IN THE EFTA COURT

Case E-16/11

MINISTRY FOR FOREIGN
AFFAIRS OF ICELAND

Reykjavík, 20 June 2012

TO THE PRESIDENT AND MEMBERS OF THE EFTA COURT

REPLY

Submitted pursuant to Article 89 (6) of the Rules of Procedure of the EFTA Court in response to the Statement in Intervention submitted by the European Commission by

THE GOVERNMENT OF ICELAND

Represented by Mr. Kristján Andri Stefánsson as its Agent,
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In

Case E-16/11

EFTA Surveillance Authority

v

Iceland

The Government of Iceland has the honour of submitting the following Reply to the Statement in Intervention submitted by the European Commission in the present case.

[1] The Ministry wishes to acknowledge that this Reply is the product of a team of lawyers and external advisors both within Iceland (State Attorney General Einar Karl Hallvarðsson, Supreme Court Attorney Jóhannes Karl Sveinsson, Lecturer Kristín Haraldsdóttir, Supreme Court Attorney Reimar Pétursson and Lecturer Dóra Guðmundsdóttir) and outside (Professor Miguel Poiares Maduro).

Introduction

1. The Commission's analysis suffers from the same essential defects as that of the Authority: as to the interpretation of the Directive, it fails to face up to the consequences of its own argument; as to the question of discrimination, it seeks impermissibly to extend the Directive's scope.

The issue as to the "obligation of result"

2. The central issue before the Court is as to the nature and extent of the "obligation of result" placed upon by the State by the Directive. Contrary to the Commission's submission, it is not the Icelandic Government's case that "the Directive does not impose obligations of result".[2] As Iceland explained in its Defence and in its Rejoinder, it considers that the Directive imposes an obligation upon the State to ensure the proper establishment, recognition and supervision of a deposit-guarantee scheme.[3] What it does not accept is that the Directive imposes a further obligation upon the State to ensure the payment of compensation in cases where the deposit-guarantee scheme is unable to do so, using its own funds if necessary.[4]

3. On this central issue, the Commission supports the case advanced by the Authority in its Reply, rather than the case advanced by the Authority in its Notice of Application and Reasoned Opinion.

4. As Iceland has already noted in its Defence and Rejoinder, the Authority's original case was that "should all else fail" the State itself would be responsible to compensate depositors.[5] In its Reply, however, the Authority sought to distance itself from this position, arguing that there is no obligation upon the State to use its own funds where a bank failure occurs on such a scale that a deposit-guarantee scheme is unable to compensate depositors.[6]

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[2] Statement in Intervention, para 44.
[3] See eg, Defence para 26 (b); Rejoinder para 10.
[4] See eg, Defence para 26 (c); Rejoinder para 13.
[5] See Iceland's Rejoinder paras 37, and 38 and the pleadings quoted there.
[6] Reply, paras 33, 38.

5. In its Statement in Intervention, the Commission explains that the view it expressed in its initial proposal for the Directive was that:[7]

> "It was therefore acknowledged by the Commission that a Member State may have to step in bringing financial assistance to a scheme if all other options fail to ensure that it is in a position to repay depositors within the time limit." (emphasis added)

6. That language rightly acknowledges the inescapable consequence of the Commission and the Authority's argument: if the State is to "ensure" that depositors are compensated in all circumstances, then the deposit-guarantee scheme must, ultimately, be backed by the resources of the State. Like the Authority, the Commission seeks to avoid this consequence: one of the Commission's two "principal remarks" about Iceland's case is that:[8]

> "There is ... no obligation imposed by the Directive to provide State funding of whatever nature."

7. The Commission's case is that the use of State funding is just one of the options of the Member States.[9] Thus, its argument is much closer to that advanced by the Authority in its Reply: that the Directive does not require State funding, but that it is a matter for the discretion of the State.

8. The Commission rightly acknowledges that there may be circumstances where the demands upon a deposit-guarantee scheme are too great to be met by the scheme itself. In its Statement in Intervention, it explains that:[10]

> "while schemes should in principle be funded by the banks, there may be cases where the result can only be achieved through external support."

9. Thus, one might characterise its position as being:

> "should all else fail, external support must step in."

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[7] Statement in Intervention, para 19.
[8] Statement in Intervention, para45.
[9] Eg para 11.
[10] Statement in Intervention, para 22. See also Statement in Intervention, para 14.

10. But the inescapable logic of this position is that in at least some circumstances, such "external support" has to be State support.

11. This is a point of principle – it does not depend upon the particular facts that arose in Iceland in 2008. Potential sources of "external support" in the private sector may perceive the credit risk to be unacceptably high in the case of a bankrupt deposit-guarantee scheme in a state that has suffered a widespread banking failure. If so, what is the "obligation of result" upon the State?

12. The answer of the Authority and the Commission is clear: the State must ensure that compensation is paid – there are no exceptions to this obligation. Thus if "all else fails", and no other "external support" is available, the State must step in.

