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HE Mr Steingrimur J. Sigfusson
Minister of Finance, Fisheries and
Agriculture
Reykjavik
Iceland

11 February 2009

Dear Minister,

LANDSBANKI FREEZING ORDER 2008

Your predecessor Arni Mathiesen wrote to the Chancellor on 16 December about several aspects of the Landsbanki Freezing Order 2008. I have been asked to respond on his behalf. The delay in my reply has been due to the need to consult legal counsel to ensure you receive as detailed a reply as possible.

The freezing order

1. The Treasury made the freezing order on 8 October 2008, in exercise of powers conferred under Part 2 of the Anti-terrorism, Crime and Security Act 2001 ("the Act"). The Treasury can make an order in response to a likelihood of action which would be a threat to the United Kingdom's economy (or part of it). A power such as this has formed part of the United Kingdom's legislation for many years before being included in the Act.
2. As the Treasury made clear in the statement given to the Government of Iceland on 15 October 2008, this exercise of the power is not related to terrorism. The Chancellor of the Exchequer also made this clear at the Treasury Select Committee hearing on 3 November and other Treasury Ministers have emphasised this in Parliament on 27 and 28 October and again on 6 November 2008.

The specified persons

3. The following are specified persons for the purposes of the freezing order—
Landsbanki Islands h.f. ("Landsbanki");



the Authorities:

- the Central Bank of Iceland;
- the Fjármálaeftirlitið ("the FME");
- the Landsbanki receivership committee established by the FME;
- the Government of Iceland.

(See article 3 of the freezing order)

4. Each of the specified persons falls within the description of persons who are the Government of a country outside the United Kingdom or the resident of such a country. Under the Act, "residents" includes bodies corporate. *(See sections 4 and 9 of the Act.)*

The power to make freezing orders

5. Section 4 of the Act allows the Treasury to make a freezing Order if two conditions are satisfied.
6. The first condition, in this case, is that the Treasury must reasonably believe that action to the detriment of the United Kingdom's economy (or part of it) has been or is likely to be taken by a person or persons. *(See section 4(2)(a) of the Act.)*
7. The second condition is that such person or persons must be the government of or a resident of a country or territory outside the United Kingdom. *(See sections 4(3) and (4) of the Act.)* As noted above, each person specified in the freezing order falls within that description.
8. A further requirement of making a freezing order under the Act applicable in this case is that the Treasury must reasonably believe that the persons specified in the freezing order have taken or are likely to take the action in question. *(See section 5 of the Act.)*
9. The conditions and the further requirement are satisfied for the reasons given in this letter. In taking its decision to make the freezing order, the Treasury also considered issues of proportionality, EC and EEA law.

Outline of reasons

10. Landsbanki was the second largest commercial Icelandic bank. In the United Kingdom, it has primarily operated through its London branch which, as a branch of an EEA bank, is regulated by the financial services regulator in Iceland rather than the UK's Financial Services Authority (the FSA). Landsbanki had a very large number of UK retail depositors, who had an aggregate exposure of around £4.5bn, as well as a large number of UK wholesale depositors - including building societies and local authorities.
11. The primary reason for the Treasury making the freezing order was its belief that the Icelandic Government was likely to take discriminatory action to use

Landsbanki assets to protect Icelandic depositors and that this would be of severe detriment to UK depositors and other UK creditors.

12. Furthermore, at the time, retail depositor confidence was critical for ensuring financial stability. Depositors with Landsbanki needed assurance that they would be compensated in respect of any inability of a financial institution to repay deposits, as they would reasonably expect; but the actions of the Icelandic Government risked severely undermining retail depositor confidence not only among depositors with Landsbanki but more generally.
13. The failure of Landsbanki also created the likelihood of contagion through the financial system, triggering retail outflows in similar financial institutions. The Treasury believed this was a likely consequence of the actions of Landsbanki and the Authorities.
14. Furthermore, the Treasury believed that failure by the Government of Iceland and the Authorities to provide appropriate safeguards for UK creditors meant that the UK banking sector through the UK's Financial Services Compensation Scheme was likely to be subject to enhanced levies to fund compensation to depositors at a time when financial institutions were under stress.
15. The Treasury believed that each of these matters was likely to be to the detriment of the UK economy (or parts of it).

