreover, that the emergency measures were proportionate to the objective to remedy a genuine and sufficiently serious threat to the domestic banking system, the functioning of which constitutes one of the fundamental interests of society. An assessment under Article 36 EEA will not lead to another conclusion.

2.5 The principle of legal certainty

In relation to the claim that the measures are discriminatory, the complainant also states that his legitimate expectations were breached contrary to general principles of law. The protection of legitimate expectations and the principle of non-retroactivity both form part of the principle of legal certainty, which is recognised as a general principle of EEA law.[19] As stated above, the general principles of EEA law are not applicable with regard to those measures of national law that do not come within the scope of EEA law. Therefore, the Authority considers that the EEA principle of legal certainty is not applicable in the case under examination. However, in light of the complainant's submissions the Authority will, nevertheless, briefly comment on the matter.

As regards the principle of legitimate expectations, the Authority notes that prior to the enactment of the emergency measures, there was no State action which could have made unsecured creditors believe that the Icelandic authorities would not make changes to the insolvency order for financial institutions, even in times of crisis.

Regarding non-retroactivity, the emergency measures did not take effect prior to their enactment. Thus, these measures had no effect for the past. They were, however, immediately applicable and thus affected past transactions, which still had effects. When reviewing Community measures, the Court of Justice has generally considered that immediate application requires justification by an overriding public interest consideration. On the assumption that such a test would be applicable to the emergency measures the

[19] Case E-1/04, *Fokus Bank*, cited above, paragraph 37; Joined Cases E-5/04, E-6/04, E-7/04 *Fesil ASA and others v the Authority* [2005] EFTA Ct. Rep. 121 paragraph 163.

Authority considers that the result of its application would not lead to a different outcome from that of the proportionality conducted above.

3. Final remarks

The Authority invites the complainant to provide his views on the preliminary findings of the Authority and any other information deemed relevant to the case by **15 January 2010.**

Yours sincerely,

Hallgrímur Ásgeirsson
Director
Internal Market Affairs Directorate

EFTA SURVEILLANCE AUTHORITY

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Brussels, 10 December 2009
Case No: 66796
Event No: 539092

Subject: Complaints against Iceland concerning the actions as regards the banking crisis – your ref

1. Introduction

Reference is made to your letter of 24 June 2009 and our letter of 14 July 2009 (Event No: 524509).

The complainant is bank that subscribed bonds issued by Glitnir bank hf. ("Glitnir").

The complainant alleges that measures taken by the Icelandic authorities are in breach of:

1. The rule of non-discrimination, both as a general rule (Article 4 of the EEA Agreement) and as a rule specifically applicable to the free movement of capital (Article 40 of the EEA Agreement); and
2. The prohibition of restrictions to the principles of free movement of capital (Article 40 of the EEA Agreement) and of freedom to provide services (Article 36 of the EEA Agreement)

In this letter, the Authority will give its preliminary assessment of issues raised in the complaint.

The Authority sees two main measures taken by the Icelandic authorities relevant to the complainant's position. First, there is the legislative amendment of 6 October 2008 giving depositors priority over other unsecured creditors (see Article 6 of Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc.). Second, there are the various decisions of the Icelandic Financial Supervisory Authority ("the FME") to transfer assets and liabilities from the existing banks to newly established entities, taken on the basis of Article 5 of the said Act. Given that the measures are closely interlinked and form part of the Icelandic authorities' actions to save the Icelandic financial system, in the following, the Authority will mostly examine them together.

As the complainant is not a depositor, this letter does not deal with the compatibility under EEA law of the difference in treatment, due to the Icelandic emergency measures, between domestic deposits and deposits held in branches of Icelandic banks in other EEA States.

2 The compatibility of the emergency measures with the EEA Agreement

2.1 Introduction

By Article 6 of the Icelandic Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc. ("the Emergency Act"), Article 103 of the Icelandic Act 161/2002 on Financial Undertakings was amended so that in dividing the estate of a bankrupt financial undertaking, claims for deposits, pursuant to the Icelandic Act on Deposit Guarantees and an Investor Compensation Scheme, shall have priority as provided for in Article 112, Paragraph 1 of the Icelandic Act No. 21/1991 on Bankruptcy etc. This implies that claims for deposits, together with claims for wages and some other claims, will be covered before unsecured general claims when the estate of a bankrupt financial undertaking is divided.

Based on Article 100a of the Icelandic Act on Financial Undertakings, as amended by Article 5 of the Emergency Act, the FME decided to transfer some assets, some liabilities and some guarantees from Glitnir to a newly established entity. Similar action was taken as regards two other Icelandic banks; Kaupthing and Landsbanki. To ensure the viability of the new entities, the Icelandic authorities intended to transfer more assets than liabilities to the new banks. However, the old banks were to be compensated for the net value of the transferred assets. The compensation was to take the form of financial instruments issued by the new banks to the old banks.

2.2 Discrimination under Article 40 EEA

Article 125 EEA corresponds to Article 345 TFEU (ex 295 EC) and provides that the EEA "*[...] Agreement in no way prejudices the rules of the Contracting Parties governing the system of property ownership*". The Icelandic rules on insolvency proceedings concerning financial institutions can be seen as falling within the scope of Article 125 EEA. Even if this were to be the case, such national measures would, however, remain subject to the fundamental rules of EEA law, including those of non-discrimination and free movement of capital.[1]

With regard to discrimination, the complainant refers to both Articles 4 and 40 EEA. According to the case law of the EFTA Court, the general non-discrimination principle in Article 4 EEA applies independently only to situations governed by EEA law for which the EEA Agreement lays down no specific rules prohibiting discrimination. The principle of non-discrimination has been given effect in the field of free movement of capital by Article 40 EEA.[2] Consequently, as the case here concerns the free movement of capital the Authority has examined issues of alleged discrimination under Article 40 EEA.

Articles 6 and 9 of the Emergency Act do not make any distinction on grounds of nationality and apply equally to Icelandic nationals (or entities) and nationals (or entities) of other States, including EEA States. They are therefore not, *a priori*, discriminatory in

[1] See to that effect Case C-452/01 *Ospelt and Schlössle Weissenberg* [2003] ECR I-9743, paragraph 24 and the case law cited and Case E-2/06 *the Authority v Norway* [2007] EFTA Ct. Rep.167, paragraph 62.
[2] Case E-1/00 *Íslandsbanki-FBA* [2000-2001] EFTA Ct. Rep. 8, paragraphs 35-36.

EFTA SURVEILLANCE AUTHORITY

nature.[3] In addition, the measures apply in principle irrespective of the residence of the originator of the credit or of the place where the credit is provided.

In making the distinction between deposits and other unsecured creditors, the subsequent measures taken by Iceland, again, do not constitute direct discrimination on the grounds of nationality, residence or of the place where capital is invested as the measures were not expressly based on such grounds. The measures may, however, amount to indirect discrimination of other unsecured creditors. Such a conclusion presupposes that depositors and other unsecured creditors were in comparable situations with regard to the emergency measures.

It has been argued that this was the case as both deposits and unsecured credits constitute claims with the right to payment into, ultimately, the estate of the debtor without collateral. However, the underlying flow of capital is different for deposits, which can normally be withdrawn on a daily or short-term basis, than for loans to banks, which usually are agreed for medium or long terms. Moreover, there are considerable differences in the psychological role which depositors and, in particular, retail depositors play in terms of public perception as compared to that of professional financial institutions. The general confidence of retail depositors in the functioning and stability of banks with which they have entrusted their savings is an essential feature and prerequisite for the stability of both the banking and the financial system. Lack of confidence by retail depositors is likely to trigger a run on banks, potentially with severe consequences for the stability of the financial system. This danger was generally imminent in Europe, and in particular in Iceland, when the FME emergency measures were taken in October 2008. The Authority, therefore, takes the view that depositors and other unsecured creditors were not in comparable situations with regard to the FME emergency measures.

In the complaint it is also maintained that bilateral agreements similar to the so-called Icesave Agreements between Iceland and the UK and the Netherlands would constitute undue discrimination between the creditors of the banks based on nationality. It is the understanding of the Authority that the priority of depositors, including those who would be affected by such agreements, in principle, stems from the Emergency Act, which granted priority to all deposits. As has been concluded above, depositors and other unsecured creditors are not in a comparable situation and therefore treating them differently does not constitute discrimination.

The issue also arises whether unsecured creditors are in a comparable situation to guarantee holders. In relation to the split, the following liabilities and guarantees were, with some exceptions, transferred to New Glitnir (later Íslandsbanki) according to the

[3] See to that effect Case C-452/01 *Ospelt and Schlössle Weissenberg*, cited above, paragraph 37.

FME's decision of 14 October 2008, as amended on 19 October 2008:

- domestic deposits;
- export and import guarantees;
- guarantees due to discharge of contract by companies and individuals regarding regular activities; and
- debt backed by collateral which rested upon appropriated assets which were transferred to the new bank.

This approach was used also for Kaupthing and Landsbanki.

This left foreign depositors, bondholders, lenders and other creditors in the old banks. As regards the three last groups of creditors, their nationality, domicile or place of establishment was of no significance. Also Icelandic bondholders and most of the creditors, other than depositors, were left in the old banks.

According to information provided by the Icelandic Government, none of the new entities have taken over debt backed by collateral which rested upon appropriated assets which were transferred to the new banks.

The guarantee holders are only potential creditors of the banks. Only if the underlying obligation is not honoured will the guarantee holders enter into creditor positions towards the banks. To the Authority, this strongly indicates that the position of the guarantee holders was not comparable to the position of the unsecured general creditors. More importantly, the Authority has no information indicating that the nationality or the place of residence of the guarantee holders or the place of the underlying claim was, directly or indirectly, decisive for whether the guarantees were transferred.

Based on the above, the Authority concludes that the equal treatment requirements of Article 40 EEA are fulfilled as regards the Icelandic emergency measures.

Paragraph 87 of the complaint refers to communications in the field of state aid issued by the Commission in relation to the financial crisis. Similar instruments have also been adopted by the Authority and have been applied in the Authority's decision making practice. The complaint (paragraphs 89-90) notes that the communications provide that the state aid measures shall be compatible with the principle of non-discrimination and the fundamental freedoms. These references (*e.g.* paragraph 16 of the Authority's guidelines *Temporary Rules Regarding Financial Crisis*) to the principle of non-discrimination are simply references to the general principle of EEA law and do not have any content beyond the application of that principle. It follows from the above that as regards the free movement of capital the principle is given effect by Article 40 EEA, which is for the reasons stated above not breached in this case.

2.3 Non-discriminatory restrictions

The complainant also alleges that the emergency measures constituted non-discriminatory restrictions on the free movement of capital and services, cf. Articles 40 and 36 EEA. According to the case law of the EFTA Court, it follows from the wording of these two provisions, as well as their placement in different chapters of the Agreement, that they are intended to regulate different situations. Articles 36 and 40 EEA are, as a rule, not

intended to apply simultaneously.[4] Potentially, the emergency measures might make it less attractive for Icelandic financial institutions to provide services in other EEA States, and customers of financial institutions from buying such services. However, in the case at hand, the main issue at stake is the negative effects the emergency measures have on holders of unsecured credit claims as is evident from the complaint itself. Therefore, the Authority considers that the *free movement of capital* is the predominant feature of the case and will accordingly examine the issue under Article 40 EEA. In any event the Authority is of the opinion that the conclusion reached would have been the same had the issue been analysed under Article 36 EEA.

The principle of free movement of capital can also preclude non-discriminatory measures which adversely affect the flow of capital.[5] In the case at hand, it could be argued that the changes introduced to the ranking order of unsecured credit claims against financial institutions in insolvency proceedings may dissuade the provision of unsecured credit by financial institutions to other financial institutions. Consequently, such measures could be considered to be restrictive of the free movement of capital.

In examining that issue the Authority considers it appropriate to start by examining secondary legislation.

The Winding-up Directive 2001/24/EC, which has been incorporated into the EEA Agreement, generally recognises that EEA States may rank creditors' claims on the estate of a bank in winding-up proceedings. According to Article 10(2) letter h of the Directive, the law of the credit institution's home EEA State shall determine, *inter alia*, "the ranking of claims".

Article 16(2) of the Directive states that: *"The claims of all creditors whose domiciles, normal places of residence or head offices are in Member States other than the home Member State shall be treated in the same way and accorded the same ranking as claims of an equivalent nature which may be lodged by creditors having their domiciles, normal places of residence, or head offices in the home Member State".*[6]

In December 2007, the European Commission issued a report on a public consultation on the reorganisation and winding-up of credit institutions.[7] The report recognises that some Member States have granted certain creditors priority rights in accordance with the Directive.[8] The same report also reveals that in the context of the Winding-up Directive, some Member States have introduced priority rights relating to deposit claims.[9]

The general Insolvency Proceedings Regulation (EC) No 1346/2002 determines the jurisdiction for insolvency proceedings, but covers only to a limited extent substantive law questions. Although this Regulation has not been incorporated into the EEA Agreement, it can nonetheless serve as a point of reference for the assessment of whether the Icelandic

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[4] Case E-1/00 *Íslandsbanki-FBA*, cited above, paragraphs 32-33.
[5] Case C-98/01 *Commission* v. *United Kingdom* [2003] ECR I-4641, paragraph 47, Case C-463/00 *Commission* v. *Spain* [2003] ECR I-4581, paragraph 61,
[6] Emphasis added; see also Recital 17 to the Directive.
[7] European Commission, Summary of the public consultation on the reorganisation and winding-up of credit institutions, December 2007. See: http://ec.europa.eu/internal_market/bank/docs/windingup/spc_en.pdf.
[8] Page 4 (point 11) and page 6 (point 23).
[9] Page 10 (points 50-52).

emergency measures are restrictive of the free movement of capital within the EEA. Firstly, Regulation 1346/2002, does not preclude EU Member States from adopting national legislation granting certain creditors priority rights against the assets of the estate of the bankrupt company. Secondly, the Regulation expressly does not apply to providers of financial services, such as banks.[10] Indeed, Recital 9 to the Regulation states that such undertakings *"are subject to special arrangements and, to some extent, the national supervisory authorities may have extremely wide-ranging powers of intervention"*.

Therefore, provided that the measures are non-discriminatory, as is the case here, EEA States may enact national legislation that grants deposit claims a higher ranking, and thus preferential treatment, compared to claims of other creditors in winding-up proceedings. It is, therefore, the view of the Authority that EEA States can, as a matter of principle, enact such general legislation without it constituting a restriction for the purposes of Article 40 EEA.

However, the issue arises whether the Icelandic legislation could nevertheless be regarded as involving a restriction on the free movement of capital in light of the timing of the measure. The changes to the insolvency order came into effect without prior stakeholder consultation and at a time when the consequences of the new regime were not just of a theoretical nature, but entailed immediate effects on the unsecured claims affected, both positive (as regards deposits) and negative (as regards other unsecured credits). To the Authority's knowledge, there is no case law from the European Court of Justice or the EFTA Court to the effect that the timing or the procedure for adoption of a measure, that does not constitute a restriction, as such alter the classification of the measure into a restriction. To the extent that the measures come within the ambit of EEA law, these considerations are addressed under the principle of legal certainty.

The question also needs to be addressed whether the FME measures themselves can be regarded as non-discriminatory restrictions under Article 40 EEA. The case law of the European Court of Justice concerning such restrictions, generally referred to as the "golden share" case law, has primarily been limited to measures concerning limitation of state privileges regarding shareholdings in previously state-owned companies.[11] The rationale behind concluding that these measures constituted restrictions was that the measures hindered shareholders from other EEA States from fully exercising their influence on the company corresponding to their portion of the shareholding in the company. In addition, the Court of Justice has concluded that prior authorisation schemes for the acquisition of real estate constitute restrictions for the purposes of Article 63 TFEU (ex 56 EC).[12]

The FME measures concern the splits between the existing assets and liabilities of the Icelandic banks into new banks and old banks. The effect of the transfers of assets will be outlined in detail below. Any detrimental effect on the claims of the creditors is first and foremost a consequence of the change in the order of ranking in insolvency proceedings, which does not constitute a restriction on the free movement of capital. In the Authority's opinion, the logic underlying the restrictions identified in the golden shares case law referred to above cannot be transposed to a situation such as is at stake here.

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[10] Article 1(2) and Recital 9.

[11] See.e.g. Case C-98/01 *Commission v United Kingdom*, cited above; Case C-463/00 *Commission v Spain*, cited above; Joined Cases C-282/04 and C-283/04 *Commission v the Netherlands* [2006] ECR I-9141; C-112/05 *Commission v Germany* [2007] ECR I-8995.

[12] See e.g. Case C-300/01 *Salzmann* [2003] ECR I-4899; Case C-370/05 *Festersen* [2007] ECR I-1129.

If the old banks had insufficient assets to cover the deposits and other claims with priority, nothing would have been left for the other unsecured creditors. In such circumstances, the latter's position would not have been influenced by the transfer of assets.

However, even in a situation where there are assets enough to cover all prioritised claims and parts of the claims of unsecured general creditors, the Authority finds that the latter creditors' coverage is not affected by the transfer of assets when the transferred liabilities are taken into account. The Authority would like to illustrate this with examples.

Let us take an example of a simplified balance sheet for a bank with more liabilities than assets:

Assets	Liabilities	
800	Domestic deposits	100
	Non-domestic deposits	200
	Unsecured liabilities with normal priority	700
	Equity	
		-200

If this bank were wound up according to the Icelandic legislation as per 6 October 2008, the depositors would get full coverage of their claims. The other creditors would get (800-300) / 700 = 500 / 700 = 71.4 % coverage of their claims.

