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Reykjavík, 2 May 2011

Subject: Response of the Government of Iceland to the Authority's Letter of Formal Notice, dated 26 May 2010 – Case No. 65560

In reference to the letter from the EFTA Surveillance Authority ("the Authority") dated 26 May 2010 (Case No: 65560, Event No: 557521), the Icelandic Government ("the Government") welcomes the opportunity to submit its observations and comments on the facts, statements and conclusions presented in the letter.

1. INTRODUCTION

1.1. The Government's position

The Government maintains its prior position that it has not failed to comply with its obligations under Directive 94/19/EC ("the Directive") and under Article 4 of the Agreement on a European Economic Area (EEA). The Government, consequently, objects to any and all statements made by you to the contrary and urges that this matter be concluded without any further action on your behalf.

1.2. Summary of arguments

(i) The Government fully *transposed* the Directive into Icelandic law with the adoption of Act No. 98/1999 on Deposit Guarantees and an Investor Compensation Scheme, and following that, established a deposit-guarantee scheme (hereinafter also referred to as "TIF") as stipulated in the Directive. That scheme is similar to that established by other EEA States and in accordance with the provisions of the Directive. Nothing in the Directive supports the Authority's construction.

(ii) The Government rejects the contention that the Directive imposes an *obligation of result* upon the Member States. This would lead inter alia to a *de facto* state guarantee for all deposits amounting to EUR 20,887 for each account in each and every bank. Such an unlimited obligation would be contrary to the EEA's key objective of promoting competition within the internal market. Nor would it conform to EEA state-aid rules which prevent Member States from interfering with markets unless specifically authorised to do so.

(iii) The so-called legal concept of *obligation of result* in EU law is unclear and does not suffice as legal basis for imposing a duty on Member States which would jeopardise their financial stability. Reference to the case law of the ECJ does not support the view that such unconditional principle of EEA law exists, nor that it would apply in this case. An obligation of result can only materialise – or deem to be breached – once it becomes clear that the actions of a Government did not suffice to ensure the minimum protection for deposits stipulated in the Directive. This is by no means evident.

(iv) The Government ensured - to the extent possible while dealing with a complete collapse of a banking system - that all retail depositors in the failed Icelandic banks would receive compensation in a form of payments from the estates of those banks. Deposit claims were granted priority ranking when the collapse became unavoidable, thus making up for the obvious shortcomings of any Deposit-guarantee scheme in the event of a total banking system collapse.[1] This compensation in many instances far exceeds the minimum deposit guarantee in case of all the collapsed banks. If any obligation of result exists it has been discharged by these actions of the Government.

(v) Should the Icelandic Government, contrary to expectations, be found to be in breach of the provisions of the said Directive, it maintains that such a breach should be considered *justifiable* in view of the fact that *no deposit-guarantee* scheme envisioned by the Directive could have dealt with a financial crisis of the magnitude experienced in Iceland in the autumn of 2008.

(vi) Should the Government, contrary to expectations, be found to be in breach of the provisions of the said Directive, it maintains that such a breach is *justifiable* in view of the various unilateral actions undertaken by the United Kingdom and the Netherlands governments in breach of the EEA Agreement against Landsbanki, the Icelandic state, and other Icelandic interests and their effect on the Government's reaction to the crisis. These actions obstructed the Icelandic Government's efforts to efficiently reorganise and wind-up Landsbanki to facilitate payments under the deposit guarantee scheme, which efficiency under normal circumstances is now historically evident by the swift resolution of the

[1] All retail depositors in Landsbanki branches have received payment in accordance with the minimum amount stipulated in the Directive. This minimum amount was paid out by the deposit-guarantee schemes in the United Kingdom and Netherlands. The remaining dispute is of a commercial and political nature and concerns, i.a. the pace of payments and ultimate liability for a possible shortfall in the settlement between the Icelandic deposit-guarantee scheme, on the one hand, and the schemes in the United Kingdom and the Netherlands, on the other hand. The Directive does not apply to this dispute. The first payments to the United Kingdom and the Netherlands schemes are expected to be substantial and to take place later this year. These payments are expected to continue in coming years and according to figures from Landsbanki's estate should comprise at least 90% of the claims made by the United Kingdom and the Netherlands' schemes – with accrued interest until 22 April 2009 - regardless of the EUR 20,887 minimum. Current market prices suggest a 100% recovery is not inconceivable. Market participants estimate the value of the assets to be higher than the conservative estimates by the resolution committee and have put money on recovery exceeding 100% of priority claims.

Kaupthing Edge internet depositor's payment from the estate undisturbed by the German Government. These ill-advised and disproportionate actions justify any breach which the Government may have committed as a consequence.

(vii) The Government rejects the Authority's contention that its actions during and following the banking crisis of October 2008 constituted a violation of Articles 4 (1) and 7(1) of the Directive and/or of Article 4 of the EEA Agreement by discriminating between depositors in domestic and non-domestic branches of the Icelandic banks with respect to the minimum guarantee. The Government's action did not discriminate based on nationality, as all non-domestic depositors in Icelandic branches received the same treatment as Icelandic depositors. The difference in treatment related to the location of the deposits and not the nationality of depositors. Furthermore, the situation of depositors of domestic branches, on the one hand, and depositors of the branches abroad, on the other hand, were by all objective measures incomparable. However, should these measures be found to have been discriminatory in some respect, they were fully justified by having a legitimate aim and passing the test of proportionality.

(viii) Finally, full consideration must be had for the *force majeure* principle when assessing the unforeseeable, dire and exceptional circumstances of the case and the Government's inability to fulfil the obligations which the Authority alleges were incumbent upon it according to the Directive.

The above-mentioned arguments are described more thoroughly under the corresponding sections of Chapter 3 below (3.1-3.6) as well as in Chapters 4 and 5.

2. BACKGROUND AND FACTS

2.1. Summary: The regulatory framework of cross-border banking

The case at hand is a consequence of the development of cross-border banking within the EEA. Prior to the 2008 crisis, the focus of EU efforts concerning cross-border banks was on enabling their normal activities and not their crisis management. Therefore, despite the comprehensiveness of Directive 2006/48/EC (relating to the taking up and pursuit of the business of credit institutions), the provisions which may apply to crisis management in a cross-border bank are relatively general in nature and fail to take into account some of the specific elements likely to become contentious in a cross-border crisis requiring significant financial intervention. The only two Directives directly applicable to bank insolvency are the Deposit Guarantee Directive and the Winding Up Directive (Directive 2001/24/EC on the reorganisation and winding up of credit institutions). The Deposit Guarantee Directive provides for the establishment of a guarantee scheme at the national level which is to provide a certain minimum payment to depositors in the case of insolvency. The Winding Up Directive places the sole power to decide on the reorganisation and winding up of a failed bank with the home state.

This regime for bank insolvencies does not contain clear or exhaustive guidance on how to deal with bank insolvencies or a banking crisis of international proportions. This was amply demonstrated when the international banking crisis of 2008 peaked in the weeks following

Lehman Brothers' collapse. The panic prevailing at that time made governments scramble to take unilateral protective measures within their jurisdictions, e.g. by:

- declaring *blanket guarantees* on deposits with the corresponding distortion to competition and upsets to capital flows[2];
- *asset freezing or ring-fencing* to protect national interests, at the expense of the orderly and efficient wind-up of failed banks. Such unilateral protective measures are almost always counterproductive and upsetting.

In other words, the insolvency regime did not stand the test of the crisis.

At the level of the state, the respective central bank and national treasury are typically viewed as lenders of last resort for banks within their jurisdiction. These institutions, however, often face hard choices when cross-border banks become insolvent. Due to limited financial resources, they can only be responsible for systemic risks within their own jurisdiction. This unavoidably creates a dilemma when a foreign branch is not considered to be of systemic importance for the host state. The EEA Agreement does not address such situations and actions of this sort. Thus, the power of the governments of respective member states to act to safeguard their country's financial stability in the event of a full blown banking crisis by declaring full guarantee of deposits and thus stopping multiple bank-runs is *ultra vires* of the EEA.[3]

2.2. Iceland in October 2008.

The Government reiterates its previous position as regards the situation in Iceland in October 2008. The Letter of Formal Notice ("LFN") fails to give any consideration to the circumstances which prevailed at the time: the insolvency of practically all the Icelandic banks; the extremely disproportionate size of the banking system relative to the state budget; the uncontrollable "run" already underway on deposits in the non-domestic branches; and the limited size of the country's currency reserves. In fact, the Authority seems to conclude that this unique and unprecedented situation is completely irrelevant to the dispute, maintaining *obligation of result* to be applicable regardless of the circumstances at hand and that Member States are liable on the basis of an objective principle without their action or inaction being relevant.

The Government strongly disagrees with the above assumption and maintains that the specific facts and extenuating circumstances of the case are very important when determining a Member

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[2] To name two examples: the Irish Government announced *blanket guarantees* for banks operating in Ireland; as did the Danish Government, see European Commission: State Aid NN51/2008 – Guarantee scheme for banks in Denmark. In all 9 EU countries introduced full *depositor guarantee* i.e. Austria, Denmark, Germany, Greece, Hungary, Ireland, Portugal, Slovakia, and Slovenia either by government commitments as in Germany, Hungary and Portugal or by changes in regulation. All was done on basis of these states deeming it necessary to preserve depositor confidence and maintain financial stability in the economy within their own jurisdiction. The full depositor guarantee in Iceland was by government commitment. Source: International Association of Deposit Insurers and International Monetary Fund: Report to the Financial Stability Board on Unwinding Temporary Deposit Insurance Arrangements, September 2009.

[3] As a contracting party to the EEA Agreement, Iceland has not conferred decision making power either judicial, executive or legislative in the field of financial stability to any EEA institution. Such is furthermore also the state of play within the EU as clearly evidenced by actions of several member states governments in the midst of the crisis, see also section 2.3.