Background

- Non-discrimination and depositor protection

16. The EEA agreement, to which Iceland is a contracting party, contains prohibitions against discrimination on the grounds of nationality.

17. Article 4 provides:

"Within the scope of application of this Agreement, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality shall be prohibited."

18. Article 40 provides:

"Within the framework of the provisions of this Agreement, there shall be no restrictions between the Contracting Parties on the movement of capital belonging to persons resident in EC Member States or EFTA States and no discrimination based on the nationality or on the place of residence of the parties or on the place where such capital is invested."

19. Article 42(1) provides:

"Where domestic rules governing the capital market and the credit system are applied to the movements of capital liberalized in accordance with the

provisions of this Agreement, this shall be done in a non-discriminatory manner."

20. By virtue of the EEA Agreement, the Deposit Guarantee Scheme Directive (94/19/EC) is binding on Iceland.
21. The purpose of this directive is to ensure the provision of cover for depositors, wherever their deposits are located in the Community (and the EEA) in the event of the unavailability of deposits made with a credit institution which is a member of a deposit guarantee-scheme. It currently imposes a minimum guarantee of €20,000 per depositor.
22. Iceland is obliged to implement the Directive into national legislation: to have a deposit guarantee scheme which is capable of providing the level of compensation required by the Directive.
23. Iceland's Depositors' and Investors' Guarantee Fund of Iceland ("IDGF") in theory satisfies the Directive requirements insofar as it acknowledges the need to provide protection to eligible depositors of up to €20,887 each. However, the manner in which the IDGF was structured and funded meant that (as has proved to be the case) it would be unlikely in practice to be capable of satisfying its obligations to depositors in the event that one or more of the Icelandic banks defaulted on their obligations to depositors.
24. Given that the IDGF was inherently incapable of satisfying the requirements of Directive 94/19/EC, the UK considers that the Government of Iceland was and is legally obliged to provide the IDGF with sufficient funds to enable the IDGF to discharge its obligations to compensate depositors within the periods laid down by that Directive. Further and in any event, the Government of Iceland was and is liable under the EEA Agreement to compensate depositors with Icelandic banks to the extent that the IDGF does not pay depositors the minimum amount of their deposits which is required to be protected under Directive 94/19/EC.
25. Accordingly in the event of a need to pay out in respect of an Icelandic bank, the correct procedure should be that the IDGF should pay the first €20,887 of any claim by an eligible depositor with the UK branch of that bank, within the periods specified by Directive 94/19/EC, either from funds available to it or, in the event of a deficiency in such funds, from funds provided to the IDGF by the Government of Iceland.
26. Furthermore, the Government of Iceland is required to ensure that UK depositors (and other creditors) are treated as favourably as Icelandic depositors in the same company by virtue of the EEA provisions relating to non-discrimination.
27. The situation concerning Icelandic banks and depositor protection falls within the scope of the EEA agreement because it concerns action taken by Iceland in relation to persons (both the Icelandic banks concerned and their customers) exercising their freedom to provide and to receive services. And

in the context of depositor protection, the prohibition against discrimination extends to direct or indirect discrimination in relation to customers with accounts at branches of Icelandic banks outside Iceland, compared with customers of branches of such banks in Iceland.

28. As is detailed further below, these principles were breached by Iceland in relation to Landsbanki.

Actions and events leading up to the Landsbanki failure

29. It is familiar background that, in the autumn of 2008, the global economy was in the grip of a severe banking crisis.

30. Iceland has been particularly exposed to the effects of the banking crisis. Its banks expanded (in large part by making acquisitions) across Europe to the point where, at the end of 2007, Icelandic banks' assets were said to amount to ten times Iceland's gross domestic product. With an international banking sector that was very large relative to its GDP and its own currency, Iceland's banking sector was exposed to foreign exchange liquidity and other market risks.

