

Case No: 66448
Event No: 515885
Dec. No: 205/09/COL

EFTA SURVEILLANCE AUTHORITY DECISION
of 8 May 2009

on the scheme for temporary recapitalisation of fundamentally sound banks in order to
foster financial stability and lending to the real economy

(Norway)

THE EFTA SURVEILLANCE AUTHORITY¹

Having regard to the Agreement on the European Economic Area², in particular Articles 61 to 63 thereof and Protocol 26 thereto,

Having regard to the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice³, in particular Article 24 thereof,

Having regard to Article 1(3) of Part I and Article 4(3) of Part II of Protocol 3 to the Surveillance and Court Agreement⁴,

Having regard to the Authority's Guidelines on the application and interpretation of Articles 61 and 62 of the EEA Agreement⁵, and in particular the Chapter on the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition thereof⁶,

Having regard to Decision No 195/04/COL of 14 July 2004 on the implementing provisions referred to under Article 27 of Part II of Protocol 3⁷,

Whereas:

¹ Hereinafter referred to as the Authority.

² Hereinafter referred to as the EEA Agreement.

³ Hereinafter referred to as the Surveillance and Court Agreement.

⁴ Hereinafter referred to as Protocol 3.

⁵ Guidelines on the application and interpretation of Articles 61 and 62 of the EEA Agreement and Article 1 of Protocol 3 to the Surveillance and Court Agreement, adopted and issued by the Authority on 19 January 1994, published in the Official Journal of the European Union (hereinafter referred to as OJ) L 231 of 03.09.1994, p. 1, and EEA Supplement No 32 of 03.09.1994, p. 1. Hereinafter referred to as the State Aid Guidelines. The updated version of the State Aid Guidelines is published on the Authority's website: <http://www.eftasurv.int/fieldsOfWork/fieldstateaid/guidelines/>.

⁶ Hereinafter referred to as the Recapitalisation Guidelines.

⁷ Decision No 195/04/COL of 14 July 2004, published in OJ C 139 of 25.05.2006, p. 57, and EEA Supplement No 26 of 25.05.2006, p. 1, as amended by Decision No 319/05/COL of 14 December 2005, published in OJ C 286 of 23.11.2006, p. 9, and EEA Supplement No 57 of 23.11.2006, p. 31.

I. FACTS

1 Procedure

On 28 April 2009, the Norwegian authorities notified, pursuant to Article 1(3) of Part I of Protocol 3, a scheme for the temporary recapitalisation of fundamentally sound banks in order to foster financial stability and lending to the real economy (Event No 516522).⁸

2 The objective of the aid measure

The Norwegian authorities have explained that there is considerable uncertainty concerning the evolution of the Norwegian economy and the developments in the banks' lending policy and activity. There is a strong interdependence between the real economy and the financial system. The desire to reduce risks in the face of mounting losses may cause banks to tighten the supply of credit. The effect of reduced external demand on the Norwegian economy is exacerbated by a tightening of lending conditions for businesses and households, thereby hampering investments and activity in the real economy and amplifying the negative effects of the general economic downturn.

The Norwegian authorities have indicated that lending surveys carried out by the Norwegian Central Bank (*Norges Bank*) and the Financial Supervisory Authority (*Kredittilsynet*) show that banks have been tightening credit standards substantially, particularly for corporate loans. They also show that capital ratios are a key concern for banks when evaluating their lending policy. At present, Norwegian banks are financially sound but they need to strengthen their core capital in order to be able to maintain a normal supply of credit.

In December 2008, Norges Bank recommended that the Government take measures to improve bank solidity in order to enhance lending to the real economy. This recommendation was endorsed by the Financial Supervisory Authority.

The Norwegian authorities have explained that some of the larger Norwegian banks have relatively low core capital ratios and need recapitalisation in order to be able to continue lending to the real economy.⁹ Smaller banks with high capital ratios may also need additional core capital to maintain or increase lending in line with the purpose of the notified scheme. The Norwegian authorities foresee that certain small banks may have more limited ways of funding themselves and a rather narrow lending portfolio. Accordingly, they are more exposed to liquidity risks than banks with a broader business basis. Thus, even if they originally had higher capital ratios, such factors may imply that core capital is more easily eroded than would be the case for other banks. The Norwegian authorities have accordingly considered that both the situation in the banking sector and the outlook for the Norwegian economy require a state measure offering recapitalisation of fundamentally sound banks in order to restore financial stability and foster lending to the real economy.

⁸ Hereinafter referred to as the recapitalisation scheme.

⁹ At the end of 2008, there were 121 Norwegian savings banks and 18 Norwegian commercial banks. Approximately 77% of Norwegian banks had core capital ratios above 12%. These were however mainly smaller savings banks, and represented only about 11% of total bank assets. On the other hand, a very limited number of banks had a core capital ratio below 7%.