State's obligations vis-à-vis the Directive. The Government has in prior correspondence with the Authority submitted various data and documents regarding the collapse of the Icelandic banks and refers to those in general.[4] To summarise this briefly, the following are key points:

- Gross revenues in the state budget for 2008 totalled ISK 460 billion.
- At the time of their collapse, total deposits in the Icelandic banks amounted to around ISK 3,100 billion, of which the equivalent of ISK 1,700 billion was in foreign currencies held by the banks' foreign branches. Due to the liquidity crisis in the interbank market the composition of the banks' funding had rapidly changed with increased emphasis on deposits (growing from about 25% of total liabilities to 40% in 2008).[5]
- The foreign currency reserves of the Central Bank of Iceland amounted to ISK 350 billion at the end of September 2008, i.e. approximately 20% of the total deposits held by non-domestic branches. If the Government had attempted to guarantee deposits in non-domestic branches, the country's foreign currency reserves would, in all likelihood, have been exhausted in less than two days by the on-going run on the non-domestic branches.[6]
- The ISK fell dramatically and virtually without any impediment in a very thin foreign exchange market. Foreign currency rationing had to be introduced, which led to the development of a dual foreign exchange market. At the end of September 2008 the Central Bank's quoted rate for the ISK had already fallen by 37% against the euro and continued to fall rapidly during the crisis month of October.
- A record GDP contraction was expected to follow in the wake of the financial crisis.
- The UK and Dutch governments compensated Icesave depositors of the Amsterdam and London branches at the turn of the year 2008-2009, and as a result the claims against Landsbanki relating to the deposits were subrogated or assigned to them respectively. The two governments, or rather their depositors' guarantee funds, now hold priority claims against the estate of Landsbanki and are expected to receive payment covering at least 90% of their claims according to current estimates by the Resolution Committee of Landsbanki

When assessing the actions of the Icelandic Government these factors have to be taken into account. The foreign currency reserves were needed to address the real threat of a payment default by the Icelandic state itself. Acquiring financing for payments to depositors in the foreign branches in the market was impossible, not least due to the actions of the Governments of the United Kingdom and the Netherlands. Swift pay-out from the estate of Landsbanki to depositors was also prevented for reasons beyond the control of the Icelandic Government.[7]

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[4] Reference is also made to a detailed analysis of the financial crisis in Iceland in the Financial Stability report prepared by the Central Bank of Iceland in 2009, see http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=7357

[5] http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=8480

[6] The depositor guarantee in Iceland was done by a way of Government commitment, see further footnote 2 for different methodology applied by EU states.

[7] In Kaupthing Bank deposits in "Kaupthing Edge" were paid relatively swiftly through agreement reached with national authorities.

2.3. Unilateral actions by the United Kingdom and the Netherlands in connection with the banking crisis in Iceland.

2.3.1. *The rationale behind and effects stemming from the decisions of national Governments to pay depositors in the United Kingdom and the Netherlands*

All Icesave depositors of the Amsterdam and London branches of Landsbanki received compensation for their deposits relatively soon after the collapse of Landsbanki.[8] This compensation was made by a unilateral decision of the UK and the Dutch authorities respectively, and was paid by their deposit guarantee schemes, who in turn subsequently lodged claims for the reimbursement of the relevant amounts with TIF with the involvement of the Icelandic Government. The real reasons prompting the decision of the UK Treasury – or rather the Chancellor of the Exchequer himself – are set out in a letter dated 8 October 2008 from the Chancellor to the permanent secretary of the UK Treasury:

> *...today I have taken the action to freeze the funds and financial assets held by Landsbanki in the UK. This action is proportionate, will prevent detriment to the UK economy through maintaining depositor confidence in the wider banking system [emphasis added].*

This main objective of the actions of the UK Government is clearly illustrated in a written advice to the Chancellor from the permanent secretary of the UK Treasury contemplating how UK could provide full guarantees or pay-outs to Icesave depositors in the London branch of Landsbanki:

> *At present, the responsibility for this [the EUR 20,887] lies with the Icelandic scheme. This would involve, in effect, a loan to the Icelandic authorities, either directly or more likely by simply making the payments and then pressing those authorities for the repayment to the Government [emphasis added].*

As it turns out, the UK Government never anticipated that the Icelandic deposit-guarantee scheme would be able to pay the minimum compensation amount, but rather that the Icelandic authorities would need to be *"pressed"* for repayment. This is an important element of the case and reveals clearly that no "regular" retail depositors of Icesave have suffered losses due to failings of a deposit-guarantee scheme. Calculated government intervention prevented that.

The so-called Icesave dispute is much more about necessary measures taken by three governments when dealing with a totally unprecedented situation - the co-ordination and settlement of dispute about responsibility for those measures – rather than the correct implementation of the Directive. Article 7 of the Directive does not apply to this situation and the Directive's objectives are of limited consequence in this situation.

2.3.2. *Other actions of the Governments of the Netherlands and the United Kingdom directly affecting Iceland's economy and dealing with the banking collapse.*

When evaluating the actions of the Government, as well as the ability of TIF to deal with Landsbanki's retail deposits, certain actions of the governments of the United Kingdom and the

[8] On-demand deposits were paid in December 2008 and January 2009. Some term deposit holders in the UK refused to accept payment and chose to wait for their claims to become due.

Netherlands need also be considered. Some of them constituted serious breaches of the cross-border banking regulations and also prevented or delayed liquidation of assets to commence payment of the deposit claims against Landsbanki.

It is also of outmost importance to recognise that these actions had mostly taken effect *before* the Icelandic Financial Supervisory Authority (FME) implemented the Icelandic Emergency Legislation and split Landsbanki up on 9 October 2008.

The FSA Supervisory Order 3 October 2008

On 3 October 2008, the FSA issued a Supervisory Notice ("the Notice") which required Landsbanki to take certain actions with regard to its London Branch. The actions related to the liquidity of the Branch and particularly the retail deposits (Icesave) on the Branch's balance sheet. The Notice contained a list of requirements which Landsbanki began to implement until events made it incapable of fulfilling those requirements. During the first half of 2009, London Branch sought to have the Notice revoked in its entirety and the FSA eventually agreed to revoke the majority of the Notice requirements except three clauses described below:

- Clause 1.1(a) - must maintain in a bank account within the UK cash reserves of not less than 20% of total Instant access retail deposits

- Clause 1.1(b) - Open a segregated Trust account with the Bank of England or another FSA approved provider in respect of deposits received from depositors from 2 October 2008 and to hold those deposits for the sole purpose of repaying those depositors

- Clause 1.1 (c) - the requirement relates to cash reserves at the Bank of England or another FSA approved provider and any assets held by the London Branch as at the date of the Notice. It prevents London Branch from taking any action with regard to those assets: (1) Which has, or may have, the effect of transferring the assets to a location outside the UK; (2) Which has, or may have, the effect of creating any charge, security interest or other similar economic interest over the assets (3); Unless London Branch has given the FSA at least 3 days written notice of the proposed action and the FSA has confirmed, in writing, that it has no objection to the proposals

- Cash reserves kept in a UK bank account referred to in 1.1(a) *must not be used for any purpose other than repaying depositors of the London Branch.*

The effects of the Supervisory Notice on London Branch were numerous but, most importantly, cash held at the Bank of England in an account opened pursuant to the Notice was only be applied to repay customer deposits; and cash generated as a result of the sale of assets held in the UK on 3 October 2008 may not be transferred out of the UK without the consent of the FSA.

The requirements were illegitimate at the time they were made and even more so when Landsbanki eventually became subject to EEA Insolvency Measures in its home state of Iceland, controlled and managed by a Resolution Committee appointed by the Icelandic authorities and subject to the control of the Icelandic courts and Icelandic law. All this contravened and obstructed the provisions and proper operation of the currently applicable Winding Up Directive and of the Credit Institutions (Reorganisation and Winding Up) Regulations 2004. It also prevented full exercise by the Administrators/Liquidators, who are and must be recognised in the UK, of the powers that they are entrusted with under the Reorganisation and Winding Up Directive and Regulations in the UK.

The FSA contemplated an even more extensive attempt to initiate a process in the UK whereby creditors would be given the chance to go to court and attempt to gain control over the assets of Landsbanki. Those plans were abolished after strong resistance from the Resolution Committee and Winding-up Board of Landsbanki, as well as the Icelandic Government. The FSA eventually lifted the remaining requirements of the Supervisory Notice as late as on 20 July 2010[9]

Freezing Order of the United Kingdom Government / Anti-Terrorism, Crime and Security Act of 2001 on 8 October 2008.

The United Kingdom Government not only caused the funds of Landsbanki in the UK to be frozen through the Supervisory Notice. The next step to securing UK interests was the Freezing Order of the UK Government. It must be emphasised that the original Order included reference not only to funds of Landsbanki or other commercial banks of Iceland, but also mentioned the Icelandic Treasury, the Icelandic FSA and the Central Bank of Iceland. As described in the Financial Stability report of the Icelandic Central Bank of 2009, this had enormously damaging results. A large number of banks outside the UK refused to fulfil and execute legitimate payment orders, irrespective of currency or origin of payment and:

> *Numerous innocent Icelandic companies and individuals were thus turned into defaulters, with concomitant cost and damage to their reputation.*[10]

Despite various attempts to reverse it by the Icelandic Government and the Central Bank of Iceland the Freezing Order remained in force until 9 June 2009.[11] During this time the effects on the cross-border payment system were enormous and the bulk of it had to be routed through the Central Bank's infrastructure. Despite numerous requests the UK Authorities have never explained why such a wide ranging and heavy-handed approach was needed.[12] As evident in various comments by UK politicians the purpose of the Freezing Order was to press the Icelandic

[9] FSA, Notice of Rescission, dated 20 July 2010.

[10] Financial Stability Report, op.cit, page 28.

[11] The Icesave Agreement (Loan Agreement between The Depositors' and Investors' Guarantee Fund of Iceland, Iceland and the UK and Dutch governments) is dated 5 June 2009. The Freezing Order was rescinded four days later. The funds of Landsbanki in the Bank of England were still frozen on basis of the Supervisory order of FSA at virtually no interest.

[12] For an illustrative description see for example Willem H. Buiter and Anne Sibert, *The Icelandic banking crisis and what to do about it (page 1)*: "The official excuse of the British government for its thuggish behaviour was that the Icelandic authorities had informed it that they would not honour Iceland's deposit guarantees for the UK subsidiaries of its banks. Transcripts of key conversations on the issue between British and Icelandic authorities suggest that, if the story of Pinocchio is anything to go by, a lot of people in HM Treasury today have noses that are rather longer than they used to be."