13. It is of course correct that, as the Commission contends, the Contracting States enjoy a margin of discretion as to the means by which they implement the Directive. Thus, the particular means by which a deposit-guarantee scheme is funded is a matter for the Contracting States. On the Commission's argument, the States also enjoy a discretion as to precisely how "external sources" are utilised to provide additional support to a deposit-guarantee scheme that cannot pay out compensation. Where the Contracting States use their own resources to fund the compensation, there is also discretion as to how it is funded: whether by acting as lender of last resort, or through the use of State guarantees, for example. Either way, State resources are involved.[11]

14. But on the Commission and the Authority's argument, there is no discretion at all as to whether the State must use its resources, once it is clear that other forms of external support are not available. The inescapable logic of the position of the Commission and the Authority is that the State must step in.

15. The Authority and the Commission now seek to avoid this consequence for three reasons. First, there is nothing at all in the text of the Directive to suggest that the State must underwrite the deposit-guarantee scheme in this way. The Commission argues that the

[11] As to the use of State guarantees, see the *Authority's State Aid Guidelines on State Guarantees* : http://www.eftasurv.int/state-aid/legal-framework/state-aid-guidelines/ which explains the circumstances in which the provision of a State guarantee will amount to State aid, noting that "[t]he benefit of a state guarantee is that the risk associated with the guarantee is carried by the State. Such risk-carrying by the State should normally be remunerated by an appropriate premium": Annex II para 2.1 .

wording of the Directive supports its case, but that language draws a fundamental distinction between (i) the obligations upon the State to establish and supervise a deposit-guarantee scheme and (ii) the obligations upon the deposit-guarantee scheme itself, established under those rules. It is of course correct that the Directive places obligations only upon States, as the Commission says.[12] That offers, however, no substantive answer to the key issue, which is whether the Directive imposes an obligation upon the State other than to set up and supervise a guarantee scheme.

16. Secondly, if there was an obligation under the Directive to provide such compensation, then it would fall outside the scope of State aid supervision: it would be a legal duty upon the Member States to provide such financial support when all else failed. There would be no requirement for State aid approval by the Commission, or the Authority. The Commission makes clear however that it remains of the view that such approval would be needed.[13] As such, as a matter of law, this funding cannot be a requirement of the Directive itself.[14] The Commission's position is accordingly incoherent.

17. Thirdly, their argument has a further absurd consequence: if such an obligation does arise in this case, it must also arise in a range of other cases where directives require the Contracting States to guarantee that certain market operators provide financial benefits to a particular group, whether consumers, workers or others. If the Commission and the Authority are right in their core argument in this case, the State must also guarantee the protection of such financial interests in all such cases, even when the market operators in question are no longer in a position to do so. In its Defence and Rejoinder, Iceland gave some concrete examples. [15] There is no reason, based upon the wording and context of those directives, why the "obligation of result" that they impose should be interpreted materially differently. This serves to make clear that the concept of obligation of result that the Authority and the Commission are trying to introduce in this case is entirely unsustainable.

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[12] Statement in Intervention, para 56.
[13] Statement in Intervention, para 18.
[14] Case T-351/02 *Deutsche Bahn v Commission* [2006] ECR II-1047, paras 99 -102.
[15] See Defence para 231-245, Rejoinder paras 25-35.

The practical necessity for State support

18. The foregoing submissions demonstrate why, as a matter of principle, the Commission's argument leads to the need for State support. In its efforts to avoid this conclusion, the Commission made certain practical proposals as to how external support for a deposit-guarantee scheme could be secured without recourse to the resources of the State. For the reasons already given, it is inherent to the Commission's analysis that the State is under a legal obligation to ensure that depositors are paid compensation where deposits become unavailable, irrespective of circumstances. As a consequence, even if the Commission were able to demonstrate that in at least some circumstances the State might be able to ensure such payments are made in the event of the failure of a deposit-guarantee scheme without recourse to State resources, that provides no answer to Iceland's case. Thus, the practical proposals made by the Commission in this case cannot answer the legal question to be decided by the Court. They are, in any event, entirely unrealistic, when considered in the context of a large scale banking crash. The Commission's approach is so lacking in practical reality that it serves to confirm that it cannot have been the intention of the legislator to impose such an obligation upon the States.

19. First, the Commission explains that its recent proposal to introduce a minimum harmonised level of funding for deposit-guarantee schemes (of 1.5% of bank assets) "foresees further adequate alternative funding arrangements to enable schemes to obtain short term funding where necessary to meet claims, if this is necessary."[16]

20. Whilst this may well be an adequate approach to an isolated banking failure, it is nothing more than wishful thinking when one contemplates a substantial failure of the kind that occurred in Iceland. As the Icelandic Institute of Economic Studies has shown, there is no possibility of such funding in the case of a large scale banking crisis.