31. On many occasions in 2008, the UK authorities raised concerns with the Icelandic authorities and requested that action be taken to mitigate risks relating to the Icelandic financial sector. However, action taken by the Icelandic authorities was not adequate to prevent Iceland's financial sector from suffering catastrophic shocks in the autumn of 2008. All three of the largest commercial banks in Iceland were severely affected.

32. Initial recognition of the severity of the situation came on 29 September 2008, with the Government of Iceland's announcement of an agreement to inject €600 million of emergency funding into Glitnir Bank hf (Iceland's third largest bank) in return for a 75% controlling stake in Glitnir.

33. On 30 September Fitch reduced Landsbanki's long-term ratings from A to BBB and Moody's placed all of Landsbanki's ratings on review for possible downgrade.

34. Also by October 2008, it had become apparent that Landsbanki was in severe financial difficulties, potentially so as to trigger the depositor protection requirements.

35. On 5 October the FSA had required Landsbanki to transfer £200m to its London branch's account with the Bank of England by the following day in order to cover the large cash outflows from the London branch (the FSA also required Landsbanki to transfer a further £53m to Heritable, Landsbanki's UK subsidiary).

36. These transfers were not made on 6 October, despite the FSA repeating its requirement on that day.

37. It appears that the Central Bank of Iceland was expected to play a role in ensuring that Landsbanki's London branch remained in funds as it was to undertake a repo transaction with Landsbanki in order to provide the necessary funds. The Central Bank also had responsibility for authorising foreign currency payments to the UK branch of Landsbanki. However, the Treasury believes that the Central Bank took action such that necessary transfers of funds did not take place, meaning that it would not be possible for Landsbanki's London branch to continue to fulfil its claims to UK creditors.
38. On 6 October the FME suspended the trading of financial instruments in Iceland's main banks and other financial institutions.
39. On the night of 6/7 October, the Icelandic Parliament passed emergency legislation to amend Article 100 of Act No. 161/2002 on Financial Undertakings and conferred on the FME the power to take control of banks.
40. On 7 October, the FME took control of Glitnir and appointed a receivership/resolution committee.
41. Also on 7 October, the FME used this power to establish the Landsbanki receivership committee and this committee assumed the role of the Board of Directors of Landsbanki, with immediate effect.
42. The Landsbanki receivership committee stated the following:
- "The objective of the committee is to ensure the continued operations of the commercial banking operations of Landsbanki Islands hf. in Iceland.
 - A public notice to debtors will not be issued.
 - Provisions of Icelandic insolvency laws do not apply to the operations of Landsbanki while the receivership committee is responsible for the matters of the bank. Ceasure (*sic*) of assets cannot be made against Landsbanki during the same period."
43. On 7 October 2008, Landsbanki announced on its UK "Icesave" website that depositors could not withdraw money from, or make deposits into, their accounts, stating
- "We are not currently processing any deposits or any withdrawal requests through our Icesave internet accounts. We apologise for any inconvenience this may cause our customers. We hope to provide you with more information shortly".*
44. From 7 October 2008 onwards, Landsbanki has been under the control of the Landsbanki receivership committee appointed by the FME.

Discrimination Issues

45. During the lead-up to the failure of Landsbanki, various discussions and statements gave the Treasury reason to believe that the Government of

Iceland and other specified persons were likely to use Landsbanki assets to protect Icelandic savers, to the detriment of non-Icelandic savers.