Let us now assume that the bank is split in the way that all the domestic deposits are transferred to a new entity together with 150 of the assets and the new bank issues a bond of 50 to the old bank to compensate for the net value of the transferred assets. The balance sheet of the old bank would be:

Assets	Liabilities	
650	Non-domestic depositors	200
50	Unsecured liabilities with normal priority	700
	Equity	
		-200

A winding-up in this situation would lead to 100 % coverage of the non-domestic deposits. The rest of the assets, 500, would be shared between the other creditors. This would give them a coverage of 500/700 = 71.4 % of their claims.

The simplified examples are of course theoretical. The valuation of the assets is a complex process. There is a margin for error, but that can as well be to the benefit of the other creditors if the transferred assets are estimated to be of a higher value than the real one.

Against this background, the Authority takes the view that, in principle, the coverage of the complaining bank was not affected by the transfers of assets.

Based on all of the above, the Authority considers that the measures do not constitute a restriction under Article 40 EEA.

2.4 Justification

Although having reached the above conclusion, the Authority has, for the sake of completeness, examined whether a hypothetical restriction on the free movement of capital in the EEA would be justified. Article 40 EEA is essentially identical in substance to provisions under EU law prohibiting restrictions on the movement of capital in relations between Member States.[13] The EFTA Court, in determining whether restrictions can be justified, has held that the rules of the EEA Agreement governing the free movement of capital are essentially identical in substance to those in the TFEU. Consequently, national rules restricting the free movement of capital in the EEA may, as in EU law, be justified on grounds such as those stipulated in Article 65 TFEU (ex 58 EC) or on considerations of overriding public interest. In order to be so justified, the national rules must be suitable for securing the objective that they pursue and must not exceed what is necessary in order to achieve it, so as to accord with the principle of proportionality.[14] Deviations from the fundamental principles and freedoms of the EEA Agreement must be construed narrowly and justification can only be accepted in the case of a *genuine and sufficiently serious threat affecting one of the fundamental interests of society.*[15]

The Authority takes the view that the Icelandic emergency measures changing the ranking of creditors were taken in extreme circumstances entailing a real risk of a collapse of the whole Icelandic banking system. Depositors in Europe (and elsewhere) feared for the solvency of commercial banks, for the stability of the financial systems and for the safety of their deposits. The ability of deposit guarantee schemes to pay out deposits was questioned.

It was against this background that Articles 6 and 9 of the Emergency Act were intended by Iceland to enhance protection of depositors with the aim of safeguarding the functioning of the Icelandic domestic banking system. The purpose of the amendments can be seen as conveying to depositors the message that even in the worst case (insolvency of the affected banks), deposits would be safe and would not have to be withdrawn in an uncontrollable manner. The psychological importance of such reassurances for the overall domestic confidence in the functioning of the Icelandic banking system should, in the view of the Authority, not be underestimated.

In *Campus Oil* the European Court of Justice considered, as regards petroleum supply, that petroleum products are of fundamental importance for a country's existence since not only its economy but above all its institutions, its essential public services and even the survival of its inhabitants, depend upon them. An interruption of supplies of petroleum products, with the resulting dangers for the country's existence, could therefore seriously affect the public security that the [ex EC] Treaty allows states to protect. The aim of ensuring a minimum supply of petroleum products at all times transcends purely economic interests.[16]

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[13] Case E-1/04 *Fokus Bank* [2004] EFTA Ct. Rep. 11, paragraph 23 with reference to Case C-452/01 *Ospelt and Schlössle Weissenberg*, cited above, paragraph 28.
[14] Case E-10/04 *Piazza* [2005] EFTA Ct. Rep. 76, paragraph 39 with reference to Case C-174/04 *Commission v Italy* [2005] ECR I-4933, paragraph 35.
[15] See Case E-10/04 *Piazza*, cited above, paragraph 42; Case E-3/98 *Rainford-Towning* [1998] EFTA Ct. Rep. 205, paragraph 42.
[16] Case 72/83 *Campus Oil and Others* [1984] ECR 2727, paragraphs 34 and 35.

The same reasons apply, in the view of the Authority, to the functioning of a country's banking system and the systemic significance of the banking system for the proper functioning of the state's real overall economy as well as the security of the general public and the functioning of society. The existence of a banking system is of vital importance not only for the economy of the state but also from a public security point of view, since the payment systems of the country depend thereon. Conversely, the collapse of these systems would result in immediate bank runs and could potentially lead to the collapse of the whole economic system and jeopardise the functioning of society at large.

It is settled case law of the European Court of Justice that mere economic grounds cannot serve as justification for obstacles prohibited by the Treaty.[17] However, with reference to the above, the Authority considers that the objective of the emergency measures was not merely economic. The objective of safeguarding the functioning of the domestic banking system and the real overall economy constitutes, as a matter of principle, an overriding public interest consideration because this objective aims at warding off a genuine and sufficiently serious threat affecting one of the fundamental interests of society. The pursuit of such an aim is capable of justifying restrictions on the free movement of capital within the EEA, provided that the measures taken can be regarded as proportionate to the attainment of the objective pursued.

The Authority considers that the emergency measures can be seen as suitable for the attainment of the aim of safeguarding the functioning of the Icelandic domestic banking system. Giving depositors higher ranking in insolvency proceedings and the transfer of domestic deposits to the new banks contributed to rebuilding confidence of the domestic depositors in the safety of their deposits.

Further, the changes in the ranking order did not go beyond what was necessary in order to attain the legitimate aim. The Authority notes that confidence, in particular that of depositors is of systemic importance for the functioning of any banking system. This justifies measures to protect depositors. Conversely, financial institutions and large economic operators as investors do not need the same level of protection. Moreover, it is the view of the Authority that equally suitable, but less restrictive, measures which the Icelandic authorities could have taken are not apparent.

The proportionality of the emergency measures has to be considered against the background that, at the time these measures were taken, almost the entire banking sector in Iceland was on the brink of collapse. According to the International Monetary Fund (IMF)[18], Iceland's economy was in the midst of a banking crisis of such extraordinary proportions that it was expected to lead to a deep recession, a sharp rise in the fiscal deficit, and a dramatic surge in public sector debt, reflecting a very high fiscal cost of restructuring the banking system. The virtual collapse of the on-shore foreign exchange market posed, in view of the IMF, a serious and immediate risk to the economy considering its very high import dependence. The Central Bank of Iceland and the State had suffered a loss in creditworthiness in the eyes of the international financial community. This situation in which Iceland suddenly found itself was an unprecedented calamity for a developed country.

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[17] See, in relation to the free movement of capital, Case C-367/98, *Commission* v *Portugal* [2002] ECR I-4731, paragraph 52.

[18] http://www.imf.org/external/pubs/ft/scr/2008/cr08362.pdf and http://www.imf.org/external/pubs/ft/survey/2008/123108.pdf

The functioning of a country's banking system is of systemic significance for the proper functioning of the state's real overall economy and the functioning of society. The existence of a banking system is of vital importance not only for the economy of the state but also for society as a whole, since payment systems of the country depend thereon. Consequently, the measures taken by the Icelandic authorities were aimed to remedy a real and imminent danger of total collapse of the domestic banking system. Similarly, the Icelandic measures were designed to safeguard the functioning of the economy as such rather than the interests of individual depositors.

Conversely, the success of the emergency measures depended largely on the credibility of the action taken. Measures taken to back up the Icelandic banks as a whole would probably have lacked the necessary credibility. In its budget for 2008, Iceland's total State revenue was estimated at ISK 460 billion. The deposits in the Icelandic banks alone were at the time of their collapse around ISK 2.800 billion, thereof the equivalent of ISK 1.600 billion in foreign currencies in the foreign branches of the banks. The foreign currency reserves of Iceland consisted of ISK 410 billion in October 2008, i.e. approximately 1/4 of deposits in the non-domestic branches. In comparison, according to publicly available information, the total credit claims against Glitnir, Kaupthing and Landsbanki accounted for ISK 13.597 billion by June 2008.

In contrast, the three banking groups covered by the measures taken under the Icelandic emergency legislation in October 2008, together, played a predominant role in the Icelandic banking sector both numerically and in terms of significance. In particular, and according to the Icelandic authorities, by October 2008, the total operations of Glitnir, Kaupthing and Landsbanki accounted for over 85% of retail banking in Iceland. Consequently, practically the entire payments systems of the country depended upon them. Almost every family and business in Iceland is said to have been a customer, holding cheque and savings accounts with these banks. The Icelandic authorities claim that deposits with banks are not just savings; the current accounts are used by the bank's customers for their regular financial transactions. Limits in accessing such accounts would have instantly risked causing a full run on the banks with consequent serious risks for public security. Businesses could not have used funds to pay for their resources and to pay wages to employees; retail suppliers could not have imported necessities for the public, drugs and food etc; lawyers' trust accounts and other similar forms of deposits would have been non-operable with dire consequences. The general public would not have been able to access money deposited at the banks, e.g. proceeds from sales of real-estate, to finance the purchase of a new home. Money could not have been withdrawn to honour large payment obligations to banks and other institutions. This would have increased the already existing risk of systemic financial collapse.

It does not appear that equally suitable but less restrictive measures could have been taken by the Icelandic authorities; for example imposing limits on deposit withdrawals or access to savings accounts. Such measures would have implied a considerable risk of triggering a run on the new banks as well as the few remaining solvent banks. The Authority recalls that the very objective of the measures taken by the Icelandic authorities was to restore the confidence in the banking system in order to prevent a full bank run.

The complaint (paragraph 70) refers to some alternative measures that could have been taken by the Icelandic Government, which the complainant considers would be less restrictive means to achieve the Government's aim, such as recapitalisation of the banks without performing a split, issuing a state guarantee for the banks or transfer some

selected liabilities into a specific vehicle without differentiating between categories of creditors.

The Authority considers that it follows from the above that a recapitalisation of the banks was not an option that was open to the Icelandic Government given the amount of money that would have been needed to credibly undertake that operation. Similarly, granting them a state guarantee would, given their size in relation to the Icelandic State, not have been a credible alternative. These alternatives would, to the extent the Icelandic Government could have taken them, therefore, not have been likely to achieve the aim of the safeguarding the functioning of the Icelandic banking system. As regards differentiation between categories of creditors, the Authority has stated above that measures to ensure the confidence of depositors are justified in view of the systemic importance of their confidence for the functioning of any banking system.

It is therefore the view of the Authority that on the assumption that the measures were a restriction under Article 40 EEA they would have been justified as safeguarding the functioning of the Icelandic banking system. Moreover, that the emergency measures were proportionate to the objective to remedy a genuine and sufficiently serious threat to the domestic banking system, the functioning of which constitutes one of the fundamental interests of society. An assessment under Article 36 EEA will not lead to another conclusion.

2.5 The principle of legal certainty

In relation to the claim that the measures are discriminatory, the complainant also states that his legitimate expectations were breached contrary to general principles of law. The protection of legitimate expectations and the principle of non-retroactivity both form part of the principle of legal certainty, which is recognised as a general principle of EEA law.[19] As stated above, the general principles of EEA law are not applicable with regard to those measures of national law that do not come within the scope of EEA law. Therefore, the Authority considers that the EEA principle of legal certainty is not applicable in the case under examination. However, in light of the complainant's submissions the Authority will, nevertheless, briefly comment on the matter.

As regards the principle of legitimate expectations, the Authority notes that prior to the enactment of the emergency measures, there was no State action which could have made unsecured creditors believe that the Icelandic authorities would not make changes to the insolvency order for financial institutions, even in times of crisis.

Regarding non-retroactivity, the emergency measures did not take effect prior to their enactment. Thus, these measures had no effect for the past. They were, however, immediately applicable and thus affected past transactions, which still had effects. When reviewing Community measures, the Court of Justice has generally considered that immediate application requires justification by an overriding public interest consideration. On the assumption that such a test would be applicable to the emergency measures the

[19] Case E-1/04, *Fokus Bank*, cited above, paragraph 37; Joined Cases E-5/04, E-6/04, E-7/04 *Fesil ASA and others v the Authority* [2005] EFTA Ct. Rep. 121 paragraph 163.

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Authority considers that the result of its application would not lead to a different outcome from that of the proportionality conducted above.

3. Final remarks

The Authority invites the complainant to provide his views on the preliminary findings of the Authority and any other information deemed relevant to the case by **15 January 2010.**

Yours sincerely,

Hallgrímur Ásgeirsson
Director
Internal Market Affairs Directorate

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Brussels, 10 December 2009
Case No: 66795
Event No: 539091

EFTA SURVEILLANCE AUTHORITY

Subject: Complaints against Iceland concerning the actions as regards the banking crisis – your re

1. Introduction

Reference is made to your letter of 24 June 2009 and our letter of 14 July 2009 (Event No: 524507).

The complainant is a bank that subscribed bonds issued by Glitnir bank hf. ("Glitnir"), Landsbanki Íslands hf. ("Landsbanki") and Kaupthing bank hf. ("Kaupthing"), revolving credit facilities and term loan facilities issued by Glitnir, Landsbanki and Kaupthing.

The complainant alleges that measures taken by the Icelandic authorities are in breach of:

1. The rule of non-discrimination, both as a general rule (Article 4 of the EEA Agreement) and as a rule specifically applicable to the free movement of capital (Article 40 of the EEA Agreement); and
2. The prohibition of restrictions to the principles of free movement of capital (Article 40 of the EEA Agreement) and of freedom to provide services (Article 36 of the EEA Agreement)

In this letter, the Authority will give its preliminary assessment of issues raised in the complaint.

The Authority sees two main measures taken by the Icelandic authorities relevant to the complainant's position. First, there is the legislative amendment of 6 October 2008 giving depositors priority over other unsecured creditors (see Article 6 of Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc.). Second, there are the various decisions of the Icelandic Financial Supervisory Authority ("the FME") to transfer assets and liabilities from the existing banks to newly established entities, taken on the basis of Article 5 of the said Act. Given that the measures are closely interlinked and form part of the Icelandic authorities' actions to save the

Icelandic financial system, in the following, the Authority will mostly examine them together.

As the complainant is not a depositor, this letter does not deal with the compatibility under EEA law of the difference in treatment, due to the Icelandic emergency measures, between domestic deposits and deposits held in branches of Icelandic banks in other EEA States.

2 The compatibility of the emergency measures with the EEA Agreement

2.1 Introduction

By Article 6 of the Icelandic Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc. ("the Emergency Act"), Article 103 of the Icelandic Act 161/2002 on Financial Undertakings was amended so that in dividing the estate of a bankrupt financial undertaking, claims for deposits, pursuant to the Icelandic Act on Deposit Guarantees and an Investor Compensation Scheme, shall have priority as provided for in Article 112, Paragraph 1 of the Icelandic Act No. 21/1991 on Bankruptcy etc. This implies that claims for deposits, together with claims for wages and some other claims, will be covered before unsecured general claims when the estate of a bankrupt financial undertaking is divided.

Based on Article 100a of the Icelandic Act on Financial Undertakings, as amended by Article 5 of the Emergency Act, the FME decided to transfer some assets, some liabilities and some guarantees from Kaupthing, Landsbanki and Glitnir to newly established entities. To ensure the viability of the new entities, the Icelandic authorities intended to transfer more assets than liabilities to the new banks. However, the old banks were to be compensated for the net value of the transferred assets. The compensation was to take the form of financial instruments issued by the new banks to the old banks.

2.2 Discrimination under Article 40 EEA

Article 125 EEA corresponds to Article 345 TFEU (ex 295 EC) and provides that the EEA "*[...] Agreement in no way prejudices the rules of the Contracting Parties governing the system of property ownership*". The Icelandic rules on insolvency proceedings concerning financial institutions can be seen as falling within the scope of Article 125 EEA. Even if this were to be the case, such national measures would, however, remain subject to the fundamental rules of EEA law, including those of non-discrimination and free movement of capital.[1]

With regard to discrimination, the complainant refers to both Articles 4 and 40 EEA. According to the case law of the EFTA Court, the general non-discrimination principle in Article 4 EEA applies independently only to situations governed by EEA law for which the EEA Agreement lays down no specific rules prohibiting discrimination. The principle of non-discrimination has been given effect in the field of free movement of capital by Article 40 EEA.[2] Consequently, as the case here concerns the free movement of capital the Authority has examined issues of alleged discrimination under Article 40 EEA.

Articles 6 and 9 of the Emergency Act do not make any distinction on grounds of nationality and apply equally to Icelandic nationals (or entities) and nationals (or entities)

[1] See to that effect Case C-452/01 *Ospelt and Schlössle Weissenberg* [2003] ECR I-9743, paragraph 24 and the case law cited and Case E-2/06 *the Authority v Norway* [2007] EFTA Ct. Rep.167, paragraph 62.
[2] Case E-1/00 *Íslandsbanki-FBA* [2000-2001] EFTA Ct. Rep. 8, paragraphs 35-36.

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of other States, including EEA States. They are therefore not, *a priori*, discriminatory in nature.[3] In addition, the measures apply in principle irrespective of the residence of the originator of the credit or of the place where the credit is provided.

In making the distinction between deposits and other unsecured creditors, the subsequent measures taken by Iceland, again, do not constitute direct discrimination on the grounds of nationality, residence or of the place where capital is invested as the measures were not expressly based on such grounds. The measures may, however, amount to indirect discrimination of other unsecured creditors. Such a conclusion presupposes that depositors and other unsecured creditors were in comparable situations with regard to the emergency measures.

It has been argued that this was the case as both deposits and unsecured credits constitute claims with the right to payment into, ultimately, the estate of the debtor without collateral. However, the underlying flow of capital is different for deposits, which can normally be withdrawn on a daily or short-term basis, than for loans to banks, which usually are agreed for medium or long terms. Moreover, there are considerable differences in the psychological role which depositors and, in particular, retail depositors play in terms of public perception as compared to that of professional financial institutions. The general confidence of retail depositors in the functioning and stability of banks with which they have entrusted their savings is an essential feature and prerequisite for the stability of both the banking and the financial system. Lack of confidence by retail depositors is likely to trigger a run on banks, potentially with severe consequences for the stability of the financial system. This danger was generally imminent in Europe, and in particular in Iceland, when the FME emergency measures were taken in October 2008. The Authority, therefore, takes the view that depositors and other unsecured creditors were not in comparable situations with regard to the FME emergency measures.