21. The Commission goes on to explain this proposal in more detail:[17]

> "It is up to the States how to arrange that the scheme is able to ensure that compensation is paid in accordance with the Directive. This could equally entail that the remaining banks as well as the newly created banks (as in the case of the Icelandic

[16] Statement in Intervention, para 22.
[17] Statement in Intervention, para 45.

bank crisis) are compelled to contribute to the refinancing of the scheme to the extent necessary for ensuring the repayment of depositors, or that the schemes take out long term loans at market rates." (original emphasis)

22. As to the question of long term loans, this would in practice inevitably involve the resources of the State, at least as guarantor. In the case of Iceland, TIF was practically bankrupt. There was no possibility that it could have obtained loans without such a guarantee.[18]

23. As to the suggestion that the "remaining banks" can be compelled to pay, there may be very little left by way of remaining banks. In Iceland's case (as the Court will have noted) 85% of the banking system failed within days. By March 2009, 93% of Iceland's commercial banking sector had failed.[19]

24. As to the suggestion that the newly created Icelandic banks could have been made to pay, the Commission develops this argument further under the heading of discrimination.[20] The Authority has never sought to advance this argument, and in the Icelandic Government's submission, it is wholly lacking in reality. It is also inconsistent with recital 23 of the Directive, which as the Commission rightly notes[21] states that whilst the cost of financing deposit-guarantee schemes "must be borne, in principle, by the credit institutions themselves ... this must not, however, jeopardize the stability of the banking system of the Member State concerned."

25. Iceland has obtained comments on this proposal from the Icelandic Financial Supervisory Authority ("FME") and the Central Bank of Iceland which explain why this proposal is completely unrealistic, and which are annexed to this Reply. The liability faced by TIF had to be paid within a year under the Directive. This represented around 30% of the new banks total assets at the year end of 2008. The amount was equivalent to approximately 2.5 times the ISK 288 billion of the new banks at the end of 2008. Had they been required to finance the TIF's obligations, they would have had negative equity of around ISK 419 bn as of year end 2008, and would not have satisfied the conditions for a banking licence or the regulatory requirements of the FME. Moreover, the banks'

[18] Defence, para 61.
[19] Defence, para 52.
[20] Statement in Intervention, para 71.
[21] Statement in Intervention, para 14

liquidity would have sufficed to pay only a very small portion of the liabilities of TIF[22], and there was no possibility of raising further funds abroad. The reality is that without the injection of further funds, the banks would have no choice but to turn to the FME and become subject once again to the Emergency Act, with the attendant damage to the Icelandic economy and financial markets.

26. Thus, overall, the reality is that the new banks could not possibly have met those liabilities without a large injection of further resources from the State – if the State had been in a position to do so. As the Central Bank of Iceland explains, that was in any event "completely impossible". Once again, the Commission's argument essentially comes to an obligation upon the State to fund the compensation.

The Commission's second "principal remark": State liability in damages

27. The Commission's second "principal remark" concerns the question of State liability.[23] Here, there is a measure of agreement between its position and that of Iceland. The Commission rightly seeks to distinguish between the obligations of the State imposed by the Directive itself, and the issue of State liability which might arise on *Sveinbjörnsdóttir* grounds. Iceland of course disagrees with the Commission as to the content of those obligations, but has argued in its Defence and Rejoinder that it is critical to keep distinct these two potential sources of obligation. In order to succeed, the Authority must show that the obligation upon the State to ensure that compensation is paid to depositors in this case is an obligation that arises under the Directive itself. It is not a matter of compensation for a failure to implement the Directive.[24]

28. The Commission argues that it does not follow from the judgment in *Paul* or *Francovich* that the State is "released from its obligations under a directive" (emphasis added).[25] Iceland understands the Commission's point to be that there may be an obligation to act under a Directive even if the conditions for *Sveinbjörnsdóttir* liability are not made out.

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[22] It is to be noted that the FME refers to a liability of TIF of ISK 707 bn, rather than ISK 659 bn, the figure given by Iceland in its pleadings before this Court. This difference is accounted for by the date and exchange rate used to calculate the liability.
[23] Statement in Intervention, para 47.
[24] See Defence para 10, Rejoinder para 41.
[25] Statement in Intervention, para 53.

If that is its point, then Iceland agrees. The issue is as to the nature of the obligations that the Directive imposes. The difficulty for the Commission (and the Authority) is that they seek to derive an obligation upon the States to ensure that compensation is paid, even though there is no such express obligation in the Directive and the conditions for liabilty under *Sveinbjörnsdóttir* are not satisfied.

29. The judgment in *Francovich* is of importance to this case for a reason that is unrelated to the question of State liability for damages: it assists in identifying the nature of the obligations arising under the Directive itself. In that case, the Court of Justice rejected a claim that Directive 80/987/EC could give rise to direct effect because the provisions in question did not identify the person who was obliged to provide the guarantee required in the event of employer insolvency.[26] There is a strong parallel to the present case.

The Commission's remaining arguments on the Directive

30. Whilst the foregoing submissions seek to respond to the Commission's arguments on the central issue in respect of the interpretation of the Directive, Iceland makes the following additional points in respect of the central issues raised in the Commission's analysis.[27]

The place of the Directive in the legislative scheme

31. The Commission argues that the Directive is the "last element in a chain of measures established in EU law against bank failures".[28] It seeks to portray the Directive as the final line of defence of the consumer against a banking collapse. The implication is that if the Directive were to fail to guarantee compensation, the consumer would be left without any recourse at all, whereas (at least on the Commission's analysis) the consumer enjoys complete protection for the sums which the Directive guarantees.