Government to take on the commitment to guarantee the repayments of the UK Treasury to the Icesave retail depositors in the UK.[13]

Moreover the continuation of the Freezing Order for several months impeded Landsbanki's orderly winding up and constitutes a serious infringement of the main principles of the Winding Up Directive.

Application of Emergency regulations in the Amsterdam Branch of Landsbanki

On *7 October 2008* the Dutch Central Bank (DNB) submitted a petition to the District Court of Amsterdam asking for a ruling that certain emergency regulations of Dutch law were applicable. On 13 October 2008 the court declared that those regulations should apply and appointed administrators to handle the affairs of the branch, including all assets and dealings with customers of the branch.

The initial time period decided by the court was 18 months, commencing in October 2008. The Icelandic Government objected to this process and especially to the petition made by the court appointing administrators for the Amsterdam Branch to extend the process even further. The Minister of Economic Affairs in Iceland wrote a letter to the president of DNB on 8 February 2010 arguing that the process in Holland was in serious breach of the orderly winding-up of Landsbanki in accordance with the applicable Directives.[14]

The administrative proceedings in Amsterdam continued from October 2008 until March 2010 when the district court in Amsterdam finally decided to lift the emergency application. During this period no assets in the Amsterdam branch could be sold or used for the purposes of repaying depositor claims. This unlawful arrangement increased the administrative costs of winding-up Landsbanki's estate very substantially and delayed the resolution process.

The IMF Stand-by Arrangement

It should also be noted that after the 3rd week of October 2008 when Iceland had finalised and formally submitted a Letter of Intent to the IMF seeking emergency assistance, the program's passage through the IMF Executive Board was blocked for weeks by states determined to press Iceland to pay instantly the so called [Icesave] state obligations. At that time the UK and Netherlands categorically refused requests to have the issue of such an obligation ruled on in either an EU or an EEA Court of Law. Financial Times dug into the issue of the political IMF blockage on November 12th 2008:

> *"Wouter Bos, Dutch finance minister, suggested there was a link between the IMF plan and compensation disputes with Iceland, which also involve the Netherlands. He told Dutch television that The Hague would oppose the IMF plan until their compensation dispute was resolved. "Luckily*

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[13] "We are freezing the assets of *Icelandic companies* in the United Kingdom where we can." – Gordon Brown (http://news.bbc.co.uk/2/hi/uk_news/politics/7662027.stm). See also e.g: Lord Myners, House of Lords debate on 28 October 2008: "...The Treasury considers that the freezing order *should remain in place* until the Government have successfully agreed with the Icelandic authorities a mechanism whereby the Icelandic Government can honour their obligations to UK depositors [emphasis added]."

[14] Letter from the Ministry of Economic Affairs in Iceland of 8 February 2010 to De Nederlandsche Bank

we have powerful allies as Britain and Germany have the same problem with Iceland," he is reported to have said."[15]

The blockage lasted until late November 2008[16] and subsequent reviews under Iceland's Stand-By Arrangement throughout the year 2009 were held up because of opposition within the Executive Board to its endorsement while the issue of the deposit guarantees remained unsettled.

The former Governor of the Central Bank of Iceland has described the events in a following way:

> *...the IMF seemed in a way to become an instrument in bringing about the deposit guarantee settlement with the UK and Dutch governments. The first review which was initially scheduled for February of this year [2009] was not completed until late October, eight months behind schedule. The recent agreement with the Dutch and the UK authorities cleared the way for the completion of the review, as confirmed in statements from the Icelandic Government. Virtually all other external financing was contingent upon the completion of the IMF review...*[17]

The Governments of the United Kingdom and the Netherlands seem to have used their influence within the IMF to increase the pressure on Iceland to accept their claims for unconditional guarantee as regards the deposits during the negotiations sessions conducted between early 2009 and late 2010. All this delayed the economic recovery of Iceland and as indicated in the above citation, all external financing was held in abeyance.

2.4. Recoveries from the Landsbanki estate

Assessing the recoveries from the Landsbanki estate is an important aspect in considering the Icesave issue. Estimates of recoveries by Landsbanki's Resolution Committee have improved significantly over the past year and currently it is anticipated that the recoveries will almost cover full depositor liabilities. It should be emphasised that the total outlay of the deposit guarantee schemes in the United Kingdom and the Netherlands amounted to approximately ISK 1,100 billion, of which only 650 billion are payments of the minimum guaranteed amount, i.e. EUR 20,887 per account. It is therefore apparent that the two guarantee schemes stand to receive at least ISK 1000 billion rather than the ISK 650 billion according to the mandatory minimum guarantee. This would not have been the case if the Icelandic Government had not made the deposits priority claims. The Authority must also consider that Landsbanki had top-up arrangements with the

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[15] Financial Times November 12th 2008: "Iceland's rescue package flounders". See also on the subject of the blockage: "Dutch and British block IMF loan to Iceland" in NRC Handelsblad on November 7th 2008: *"Iceland's Prime Minister Geir Haarde said that the IMF loan and the finding of a solution to reimburse Icesave clients "are two separate things" and that they should not be linked".*

[16] On November 16th in the aftermath of a diplomatic upheaval following the 4th of November ECOFIN meeting in Brussels, the French Presidency of the EU negotiated *Agreed Guidelines* between Iceland, the UK, Netherlands and Germany on how to proceed to amicably solve the dispute referring directly to the IMF programme going through as a result. The blockage was thus lifted on November 19th when Iceland's emergency program passed through the IMF Executive Board. As regards Germany the priority status of depositor claims on the estate of Kauphting concerning Kaupthing Edge internet accounts insured early payments and the issue went quickly out of inter-state level of relations.

[17] Ingimundur Friðriksson, *The collapse of the Icelandic banks and cross-border collaboration*, Presentation prepared for a SUERF, CEPS and Belgian Financial Forum Conference on Crisis Management on 16 November 2009, published by the Central Bank of Iceland.

Guarantee Schemes in the United Kingdom and the Netherlands for deposit liabilities above the minimum amount, and by no means was the Icelandic Government responsible for securing funding for those arrangements.

Landsbanki's winding-up process has been underway since October 2008 and currently there is much greater clarity as to the nature and value of the bank's assets than when it began. The estate is expected to effect interim payments to creditors later this year. According to information from the administrators of Landsbanki the most important assumptions as regards recovery rate are as follows.[18]

- The current estimate by Landsbanki's Resolution committee is that the equivalent of at least 90% of priority claims will be recovered.
- About half of the recoveries will be paid out to creditors in 2011-2012.
- Recovery estimates have been steadily increasing, by 2-3% each quarter.
- The assets of the Landsbanki estate are comprised of
  (a) *Cash and bank bonds* (now amounting to 60% of expected recoveries);
  (b) *Loans to customers* (now amounting to 30% of expected recoveries), already heavily written-down from previous book value. The loans were mostly extended to UK companies.
  (c) Equity, derivative claims, bonds and misc. (now amounting to about 10% of expected recoveries). Uncertainty is greatest regarding the quality of this class of assets. However, recent news about the proposed sale of the estate's holding in the UK retail chain Iceland Foods indicates that these assets are currently undervalued.

It should also be noted, as an indication of expectations of recovery from Landsbanki's estate, that general unsecured claims are currently traded at 6-10% of their original value, indicating that general creditors' with good knowledge of the assets believe those assets to be worth substantially more than 100% of priority claims.

The Icelandic Government is optimistic that in due course all depositor claims will be paid in full with interest until 22 April 2009 (the reference date for cut-off as regards interest). The Icelandic Government follows the winding-up of Landsbanki closely and will update the Authority as new financial information become available in the coming weeks and months.

3. THE AUTHORITY'S ALLEGATIONS AND THE GOVERNMENT'S LEGAL ARGUMENTS

The Authority alleges that the Government has violated its obligations by failing to ensure payment of minimum compensation according to Article 7 of the Directive to Icesave depositors in the Netherlands and in the UK within the time limits stipulated in Article 10 of the Directive. This section sets out the Government's arguments in response to the alleged violations.

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[18] See Financial information for Q4 2010 on the website of LBI http://lbi.is

3.1. The Government fully transposed the Directive into Icelandic law with the adoption of Act No. 98/1999 on Deposit Guarantees and an Investor Compensation Scheme, and following that, established a deposit-guarantee scheme (hereinafter also referred to as "TIF") as stipulated in the Directive. The scheme is similar to that of other EEA States and in accordance with the provisions of the Directive.

As previously argued in a letter from the Government to the Authority of 23 March 2010, Iceland implemented Directive 94/19/EC as well as Directive 97/9/EC on Investor Schemes through the Icelandic Act 98/1999 and Regulation 120/2000. Iceland fully complied with its obligations under Directive 94/19/EC and a scheme was set up ensuring the minimum guarantee in a way that is accepted by all EEA Member States.

The Directive contains no provisions regarding the financing of deposit-guarantee schemes. As the Directive was implemented in Iceland by the Icelandic parliament Althingi, the deposits department of the Icelandic scheme was set up to collect and keep in reserve a minimum of 1% of the average amount of guaranteed deposits in commercial banks and savings banks during the preceding year (Article 6 of Act No. 98/1999). Should the targeted percentage not be achieved at any given time the financial institutions were obliged to submit guarantees as stipulated in Article 6 (2):

> *If, notwithstanding the above, the total assets of the Department do not amount to the required minimum, all commercial and savings banks shall submit a declaration of liability. In the declaration, each commercial and savings bank shall undertake to render a special contribution to the Department when the Department is obliged to refund deposits pursuant to Chapter III below in any commercial or savings bank that is a member of the Fund.*
>
> *The declaration of liability shall extend to a proportion of the amount required to make up the minimum corresponding to the proportion of the commercial or savings bank in question of the aggregate guaranteed deposits. However, demands for contributions to the Department based on declarations of liability shall not exceed the equivalent of one-tenth of the minimum total assets of the Fund. Under the aforesaid conditions, commercial and savings banks shall render payment to the Fund on demand.*

The Article referred to reveals that there was a fully operational system in place following the adoption of Act No. 98/1999. This system was entirely comparable to the financing of other schemes established or maintained by Member States of the EEA that had implemented the Directive. It even had a considerable advantage over a post-funded scheme - which would be subject to even more severe losses than a pre-funded scheme in the case of a total collapse of the entire financial sector, as was the case in Iceland.

