Brussels, 19 April 2012
Cases No: 68809 and 69278
Event No: 585210
Dec. No: 134/12/COL

EFTA SURVEILLANCE AUTHORITY

Icelandic Mission to the EU
Rond-Point Schuman 11
1040 Brussels

Dear Sirs,

Subject: **Letter of formal notice to Iceland for failing to comply with its obligation under Article 40 of the Agreement on the European Economic Area by maintaining in force a ban on the exchange rate indexation of loans in Icelandic króna**

1 Introduction

According to Icelandic law, the exchange rate indexation of loans in Icelandic króna ("ISK") is prohibited. Following two complaints relating to the ban on exchange rate indexation of loans in ISK, the EFTA Surveillance Authority ("the Authority") has assessed the compatibility of these rules with Article 40 (free movement of capital) of the Agreement on the European Economic Area ("EEA").

2 Correspondence

In a letter dated 15 November 2010, the Authority informed the Icelandic Government that it had received a complaint against Iceland regarding alleged breach of Article 40 of the EEA Agreement for maintaining in force a ban on exchange rate indexation of loans in ISK. In that letter, the Authority invited Iceland to provide further information regarding the case.

In an e-mail of 27 January 2011, the Icelandic Government asked for an extended time limit to reply to the above letter until 15 February 2011.

By a letter of 1 February 2011, the Authority informed the Icelandic Government that it had received a new complaint concerning the ban on exchange rate indexation of loans in ISK. In that letter, the Authority invited Iceland to provide additional information regarding the case.

In an e-mail of 14 February 2011, the Icelandic Government asked for an extended time limit to submit the requested information to 28 February 2011.

On 5 April 2011, the Icelandic Government stated that an answer would be forthcoming around mid May. The case was discussed at the package meeting in Reykjavík on 7 June 2011.

The Icelandic Government finally replied to the above-mentioned letters in a letter dated 21 June 2011.

3 Relevant national law

3.1 Act No 38/2001 on Interest and Price Indexation

Act No 38/2001 on Interest and Price Indexation (*lög nr. 38/2001 um vexti og verðtryggingu*) applies to any kind of reimbursement for loans and price indexation of loans in Iceland.

Chapter VI of the Act (Articles 13-16) is on the price indexation of savings and loans and applies to obligations concerning savings and loans in ISK according to Article 13 of the Act.

Article 13 of the Act on Interest and Price Indexation reads:

"The provisions of this Chapter shall apply to obligations concerning savings and loans in Icelandic krónur (ISK) where the debtor promises to pay money and it has been agreed or stipulated that the payments should be price-indexed. Price indexation as referred to in this Chapter shall mean changes in line with a domestic price index. Authorisation for price indexation shall be as provided for in Article 14 of this Act unless otherwise provided for by law.

Derivative agreements do not fall within the scope of this Chapter."[1]

According to Article 14 (1) of Act No 38/2001, savings and loans may be price indexed if the basis of the price indexation is the consumer price index as calculated by Statistics Iceland in accordance with the law applicable to the index and published monthly in the Legal Gazette.

Furthermore, it is stated in Article 14(2) of Act No 38/2001 that a loan agreement may be based on a share price index, domestic or foreign, or a collection of such indices which do not measure changes to general price levels.

Act No 38/2001 does not expressly refer to exchange rate indexation of loans in ISK. However, in the previous Act on Interest No 25/1987, the concept of "exchange rate indexation" was considered to be part of the concept of "price indexation". In the preparatory works to Act No 38/2001 it is stated that exchange rate indexation of loans shall not be permitted anymore.

In two rulings of 16 June 2010[2], the Supreme Court of Iceland confirmed that since Act No 38/2001 does not provide a legal basis for the granting of exchange rate indexed loans

[1] Translation taken from the website of the Ministry of Economic Affairs http://eng.efnahagsraduneyti.is/laws-and-regulations/nr/2963

[2] Supreme Court rulings No 92/2010 and No 153/2010.

in ISK, the granting of such loans is not legal. Those two rulings concerned the granting of exchange rate indexed loans to two individuals. In its ruling of 14 February 2011[3], the Supreme Court of Iceland ruled that the prohibition of the granting of exchange rate indexed loans in ISK also applies to legal persons.

On 29 December 2010, Act No 38/2001 on Interest and Price Indexation was amended by Act No 151/2010. The amendment addresses the question of how the interest of exchange rate indexed loans in ISK, that have already been granted, shall be re-calculated. The amendments do not change the provisions in the Act concerning the legality of the granting of exchange rate indexed loans in ISK and the granting of such loans is, therefore, still prohibited under Icelandic law.