The objective of the scheme is to contribute Tier 1 capital¹⁰ to the banks in order to strengthen the banks and to improve the ability of the banks to maintain ordinary lending activities. The scheme is only open for fundamentally sound banks and has, according to the Norwegian authorities, been designed to achieve the purpose of ensuring lending to the real economy, whilst minimising distortions of competition.

Under the recapitalisation scheme, a Government Finance Fund (*Statens finansfond*)¹¹ has been set up with the purpose of temporarily contributing Tier 1 capital to Norwegian banks¹²: acquisition by the Fund of either hybrid securities or preference capital instruments shall be based upon an application from the individual bank. The conditions shall be governed by an agreement between the Fund and the individual bank, setting out the exact modalities of the recapitalisation (e.g. nominal value, amount, remuneration and exit incentives).

3 National legal basis for the aid measure

The national legal basis establishing the Fund is *Lov 6. mars 2009 nr. 12 om Statens finansfond*. An implementing regulation relating to the Fund and its activities will also be adopted.¹³

4 Budget and duration

In 2008, Norges Bank carried out a macroeconomic stress test for the six largest Norwegian banks. The test replicated a negative scenario where the outcome was that banks would record losses amounting to on average 2,3% of their risk-weighted assets. On the basis of this test, Norges Bank estimated the need for recapitalisation of the ten largest banks to be NOK 34 billion. In accordance with the results of this test, sufficient resources (NOK 50 billion, approximately 5.1 billion EUR) have been allocated to the Fund.

The scheme shall be of a temporary nature and the rules are expected to enter into force in May 2009, with a window of six months for the Fund to reach agreements with banks that apply for recapitalisation. The deadline for submitting applications to the Fund will be set 6 weeks prior to the expiry of that 6-month period in order to give the Fund time to conclude an agreement with the applicant bank before the window closes in November 2009. Within this time period, the Norwegian authorities will also evaluate whether the measure would be needed for a longer period, in which case the scheme will be re-notified.

5 The recapitalisation scheme

5.1 The beneficiaries

The Norwegian authorities have explained that only Norwegian banks that are financially sound are eligible for aid under the notified scheme.

The Norwegian Financial Supervisory Authority will exercise a gate-keeping function and determine whether a bank is eligible under the scheme.¹⁴ As part of its regular surveillance functions, the Financial Supervisory Authority receives from each bank information on

¹⁰ Tier 1 capital is the core measure of a bank's financial strength from a regulator's point of view. It is composed of core capital, which consists primarily of common stock and disclosed reserves (or retained earnings), but may also include irredeemable non-cumulative preferred stock.

¹¹ Hereinafter referred to as the Fund.

¹² The term "Norwegian banks" includes Norwegian banks owned by foreign banks, but excludes branches in Norway of foreign banks, other credit institutions than banks and other types of financial institutions.

¹³ Hereinafter referred to as the Regulation.

¹⁴ Section 2 of the Regulation.

loan portfolios and other elements of its balance sheet, business plans and their own assessment of future risk factors. When a bank applies to the Fund for a capital injection, the Financial Supervisory Authority will be asked to make an assessment as to the bank's eligibility under the scheme. The test, according to Section 2 of the Regulation, is that "*the bank meets the Tier 1 capital ratio requirement with a good margin, also when likely developments in the near future are taken into consideration*". According to the Norwegian authorities, the Financial Supervisory Authority will presume that this requirement is met if the bank in question has a core capital ratio at or above 6%, *i.e.* 2 percentage points above the regulatory minimum requirement. In all cases, the Financial Supervisory Authority shall base its analysis on up-to-date information, taking into account a bank's various risk exposures, asset quality, and business prospects, as well as the formal capital adequacy ratios, in order to conclude that a bank is fundamentally sound also in light of likely developments in the near future.

5.2 Maximum capital increases

Maximum limits for increases in core capital ratios through capital injections from the Fund are foreseen as follows:

- a) a bank with a core capital ratio below 7% may be recapitalised to a maximum core capital ratio of 10%;
- b) a bank with a core capital ratio between 7% and 10% may be recapitalised by up to 3% core capital, but not above a core capital ratio of 12%;
- c) a bank with a core capital ratio above 10% may be recapitalised by maximum 2% core capital.¹⁵

Banks which will have a core capital ratio in excess of 12% after the state capital injections shall document their need for a capital contribution and the Fund will assess the case in light of the bank's situation and in light of how lending to the real economy may be stimulated.

Likewise, an application for an increase in core capital of more than 2% must include appropriate documentation justifying the need for such a large injection of capital.

