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Case E-16/11

EFTA SURVEILLANCE AUTHORITY

v

ICELAND

SPEECH OF THE ICELANDIC GOVERNMENT

Introduction

1. At the heart of this case is a short point of interpretation of the Deposit Guarantee Directive. It arose out of dramatic and extraordinary events in Iceland in 2008. But the answer does not depend on those particular facts. It's a point of general importance across the EEA, of far wider significance than this case. The essential issue is whether the Contracting States are obliged by the Deposit Guarantee Directive to underwrite their banking systems.

2. Iceland's central point is that there is no such duty. The Authority's argument imposes huge financial obligations upon the Contracting States – obligations that may be triggered at times of economic crisis when the States can least afford it. The Authority's interpretation creates a link between the liabilities of the banks and the liability of the State itself; a link which brings dangers that recent events have highlighted. There is nothing to suggest that the Contracting Parties intended to assume any such burden.

3. I'm going to make submissions under three heads.

a. First, I'm going to seek to define the issues raised by the claim. In some respects the submissions of the Authority and the Commission have obscured, rather than cast light, on those issues.

b. Secondly, I'll explain the nature of Iceland's Defence. The arguments of the Authority and the Commission have misconstrued it.

c. Thirdly, I'm going to explain why the Authority's discrimination claim lacks any foundation, in law or in fact.

(1) The issues raised by the Claim

4. The starting point is to consider what the Authority is asking the Court to do. It seeks a declaration that Iceland has breached EEA law by "failing to ensure" the payment of the compensation required by the Directive to Icesave depositors in the UK and Netherlands. But what does it mean by "failing to ensure"? What is the "obligation of result" that the Authority says lies upon the Contracting States? The Authority has not been consistent about this.

5. At first, the position seemed clear. The Authority argued that this meant that, to quote, "should all else fail" the State would have to step in and be responsible for the payment of compensation to depositors. It said this in its Application,[1] its Reasoned Opinion[2] and its Letter of Formal Notice[3].

6. This is an important submission. It faces up to the logic of the Authority's position: if the State is obliged to "ensure" that compensation is paid, then ultimately, it must be the

[1] Para 133.

[2] Annex 5 to the Application, p 16.

[3] Annex 3, p 9

provider of last resort. If "all else fails" and there is no other source of funds, the State will have to use its own resources.

7. But in its pleadings the Authority seeks to avoid this consequence of its argument. It says that the Member States have a choice in how they implement the Directive.[4] They may choose to use their own resources, or they may draw on private funds to support a deposit guarantee scheme. The Commission takes the same view.

8. This provides no answer: if the obligation of result imposed by the Directive is that the State must ensure, whatever the circumstances, the payment of compensation, then if all else fails, the State will have to step in. That will be the case no matter how many hypothetical choices a State has. The logic of the Authority's argument is that the state is left with no choice at all about whether to use its resources to fund a deposit guarantee scheme - at least where all else fails.

9. This point does not depend on the particular facts that arose in Iceland, or any other Contracting State. It's simply the logic of the construction adopted by the Authority and the Commission.

10. The Icelandic banking crash is significant because it shows that this point is not hypothetical, or merely academic. The fact is that widespread banking failures do happen. And if so, then where is the money to come from other than the State? There may be no banks left to provide funding: in Iceland 85% of the banking system failed in a three day period. Almost all the other commercial banks failed in the months that followed.[5] So the Authority was right to recognise that the consequence of its argument is that if all else fails, the State will have to step in. It's implicit in its argument that the State must guarantee the deposit guarantee scheme.

[4] Reply, paras 41, 42.

[5] 93% of the commercial banking sector by March 2009. Overall banks representing 99% of the Icelandic banking sector have been subject to winding up or restructuring: Defence para 52.

Why this point matters

11. This consequence of the Authority's case is of real importance. Otherwise, it might be thought that their argument has a superficial attraction. They argue that:

    - The Directive requires that a deposit guarantee scheme should pay compensation, and it's for the State to ensure that this happens somehow.

    - The Directive does not harmonise the mechanism of funding, and that is simply up to the State to decide.