3.2 Act No 87/1992 on Foreign Exchange

On 28 November 2008, Iceland introduced currency controls by Act No 134/2008 amending the Foreign Exchange Act No 87/1992 (*lög 134/2008 um breytingu á lögum nr. 87/1992 um gjaldeyrismál*). At the same time Rules No 1082/2008 on foreign exchange were issued. In conjunction with those amendments to the Foreign Exchange Act, the Icelandic Government sent notifications dated 28 November 2008 to the EEA Joint Committee and the Standing Committee of the EFTA States according to the procedure permitted under Article 45(3) EEA and Article 1(2) of Protocol 2 of the Agreement on a Standing Committee. The Foreign Exchange Act has been amended nine times since the currency controls were introduced by Act No 134/2008. Furthermore, the Rules on foreign exchange have been replaced three times by new Rules on foreign exchange, the rules currently in force are Rules No 370/2010 on foreign exchange.

According to Article 1(6) of the Foreign Exchange Act, cross-border movement of capital shall mean the transfer or transport of capital across national borders and transfer or transport of capital between residents and non-residents in certain instances.

Article 13b(2) of the Foreign Exchange Act state that all cross-border movement of foreign-denominated capital is prohibited unless it is for the purchase of goods or services or is particularly exempted according to the rules.

Furthermore, according to Article 13b(3) of the Foreign Exchange Act, all cross-border movement of capital denominated in domestic currency is prohibited unless specifically exempted.

Article 13g of the Foreign Exchange Act concerns the borrowing and lending. According to Article 13g(1) of the Act, the borrowing and lending between residents and non-residents for purposes other than cross-border trading in goods and services is prohibited unless such borrowing and lending takes place between undertakings in the same conglomerate.

According to Article 13n of the Foreign Exchange Act, several parties are exempted from some or all the provisions of the Act. According to Article 13n(6) of the rules, commercial banks, savings banks and credit institutions operating under the supervision of the Financial Supervisory Authority, are authorized to engage in spot, forward, and swap transactions with foreign currency. Furthermore, such institutions are exempt from the provisions of Articles 13g, 13h, 13l of the Act . Consequently, commercial banks, savings

[3] Supreme Court ruling No 603/2010.

banks and credit institutions operating under the supervision of the Icelandic Financial Supervisory Authority, are not subject to the general ban under Article 13g on the borrowing and lending between residents and non-residents.

4 Relevant EEA law

4.1 EEA fundamental freedoms

Article 40 EEA reads:

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

Article 1 of the Capital Movements Directive[4] states that *"Member States shall abolish restrictions on movements of capital taking place between persons resident in Member States. To facilitate application of this Directive, capital movements shall be classified in accordance with the Nomenclature in Annex I."* That non-exhaustive Nomenclature has, according to case law, an indicative value for the purposes of defining the notion of capital movements.[5]

The opening words of the Nomenclature are as follows:

> *"In this Nomenclature, capital movements are classified according to the economic nature of the assets and liabilities they concern, denominated either in national currency or in foreign exchange."*
>
> *The capital movements listed in this Nomenclature are taken to cover:*
>
> *[...]*
>
> *- operations to repay credits or loans."*

Section VII of Annex I to the Nomenclature has the heading *"CREDITS RELATED TO COMMERCIAL TRANSACTIONS OR TO THE PROVISION OF SERVICES IN WHICH A RESIDENT IS PARTICIPATING"*. Under that heading are listed:

> *"1. Short-term (less than one year).*
> *2. Medium-term (from one to five years).*
> *3. Long-term (five years or more).*

[4] Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty.
[5] Case E-2/06 *EFTA Surveillance Authority* v *Norway*, [2007] EFTA Court Report, p. 164, paragraph 67; Case C -222/97 *Manfred Trummer* [1999] ECR I-1661, paragraph 21; Case C-464/98 *Stefan* [2001] ECR I-173, paragraph 5; Joined Cases C-515/99, C-519/99 - C-524/99 and C-526/99 - C-540199 *Reisch* [2002] ECR I-2157, paragraph 30; Case C-386/04 *Centro di Musicologica Walter Stauffer* [2006] ECR I-8203, paragraph 22, and Case C-370/05 *Festersen*, [2007] ECR I-1135, paragraph 23.

A – Credits granted by non-residents to residents
B – Credits granted by residents to non-residents"

Section VIII of Annex I to the Nomenclature has the heading *"FINANCIAL LOANS AND CREDITS (not included under I, VII and XI)"*. Under that heading are listed:

"1. Short-term (less than one year).
2. Medium-term (from one to five years).
3. Long-term (five years or more).

