

Ownership and sale of Íslandsbanki hf.: Status report on proposed sale process

- English translation of summary -

4th of March 2020

Summary

This report relating to Íslandsbanki hf. ("Íslandsbanki") is prepared in accordance with item i. and j. of Article 4 of Act no. 88/2009 on the Icelandic State Financial Investments („ISFI“ (ISFI’s Act“), which states that it is the responsibility of ISFI to submit proposals to the minister of finance and economic affairs (the “Minister”) as to whether and when specific state holdings in financial undertakings shall be offered for sale and to develop and execute such proposals. In January 2016, ISFI published a similar report on Landsbankinn hf. ("Landsbankinn").

ISFI considers it important to reduce the state's holdings in financial undertakings, due to the associated risks and decreasing benefits of ownership, which are partly attributable to the decline in positive extraordinary one-off items. ISFI considers this to be in line with emphases set out in the coalition agreement of the government, dated November 2017, and also in the *White Paper on a future vision regarding the financial system in Iceland* from December 2018. Further, an authorization to sell the state holdings in Íslandsbanki is in the general budget for 2020. ISFI therefore considers it appropriate to aim at offering a minimum of one-fifth of shares in Íslandsbanki in a dual track sale process, which would primarily be focused on an initial public offering (“IPO”), with listing following a public offering (“IPO track”), and simultaneously offer for sale a part or possibly all of the bank's share capital through an auction (“M&A track”). As Table S1 shows, the IPO track could include single listing of the shares on a domestic exchange or a dual listing domestically and internationally, but the M&A track would rather be a sale of potentially all the shares to a foreign bank or the sale of a minority stake to a specialized institutional investor, with expertise in financial markets.¹ ISFI therefore does not consider a merger with Arion bank hf. ("Arion Bank") or Landsbankinn, unless a specific law is enacted, as ISFI considers a merger would result in more disadvantages than advantages, as discussed in a separate annex.

Table S1: Dual track sale process of Íslandsbanki

IPO track

- Single listing
- Dual listing

M&A track

- Partial sale to institutional investors
- Sale in whole to a foreign bank

These considerations are in line with plans proposed by ISFI in a letter to the Minister on 22nd of May 2019 regarding submitting a draft of a proposal to the Minister in relation to initiating formal sale of shares in Íslandsbanki. Such a sales process is in accordance with provisions of Act no. 88/2009 and Act no. 155/2012 on the sale of the state's holdings in financial undertakings concerning competition, transparency, disclosure of information to the public, dispersed ownership and open, objective and efficient sale process.

ISFI considers that sale process, i.e. from the publication of this report, cf. items i. and j. Article 4 of Act no. 88/2009, submission of ISFI’s sale proposal to the Minister according to paragraph 1 Article 1 of Act no. 155/2012, the Minister's decision to initiate a sales process, cf. paragraph 2 Article 1 of Act no. 155/2012 and to the Minister's decision to accept or reject existing bids, cf. paragraph 2 Article 4 of

¹ It is of course possible that such specialized institutional investor is a foreign bank.

the same Act, may be completed in the second half of 2021 or in the first half of 2022, as shown in Table S2. The timing of the next parliamentary elections is not taken into consideration in the execution of the sale process.

Table S2: Overview of timing and decisions to be made by ISFI and the Minister²

1H 2020	Status report issued by ISFI	Item i. and j. of Article 4 of Act no. 88/2009
	ISFI submits a proposal to the Minister regarding sale	Paragraph 1 Article 1 of Act no. 155/2012
	Decision by Minister initiating a sale process	Paragraph 2 Article 2 of Act no. 155/2012
	2H 2021 or 1H 2022	Decision by Minister whether to accept or reject offers

In preparing a proposal to the Minister, cf. paragraph 1 Article 1 of Act no. 155/2012, and in the management of the sale process that ISFI is responsible for, cf. paragraph 1 Article 4 of the Act no. 155/2012, ISFI will assess in accordance with criteria on the appropriateness of initiating a sale process of the state’s holdings, which were published in said report on Landsbankinn, and having regard to the objectives of the ownership policy of the state for financial undertakings, that ISFI is obliged to apply, where it is stated that acceptable conditions need to be present before a state holding is sold, which are shown in Table S3. ISFI is of the opinion that, based on Íslandsbanki's current profitability and valuation of shares in European banks, the state's holding in the bank is unlikely to be sold at a price equivalent to the book value in the central government’s accounts, corresponding to 0.8x of the bank's underlying shareholder’s equity, or price-to-book multiple. ISFI considers that these criteria are not fully met as of now, but ISFI believes that they will be when it comes to the sale of the shares, as will be discussed below, and therefore does not prevent it from submitting a proposal.