12. But once it's appreciated that this requires the State to provide financial support to a deposit guarantee scheme when all else fails, the argument starts to unravel, for three reasons:

13. **First - and most importantly -** there is nothing at all in the Directive to suggest that any form of State guarantee, or State funding is required. It places an obligation upon the State to set up, and to supervise a deposit guarantee scheme, but there is no suggestion at all it must pay compensation.

14. The recitals make clear that the funding for deposit guarantee schemes will come from the banks.[6] To quote "the cost of financing such schemes must be borne in principle by credit institutions themselves".[7] If the States were required to pay compensation – where all else fails, no matter what the circumstances - the exposure would be vast. The Icelandic Institute of Economic Studies calculates it to be equivalent to an average of 83% of GDP across the EU. The States would plainly have to make very large – perhaps unmanageable - provision for this exposure.

[6] See recitals 4, 23 and 25.

[7] Recital 4. Opinion of the Economic and Social Committee, para 3.1.5, quoted in the first recital to the Directive. "on competitive grounds" deposit guarantee schemes should be funded by banks, and not public authorities.

15. The Authority's argument converts the Directive from a measure funded by the banks, into a measure that imposes huge potential liabilities on the State. None of that can be found in the Directive.

16. **Secondly,** if the Authority's argument is right, it creates a gap in the system of State Aid supervision. If the State is obliged to ensure that compensation is paid under the Directive when all else fails, such a use of State funds would not be State aid. The case law of the European Court establishes that a payment made under a Directive obligation cannot be State aid.[8]

17. Such a gap in State aid supervision would certainly be surprising. There is obviously scope for serious distortions of competition if a State bails out a deposit guarantee scheme - in effect subsidising its banks. The point of the State aid rules is to ensure that this kind of activity is regulated by the Authority. It very recently gave approval to Iceland for the State aid granted to its banking system following the crash. Yet one of the consequences of the Authority's argument is that if all else fails, the State is under a duty to pay - there can be no question of needing the Authority's approval.

18. **Thirdly,** the Authority's argument leads to absurd consequences in a range of other situations where EEA law requires the State to impose obligations on others. One example was raised by the Authority itself in its Reply: the Package Travel Directive.[9] On the Authority's argument, if a travel company goes bust, and if "all else fails" it would be for the State to provide reimbursement to the consumer.

19. It might even be argued that such a result is necessary for the Package Travel Directive to provide effective consumer protection, if consumers are to be encouraged to exercise the freedom to receive services provided in other Member States. This is precisely the form of argument that Iceland has faced in this case.

[8] Case T-351/02 *Deutsche Bahn v Commission* [2006] ECR II-1047, paras 99-102.

[9] Dir 90/314/EEC on package travel, package holidays and package tours of 13 June 1990.

20. But the Package Travel Directive does not make the State the ultimate guarantor of holiday makers, any more than the Deposit Guarantee Directive makes the State the ultimate guarantor of bank deposits.

21. The Authority's argument imposes an obligation of result far beyond the language and purpose of the Directive and the expectation of the Contracting parties.

22. The most that can be said for the Authority on the face of the Directive is that Article 10 provides that deposit guarantee schemes shall be in a position to pay duly verified claims within 12 months. But it's clear from the judgment of the Court of Justice in *Francovich* that this cannot create an automatic obligation on the State to pay. Such an obligation can only arise if the conditions for state liability in damages are fulfilled.

23. In the *Francovich* case the employee insolvency directive required the Member States to, to quote "ensure that guarantee institutions guarantee... outstanding claims from contracts of employment."[10] But even that language was not enough to make the State itself automatically liable to make such payments.[11] The payment obligation lay with the guarantee institutions. The State can only become liable where the criteria for the award of damages are satisfied.

(2) The nature of Iceland's Defence

24. I'll turn now to the second head of my submissions: the nature of Iceland's Defence. Iceland wishes to clear up two important misconceptions.

(i) An obligation of result

[10] Dir 80/987/EC, Art 3(1).

[11] Art 5 said it was for employers to pay, unless covered by public authorities.