In addition to the discussion above, bearing in mind the circumstances emerging in Iceland with the almost total collapse of the country's banking system, it is important to examine the situation of other deposit-guarantee schemes of the EU Member States, since the decisions of the Authority will have general reference. The European Forum of Deposit Insurers (EFDI) issued a detailed report on all deposit-guarantee schemes in Europe in October 2006. The report clearly demonstrates the flaws of the Directive. It is asserted by EFDI that no EU deposit-guarantee scheme would sustain a systematic collapse.[19] Among other things, EFDI points out the fact that in many EU countries the participants in the country's deposit-guarantee scheme fund are only a few financial institutions. As a result, the schemes are not able to compensate depositors if any bank, no matter what its size, were to collapse. In addition, the EFDI report argues that the funding from the banks, based on their mandatory premium stipulated in the Directive, does not even suffice to compensation for a collapse of a small domestic bank.

Another report issued by the EU Commission: *"Investigating the efficiency of the EU Deposit Guarantee Scheme"*, examines the efficiency of all deposit-guarantee schemes within EU. The report was a product of the European Commission's review process of Directive 94/19/EC on Deposit-guarantee schemes (DGS). The report describes i.a. many efficiency tests that the Commission conducted on all the EU deposit-guarantee scheme funds. No guarantee fund of any EU country could survive an efficiency test corresponding to a major impact. A major impact is defined as an impact where 3.24% of eligible deposits are paid through any relevant national guarantee scheme. In Iceland approximately 85% of all eligible deposits in the country became the object of potential pay-out from the Icelandic deposit-guarantee scheme.

These reports clearly demonstrate that the situation of the Icelandic deposit-guarantee scheme is in no way different from that of the deposit-guarantee schemes of any other EEA State and a situation like that in Iceland would have emerged under similar circumstances in any other EEA State.

The LFN does not refer to any special flaws in the implementation nor has the Authority previously suggested there were any faults in the implementation of the funding of the scheme. Thus, the Government argues that the laws and regulations implementing the Directive were in full accordance with Directive and acknowledged practise within the EEA.

3.2. The Directive does not impose an *obligation of result* upon the Member States. Any other interpretation would lead to a de facto state guarantee contrary to the EEA's main objectives of promoting competition within the state-aid rules preventing Member States from interfering with markets unless specifically authorised to.

The Government concurs with the Authority that the obligations of the Directive must be interpreted in light of its context and objectives.[20] However, when so interpreted the Directive does not support the conclusions drawn by the Authority.

3.2.1. The context of the Directive

The Government draws attention to the place of the Directive in the Treaties. It is based on former Article 57(2) TEC[21] which provided a legal basis for coordinating measures to abolish obstacles

[19] Similar statements can be found in a report issued by the French Central Bank in 2000, chaired at the time by Jean-Claude Trichet, e.g. on page 179 in the report; *"It is accepted that deposit-guarantee schemes are neither meant nor able to deal with systematic banking crises, which fall within the remit of other parts of the safety net, e.g. supervisors, central bank, governments"*.

[20] See the Letter of Formal Notice, para. 4 on p. 7.

to the right of establishment and the freedom to provide services. The aim of the Directive is to promote the harmonious development of the activities of credit institutions throughout the Community by eliminating restrictions to the freedom of establishment and the freedom to provide service, while increasing the stability of the banking system and the protection of savers (Case C-233/94 *Germany v European Parliament and Council* [1997] ECR I-2405, paragraph 13). As the Court of Justice has found, the Directive's consumer protection aim is of *incidental effect* and the Directive was therefore correctly based on the above provision and not on Treaty provisions underpinning a high level of consumer protection in the Community.

The Directive is a minimum harmonisation directive, which must be read in the context of single market rules on establishment and services, and other harmonisation measures under former Article 57(2), i.e. harmonisation of rules relating to the taking up and pursuit of the business of credit institutions. As rules relating to deposit guarantees varied among Member States, it was found necessary, in addition to establishing home state regulation and mutual recognition, to harmonise requirements for deposit-guarantee schemes. However, a prohibition on the export of guarantees of a higher amount was maintained in order to promote competition in the market.

The Directive's primary aim was to harmonise deposit-guarantee schemes in order to avoid different rules in different Member States distorting competition in the single market.

It follows from the above that a *state-guarantee or state funding* of deposit-guarantee schemes would contradict the aims and objectives of the Directive, as argued further below and as is also clear from the wording of Articles 3(1) and 4 of the Directive[22] and from the wording of Article 7(1) of the Directive (as it was at the time, before the provision was amended by Directive 2009/14/EC). Hence, it is obvious that the Directive was never meant to place any kind of financial obligation on the Member States in case of the inability of the insurance schemes to deal with large-scale banking failures. Competition and State-Aid issues would have had to be addressed explicitly had this been the intention.

3.2.2. No de facto or implied state guarantee

If the Authority's views were accepted this would imply that a *de facto* state guarantee existed. A state guarantee, or financing, of a deposit-guarantee scheme does not conform with the general context of the Directive. It would also result in discrimination between Member States, as depositors would not only have to evaluate the bank in which their deposit was to be made but also the state finances of the respective Member State where the bank was registered.

The Authority states on page 8 of its LFN that the "Directive does not lay down any possibility of derogating from that obligation" to introduce and officially recognise one or more deposit-guarantee schemes providing coverage up to EUR 20,000. The Government firmly objects to the reasoning of this statement and maintains that the context of the provisions and recitals of the Directive does not lead to responsibility on the part of the state for the amounts.

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[21] Subsequently Article 47(2) TEC and now (amended) Article 53 TFEU.

[22] Article 3(1) stipulates that an alternative guarantee fund may not consist of a guarantee granted by Member States or local or regional authorities.

The Government finds the reference to Recital 24 on page 8 of the LFN misleading. Recital 24 of the Directive states:

> *Whereas this Directive may not result in the Member States' or their competent authorities' being made liable in respect of depositors if they have ensured that one or more schemes guaranteeing deposits or credit institutions themselves and ensuring the compensation or protection of depositors under the conditions prescribed in this Directive have been introduced and officially recognized;*

The Government would like to draw the Authority's attention to the last part of the recital. When interpreted in the context of the entire recital, the obligation to "have ensured" concerns the introduction and official recognition of one or more deposit-guarantee schemes set up under the *conditions prescribed* in the Directive. This cannot refer solely to the conditions prescribed in Article 7(1) – as the Authority argues - disregarding other important aspects.

Theoretically, circumstances could arise under which the deposit-guarantee schemes were not sufficiently funded to compensate depositors. In October 2008, Iceland was faced with the insolvency of all its major banks and the deposit-guarantee scheme was undeniably unable to deliver compensation to all depositors as required. No deposit-guarantee scheme in the EEA was capable of dealing with a systemic financial crisis.

The Government has maintained that the deposit-guarantee schemes stipulated in the Directive were not designed to deal with the collapse of a large financial institution of systemic importance, let alone the total collapse of a country's entire banking system. This stems from the fact that the Directive does not impose or even imply a legal obligation on a state to provide the funds needed to ensure that depositors receive full compensation for their unavailable deposits should a financial institution become insolvent.

Article 7(1) reads:

> *Deposit-guarantee schemes shall stipulate that the aggregate deposits of each depositor must be covered up to ECU 20 000 in the event of deposits' being unavailable.*

Two points must be emphasised when constructing the article:

- *Firstly,* the paragraph starts with *"Deposit-guarantee schemes"* which, in a basic sense, refers to the *schemes* to be implemented.

- *Secondly,* the term "stipulate" entails that the deposit-guarantee scheme should cover aggregate deposits up to ECU 20,000 in the event of deposits being unavailable. The Government insists that Article 7 does not, however, oblige a Member State to *guarantee* the amount protected by the Article. To have that effect, an explicit provision stating that Member States are responsible for compensation for unavailable deposits would have had to be incorporated into the Directive. That would not have been a complicated exercise.

Nothing in the preparatory legislative work of the Directive implies that a *de facto* state guarantee is to be provided for the deposit-guarantee scheme.[23] Nor has any state made specific financial provisions to fund its deposit-guarantee scheme in case of systemic breakdown. A liability of that magnitude would have to be addressed in the state budget, and the Government is not aware of any such practice among EEA States.

It should be noted that the wording of the Directive makes reference to the *schemes* and not to the Member States when addressing the relevant factors of the deposit-guarantee schemes, whether this concerns compensation to a depositor or financing of the schemes. This is evident e.g. in paragraph 2 of Article 4 regarding the "topping up" system.

Similarly, the Directive refers directly to Member States when defining their role in establishing schemes with all the relevant aspects, for example, in the fourth paragraph of Article 4. As a result, a reference to the deposit-guarantee scheme cannot and should not be confused with a reference to the relevant Member State.

The *separation of the two*, i.e. the deposit-guarantee scheme on the one hand and the Member State on the other, in the Directive clearly confirms that a definite distinction is made between them, which in turn further supports the legal interpretation that Article 7(1) does not involve an obligation on a Member State to provide any funds lacking at a time when deposits become unavailable and cannot be compensated by a deposit-guarantee scheme. The statements in the Authority's letter of formal notice in paragraph 4, page 9, cannot hold up to scrutiny. Without providing further explanations or reasons the Authority sees Article 10(1) of the Directive as a basis for assuming a state guarantee. The Article only provides a concession for the relevant deposit-guarantee scheme to delay payment for a certain period of time due to special circumstances. By no means can it be concluded that provisions of Article 10(1) confer any special obligations upon the State to intervene or make arrangements for the payments of claims directed at the deposit-guarantee scheme in Iceland.

3.2.3. The relevance of the Amending Directive of 2009

In constructing the Directive and the duties it imposes on the Member States it is important to acknowledge that the text of Article 7(1) was amended by Article 3(3) of Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay ("the Amending Directive"). Although the Amending Directive contained a number of substantial changes the only

[23] On the contrary, a document titled: *Proposal for a Council Directive on deposit-guarantee schemes no. COM (92) 188 final - SYN 415, Brussels, 4 June 1992*, reads as follows: "The question of whether the public sector would be able to provide assistance for guarantee schemes in emergency situations of exceptional gravity and when the schemes' resources have been exhausted, has been raised in order to enable them to respect their commitments to depositors.
- It did not seem appropriate, in the proposal for a Directive, to prohibit such assistance, which could prove necessary in practice, although it *is not desirable as a general rule and could not be allowed to contravene the rules of the Treaty concerning state aid.*"

one of importance for this case was the change stipulated in Article 3(3) of the Amending Directive which reads:

> 3. Article 7 shall be amended as follows:
>
> (a) paragraph 1 shall be replaced by the following:
>
> '1. Member States shall ensure that the coverage for the aggregate deposits of each depositor shall be at least EUR 50 000 in the event of deposits being unavailable.