46. Statements made by the Government of Iceland and its Prime Minister led the Treasury to believe that the Government of Iceland was intending to stand behind the IDGF in respect of domestic and commercial and saving banks and their branches in Iceland and deposits of depositors in Iceland, but not abroad: for example, the Prime Minister's address to the nation on 6 October stated that all Icelanders' deposits were safe, but made no reference to foreign deposits.
47. On 7 October 2008, the Chancellor of the Exchequer spoke to the Icelandic Finance Minister. The Finance Minister told him that, while the Government of Iceland intended to guarantee in full the deposits of branches in Iceland, it did not intend to treat in the same way deposits in branches outside Iceland. Nor could he guarantee that the IDGF would be able to pay UK depositors the minimum amount guaranteed by Directive 94/19/EC.
48. The Treasury appreciated that a failure to provide the appropriate level of depositor protection and discriminative treatment of non-Icelandic deposits and depositors and creditors would be unlawful by virtue of Iceland's obligations as a member of the EEA. Also, at the time, the Government of Iceland was failing to cooperate adequately with Her Majesty's Government or to communicate adequately on matters critical to UK financial stability. However the Treasury did not consider that either failure, of itself, amounted to a trigger for using the powers in the Act.
49. The Treasury also took into account that the authorities in Iceland had made contradictory statements on the question whether or not they would seek to honour commitments made (see, for example, a letter dated 5 October from the Ministry of Business Affairs); and the statements suggesting that the authorities in Iceland would honour their commitments were not supported by their actions.
50. The Treasury believed that if (as appeared to the Treasury to be the case) the Government of Iceland were to use some or all of the assets of Landsbanki to protect Icelandic depositors in full to the material detriment of its other depositors and creditors, this would be of severe detriment to UK depositors and other UK creditors of Landsbanki. Such action would reduce the amounts otherwise available if depositors with, and creditors of, Landsbanki were treated on a non-discriminatory basis. In particular, UK local authorities and charities risked suffering substantial losses as a result of their deposits in Landsbanki.
51. The Treasury also believed that the failure by the Government of Iceland and its authorities to provide appropriate safeguards for UK creditors means that the UK banking sector through the Financial Services Compensation Scheme was likely to have to pay compensation to depositors at a time when financial institutions were under financial stress and could be undermined.

52. Accordingly, at the time it made the freezing order, it appeared likely that the Government of Iceland and the other specified persons had taken or were likely to take action to the detriment of the UK economy.

Deposit guarantee issues

53. As Landsbanki could not pay claims by UK depositors, this became a matter for consideration under the EC deposit guarantee scheme directive as outlined above.

54. From August 2008 onwards, the Treasury had been seeking clarification from the Icelandic authorities as to the operation of the IDGF. Discussions continued through September, at official and Ministerial level.

55. Despite assurances that the Government of Iceland would honour its obligation to provide depositor protection for the depositors of the UK branch of Landsbanki in the event of a default, there was never any clarity on the practical arrangements by which Iceland would be able to meet its commitments. This was despite numerous requests from the Treasury for clarification as to the practical arrangements for effecting a pay out to depositors with the Landsbanki branch. This includes a letter sent from the Treasury on 6 October 2008 to the Permanent Secretary of the Icelandic Ministry of Business Affairs requesting discussion of the arrangements relating to the IDGF.

56. The FSA determined, on 8 October, that the UK branch of Landsbanki was in default for the purposes of the Financial Services Compensation Scheme. To maintain financial stability and protect retail depositors, the Government committed itself to protecting in full retail depositors with the Icesave brand of the branch.

57. At the time of the freezing order, it was apparent to the Treasury that the Government of Iceland was not likely to honour its obligations under Directive 94/19/EC in the event that (as proved to be the case) the IDGF did not have sufficient funds available to pay out Landsbanki depositors.

Risk of contagion from loss of depositor confidence

58. The Treasury believe that the maintenance of depositor confidence is critical to ensuring financial stability in the UK and that action which damages depositor confidence is likely to be to the detriment to the UK economy.

59. At the time of the making of the freezing order, the Treasury believed that there was also likely to be a detriment to the UK economy (or parts of it) by virtue of the effect of the above matters on depositor confidence. In particular, the Treasury believed that it was likely that a loss of depositor confidence would be caused by fears of losses resulting from the failure of Landsbanki, the discriminatory nature of the action taken by the Icelandic authorities, doubts as to the effectiveness of Icelandic compensation, and the failure of the specified persons to deal appropriately with the situation.