First, and despite what the Commission says,[12] Iceland does accept that the Directive imposes an obligation of result upon the Contracting States. The dispute, of course is as to the nature of that obligation. Iceland entirely accepts it was under an obligation to establish, and to supervise a deposit guarantee scheme. There's no dispute that it did so. It was funded entirely in accordance with EU norms, as the Commission's Impact Assessment shows.[13]

25. There is also no dispute that the TIF could not cope with the almost total failure of Iceland's banks. But the critical point is that this does not show any failure on Iceland's part to implement the Directive properly. No deposit guarantee scheme could have coped with such a wide-scale banking failure. We made that point in Iceland's Defence, and backed it up with the analysis of the Institute of Economic Affairs and no party has disputed it.[14]

26. The point is strongly reinforced by the Commission's Impact Assessment. It shows that none of the Deposit Guarantee Schemes in Europe could have withstood a crash even a fraction of the severity of the one that took place in Iceland. The average funding level across the EU is 0.5% of liability –not enough for even a mid-sized banking failure. But there is no suggestion by the Commission that this is due to some form of systemic failure of implementation of the Directive across Europe.

27. This is very different to what the Commission now says. At paragraph 45 of its Intervention it says the States are obliged, to quote, "to ensure that the scheme is constantly and at any moment capable of being in a position to pay duly verified claims by depositors." Its own Impact Assessment shows that no scheme could possibly do this.

[12] Statement in Intervention, para 44.

[13] Funded to 1% of deposits in the previous year. Defence, para 36. The Impact Assessment is quoted at para 122 of the Defence: the ratio between ex –ante funds and eligible deposits is 0.01 – 2.3%.

[14] See Defence para 5.

28. What the Impact Assessment demonstrates is the practical limitations of deposit guarantee schemes. They are not an absolute guarantee, or a cure-all for banking failure. They are much more limited than that. Otherwise, the banks would have to tie up so much of their assets that the business of banking would be unworkable. If the State is going to have to step in if all else fails, then its resources will have to be tied up.

29. It's remarkably telling that in 2010, faced with concerns about the weakness of deposit guarantee schemes, the Commission's response was to suggest harmonised funding at a level that would protect against a mid-sized failure, meaning 2% of eligible deposits – not 85%.[15] And even that has proven to be politically unacceptable, so far.

30. There was no suggestion then that the Contracting States had to ensure that a deposit guarantee scheme should be funded to a level that would enable to it cope with any banking crash, or, more importantly for this case, to step in if the scheme failed. In fact the Impact Assessment accepted that any such intervention would have to comply with State aid rules.

(ii) No exemption for a large scale bank failure

31. **The second point** I want to make about Iceland's Defence follows on from this. Iceland does not argue that the Directive is somehow inapplicable to a large scale banking crash.

32. But in interpreting the Directive, it's necessary to bear in mind the reality of deposit-guarantee schemes. No deposit guarantee scheme can offer absolute protection in all circumstances, however attractive that may sound in theory. Any attempt to underwrite it using the resources of the State creates its own problems: huge costs for the state, moral hazard on the part of the banks, and a linkage between the liabilities of the banks and the financial exposure of the State. That kind of link can have very serious

[15] Defence, para 133.

consequences. A severe financial crisis easily turns to a possible sovereign default. Events in Spain have shown this is not a hypothetical concern.

33. Where widespread banking failure takes place, other policy tools are required. The Commission is considering a package of reforms to banking supervision in Europe that aims to strengthen the measures available.[16] The use of State aid in particular allows the Authority to ensure that any injection of State funds into the banking system is no more extensive than it needs to be, and that the single market is not detrimentally affected.

34. In this case, the stated justification for the Authority's interpretation is consumer protection. But consumer protection must always strike a balance as between its costs and benefits. That's why EEA law aims at a high level of consumer protection, not the highest possible. The Authority's approach creates serious risks and burdens for the State, beyond their contemplation when they adopted the Directive. That is ultimately to the detriment of consumers themselves.

35. Before turning to discrimination, Iceland wishes to make clear it maintains its plea of *force majeure* in the alternative.