Instead of referring to "Deposit-guarantee schemes" the text now refers to the "Member States" and instead of "stipulate" it now reads "ensure".

The changes demonstrate that the wording – before the amendment - was unclear and not sufficiently precise to form a basis upon which a case can be built to establish a Member State's obligation of result.

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All of the above aspects demonstrate that the deposit-guarantee schemes cannot and were not meant to sustain an economic collapse and that the Directive does not give rise to a legal obligation on Member States to fund payments to depositors in case of an economic collapse. The Government finds it absolutely clear, considering the above, that any doubt as to its legal obligations in this context must be interpreted in its favour.

The Government also points to the fact that, if the interpretation proposed by the Authority prevails, all the Member States could *de facto* face a serious threat of sovereign default should they be confronted with even a medium-sized banking crisis. The Government maintains that any such interpretation is contrary to the fundamental principles of EU law.

3.3. The Directive does not impose an obligation of result – The case of Paul and others.

3.3.1. General

The Government disagrees with the Authority that an unconditional "obligation of result" exists as a stand-alone legal principle, and certainly not without a direct and unambiguous wording to that effect in the text of a Directive.

Even if the argument in the paragraph above was not accepted, an obligation of result can only materialise – or deem to be breached – once it becomes evident that action or inaction by the Government did not suffice to ensure the minimum protection of deposits stipulated in the Directive. This is not clear yet and, as described in section 2.4. (Recoveries of Landsbanki), chances are that the actions of the Icelandic Government during the crisis will result in full payment of all the deposits in Landsbanki through the winding-up procedure, with the addition of considerable interest.[24] In any case the minimum of EUR 20.887 per account is secured with the Landsbanki estate.

3.3.2. The case of Paul and others

The Government notes that the Authority relies heavily in this regard on the ECJ's judgement in the case of *Paul and others*[25] as precedent. The Government argues that due to the different circumstances and facts of that case it does not resolve the current issue.

In the case referred to, a German bank became insolvent and depositors were unable to receive any compensation from the deposit-guarantee scheme established in Germany. The bank's applications for membership in the scheme had been rejected by the scheme, as the bank failed to comply with admission requirements – but appears to have been granted a licence to accept deposits at the same time. When the case was referred to the ECJ for a preliminary judgment the German authorities had already acknowledged the state's responsibility for the minimum amount set forth in the Directive 94/19. Thus, the case concerned Germany's responsibility for deposits *exceeding* the amount provided for in the Directive in case of a financial institution's insolvency.

Although the ECJ did not directly address how Article 7(1) should be interpreted as regards the minimum guarantee stipulated, some conclusions may be drawn from this example. The plaintiffs based their case on two grounds. Firstly, that Germany should be made liable for their losses due to its failure in implementing the Directive. Secondly, that the state's liability could be based on its failure to supervise the bank. The Government finds paragraphs 29 to 31 of the judgment to be of relevance in demonstrating how the ECJ interprets the Directive:

> *29. The purpose of Article 3(2) to (5) of Directive 94/19 is to guarantee to depositors that the credit institution in which they make their deposits belongs to a deposit-guarantee scheme, in order to ensure protection of their right to compensation in the event that their deposits are unavailable, in accordance with the rules laid down in that directive and more specifically in Article 7 thereof. Those provisions thus relate only to the introduction and proper functioning of the deposit-guarantee scheme as provided for by Directive 94/19.*
>
> *30. Under those conditions, as pointed out by the governments which submitted observations to the Court and by the Commission, if the compensation of depositors is ensured in the event that their deposits are unavailable, as prescribed by Directive 94/19, Article 3(2) to (5) thereof does not confer on depositors a right to have the competent authorities take supervisory measures in their interest.*
>
> *31. That interpretation of Directive 94/19 is supported by the 24th recital in the preamble thereto, which states that the directive <u>may not result in the Member States' or their competent authorities' being made liable in respect of depositors</u> if they have ensured the compensation or protection of depositors under the conditions prescribed in the directive. [Emphasis added]*

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[24] Recent judgments from the District Court of Reykjavik (28 April 2011) upheld priority ranking in the estate of Landsbanki for penalty interest for the period from 8 October 2008 until 22 April 2009 in addition to the principal for all depositor claims. Those cases are expected to be appealed to the Supreme Court of Iceland and final judgements on that issue should be available later this year.

The importance of these three paragraphs stems from the fact that the Court notes that the Directive does not confer on depositors the right to have competent authorities take supervisory measures in their interests. That is because no such obligation is imposed on the Member States in the Directive.

Similarly, the Directive places no positive obligations on the Member States to provide funds or guarantees and, in fact, dismisses any such measure in the 23th recital, as already mentioned. Consequently, as the Court notes in paragraph 31, the Member States cannot be made liable in respect of depositors if they have "ensured the compensation or protection of depositors under the condition *prescribed in the directive.*" [Emphasis added].

In particular the Government objects to the inaccurate reference to *Paul and others* [26] on page 7 in the Letter of Formal Notice where it reads:

> *The Court of Justice of the European Union (Court of Justice) held in Paul and others that Directive 94/19/EC gives a right on depositors to a refund of at least 20,000 EUR each wherever deposits are located in the EU in the event of the unavailability of deposit. Although the Court did not have to rule specifically on the matter, it is evident from the judgment that the Court considers the provisions of Articles 7 and 10 of the Directive 94/19/EC to be clear and precise. Consequently, individual depositors have rights conferred on them by the directive.*

The Court actually stated the following in paragraphs 26 and 27:

> *26. In that regard, it should be borne in mind that Directive 94/19 seeks to introduce cover for depositors, wherever deposits are located in the Community, in the event of the unavailability of deposits made with a credit institution which is a member of a deposit guarantee-scheme.*
>
> *27. The depositor's right to compensation in such a situation is governed by Article 7(1) and (6) of that directive. Article 7(1) determines the maximum amount of compensation which a depositor may claim on the basis of the directive, whilst Article 7(3) specifies that Member States may under their national law provide for rules offering depositors a higher or more comprehensive cover for deposits. Article 7(6) of Directive 94/19 requires Member States to ensure that the depositor's rights to compensation, as defined in particular in Article 7(1) and (3), may be the subject of an action by the depositor against the deposit-guarantee scheme.*

Firstly, as pointed out by the Authority, the Court was not ruling specifically on the relevance of Article 7(1), its correct interpretation or questions regarding obligation of result. Secondly, the use of the wording *"seeks to introduce cover"* does not imply that the Directive entails an unconditional right – and certainly not a full state guarantee - but rather that it aims at achieving the goal described in Article 7.

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[25] Case C-222/02 *Paul and others* [2004] ECR I-9425.

[26] Case C-222/02 *Paul and others* [2004] ECR I-9425.

Paragraph 27 of the judgment does not indicate any opinion of the Court on the Member States' responsibility to finance or guarantee unavailable deposits from either credit institutions or deposit-guarantee schemes. The first half of the paragraph refers to the maximum amount and the authorisation to offer higher amounts. The second emphasises the Member State's duty to ensure that a claim for compensation can be the subject of *an action* by a depositor *against the deposit guarantee scheme*. This is not a matter being disputed in the case at hand.

The case of *Paul and others* is therefore not decisive for this dispute.

3.4. The adoption of the "Emergency Law". Icelandic efforts to reorganise the banking sector with ensuring swift compensation to retail depositors as a priority.

Article 6 of Act No. 125/2008 (the "Emergency Law"), which was adopted by the Althingi on 6 October 2008, added a new paragraph to Article 103 of the Act on Financial Undertakings making claims for deposits *priority claims* in the case of financial institutions becoming insolvent. The third paragraph of Article 102 of Act 161/2002 on processing claims now reads:

> *The same rules apply to the winding-up of a financial undertaking as apply to priority of claims against any estate under bankruptcy proceedings, with the exception that claims for deposits, as defined in the Act on Deposit Guarantees and an Investor Compensation Scheme, shall be included in priority claims as referred to in the first and second paragraphs of Article 112 of the Act on Bankruptcy etc. To the extent that the priority of claims can be determined under that Act by the date the court ruling on bankruptcy proceedings is issued, the date of the court ruling on the winding-up of a financial undertaking shall apply.*

The change is very important since it had the effect of ensuring that sufficient funds were available to pay swiftly all depositors of the Icelandic banks their minimum compensation as stipulated in the Directive. The only possible exception is Landsbanki. As previously described, it is not clear at this point whether the remaining assets of the estate will prove to be sufficient but it can be asserted that they will cover at least 90% of the total priority claims.

It must be borne in mind that while the total amount of depositor claims into the estate is valued at ISK 1,300 billion, the claims falling under the minimum guarantee only amount to half of that figure, or ISK 650 billion. Hence, the assets of Landsbanki easily cover the full value of the minimum guaranteed amount.

It remains to be seen, however, whether the minimum guarantee claims rank *pari passu* with other deposits paid by the UK and Netherlands authorities. The Icelandic deposit guarantee fund has maintained that all claims resulting from payments towards the minimum guarantee should be the first to receive payment from Landsbanki's estate but it is expected that the courts of Iceland will determine the merits of that position relatively soon.

By introducing and implementing these changes the Government showed its utmost willingness and determination to comply with the obligations entailed in the Directive and to ensure compensation of depositors. It has been proven beyond doubt with the increasing clarity regarding recoveries from the estates of the collapsed banks that the depositors could and can be compensated in accordance with the Directive.

Given the complete collapse of a banking system, no possible or realistic alternative can be found to such payment through claims on a bankrupt estate. There is no banking system left to post-fund the guarantee scheme and no guarantee fund in the world has the necessary resources to cope effectively with reimbursement of all deposits in all banks. Hence, the only possible way to ensure payment to depositors was to give them direct access to the value of the assets of the collapsed banks, in the form of priority ranking in the respective estates. As regards Landsbanki various legal issues, such as the UK Freezing Order, challenges to the emergency legislation, disputes over the priority ranking of so called wholesale deposits as well as disputes over claims made by the UK and Netherlands authorities for regards costs and interest in the winding-up process have delayed the pay-out of interim distributions to depositors (or the UK and Netherlands authorities on their behalf).