The Fund will decide on the actual amount to be allocated on the basis of an assessment of various risk factors, business plans and prospects. The Norwegian authorities have explained that if the Fund is not convinced, on the basis of the evidence provided, that there is a need for any aid under the scheme, it will reject the application. Banks placed in the highest risk category that request a capital increase of more than 2% will be subject to particular scrutiny.

Cases where the recapitalisation will correspond to more than 2% of the core capital ratio will be reported to the Authority.

5.3 Assignment to a risk class

The Fund shall assign each bank to one of three risk classes, based on objective criteria.¹⁶ The risk class will determine the coupon to be paid on capital injected by the Fund and will remain fixed for the duration of the agreement between the bank and the Fund.

¹⁵ Section 2 of the Regulation.

¹⁶ Section 10 of the Regulation.

The Regulation stipulates that banks with an external rating from an authorised credit rating agency shall be assigned to a risk class as follows:

Risk class	1	2	3
Rating	AA- or better	From A- to A+	BBB+ or lower

The Norwegian authorities have explained that few Norwegian banks are rated by international rating agencies. Other banks are, however, rated regularly by the largest Norwegian banks. Banks that are not rated by an authorised credit rating agency will be assessed according to principles similar to those applied by official credit rating agencies.¹⁷

The Norwegian authorities estimate that very few Norwegian banks will fall within risk class 1, a number of banks will fall within risk class 2, and the majority of banks will be assigned to risk class 3 (around three quarters of all Norwegian banks).

5.4 Recapitalisation instruments

The legislation provides for two alternative capital instruments, a Hybrid Tier 1 security (“*fondsobligasjon*”) and a Tier 1 preference capital instrument (“*preferansekapitalinstrument*”). Both instruments qualify as Tier 1 capital and will have no voting rights attached to them. The instruments shall have a preferential right to a non-cumulative claim for annual interest, which shall be conditional upon there being a profit and upon the capital adequacy ratio being no less than 0,2% higher than the minimum capital adequacy ratio required at any given time. The interest shall be covered until it has either been paid in full or the profit has been exhausted.

The price for the recapitalisation will be fixed individually for each bank on the basis of the interest rate applicable. In addition, there will be an add-on depending on the risk category of the bank and the type of instrument chosen.

The Norwegian authorities consider that the system by which the rate of remuneration for each bank for each instrument is calculated corresponds to the methodology established by the European Central Bank¹⁸ in its recommendation of 20th November 2008¹⁹ and therefore complies with the Recapitalisation Guidelines.

The Norwegian authorities have explained that Norwegian banks’ assets are, to a large extent, floating rate assets. In order to minimise interest rate risk, banks will generally try to have the same maturities of interest rate contracts on both sides of the balance sheet. Maturity matching thus requires that Norwegian banks have mostly floating rate liabilities. Against this background, the Norwegian authorities have proposed that the remuneration of a recapitalisation is based on the yield for either a short term 6-month government certificate or a 5-year government bond.

¹⁷ This implies that a number of criteria such as core capital ratio, total return, composition and credit quality of the lending portfolio, deposit to loan ratio, losses and risk exposure (credit risk, liquidity risk, market risk and operational risk) will be assessed. The Fund, or experts hired by the Fund, may use ratings provided by the largest banks operating in Norway, e.g. the credit analysis by DnB NOR (Norway’s largest financial services group), as a starting point for determining the appropriate risk class.

¹⁸ Hereinafter referred to as the ECB.

¹⁹ Hereinafter referred to as the ECB Recommendation.

According to the explanations of the Norwegian authorities, the cost of recapitalisation for the banks over a five year period will be the same irrespective of which option a bank chooses. They illustrate this point by comparing the net present cost of recapitalisation for the banks using the option based on a 5-year government bond yield, with the net present cost of recapitalisation for the banks using the option based on the 6-month government certificate yield over a period of five years.²⁰

Therefore the Norwegian authorities consider that, even though the 6-month government certificate yield today is lower than the 5-year government bond yield, the cost of recapitalisation for the banks over a five year period will be the same irrespective of which option is chosen.

5.4.1 *The Hybrid Tier 1 security*

The Hybrid Tier 1 security shall absorb losses after ordinary share capital (preference with respect to loss absorption). It is designed as a callable perpetual, with a fixed coupon determined as the Norwegian government bond rate, with the following add-on:

- 5,0 % for banks in risk class 1;
- 5,5 % for banks in risk class 2;
- 6,0 % for banks in risk class 3.²¹

In line with the ECB Recommendation, the minimum add-on element is calculated as the issuing bank's 5-year CDS spreads on subordinated debt over the reference period 1 January 2007 through 31 August 2008 plus 200 basis points for operational costs plus an additional 100 basis points to reflect the seniority of the hybrid in relation to subordinated debt. A mark-up is then applied for banks in risk classes 2 and 3.