In the complaint it is also maintained that the so-called Icesave Agreements between Iceland and the UK and the Netherlands constitute undue discrimination between the creditors of Landsbanki based on nationality. It is the understanding of the Authority that the priority of depositors, including those who would be affected by such agreements, in principle, stems from the Emergency Act, which granted priority to all deposits. As has been concluded above, depositors and other unsecured creditors are not in a comparable situation and therefore treating them differently does not constitute discrimination.

The issue also arises whether unsecured creditors are in a comparable situation to guarantee holders. In relation to the split, the following liabilities and guarantees were, with some exceptions, transferred to New Glitnir (later Íslandsbanki) according to the FME's decision of 14 October 2008, as amended on 19 October 2008:

- domestic deposits;
- export and import guarantees;
- guarantees due to discharge of contract by companies and individuals regarding regular activities; and
- debt backed by collateral which rested upon appropriated assets which were transferred to the new bank.

This approach was used also for Kaupthing and Landsbanki.

[3] See to that effect Case C-452/01 *Ospelt and Schlössle Weissenberg*, cited above, paragraph 37.

This left foreign depositors, bondholders, lenders and other creditors in the old banks. As regards the three last groups of creditors, their nationality, domicile or place of establishment was of no significance. Also Icelandic bondholders and most of the creditors, other than depositors, were left in the old banks.

According to information provided by the Icelandic Government, none of the new entities have taken over debt backed by collateral which rested upon appropriated assets which were transferred to the new banks.

The guarantee holders are only potential creditors of the banks. Only if the underlying obligation is not honoured will the guarantee holders enter into creditor positions towards the banks. To the Authority, this strongly indicates that the position of the guarantee holders was not comparable to the position of the unsecured general creditors. More importantly, the Authority has no information indicating that the nationality or the place of residence of the guarantee holders or the place of the underlying claim was, directly or indirectly, decisive for whether the guarantees were transferred.

Based on the above, the Authority concludes that the equal treatment requirements of Article 40 EEA are fulfilled as regards the Icelandic emergency measures.

Paragraph 100 of the complaint refers to communications in the field of state aid issued by the Commission in relation to the financial crisis. Similar instruments have also been adopted by the Authority and have been applied in the Authority's decision making practice. The complaint (paragraphs 102-103) notes that the communications provide that the state aid measures shall be compatible with the principle of non-discrimination and the fundamental freedoms. These references (*e.g.* paragraph 16 of the Authority's guidelines *Temporary Rules Regarding Financial Crisis*) to the principle of non-discrimination are simply references to the general principle of EEA law and do not have any content beyond the application of that principle. It follows from the above that as regards the free movement of capital the principle is given effect by Article 40 EEA, which is for the reasons stated above not breached in this case.

2.3 Non-discriminatory restrictions

The complainant also alleges that the emergency measures constituted non-discriminatory restrictions on the free movement of capital and services, cf. Articles 40 and 36 EEA. According to the case law of the EFTA Court, it follows from the wording of these two provisions, as well as their placement in different chapters of the Agreement, that they are intended to regulate different situations. Articles 36 and 40 EEA are, as a rule, not intended to apply simultaneously.[4] Potentially, the emergency measures might make it less attractive for Icelandic financial institutions to provide services in other EEA States, and customers of financial institutions from buying such services. However, in the case at hand, the main issue at stake is the negative effects the emergency measures have on holders of unsecured credit claims as is evident from the complaint itself. Therefore, the Authority considers that the *free movement of capital* is the predominant feature of the case and will accordingly examine the issue under Article 40 EEA. In any event the Authority is of the opinion that the conclusion reached would have been the same had the

[4] Case E-1/00 *Íslandsbanki-FBA*, cited above, paragraphs 32-33.

issue been analysed under Article 36 EEA.

The principle of free movement of capital can also preclude non-discriminatory measures which adversely affect the flow of capital.[5] In the case at hand, it could be argued that the changes introduced to the ranking order of unsecured credit claims against financial institutions in insolvency proceedings may dissuade the provision of unsecured credit by financial institutions to other financial institutions. Consequently, such measures could be considered to be restrictive of the free movement of capital.

In examining that issue the Authority considers it appropriate to start by examining secondary legislation.

The Winding-up Directive 2001/24/EC, which has been incorporated into the EEA Agreement, generally recognises that EEA States may rank creditors' claims on the estate of a bank in winding-up proceedings. According to Article 10(2) letter h of the Directive, the law of the credit institution's home EEA State shall determine, *inter alia*, "the ranking of claims".

Article 16(2) of the Directive states that: *"The claims of all creditors whose domiciles, normal places of residence or head offices are in Member States other than the home Member State shall be treated in the same way and accorded the same ranking as claims of an equivalent nature which may be lodged by creditors having their domiciles, normal places of residence, or head offices in the home Member State".*[6]

In December 2007, the European Commission issued a report on a public consultation on the reorganisation and winding-up of credit institutions.[7] The report recognises that some Member States have granted certain creditors priority rights in accordance with the Directive.[8] The same report also reveals that in the context of the Winding-up Directive, some Member States have introduced priority rights relating to deposit claims.[9]

The general Insolvency Proceedings Regulation (EC) No 1346/2002 determines the jurisdiction for insolvency proceedings, but covers only to a limited extent substantive law questions. Although this Regulation has not been incorporated into the EEA Agreement, it can nonetheless serve as a point of reference for the assessment of whether the Icelandic emergency measures are restrictive of the free movement of capital within the EEA. Firstly, Regulation 1346/2002, does not preclude EU Member States from adopting national legislation granting certain creditors priority rights against the assets of the estate of the bankrupt company. Secondly, the Regulation expressly does not apply to providers of financial services, such as banks.[10] Indeed, Recital 9 to the Regulation states that such undertakings *"are subject to special arrangements and, to some extent, the national supervisory authorities may have extremely wide-ranging powers of intervention"*.

[5] Case C-98/01 *Commission* v. *United Kingdom* [2003] ECR I-4641, paragraph 47, Case C-463/00 *Commission* v. *Spain* [2003] ECR I-4581, paragraph 61,
[6] Emphasis added; see also Recital 17 to the Directive.
[7] European Commission, Summary of the public consultation on the reorganisation and winding-up of credit institutions, December 2007. See: http://ec.europa.eu/internal_market/bank/docs/windingup/spc_en.pdf.
[8] Page 4 (point 11) and page 6 (point 23).
[9] Page 10 (points 50-52).
[10] Article 1(2) and Recital 9.

Therefore, provided that the measures are non-discriminatory, as is the case here, EEA States may enact national legislation that grants deposit claims a higher ranking, and thus preferential treatment, compared to claims of other creditors in winding-up proceedings. It is, therefore, the view of the Authority that EEA States can, as a matter of principle, enact such general legislation without it constituting a restriction for the purposes of Article 40 EEA.

However, the issue arises whether the Icelandic legislation could nevertheless be regarded as involving a restriction on the free movement of capital in light of the timing of the measure. The changes to the insolvency order came into effect without prior stakeholder consultation and at a time when the consequences of the new regime were not just of a theoretical nature, but entailed immediate effects on the unsecured claims affected, both positive (as regards deposits) and negative (as regards other unsecured credits). To the Authority's knowledge, there is no case law from the European Court of Justice or the EFTA Court to the effect that the timing or the procedure for adoption of a measure, that does not constitute a restriction, as such alter the classification of the measure into a restriction. To the extent that the measures come within the ambit of EEA law, these considerations are addressed under the principle of legal certainty.

The question also needs to be addressed whether the FME measures themselves can be regarded as non-discriminatory restrictions under Article 40 EEA. The case law of the European Court of Justice concerning such restrictions, generally referred to as the "golden share" case law, has primarily been limited to measures concerning limitation of state privileges regarding shareholdings in previously state-owned companies.[11] The rationale behind concluding that these measures constituted restrictions was that the measures hindered shareholders from other EEA States from fully exercising their influence on the company corresponding to their portion of the shareholding in the company. In addition, the Court of Justice has concluded that prior authorisation schemes for the acquisition of real estate constitute restrictions for the purposes of Article 63 TFEU (ex 56 EC).[12]

The FME measures concern the splits between the existing assets and liabilities of the Icelandic banks into new banks and old banks. The effect of the transfers of assets will be outlined in detail below. Any detrimental effect on the claims of the creditors is first and foremost a consequence of the change in the order of ranking in insolvency proceedings, which does not constitute a restriction on the free movement of capital. In the Authority's opinion, the logic underlying the restrictions identified in the golden shares case law referred to above cannot be transposed to a situation such as is at stake here.

If the old banks had insufficient assets to cover the deposits and other claims with priority, nothing would have been left for the other unsecured creditors. In such circumstances, the latter's position would not have been influenced by the transfer of assets.

However, even in a situation where there are assets enough to cover all prioritised claims and parts of the claims of unsecured general creditors, the Authority finds that the latter creditors' coverage is not affected by the transfer of assets when the transferred liabilities

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[11] See.e.g. Case C-98/01 *Commission v United Kingdom*, cited above; Case C-463/00 *Commission v Spain*, cited above; Joined Cases C-282/04 and C-283/04 *Commission v the Netherlands* [2006] ECR I-9141; C-112/05 *Commission v Germany* [2007] ECR I-8995.

[12] See e.g. Case C-300/01 *Salzmann* [2003] ECR I-4899; Case C-370/05 *Festersen* [2007] ECR I-1129.

are taken into account. The Authority would like to illustrate this with examples.

Let us take an example of a simplified balance sheet for a bank with more liabilities than assets:

Assets	Liabilities	
800	Domestic deposits	100
	Non-domestic deposits	200
	Unsecured liabilities with normal priority	700
	Equity	
		-200

If this bank were wound up according to the Icelandic legislation as per 6 October 2008, the depositors would get full coverage of their claims. The other creditors would get (800-300) / 700 = 500 / 700 = 71.4 % coverage of their claims.

Let us now assume that the bank is split in the way that all the domestic deposits are transferred to a new entity together with 150 of the assets and the new bank issues a bond of 50 to the old bank to compensate for the net value of the transferred assets. The balance sheet of the old bank would be:

Assets	Liabilities	
650	Non-domestic depositors	200
50	Unsecured liabilities with normal priority	700
	Equity	
		-200

A winding-up in this situation would lead to 100 % coverage of the non-domestic deposits. The rest of the assets, 500, would be shared between the other creditors. This would give them a coverage of 500/700 = 71.4 % of their claims.

The simplified examples are of course theoretical. The valuation of the assets is a complex process. There is a margin for error, but that can as well be to the benefit of the other creditors if the transferred assets are estimated to be of a higher value than the real one.

Against this background, the Authority takes the view that, in principle, the coverage of the complaining bank was not affected by the transfers of assets.

Based on all of the above, the Authority considers that the measures do not constitute a restriction under Article 40 EEA.

2.4 Justification

Although having reached the above conclusion, the Authority has, for the sake of completeness, examined whether a hypothetical restriction on the free movement of capital in the EEA would be justified. Article 40 EEA is essentially identical in substance to provisions under EU law prohibiting restrictions on the movement of capital in relations between Member States.[13] The EFTA Court, in determining whether restrictions can be justified, has held that the rules of the EEA Agreement governing the free movement of capital are essentially identical in substance to those in the TFEU. Consequently, national rules restricting the free movement of capital in the EEA may, as in EU law, be justified on grounds such as those stipulated in Article 65 TFEU (ex 58 EC) or on considerations of overriding public interest. In order to be so justified, the national rules must be suitable for securing the objective that they pursue and must not exceed what is necessary in order to achieve it, so as to accord with the principle of proportionality.[14] Deviations from the fundamental principles and freedoms of the EEA Agreement must be construed narrowly and justification can only be accepted in the case of a *genuine and sufficiently serious threat affecting one of the fundamental interests of society*.[15]

The Authority takes the view that the Icelandic emergency measures changing the ranking of creditors were taken in extreme circumstances entailing a real risk of a collapse of the whole Icelandic banking system. Depositors in Europe (and elsewhere) feared for the solvency of commercial banks, for the stability of the financial systems and for the safety of their deposits. The ability of deposit guarantee schemes to pay out deposits was questioned.

It was against this background that Articles 6 and 9 of the Emergency Act were intended by Iceland to enhance protection of depositors with the aim of safeguarding the functioning of the Icelandic domestic banking system. The purpose of the amendments can be seen as conveying to depositors the message that even in the worst case (insolvency of the affected banks), deposits would be safe and would not have to be withdrawn in an uncontrollable manner. The psychological importance of such reassurances for the overall domestic confidence in the functioning of the Icelandic banking system should, in the view of the Authority, not be underestimated.

In *Campus Oil* the European Court of Justice considered, as regards petroleum supply, that petroleum products are of fundamental importance for a country's existence since not only its economy but above all its institutions, its essential public services and even the survival of its inhabitants, depend upon them. An interruption of supplies of petroleum products, with the resulting dangers for the country's existence, could therefore seriously affect the public security that the [ex EC] Treaty allows states to protect. The aim of ensuring a minimum supply of petroleum products at all times transcends purely economic interests.[16]

The same reasons apply, in the view of the Authority, to the functioning of a country's banking system and the systemic significance of the banking system for the proper functioning of the state's real overall economy as well as the security of the general public and the functioning of society. The existence of a banking system is of vital importance

[13] Case E-1/04 *Fokus Bank* [2004] EFTA Ct. Rep. 11, paragraph 23 with reference to Case C-452/01 *Ospelt and Schlössle Weissenberg*, cited above, paragraph 28.
[14] Case E-10/04 *Piazza* [2005] EFTA Ct. Rep. 76, paragraph 39 with reference to Case C-174/04 *Commission v Italy* [2005] ECR I-4933, paragraph 35.
[15] See Case E-10/04 *Piazza*, cited above, paragraph 42; Case E-3/98 *Rainford-Towning* [1998] EFTA Ct. Rep. 205, paragraph 42.
[16] Case 72/83 *Campus Oil and Others* [1984] ECR 2727, paragraphs 34 and 35.

not only for the economy of the state but also from a public security point of view, since the payment systems of the country depend thereon. Conversely, the collapse of these systems would result in immediate bank runs and could potentially lead to the collapse of the whole economic system and jeopardise the functioning of society at large.

It is settled case law of the European Court of Justice that mere economic grounds cannot serve as justification for obstacles prohibited by the Treaty.[17] However, with reference to the above, the Authority considers that the objective of the emergency measures was not merely economic. The objective of safeguarding the functioning of the domestic banking system and the real overall economy constitutes, as a matter of principle, an overriding public interest consideration because this objective aims at warding off a genuine and sufficiently serious threat affecting one of the fundamental interests of society. The pursuit of such an aim is capable of justifying restrictions on the free movement of capital within the EEA, provided that the measures taken can be regarded as proportionate to the attainment of the objective pursued.

The Authority considers that the emergency measures can be seen as suitable for the attainment of the aim of safeguarding the functioning of the Icelandic domestic banking system. Giving depositors higher ranking in insolvency proceedings and the transfer of domestic deposits to the new banks contributed to rebuilding confidence of the domestic depositors in the safety of their deposits.

Further, the changes in the ranking order did not go beyond what was necessary in order to attain the legitimate aim. The Authority notes that confidence, in particular that of depositors is of systemic importance for the functioning of any banking system. This justifies measures to protect depositors. Conversely, financial institutions and large economic operators as investors do not need the same level of protection. Moreover, it is the view of the Authority that equally suitable, but less restrictive, measures which the Icelandic authorities could have taken are not apparent.

The proportionality of the emergency measures has to be considered against the background that, at the time these measures were taken, almost the entire banking sector in Iceland was on the brink of collapse. According to the International Monetary Fund (IMF)[18], Iceland's economy was in the midst of a banking crisis of such extraordinary proportions that it was expected to lead to a deep recession, a sharp rise in the fiscal deficit, and a dramatic surge in public sector debt, reflecting a very high fiscal cost of restructuring the banking system. The virtual collapse of the on-shore foreign exchange market posed, in view of the IMF, a serious and immediate risk to the economy considering its very high import dependence. The Central Bank of Iceland and the State had suffered a loss in creditworthiness in the eyes of the international financial community. This situation in which Iceland suddenly found itself was an unprecedented calamity for a developed country.

The functioning of a country's banking system is of systemic significance for the proper functioning of the state's real overall economy and the functioning of society. The

[17] See, in relation to the free movement of capital, Case C-367/98, *Commission* v *Portugal* [2002] ECR I-4731, paragraph 52.

[18] http://www.imf.org/external/pubs/ft/scr/2008/cr08362.pdf and http://www.imf.org/external/pubs/ft/survey/2008/123108.pdf

existence of a banking system is of vital importance not only for the economy of the state but also for society as a whole, since payment systems of the country depend thereon. Consequently, the measures taken by the Icelandic authorities were aimed to remedy a real and imminent danger of total collapse of the domestic banking system. Similarly, the Icelandic measures were designed to safeguard the functioning of the economy as such rather than the interests of individual depositors.

Conversely, the success of the emergency measures depended largely on the credibility of the action taken. Measures taken to back up the Icelandic banks as a whole would probably have lacked the necessary credibility. In its budget for 2008, Iceland's total State revenue was estimated at ISK 460 billion. The deposits in the Icelandic banks alone were at the time of their collapse around ISK 2.800 billion, thereof the equivalent of ISK 1.600 billion in foreign currencies in the foreign branches of the banks. The foreign currency reserves of Iceland consisted of ISK 410 billion in October 2008, i.e. approximately 1/4 of deposits in the non-domestic branches. In comparison, according to publicly available information, the total credit claims against Glitnir, Kaupthing and Landsbanki accounted for ISK 13.597 billion by June 2008.