Consequently, it cannot be argued that the Government has not fulfilled its obligation as stipulated in the Directive. While in fairness the Government does acknowledge that this method of giving priority ranking to deposits may entail a delay in delivering the required result, the significance of this must be assessed bearing in mind the scale of the economic turmoil which occurred in Iceland. The fact remains, as previously mentioned that every depositor of the foreign branches of the Icelandic banks has been compensated.

Considering the changes made to Icelandic law in order to ensure the compensation of depositors and the effect of these changes, the Government refutes any statements that it has failed to fulfil an obligation of result under the Directive.

3.5. No deposit-guarantee scheme envisioned by the Directive could have dealt with a financial crisis of the magnitude experienced in Iceland in the autumn of 2008.

No deposit-guarantee scheme can cope with the total collapse of a banking system just as no insurance scheme can compensate every loss if all risks materialise at the same time. For obvious reasons deposit-guarantee schemes are not expected to have that financial capacity. The Icelandic deposit-guarantee scheme was unable to compensate all depositors of the Icelandic banks in October 2008 upon the systemic breakdown of the country's entire banking system. Such a situation could not have been reasonably foreseen by the Icelandic legislator when adopting the legislation transposing the Directive or, for that matter, by the EU.

The systemic failure scenario and possible consequences should have been addressed in the Directive if the intention was for the deposit-guarantee scheme to be able to compensate the minimum amount in such cases. The Directive has no direct reference to state financing and only refers to its effects on credit institutions' financial status. The 23rd recital reads:

> *Whereas it is not indispensable, in this Directive, to harmonize the methods of financing schemes guaranteeing deposits or credit institutions themselves, given, on the one hand, that the cost of financing such schemes must be borne, in principle, by credit institutions themselves and, on the other hand, that the financing capacity of such schemes must be in proportion to their liabilities; whereas this must not, however, jeopardize the stability of the banking system of the Member State concerned;*

The main concern described here is not to impose too heavy a financial burden on the credit institutions. Moreover, the Directive clearly expresses the EU's concern that a deposit-guarantee scheme might cause an imbalance between the financial institutions of the different countries should the states themselves finance the schemes. Article 3(1) states:

- the system must not consist of a guarantee granted to a credit institution by a Member State itself or by any of its local or regional authorities,

This consideration cannot be expressed more clearly. State guarantees are to be avoided. It is also evident from the 13th recital of the Directive that there were concerns as to how the different deposit-guarantee schemes in the Member States could have a negative effect on competition within the EEA. Therefore, the Directive entails some mechanisms to eliminate the negative effects on competition by the varying amounts being guaranteed. Any Member State's direct involvement would have damaging effects on competition as it would create an advantage for the financial institutions benefitting from the support of a state-guaranteed deposit-guarantee scheme.

The Icelandic deposit-guarantee scheme as provided for in Act No. 98/1999 was comparable to the best deposit-guarantee schemes in Europe. It was an *ex-ante* system, designed to minimise depositors' risk of losing their deposits should banks become insolvent by having the banks contribute to the scheme on a regular basis. The same funding mechanism was used in 21 Member States while only six Member States used *ex-post* financing.[27] The latter method is almost certainly incapable of dealing with a total collapse of a banking system.

The Directive was flawed in the sense that it did not provide for adequate funding of the deposit-guarantee scheme it stipulated. Even the Commission's own research has revealed that deposit-guarantee schemes in six Member States would not be capable of coping with a *medium-sized* bank failure.[28] The Government is of the opinion that in principle no distinction should be made with regard to the funding of the deposit-guarantee scheme at a point in time (a) when the economy is functioning normally or (b) after a financial system has suffered a breakdown, as was the case of Iceland in October 2008. This logical principle is even clearer when the 24th recital is read with the Member States' role in mind:

Whereas this Directive may not result in the Member States' or their competent authorities' being made liable in respect of depositors if they have ensured that one or more schemes guaranteeing deposits or credit institutions themselves and ensuring the compensation or protection of depositors under the conditions prescribed in this Directive have been introduced and officially recognized; [emphasis added]

That the Commission itself was aware of those weaknesses in the Directive was evident in the afore-mentioned report of May 2008 - *Investigating the efficiency of EU Deposit Guarantee Schemes* - which was a part of a review process initiated by the Commission.[29] Among the main conclusions of that report, as stated in the executive summary on page 2, were the following:

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[27] COMMISSION STAFF WORKING DOCUMENT - IMPACT ASSESSMENT. Accompanying document to the Proposal for a DIRECTIVE .../.../EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on Deposit Guarantee Schemes [...] p. 19. See: http://ec.europa.eu/internal_market/bank/docs/guarantee/20100712_ia_en.pdf

[28] COMMISSION STAFF WORKING DOCUMENT - IMPACT ASSESSMENT. Accompanying document to the Proposal for a DIRECTIVE .../.../EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on Deposit Guarantee Schemes

[29] See "Investigating the efficiency of EU Deposit Guarantee Schemes." European Commission, Joint Research Centre, Unit G09, Ispra (Italy), May 2008, p. 3. Accessible at:

Even though DGS thus seem to be robust for smaller failures, there are clear limits: on average, without resorting to unlimited borrowing DGS declare themselves capable of coping with a single crisis of any of the smallest 64% of their members.[30]

Moreover, the report **did not** assume that Member States had an obligation to provide funds in serious economic situations when assessing the robustness of the different deposit-guarantee schemes of the Member States. It is pointed out hypothetically that for the Member States that informed the Commission that their deposit-guarantee schemes had unlimited borrowing capacity, as opposed to those where borrowing was not allowed or limited, the deposit-guarantee schemes' funding capacity was 100%. But it further explained:

This number would suggest significant robustness of the schemes to cover any bank failure. In practice, this declaration may be viewed as hypothetical, considering that in case of high impact interventions other authorities (Government or Central Bank) would be likely to step in, by providing guarantees or acting directly to preserve financial stability.[31]

The underlined words reveal that the report did not consider that there was an obligation for the Member States to intervene in case of the deposit-guarantee scheme having insufficient funds.

Deposit-guarantee schemes are not an effective tool to compensate depositors or settle turbulent financial markets in case of extreme systemic failures, like the one Iceland was exposed to in October 2008. Therefore the Government must stress that the Directive was not intended for cases of systemic collapse of entire financial sectors. Hence the inability of its deposit-guarantee scheme to deal with such a situation does not constitute a breach of an obligation of result by a Member State

3.6. The application of the Directive when the resolution of a banking crisis by the home state is jeopardized by unilateral, counter-productive and illegitimate actions of the host state

Should the Icelandic Government, contrary to expectations, be found to be in breach of the provisions of the said Directive, it maintains that such a breach should be considered justifiable in view of the various unilateral actions undertaken by the United Kingdom and the Netherlands governments in breach of the EEA Agreement against Landsbanki, the Icelandic state, and other Icelandic interests.

These actions impeded the Icelandic Government's efforts to efficiently reorganise and wind up Landsbanki to facilitate payments to depositors as described in section 3.4 above. In addition, these actions caused significant damage for Iceland's efforts and justify any breach which Iceland may have committed as a consequence. We refer to section 2.3 for further substantiation.

http://ec.europa.eu/internal_market/bank/docs/guarantee/deposit/report_en.pdf.

[30] See "Investigating the efficiency of EU Deposit Guarantee Schemes",., p. 2.

[31] See "Investigating the efficiency of EU Deposit Guarantee Schemes"", p. 30.

4. ALLEGED DISCRIMINATION

4.1. General

The Government concurs with the Authority's view that when assessing Iceland's obligations under the EEA Agreement, Article 4 EEA and/or Articles 4(1) and 7(1) of Directive 94/19/EC, it is the situation of deposit holders with regard to the protection stipulated by the Directive that has to be assessed.

While concurring with the Authority that the provisions of the Directive must be interpreted in light of the context and objectives of the Directive, the Government does not agree that the ECJ's decision in Joined Cases C-402/07 and C-432/97 *Sturgeon,*[32] referred to by the Authority in LFN, is of relevance to this issue. In *Sturgeon,* the Court's fourth chamber found (in absence of the point being argued) that secondary legislation on consumer protection relating to air travel was to be interpreted in accordance with primary EU law as a whole, including the principle of equal treatment.[33]

The Government maintains that, because of the difference in purpose and scope of the EEA Agreement compared to the EU primary law, Sturgeon is not a relevant ruling for the interpretation of the EEA Agreement.

The principle of non-discrimination on grounds of nationality in Article 4 EEA applies as a fundamental principle to situations within the scope of the EEA Agreement and as such is relevant for the interpretation of provisions covering situations that fall within the Agreement's scope. The Government recalls, however, that Article 4 EEA applies independently only to situations that are not subject to a more specific prohibition of discrimination on grounds of nationality.[34] The Government contends that the situation of depositors falls within the scope of the Directive (internal market harmonisation) and accordingly Article 4 EEA does not apply independently.

In so far as the Authority maintains that Article 4 EEA applies to the situation of deposit holders in respect of the protection stipulated by the Directive, it is contended that the assessment of discrimination on grounds of nationality is the same under Articles 4(1) and 7(1) of the Directive, on the one hand, and Article 4 EEA on the other.

In response to the LFN, the Government maintains that depositors in the domestic branches of the Icelandic banks and depositors in the banks' branches in other EEA states were not in a comparable situation. A number of legal and factual circumstances distinguish the two groups of deposit holders. As a result of these differences the Government's responses to the economic meltdown in October 2008 had different effect on domestic deposit holders as compared to deposit holders in other EEA states.

Although the Government decided to transfer only domestic deposits, no distinction was made between depositors of different nationalities. Any distinction was solely based on the location of the deposit, i.e. whether they were in the domestic banks or their non-domestic branches.

A number of factors explain these differing actions. While regulation and supervision of financial institutions has been partially harmonised in the EEA, the responsibility for the stability of each

[32] [2009] ECR I-10923.

[33] *Sturgeon*, para. 48.