32. That is far from the reality of the position. The worldwide banking crisis that took place in 2008 instead called for a range of other measures to ensure that depositors and other creditors of collapsed banks throughout Europe were protected, as summarised in

[26] Judgment, paras 25, 26, quoted in Iceland's Defence, para 239.
[27] Iceland disagrees with much of what the Commission says in its Statement in Intervention, but has not sought to plead to it line-by-line.
[28] Statement in Intervention, paras 10, 39.

Iceland's Defence.[29] By way of examples, the Commission and the Authority authorised very large sums of State aid on an emergency basis.[30] Moreover, Directive 2001/24/EC protects the interests of creditors in the event of a bank winding up. In the case of Iceland, depositors were granted priority status in the winding up of the banks. Depositors (and in the case of Landsbanki/Icesave, almost exclusively the UK and Dutch Governments), stand to make full recovery of the sums deposited.[31] On 31 May 2012, the Winding-up Board of Landsbanki announced that the estimated value of its assets exceeded the book value of its priority claims, and that it had made a second partial payment to priority creditors.[32] As a result, over ISK594 billion had been paid on aggregate, representing around 43% of the claims of all priority creditors (not just deposits covered by TIF). The sum guaranteed by TIF was ISK 659 billion.

33. Thus, the reality is that the deposit-guarantee Directive is just <u>one</u> "element in the safety net", as the Commission itself described it, in its proposal for the Directive.[33] On 6 June 2012, the Commission published further significant proposals for banking regulation in the form of a draft directive governing bank resolution measures, whereby a failing bank can be saved in whole or in part through the intervention of a State.[34] The Commission explained that at the time of the Icelandic banking crash, there was "no legislation at EU level governing the entire process of bank resolution".[35] These new proposals acknowledge the insufficiency of the existing regime to deal with the banking crisis of recent years.

34. The central point, however, is that none of these measures on their own provide an <u>absolute guarantee</u> of consumer protection. The legislator's objective is that taken

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[29] Defence, paras 41 -44.
[30] For an up to date overview, see: http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/12/397&format=HTML&aged=0&language=EN&guiLanguage=en
[31] Defence, para 60.
[32] http://www.lbi.is/home/news/news-item/2012/05/31/Announcement-from-Landsbanki-Islands-hf.---Creditors-Meeting/
As explained in Iceland's Defence, the total sum guaranteed by TIF was ISK 659 billion, but it is expected that depositors will now make full recovery.
[33] Proposal, pg 3.
[34] http://ec.europa.eu/commission_2010-2014/barnier/headlines/news/2012/06/20120606_en.htmhttp://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/570&format=HTML&aged=0&language=EN&guiLanguage=en
[35] http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/impact_ass_en.pdf , p 12.

together they should provide a coherent, and proportionate, system of banking regulation and consumer protection. A balance is struck between the costs and benefits, the rewards of security and the risk of moral hazard.

35. It is doubtful that a form of "absolute guarantee" of deposits would even be possible. Even a State guarantee may not be entirely reliable, as the falling credit ratings of some Southern European states demonstrate. It now appears that the Commission is considering a further integration in the financial markets with discussions on a banking union including a common deposit guarantee scheme.[36] The initiative is apparently backed by the French President, the Italian Prime Minister and the European Central Bank. The policy response is not that the troubled States must simply ensure that deposits are protected, as the Commission suggests in this case.

36. Moreover, the true role of the deposit-guarantee scheme in the scheme of legislation is made apparent by Case C-233/94 *Germany v. Parliament and Council* [1997] ECR I-2405. In his Opinion in that case, Advocate General Léger observed that the Directive pursued two goals, "freedom of establishment and freedom to provide services in the banking system on the one hand, the stability of the banking system and protection for savers, on the other".[37] He nevertheless concluded that the objective of harmonising bank deposit-guarantee schemes "in order to impose identical constraints on all economic operators in this area" was paramount. The limitations on the measures contained in the Directive served to demonstrate that that "protection of depositors is sacrificed, even if only temporarily, to the demands of harmonisation".[38] The judgment of the Court also emphasised that the Directive "abolishes obstacles to the right of establishment and the freedom to provide services".[39]

37. Thus, the Directive is essentially a measure for the harmonisation of the activities of banks. There is no hint at all in the Directive, or the analysis in the *Germany v Parliament and Council* case that it contains the further objective of introducing a

[36] http://ec.europa.eu/europe2020/pdf/nd/eccomm2012_en.pdf, p 5.
See – separate document with references.
[37] Opinion, para 35.
[38] Paras 38 -46.
[39] Judgment, para 19. See also para 15.

harmonised regime for the provision of State support for the banking system, even where "all else fails".

38. Advocate General Léger also noted the potential for some degree of competition among credit institutions and states arising out of the potential to choose among different deposit-guarantee schemes adopted by a Contracting States under the minimum harmonisation afforded by the Directive.[40] Thus, it appears that the Advocate General did not consider that there was an obligation upon the State to step in: if there was, then such different schemes would be equally guaranteed by the State and there would be no scope at all for such competition as to the ability of such schemes to guarantee deposits.