The Norwegian authorities have indicated that Norges Bank has estimated the median spread on subordinated CDS contracts for DnB NOR²², the only Norwegian bank for which CDS contracts are traded, at 100 basis points for the period 1 January 2007 to 31 August 2008.²³

To stimulate redemption, the coupon is increased by 1% after each of years 4 and 5. The instrument will retain that higher fixed coupon until redemption. Redemption is conditional upon permission being granted by the Financial Supervisory Authority, which needs to verify that capital adequacy requirements will continue to be fulfilled after the redemption.

5.4.2 *The Tier 1 preference capital instrument*

The Tier 1 preference capital instrument shall rank *pari passu* (absorb losses in parallel) with ordinary shares. It may be called after 3 years. It is designed as a mandatory convertible and will convert to ordinary shares after five years, unless it is redeemed or converted before that. The instrument shall have a fixed coupon determined as the Norwegian government bond rate, with the following add-on:

²⁰ Based on the yield of 6-month government certificates purchased in the forward market.

²¹ Section 11 of the Regulation.

²² The Norwegian authorities have calculated this figure based on the sum of all spreads on regular senior bank bonds in relation to government bonds and the CDS spreads for subordinated loans relative to senior bank bonds.

²³ In contrast, within the euro zone, the ECB has estimated the median of all A CDS subordinated debt spreads at 73 basis points.

- 6,0 % for banks in risk class 1;
- 6,5 % for banks in risk class 2;
- 7,0 % for banks in risk class 3.²⁴

In line with the ECB Recommendation, the minimum add-on is established as 600 basis points (500 basis points equity risk premium and 100 basis points to cover operational costs). A mark-up is applied to banks in risk classes 2 and 3.

As noted above, the instrument may be called after three years. The method for calculating the redemption value shall be specified in the agreement with the bank and cannot be less than the par value.²⁵ Early redemption shall for instance be stimulated by including in the agreement an increase of the redemption rate in the fourth and fifth year, making early redemption less expensive compared to late redemption.

In addition, the incentive to redeem, instead of allowing mandatory conversion to take place, shall be ensured by setting a conversion rate at the end of the five year period that is more favourable to the Fund than conversion at the then market price, and also more favourable to the Fund compared to a redemption before the end of year five (in other words the method adopted shall provide for significant dilution of existing shareholders).

The Norwegian authorities have explained that the Fund shall have a right to convert the instrument to ordinary shares/primary capital certificates if the preferred capital constitutes a significant portion of the bank's book equity. The Fund shall specify in the agreement with each individual bank what constitutes a significant portion. The significant portion threshold shall be no higher than 50%.²⁶

The individual agreement may also include an option for the bank to convert the instrument to ordinary shares/primary capital certificates if 'own funds' have been written down considerably (by more than 20%). The method for calculating how many shares the Fund shall receive upon the conversion shall be specified in the agreement with the bank and shall ensure a reasonable relationship between the redemption value and potential gain, on the one hand, and conversion and potential loss on the other hand.²⁷

5.5 Behavioural safeguards

According to the Norwegian authorities, the scheme is supplemented by a number of behavioural safeguards.

The Fund shall make capital contributions conditional upon them being used in line with the aims of the scheme, and not being used contrary to the purpose thereof, and upon the bank refraining from exploiting the capital contribution in its marketing or for purposes of implementing aggressive commercial strategies.²⁸

²⁴ Section 12 of the Regulation.

²⁵ Section 13 of the Regulation.

²⁶ Section 12 of the Regulation.

²⁷ If the conversion rate were to be fixed as the average of the initial market price and the market price at conversion, the upside for the Fund should be secured through a corresponding increase in redemption value, providing for symmetry between downside risk and potential gain. If the conversion rate were to be fixed at the market price at the time of conversion, the Fund would not participate in losses in share value before conversion. In such a case the upside for the Fund should also be more limited.

²⁸ Section 8 of the Regulation.

Additional restrictions exist such as (i) a ban on increase of salaries and other benefits of managerial personnel until 31 December 2010; (ii) an almost complete ban on bonuses for the financial years 2009 and 2010 with a prohibition on paying out accrued bonuses thereafter; (iii) a prohibition on managerial personnel receiving shares or similar on favourable terms, and (iv) a prohibition on initiating new share option programmes or extending or renewing existing ones.

II. ASSESSMENT

1 The presence of state aid

Article 61(1) EEA reads as follows:

“Save as otherwise provided in this Agreement, any aid granted by EC Member States, EFTA States or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Contracting Parties, be incompatible with the functioning of this Agreement.”

To qualify as state aid, the measure must firstly be granted by the State or through state resources. The notified scheme consists of capital injections made by the Fund with resources from the national budget. For this purpose, a total budget of NOK 50 billion has been allocated to the Fund.