[34] See in particular Case E-10/04 *Paolo Piazza v Paul Schurte AG* [2005] EFTA Court Report p. 76, para. 31 and Case E-7/07 *Seabrokers AS v The Norwegian State* [2008] ETA Court Report, p. 172, para. 27.

Member State's financial system rests with its authorities, which in financial crises can result in official actions being taken against non-domestic branches. As described in section 2, the Government's hands were tied because of actions by the Dutch and UK authorities who had made the assets of the Icelandic banks' branches unavailable. Any cooperation in restructuring the Icelandic banks involving deposits protected by the Directive was therefore ruled out by the actions of the respective states' authorities. Furthermore, as described below, any such action was unlikely to achiev the desired objective.

As described in section 2.3 above, the UK and Dutch Governments took unilateral decisions to compensate depositors in their respective countries, in part to maintain depositor confidence in the wider banking system. Retail depositors in the UK and Netherlands thereby enjoyed a refund of their deposits protected by the minimum guarantee and in addition full compensation in the UK and compensation of up to EUR 100,000 in the Netherlands, while depositors in Iceland had their deposits transferred to a new entity, with uncertain prospects for recovery at the time despite Government assurances.[35] Recovery was definitely uncertain, given the difficult economic circumstances prevailing in Iceland at the time. In addition, because of the restrictions imposed on cross-border currency transactions, alternative options for depositing money did not exist for domestic deposit holders. Because the assets of non-domestic depositors were in currencies other than ISK, they could turn to other, non-Icelandic, financial institutions, while the vast majority of domestic deposits were in ISK, a currency which at that time was all but impossible to exchange for foreign currency.

4.2. Incomparable situation of domestic and non-domestic depositors

With respect to the alleged discrimination it must first be noted that *no direct discrimination* took place when the Government drew a line between depositors in Icelandic branches and the Icesave depositors. Nationals of other EEA States holding deposits in Icelandic branches were treated in the same manner as Icelandic depositors, regardless of nationality, and Icelandic depositors in branches abroad were treated in the same way as foreign depositors.[36]

Furthermore, there was *no indirect discrimination* involved. Instead various objective factors distinguished the depositors at Landsbanki's Icelandic branches from the depositors at Icesave. Some of the key distinguishing factors are the following:

4.2.1. Different denomination of deposits

The Icelandic branch deposits were primarily denominated in ISK while the Icesave deposits were denominated solely in EUR and GBP. Consequently, these deposits are fundamentally different in nature. The ISK, e.g., is legal tender in Iceland and the Icelandic Central Bank is charged with its issue and acts as a lender of last resort.

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[35]It should be noted that no amendments were made to Act 98/1999 on Deposit Guarantees and Investor Compensation Scheme in this respect in October 2008.

[36] It must be emphasised that a large portion of the deposits in the Icelandic branches are owned by foreign investors. Precise figures are not available but it is estimated that they comprise about 18% of the total amount of deposits transferred in the case of Landsbanki.

In addition, the difference in denomination means that the Icelandic Government is in a much better position to formulate a response to any financial crisis with respect to ISK. There are, theoretically, no limits to its access to ISK while there are very real limits to the Government's access to EUR and GBP. As a result, the credit risk associated with ISK deposits is different than for EUR and GBP deposits.

4.2.2. Different connection to the Icelandic payment system

The Icelandic branch depositors were a part of the Icelandic payment system. That system provides automatic transfer between Icelandic banks, is very widely used for payments of salaries, goods and services, etc. The Icesave deposits were not part of that system. Consequently, the smooth functioning of the Icelandic payment system (and with it the entire Icelandic economy) was not dependant on the Icesave deposits' availability.

4.2.3. Different overall relationship with bank

The Icelandic branch depositors are likely to have been engaged in a comprehensive relationship with Landsbanki. They very probably had credit cards, car loans, mortgages, etc. from Landsbanki and, consequently, a certain level of customer loyalty. Icesave depositors had no such connections with Landsbanki. As a result, in designing a policy response to the difficulties at Landsbanki it was reasonable to presume that the Icesave depositors would have no particular loyalty or allegiance to the resurrected operations of Landsbanki.

4.2.4. Different availability of set-offs

As already explained, a major portion of the Icelandic branch depositors had various other relationships with Landsbanki. To a large extent these depositors may have been expected to have taken out loans from Landsbanki considerably larger than their amounts on deposit. In an insolvency they would therefore under all circumstances have received a full recovery on their deposit claim through set-offs, see Article 100 of the Icelandic Bankruptcy Act. This right to set-off acts as a security for those Icelandic branch depositors who can avail themselves of it.

As Icesave depositors as a rule had no other business with Landsbanki, they would not have been able to claim satisfaction for their deposit claims through set-offs. This means that they have no security for repayment and are thus in a distinctly different position.

4.2.5. Different required rate of return

The Icelandic branch depositors held their money in accounts which paid modest interest rates compared to REIBOR. Their modest rate of return provided Landsbanki with funding on which it could base low-risk operations. As the Icelandic branch deposits are for the most part in ISK they could only be used to fund Icelandic assets.

Icesave depositors, however, were chasing high rates of return, considerably higher than LIBOR or EURIBOR. To provide such returns their funding had to be used for risky operations in foreign currencies. This difference between these two groups is significant and has a direct impact on policy choices.

4.2.6. *Implications of the differences for policy choices*

These and other distinct differences, all of which are based on objective criteria – with no connection to nationality – distinguish the depositors at Icelandic branches from Icesave depositors. The two different groups of depositors required different treatment in the Government's policy response to the Icelandic banking collapse

4.3. Aims of the actions taken by the Government

The Government has in prior correspondence given the Authority insight into and details of its actions in response to the financial meltdown of October 2008.

The first priority was to achieve domestic stability. All actions therefore had to take into account the depositors in Icelandic branches. By declaring that all Icelandic branch deposits were secure, the Government avoided a wide-spread panic in Iceland.[37]

As explained in detail in the Government's letter to the Authority of 27 February 2009, initial measures focused on resolving the liquidity problems of the banks and prioritised achieving domestic stability. These measures aimed at ensuring an effective flow of capital to and from the country; ensuring that funds were available to pay for goods and services; restoring confidence in the banking industry and the financial system; ensuring that domestic payment systems would function effectively; and preventing the banking collapse from having a spill-over effect, leading to the effective collapse of the Icelandic economy. The Government sought to achieve these goals without violating the EEA Agreement.

The Government lacked the financial capacity to consider measures to cover all deposits in the three banks that collapsed in October 2008. As previously pointed out, the foreign currency reserves of the Central Bank of Iceland were dwarfed by the amount of the deposits in the banks' foreign branches (the former were ISK 350 billion compared to ISK 1,700 billion in deposits) and the banks themselves only had limited currency reserves. TIF estimated that the amount of deposits in EEA branches of the three banks, falling under the minimum guarantee, was approximately ISK 665 billion.[38]

The Government maintains that its acts at the relevant time must be viewed in the overall context. As the Government explained, and is discussed in further detail below, a number of factors must be considered when assessing the Government's actions against the relevant provisions of EEA law. As the Government emphasised previously, its reasons for transferring only domestic deposits were that this was required to save the retail banking system (85-95% of which was under imminent threat) and to ensure continued banking operations and systemic stability preventing complete loss of confidence and consequential bank-runs.

[37] Special reference is made to section 4.2. in the Government's letter to ESA of 27 February 2009.

[38] The Government's letter to ESA of 26 May 2009, p. 3.

Due to a combination of factors, the Government concluded that a transfer of non-domestic deposits was not a viable option. As explained above, a number of relevant factors distinguish the situation of domestic from that of non-domestic depositors for the purposes of Iceland's obligations pursuant to Directive 94/19/EC, and/or Article 4 EEA.

If, contrary to the view of the Government, these measures are considered to differentiate between comparable situations, leading to prima facie indirect discrimination, the Government maintains that the measures are in any event justified by and proportionate to the aims pursued.[39]

Because the Icelandic branch depositors and the Icesave depositors were not in a comparable situation (as described in more detail in sections 4.2.1 – 4.2.6 above) the difference in their treatment by the Government cannot be regarded as discrimination. The Icesave depositors had claims in foreign currency, were seeking high returns, had no security in the form of set-offs, limited or no customer loyalty to Landsbanki, and were of no significance for the Icelandic payment system. Confidence among them was already seriously damaged, and massive withdrawals had been made from accounts in the banks' non-domestic branches. A bank run was already underway in the UK and Dutch branches and could not be halted by transferring the deposits to the newly established banks, as was done in Iceland.

The situation in Iceland was different. Here action *could be taken* and therefore domestic depositors were affected in a different manner. The Government believed that a run on the domestic banks could potentially be averted as the situation had not deteriorated to the same extent as in the overseas branches. Domestic depositors had no alternatives for their deposits and it was assumed that it was possible to avoid a bank run and widespread panic by declaring that all deposits were safe and transferring them to new banks. As non-domestic depositors had their deposits in other currencies than ISK, they could therefore turn to other non-Icelandic financial institutions, while the vast majority of domestic deposits were in ISK, a currency which at that time was all but impossible to exchange for foreign currency.

The different situation of Icelandic branch depositors and Icesave depositors is also clearly evident when the wider effects of the banking crisis of 2008 are considered. In October 2008 the Government was already aware of the fact that Icelandic branch depositors would face substantial negative economic consequences because of the collapse. This has turned out to be the case in Iceland: the large-scale ISK devaluation eroded asset values and sent inflation spiralling, increasing widespread indexed debt accordingly; taxes and tax rates have been increased, and public spending has had to be cut back severely due to the enormous cost borne by the Treasury in the wake of the banking collapse and for restructuring the financial system as a whole.

As a result, significant uncertainty exists as to which group of depositors will eventually suffer less damage because of the banking collapse in Iceland. These groups are being treated differently, but it cannot be said with any certainty which group is receiving better treatment. The following table illustrates the differences in treatment and the uncertainties regarding the value the respective group of depositors will receive in the long term:

[39] As accepted by the Authority in cases concerning complaints regarding the Emergency Law.