The Commission's original proposal for the Directive

39. The Commission quotes selectively from the proposal for the Directive.[41] The Icelandic Government respectfully asks the Court to read the relevant passages in full. At page 7 of the Proposal, there is a heading "Questions not dealt with in the proposal". Under that heading, the Commission explains that there are "wide differences in the funding" of existing deposit-guarantee schemes: whether they rely on ex ante or ex post contributions. It then notes that it had received "the assurance that the financing arrangements are sufficiently sound to pay off all deposits covered, including those at branches at Member States".[42] But it is of critical importance that the Commission went on to make clear that it was not proceeding on the basis that this "assurance" meant that the deposit-guarantee schemes would be able to withstand a banking crash of any conceivable size. If that had been the Commission's intention, it might have been expected to look more closely at the "assurance" it had received. Instead it explained:

> "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."

[40] Opinion, para 160.
[41] Statement in Intervention, paras 14 -19.
[42] Proposal, pg 8.

40. Thus, the Commission did not proceed on the assumption that the Directive would provide an answer to the question as to what should happen if the deposit-guarantee schemes should fail. Rather, it explicitly acknowledged that it was possible that such a scheme would be unable to meet its obligations. The Commission plainly considered that assistance by the Member States was undesirable, even if it did not rule it out. It instead made clear that such assistance must comply with the State aid rules.

41. It expressed exactly the same view on page 8 of its Impact Assessment: whilst "DGS are financed by banks ... in a systemic crisis a DGS may reach their limits". [43] But: "even if in such cases governments stepped in under strict obedience of state aid rules, this would not be triggered under a legal obligation in the DGS Directive". [44]

42. The critical point is that the Commission recognised that such funding would be outside the scope of the Directive and therefore subject to State aid rules. That is simply inconsistent with the argument that there is a duty on the States to ensure that compensation is paid in all circumstances.

The proposal for reform of the Directive

43. The Commission relies upon its proposal in order to address Iceland's point that the proposed funding requirement is only sufficient to provide cover for a medium-sized banking failure, as the Commission explained in its Impact Assessment.[45] In Iceland's submission, the Impact Assessment demonstrates a pragmatic understanding as to the limitations of deposit-guarantee schemes. It would be wholly unrealistic to fund those schemes to a level that could withstand a system-wide banking failure.

44. In its Statement in Intervention, however, the Commission argues that its proposal identifies only a "minimum target level for ex ante funds" (original emphasis).[46] It explains:[47]

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[43] This passage is quoted at greater length in paragraph 135 of Iceland's Defence.
[44] See Defence, para 135.
[45] See Defence paras 130-134.
[46] Statement in Intervention, para 23.
[47] Statement in Intervention, para 23.

"In other words, if Member States consider it too low, they can set a higher target level that would better reflect its specific situation or the riskiness of their banking system. This means that Member States are responsible not only for ensuring a given target level but eventually for protecting depositors up to the coverage level, irrespective of the target fund level. This is all the more obvious since, while the target fund has to be reached within 10 years, the obligation to cover depositors is applicable at all times." (emphasis added)

45. This submission provides no answer at all to the Icelandic Government's case. The Commission proposed a level of funding of 1.5% on the basis that it struck an appropriate balance between costs and benefits, because it "would only moderately affect bank profits at EU level ... and lead to very limited costs for depositors".[48] It made no attempt to argue for funding to a level that would cover a system-wide banking crash.

46. At the end of its Statement in Intervention, where it discusses its Impact Assessment,[49] the Commission explains that:[50]

"On the basis of historical data from the 2008 crisis in the EU, the Commission considered a range of target levels for deposit guarantee funds, including high target levels that would be necessary in case of a big bank failure, but this option was discarded as very costly (7.25% of covered deposits) and thereby politically unacceptable." (emphasis added)

47. In these proceedings it is arguing that through the adoption of the Directive, the Contracting States have nevertheless committed to ensure that compensation is paid even in the event of a complete bank failure of 100% of covered deposits. Yet it previously recognised that even funding for 7.25% of deposits was too costly to be politically acceptable.[51] In its Impact Assessment the Commission noted that only two Member States would be able to handle such a failure with the funds at their disposal within the time limited provided by the Directive, and four if they were given ten years to raise the funds.[52] Moreover, such a requirement would give rise to a 29% reduction in bank operating profits.[53] If the argument advanced in these proceedings by the Commission and the Authority were correct, the Contracting States would have no choice but to make

[48] Impact Assessment, pg 58, quoted more extensively at para 132 of Iceland's Defence.
[49] Statement in Intervention, paras 72-77.
[50] Statement in Intervention, para 74.
[51] Impact Assessment, pgs 52- 58.
[52] Impact Assessment, pg 53 and Annex 15.
[53] Impact Assessment, pg 54, first para.

very substantial provision to meet the obligation to guarantee the performance of the deposit guarantee scheme in all circumstances. The Commission has itself recognised the political difficulty (if not impossibility) of such an approach. Iceland respectfully submits that this cannot have been the intention of the legislator.

48. Even the 1.5% sought by the Commission in its proposal has been resisted by the Member States. In June 2011, the Council put forward a "Presidency compromise" in which it reduced the target level of funding to 0.5% to be reached by 2027, rather than the 1.5% by 2020 that the Commission had proposed.[54] Plainly even 1.5% was considered to be too onerous.