In contrast, the three banking groups covered by the measures taken under the Icelandic emergency legislation in October 2008, together, played a predominant role in the Icelandic banking sector both numerically and in terms of significance. In particular, and according to the Icelandic authorities, by October 2008, the total operations of Glitnir, Kaupthing and Landsbanki accounted for over 85% of retail banking in Iceland. Consequently, practically the entire payments systems of the country depended upon them. Almost every family and business in Iceland is said to have been a customer, holding cheque and savings accounts with these banks. The Icelandic authorities claim that deposits with banks are not just savings; the current accounts are used by the bank's customers for their regular financial transactions. Limits in accessing such accounts would have instantly risked causing a full run on the banks with consequent serious risks for public security. Businesses could not have used funds to pay for their resources and to pay wages to employees; retail suppliers could not have imported necessities for the public, drugs and food etc; lawyers' trust accounts and other similar forms of deposits would have been non-operable with dire consequences. The general public would not have been able to access money deposited at the banks, e.g. proceeds from sales of real-estate, to finance the purchase of a new home. Money could not have been withdrawn to honour large payment obligations to banks and other institutions. This would have increased the already existing risk of systemic financial collapse.

It does not appear that equally suitable but less restrictive measures could have been taken by the Icelandic authorities; for example imposing limits on deposit withdrawals or access to savings accounts. Such measures would have implied a considerable risk of triggering a run on the new banks as well as the few remaining solvent banks. The Authority recalls that the very objective of the measures taken by the Icelandic authorities was to restore the confidence in the banking system in order to prevent a full bank run.

The complaint (paragraph 83) refers to some alternative measures that could have been taken by the Icelandic Government, which the complainant considers would be less restrictive means to achieve the Government's aim, such as recapitalisation of the banks without performing a split, issuing a state guarantee for the banks or transfer some

selected liabilities into a specific vehicle without differentiating between categories of creditors.

The Authority considers that it follows from the above that a recapitalisation of the banks was not an option that was open to the Icelandic Government given the amount of money that would have been needed to credibly undertake that operation. Similarly, granting

them a state guarantee would, given their size in relation to the Icelandic State, not have been a credible alternative. These alternatives would, to the extent the Icelandic Government could have taken them, therefore, not have been likely to achieve the aim of the safeguarding the functioning of the Icelandic banking system. As regards differentiation between categories of creditors, the Authority has stated above that measures to ensure the confidence of depositors are justified in view of the systemic importance of their confidence for the functioning of any banking system.

It is therefore the view of the Authority that on the assumption that the measures were a restriction under Article 40 EEA they would have been justified as safeguarding the functioning of the Icelandic banking system. Moreover, that the emergency measures were proportionate to the objective to remedy a genuine and sufficiently serious threat to the domestic banking system, the functioning of which constitutes one of the fundamental interests of society. An assessment under Article 36 EEA will not lead to another conclusion.

2.5 The principle of legal certainty

In relation to the claim that the measures are discriminatory, the complainant also states that his legitimate expectations were breached contrary to general principles of law. The protection of legitimate expectations and the principle of non-retroactivity both form part of the principle of legal certainty, which is recognised as a general principle of EEA law.[19] As stated above, the general principles of EEA law are not applicable with regard to those measures of national law that do not come within the scope of EEA law. Therefore, the Authority considers that the EEA principle of legal certainty is not applicable in the case under examination. However, in light of the complainant's submissions the Authority will, nevertheless, briefly comment on the matter.

As regards the principle of legitimate expectations, the Authority notes that prior to the enactment of the emergency measures, there was no State action which could have made unsecured creditors believe that the Icelandic authorities would not make changes to the insolvency order for financial institutions, even in times of crisis.

Regarding non-retroactivity, the emergency measures did not take effect prior to their enactment. Thus, these measures had no effect for the past. They were, however, immediately applicable and thus affected past transactions, which still had effects. When reviewing Community measures, the Court of Justice has generally considered that immediate application requires justification by an overriding public interest consideration. On the assumption that such a test would be applicable to the emergency measures the

Authority considers that the result of its application would not lead to a different outcome from that of the proportionality conducted above.

[19] Case E-1/04, *Fokus Bank*, cited above, paragraph 37; Joined Cases E-5/04, E-6/04, E-7/04 *Fesil ASA and others v the Authority* [2005] EFTA Ct. Rep. 121 paragraph 163.

EFTA SURVEILLANCE AUTHORITY

3. Final remarks

The Authority invites the complainant to provide his views on the preliminary findings of the Authority and any other information deemed relevant to the case by **15 January 2010**.

Yours sincerely,

Hallgrímur Ásgeirsson
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Brussels, 10 December 2009
Case No: 66794
Event No: 539090

EFTA SURVEILLANCE AUTHORITY

Subject: Complaints against Iceland concerning the actions as regards the banking crisis – your ref:

1. Introduction

Reference is made to your letter of 24 June 2009 and our letter of 14 July 2009 (Event No: 524506).

The complainant is a bank which subscribed bonds issued by Glitnir bank hf. ("Glitnir"), Landsbanki Íslands hf. ("Landsbanki") and Kaupthing bank hf. ("Kaupthing").

The complainant alleges that measures taken by the Icelandic authorities are in breach of:

1. The rule of non-discrimination, both as a general rule (Article 4 of the EEA Agreement) and as a rule specifically applicable to the free movement of capital (Article 40 of the EEA Agreement); and
2. The prohibition of restrictions to the principles of free movement of capital (Article 40 of the EEA Agreement) and of freedom to provide services (Article 36 of the EEA Agreement)

In this letter, the Authority will give its preliminary assessment of issues raised in the complaint.

The Authority sees two main measures taken by the Icelandic authorities relevant to the complainant's position. First, there is the legislative amendment of 6 October 2008 giving depositors priority over other unsecured creditors (see Article 6 of Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc.). Second, there are the various decisions of the Icelandic Financial Supervisory Authority ("the FME") to transfer assets and liabilities from the existing banks to newly established entities, taken on the basis of Article 5 of the said Act. Given that the measures are closely interlinked and form part of the Icelandic authorities' actions to save the

Icelandic financial system, in the following, the Authority will mostly examine them together.

As the complainant is not a depositor, this letter does not deal with the compatibility under EEA law of the difference in treatment, due to the Icelandic emergency measures, between domestic deposits and deposits held in branches of Icelandic banks in other EEA States.

2 The compatibility of the emergency measures with the EEA Agreement

2.1 Introduction

By Article 6 of the Icelandic Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc. ("the Emergency Act"), Article 103 of the Icelandic Act 161/2002 on Financial Undertakings was amended so that in dividing the estate of a bankrupt financial undertaking, claims for deposits, pursuant to the Icelandic Act on Deposit Guarantees and an Investor Compensation Scheme, shall have priority as provided for in Article 112, Paragraph 1 of the Icelandic Act No. 21/1991 on Bankruptcy etc. This implies that claims for deposits, together with claims for wages and some other claims, will be covered before unsecured general claims when the estate of a bankrupt financial undertaking is divided.

Based on Article 100a of the Icelandic Act on Financial Undertakings, as amended by Article 5 of the Emergency Act, the FME decided to transfer some assets, some liabilities and some guarantees from Kaupthing, Landsbanki and Glitnir to newly established entities. To ensure the viability of the new entities, the Icelandic authorities intended to transfer more assets than liabilities to the new banks. However, the old banks were to be compensated for the net value of the transferred assets. The compensation was to take the form of financial instruments issued by the new banks to the old banks.

2.2 Discrimination under Article 40 EEA

Article 125 EEA corresponds to Article 345 TFEU (ex 295 EC) and provides that the EEA "*[...] Agreement in no way prejudices the rules of the Contracting Parties governing the system of property ownership*". The Icelandic rules on insolvency proceedings concerning financial institutions can be seen as falling within the scope of Article 125 EEA. Even if this were to be the case, such national measures would, however, remain subject to the fundamental rules of EEA law, including those of non-discrimination and free movement of capital.[1]

With regard to discrimination, the complainant refers to both Articles 4 and 40 EEA. According to the case law of the EFTA Court, the general non-discrimination principle in Article 4 EEA applies independently only to situations governed by EEA law for which the EEA Agreement lays down no specific rules prohibiting discrimination. The principle of non-discrimination has been given effect in the field of free movement of capital by Article 40 EEA.[2] Consequently, as the case here concerns the free movement of capital the Authority has examined issues of alleged discrimination under Article 40 EEA.

Articles 6 and 9 of the Emergency Act do not make any distinction on grounds of nationality and apply equally to Icelandic nationals (or entities) and nationals (or entities)

[1] See to that effect Case C-452/01 *Ospelt and Schlössle Weissenberg* [2003] ECR I-9743, paragraph 24 and the case law cited and Case E-2/06 *the Authority v Norway* [2007] EFTA Ct. Rep.167, paragraph 62.
[2] Case E-1/00 *Íslandsbanki-FBA* [2000-2001] EFTA Ct. Rep. 8, paragraphs 35-36.

of other States, including EEA States. They are therefore not, *a priori*, discriminatory in nature.[3] In addition, the measures apply in principle irrespective of the residence of the originator of the credit or of the place where the credit is provided.

In making the distinction between deposits and other unsecured creditors, the subsequent measures taken by Iceland, again, do not constitute direct discrimination on the grounds of nationality, residence or of the place where capital is invested as the measures were not expressly based on such grounds. The measures may, however, amount to indirect discrimination of other unsecured creditors. Such a conclusion presupposes that depositors and other unsecured creditors were in comparable situations with regard to the emergency measures.

It has been argued that this was the case as both deposits and unsecured credits constitute claims with the right to payment into, ultimately, the estate of the debtor without collateral. However, the underlying flow of capital is different for deposits, which can normally be withdrawn on a daily or short-term basis, than for loans to banks, which usually are agreed for medium or long terms. Moreover, there are considerable differences in the psychological role which depositors and, in particular, retail depositors play in terms of public perception as compared to that of professional financial institutions. The general confidence of retail depositors in the functioning and stability of banks with which they have entrusted their savings is an essential feature and prerequisite for the stability of both the banking and the financial system. Lack of confidence by retail depositors is likely to trigger a run on banks, potentially with severe consequences for the stability of the financial system. This danger was generally imminent in Europe, and in particular in Iceland, when the FME emergency measures were taken in October 2008. The Authority, therefore, takes the view that depositors and other unsecured creditors were not in comparable situations with regard to the FME emergency measures.

In the complaint it is also maintained that the so-called Icesave Agreements between Iceland and the UK and the Netherlands constitute undue discrimination between the creditors of Landsbanki based on nationality. It is the understanding of the Authority that the priority of depositors, including those who would be affected by such agreements, in principle, stems from the Emergency Act, which granted priority to all deposits. As has been concluded above, depositors and other unsecured creditors are not in a comparable situation and therefore treating them differently does not constitute discrimination.

The issue also arises whether unsecured creditors are in a comparable situation to guarantee holders. In relation to the split, the following liabilities and guarantees were, with some exceptions, transferred to New Glitnir (later Íslandsbanki) according to the FME's decision of 14 October 2008, as amended on 19 October 2008:

- domestic deposits;
- export and import guarantees;
- guarantees due to discharge of contract by companies and individuals regarding regular activities; and
- debt backed by collateral which rested upon appropriated assets which were transferred to the new bank.

This approach was used also for Kaupthing and Landsbanki.

[3] See to that effect Case C-452/01 *Ospelt and Schlössle Weissenberg*, cited above, paragraph 37.

This left foreign depositors, bondholders, lenders and other creditors in the old banks. As regards the three last groups of creditors, their nationality, domicile or place of establishment was of no significance. Also Icelandic bondholders and most of the creditors, other than depositors, were left in the old banks.

According to information provided by the Icelandic Government, none of the new entities have taken over debt backed by collateral which rested upon appropriated assets which were transferred to the new banks.

The guarantee holders are only potential creditors of the banks. Only if the underlying obligation is not honoured will the guarantee holders enter into creditor positions towards the banks. To the Authority, this strongly indicates that the position of the guarantee holders was not comparable to the position of the unsecured general creditors. More importantly, the Authority has no information indicating that the nationality or the place of residence of the guarantee holders or the place of the underlying claim was, directly or indirectly, decisive for whether the guarantees were transferred.

Based on the above, the Authority concludes that the equal treatment requirements of Article 40 EEA are fulfilled as regards the Icelandic emergency measures.

Paragraph 100 of the complaint refers to communications in the field of state aid issued by the Commission in relation to the financial crisis. Similar instruments have also been adopted by the Authority and have been applied in the Authority's decision making practice. The complaint (paragraphs 102-103) notes that the communications provide that the state aid measures shall be compatible with the principle of non-discrimination and the fundamental freedoms. These references (*e.g.* paragraph 16 of the Authority's guidelines *Temporary Rules Regarding Financial Crisis*) to the principle of non-discrimination are simply references to the general principle of EEA law and do not have any content beyond the application of that principle. It follows from the above that as regards the free movement of capital the principle is given effect by Article 40 EEA, which is for the reasons stated above not breached in this case.

2.3 Non-discriminatory restrictions

The complainant also alleges that the emergency measures constituted non-discriminatory restrictions on the free movement of capital and services, cf. Articles 40 and 36 EEA. According to the case law of the EFTA Court, it follows from the wording of these two provisions, as well as their placement in different chapters of the Agreement, that they are intended to regulate different situations. Articles 36 and 40 EEA are, as a rule, not intended to apply simultaneously.[4] Potentially, the emergency measures might make it less attractive for Icelandic financial institutions to provide services in other EEA States, and customers of financial institutions from buying such services. However, in the case at hand, the main issue at stake is the negative effects the emergency measures have on holders of unsecured credit claims as is evident from the complaint itself. Therefore, the Authority considers that the *free movement of capital* is the predominant feature of the case and will accordingly examine the issue under Article 40 EEA. In any event the Authority is of the opinion that the conclusion reached would have been the same had the issue been analysed under Article 36 EEA.

[4] Case E-1/00 *Íslandsbanki-FBA*, cited above, paragraphs 32-33.

The principle of free movement of capital can also preclude non-discriminatory measures which adversely affect the flow of capital.[5] In the case at hand, it could be argued that the changes introduced to the ranking order of unsecured credit claims against financial institutions in insolvency proceedings may dissuade the provision of unsecured credit by financial institutions to other financial institutions. Consequently, such measures could be considered to be restrictive of the free movement of capital.

In examining that issue the Authority considers it appropriate to start by examining secondary legislation.

The Winding-up Directive 2001/24/EC, which has been incorporated into the EEA Agreement, generally recognises that EEA States may rank creditors' claims on the estate of a bank in winding-up proceedings. According to Article 10(2) letter h of the Directive, the law of the credit institution's home EEA State shall determine, *inter alia*, "the ranking of claims".

Article 16(2) of the Directive states that: *"The claims of all creditors whose domiciles, normal places of residence or head offices are in Member States other than the home Member State shall be treated in the same way and accorded the same ranking as claims of an equivalent nature which may be lodged by creditors having their domiciles, normal places of residence, or head offices in the home Member State".*[6]

In December 2007, the European Commission issued a report on a public consultation on the reorganisation and winding-up of credit institutions.[7] The report recognises that some Member States have granted certain creditors priority rights in accordance with the Directive.[8] The same report also reveals that in the context of the Winding-up Directive, some Member States have introduced priority rights relating to deposit claims.[9]

The general Insolvency Proceedings Regulation (EC) No 1346/2002 determines the jurisdiction for insolvency proceedings, but covers only to a limited extent substantive law questions. Although this Regulation has not been incorporated into the EEA Agreement, it can nonetheless serve as a point of reference for the assessment of whether the Icelandic

[5] Case C-98/01 *Commission* v. *United Kingdom* [2003] ECR I-4641, paragraph 47, Case C-463/00 *Commission* v. *Spain* [2003] ECR I-4581, paragraph 61,
[6] Emphasis added; see also Recital 17 to the Directive.
[7] European Commission, Summary of the public consultation on the reorganisation and winding-up of credit institutions, December 2007. See: http://ec.europa.eu/internal_market/bank/docs/windingup/spc_en.pdf.
[8] Page 4 (point 11) and page 6 (point 23).
[9] Page 10 (points 50-52).

emergency measures are restrictive of the free movement of capital within the EEA. Firstly, Regulation 1346/2002, does not preclude EU Member States from adopting national legislation granting certain creditors priority rights against the assets of the estate of the bankrupt company. Secondly, the Regulation expressly does not apply to providers of financial services, such as banks.[10] Indeed, Recital 9 to the Regulation states that such undertakings *"are subject to special arrangements and, to some extent, the national supervisory authorities may have extremely wide-ranging powers of intervention"*.

Therefore, provided that the measures are non-discriminatory, as is the case here, EEA States may enact national legislation that grants deposit claims a higher ranking, and thus preferential treatment, compared to claims of other creditors in winding-up proceedings. It is, therefore, the view of the Authority that EEA States can, as a matter of principle, enact such general legislation without it constituting a restriction for the purposes of Article 40 EEA.

However, the issue arises whether the Icelandic legislation could nevertheless be regarded as involving a restriction on the free movement of capital in light of the timing of the measure. The changes to the insolvency order came into effect without prior stakeholder consultation and at a time when the consequences of the new regime were not just of a theoretical nature, but entailed immediate effects on the unsecured claims affected, both positive (as regards deposits) and negative (as regards other unsecured credits). To the Authority's knowledge, there is no case law from the European Court of Justice or the EFTA Court to the effect that the timing or the procedure for adoption of a measure, that does not constitute a restriction, as such alter the classification of the measure into a restriction. To the extent that the measures come within the ambit of EEA law, these considerations are addressed under the principle of legal certainty.