Further, the recapitalisation measures allow the beneficiaries to secure the required capital on more favourable conditions than would otherwise be possible in the light of the prevailing conditions in the financial markets. The Authority considers that, given the current difficulties on capital markets, the State is investing because no market economy operator would have been willing to invest on similar terms. Moreover, the notified measure is selective in that only fundamentally sound Norwegian banks and not any other financial institutions or other undertakings are eligible under scheme. This gives an economic advantage to the beneficiaries and strengthens their position compared to that of their competitors in Norway and in other EEA Member States and must therefore be regarded as distorting competition and affecting trade between Contracting Parties.

For these reasons, the Authority considers that the notified recapitalisation scheme constitutes state aid within the meaning of Article 61(1) EEA.

2 Procedural requirements

Pursuant to Article 1(3) of Part I of Protocol 3, *“the EFTA Surveillance Authority shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid (...). The State concerned shall not put its proposed measures into effect until the procedure has resulted in a final decision”*.

By notifying the recapitalisation scheme on 28 April 2009, the Norwegian authorities complied with the notification requirement. They have committed not to implement the scheme until the Authority has approved the measure, thereby also complying with the standstill obligation.

The Authority can therefore conclude that the Norwegian authorities have respected their obligations pursuant to Article 1(3) of Part I of Protocol 3.

3 Compatibility of the aid

3.1 Application of Article 61(3)(b) EEA and the Recapitalisation Guidelines

Article 61(3)(b) EEA provides that “*aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of an EC State or an EFTA State*”(emphasis added) may be held compatible with the functioning of the EEA Agreement.

The Authority does not dispute the analysis of the Norwegian authorities that the current global financial crisis has restricted lending to the real economy on a national scale. Should this situation not be addressed, it would have a systemic effect on the Norwegian economy as a whole. The Authority therefore finds that the notified scheme aims at remedying a serious disturbance in the Norwegian economy.

Based on Article 61(3)(b) EEA, the Authority adopted in January 2009 the Recapitalisation Guidelines laying down the rules for the assessment of aid granted in the form of recapitalisation in the context of the current financial crisis. Accordingly, the Authority will assess the current notification on the basis of the provisions of the Recapitalisation Guidelines.

The Recapitalisation Guidelines provide that “*in the context of the current situation in the financial markets, the recapitalisation of banks can serve a number of objectives. First, recapitalisations contribute to the restoration of financial stability and help restore the confidence needed for the recovery of inter-bank lending. [...] Second, recapitalisations can have as objective to ensure lending to the real economy*”.²⁹ Moreover “*banks must have sufficiently favourable terms of access to capital in order to make the recapitalisation as effective as necessary. On the other hand, the conditions tied to any recapitalisation measure should ensure a level playing field and, in the longer term, a return to normal market conditions. State interventions should therefore be proportionate and temporary and should be designed in a way that provides incentives for banks to redeem the State as soon as market circumstances permit (...). In all cases, EFTA States should ensure that any recapitalisation of a bank is based on genuine need*” (emphasis added).³⁰

The notified measures must therefore fulfil the following conditions:

- Appropriateness (adequacy of the measure to meet the objectives set): the aid measure must be well targeted in order to effectively meet the aim of fostering financial stability and lending to the real economy;
- Necessity: the aid measure must, in its amount and form, be necessary to achieve the stated objective³¹;
- Proportionality: the positive effects of the aid measure must be properly balanced against the distortions of competition, in order for the distortions to be limited to the minimum necessary to reach the measures’ objectives.

²⁹ Paragraphs 4 and 5 of the Recapitalisation Guidelines.

³⁰ Paragraph 11 of the Recapitalisation Guidelines.

³¹ Case C-390/06 *Nuova Agricast v Ministero delle Attività Produttive*, judgment of 15 April 2008 (not yet reported), paragraph 68. The Court held that “[a]s it is clear from Case 730/79 [...] aid which improves the financial situation of the recipient undertaking without being necessary for the attainment of the objectives specified in Article 87(3) EC cannot be considered compatible with the common market.”

3.2 Appropriateness

The Authority must firstly assess whether the measure proposed, *i.e.* state recapitalisation of fundamentally sound banks, is an appropriate measure to achieve the stated objectives of fostering financial stability and lending to the real economy

The Authority acknowledges that credit institutions may need extra capital in the present market circumstances in order to ensure a sufficient flow of credit to the entire economy, thereby counteracting a further deepening of the crisis. In addition, uncertainties as regards economic prospects have weakened trust in the long term solidity of financial institutions. Recapitalisation of fundamentally sound banks should ensure that financial institutions are sufficiently strongly capitalised so as to better withstand potential losses and maintain normal lending activities.