49. In any event, by the time a large scale banking crash has happened, or is imminent, it may already be too late for the State to "set a higher target level". An attempt to do so might itself precipitate the collapse of the banks. The present situation in Europe illustrates the point: news reports explain that the banks of Greece, Ireland, Italy, Portugal and Spain have faced substantial withdrawals (if not, at time of writing, a run), and the deposit-guarantee scheme of Spain has been described as "depleted and now exists in name only", whilst the scheme of Italy is reported to be "unfunded".[55]

50. An attempt by the State to extract greater contributions from the Spanish or Italian banks, and yet further reduce their liquidity, might well prove calamitous.

51. The difficulty is that the threat in those States does not appear to be confined to a single bank: it may well be that the risk of failure is systemic. The Commission's argument leads therefore to the built-in limitation upon deposit-guarantee schemes: it is simply not compatible with the operation of an effective banking system to set aside sufficient reserves to cover such a systemic failure. Nor is it remotely realistic to obtain a commercial loan facility to cover such an eventuality – at least in the absence of a state guarantee. Once again, on the Commission's argument, State resources are required.

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[54] http://register.consilium.europa.eu/pdf/en/11/st11/st11359.en11.pdf, Art 9(1).
[55] The New York Times, 24 May 2012: http://www.nytimes.com/2012/05/25/business/global/in-spain-bank-transfers-reflect-broader-fears.html?_r=2&pagewanted=all
Bloomberg, 29 May 2012: http://www.bloomberg.com/news/2012-05-29/greek-exit-from-euro-seen-exposing-deposit-guaranty-flaws.html

The wording and purpose of the Directive

52. The Icelandic Government has already addressed the Commission's argument as to the wording of the Directive.[56] As to its purpose, the Commission's essential argument is that it is necessary that depositors should be able to rely upon deposit-guarantee schemes to pay out, and that:[57]

> "If Member States were not bound to ensure, following the introduction of a scheme that it is actually in a position to repay depositors, the provision will become totally ineffective in achieving the objective of guaranteeing depositors when deposits become unavailable. It would also fail the purpose of last resort protection."

53. There are two difficulties with this argument. First it assumes that the Contracting States are even capable of guaranteeing that the deposit-guarantee fund should pay out in all circumstances. As already explained that is at the very least open to doubt. Even in 2007, the shortfall in deposit-guarantee funds across Europe, as a percentage of Government revenue ranged up to 830%.[58] In present circumstances, where there is a real possibility of sovereign default by one or more Member States of the EU, that seems all the more unlikely. Such an interpretation cannot have been the intention of the legislator.

54. Secondly, it also assumes that consumers, and the fundamental freedoms, are best served by a guarantee that operates in all circumstances. That fails to acknowledge the enormous costs that any such guarantee would impose – on consumers and/or the State. Instead, the appropriate course is to strike a balance, as the Commission did in its Impact Assessment and its proposal for reform.

55. To acknowledge that a deposit-guarantee scheme may not be able to pay out in the circumstances of a comprehensive bank crash does not undermine its usefulness, any more than a home insurance policy is rendered useless because an insurance company might, in extreme circumstances, become insolvent before it can pay out on a claim. The fact is that all insurance comes with an inherent risk as to the viability of the provider on a payout. As already explained, the Directive is an internal market measure that aims at a "high level", but not absolute, level of consumer protection. The reality is that the

[56] See para 15 above and the detailed submissions made in Iceland's Defence at paras 153- 224.
[57] Statement in Intervention, para 40.
[58] Report of Icelandic Institute of Economic Studies, fig 10.

legislation is likely to prove effective in a wide range of plausible scenarios, even if not in the kind of extreme circumstances that occurred in Iceland in 2008. A deposit-guarantee scheme can never be a perfect solution although it serves a useful purpose in building confidence and thereby reducing the risk of bank failure, and can serve to meet a wide range of small or even medium scale failures – as the Commission acknowledged in its Impact Assessment. Even if the Member States were to increase cover to the level need for a mid-sized banking failure, informed consumers may still feel concerns in the present economic climate. That is not down to a failure of the Contracting States: it is simply inherent to the nature of deposit-guarantee schemes. The submissions of the Commission (like the Authority) are simply blind to this reality.

56. As to the level of compensation, the Commission appears to have misunderstood Iceland's argument.[59] Iceland fully appreciates that the Authority's argument is that the States are obliged to ensure payment of €20,000 per depositor, and not the entire amount. It certainly did not intend to suggest otherwise in its Defence. This undoubtedly reflects the balance struck in the Directive between the requirements of consumer protection and the costs of a deposit-guarantee scheme. But the absence of any explicit requirement for the State to underwrite that guarantee scheme is a further reflection of this balance.

57. As to case C-222/02 *Paul v Germany* [2004] ECR I-9425, Iceland does not repeat the extensive submissions it made in its Defence.[60] On a fair reading, that case provides no support at all for the position of the Commission in these proceedings. The point made by Iceland in its Defence,[61] and disputed by the Commission[62] is that nothing in that judgment indicates the State itself is under an obligation under the Directive to guarantee compensation. Such an obligation cannot be found in the judgment in *Paul*, any more than in the Directive itself.