	Received	Uncertainty	Limits on use	When free for use
Icesave depositors	Priority claim on "Old" Landsbanki	Recovery rate (est. at 90%)	Wait for pay out	50% est. by 2012
Icelandic branch depositors	A deposit in "New" Landsbanki	Exchange rate (the ISK is considerably less worth than late 2008.	Capital controls, wait for lifting	Uncertain

Furthermore, possible ISK depreciation following the relaxing of capital controls could easily magnify the loss for the Icelandic branch depositor compared to the Icesave depositor. It should also be noted that the Government's good faith can be inferred from its granting of priority rights to all depositors without distinction, including the Icesave depositors. The allocation of priority to this group comes at no small cost for Icelandic residents. The Central Bank of Iceland, Icelandic Pension funds and the Icelandic Housing Fund all hold very large unsecured claims against the estates of the collapsed banks. The losses of these institutions amount to a very considerable proportion of GDP. They demonstrate that the Government's actions were not aimed at discriminating in favour of Icelandic lenders or depositors, nor did they have this effect. On the contrary, the actions undertaken were the only possible way forward to deal with a financial system in an unprecedented and extreme situation and took due note of European legal obligations.

4.4. Objective justifications for the alleged breaches.

Should the Authority nonetheless consider that all depositors were in a comparable situation in respect of the deposit guarantee protected by the Directive, and that the contested measures indeed placed depositors of a Member State nationality other than Icelandic at a disadvantage, the Government maintains that any alleged indirect discrimination on grounds of nationality is justified by public interest objectives. The measures taken were both necessary and proportionate to the aim pursued of restoring the functioning and credibility of the domestic banking system and thereby its entire financial system.

Article 4 EEA, whether applied as a principle relevant for the interpretation of the provisions of the Directive or independently, within the scope of the EEA Agreement, provides that indirectly discriminatory measures may be justified, if they are based on objective reasons unrelated to nationality. The public interest objectives pursued in relation to the banking crisis did not take the nationality of depositors into account. The Government maintains that preserving the financial stability of the economy and countering circumstances that would seriously undermine the financial system, as well as dependent public and private services, provides grounds of justification for alleged indirect discrimination - as the former are of fundamental importance for the country's existence.[40] In addition, as previously pointed out, one of the objectives of Directive 94/19/EC is to ensure the stability of the banking system through regulation of deposit guarantees.

[40] As the Authority has found in its Decision of 15 December 2010, paragraphs 91-93, with reference to the decision of the Court of Justice in *Campus Oil*.

The Government maintains that same considerations must be applied to interpreting the Directive as in considering justified measures with regard to Article 4 EEA.

As regards the necessity and suitability of the measures taken when domestic deposits were transferred to the new banks, the Government refers to its previous explanations. The Government argues that an attempt to include non-domestic depositors in its actions would have undermined the credibility of the whole rescue and stabilising efforts and made them meaningless. Confidence among depositors abroad was already seriously damaged and massive withdrawals had been made from accounts of the banks' non-domestic branches. A bank run was already underway in the UK and Dutch branches and could not be halted by transferring the deposits to the newly established banks, as was done in Iceland.

The situation in Iceland was different. Here action *could be taken* and in Iceland transfer of deposits was indisputably within the power of the Government. The Government believed that a run on the domestic banks could potentially be averted if credible assurance was offered, as the situation had not deteriorated to the same extent as in the overseas branches. This assessment was proved correct, as explained in the Government's letter to ESA of 26 May 2009.[41]

The Government finally maintains that, when assessed in the context of all of its measures (including the issuing of debt instruments in favour of the old banks and prioritising the claims of deposit holders in any winding-up-procedures) and given the dire financial circumstances which it faced, the Government's decision to transfer domestic deposits to the new banks was suitable to achieve the aim sought and did not excessively impinge upon the protection of depositors in other EEA states stipulated by the Directive.

5. THE PRIVATE NATURE OF THE ICELANDIC DEPOSITORS' AND INVESTORS' GUARANTEE FUND

The Authority assumes that no distinction can be made between the Icelandic Depositors' and Investors' Guarantee Fund and the state despite the fact that Article 2 of Act No. 98/1999 stipulates that the fund is a private institution.[42] The article reads:

> *Guarantees under this Act are entrusted to a special institute named the Depositors' and Investors' Guarantee Fund, hereinafter referred to as the "Fund". The Fund is a private foundation, operating in two independent departments, the Deposit Department and the Securities Department, with separate finances and accounting, cf. however the provisions of Article 12.*

The Fund is a private non-profit fund whereby, according to Article 4, private institutions nominate four out of six members of the board and the Minister of Commerce nominates two

[41] See in particular figures referred to in the letter, p. 4, showing that large scale withdrawals did not occur domestically and public confidence in the system was maintained.

[42] See the Letter of Formal Notice, para. 4 on p. 9.

members. Consequently, the state does not have the required majority on the board to exercise formal or informal (effective) control over the Fund.

No payments have been made by the Fund since the economic collapse of October 2008. The Authority is right stating that the Fund did make agreements regarding the repayment of deposits already compensated in the Netherlands and the UK. However, these agreements cannot be seen as proof of a direct or indirect link to the Icelandic state. In the agreements it was explicitly stated that the Depositors' and Investors' Guarantee Fund of Iceland was a private foundation incorporated under Icelandic law.[43] These agreements by no means attest to any direct or informal control of the Fund by the Icelandic state.

On page 12 of the LFN the Authority states that "the depositors with the Icesave branches in the Netherlands and the United Kingdom are the only ones who have not received even the minimum compensation from the deposit-guarantee scheme responsible under the Directive." Once again the Authority does not acknowledge the fact that the depositors in question have been compensated with at least the minimum amount as stipulated in the Directive and that these claims are now formally pursued by official bodies of the Dutch and UK authorities.

The Government objects to the conclusions drawn in Section 4.2 of the LFN. In its previous correspondence the Government has described the enormous scale of the economic collapse in Iceland in October 2008. The Authority disagrees with the Government's view that the deposit-guarantee schemes according to the Directive cannot cope with a financial meltdown and says in the LFN that "[t]he terms of the Directive itself cannot support such an argument."

Although it is not explicitly stated in its text, the system as conceived by the Directive cannot deal with an economic meltdown e.g. where deposit-guarantee schemes are post-funded. In a post-funded scheme, which financial institutions should finance the scheme in a case where all banks become insolvent?

6. IMPOSSIBILITY AND FORCE MAJEURE

In its previous exchange of information with the Authority, the Government has delivered to the Authority extensive and detailed information, both in facts and figures, on the economic crisis and the collapse of the Icelandic banks in the autumn of 2008. All of this information demonstrates that the Government could not provide the funds needed in order to compensate depositors, as the Authority deems it should have, nor apply the emergency measures it took to depositors in the foreign branches of the Icelandic banks. It was absolutely, physically impossible to provide the funds needed to pay the amounts required in the relevant currencies.

In its case law the ECJ has acknowledged the term "impossibility", which has been introduced as defence by Member States allegedly in breach of their obligations. In *Case 52/84 Commission v Belgium [1986] ECR 89*, the Court stated that impossibility is a Member State's only option of defence when opposing an application by the Commission for failure of implementing a binding

[43] See top of page 2 of the Loan Agreement dated 5 June 2009. Available at http://www.island.is/media/frettir/01.pdf.

decision. Although impossibility comes into play in some of the previous arguments the Government emphasises it as a general argument against any alleged breaches.

In October 2008 Iceland encountered an unforeseen and insurmountable situation whereby decisive actions had to be taken in the interest of the general public to limit the irrevocable damage to the economy and the negative social consequences of damage already done.[44] The situation deteriorated quickly to a point where the Government's control was weakening and extreme measures were needed to calm the situation. This was an economic crisis of unprecedented scale with potentially devastating effects for the general public in Iceland. It cannot be argued that economic difficulties of this magnitude could have been foreseen when Iceland transposed the Directive and at the time of the establishment of TIF the Icelandic DGS.

The Authority refers to the ECJ's jurisprudence on Member States' ability to refer to exceptional circumstances and maintains that, having failed to avail itself of a derogation provided for in the Directive, the Government cannot be exonerated from its fulfilling its obligations. The Government objects to and considers the cases referred to as irrelevant given the exceptional circumstances of this case. Even though the Directive entails a consideration for exceptional circumstances by providing for a delay in payments to depositors, such a deviation from the general rule of repayment is far from sufficient to meet the needs in a situation like the one Iceland was faced with.

The ECJ has expressed the following definition of force majeure:

> *As the court has consistently held, apart from special features of specific areas in which it is used, the concept of force majeure essentially covers extraneous circumstances which make it impossible for the relevant action to be carried out . Even though it does not presuppose absolute impossibility it nevertheless requires abnormal difficulties which are independent of the will of the person concerned and appear inevitable even if all due care is taken.*[45]

It is obvious that the external difficulties that the Icelandic Government was faced with in 2008 were in accordance with the referenced description.

FINAL REMARKS

In this reply to the Letter of Formal Notice the Government has set forth its objections to the conclusions of the Authority on the relevant matters. The Government also refers in general to previous exchanges with the Authority. We believe the arguments put forward in this letter should enable the Authority to conclude the case without further action. In this respect we point especially to the following factors:

(1) Within 3-5 months the courts of Iceland will have finally determined the legality of the priority claims by the deposit-guarantee schemes of the United Kingdom and the Netherlands, lodged in the winding up proceedings of Landsbanki.

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[44] As much was recognised in the Agreed Guidelines of 17 November 2008, in which reference is made to "the unprecedented difficult situation of Iceland and therefore the necessity of finding arrangements that allow Iceland to restore its financial system and its economy."

[45] Case 70/86 *Commission v Greece* [1987] ECR 3545, para 8.

(2) The courts will also decide upon the interest accrued on these claims and associated costs.

(3) Within few weeks the Landsbanki estate will publish an updated estimate of the value of the estate's assets and expected recovery rate. The estate is preparing the sale of its largest single asset this year, which will affect the recovery rate to a considerable degree. The expectation is therefore of an upward revision from the current estimated recovery rate of 90%.

(4) Landsbanki is expected to commence payment to the deposit insurance schemes of the United Kingdom and the Netherlands of considerable amounts towards their claims later this year. According to information from Landsbanki ISK 361 billion were available in cash at the end of last year for payment to the deposit-guarantee schemes in the United Kingdom and the Netherlands. It is possible that estimates and a schedule for full payment will soon be available.

The Government expresses its commitment to provide the Authority with further information on this issue, but reiterates its firm conviction that it has not breached either the Directive or the EEA Agreement

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