The provision of capital to fundamentally sound banks can therefore be seen as an appropriate measure to ensure conditions favourable to lending to the real economy in line with the requirement of the Recapitalisation Guidelines.

3.3 Necessity

The aid measure must, in its amount and form, be necessary to achieve the stated objectives, having regard to the current exceptional circumstances. It may therefore be considered that only aid to fundamentally sound banks is necessary for the purposes of the stated objectives.

The Norwegian authorities envisage that the notified scheme will enter into force in May 2009 and be open for 6 months. A deadline for the submission of applications for a capital injection will be set 6 weeks prior to the expiry of the 6-month period (approximately end-September 2009).

In addition, the capital injections are intended to be temporary. Incentives to encourage the banks to repay the capital injected are embedded in the scheme and a number of significant behavioural constraints are imposed, further incentivising a return to normal market conditions.

By limiting the temporal scope of the scheme, the Authority considers that the Norwegian authorities have confined the potential state aid to the context of the current situation on financial markets and the serious disturbance presently existing in the Norwegian economy.

The Recapitalisation Guidelines underline the importance of the distinction between fundamentally sound, well-performing banks, and distressed, less-performing banks.³²

The Norwegian authorities have explained that only banks that are fundamentally sound are eligible to participate in the notified scheme. On the basis of the information provided by the banks when applying for the capital injection and on the basis of objective criteria (formal capital adequacy ratios, analysis of each bank's various risk exposures, asset quality, business prospects, etc.), the Norwegian Financial Supervisory Authority will exercise a "gate-keeping" function and assess whether a bank is fundamentally sound. The scheme will only be open to banks that are found by the Financial Supervisory Authority

³² Paragraph 12 of the Recapitalisation Guidelines.

to meet Tier 1 capital requirements “with a good margin, also when likely developments in the near future are taken into consideration”.³³

It may therefore be concluded that the notified scheme respects the distinction operated in the Recapitalisation Guidelines and will not be used to recapitalise banks which are not fundamentally sound.

EFTA States should ensure that any recapitalisation of a bank is based on genuine need.³⁴ In December 2008, Norges Bank carried out a stress test for the six largest Norwegian banks. The test replicated a negative scenario where the outcome was that banks would record losses amounting to on average 2.3% of their risk-weighted assets. Norges Bank estimated the need for funds to recapitalise the 10 largest banks after the simulated negative developments at approximately NOK 34 billion. Based on those conclusions, the Norwegian authorities have estimated that NOK 50 billion will be sufficient to allow for an increase in the core capital of all Norwegian banks by on average 2,3%. The budget of the scheme is therefore NOK 50 billion.

The level of capital injection proposed by the Norwegian authorities is thus related to the specific conditions on the Norwegian banking market. The Norwegian authorities have set maximum limits for increases in core capital ratios through capital injections from the Fund which are linked to the level of core capital existing in a bank prior to any state intervention. Thus banks with a core capital ratio below 7% may apply for recapitalisation to bring them up to a core capital ratio of no more than 10%.³⁵ Banks with a core capital ratio between 7% and 10% may be recapitalised by up to 3 percentage points, but not beyond a core capital ratio of 12%. Banks with a core capital ratio above 10% can only apply for a maximum core capital injection of up to 2 percentage points.

As noted above, the actual amount of any capital injection will be decided by the Fund and specified in the agreement with the individual applicant bank. In addition, priority will be given to applications from banks of systemic importance, thereby ensuring that the objective of restoring financial stability is also taken into account.³⁶ Furthermore, the Fund will require additional justification in relation to any application for a capital injection of more than 2 percentage points in order to verify the need for such a large capital injection.

Any cases in which a capital injection of more than 2% has been made will be reported to the Authority.

The Fund will also require additional justification in relation to any application where the proposed injection will bring the core capital ratio of the applicant bank above 12%. The Fund will therefore be in a position to verify the need, despite an already high level of capitalisation, for state intervention. The Authority notes that this situation concerns mainly small savings banks with limited ways of financing themselves. These banks represent a small part of the market (only 11% of total bank assets) and are primarily active on local markets. If the specific need of the bank is not sufficiently justified, the Fund will reject its application.

³³ Section 2 of the Regulation.

³⁴ Paragraph 11 of the Recapitalisation Guidelines.

³⁵ Since banks with a capital ratio below 6% will generally not be eligible under the scheme, the maximum increase for banks in this category will be 4%. As mentioned in footnote 9 above, there are very few banks with a core capital level below 7%.

³⁶ Section 2 of the Regulation.

Based on the foregoing considerations, the Authority concludes that the notified scheme is constructed in such a way as to ensure that any injection of capital is based on genuine need.

