EFTA SURVEILLANCE AUTHORITY

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Brussels, 4 December 2009
Case No: 66740
Event No: 534906

Norton Rose LLP
Attn: Mr Joseph Tirado
3 More London Riverside
London SE1 2AQ
United Kingdom

Dear Mr Tirado,

Subject: Complaints against Iceland concerning the actions as regards the banking crisis – your ref: JTIR/MKNO/LN23513

1. Introduction

Reference is made to your letter of 29 May 2009 and our letter of 24 June 2009 (Event No: 522059).

You represent 39 banks that are creditors of the Icelandic banks Glitnir bank hf. ("Glitnir"), Kaupthing bank hf. ("Kaupthing"), Landsbanki Íslands hf. ("Landsbanki"), Sparisjóður Reykjavíkur og nágrennis hf. ("SPRON"), and Sparisjóðabanki Íslands hf. ("Spar"). In our letter of 24 June 2009, your clients (hereinafter referred to as "the complainants") were invited to inform the EFTA Surveillance Authority if any of them were depositors at any of the Icelandic banks. As the Authority has not received further information on this matter, it is assumed that all the banks are general unsecured creditors.

The complaints allege that:

1. The Icelandic authorities discriminated against foreign creditors of the Icelandic banks (contrary to Articles 4 and 40 of the EEA Agreement);
2. The transfers of assets and liabilities to the new entities amounted to unlawful state aid, contrary to Article 61 of the EEA Agreement;
3. The Icelandic authorities breached Article 16 of Directive 2001/24/EC on the reorganisation of and winding up of credit institutions, which requires that all the claims of foreign creditors shall be treated in the same way as those of Icelandic creditors;
4. The actions of the Icelandic authorities unlawfully interfered with the complainants' rights to peaceful enjoyment of their possessions (Article 1 of the First Protocol to the European Convention on Human Rights); and
5. The legitimate expectations of the complainants were breached contrary to general principles of law.

In this letter, the Authority will give its preliminary assessment of the internal market issues relevant for the complaints. The letter will not deal with State aid, which is being dealt with by the Authority in a separate procedure under case number 66754.

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. 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 your clients 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 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.

As regards Spar, some deposits and some guarantees were transferred to the Icelandic Central Bank, New Kaupthing Bank and Byr Savings Bank. As compensation for the transfer of liabilities, some assets were transferred along with the liabilities. Should there turn out to be a difference between the transferred liabilities and the assets (i.e. if the assets are of a higher value than the liabilities), the remainder shall be paid to Spar, according to the FME decisions of 21 March 2009 and 17 April 2009.

As regards SPRON, most of the deposits and some guarantees were transferred to New Kaupthing Bank. All the assets of the bank were transferred to a special purpose vehicle fully owned by SPRON. The subsidiary issued a bond to New Kaupthing Bank to

compensate for the transferred liabilities. SPRON's shares in the subsidiary and all the subsidiary's assets were collateralised for the bond.

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]

The complaints 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.

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,

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[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.

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

therefore, takes the view that depositors and other unsecured creditors were not in comparable situations with regard to the FME emergency measures.

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. The situation for SPRON and Spar was explained above. Also in those cases only deposits and some guarantees were transferred to other entities.

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.

2.3 Non-discriminatory restrictions

The principle of free movement of capital can also preclude non-discriminatory measures which adversely affect the flow of capital.[4] 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 consider secondary

[4] 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,

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".*[5]

In December 2007, the European Commission issued a report on a public consultation on the reorganisation and winding-up of credit institutions.[6] The report recognises that some Member States have granted certain creditors priority rights in accordance with the Directive.[7] 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.[8]

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.[9] 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

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

[6] 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.

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

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

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

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.[10] 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).[11]

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 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

[10] 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.

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

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 banks 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.[12] 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.[13] 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*

[12] 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.

[13] 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.