The question also needs to be addressed whether the FME measures themselves can be regarded as non-discriminatory restrictions under Article 40 EEA. The case law of the European Court of Justice concerning such restrictions, generally referred to as the "golden share" case law, has primarily been limited to measures concerning limitation of state privileges regarding shareholdings in previously state-owned companies.[11] The rationale behind concluding that these measures constituted restrictions was that the measures hindered shareholders from other EEA States from fully exercising their influence on the company corresponding to their portion of the shareholding in the company. In addition, the Court of Justice has concluded that prior authorisation schemes for the acquisition of real estate constitute restrictions for the purposes of Article 63 TFEU (ex 56 EC).[12]

The FME measures concern the splits between the existing assets and liabilities of the Icelandic banks into new banks and old banks. The effect of the transfers of assets will be outlined in detail below. Any detrimental effect on the claims of the creditors is first and foremost a consequence of the change in the order of ranking in insolvency proceedings, which does not constitute a restriction on the free movement of capital. In the Authority's opinion, the logic underlying the restrictions identified in the golden shares case law referred to above cannot be transposed to a situation such as is at stake here.

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[10] Article 1(2) and Recital 9.

[11] See.e.g. Case C-98/01 *Commission v United Kingdom*, cited above; Case C-463/00 *Commission v Spain*, cited above; Joined Cases C-282/04 and C-283/04 *Commission v the Netherlands* [2006] ECR I-9141; C-112/05 *Commission v Germany* [2007] ECR I-8995.

[12] See e.g. Case C-300/01 *Salzmann* [2003] ECR I-4899; Case C-370/05 *Festersen* [2007] ECR I-1129.

If the old banks had insufficient assets to cover the deposits and other claims with priority, nothing would have been left for the other unsecured creditors. In such circumstances, the latter's position would not have been influenced by the transfer of assets.

However, even in a situation where there are assets enough to cover all prioritised claims and parts of the claims of unsecured general creditors, the Authority finds that the latter creditors' coverage is not affected by the transfer of assets when the transferred liabilities are taken into account. The Authority would like to illustrate this with examples.

Let us take an example of a simplified balance sheet for a bank with more liabilities than assets:

Assets	Liabilities	
800	Domestic deposits	100
	Non-domestic deposits	200
	Unsecured liabilities with normal priority	700
	Equity	
		-200

If this bank were wound up according to the Icelandic legislation as per 6 October 2008, the depositors would get full coverage of their claims. The other creditors would get (800-300) / 700 = 500 / 700 = 71.4 % coverage of their claims.

Let us now assume that the bank is split in the way that all the domestic deposits are transferred to a new entity together with 150 of the assets and the new bank issues a bond of 50 to the old bank to compensate for the net value of the transferred assets. The balance sheet of the old bank would be:

Assets	Liabilities	
650	Non-domestic depositors	200
50	Unsecured liabilities with normal priority	700
	Equity	
		-200

A winding-up in this situation would lead to 100 % coverage of the non-domestic deposits. The rest of the assets, 500, would be shared between the other creditors. This would give them a coverage of 500/700 = 71.4 % of their claims.

The simplified examples are of course theoretical. The valuation of the assets is a complex process. There is a margin for error, but that can as well be to the benefit of the other creditors if the transferred assets are estimated to be of a higher value than the real one.

Against this background, the Authority takes the view that, in principle, the coverage of the complaining bank was not affected by the transfers of assets.

Based on all of the above, the Authority considers that the measures do not constitute a restriction under Article 40 EEA.

2.4 Justification

Although having reached the above conclusion, the Authority has, for the sake of completeness, examined whether a hypothetical restriction on the free movement of capital in the EEA would be justified. Article 40 EEA is essentially identical in substance to provisions under EU law prohibiting restrictions on the movement of capital in relations between Member States.[13] The EFTA Court, in determining whether restrictions can be justified, has held that the rules of the EEA Agreement governing the free movement of capital are essentially identical in substance to those in the TFEU. Consequently, national rules restricting the free movement of capital in the EEA may, as in EU law, be justified on grounds such as those stipulated in Article 65 TFEU (ex 58 EC) or on considerations of overriding public interest. In order to be so justified, the national rules must be suitable for securing the objective that they pursue and must not exceed what is necessary in order to achieve it, so as to accord with the principle of proportionality.[14] Deviations from the fundamental principles and freedoms of the EEA Agreement must be construed narrowly and justification can only be accepted in the case of a *genuine and sufficiently serious threat affecting one of the fundamental interests of society.*[15]

The Authority takes the view that the Icelandic emergency measures changing the ranking of creditors were taken in extreme circumstances entailing a real risk of a collapse of the whole Icelandic banking system. Depositors in Europe (and elsewhere) feared for the solvency of commercial banks, for the stability of the financial systems and for the safety of their deposits. The ability of deposit guarantee schemes to pay out deposits was questioned.

It was against this background that Articles 6 and 9 of the Emergency Act were intended by Iceland to enhance protection of depositors with the aim of safeguarding the functioning of the Icelandic domestic banking system. The purpose of the amendments can be seen as conveying to depositors the message that even in the worst case (insolvency of the affected banks), deposits would be safe and would not have to be withdrawn in an uncontrollable manner. The psychological importance of such reassurances for the overall domestic confidence in the functioning of the Icelandic banking system should, in the view of the Authority, not be underestimated.

In *Campus Oil* the European Court of Justice considered, as regards petroleum supply, that petroleum products are of fundamental importance for a country's existence since not only its economy but above all its institutions, its essential public services and even the survival of its inhabitants, depend upon them. An interruption of supplies of petroleum products, with the resulting dangers for the country's existence, could therefore seriously affect the public security that the [ex EC] Treaty allows states to protect. The aim of ensuring a minimum supply of petroleum products at all times transcends purely economic interests.[16]

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[13] Case E-1/04 *Fokus Bank* [2004] EFTA Ct. Rep. 11, paragraph 23 with reference to Case C-452/01 *Ospelt and Schlössle Weissenberg*, cited above, paragraph 28.

[14] Case E-10/04 *Piazza* [2005] EFTA Ct. Rep. 76, paragraph 39 with reference to Case C-174/04 *Commission v Italy* [2005] ECR I-4933, paragraph 35.

[15] See Case E-10/04 *Piazza*, cited above, paragraph 42; Case E-3/98 *Rainford-Towning* [1998] EFTA Ct. Rep. 205, paragraph 42.

[16] Case 72/83 *Campus Oil and Others* [1984] ECR 2727, paragraphs 34 and 35.

The same reasons apply, in the view of the Authority, to the functioning of a country's banking system and the systemic significance of the banking system for the proper functioning of the state's real overall economy as well as the security of the general public and the functioning of society. The existence of a banking system is of vital importance not only for the economy of the state but also from a public security point of view, since the payment systems of the country depend thereon. Conversely, the collapse of these systems would result in immediate bank runs and could potentially lead to the collapse of the whole economic system and jeopardise the functioning of society at large.

It is settled case law of the European Court of Justice that mere economic grounds cannot serve as justification for obstacles prohibited by the Treaty.[17] However, with reference to the above, the Authority considers that the objective of the emergency measures was not merely economic. The objective of safeguarding the functioning of the domestic banking system and the real overall economy constitutes, as a matter of principle, an overriding public interest consideration because this objective aims at warding off a genuine and sufficiently serious threat affecting one of the fundamental interests of society. The pursuit of such an aim is capable of justifying restrictions on the free movement of capital within the EEA, provided that the measures taken can be regarded as proportionate to the attainment of the objective pursued.

The Authority considers that the emergency measures can be seen as suitable for the attainment of the aim of safeguarding the functioning of the Icelandic domestic banking system. Giving depositors higher ranking in insolvency proceedings and the transfer of domestic deposits to the new banks contributed to rebuilding confidence of the domestic depositors in the safety of their deposits.

Further, the changes in the ranking order did not go beyond what was necessary in order to attain the legitimate aim. The Authority notes that confidence, in particular that of depositors is of systemic importance for the functioning of any banking system. This justifies measures to protect depositors. Conversely, financial institutions and large economic operators as investors do not need the same level of protection. Moreover, it is the view of the Authority that equally suitable, but less restrictive, measures which the Icelandic authorities could have taken are not apparent.

The proportionality of the emergency measures has to be considered against the background that, at the time these measures were taken, almost the entire banking sector in Iceland was on the brink of collapse. According to the International Monetary Fund (IMF)[18], Iceland's economy was in the midst of a banking crisis of such extraordinary proportions that it was expected to lead to a deep recession, a sharp rise in the fiscal deficit, and a dramatic surge in public sector debt, reflecting a very high fiscal cost of restructuring the banking system. The virtual collapse of the on-shore foreign exchange market posed, in view of the IMF, a serious and immediate risk to the economy considering its very high import dependence. The Central Bank of Iceland and the State had suffered a loss in creditworthiness in the eyes of the international financial community. This situation in which Iceland suddenly found itself was an unprecedented calamity for a developed country.

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[17] See, in relation to the free movement of capital, Case C-367/98, *Commission* v *Portugal* [2002] ECR I-4731, paragraph 52.

[18] http://www.imf.org/external/pubs/ft/scr/2008/cr08362.pdf and http://www.imf.org/external/pubs/ft/survey/2008/123108.pdf

The functioning of a country's banking system is of systemic significance for the proper functioning of the state's real overall economy and the functioning of society. The existence of a banking system is of vital importance not only for the economy of the state but also for society as a whole, since payment systems of the country depend thereon. Consequently, the measures taken by the Icelandic authorities were aimed to remedy a real and imminent danger of total collapse of the domestic banking system. Similarly, the Icelandic measures were designed to safeguard the functioning of the economy as such rather than the interests of individual depositors.

Conversely, the success of the emergency measures depended largely on the credibility of the action taken. Measures taken to back up the Icelandic banks as a whole would probably have lacked the necessary credibility. In its budget for 2008, Iceland's total State revenue was estimated at ISK 460 billion. The deposits in the Icelandic banks alone were at the time of their collapse around ISK 2.800 billion, thereof the equivalent of ISK 1.600 billion in foreign currencies in the foreign branches of the banks. The foreign currency reserves of Iceland consisted of ISK 410 billion in October 2008, i.e. approximately 1/4 of deposits in the non-domestic branches. In comparison, according to publicly available information, the total credit claims against Glitnir, Kaupthing and Landsbanki accounted for ISK 13.597 billion by June 2008.

In contrast, the three banking groups covered by the measures taken under the Icelandic emergency legislation in October 2008, together, played a predominant role in the Icelandic banking sector both numerically and in terms of significance. In particular, and according to the Icelandic authorities, by October 2008, the total operations of Glitnir, Kaupthing and Landsbanki accounted for over 85% of retail banking in Iceland. Consequently, practically the entire payments systems of the country depended upon them. Almost every family and business in Iceland is said to have been a customer, holding cheque and savings accounts with these banks. The Icelandic authorities claim that deposits with banks are not just savings; the current accounts are used by the bank's customers for their regular financial transactions. Limits in accessing such accounts would have instantly risked causing a full run on the banks with consequent serious risks for public security. Businesses could not have used funds to pay for their resources and to pay wages to employees; retail suppliers could not have imported necessities for the public, drugs and food etc; lawyers' trust accounts and other similar forms of deposits would have been non-operable with dire consequences. The general public would not have been able to access money deposited at the banks, e.g. proceeds from sales of real-estate, to finance the purchase of a new home. Money could not have been withdrawn to honour large payment obligations to banks and other institutions. This would have increased the already existing risk of systemic financial collapse.

It does not appear that equally suitable but less restrictive measures could have been taken by the Icelandic authorities; for example imposing limits on deposit withdrawals or access to savings accounts. Such measures would have implied a considerable risk of triggering a run on the new banks as well as the few remaining solvent banks. The Authority recalls that the very objective of the measures taken by the Icelandic authorities was to restore the confidence in the banking system in order to prevent a full bank run.

The complaint (paragraph 83) refers to some alternative measures that could have been taken by the Icelandic Government, which the complainant considers would be less restrictive means to achieve the Government's aim, such as recapitalisation of the banks without performing a split, issuing a state guarantee for the banks or transfer some selected liabilities into a specific vehicle without differentiating between categories of creditors.

The Authority considers that it follows from the above that a recapitalisation of the banks was not an option that was open to the Icelandic Government given the amount of money that would have been needed to credibly undertake that operation. Similarly, granting them a state guarantee would, given their size in relation to the Icelandic State, not have been a credible alternative. These alternatives would, to the extent the Icelandic Government could have taken them, therefore, not have been likely to achieve the aim of the safeguarding the functioning of the Icelandic banking system. As regards differentiation between categories of creditors, the Authority has stated above that measures to ensure the confidence of depositors are justified in view of the systemic importance of their confidence for the functioning of any banking system.

It is therefore the view of the Authority that on the assumption that the measures were a restriction under Article 40 EEA they would have been justified as safeguarding the functioning of the Icelandic banking system. Moreover, that the emergency measures were proportionate to the objective to remedy a genuine and sufficiently serious threat to the domestic banking system, the functioning of which constitutes one of the fundamental interests of society. An assessment under Article 36 EEA will not lead to another conclusion.

2.5 The principle of legal certainty

In relation to the claim that the measures are discriminatory, the complainant also states that his legitimate expectations were breached contrary to general principles of law. The protection of legitimate expectations and the principle of non-retroactivity both form part of the principle of legal certainty, which is recognised as a general principle of EEA law.[19] As stated above, the general principles of EEA law are not applicable with regard to those measures of national law that do not come within the scope of EEA law. Therefore, the Authority considers that the EEA principle of legal certainty is not applicable in the case under examination. However, in light of the complainant's submissions the Authority will, nevertheless, briefly comment on the matter.

As regards the principle of legitimate expectations, the Authority notes that prior to the enactment of the emergency measures, there was no State action which could have made unsecured creditors believe that the Icelandic authorities would not make changes to the insolvency order for financial institutions, even in times of crisis.

Regarding non-retroactivity, the emergency measures did not take effect prior to their enactment. Thus, these measures had no effect for the past. They were, however, immediately applicable and thus affected past transactions, which still had effects. When reviewing Community measures, the Court of Justice has generally considered that immediate application requires justification by an overriding public interest consideration. On the assumption that such a test would be applicable to the emergency measures the

[19] Case E-1/04, *Fokus Bank*, cited above, paragraph 37; Joined Cases E-5/04, E-6/04, E-7/04 *Fesil ASA and others v the Authority* [2005] EFTA Ct. Rep. 121 paragraph 163.

Authority considers that the result of its application would not lead to a different outcome from that of the proportionality conducted above.

3. Final remarks

The Authority invites the complainant to provide his views on the preliminary findings of the Authority and any other information deemed relevant to the case by **15 January 2010.**

Yours sincerely,

Hallgrímur Ásgeirsson
Director
Internal Market Affairs Directorate

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Brussels, 10 December 2009
Case No: 66793
Event No: 539089

EFTA SURVEILLANCE AUTHORITY

De...

Subject: Complaint against Iceland concerning the actions as regards the banking crisis – your ref:

1. Introduction

Reference is made to your letter of 24 June 2009 and our letter of 14 July 2009 (Event No: 524399).

The complainant is a bank which subscribed bonds issued by Glitnir bank hf. ("Glitnir"), Landsbanki Íslands hf. ("Landsbanki") and Kaupthing bank hf. ("Kaupthing"), acted as lender to Glitnir, Landsbanki and Kaupthing and acted as repo and securities lending party to Landsbanki.

The complainant alleges that measures taken by the Icelandic authorities are in breach of:

1. The rule of non-discrimination, both as a general rule (Article 4 of the EEA Agreement) and as a rule specifically applicable to the free movement of capital (Article 40 of the EEA Agreement); and
2. The prohibition of restrictions to the principles of free movement of capital (Article 40 of the EEA Agreement) and of freedom to provide services (Article 36 of the EEA Agreement)

In this letter, the Authority will give its preliminary assessment of issues raised in the complaint.

The Authority sees two main measures taken by the Icelandic authorities relevant to the complainant's position. First, there is the legislative amendment of 6 October 2008 giving depositors priority over other unsecured creditors (see Article 6 of Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc.). Second, there are the various decisions of the Icelandic Financial Supervisory Authority ("the FME") to transfer assets and liabilities from the existing banks to newly established entities, taken on the basis of Article 5 of the said Act. Given that the measures are closely interlinked and form part of the Icelandic authorities' actions to save the Icelandic financial system, in the following, the Authority will mostly examine them together.

As the complainant is not a depositor, this letter does not deal with the compatibility under EEA law of the difference in treatment, due to the Icelandic emergency measures, between domestic deposits and deposits held in branches of Icelandic banks in other EEA States.

2 The compatibility of the emergency measures with the EEA Agreement

2.1 Introduction

By Article 6 of the Icelandic Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc. ("the Emergency Act"), Article 103 of the Icelandic Act 161/2002 on Financial Undertakings was amended so that in dividing the estate of a bankrupt financial undertaking, claims for deposits, pursuant to the Icelandic Act on Deposit Guarantees and an Investor Compensation Scheme, shall have priority as provided for in Article 112, Paragraph 1 of the Icelandic Act No. 21/1991 on Bankruptcy etc. This implies that claims for deposits, together with claims for wages and some other claims, will be covered before unsecured general claims when the estate of a bankrupt financial undertaking is divided.

Based on Article 100a of the Icelandic Act on Financial Undertakings, as amended by Article 5 of the Emergency Act, the FME decided to transfer some assets, some liabilities and some guarantees from Kaupthing, Landsbanki and Glitnir to newly established entities. To ensure the viability of the new entities, the Icelandic authorities intended to transfer more assets than liabilities to the new banks. However, the old banks were to be compensated for the net value of the transferred assets. The compensation was to take the form of financial instruments issued by the new banks to the old banks.