A – Loans and credits granted by non-residents to residents
B – Loans and residents to non-residents"

According to the explanatory notes in Directive 88/361/EEC, financial loans and credits include *"Financing of every kind granted by financial institutions, including financing related to commercial transactions or to the provision of services in which no resident is participating."* Furthermore, the category also includes *"mortgage loans, consumer credit and financial leasing, as well as back-up facilities and other note-issuance facilities."*

5 The Authority's assessment

5.1 Existence of a restriction on the free movement of capital

As a preliminary remark, the Authority notes that although there is a general ban in Article 13g of the Foreign Exchange Act on the borrowing and lending between residents and non-residents, Icelandic financial institutions are not restricted in borrowing money from foreign undertakings since they are, according to Article 13n(6) of the Act, exempted from the ban in Article 13g. The currency controls do, therefore, not restrict Icelandic financial institutions in financing themselves in foreign currencies.

Turning to the issue of the existence of a restriction, the Court of Justice and the EFTA Court have repeatedly held that national rules which are liable to impede the free movement of capital and to dissuade investors in other Member States from exercising that freedom must be regarded as restrictions within the meaning of Article 63 TFEU/Article 40 EEA.[6]

In the complaints it is alleged that the ban on exchange rate indexation of loans in Iceland has the effect of making it less attractive for financial institutions to finance themselves in other currencies than ISK.

In *Trummer and Mayer*[7] the Court of Justice concluded that the free movement of capital precluded the application of national rules that required a mortgage securing a debt payable in the currency of another Member State to be registered in the national currency. The Court of Justice emphasised that such rules would have the effect of weakening the link between the debt to be secured (payable in the currency of another Member State) and the mortgage. This rule would therefore reduce the attractiveness and effectiveness of such

[6] See *e.g.* Cases C-367/98 *Commission v. Portugal* [2002] ECR I-4731, paragraphs 44-46; C-483/99 *Commission* v. *France* [2002] ECR I-4781, paragraphs 40-42, Case C-98/01 *Commission* v. *United Kingdom*, [2003] ECR I-4641, paragraph 47, and Case C-463/00 *Commission* v. *Spain* [2003] ECR I-4581, paragraph 61.
[7] C-222/97 *Trummer and Mayer* [1999] ECR I-1661.

a security. As a consequence the rules are liable to dissuade parties from denominating a debt in the currency of another Member State and thus deprive them of a right which constitutes a component element of the free movement of capital.[8]

With reference to *Trummer and Mayer* the Court of Justice, in *Westdeutsche Landesbank Girozentrale,* again confirmed that the provision on free movement of capital "*was to be construed as precluding the application of national rules such as those at issue in the main proceedings, requiring a mortgage securing a debt payable in the currency of another Member State to be registered in the national currency*".[9]

As explained above, the granting of loans can fall under the scope of capital movements (see the nomenclature of Directive 88/361/EEC), regardless of whether the loan is denominated in the national currency or in a foreign currency. An exchange rate indexed loan is not a loan granted in foreign currency but a loan granted in ISK. Such a loan is, however, indexed to the value of certain other foreign currencies. It was common in Iceland to grant exchange rate indexed loans in so-called "currency baskets" *i.e.* the loans were indexed to the value of certain foreign currencies such as USD, EUR, CHF and JPY. It varied between loan agreements which currencies were involved and the percentage of each currency in the "currency basket" differed between agreements as well.

Although exchange rate indexed loans were granted in ISK, such loans were inevitably linked to the value of other currencies. In order to reflect the risk of granting such loans in ISK, Icelandic financial institutions would therefore probably seek to finance the loans in the currencies that the loans were indexed to.

A total ban on the granting of exchange rate indexed loans in ISK, such as laid down in Act no 38/2001, will dissuade Icelandic financial institutions from financing their loans in other currencies than the national currency and therefore constitutes a restriction on the free movement of capital as provided for under Article 40 EEA.

In its letter dated 21 June 2011, the Icelandic Government states that, to its knowledge, there have in practice been no providers of capital from other EEA States that have seen their capital movements hindered as a result of the ban of exchange rate indexation of loans in ISK. Lenders have been domestic and the Icelandic Government considers consequently that the cross border element that is necessary for the application of Article 40 EEA, in practice, is absent in the present case.

The Authority considers that this has no impact on the conclusion reached above. Under the fundamental freedoms there is no requirement to establish actual effects of a provision restrictive of the freedoms.[10] Moreover, the fact that many of the agreements coming within the scope of the ban might lack the cross-border element necessary to trigger the application of Article 40 EEA is not relevant for the purposes of these infringement proceedings. It follows from the above that the restriction of the free movement of capital identified by the Authority in the present letter of formal notice is concerned with Icelandic financial institutions being dissuaded from financing their loans in other currencies than the national currency. Such a restriction will primarily affect the

[8] C-222/97 *Trummer and Mayer,* cited above, paragraph 26-28.
[9] C-464/98 *Westdeutsche Landesbank Girozentrale* v *Friedrich Stefan and Republik Österreich* [2001] ECR I-173, paragraph 19.
[10] See, *e.g.*, in relation to the free movement of goods, Case C-184/96 *Commission v France* [1998] ECR I-6197, paragraph 17.

relationship between the Icelandic financial institutions and their (potential) lenders in other EEA States.