60. In the financial situation of the autumn of 2008, the Treasury believed that bank depositors were extremely nervous. A suggestion that deposits at one institution were at risk would have been likely to have resulted in depositors removing deposits not only from that institution but also from other similar institutions, i.e. a run on certain banks could have been triggered, in particular branches and subsidiaries of other overseas banks. Any such run in the UK would be to the detriment of the UK economy. Further details are as follows.
61. As outlined above, Landsbanki had a very large number of UK retail depositors - an aggregate exposure of around £4.5bn - as well as a large number of UK wholesale depositors - including building societies and local authorities.
62. At the time of the freezing order, there was an extremely high level of retail depositor anxiety about the Icesave products (provided by the Landsbanki London branch).
63. Depositor confidence was at risk as a result of Landsbanki's failure, and there was a likelihood that, if not properly managed, loss of confidence would cause contagion throughout the banking system, triggering retail outflows in similar financial institutions.
64. Ordinarily, even in the circumstances of the failure of a bank, the Treasury would expect sufficient depositor confidence to be maintained, so as to prevent a run on other similar institutions, by way of the depositor guarantee schemes. Effective depositor guarantee schemes are central to providing depositors with reassurance that any loss of their money will be compensated, as they would reasonably expect.
65. However, at the time of the freezing order, the Treasury believed that the actions of the Government of Iceland and other specified persons were such as to cause doubts in the minds of depositors about the effectiveness of Iceland's compensation scheme, exacerbated by the apparent refusal of the Government of Iceland to stand behind the scheme. In particular, the actions of the specified persons outlined above risked severely undermining depositor confidence, by failing to give depositors covered by the Icelandic deposit guarantee scheme assurance that they would receive the compensation to which they were entitled and as they would reasonably expect.
66. There was, as a result, significant risk that the failure of Landsbanki would have caused contagion throughout the system, triggering outflows in similar financial institutions, to the detriment of the UK economy.

Proportionality

67. The freezing order applies in respect of the various persons specified in the order in a proportionate manner. The freeze applies to funds owned held or controlled by Landsbanki. For funds owned, held or controlled by the other specified persons, it applies only to funds relating to Landsbanki.

Furthermore, the Order extends to the United Kingdom and the asset-freezing prohibitions apply to persons in the United Kingdom or persons elsewhere who fall within the categories of British citizens, nationals and companies listed in article 3 of the freezing order.

68. In this case, it was proportionate to take precautionary action to freeze funds still within the jurisdiction in an effort to safeguard the position of UK depositors and other creditors in order to protect both them and the wider UK economy.

69. The Treasury also considered that the action of freezing funds and financial assets would bolster retail depositor confidence and the confidence of wholesale creditors, helping to avert risks highlighted above, and protecting the UK economy, by demonstrating that Landsbanki's assets would not be taken out of the United Kingdom without firm assurances that United Kingdom depositors and creditors would be treated as fairly as Icelandic depositors and creditors.

70. Furthermore, the freezing order does not mean that no transactions can be carried out but that a licence must be sought for a transaction under Article 6; and we note that no complaint is made about how Article 6 is administered.

Reasons why the freezing order remains in effect

Discrimination

71. As it transpired, the Treasury's concerns about discriminatory action were borne out on 9 October, the day following the making of the freezing order, when the FME took a decision to transfer the Icelandic operations of Landsbanki to New Landsbanki Islands hf ("NBI"). The operations of the London branch, including the bulk of UK depositors, were excluded from the transfer and therefore left in Landsbanki - assets of foreign branches of Landsbanki (except certain qualifying loans) are listed in the annex of assets of Landsbanki which are not transferred to NBI.

72. The FME decision states that NBI takes over obligations of the branches of Landsbanki in Iceland. Subsequent FME decisions of 12 October and 19 October have modified the effect of the original decision, and these are stated to be retrospective to 9 October.

73. The Treasury believes that the creation of NBI as a solvent Icelandic institution has entailed a transfer of a greater proportion of assets from the insolvent estate of Landsbanki than the proportion of liabilities that were also transferred.

74. The FME decision of 9 October includes provision for evaluation of the difference between assets and liabilities transferred to NBI and for NBI to pay Landsbanki the difference. However, the Treasury believes that this will still result in NBI having received a disproportionate share of the assets, to the

detriment of creditors of the old company. The decision of 19 October increases the time for completing the valuation to 90 days.