² Furthermore, the Minister is obliged, according to article 5 in Act no. 155/2012, to submit a report to Alþingi after the sale process.

Table S3: ISFI’s economic criteria and objectives in the ownership policy in relation to sale process³

ISFI’s economic criteria	Ownership policy objectives
<ul style="list-style-type: none">• Strength and stability of the Icelandic economy• Acceptable valuations of shares in financial undertakings• Sufficient interest and capacity by markets to invest in the holdings• The readiness of the financial undertaking	<ul style="list-style-type: none">• That acceptable conditions are present before a sale is commenced• To safeguard the long term interests of the state in regards to risk of ownership• To support long term viable ownership

ISFI therefore assumes that the sales process will take longer than originally planned. ISFI considers it important to prepare Íslandsbanki for sale and to ensure flexibility in sales process. These emphases are fully consistent with the sales process of governments in other European countries of holdings in financial undertakings, such as the sale by the Dutch state of holdings in ABN AMRO Group N.V. ("ABN AMRO"). That process took over two years from the publication by Netherlands Financial Investments ("NLI") of a similar report (August 23, 2013), until the IPO of the shares (20th November 2015).

It is important for the sale of Íslandsbanki that preparation begins as soon as possible, in order to maximize the recovery and the return of the treasury’s equity contribution. Íslandsbanki’s return on equity ("ROE") was only 4.8% for the year 2019 and therefore lower than the state’s requirement for ROE.⁴ ISFI considers that the ROE of the bank must improve quarter-over-quarter over the next few years. For example, an expected ROE of 8% could result in a price which would be similar to the book value in the central government’s accounts, as expected ROE is the most important factor in determining market value of the shares of European banks. The current low ROE of the bank is partly explained by high taxation and regulatory capital requirements. However, in the coming years, these burdensome requirements are expected to decrease, with a positive impact on the ROE of Íslandsbanki and other Icelandic financial undertakings. First of all, amendments have been made to Act no. 155/2010 on a special tax on financial undertakings, where the tax ratio was reduced from 0.376% to 0.145% in phases until 2023. Secondly, the general contribution to the Depositors' and Investors' Guarantee Fund ("TIF") was reduced in June last year by amendments to Act no. 98/1999 on Deposit Guarantees and Investor Insurance Schemes. Further to this, the premium’s base will be reduced. These changes are expected to result in a 55% reduction in premiums according to an announcement from the Ministry of Finance and Economic Affairs on 23rd of January.^{5,6} Thirdly, the capital requirements of financial undertakings for loans to small and medium enterprises ("SME") will decrease after the implementation of Regulation (EU) no. 2019/876, which came to an effect in Iceland

³ Source: ISFI and the *Ministry* of Finance and Economic affairs.

⁴ The required ROE by ISFI equals the risk free interest rate, which is the rate of interest on deposit institution’s accounts at the Central Bank, in addition to a 5% premium. After the decision by the Monetary Policy Committee on 5th of February, the rate of interest is 2.5% and therefore the required ROE by ISFI is 7.5%.

⁵ See

<https://www.stjornarradid.is/efst-a-baugi/frettir/stok-frett/2020/01/23/Svigrum-fjarmalafyrirtaekja-aukid/>.

⁶ Here no account is taken of any premium paid to a resolution fund, which will be established according to a bill before Alþingi on the resolution of credit institutions and securities companies.