5.2 Justifications

In its letter dated 21 June 2011, the Icelandic Government argues that the objectives of protecting individual persons as well as the society in general against the risk presented by loans in ISK with indexation linked to foreign currency, are valid justifications for a restriction under Article 40 EEA. The prohibition of such loans is appropriate and necessary as there are no other measures that could effectively achieve the objectives sought. The Icelandic Government finally recalls the ruling of the Court of Justice in the *Alpine Investments* case[11] where it was held that a prohibition of cold calling in the financial sector was justified and proportionate. In the opinon of the Icelandic Government, cold calling is minor compared to the risks that loans with indexation linked to foreign currency pose to individual persons and society.

National measures liable to hinder or make less attractive the exercise of the four fundamental freedoms may be in conformity with EEA law if they fulfil the conditions of being applied in a non-discriminatory manner, justified by imperative requirements in the general interest, suitable to attain the objective which they pursue and not going beyond what is necessary in order to attain the objective.[12]

Contracts with exchange rate indexation of loans may involve risk for consumers, since consumers usually have their income in the national currency and are therefore not prepared to react to fluctuation in the value of other currencies. Furthermore, consumers might not have the ability to assess the risk involved in such contracts.

Therefore, the Authority does not contest that the aim of protecting consumers can serve as a justification ground when it comes to restrictions on offering certain high risk financial products to individuals. A total ban on the granting of such loans can, however, not be seen as a proportionate measure to protect that aim. Iceland could introduce other less restrictive measures to protect consumers from the risk that exchange rate indexed loans may involve. Such measures could include informing the consumers in an adequate and clear manner about the risks involved before contracting a loan with an exchange rate indexation, or possibly granting the consumers a right to retract, within a certain time period, from a signed loan contract.

In this context, the Authority wishes to point out that, in general, rules aiming at ensuring consumer protection relate to, *inter alia*, the advertising and marketing of credit products, adequate and transparent pre-contractual information about offers and related risks, as well as thorough creditworthiness assessments[13].

It should further be noticed that, Article 14(2) of Act 38/2001 provides that loan agreements may be indexed to both domestic and foreign stock price indices. The Court of Justice has held "*it must be recalled that national legislation is appropriate for ensuring attainment of the objective pursued only if it genuinely reflects a concern to attain it in a*

---

[11] Case 384/93, *Alpine Investment* vs *Minister van Financien*, [1995] ECR I-01141.

[12] See e.g. C-55/94 *Gebhard,* [1995] ECR I-4165, paragraph 37.

[13] For additional information, see the EC Commission's Staff Working Paper accompanying the European Parliament's and Council's proposal for a Directive on credit arrangements relating to residential property, SEC(2011) 355 final of 31.3.2011, available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SEC:2011:0355:FIN:EN:PDF

consistent and systematic manner".[14] The Icelandic Government has not presented the Authority with any information indicating that, given the possible flucations of such indices, allowing this type of indexation entails significantly less risks for consumers than exchange rates indexation. Therefore, the Authority considers that in any event the Icelandic legislation is inconsistent with regard to the pursuit of the objective of consumer protection.

The conclusion above, that the Icelandic legislation is not compatible with the principle of proportionality applies *a fortiori* with regard to its application to legal persons. Contrary to the situation relating to consumers, this group of persons has the necessary means and resources to be able to adequately assess any risks involved when considering contracting a loan with an exchange rate indexation.

5. Conclusions

Accordingly, as its information presently stands, the Authority must conclude that, by maintaining in force a ban on the exchange rate indexation of loans in ISK, as laid down in Act No 38/2001 on Interest and Price Indexation (*lög nr. 38/2001 um vexti og verðtryggingu*), in particular Articles 13 and 14 of the Act, Iceland has failed to fulfil its obligation arising from Article 40 of the Agreement on the European Economic Area.

In these circumstances, and acting under Article 31 of the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice, the Authority invites the Icelandic Government to submit its observations on the content of this letter *within two months* following receipt thereof.

After the time limit has expired, the Authority will consider, in the light of any observations received from the Icelandic Government, whether to deliver a reasoned opinion in accordance with Article 31 of the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice.

Done at Brussels, 19 April 2012

For the EFTA Surveillance Authority

S. Monauni-Tömördy

Sabine Monauni-Tömördy
College Member

[14] Case C-169/07 *Hartlauer* [2009] ECR I-1721, paragraph 55. See also Case C-500/06 *Corporación Dermoestéticas* [2008] ECR I-5785, paragraph 39.