75. On 8 December 2008, Landsbanki was granted a moratorium to prevent creditors bringing or continuing legal proceedings against Landsbanki.
76. The moratorium was included as an additional measure available to the authorities under Icelandic legislation introduced on 13 November; this made certain changes to a pre-existing moratorium process that had been part of Icelandic insolvency law. The principal effect of the moratorium is that no creditor will be able to take legal action in respect of any claim against Landsbanki for up to two years, and postpones any creditor action currently underway.
77. The stated aim of the moratorium is to preserve value and to avoid the need for "fire sales" at a time when asset values are depressed. Despite repeated requests, neither the Icelandic authorities nor the Landsbanki Resolution Committee (as the Landsbanki receivership committee is now called) have been able to provide a memorandum setting out the strategy for the winding up of Landsbanki and the allocation and distribution of recoveries. The process remains opaque.
78. Under the current arrangements, the Treasury believe that to date Icelandic creditors have been preferred in the restructuring of Landsbanki. So it remains likely that UK (and other foreign) creditors will receive discriminatory treatment compared to Icelandic creditors in the insolvency proceedings of Landsbanki, to the detriment of the UK economy, or parts of it.

Depositor confidence

79. In order to mitigate harm to depositor confidence, on 8 October 2008 the UK Government offered a guarantee of retail deposits with the UK branches and subsidiaries of the Icelandic banks that went beyond the UK's legal obligations.
80. Under this guarantee, UK retail depositors of Landsbanki have received compensation from the FSCS. Part of this compensation reflects the sums that the IDGF should have paid, part reflects the amount that the FSCS was in any event obliged to pay due to Landsbanki's voluntary membership of the UK's scheme and part reflects the Treasury's additional guarantee. The Treasury has funded the aspects that the FSCS would not ordinarily have met. In the absence of any reimbursement from Landsbanki or the IDGF, all of this cost – an estimated £2.5bn - will fall on UK taxpayers.
81. The Treasury believes that the UK's action to guarantee UK retail deposits helped maintain or restore depositor confidence in the UK in relation to the collapse of the Icelandic banks. It also means that retail depositors suffered no more than a short delay in the repayment of their money. A further consequence is that the largest creditors of Landsbanki are now the FSCS and the Treasury, as a result of their payout to UK retail depositors.

82. The Treasury has noted that the Government of Iceland has since publicly committed itself to honouring its obligations under Directive 94/19/EC, for example in its Letter of Intent under the IMF Stand-By Arrangement, and in the EU "Agreed Guidelines" of 17 November 2008. However, despite the willingness of the UK authorities to reach an agreement, the financing arrangements that are necessary if Iceland is to meet its obligations to depositors (and to depositor rights which have been transferred to the FSCS) have not yet been agreed and, as yet, we understand that the Icelandic authorities do not have the necessary political mandate to conclude negotiations.
83. Also, it remains the case that obligations to UK wholesale depositors and creditors have not been honoured. Wholesale depositors do not have protection under the FSCS. This includes many local and other public authorities, which have significant sums deposited with Landsbanki. The extent of the detriment suffered by wholesale creditors will depend on the extent that they are covered by the IDGF and/or receive payment as part of the receivership or resolution of Landsbanki. To date these matters are still opaque as detailed above.
84. The Treasury have considered the proportionality of keeping the freezing order in force. On the information currently available to the Treasury, the funds affected by the freezing order are not believed to be materially greater in amount than the exposures that the UK has sought to protect through the freezing order. The matter is kept under continued review but, as at the time of writing this letter, the Treasury's considered view is that the freezing order remains proportionate.

Conclusion

85. As a consequence of the above, the Treasury believe that the reasons for making the freezing order were sound and believe that the conditions for keeping the order in force remain satisfied.

I hope that the above provides a satisfactory response to the points raised in your predecessor's letter. We remain keen to help you address the current very difficult economic situation. In this context I hope we can reach an early and successful conclusion to our loan agreement discussions.

CLIVE MAXWELL