2.2 Discrimination under Article 40 EEA

Article 125 EEA corresponds to Article 345 TFEU (ex 295 EC) and provides that the EEA "*[...] Agreement in no way prejudices the rules of the Contracting Parties governing the system of property ownership*". The Icelandic rules on insolvency proceedings concerning financial institutions can be seen as falling within the scope of Article 125 EEA. Even if this were to be the case, such national measures would, however, remain subject to the fundamental rules of EEA law, including those of non-discrimination and free movement of capital.[1]

With regard to discrimination, the complainant refers to both Articles 4 and 40 EEA. According to the case law of the EFTA Court, the general non-discrimination principle in Article 4 EEA applies independently only to situations governed by EEA law for which the EEA Agreement lays down no specific rules prohibiting discrimination. The principle of non-discrimination has been given effect in the field of free movement of capital by

[1] See to that effect Case C-452/01 *Ospelt and Schlössle Weissenberg* [2003] ECR I-9743, paragraph 24 and the case law cited and Case E-2/06 *the Authority v Norway* [2007] EFTA Ct. Rep.167, paragraph 62.

Article 40 EEA.[2] Consequently, as the case here concerns the free movement of capital the Authority has examined issues of alleged discrimination under Article 40 EEA.

Articles 6 and 9 of the Emergency Act do not make any distinction on grounds of nationality and apply equally to Icelandic nationals (or entities) and nationals (or entities) of other States, including EEA States. They are therefore not, *a priori*, discriminatory in nature.[3] In addition, the measures apply in principle irrespective of the residence of the originator of the credit or of the place where the credit is provided.

In making the distinction between deposits and other unsecured creditors, the subsequent measures taken by Iceland, again, do not constitute direct discrimination on the grounds of nationality, residence or of the place where capital is invested as the measures were not expressly based on such grounds. The measures may, however, amount to indirect discrimination of other unsecured creditors. Such a conclusion presupposes that depositors and other unsecured creditors were in comparable situations with regard to the emergency measures.

It has been argued that this was the case as both deposits and unsecured credits constitute claims with the right to payment into, ultimately, the estate of the debtor without collateral. However, the underlying flow of capital is different for deposits, which can normally be withdrawn on a daily or short-term basis, than for loans to banks, which usually are agreed for medium or long terms. Moreover, there are considerable differences in the psychological role which depositors and, in particular, retail depositors play in terms of public perception as compared to that of professional financial institutions. The general confidence of retail depositors in the functioning and stability of banks with which they have entrusted their savings is an essential feature and prerequisite for the stability of both the banking and the financial system. Lack of confidence by retail depositors is likely to trigger a run on banks, potentially with severe consequences for the stability of the financial system. This danger was generally imminent in Europe, and in particular in Iceland, when the FME emergency measures were taken in October 2008. The Authority, therefore, takes the view that depositors and other unsecured creditors were not in comparable situations with regard to the FME emergency measures.

In the complaint it is also maintained that the so-called Icesave Agreements between Iceland and the UK and the Netherlands constitute undue discrimination between the creditors of Landsbanki based on nationality. It is the understanding of the Authority that the priority of depositors, including those who would be affected by such agreements, in principle, stems from the Emergency Act, which granted priority to all deposits. As has been concluded above, depositors and other unsecured creditors are not in a comparable situation and therefore treating them differently does not constitute discrimination.

The issue also arises whether unsecured creditors are in a comparable situation to guarantee holders. In relation to the split, the following liabilities and guarantees were, with some exceptions, transferred to New Glitnir (later Íslandsbanki) according to the

[2] Case E-1/00 *Íslandsbanki-FBA* [2000-2001] EFTA Ct. Rep. 8, paragraphs 35-36.
[3] See to that effect Case C-452/01 *Ospelt and Schlössle Weissenberg*, cited above, paragraph 37.

FME's decision of 14 October 2008, as amended on 19 October 2008:

- domestic deposits;
- export and import guarantees;
- guarantees due to discharge of contract by companies and individuals regarding regular activities; and
- debt backed by collateral which rested upon appropriated assets which were transferred to the new bank.

This approach was used also for Kaupthing and Landsbanki.

This left foreign depositors, bondholders, lenders and other creditors in the old banks. As regards the three last groups of creditors, their nationality, domicile or place of establishment was of no significance. Also Icelandic bondholders and most of the creditors, other than depositors, were left in the old banks.

According to information provided by the Icelandic Government, none of the new entities have taken over debt backed by collateral which rested upon appropriated assets which were transferred to the new banks.

The guarantee holders are only potential creditors of the banks. Only if the underlying obligation is not honoured will the guarantee holders enter into creditor positions towards the banks. To the Authority, this strongly indicates that the position of the guarantee holders was not comparable to the position of the unsecured general creditors. More importantly, the Authority has no information indicating that the nationality or the place of residence of the guarantee holders or the place of the underlying claim was, directly or indirectly, decisive for whether the guarantees were transferred.

Based on the above, the Authority concludes that the equal treatment requirements of Article 40 EEA are fulfilled as regards the Icelandic emergency measures.

Paragraph 100 of the complaint refers to communications in the field of state aid issued by the Commission in relation to the financial crisis. Similar instruments have also been adopted by the Authority and have been applied in the Authority's decision making practice. The complaint (paragraphs 102-103) notes that the communications provide that the state aid measures shall be compatible with the principle of non-discrimination and the fundamental freedoms. These references (*e.g.* paragraph 16 of the Authority's guidelines *Temporary Rules Regarding Financial Crisis*) to the principle of non-discrimination are simply references to the general principle of EEA law and do not have any content beyond the application of that principle. It follows from the above that as regards the free movement of capital the principle is given effect by Article 40 EEA, which is for the reasons stated above not breached in this case.

2.3 Non-discriminatory restrictions

The complainant also alleges that the emergency measures constituted non-discriminatory restrictions on the free movement of capital and services, cf. Articles 40 and 36 EEA. According to the case law of the EFTA Court, it follows from the wording of these two provisions, as well as their placement in different chapters of the Agreement, that they are intended to regulate different situations. Articles 36 and 40 EEA are, as a rule, not

intended to apply simultaneously.[4] Potentially, the emergency measures might make it less attractive for Icelandic financial institutions to provide services in other EEA States, and customers of financial institutions from buying such services. However, in the case at hand, the main issue at stake is the negative effects the emergency measures have on holders of unsecured credit claims as is evident from the complaint itself. Therefore, the Authority considers that the *free movement of capital* is the predominant feature of the case and will accordingly examine the issue under Article 40 EEA. In any event the Authority is of the opinion that the conclusion reached would have been the same had the issue been analysed under Article 36 EEA.

The principle of free movement of capital can also preclude non-discriminatory measures which adversely affect the flow of capital.[5] In the case at hand, it could be argued that the changes introduced to the ranking order of unsecured credit claims against financial institutions in insolvency proceedings may dissuade the provision of unsecured credit by financial institutions to other financial institutions. Consequently, such measures could be considered to be restrictive of the free movement of capital.

In examining that issue the Authority considers it appropriate to start by examining secondary legislation.

The Winding-up Directive 2001/24/EC, which has been incorporated into the EEA Agreement, generally recognises that EEA States may rank creditors' claims on the estate of a bank in winding-up proceedings. According to Article 10(2) letter h of the Directive, the law of the credit institution's home EEA State shall determine, *inter alia*, "the ranking of claims".

Article 16(2) of the Directive states that: *"The claims of all creditors whose domiciles, normal places of residence or head offices are in Member States other than the home Member State shall be treated in the same way and accorded the same ranking as claims of an equivalent nature which may be lodged by creditors having their domiciles, normal places of residence, or head offices in the home Member State"*.[6]

In December 2007, the European Commission issued a report on a public consultation on the reorganisation and winding-up of credit institutions.[7] The report recognises that some Member States have granted certain creditors priority rights in accordance with the Directive.[8] The same report also reveals that in the context of the Winding-up Directive, some Member States have introduced priority rights relating to deposit claims.[9]

The general Insolvency Proceedings Regulation (EC) No 1346/2002 determines the jurisdiction for insolvency proceedings, but covers only to a limited extent substantive law questions. Although this Regulation has not been incorporated into the EEA Agreement, it can nonetheless serve as a point of reference for the assessment of whether the Icelandic

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[4] Case E-1/00 *Íslandsbanki-FBA*, cited above, paragraphs 32-33.
[5] Case C-98/01 *Commission* v. *United Kingdom* [2003] ECR I-4641, paragraph 47, Case C-463/00 *Commission* v. *Spain* [2003] ECR I-4581, paragraph 61,
[6] Emphasis added; see also Recital 17 to the Directive.
[7] European Commission, Summary of the public consultation on the reorganisation and winding-up of credit institutions, December 2007. See: http://ec.europa.eu/internal_market/bank/docs/windingup/spc_en.pdf.
[8] Page 4 (point 11) and page 6 (point 23).
[9] Page 10 (points 50-52).

emergency measures are restrictive of the free movement of capital within the EEA. Firstly, Regulation 1346/2002, does not preclude EU Member States from adopting national legislation granting certain creditors priority rights against the assets of the estate of the bankrupt company. Secondly, the Regulation expressly does not apply to providers of financial services, such as banks.[10] Indeed, Recital 9 to the Regulation states that such undertakings *"are subject to special arrangements and, to some extent, the national supervisory authorities may have extremely wide-ranging powers of intervention"*.

Therefore, provided that the measures are non-discriminatory, as is the case here, EEA States may enact national legislation that grants deposit claims a higher ranking, and thus preferential treatment, compared to claims of other creditors in winding-up proceedings. It is, therefore, the view of the Authority that EEA States can, as a matter of principle, enact such general legislation without it constituting a restriction for the purposes of Article 40 EEA.

However, the issue arises whether the Icelandic legislation could nevertheless be regarded as involving a restriction on the free movement of capital in light of the timing of the measure. The changes to the insolvency order came into effect without prior stakeholder consultation and at a time when the consequences of the new regime were not just of a theoretical nature, but entailed immediate effects on the unsecured claims affected, both positive (as regards deposits) and negative (as regards other unsecured credits). To the Authority's knowledge, there is no case law from the European Court of Justice or the EFTA Court to the effect that the timing or the procedure for adoption of a measure, that does not constitute a restriction, as such alter the classification of the measure into a restriction. To the extent that the measures come within the ambit of EEA law, these considerations are addressed under the principle of legal certainty.

The question also needs to be addressed whether the FME measures themselves can be regarded as non-discriminatory restrictions under Article 40 EEA. The case law of the European Court of Justice concerning such restrictions, generally referred to as the "golden share" case law, has primarily been limited to measures concerning limitation of state privileges regarding shareholdings in previously state-owned companies.[11] The rationale behind concluding that these measures constituted restrictions was that the measures hindered shareholders from other EEA States from fully exercising their influence on the company corresponding to their portion of the shareholding in the company. In addition, the Court of Justice has concluded that prior authorisation schemes for the acquisition of real estate constitute restrictions for the purposes of Article 63 TFEU (ex 56 EC).[12]

The FME measures concern the splits between the existing assets and liabilities of the Icelandic banks into new banks and old banks. The effect of the transfers of assets will be outlined in detail below. Any detrimental effect on the claims of the creditors is first and foremost a consequence of the change in the order of ranking in insolvency proceedings, which does not constitute a restriction on the free movement of capital. In the Authority's opinion, the logic underlying the restrictions identified in the golden shares case law referred to above cannot be transposed to a situation such as is at stake here.

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[10] Article 1(2) and Recital 9.

[11] See.e.g. Case C-98/01 *Commission v United Kingdom*, cited above; Case C-463/00 *Commission v Spain*, cited above; Joined Cases C-282/04 and C-283/04 *Commission v the Netherlands* [2006] ECR I-9141; C-112/05 *Commission v Germany* [2007] ECR I-8995.

[12] See e.g. Case C-300/01 *Salzmann* [2003] ECR I-4899; Case C-370/05 *Festersen* [2007] ECR I-1129.

If the old banks had insufficient assets to cover the deposits and other claims with priority, nothing would have been left for the other unsecured creditors. In such circumstances, the latter's position would not have been influenced by the transfer of assets.

However, even in a situation where there are assets enough to cover all prioritised claims and parts of the claims of unsecured general creditors, the Authority finds that the latter creditors' coverage is not affected by the transfer of assets when the transferred liabilities are taken into account. The Authority would like to illustrate this with examples.

Let us take an example of a simplified balance sheet for a bank with more liabilities than assets:

Assets	Liabilities	
800	Domestic deposits	100
	Non-domestic deposits	200
	Unsecured liabilities with normal priority	700
	Equity	
		-200

If this bank were wound up according to the Icelandic legislation as per 6 October 2008, the depositors would get full coverage of their claims. The other creditors would get (800-300) / 700 = 500 / 700 = 71.4 % coverage of their claims.

Let us now assume that the bank is split in the way that all the domestic deposits are transferred to a new entity together with 150 of the assets and the new bank issues a bond of 50 to the old bank to compensate for the net value of the transferred assets. The balance sheet of the old bank would be:

Assets	Liabilities	
650	Non-domestic depositors	200
50	Unsecured liabilities with normal priority	700
	Equity	
		-200

A winding-up in this situation would lead to 100 % coverage of the non-domestic deposits. The rest of the assets, 500, would be shared between the other creditors. This would give them a coverage of 500/700 = 71.4 % of their claims.

The simplified examples are of course theoretical. The valuation of the assets is a complex process. There is a margin for error, but that can as well be to the benefit of the other creditors if the transferred assets are estimated to be of a higher value than the real one.

Against this background, the Authority takes the view that, in principle, the coverage of the complaining bank was not affected by the transfers of assets.

Based on all of the above, the Authority considers that the measures do not constitute a restriction under Article 40 EEA.

2.4 Justification

Although having reached the above conclusion, the Authority has, for the sake of completeness, examined whether a hypothetical restriction on the free movement of capital in the EEA would be justified. Article 40 EEA is essentially identical in substance to provisions under EU law prohibiting restrictions on the movement of capital in relations between Member States.[13] The EFTA Court, in determining whether restrictions can be justified, has held that the rules of the EEA Agreement governing the free movement of capital are essentially identical in substance to those in the TFEU. Consequently, national rules restricting the free movement of capital in the EEA may, as in EU law, be justified on grounds such as those stipulated in Article 65 TFEU (ex 58 EC) or on considerations of overriding public interest. In order to be so justified, the national rules must be suitable for securing the objective that they pursue and must not exceed what is necessary in order to achieve it, so as to accord with the principle of proportionality.[14] Deviations from the fundamental principles and freedoms of the EEA Agreement must be construed narrowly and justification can only be accepted in the case of a *genuine and sufficiently serious threat affecting one of the fundamental interests of society.*[15]

The Authority takes the view that the Icelandic emergency measures changing the ranking of creditors were taken in extreme circumstances entailing a real risk of a collapse of the whole Icelandic banking system. Depositors in Europe (and elsewhere) feared for the solvency of commercial banks, for the stability of the financial systems and for the safety of their deposits. The ability of deposit guarantee schemes to pay out deposits was questioned.

It was against this background that Articles 6 and 9 of the Emergency Act were intended by Iceland to enhance protection of depositors with the aim of safeguarding the functioning of the Icelandic domestic banking system. The purpose of the amendments can be seen as conveying to depositors the message that even in the worst case (insolvency of the affected banks), deposits would be safe and would not have to be withdrawn in an uncontrollable manner. The psychological importance of such reassurances for the overall domestic confidence in the functioning of the Icelandic banking system should, in the view of the Authority, not be underestimated.

In *Campus Oil* the European Court of Justice considered, as regards petroleum supply, that petroleum products are of fundamental importance for a country's existence since not only its economy but above all its institutions, its essential public services and even the survival of its inhabitants, depend upon them. An interruption of supplies of petroleum products, with the resulting dangers for the country's existence, could therefore seriously affect the public security that the [ex EC] Treaty allows states to protect. The aim of ensuring a minimum supply of petroleum products at all times transcends purely economic interests.[16]

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[13] Case E-1/04 *Fokus Bank* [2004] EFTA Ct. Rep. 11, paragraph 23 with reference to Case C-452/01 *Ospelt and Schlössle Weissenberg*, cited above, paragraph 28.
[14] Case E-10/04 *Piazza* [2005] EFTA Ct. Rep. 76, paragraph 39 with reference to Case C-174/04 *Commission v Italy* [2005] ECR I-4933, paragraph 35.
[15] See Case E-10/04 *Piazza*, cited above, paragraph 42; Case E-3/98 *Rainford-Towning* [1998] EFTA Ct. Rep. 205, paragraph 42.
[16] Case 72/83 *Campus Oil and Others* [1984] ECR 2727, paragraphs 34 and 35.

The same reasons apply, in the view of the Authority, to the functioning of a country's banking system and the systemic significance of the banking system for the proper functioning of the state's real overall economy as well as the security of the general public and the functioning of society. The existence of a banking system is of vital importance not only for the economy of the state but also from a public security point of view, since the payment systems of the country depend thereon. Conversely, the collapse of these systems would result in immediate bank runs and could potentially lead to the collapse of the whole economic system and jeopardise the functioning of society at large.

It is settled case law of the European Court of Justice that mere economic grounds cannot serve as justification for obstacles prohibited by the Treaty.[17] However, with reference to the above, the Authority considers that the objective of the emergency measures was not merely economic. The objective of safeguarding the functioning of the domestic banking system and the real overall economy constitutes, as a matter of principle, an overriding public interest consideration because this objective aims at warding off a genuine and sufficiently serious threat affecting one of the fundamental interests of society. The pursuit of such an aim is capable of justifying restrictions on the free movement of capital within the EEA, provided that the measures taken can be regarded as proportionate to the attainment of the objective pursued.