[59] Statement in Intervention, para 41.
[60] Defence, paras 181-200.
[61] Defence, para 185.
[62] Statement in Intervention, para 42.

Force majeure

58. The Commission raises three objections to Iceland's plea of *force majeure*.

59. First, it argues that the wording of Article 10(2) of the Directive[63] precludes reliance upon *force majeure*, because it provides that "in wholly exceptional circumstances and in special cases a guarantee scheme may apply to the competent authorities for an extension of the time limit". As Iceland submitted in its Defence, this is of no assistance in the present case, as Article 10(2) is plainly a procedural rule imposed upon deposit-guarantee schemes, and not the Contracting States.

60. The Commission seeks to meet that argument by arguing that the Directive is addressed to the States only.[64] That misses the point: the question is as to the nature of the obligations addressed to the State: whether it is an obligation to establish and supervise a deposit-guarantee scheme (as Iceland contends) or whether there is an additional obligation to ensure that compensation is paid where a deposit-guarantee scheme is unable to do so, as the Authority, and now the Commission, contend. Iceland's argument is simply that the limitation in Article 10(2) addresses only the circumstances in which the deposit-guarantee scheme itself may approach the national authorities to seek an extension of time - it does not address the obligations of the national authorities themselves. If there is an obligation on the State to ensure compensation, Article 10(2) makes no reference to it.

61. Secondly, the Commission invokes the findings of the SIC Report that the reasons for the collapse of the Icelandic banking system were not external to the Icelandic State and that the "particular intensity" of the collapse was "alleged to be due to pre-existing domestic shortcomings".[65] It also argues that it "can therefore not rule out" that Icelandic authorities "could have better monitored and contained" the Icelandic banks through the exercise of their supervisory duties.[66]

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[63] Iceland incorrectly referred to Article 10(3) instead of Article 10(2) in paragraphs 259 and 260 of its Defence. Perhaps as a result, the Commission appears to have fallen into the same error in paragraph 56 of its Statement in Intervention.
[64] Statement in Intervention, para 56.
[65] Statement in Intervention, paras 58, 59.
[66] Statement in Intervention, para 61.

62. The Icelandic Government submits that this litigation is not the forum in which to conduct either a wide ranging enquiry into banking supervision in Iceland or to debate the details of the SIC Report. The collapse of 85% of the Icelandic banking system between 7 and 9 October 2008 was on any view extraordinary and unprecedented. Like the Commission, the Authority has not advanced a detailed analysis in support of the argument that Iceland could have prevented the collapse of the banks "by taking appropriate steps without making unreasonable sacrifices"[67], even if, with benefit of hindsight,[68] it is clear that things could have been done differently.[69]

63. The Icelandic Government wishes to briefly address one further point on *force majeure* raised by both the Netherlands and the United Kingdom Governments in their written observations. They question whether Iceland had informed the Authority of its difficulties, and proposed appropriate solutions.[70] In fact, Iceland engaged in an intensive and continuing dialogue with the Authority about the emergency Iceland faced, including the situation of TIF, and the range of measures it took in order to address it. A number of those measures have been specifically approved by the Authority, as explained in Iceland's Defence.[71] Some remain under consideration at the time of writing.

64. The Icelandic Government wishes to make clear that it disagrees with much of the written observations in the UK and Dutch Written Observations, but has not sought to plead to them more generally in this Reply to the Commission's Statement in Intervention.

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[67] Case C-314/06 *SMPR* [2007] ECR I-12273, para 24, quoted at para 249 of Iceland's Defence.
[68] In this regard, Iceland would observe that a number of international institutions viewed the development of Iceland's banking sector favourably at this time. Thus, in October 2007, Moody's reported that it "views positively Landsbanki's progress in diversifying its funding sources [into customer deposits] and the banks' declining reliance on market funding". In a report completed in August 2008, the IMF (having previously raised concerns about the banks' high reliance upon international capital markets for funding,) noted that Landsbanki and other Icelandic banks had been "particularly successful" in diversifying their funding structure through the establishment of deposit-taking businesses abroad. http://www.imf.org/external/pubs/ft/scr/2008/cr08368.pdf , p 19. It also concluded that [t]he FME responded to the challenges arising from the large banks into foreign countries and the deteriorating market conditions". http://www.imf.org/external/pubs/ft/scr/2008/cr08368.pdf p 28. In July 2008, the IMF concluded that "… the long-term economic prospects for the Icelandic economy remain enviable." http://www.imf.org/external/np/ms/2008/070408.htm.
[69] The Commission has itself found, with the benefit of hindsight, in its newly published Impact Assessment in respect of its proposed Directive on bank resolution, "neither banks nor supervisors and other authorities were sufficiently prepared for the financial crisis". http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/impact_ass_en.pdf , p 9. That reflects the wholly exceptional nature of the crisis in question.
[70] Written Observations of the Netherlands, para 38, Written Observations of the United Kingdom, para 27.
[71] Defence, para 316.

Discrimination

65. It is conspicuous that neither the Dutch nor the British Governments offer any support for the Authority's argument based on discrimination. The Commission, however, argues that Iceland has "indirectly discriminated against foreign depositors on the basis of nationality, which is prohibited by the Directive".[72] The Commission's formulation faces the same essential difficulty as the Authority: the difference in treatment complained of falls outside the scope of the Directive.