3.4 Proportionality

Finally, the Authority must assess whether capital injections are made on terms that minimise the amount of aid in order to limit the distortions of competition to the minimum necessary to achieve the stated objectives.

According to the Recapitalisation Guidelines, closeness of pricing to market prices is the best guarantee to limit competition distortions.³⁷ The recapitalisation should therefore be designed in a way that takes the market situation of each institution into account and provides an incentive for the bank to redeem the State as soon as possible. The following elements are therefore to be used when carrying out an assessment of the recapitalisation measures: objective of the recapitalisation, soundness of the beneficiary bank, remuneration, exit incentives, and safeguards against abuse of aid and distortion of competition.

The objective of the measure and the soundness of the banks have been examined above. An overall remuneration needs to adequately factor in the following elements:

- risk profile of the beneficiary;
- characteristics of the instrument chosen;
- exit incentives; and
- an appropriate benchmark risk-free rate of interest.³⁸

The Guidelines identify an appropriate method to determine the price of recapitalisations by reference to the methodology set out in the aforementioned ECB Recommendation. This methodology involves the calculation of a price corridor on the basis of different components with the lower bound identified as the required rate of return for subordinated debt and the upper bound set as the required rate of return for ordinary shares. Both the lower and upper bounds are composed of a combination of government bond yield and 'add-on' elements. The specific features of individual institutions and of EFTA States should be reflected when calculating the price corridor in a particular situation. The Authority will also accept alternative pricing methodologies, provided they lead to remunerations that are higher than the ECB methodology.³⁹

The required rate of return on subordinated debt is therefore calculated as the government bond yield plus the CDS spread of the issuing bank plus 200 basis points to cover operational costs and provide exit incentive. For other hybrid instruments having economic features similar to subordinated debt, the higher degree of seniority of these instruments is reflected by including an additional 100 basis points .

The Norwegian authorities have identified the Hybrid Tier 1 security as falling within the above description and have calculated the remuneration on that instrument as the government bond yield plus 5,0% for banks assigned to risk class 1 (the add-on is 5,5% and 6,0% for risk classes 2 and 3 respectively). They have indicated that Norges Bank has

³⁷ Paragraph 19 of the Recapitalisation Guidelines.

³⁸ Paragraph 23 of the Recapitalisation Guidelines.

³⁹ Paragraph 30 of the Recapitalisation Guidelines.

estimated the CDS spread of DnB NOR (the biggest Norwegian bank and the only one for which CDS data is available) at 100 basis points. Since the relevant data does not exist for the other Norwegian banks, the authorities have applied the same add-on for all banks. Applying the ECB methodology would therefore result in a minimum add-on of 400 basis points. As noted above, the minimum add-on under the notified scheme is 500 basis points, and it therefore complies with the Guidelines in this respect.

The required rate of return on ordinary shares is calculated as the government bond yield plus an equity risk premium of 500 basis points plus 100 basis points to cover operational costs and provide exit incentive. For other instruments having economic features similar to ordinary shares (including perpetual instruments which convert to ordinary shares), the required rate of return should be close to that for ordinary shares.

The Norwegian authorities have identified the Tier 1 preference capital instrument as falling within the above description and have calculated the remuneration on that instrument as the government bond yield plus 6,0% for banks assigned to risk class 1 (the add-on is 6,5% and 7,0% for risk classes 2 and 3 respectively). Applying the ECB methodology would result in a minimum add-on of close to 600 basis points and it may therefore be concluded that the add-on for the preference capital instrument is in line with the Recapitalisation Guidelines.

The other element of the remuneration is the government bond yield.⁴⁰ The notified scheme is based on the Norwegian government 5-year bond. However, the notified scheme also leaves applicant banks the option to tie remuneration to the 6-month government certificate. The Authority notes that, at present, the 6-month floating interest rate is approximately 1% lower than the 5-year fixed government bond rate. Thus, the remuneration would today be approximately 1% lower for a bank exercising the option of remuneration based on the 6-month floating rate.

The Norwegian authorities have argued that the two ways of pricing the capital injections are normally equivalent. They illustrate this by calculating the remuneration based on both the current 5-year Norwegian government bond rate and the net present cost of 6-month government certificates in the futures market for the five year period. This is based on the theory that parity between fixed and floating interest rates will be ensured over time.

Although the calculations are based on expectations and do not guarantee that the interest will always be the same as predicted, the Authority concludes that, on the basis of available data, it is likely that the remuneration tied to a 6-month government certificate will be within the price corridor established on the basis of the methodology described above. Moreover, the Authority has taken note of the fact that the add-on elements are above the minimum required under the Recapitalisation Guidelines.

Having dealt with the appropriate benchmark interest rate and the characteristics of the instruments on offer, the next element of remuneration to consider is the risk profile of the beneficiary.