The Authority considers that the emergency measures can be seen as suitable for the attainment of the aim of safeguarding the functioning of the Icelandic domestic banking system. Giving depositors higher ranking in insolvency proceedings and the transfer of domestic deposits to the new banks contributed to rebuilding confidence of the domestic depositors in the safety of their deposits.

Further, the changes in the ranking order did not go beyond what was necessary in order to attain the legitimate aim. The Authority notes that confidence, in particular that of depositors is of systemic importance for the functioning of any banking system. This justifies measures to protect depositors. Conversely, financial institutions and large economic operators as investors do not need the same level of protection. Moreover, it is the view of the Authority that equally suitable, but less restrictive, measures which the Icelandic authorities could have taken are not apparent.

The proportionality of the emergency measures has to be considered against the background that, at the time these measures were taken, almost the entire banking sector in Iceland was on the brink of collapse. According to the International Monetary Fund (IMF)[18], Iceland's economy was in the midst of a banking crisis of such extraordinary proportions that it was expected to lead to a deep recession, a sharp rise in the fiscal deficit, and a dramatic surge in public sector debt, reflecting a very high fiscal cost of restructuring the banking system. The virtual collapse of the on-shore foreign exchange market posed, in view of the IMF, a serious and immediate risk to the economy considering its very high import dependence. The Central Bank of Iceland and the State had suffered a loss in creditworthiness in the eyes of the international financial community. This situation in which Iceland suddenly found itself was an unprecedented calamity for a developed country.

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[17] See, in relation to the free movement of capital, Case C-367/98, *Commission* v *Portugal* [2002] ECR I-4731, paragraph 52.

[18] http://www.imf.org/external/pubs/ft/scr/2008/cr08362.pdf and http://www.imf.org/external/pubs/ft/survey/2008/123108.pdf

The functioning of a country's banking system is of systemic significance for the proper functioning of the state's real overall economy and the functioning of society. The existence of a banking system is of vital importance not only for the economy of the state but also for society as a whole, since payment systems of the country depend thereon. Consequently, the measures taken by the Icelandic authorities were aimed to remedy a real and imminent danger of total collapse of the domestic banking system. Similarly, the Icelandic measures were designed to safeguard the functioning of the economy as such rather than the interests of individual depositors.

Conversely, the success of the emergency measures depended largely on the credibility of the action taken. Measures taken to back up the Icelandic banks as a whole would probably have lacked the necessary credibility. In its budget for 2008, Iceland's total State revenue was estimated at ISK 460 billion. The deposits in the Icelandic banks alone were at the time of their collapse around ISK 2.800 billion, thereof the equivalent of ISK 1.600 billion in foreign currencies in the foreign branches of the banks. The foreign currency reserves of Iceland consisted of ISK 410 billion in October 2008, i.e. approximately 1/4 of deposits in the non-domestic branches. In comparison, according to publicly available information, the total credit claims against Glitnir, Kaupthing and Landsbanki accounted for ISK 13.597 billion by June 2008.

In contrast, the three banking groups covered by the measures taken under the Icelandic emergency legislation in October 2008, together, played a predominant role in the Icelandic banking sector both numerically and in terms of significance. In particular, and according to the Icelandic authorities, by October 2008, the total operations of Glitnir, Kaupthing and Landsbanki accounted for over 85% of retail banking in Iceland. Consequently, practically the entire payments systems of the country depended upon them. Almost every family and business in Iceland is said to have been a customer, holding cheque and savings accounts with these banks. The Icelandic authorities claim that deposits with banks are not just savings; the current accounts are used by the bank's customers for their regular financial transactions. Limits in accessing such accounts would have instantly risked causing a full run on the banks with consequent serious risks for public security. Businesses could not have used funds to pay for their resources and to pay wages to employees; retail suppliers could not have imported necessities for the public, drugs and food etc; lawyers' trust accounts and other similar forms of deposits would have been non-operable with dire consequences. The general public would not have been able to access money deposited at the banks, e.g. proceeds from sales of real-estate, to finance the purchase of a new home. Money could not have been withdrawn to honour large payment obligations to banks and other institutions. This would have increased the already existing risk of systemic financial collapse.

It does not appear that equally suitable but less restrictive measures could have been taken by the Icelandic authorities; for example imposing limits on deposit withdrawals or access to savings accounts. Such measures would have implied a considerable risk of triggering a run on the new banks as well as the few remaining solvent banks. The Authority recalls that the very objective of the measures taken by the Icelandic authorities was to restore the confidence in the banking system in order to prevent a full bank run.

The complaint (paragraph 83) refers to some alternative measures that could have been taken by the Icelandic Government, which the complainant considers would be less restrictive means to achieve the Government's aim, such as recapitalisation of the banks without performing a split, issuing a state guarantee for the banks or transfer some

selected liabilities into a specific vehicle without differentiating between categories of creditors.

The Authority considers that it follows from the above that a recapitalisation of the banks was not an option that was open to the Icelandic Government given the amount of money that would have been needed to credibly undertake that operation. Similarly, granting them a state guarantee would, given their size in relation to the Icelandic State, not have been a credible alternative. These alternatives would, to the extent the Icelandic Government could have taken them, therefore, not have been likely to achieve the aim of the safeguarding the functioning of the Icelandic banking system. As regards differentiation between categories of creditors, the Authority has stated above that measures to ensure the confidence of depositors are justified in view of the systemic importance of their confidence for the functioning of any banking system.

It is therefore the view of the Authority that on the assumption that the measures were a restriction under Article 40 EEA they would have been justified as safeguarding the functioning of the Icelandic banking system. Moreover, that the emergency measures were proportionate to the objective to remedy a genuine and sufficiently serious threat to the domestic banking system, the functioning of which constitutes one of the fundamental interests of society. An assessment under Article 36 EEA will not lead to another conclusion.

2.5 The principle of legal certainty

In relation to the claim that the measures are discriminatory, the complainant also states that his legitimate expectations were breached contrary to general principles of law. The protection of legitimate expectations and the principle of non-retroactivity both form part of the principle of legal certainty, which is recognised as a general principle of EEA law.[19] As stated above, the general principles of EEA law are not applicable with regard to those measures of national law that do not come within the scope of EEA law. Therefore, the Authority considers that the EEA principle of legal certainty is not applicable in the case under examination. However, in light of the complainant's submissions the Authority will, nevertheless, briefly comment on the matter.

As regards the principle of legitimate expectations, the Authority notes that prior to the enactment of the emergency measures, there was no State action which could have made unsecured creditors believe that the Icelandic authorities would not make changes to the insolvency order for financial institutions, even in times of crisis.

Regarding non-retroactivity, the emergency measures did not take effect prior to their enactment. Thus, these measures had no effect for the past. They were, however, immediately applicable and thus affected past transactions, which still had effects. When reviewing Community measures, the Court of Justice has generally considered that immediate application requires justification by an overriding public interest consideration. On the assumption that such a test would be applicable to the emergency measures the

[19] Case E-1/04, *Fokus Bank*, cited above, paragraph 37; Joined Cases E-5/04, E-6/04, E-7/04 *Fesil ASA and others v the Authority* [2005] EFTA Ct. Rep. 121 paragraph 163.

Authority considers that the result of its application would not lead to a different outcome from that of the proportionality conducted above.

3. Final remarks

The Authority invites the complainant to provide his views on the preliminary findings of the Authority and any other information deemed relevant to the case by **15 January 2010.**

Yours sincerely,

Hallgrímur Ásgeirsson
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Brussels, 10 December 2009
Case No: 65843
Event No: 539088

EFTA SURVEILLANCE AUTHORITY

Subject: Complaint against Iceland concerning the actions as regards the banking crisis

1. Introduction

Reference is made to your letters of 23 December 2008 and 23 April 2009 and our letter of 8 January 2009 (Event No: 503590).

The complainants are three financial institutions that subscribed bonds issued by the Icelandic bank Glitnir bank hf. ("Glitnir"). In addition, one of the complainants entered into derivative agreements with the bank.

The complainants allege that measures taken by the Icelandic authorities are in breach of:

1. The rule of non-discrimination, both as a general rule (Article 4 of the EEA Agreement) and as a rule specifically applicable to the free movement of capital (Article 40 of the EEA Agreement); and
2. The prohibition of restrictions to the principles of free movement of capital (Article 40 of the EEA Agreement) and of freedom to provide services (Article 36 of the EEA Agreement)

In this letter, the Authority will give its preliminary assessment of issues raised in the complaint.

The Authority sees two main measures taken by the Icelandic authorities relevant to the complainants' position. First, there is the legislative amendment of 6 October 2008 giving depositors priority over other unsecured creditors (see Article 6 of Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc.). Second, there are the various decisions of the Icelandic Financial Supervisory Authority ("the FME") to transfer assets and liabilities from the existing banks to newly established entities, taken on the basis of Article 5 of the said Act. Given that the measures are closely interlinked and form part of the Icelandic authorities' actions to save the

Icelandic financial system, in the following, the Authority will mostly examine them together.

As the complainants are not depositors, this letter does not deal with the compatibility under EEA law of the difference in treatment, due to the Icelandic emergency measures, between domestic deposits and deposits held in branches of Icelandic banks in other EEA States.

2 The compatibility of the emergency measures with the EEA Agreement

2.1 Introduction

By Article 6 of the Icelandic Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc. ("the Emergency Act"), Article 103 of the Icelandic Act 161/2002 on Financial Undertakings was amended so that in dividing the estate of a bankrupt financial undertaking, claims for deposits, pursuant to the Icelandic Act on Deposit Guarantees and an Investor Compensation Scheme, shall have priority as provided for in Article 112, Paragraph 1 of the Icelandic Act No. 21/1991 on Bankruptcy etc. This implies that claims for deposits, together with claims for wages and some other claims, will be covered before unsecured general claims when the estate of a bankrupt financial undertaking is divided.

Based on Article 100a of the Icelandic Act on Financial Undertakings, as amended by Article 5 of the Emergency Act, the FME decided to transfer some assets, some liabilities and some guarantees from Glitnir to a newly established entity. Similar action was taken as regards two other Icelandic banks Kaupthing and Landsbanki. To ensure the viability of the new entities, the Icelandic authorities intended to transfer more assets than liabilities to the new banks. However, the old banks were to be compensated for the net value of the transferred assets. The compensation was to take the form of financial instruments issued by the new banks to the old banks.

2.2 Discrimination under Article 40 EEA

Article 125 EEA corresponds to Article 345 TFEU (ex 295 EC) and provides that the EEA "*[...] Agreement in no way prejudices the rules of the Contracting Parties governing the system of property ownership*". The Icelandic rules on insolvency proceedings concerning financial institutions can be seen as falling within the scope of Article 125 EEA. Even if this were to be the case, such national measures would, however, remain subject to the fundamental rules of EEA law, including those of non-discrimination and free movement of capital.[1]

With regard to discrimination, the complainants refer to both Articles 4 and 40 EEA. According to the case law of the EFTA Court, the general non-discrimination principle in Article 4 EEA applies independently only to situations governed by EEA law for which the EEA Agreement lays down no specific rules prohibiting discrimination. The principle of non-discrimination has been given effect in the field of free movement of capital by Article 40 EEA.[2] Consequently, as the case here concerns the free movement of capital the Authority has examined issues of alleged discrimination under Article 40 EEA.

[1] See to that effect Case C-452/01 *Ospelt and Schlössle Weissenberg* [2003] ECR I-9743, paragraph 24 and the case law cited and Case E-2/06 *the Authority v Norway* [2007] EFTA Ct. Rep.167, paragraph 62.
[2] Case E-1/00 *Íslandsbanki-FBA* [2000-2001] EFTA Ct. Rep. 8, paragraphs 35-36.

Articles 6 and 9 of the Emergency Act do not make any distinction on grounds of nationality and apply equally to Icelandic nationals (or entities) and nationals (or entities) of other States, including EEA States. They are therefore not, *a priori*, discriminatory in nature.[3] In addition, the measures apply in principle irrespective of the residence of the originator of the credit or of the place where the credit is provided.

In making the distinction between deposits and other unsecured creditors, the subsequent measures taken by Iceland, again, do not constitute direct discrimination on the grounds of nationality, residence or of the place where capital is invested as the measures were not expressly based on such grounds. The measures may, however, amount to indirect discrimination of other unsecured creditors. Such a conclusion presupposes that depositors and other unsecured creditors were in comparable situations with regard to the emergency measures.

It has been argued that this was the case as both deposits and unsecured credits constitute claims with the right to payment into, ultimately, the estate of the debtor without collateral. However, the underlying flow of capital is different for deposits, which can normally be withdrawn on a daily or short-term basis, than for loans to banks, which usually are agreed for medium or long terms. Moreover, there are considerable differences in the psychological role which depositors and, in particular, retail depositors play in terms of public perception as compared to that of professional financial institutions. The general confidence of retail depositors in the functioning and stability of banks with which they have entrusted their savings is an essential feature and prerequisite for the stability of both the banking and the financial system. Lack of confidence by retail depositors is likely to trigger a run on banks, potentially with severe consequences for the stability of the financial system. This danger was generally imminent in Europe, and in particular in Iceland, when the FME emergency measures were taken in October 2008. The Authority, therefore, takes the view that depositors and other unsecured creditors were not in comparable situations with regard to the FME emergency measures.

In the complaint it is also maintained that bilateral agreements similar to the so-called Icesave Agreements between Iceland and the UK and the Netherlands would constitute undue discrimination between the creditors of the bank based on nationality. It is the understanding of the Authority that the priority of depositors, including those who would be affected by such agreements, in principle, stems from the Emergency Act, which granted priority to all deposits. As has been concluded above, depositors and other unsecured creditors are not in a comparable situation and therefore treating them differently does not constitute discrimination.

The issue also arises whether unsecured creditors are in a comparable situation to guarantee holders. In relation to the split, the following liabilities and guarantees were, with some exceptions, transferred to New Glitnir (later Íslandsbanki) according to the

[3] See to that effect Case C-452/01 *Ospelt and Schlössle Weissenberg*, cited above, paragraph 37.

FME's decision of 14 October 2008, as amended on 19 October 2008:

- domestic deposits;
- export and import guarantees;
- guarantees due to discharge of contract by companies and individuals regarding regular activities; and
- debt backed by collateral which rested upon appropriated assets which were transferred to the new bank.

This approach was used also for Kaupthing and Landsbanki.

This left foreign depositors, bondholders, lenders and other creditors in the old banks. As regards the three last groups of creditors, their nationality, domicile or place of establishment was of no significance. Also Icelandic bondholders and most of the creditors, other than depositors, were left in the old banks.

According to information provided by the Icelandic Government, none of the new entities have taken over debt backed by collateral which rested upon appropriated assets which were transferred to the new banks.

The guarantee holders are only potential creditors of the banks. Only if the underlying obligation is not honoured will the guarantee holders enter into creditor positions towards the banks. To the Authority, this strongly indicates that the position of the guarantee holders was not comparable to the position of the unsecured general creditors. More importantly, the Authority has no information indicating that the nationality or the place of residence of the guarantee holders or the place of the underlying claim was, directly or indirectly, decisive for whether the guarantees were transferred.

Based on the above, the Authority concludes that the equal treatment requirements of Article 40 EEA are fulfilled as regards the Icelandic emergency measures.

Paragraph 22 of the addendum to the complaint refers to communications in the field of state aid issued by the Commission in relation to the financial crisis. Similar instruments have also been adopted by the Authority and have been applied in the Authority's decision making practice. The complaint (paragraphs 24-25 of the addendum to the complaint) notes that the communications provide that the state aid measures shall be compatible with the principle of non-discrimination and the fundamental freedoms. These references (*e.g.* paragraph 16 of the Authority's guidelines *Temporary Rules Regarding Financial Crisis*) to the principle of non-discrimination are simply references to the general principle of EEA law and do not have any content beyond the application of that principle. It follows from the above that as regards the free movement of capital the principle is given effect by Article 40 EEA, which is for the reasons stated above not breached in this case.

2.3 Non-discriminatory restrictions

The complainants also allege that the emergency measures constituted non-discriminatory restrictions on the free movement of capital and services, cf. Articles 40 and 36 EEA. According to the case law of the EFTA Court, it follows from the wording of these two provisions, as well as their placement in different chapters of the Agreement, that they are intended to regulate different situations. Articles 36 and 40 EEA are, as a rule, not

EFTA SURVEILLANCE AUTHORITY

intended to apply simultaneously.[4] Potentially, the emergency measures might make it less attractive for Icelandic financial institutions to provide services in other EEA States, and customers of financial institutions from buying such services. However, in the case at hand, the main issue at stake is the negative effects the emergency measures have on holders of unsecured credit claims as is evident from the complaint itself. Therefore, the Authority considers that the *free movement of capital* is the predominant feature of the case and will accordingly examine the issue under Article 40 EEA. In any event the Authority is of the opinion that the conclusion reached would have been the same had the issue been analysed under Article 36 EEA.

The principle of free movement of capital can also preclude non-discriminatory measures which adversely affect the flow of capital.[5] In the case at hand, it could be argued that the changes introduced to the ranking order of unsecured credit claims against financial institutions in insolvency proceedings may dissuade the provision of unsecured credit by financial institutions to other financial institutions. Consequently, such measures could be considered to be restrictive of the free movement of capital.

In examining that issue the Authority considers it appropriate to start by examining secondary legislation.

The Winding-up Directive 2001/24/EC, which has been incorporated into the EEA Agreement, generally recognises that EEA States may rank creditors' claims on the estate of a bank in winding-up proceedings. According to Article 10(2) letter h of the Directive, the law of the credit institution's home EEA State shall determine, *inter alia*, "the ranking of claims".