66. The Commission argues that "by transferring deposits to the new bank, Iceland created a situation in which continuous access to covered deposits was preserved for domestic depositors only, with the effect that the Icelandic failure to ensure, under the Directive, that the scheme is in a position to compensate depositors within the time limit, only impacted foreign depositors". The Commission argues that this deprived the Directive of its *effet utile.*[73]

67. None of this provides any answer to Iceland's essential objection to this claim: the Directive is only concerned with a minimum harmonisation of the rules governing the operation of deposit-guarantee schemes. Nothing in the Directive requires equal treatment of deposits in all other respects. The difference in treatment complained of arises because of a bank restructuring that had no connection to the Directive at all. Access to deposits, which is the focus of the Commission's complaint, is not regulated by that Directive.

68. Nor can there be recourse to some wider principle that there must be equal treatment of deposits. In the circumstances of a bank failure, it is plainly legitimate for Contracting States to intervene so as to rescue some banks, or branches which are necessary to the functioning of the banking system and not others. Any other approach would be contrary to the requirement of necessity in the grant of State aid.[74]

69. Moreover, the discrimination claim cannot possibly assist the Authority and the Commission unless it is assumed that an obligation upon the States to ensure that

[72] Statement in Intervention, para 64.
[73] Statement in Intervention, para 67.
[74] See para 324 of Iceland's Defence and the Authority's guidance quoted there.

depositors are compensated arises under the Directive in any event – the first limb of the Authority's argument. If such an obligation did arise, a difference in treatment in the way a Contracting State executed this obligation might fall within the scope of the Directive. In the present case, there has been no difference in treatment in this regard: no depositors have received compensation from TIF or the Icelandic State under the deposit-guarantee scheme within the year provided for by the Directive.[75]

70. But if the Authority and/or the Commission were to succeed in establishing that there was such an obligation under the Directive, then the argument based upon discrimination would be simply redundant.

71. If, however, the Authority and the Commission fail in their principal complaint, and there is no duty upon the States to ensure the payment of compensation, then recourse to the duty of non-discrimination cannot somehow give rise to such a duty. The duty of non-discrimination requires the States to ensure that a deposit-guarantee scheme itself treats all depositors without discrimination. That requirement was not breached in the present case.

72. The Icelandic Government accordingly considers that this argument adds nothing to the Authority or the Commission's case.

73. The Commission's three remaining arguments are concerned with justification.

74. First, it argues that a defence of justification is not open to Iceland because the Directive is a harmonising measure, and "there is no express provision in the Directive allowing States to deviate from the harmonised regime".[76] The difficulty is that this argument again assumes that the Authority succeeds on the first limb of its argument. If the Authority is right, and the Directive places the Contracting States under duty to ensure compensation is paid in a case such as the present, then an appeal to justification could not succeed: the harmonised regime imposed by the Directive would preclude it. The Commission's argument based on discrimination would however again be redundant.

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[75] As explained in Iceland's Defence substantial payments have since been made from the estate of Landsbanki: see paras 111, 112.

[76] Statement in Intervention, para 69.

75. But if the Authority and the Commission fail on the first limb, nothing at all in the partially harmonised regime established by the Directive serves to preclude Iceland from establishing a justification for the difference in treatment complained of.

76. Secondly, the Commission notes that Iceland accepts that "mere economic grounds cannot serve as justification for restriction of the fundamental freedoms".[77] As Iceland explained in detail its Defence, however,[78] it is well established that "restrictions which are partly economically motivated" can be permissible where "crucial to the operation of the system in question."[79] That is why the Authority has accepted the validity of a series of measures taken by Iceland to safeguard the functioning of its domestic banking system.[80]

77. Thirdly, the Commission argues that the justification fails because the difference in treatment was not "necessary" because Iceland should have imposed an obligation upon the "new and financially sound banks" an obligation to make contributions to the deposit-guarantee fund to enable it to fulfil its obligations. The Authority has not sought to make such an argument and the Icelandic Government has already explained why it is wholly unworkable.[81]

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[77] Statement in Intervention, para
[78] Defence, paras 307 – 315.
[79] Case C-158/96 *Kholl* [1998] ECR I-1831, para 53, quoted at paragraph 307 of Iceland's Defence.
[80] Defence para 309.
[81] See paras 23 – 26 above.

Conclusion

78. The Icelandic Government maintains the submissions made in its Defence and Rejoinder and respectfully asks the Court to dismiss this application.

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LIST OF ANNEXES

Annex 1 Letter from the Icelandic Financial Supervisory Authority (is. Fjármálaeftirlitið) of 11 June 2012 in response to a query from the Ministry for Foreign Affairs on the occasion of the Statement in Intervention of the EU Commission to the EFTA Court in Case No. E-16/11 (A certified English translation accompanied by a copy of the original).

Annex 2 Letter from the Central Bank of Iceland (is. Seðlabanki Íslands) of 18 June 2012 in response to a query from the Ministry for Foreign Affairs on the occasion of the Statement in Intervention of the EU Commission to the EFTA Court in Case No. E-16/11 (A certified English translation accompanied by a copy of the original).