As noted above the Fund shall assign each bank to one of three risk classes, based on objective criteria.⁴¹ The risk class will determine the coupon to be paid on the injected

⁴⁰ This is defined in the ECB Recommendation as follows: “the sum of (i) average yield on the EMU benchmark 5-year bond over the 20 business days prior to the capital injection, and (ii) the average sovereign yield spread for the country of domicile of the financial institution over the reference period 1 January 2007 through 31 August 2008”.

⁴¹ See footnote 17 above.

capital. Annex 1 to the Recapitalisation Guidelines gives more information on how the risk profile of the beneficiary is to be assessed and identifies capital adequacy, the size of the recapitalisation, current CDS spreads and the rating and outlook of the applicant bank as relevant indicators.

The Authority is of the opinion that the method of assessment by the Fund described above under Section I.5.3 above takes sufficient account of these various indicators and therefore leads to an appropriate classification of the applicant banks in terms of risk.

The Norwegian authorities have included an extra 50 basis points in the remuneration for banks in risk class 2 and an extra 100 basis points for those in risk class 3. The rationale for this has been explained as the difference observed between the credit spread of the subordinated debt of DnB NOR and that of other Norwegian banks as mark-ups to the estimated DnB NOR CDS spread. The spread between the lowest and highest yield was observed to be no greater than approximately 100 basis points and the add-ons for the medium and high risk classes were therefore set at 50 and 100 basis points respectively.

The final element of remuneration identified in the Guidelines are the exit incentives built into the scheme. In this respect, the Authority notes that remuneration on the Hybrid Tier 1 security (which may be redeemed at any time) is increased by 1% annually in each of years 4 and 5 and maintains that higher coupon until redemption. With respect to the Tier 1 preference capital instrument, redemption is only possible after 3 years have elapsed and at the end of the fifth year, the instrument is automatically converted into ordinary shares. However, it is stipulated in the Regulation that 1) redemption shall be at no less than par value and shall increase in years 4 and 5, and 2) conversion to shares at the end of year 5 shall be on such terms as to provide the bank with incentives to redeem the instrument before automatic conversion would take place. The Norwegian authorities have also indicated that, as an additional incentive for redemption, the conversion mechanism should also be more favourable to the Fund than a conversion at the then market price, thus requiring a significant dilution of existing shareholders.

The Authority considers that, taking all of these elements into account, the notified scheme provides for an overall level of remuneration in line with the principles laid down in the Recapitalisation Guidelines.

In addition to remuneration and exit incentives, the Recapitalisation Guidelines also refer to safeguards against abuse of aid and distortion of competition and require EFTA States to attach effective and enforceable national safeguards to recapitalisation which ensure that the injected capital is used to sustain lending to the real economy so that the objective of financing the real economy is effectively attained.⁴² The Authority notes in this respect that the notified scheme contains behavioural commitments imposed on the banks benefiting from a capital injection to ensure that the funds are not used for other purposes than to support lending to the real economy. Section 6 of the Regulation ensures that the Fund is regularly informed of the lending policy of beneficiary banks, Section 8 requires banks benefiting from a capital injection to commit to use it in line with the aims of the scheme, not contrary to the purpose thereof which is to foster lending to the real economy and Section 14 gives the Fund the power to take measures to ensure that the terms governing the capital injection are complied with.

Finally, the Authority notes that the Norwegian authorities do not have in place any other state aid measures aimed at the banking sector.

⁴² Paragraph 39 of the Recapitalisation Guidelines.

5 Conclusion

On the basis of the foregoing assessment, the Authority considers that the scheme for temporary recapitalisation of fundamentally sound banks in order to foster financial stability and lending to the real economy which the Norwegian authorities are planning to implement is compatible with the functioning of the EEA Agreement within the meaning of Article 61 EEA, read in conjunction with the Recapitalisation Guidelines.

The Norwegian authorities are reminded of the obligation resulting from Article 21 of Part II of Protocol 3, read in conjunction with Article 6 of Decision No 195/04/COL, to provide annual reports on the implementation of the scheme.

The Norwegian authorities are also reminded that all plans to modify this scheme must be notified to the Authority.

HAS ADOPTED THIS DECISION:

Article 1

The EFTA Surveillance Authority has decided not to raise objections to the scheme for temporary recapitalisation of fundamentally sound banks in order to foster financial stability and lending to the real economy on the basis of Article 61 EEA, read in conjunction with the Recapitalisation Guidelines.

Article 2

This Decision is addressed to the Kingdom of Norway.

Article 3

Only the English version is authentic.

Done at Brussels, 8 May 2009

For the EFTA Surveillance Authority,

Per Sanderud
President

Kurt Jaeger
College Member