Article 16(2) of the Directive states that: *"The claims of all creditors whose domiciles, normal places of residence or head offices are in Member States other than the home Member State shall be treated in the same way and <u>accorded the same ranking as claims of an equivalent nature</u> which may be lodged by creditors having their domiciles, normal places of residence, or head offices in the home Member State".*[6]

In December 2007, the European Commission issued a report on a public consultation on the reorganisation and winding-up of credit institutions.[7] The report recognises that some Member States have granted certain creditors priority rights in accordance with the Directive.[8] The same report also reveals that in the context of the Winding-up Directive, some Member States have introduced priority rights relating to deposit claims.[9]

The general Insolvency Proceedings Regulation (EC) No 1346/2002 determines the jurisdiction for insolvency proceedings, but covers only to a limited extent substantive law questions. Although this Regulation has not been incorporated into the EEA Agreement, it can nonetheless serve as a point of reference for the assessment of whether the Icelandic

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[4] Case E-1/00 *Íslandsbanki-FBA*, cited above, paragraphs 32-33.

[5] Case C-98/01 *Commission* v. *United Kingdom* [2003] ECR I-4641, paragraph 47, Case C-463/00 *Commission* v. *Spain* [2003] ECR I-4581, paragraph 61,

[6] Emphasis added; see also Recital 17 to the Directive.

[7] European Commission, Summary of the public consultation on the reorganisation and winding-up of credit institutions, December 2007. See: http://ec.europa.eu/internal_market/bank/docs/windingup/spc_en.pdf.

[8] Page 4 (point 11) and page 6 (point 23).

[9] Page 10 (points 50-52).

emergency measures are restrictive of the free movement of capital within the EEA. Firstly, Regulation 1346/2002, does not preclude EU Member States from adopting national legislation granting certain creditors priority rights against the assets of the estate of the bankrupt company. Secondly, the Regulation expressly does not apply to providers of financial services, such as banks.[10] Indeed, Recital 9 to the Regulation states that such undertakings *"are subject to special arrangements and, to some extent, the national supervisory authorities may have extremely wide-ranging powers of intervention"*.

Therefore, provided that the measures are non-discriminatory, as is the case here, EEA States may enact national legislation that grants deposit claims a higher ranking, and thus preferential treatment, compared to claims of other creditors in winding-up proceedings. It is, therefore, the view of the Authority that EEA States can, as a matter of principle, enact such general legislation without it constituting a restriction for the purposes of Article 40 EEA.

However, the issue arises whether the Icelandic legislation could nevertheless be regarded as involving a restriction on the free movement of capital in light of the timing of the measure. The changes to the insolvency order came into effect without prior stakeholder consultation and at a time when the consequences of the new regime were not just of a theoretical nature, but entailed immediate effects on the unsecured claims affected, both positive (as regards deposits) and negative (as regards other unsecured credits). To the Authority's knowledge, there is no case law from the European Court of Justice or the EFTA Court to the effect that the timing or the procedure for adoption of a measure, that does not constitute a restriction, as such alter the classification of the measure into a restriction. To the extent that the measures come within the ambit of EEA law, these considerations are addressed under the principle of legal certainty.

The question also needs to be addressed whether the FME measures themselves can be regarded as non-discriminatory restrictions under Article 40 EEA. The case law of the European Court of Justice concerning such restrictions, generally referred to as the "golden share" case law, has primarily been limited to measures concerning limitation of state privileges regarding shareholdings in previously state-owned companies.[11] The rationale behind concluding that these measures constituted restrictions was that the measures hindered shareholders from other EEA States from fully exercising their influence on the company corresponding to their portion of the shareholding in the company. In addition, the Court of Justice has concluded that prior authorisation schemes for the acquisition of real estate constitute restrictions for the purposes of Article 63 TFEU (ex 56 EC).[12]

The FME measures concern the splits between the existing assets and liabilities of the Icelandic banks into new banks and old banks. The effect of the transfers of assets will be outlined in detail below. Any detrimental effect on the claims of the creditors is first and foremost a consequence of the change in the order of ranking in insolvency proceedings, which does not constitute a restriction on the free movement of capital. In the Authority's opinion, the logic underlying the restrictions identified in the golden shares case law referred to above cannot be transposed to a situation such as is at stake here.

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[10] Article 1(2) and Recital 9.

[11] See.e.g. Case C-98/01 *Commission v United Kingdom*, cited above; Case C-463/00 *Commission v Spain*, cited above; Joined Cases C-282/04 and C-283/04 *Commission v the Netherlands* [2006] ECR I-9141; C-112/05 *Commission v Germany* [2007] ECR I-8995.

[12] See e.g. Case C-300/01 *Salzmann* [2003] ECR I-4899; Case C-370/05 *Festersen* [2007] ECR I-1129.

If the old banks had insufficient assets to cover the deposits and other claims with priority, nothing would have been left for the other unsecured creditors. In such circumstances, the latter's position would not have been influenced by the transfer of assets.

However, even in a situation where there are assets enough to cover all prioritised claims and parts of the claims of unsecured general creditors, the Authority finds that the latter creditors' coverage is not affected by the transfer of assets when the transferred liabilities are taken into account. The Authority would like to illustrate this with examples.

Let us take an example of a simplified balance sheet for a bank with more liabilities than assets:

Assets	Liabilities	
800	Domestic deposits	100
	Non-domestic deposits	200
	Unsecured liabilities with normal priority	700
	Equity	
		-200

If this bank were wound up according to the Icelandic legislation as per 6 October 2008, the depositors would get full coverage of their claims. The other creditors would get (800-300) / 700 = 500 / 700 = <u>71.4 %</u> coverage of their claims.

Let us now assume that the bank is split in the way that all the domestic deposits are transferred to a new entity together with 150 of the assets and the new bank issues a bond of 50 to the old bank to compensate for the net value of the transferred assets. The balance sheet of the old bank would be:

Assets	Liabilities	
650	Non-domestic depositors	200
50	Unsecured liabilities with normal priority	700
	Equity	
		-200

A winding-up in this situation would lead to 100 % coverage of the non-domestic deposits. The rest of the assets, 500, would be shared between the other creditors. This would give them a coverage of 500/700 = <u>71.4 %</u> of their claims.

The simplified examples are of course theoretical. The valuation of the assets is a complex process. There is a margin for error, but that can as well be to the benefit of the other creditors if the transferred assets are estimated to be of a higher value than the real one.

Against this background, the Authority takes the view that, in principle, the coverage of the complainants was not affected by the transfers of assets.

Based on all of the above, the Authority considers that the measures do not constitute a restriction under Article 40 EEA.

2.4 Justification

Although having reached the above conclusion, the Authority has, for the sake of completeness, examined whether a hypothetical restriction on the free movement of capital in the EEA would be justified. Article 40 EEA is essentially identical in substance to provisions under EU law prohibiting restrictions on the movement of capital in relations between Member States.[13] The EFTA Court, in determining whether restrictions can be justified, has held that the rules of the EEA Agreement governing the free movement of capital are essentially identical in substance to those in the TFEU. Consequently, national rules restricting the free movement of capital in the EEA may, as in EU law, be justified on grounds such as those stipulated in Article 65 TFEU (ex 58 EC) or on considerations of overriding public interest. In order to be so justified, the national rules must be suitable for securing the objective that they pursue and must not exceed what is necessary in order to achieve it, so as to accord with the principle of proportionality.[14] Deviations from the fundamental principles and freedoms of the EEA Agreement must be construed narrowly and justification can only be accepted in the case of a *genuine and sufficiently serious threat affecting one of the fundamental interests of society.*[15]

The Authority takes the view that the Icelandic emergency measures changing the ranking of creditors were taken in extreme circumstances entailing a real risk of a collapse of the whole Icelandic banking system. Depositors in Europe (and elsewhere) feared for the solvency of commercial banks, for the stability of the financial systems and for the safety of their deposits. The ability of deposit guarantee schemes to pay out deposits was questioned.

It was against this background that Articles 6 and 9 of the Emergency Act were intended by Iceland to enhance protection of depositors with the aim of safeguarding the functioning of the Icelandic domestic banking system. The purpose of the amendments can be seen as conveying to depositors the message that even in the worst case (insolvency of the affected banks), deposits would be safe and would not have to be withdrawn in an uncontrollable manner. The psychological importance of such reassurances for the overall domestic confidence in the functioning of the Icelandic banking system should, in the view of the Authority, not be underestimated.

In *Campus Oil* the European Court of Justice considered, as regards petroleum supply, that petroleum products are of fundamental importance for a country's existence since not only its economy but above all its institutions, its essential public services and even the survival of its inhabitants, depend upon them. An interruption of supplies of petroleum products, with the resulting dangers for the country's existence, could therefore seriously affect the public security that the [ex EC] Treaty allows states to protect. The aim of ensuring a minimum supply of petroleum products at all times transcends purely economic interests.[16]

[13] Case E-1/04 *Fokus Bank* [2004] EFTA Ct. Rep. 11, paragraph 23 with reference to Case C-452/01 *Ospelt and Schlössle Weissenberg*, cited above, paragraph 28.
[14] Case E-10/04 *Piazza* [2005] EFTA Ct. Rep. 76, paragraph 39 with reference to Case C-174/04 *Commission v Italy* [2005] ECR I-4933, paragraph 35.
[15] See Case E-10/04 *Piazza*, cited above, paragraph 42; Case E-3/98 *Rainford-Towning* [1998] EFTA Ct. Rep. 205, paragraph 42.
[16] Case 72/83 *Campus Oil and Others* [1984] ECR 2727, paragraphs 34 and 35.

The same reasons apply, in the view of the Authority, to the functioning of a country's banking system and the systemic significance of the banking system for the proper functioning of the state's real overall economy as well as the security of the general public and the functioning of society. The existence of a banking system is of vital importance not only for the economy of the state but also from a public security point of view, since the payment systems of the country depend thereon. Conversely, the collapse of these systems would result in immediate bank runs and could potentially lead to the collapse of the whole economic system and jeopardise the functioning of society at large.

It is settled case law of the European Court of Justice that mere economic grounds cannot serve as justification for obstacles prohibited by the Treaty.[17] However, with reference to the above, the Authority considers that the objective of the emergency measures was not merely economic. The objective of safeguarding the functioning of the domestic banking system and the real overall economy constitutes, as a matter of principle, an overriding public interest consideration because this objective aims at warding off a genuine and sufficiently serious threat affecting one of the fundamental interests of society. The pursuit of such an aim is capable of justifying restrictions on the free movement of capital within the EEA, provided that the measures taken can be regarded as proportionate to the attainment of the objective pursued.

The Authority considers that the emergency measures can be seen as suitable for the attainment of the aim of safeguarding the functioning of the Icelandic domestic banking system. Giving depositors higher ranking in insolvency proceedings and the transfer of domestic deposits to the new banks contributed to rebuilding confidence of the domestic depositors in the safety of their deposits.

Further, the changes in the ranking order did not go beyond what was necessary in order to attain the legitimate aim. The Authority notes that confidence, in particular that of depositors is of systemic importance for the functioning of any banking system. This justifies measures to protect depositors. Conversely, financial institutions and large economic operators as investors do not need the same level of protection. Moreover, it is the view of the Authority that equally suitable, but less restrictive, measures which the Icelandic authorities could have taken are not apparent.

The proportionality of the emergency measures has to be considered against the background that, at the time these measures were taken, almost the entire banking sector in Iceland was on the brink of collapse. According to the International Monetary Fund (IMF)[18], Iceland's economy was in the midst of a banking crisis of such extraordinary proportions that it was expected to lead to a deep recession, a sharp rise in the fiscal deficit, and a dramatic surge in public sector debt, reflecting a very high fiscal cost of restructuring the banking system. The virtual collapse of the on-shore foreign exchange market posed, in view of the IMF, a serious and immediate risk to the economy considering its very high import dependence. The Central Bank of Iceland and the State had suffered a loss in creditworthiness in the eyes of the international financial community. This situation in which Iceland suddenly found itself was an unprecedented calamity for a developed country.

[17] See, in relation to the free movement of capital, Case C-367/98, *Commission* v *Portugal* [2002] ECR I-4731, paragraph 52.

[18] http://www.imf.org/external/pubs/ft/scr/2008/cr08362.pdf and http://www.imf.org/external/pubs/ft/survey/2008/123108.pdf

The functioning of a country's banking system is of systemic significance for the proper functioning of the state's real overall economy and the functioning of society. The existence of a banking system is of vital importance not only for the economy of the state but also for society as a whole, since payment systems of the country depend thereon. Consequently, the measures taken by the Icelandic authorities were aimed to remedy a real and imminent danger of total collapse of the domestic banking system. Similarly, the Icelandic measures were designed to safeguard the functioning of the economy as such rather than the interests of individual depositors.

Conversely, the success of the emergency measures depended largely on the credibility of the action taken. Measures taken to back up the Icelandic banks as a whole would probably have lacked the necessary credibility. In its budget for 2008, Iceland's total State revenue was estimated at ISK 460 billion. The deposits in the Icelandic banks alone were at the time of their collapse around ISK 2.800 billion, thereof the equivalent of ISK 1.600 billion in foreign currencies in the foreign branches of the banks. The foreign currency reserves of Iceland consisted of ISK 410 billion in October 2008, i.e. approximately 1/4 of deposits in the non-domestic branches. In comparison, according to publicly available information, the total credit claims against Glitnir, Kaupthing and Landsbanki accounted for ISK 13.597 billion by June 2008.

In contrast, the three banking groups covered by the measures taken under the Icelandic emergency legislation in October 2008, together, played a predominant role in the Icelandic banking sector both numerically and in terms of significance. In particular, and according to the Icelandic authorities, by October 2008, the total operations of Glitnir, Kaupthing and Landsbanki accounted for over 85% of retail banking in Iceland. Consequently, practically the entire payments systems of the country depended upon them. Almost every family and business in Iceland is said to have been a customer, holding cheque and savings accounts with these banks. The Icelandic authorities claim that deposits with banks are not just savings; the current accounts are used by the bank's customers for their regular financial transactions. Limits in accessing such accounts would have instantly risked causing a full run on the banks with consequent serious risks for public security. Businesses could not have used funds to pay for their resources and to pay wages to employees; retail suppliers could not have imported necessities for the public, drugs and food etc; lawyers' trust accounts and other similar forms of deposits would have been non-operable with dire consequences. The general public would not have been able to access money deposited at the banks, e.g. proceeds from sales of real-estate, to finance the purchase of a new home. Money could not have been withdrawn to honour large payment obligations to banks and other institutions. This would have increased the already existing risk of systemic financial collapse.

It does not appear that equally suitable but less restrictive measures could have been taken by the Icelandic authorities; for example imposing limits on deposit withdrawals or access to savings accounts. Such measures would have implied a considerable risk of triggering a run on the new banks as well as the few remaining solvent banks. The Authority recalls that the very objective of the measures taken by the Icelandic authorities was to restore the confidence in the banking system in order to prevent a full bank run.

The complaint (paragraph 63) refers to some alternative measures that could have been taken by the Icelandic Government, which the complainants consider would be less restrictive means to achieve the Government's aim, such as recapitalisation of the banks without performing a split, issuing a state guarantee for the banks or transfer some selected liabilities into a specific vehicle without differentiating between categories of creditors.

The Authority considers that it follows from the above that a recapitalisation of the banks was not an option that was open to the Icelandic Government given the amount of money that would have been needed to credibly undertake that operation. Similarly, granting them a state guarantee would, given their size in relation to the Icelandic State, not have been a credible alternative. These alternatives would, to the extent the Icelandic Government could have taken them, therefore, not have been likely to achieve the aim of the safeguarding the functioning of the Icelandic banking system. As regards differentiation between categories of creditors, the Authority has stated above that measures to ensure the confidence of depositors are justified in view of the systemic importance of their confidence for the functioning of any banking system.

It is therefore the view of the Authority that on the assumption that the measures were a restriction under Article 40 EEA they would have been justified as safeguarding the functioning of the Icelandic banking system. Moreover, that the emergency measures were proportionate to the objective to remedy a genuine and sufficiently serious threat to the domestic banking system, the functioning of which constitutes one of the fundamental interests of society. An assessment under Article 36 EEA will not lead to another conclusion.

2.5 The principle of legal certainty

In relation to the claim that the measures are discriminatory, the complainants also state that their legitimate expectations were breached contrary to general principles of law. The protection of legitimate expectations and the principle of non-retroactivity both form part of the principle of legal certainty, which is recognised as a general principle of EEA law.[19] As stated above, the general principles of EEA law are not applicable with regard to those measures of national law that do not come within the scope of EEA law. Therefore, the Authority considers that the EEA principle of legal certainty is not applicable in the case under examination. However, in light of the complainants' submissions the Authority will, nevertheless, briefly comment on the matter.

As regards the principle of legitimate expectations, the Authority notes that prior to the enactment of the emergency measures, there was no State action which could have made unsecured creditors believe that the Icelandic authorities would not make changes to the insolvency order for financial institutions, even in times of crisis.

Regarding non-retroactivity, the emergency measures did not take effect prior to their enactment. Thus, these measures had no effect for the past. They were, however, immediately applicable and thus affected past transactions, which still had effects. When reviewing Community measures, the Court of Justice has generally considered that immediate application requires justification by an overriding public interest consideration. On the assumption that such a test would be applicable to the emergency measures the

[19] Case E-1/04, *Fokus Bank*, cited above, paragraph 37; Joined Cases E-5/04, E-6/04, E-7/04 *Fesil ASA and others v the Authority* [2005] EFTA Ct. Rep. 121 paragraph 163.

Authority considers that the result of its application would not lead to a different outcome from that of the proportionality conducted above.

3. Final remarks

The Authority invites the complainants to provide their views on the preliminary findings of the Authority and any other information deemed relevant to the case by **15 January 2010**.

Yours sincerely,

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