Report on HF Fund - Summary

The purpose of the report is to inform Althingi of the process of the wind down of HF fund's assets and liabilities and the potential impact on the Treasury as relates to its guarantee of collection for the fund's debts. HF Fund was established by law in December 2019 with the purpose of minimising the Treasury's risk and cost in relation to the processing and settlement of the accumulated financial problems of its predecessor the Housing Financing Fund. The supervision of the HF Fund was at the same time transferred to the Ministry of Finance and Economic Affairs.

The report briefly explains the reasons for the financial problems of the HF Fund, that are rooted in the operations and financing of the Housing Financing Fund, as well as reviewing the processing of the HF Fund since its establishment. The report also includes an assessment of the fund's future financial developments and the impact on the Treasury, due to expected continued loss on operations. Therefore, the Minister of Finance and Economic Affairs considers it urgent to begin preparations and discussions in Althingi on when and in what way the Treasury will settle its guarantee.

The Housing Financing Fund was established in 1998 and took over the implementation of housing policy and lending from the State Housing Authority in accordance with the comprehensive review of housing legislation passed by Althingi on 3 March 1998. Since its establishment, various changes have been made to the operation and financing of the Fund.

The financial problems of HF Fund are mostly related to changes made to the financing arrangements of the Housing Financing Fund in 2004 when the older housing bond system was transformed and the issuance of the HFF bonds was established. In the previous arrangement, the fund had the possibility to repay its debt if the repayments of loans proved to be material, thus maintaining a balance between the cash flow of assets and liabilities. In the new system, the fund's financing had fixed cashflow with no prepayment options. Borrowers, on the other hand, have always been permitted to repay their loans at any time. Although part of the loans carry a prepayment fee, they only compensate for a part of the fund's losses on prepayment.

Soon after this change in the fund's funding, competition in the mortgage market increased and borrowers repaid their loans with the Housing Financing Fund to a significant extent. This trend has remained largely to this day, varying in periods due to the state of the financial market. After the financial crisis in the beginning of 2008, loan repayments decreased, but with the increased supply of mortgages from banks and pension funds, prepayments have proved significant since 2015. In addition, due to recommendations of the EFTA Surveillance Authority (ESA) in 2011, the Fund's lending activities were bound by significant restrictions implemented by legislation in 2012. Since that time, lending was mostly on social terms, thus significantly limiting new lending.

It has been clear for some time that the HFF funding arrangements were no longer suitable. Declining interest rates in recent years have resulted in lower interest income for the cash generated from prepayments leading to negative interest income. Given current and expected conditions the HF Fund is expected to generate further losses of operation.

When the HFF bonds were issued, the Treasury took on a guarantee of collection for the Housing Financing Fund. A guarantee of collection means that when it is confirmed that the debtor is unable to make payments and does not have assets to fulfill its obligation, the guarantee will come into effect. This is different from a surety that can be called upon at any time alongside the liability of the issuer.

Estimates based on the fund's 2022 mid-year results, show that the fund will be able to pay installments and interest on its obligations until 2034 and that no later than then the guarantee of collection of the Treasury will be tested. In that year the fund's position is expected to be negative by approximately ISK 260 billion, or present value of ISK 170 billion. If the fund was to be provided funding and it operated until 2044 when all debt has matured, the Treasury would have to contribute a total of ISK 450 billion, or ISK 200 billion in present value. However, if the fund was to be liquidated now, assets sold and distributed to the creditors for payment of debt in nominal value, the negative position would amount to ISK 47 billion.

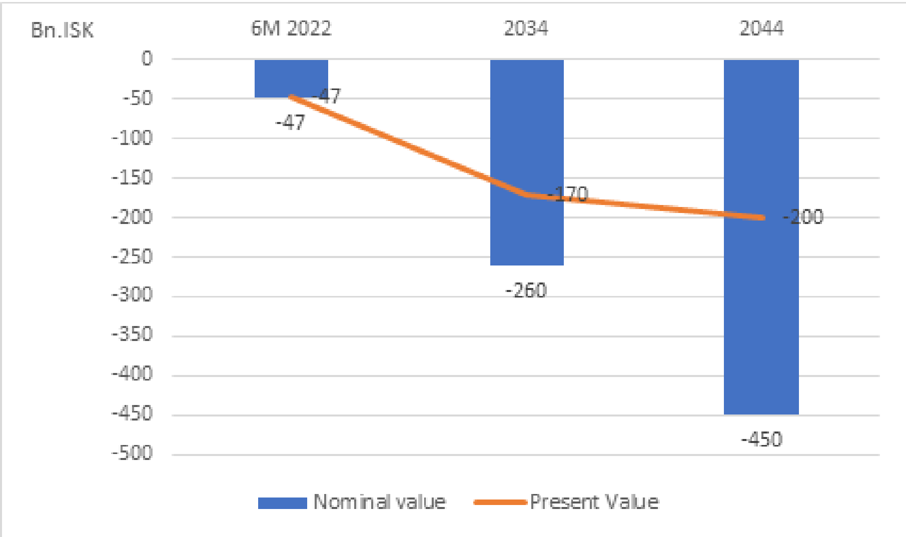

Figure 1: *Assessed capital position at different time points in nominal and present value.*

Figure 1 shows the estimated cost to the Treasury for settling the guarantee of HF Fund´s debt at three different points in time. It is clear that the cost of settling increases over time. Such estimates are affected by considerable uncertainty and should therefore be seen as a benchmark that could change. They highlight, however, how the fund's financial condition deteriorates over time. Market movements affect the market value of both assets and liabilities and therefore these figures are subject to changes. Increases in market interest rates in the past months are likely to increase losses on settlement, i.e. the value of the fund's assets has fallen. They also affect the value of these assets in the owners' books, which has likewise declined. Furthermore, increased inflation has a negative effect because indexed debt is higher than indexed assets and it is clear that inflation in 2022 will be higher than in the assumptions underlying the model.

The division of the Housing Financing Fund in 2019 and the Act establishing the HF Fund laid the foundation for the wind down of the fund's assets and liabilities. Due to the fiscal uncertainty caused by the coronavirus pandemic, those measures were delayed. The timeline has also been affected by issues that needed clarification, including an agreement with the Housing Fund to issue bonds as payment for the loan portfolio and seeing the litigation on the prepayment fees come to an end. As these things become clearer, it becomes increasingly urgent to make decisions on the wind down of HF Fund that meet the objectives of the Act to minimize the risk and costs to the Treasury as guarantor. In accordance with that Act, a special advisory task force was appointed last April to advise the Ministry in this work which is now underway.

Due to the large nature of the issue, its impact on the Treasury and numerous other parties, it is necessary to start preparations and discussions on how and when the Treasury will settle its guarantee. It is important that there is no uncertainty, equality of creditors is guaranteed and interests of taxpayers respected.

Althingi must at some point take a stance on the matter, how it will be handled, including whether further funds will be invested in the HF Fund or in other forms of settlement of its obligations. There are various arguments for seeking opportunities to liquidate the fund so that its assets can be sold or handed over as a settlement of debt in order to stop the accumulation of cost and expense to the Treasury as guarantor. In doing so, the amount of the Treasury's guarantee should be established sooner rather than later and financed in a more efficient way. The cost of settlement can be expected to increase by ca. ISK 1.5 billion per month that passes.

The Minister will present the matter to Althingi in a statement as well as a report. The aim of the report is to give Althingi the opportunity to establish an understanding on the matter, the Fund’s position and history, as well as, as the case may be, to give feedback to the Minister before further parliamentary proceedings.