1st January this year. Due to the regulation the risk exposure for SME will be lowered with a specific SME supporting factor. In this regard, Íslandsbanki has estimated that these changes will reduce the bank's risk weighted assets by 15.6 billion krónur and result in a 0.4% increase in its capital ratio. ISFI considers that taking into account the aforementioned items, the ROE of Íslandsbanki can increase from 4.8% to 6.2% and the bank is able to pay a special dividend in the amount of 3.5 billion krónur over the next two to three years.⁷ In addition, it must be taken into account that Íslandsbanki, like other financial undertakings, has undertaken extensive investments in information and financial technology, which have largely been recognized as an expense, but is expected to result in lower operating costs and increased profitability in the future. In this regard, in an interview in *Viðskiptablaðið* on 16th of January, the CEO of Íslandsbanki indicated that banks in Iceland were at certain crossroads regarding investments in digital projects. Furthermore, the CEO of Íslandsbanki also indicated that the bank has as an objective of 10% ROE. In Íslandsbanki's reply to a news article in *Markaðurinn*, on 15th of January, it was stated that the objective was to achieve the shareholder's goals over the next two to four years with revenues rising at a faster rate than expenses during that period". Finally, it is likely that the countercyclical buffer will be lowered in the future, as was mentioned by the Governor of the Central Bank of Iceland in a recent speech, since the buffer is only higher in two of the 31 European countries that have implemented it. Furthermore, ISFI has emphasized that Íslandsbanki continue to work to increase the bank's profitability in the coming quarters, by reducing operating expenses, selling assets that require excess equity compared to profitability and issuing subordinated bonds that qualify as additional tier 1 capital ("AT1"). On 19th of February, Arion bank issued such AT1 instruments raising \$100 million on acceptable terms, or with a yield of 6.25%. By that Arion bank paved the way for other financial undertakings to undergo similar transactions. Further, such AT1 debt instruments will be more advantageous, if a bill relating to several amendments to acts on taxes and charges will be enacted, but according to the bill, interest on AT1 debt instruments will be deductible from taxable income.⁸ Also, one must consider the fact that the bank's ROE, which has declined in recent periods, as previously mentioned e.g., due to reduction in positive one-off items, could decline further if write-offs of loans to customers increase if the economy contracts or if competition in the financial sector increases.

It is also important to increase flexibility in the sale process by assuming that it will take longer than the minimum period. For example, changes in external conditions, such as fluctuations in financial markets or global developments, can temporarily close IPO windows.⁹ Further, it can take more quarters, than originally planned, for Íslandsbanki to achieve acceptable ROE. Lastly, it should not be ruled out that a holding in the bank will be sold in an open sales process to specialized institutional investors with expertise in the operations of financial undertakings, which would further strengthen the bank's operations in preparation for an ultimate IPO or a sale to a foreign bank.

Simultaneously with the publication of this report, ISFI is submitting a proposal to the Minister to sell at least one-fifth of the state's holdings in Íslandsbanki, cf. Article 1 of Act no. 155/2012. The proposal is based on supporting factors in this report, relating to sale objectives, sale method and sale execution. If the Minister decides to initiate a sale process, cf. paragraph 2 Article 2 of Act no. 155/2012, the sale

⁷ It cannot be excluded that the bank uses excess capital to support growth or reserves.

⁸ Sjá <https://www.althingi.is/altext/150/s/0626.html>

⁹ The most recent example of such a development is the spread of the COVID-19 virus this year, which has had very negative impact on equity markets.

process, which will be managed by ISFI, cf. Article 4 of said Act, will take a minimum of six months after the decision. However, ISFI assumes that this part of the sales process will take longer, as the progress of the sales process will depend, amongst other things, on the development of the bank's ROE, market conditions and other factors.

Table S4 shows Íslandsbanki's financial calendar this year. The timing of earnings releases is expected to be similar in 2021 and 2022. During the sale process, ISFI will continue to monitor the progress made by Íslandsbanki with focus on that the ROE of the bank increases every quarter. In addition, ISFI will continue to monitor domestic economic growth developments compared to available forecasts and developments in domestic and foreign financial markets to be able to assess whether the bank is ready for sale at any given time, based on ISFI's criteria and the objectives of the ownership policy, which can be found in table S3. Furthermore, the disclosure of financial information by Íslandsbanki is important, as it determines IPO windows. For example, if a sale were to take place in September 2021, it would be on the basis of audited accounts for the first half of that year, and if a sale occurred in March 2022, it would be on the basis of information from the audited annual accounts of the previous year.