(3) <u>Discrimination</u>

36. As to discrimination, it's conspicuous that the United Kingdom and the Dutch Governments have so far offered no support at all to the Authority on this part of the case. Yet they are supposedly the victims of this discrimination.

37. The short answer to the discrimination claim is that the difference of treatment complained of had nothing at all to do with TIF, or the Directive. This is not a case where TIF paid out to some nationals, but not others, for example. The emergency restructuring of Iceland's domestic banking system has nothing to do with the Directive.

[16] Rejoinder, para 35.

It cannot trigger an obligation to ensure payment of €20,000 to each depositor in overseas branches.

38. I'm going to address the claim in a little more detail under three heads: first, the nature of the claim, secondly its supposed legal basis, and thirdly, Iceland's justification for its actions.

(1) Nature of the claim

39. Starting with the nature of the discrimination claim, it's necessary to consider how it fits in with the Authority's main argument on the interpretation of the Directive. The Authority is not seeking some form of generalised declaration of unfairness. The claim is highly specific: it seeks a declaration that by failing to ensure payment of the 20,000 Euros per depositor in the year provided by the Directive, Iceland breached EEA law.

40. Its primary case is of course that the terms of the Directive itself require Iceland to ensure such payments are made. Iceland disagrees, and I've already explained why. But if the Authority is right in that claim, then the discrimination claim simply does not matter: the Authority will win this application without it. The discrimination claim only matters if the Authority is *wrong* on that first claim: if, as Iceland argues, there is *no* Directive obligation to make such a payment.

41. So the Authority must argue that even if the Directive itself does not require the payment of 20,000 Euros to each depositor, this is somehow required by the principle of non-discrimination.

42. That argument might conceivably make sense if TIF had paid out compensation to Icelandic investors, but not other foreign nationals. But the claim is not based on that.

43. Nor is the claim that the bank restructure that took place in Iceland should have been extended to overseas depositors. The Authority has been quite clear about that.[17] So it is not seeking equality of treatment in this respect.

44. It's an unusual feature of the discrimination claim, to say the least, that the Authority is not arguing that the two groups should have been treated the same. The Authority's claim is that the transfer of the domestic deposits somehow triggered a specific obligation to pay 20,000 Euros to each overseas depositor within a year - even though there is no such obligation under the Directive.

45. Iceland contends that the Authority cannot begin to make out this claim at all. Either the payment of €20,000 was required by the Directive, or it was not. Either there was discrimination in giving effect to the Directive, or there was not.

46. The Authority and the Commission have sought to gloss over this by broadening the Authority's complaint. They refer to the fact that only domestic depositors had continuous access to their deposits.[18] But this application is not about access to deposits. The Authority's complaint is about the failure of Iceland to ensure the payment of compensation specifically required by the Directive, and nothing else. But that obligation cannot be derived from the principle of non-discrimination.

(2) Legal basis

47. I'll turn now to our second head of submissions: the Authority has identified no proper legal basis for its claim.

[17] Application para 175.

[18] Authority Reply, paras 56 and 57, Commission para 67.

48. Its central argument is that the difference in treatment is unlawful because it is discrimination within the scope of the Deposit Guarantee Directive.[19] Iceland of course accepts that it was obliged to implement the Directive without discrimination. But any such obligation based on the Directive can only extend as far as the Directive itself.

49. If TIF had chosen to make payment to one group of depositors, but not another, then it would be easy to see why there could be a complaint of discrimination under the Directive. But nothing of that kind took place in this case. The transfer of domestic accounts to the new banks did not damage the prospects of payment out by TIF. If anything, it might have made it easier: it released TIF from any immediate prospect of having to pay out on the domestic accounts. Nor did this involve diverting the funds of TIF, or circumventing the Directive in some other way.

50. Here again, it's necessary to again focus on the nature of the obligations imposed by the Directive. They are solely concerned with the deposit guarantee scheme. The principle of non-discrimination requires that there should be no difference in treatment in the way that scheme treats different depositors, and the way it uses its funds. But in this case, there was no difference in treatment of this kind.