Table S4: Íslandsbanki's financial calendar for 2020

Date.	Event
12 th of February 2020	Publication of audited annual accounts for 2019
6 th of May 2020	Publication of interim statements for the first three months of 2020
29 th of July 2020	Publication of reviewed accounts for the first half of 2020
28 th of October 2020	Publication of interim statements for the first nine months of 2020

Table S5 shows, on the one hand, the decisions that need to be taken in the sale process, as stipulated by relevant law, and, on the other, the steps that must be taken in a dual track sale process of holdings in accordance with general accepted practices in financial markets. Respective legislations prescribe certain steps that must be taken in the sale process, from the date of publication of this report to the submission of the Minister's report on the sale process to Alþingi. It is acknowledged that the sale process must follow customary practices. Thus, the first steps in preparation could be the appointment of financial advisers and legal advisers of Íslandsbanki and ISFI. The appointment of a financial advisor would be related to the goal of strengthening Íslandsbanki's profitability and the appointment of legal advisers to prepare the bank in other respects for sale. These two work streams, shown in the table, are closely related. When formal sale process begins, ISFI will hire global coordinators. Furthermore, it is clear that after receiving offers, ISFI needs to submit an assessment of them and the Minister needs to take a position on them. It is also clear that the Minister will always need to give his consent to take various steps, such as the publishing of prospectus and initial IPO price range and subsequent amendments of the price range. ISFI and the Minister will enter into an agreement on a common understanding of the Minister's involvement in connection with the decision to initiate a sale process.

Table S5: Progress of the sale process of holdings in Íslandsbanki¹⁰

Criteria according to law	Criteria according to market practices
<ul style="list-style-type: none"> • ISFI publishes a status report on the planned sales process of Íslandsbanki hf. (item i. and j. of Article 4 of Act no. 88/2009) • ISFI submits a proposal to the Minister (Paragraph 1 Article 1 of Act no. 155/2012) • The Minister accepts ISFI’s proposal (Paragraph 1 Article 2 of Act no. 155/2012) • Minister prepares a memorandum and seeks comments from the Central Bank • Minister submits the memorandum to parliamentary committees • Minister gives the committees a deadline • Minister receives comments from the committees 	<ul style="list-style-type: none"> • ISFI and Íslandsbanki hire financial advisor • ISFI and Íslandsbanki enter into an agreement on cost sharing • ISFI and Íslandsbanki hire domestic and international legal advisors • Íslandsbanki opens a data room • Advisors conduct legal due diligence • Advisors perform a review of IPO readiness
<ul style="list-style-type: none"> • The Minister makes a decision whether or not a sale process is initiated (Paragraph 2 Article 2 of Act no. 155/2012) • ISFI conducts the sale process in accordance with the decision of the Minister on behalf of the state (Paragraph 1 Article 4 of Act no. 155/2012) 	<ul style="list-style-type: none"> • ISFI appoints global coordinators • Advisors conduct financial due diligence • Íslandsbanki and advisors prepare prospectus and information memorandum • Íslandsbanki and advisors submit a listing application to relevant exchanges • Advisors solicit expression of interest from potential investors • Advisors and Íslandsbanki hold early look meetings with potential investors • Parties prepare drafts of share purchase agreement and shareholder agreement • Íslandsbanki announces intention to float • Research analyst presentations • Publication of prospectus and initial price range • Roadshow presentations • Adjustment of price range • Book building process
<ul style="list-style-type: none"> • ISFI evaluates offers (Paragraph 2 Article 4 of Act no. 155/2012) • The Minister’s decision whether to accept or reject offers for holding and signs relevant agreements (Paragraph 2 Article 4 of Act no. 155/2012) • The Minister submits a report on the sale process to Alþingi (Article 5 of Act no. 155/2012) 	<ul style="list-style-type: none"> • Final pricing and settlement

¹⁰ Reference: ISFI. It is assumed that at every time there will be an authorisation in the yearly general bill to the holdings.

As stated above, ISFI is submitting a proposal to the Minister simultaneously with the publication of this report, cf. Article 1 of Act no. 155/2012. If and when the Minister has accepted the proposal by ISFI, cf. Paragraph 1 Article 2 of Act no. 155/2012, he is required to prepare a memorandum and submit it to the Budget Committee and the Economic Affairs and Trade Committee of Alþingi, as well as to seek the views of the Central Bank, cf. same article.