51. If a State treats deposits differently in some other way, then the Directive has no relevance. It does not extend to all banking measures adopted by the State. It's a commonplace that bank restructuring will lead to differences in the treatment of deposits. Some banks may be saved, but not others; some branches may be saved but not others. Governments across Europe have faced tough decisions over the last four years when trying to decide which banks to rescue and which to allow to fail. The Commission has itself acknowledged this. In advancing its proposal for a new bank resolution directive it acknowledged that where an insolvent bank is split into a new

[19] Eg: Application, para 165. Art 4 EEA: NofA para 158. Defence para 302: Art 4 EEA applies only to situations governed by EEA law in regard to which the EEA Agreement lays down no specific rules prohibiting discrimination.

"good bank" and an old "bad bank", then (what it describes as) "Bank creditors that are not systematic" could be either left with the old bank, or transferred to the new.[20]

52. The Deposit Guarantee Directive has no bearing on this.

(3) Objective justification

53. My third and final head of submissions on discrimination is objective justification. Iceland would only need a justification if the Authority could establish a proper legal basis for its discrimination claim. So far, it hasn't done so. I will though explain briefly why any discrimination in this case, if established, would be plainly justified. The Authority has not seriously engaged with this issue in its written submissions.[21]

54. The essential reason for the difference in treatment is that the failure of the domestic branches posed a systemic risk to the Icelandic economy. The establishment of the new banks was part of a package of emergency measures. Those branches were critical to the survival of the Icelandic economy. They were used by almost every business and family in Iceland for the full range of ordinary banking transactions. It was essential to rescue them.

55. The objective of the restructuring was, to quote, "to safeguard the functioning of the domestic banking system and real overall economy in Iceland". Those are the words of the Authority itself, dismissing a complaint about the Icelandic Emergency Act.[22] Since then, the Authority has granted State aid approval for the restructuring of the Icelandic banks. Whilst the Authority reserved the question whether the measures were compatible with the Deposit Guarantee Directive, it can hardly have thought the aid was discriminatory or it would not have approved it.

[20] [ ].

[21] See Reply, para

[22] See Defence para 309, Decision of 15 December 2010,para 98.

56. So the position is that the restructuring of the Icelandic banks has been approved, and yet the Authority argues that there was an additional obligation to pay €20,000 in respect of each overseas savings account.

57. But where does this obligation to pay compensation come from? The Authority's first argument – that this obligation arises under the Deposit Guarantee Directive - is at least easy to understand, even if Iceland disagrees with its analysis. But it is only if the Authority is wrong on that argument that we even need consider discrimination.

58. Iceland's submission is that the restructuring of its banking system in accordance with EEA law could not somehow trigger a freestanding obligation of this kind. The Icelandic Government did what was necessary to rescue its banking system. That is why the Authority was able to grant approval for the measures that it took. As this Court has recognised, there is a wide margin of appreciation in respect of such economic policy judgments.[23]

59. The reality is that Iceland didn't have the money to extend its bank rescue to all branches. The sum due to the Icesave depositors was 140% of Iceland's Government revenue. Any attempt to do so would have risked destroying the viability of the bank rescue.[24] That is not just Iceland's submission. In the Authority's decision rejecting complaints about the Emergency Act, it explicitly recognised that any attempt to extend the rescue to the Icelandic banks as a whole would have lacked the necessary credibility to make the rescue succeed. But it's important that Iceland didn't simply abandon the overseas depositors. They were granted priority in the winding up of Landsbanki, and stand to recover all of their deposits, not just €20,000.

60. So in conclusion, if there is no discrimination in giving effect to the Directive, and the Authority has found there was no discrimination in the bank rescue, then it is impossible to see how discrimination can arise from adding these two things together.

[23] Case E-3/11 *Sigmarsson v Central Bank of Iceland*, 14 Dec 2011, para 50, quoted at para 303 of the Defence.

[24] See Defence para 81.

Conclusion

61. For these reasons, and the arguments developed in full in its written pleadings, Iceland respectfully contends that this application should be dismissed.