According to the provisions of the second Paragraph of Article 2 of Act no. 155/2012 "[the parliamentary] committees shall be given a reasonable period to comment on the substance of the memorandum", but sections of this report reflect the content of such a memorandum. As there is no further explanation of the term "reasonable time limit" in the aforementioned provision, it is not possible at this time to predict how long the submission of the Minister's memorandum and parliamentary procedure will take.

When the decision of the Minister to initiate a sale process is made, ISFI will manage the process, cf. Paragraph 1 Article 4 of Act no. 155/2012 and item j. Article 4 of Act no. 88/2009. In this regard, ISFI must "prepare [sale], [seek] offers in holdings, [evaluate] offers, [manage] negotiations with external advisors and prospective buyers, and handle contract negotiation", cf. Paragraph 1 Article 4 of Act no. 155/2012. When an offer for a holding is put forth, cf. Paragraph 2 Article 4 of Act no. 155/2012, ISFI is required to submit a reasoned assessment of any offers to the Minister. The Minister then makes a decision "whether to accept or reject offers and signs agreements on behalf of the state on the sale of the holding", cf. the same article.

Proceeds of the sale is determined by the number of shares sold and the price to book ratio of the shares sold. Table S6 shows the proceeds from the sale of a 20%, 50% and 100% holding, compared to a price to book ratio from 0.6x to 1.0x. This shows that the sale proceed is in a very wide range, or from 21.3 billion krónur. to 177.6 billion krónur, according to these assumptions. The use of proceeds from the sale of the shares is not in the hands of ISFI, but the agency considers it important that the plans on the use of proceeds be made available as soon as possible. Such intentions promote public confidence in the sale process, as is pointed out in the report, *Corporate Governance: A Policy Maker's Guide to Privatization*, by the OECD.¹¹ If the holding is sold through an IPO it is desirable to aim for a benchmark size IPO, which is about 500 million euros or dollars. To reach such a size, about one half of the shares in the bank would have to be sold at a price to book multiple of 0.8x.

Table S6: Proceeds from sale of holdings, by size of stake and price-to book multiple (amounts in billions of krónur)¹²

	<u>20% stake</u>	<u>50% stake</u>	<u>100% stake</u>
0.6x	21,3	53,3	106,6
0.8x	28,4	71,1	142,1
1.0x	35,5	88,8	177,6

¹¹ See page 31 in the report: <https://www.oecd-ilibrary.org/docserver/ea4eff68-en.pdf?expires=1580138247&id=id&accname=guest&checksum=75D3AFD3BB206A94C28A00833074CF9C>

¹² Ref.: ISFI. Book value of shareholders equity as of 30th September 2019.

At this time, it is not possible to provide a detailed time plan for the sale of holdings in Íslandsbanki. On the contrary, it is clear that if the holdings are sold through an IPO, it will take a considerable time to sell the government’s entire stake in the bank. Although it took Kaupthing just over two years to sell its 87% stake in Arion Bank, a comparison of other European countries, where Treasuries have sold shares in banks, suggest that a further sell down of shares takes a longer time. Table S7 shows how the process can be in regards to the sale of all the holdings in Íslandsbanki after the initial sale. If all shares in the bank were sold to a foreign bank, there would be no further sale. However, ISFI considers it unlikely that a foreign financial undertaking will show interest in domestic banks, as there is little activity in cross border bank mergers and while Iceland's status on the Financial Action Task Force list is unchanged. It is, however, evident that the authorities in Iceland aim to have the country removed from the list next before the next fall and therefore it is unlikely that the status will affect the sale process adversely.

If the first sale would be to a specialized institutional investors, with expertise in the operations of financial undertakings, then further sales would either be followed by an IPO or sale to a foreign bank. It is also possible that the co-owners with the state in the bank, i.e. specialized institutional investors, would also sell at the same time. Following an IPO, it is clear that all future sale of shares will take place through further IPOs given that shares in the bank are already listed on a regulated market at that time.

Table S7: Potential sale process of all the shares in Íslandsbanki after initial sale

