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Gunnar Axel Axelsson
Head of National accounts and public
finance department
Statistics Iceland
Borgartún 21A
105 Reykjavík
Iceland

Subject: Advice on the classification of the Housing Financing Fund

Ref.: Your letter of 8 June 2020

Dear Mr Axelsson,

Following your letter under reference, Eurostat would like to provide you with its opinion on the sector classification of the Housing Financing Fund (HFF), as requested by the Icelandic statistical authorities.

1. The accounting issue

The issue for which an opinion is being sought is the sector classification, according to ESA 2010, of the HFF for the years of its existence since 1999 until it was merged in 2020 into a new entity, the Housing and Construction Agency (HCA). An advice on the sector classification of the HCA was also requested.

1.1. Documentation provided

The Icelandic statistical authorities provided to Eurostat a note with detailed background information about the HFF, accompanied with a methodological analysis of the sector classification of the HFF as well as the of the newly created HCA.

1.2. Description of the case

The HFF was established in 1999 by the Housing Act No. 44/1998 as a government institution in order to support the government housing policy through promoting private home ownership at economic conditions available to all. The main tasks were the granting of mortgage loans (to individuals, municipalities, companies and to associations for the construction/purchase of rental housing and for construction of nursing homes), the payment

of housing benefits, the monitoring of housing needs in Iceland and assisting municipalities in realisation of housing policy.

The HFF was classified in the financial corporations sector (S.12) for all the years of its existence in 1999-2019.

The HFF financed its activities mainly by issuing bonds and, to a lesser extent, via loan instalments and service fees. The HFF benefited from an unlimited and irrevocable government guarantee on liabilities. The assets of the HFF mainly consisted of the loans granted. According to law, the HFF could not accept deposits.

In the first years of its existence, the HFF performed the role of the main mortgage loans lender, reaching almost an 80% share in the housing loans market. In 2004, the HFF's dominance dramatically dropped, due to the introduction of mortgage loans provided by commercial and savings banks at more favourable conditions. As a result, HFF's clients decided to refinance their loans with those from commercial banks and repaid their loans to the HFF before maturity.

As a consequence of the financial crisis in 2008, the HFF suffered losses due to significant amounts of non-performing loans. The Icelandic Treasury provided to the HFF a capital injection of more than ISK 50 billion, recorded as expenditure in national accounts.

In 2019, the Icelandic Parliament (Althing) approved a law, according to which the HFF was merged with the Iceland Construction Authority into a new institution - the Housing and Construction Agency (HCA). Accordingly, the HCA took over the policymaking and research on the housing market, the supervision of public housing support and the granting of social housing loans. The HCA, under the responsibility of the Ministry of Social Affairs, manages the Housing Fund (HF-Fund) and a rental company, Bríet. Furthermore, according to the Act on the processing of assets and liabilities of the HF-Fund, all marketable issued bonds and mortgage loans granted by the HFF before 1 January 2013 were transferred to the so-called IL-Fund, which falls under the responsibility of the Ministry of Finance.

2. Methodological analysis and clarification by Eurostat

2.1. Applicable accounting rules

Based on the documents provided, Eurostat carried out its analysis based on *ESA 2010* and on the *Manual on Government Deficit and Debt* (MGDD) published in 2019, in particular:

- ESA 2010, Chapter 2: in particular, ESA 2.12 dealing with the definition of an institutional unit;
- ESA 2010, Paragraphs 2.21-2.23 on captive financial institutions;
- ESA 2010, Chapter 3: in particular ESA 3.19 on economically significant prices;
- ESA 2010, Paragraphs 20.32-34 and 20.22 on market-non-market delineation, paragraphs 20.15 and 20.309 on public sector control; paragraphs 20.06 on the nature of government entities and 20.204 on fiscal operations;
- MGDD 2019 in section 1.6.6 Entities having the features of captive financial institutions.

2.2. Availability of national accounting analysis

In the analysis provided to Eurostat, the Icelandic statistical authorities described in detail the history, the changing role of the HFF since its creation and the HFF's governance. Further information was provided on financial resources and lending conditions and some data were disclosed on assets and liabilities of the HFF. The analysis of the newly created HCA covered similar characteristics, extended in addition to the description of individual funds of the HCA – the HF-Fund and the IL-Fund.

2.3. Analysis

2.3.1. Sector classification of the HFF

2.3.1.1. The HFF as a government controlled unit

ESA 20.15 defines control over an entity as “*the ability to determine the general policy or programme of that entity*”. In order to determine the existence of control by government over a non-profit institution, ESA further develops the criteria such as (a) the appointment of officers; (b) the provision of enabling instruments; (c) contractual agreements; (d) the degree of financing and (e) the degree of government risk exposure.

The HFF was established as a non-profit government agency with the aim to promote the government housing policy by granting loans at favourable terms. Due to its specific status of a government agency (thus not being a financial institution), it was not subject to domestic or international banking regulations. Furthermore, by government decision, the HFF was exempted from various payment obligations such as taxes or guarantee fees.

According to the Article 7 of the Housing Act, the Minister of Social Affairs appointed the Board of Directors of the HFF. The Board consisted of five members and additional five in reserve, all without nomination, for four years. The Minister decided on the remuneration of the Board members. None of the Board members was a government official, however, all members were actively or otherwise connected to the ruling political party. In 2012, the Housing Act was amended and certain eligibility requirements for the Board members were introduced.

The HFF was not directly financed by government, however, it benefited from the unlimited and irrevocable guarantee of government on the HFF's liabilities. Thus, it was the government that bore the risks related to the financing of the HFF's activities.

Given the elements described above, the HFF can be considered a government controlled entity.

2.3.1.2. The HFF as an institutional unit

The HFF was created as a non-profit government agency with the aim to support the government housing policy, in particular by granting mortgage loans to individuals, municipalities, companies and associations for the construction/purchase of rental housing and for construction of social housing and for other functions aiming to pursue public policy objectives.

The ISLF is currently classified in the financial corporation sector (S.12). According to ESA 2.22, “*the degree of independence from its parent may be demonstrated by exercising some*

substantive control over its assets and liabilities to the extent of carrying the risks and reaping the rewards associated with the assets and liabilities. Such units are classified in the financial corporations sector.”

The responsibilities of the HFF were always determined by the respective law and, in case of political decisions, they were modified on the bases of legislative changes. As an example, in 2016, the Icelandic government assigned to the HFF, in addition to its existing functions, the task of the providing loans for the construction of nursing homes, the distribution of housing benefits and providing of grants for the construction of social housing. Over the years of its existence, the core activity – to promote government housing policy by granting mortgage loans – has not been changed and interested individuals/entities, complying with general conditions and accepting the HFF’s loans terms, could be granted a mortgage loan. The Ministry of Social Affairs could interfere with lending conditions of the HFF via laws and regulations issued by the Minister.

As concerns financial resources, in 2004, as a result of the political reform, the HFF changed the financing from a housing bond system¹ to the direct issuance of housing bonds.

Based on the arguments above, it can be considered that government controlled assets and liabilities of the HFF and, thus, the entity cannot be deemed an institutional unit but rather as functioning on autopilot, as defined by ESA 2.23: “*An entity of this type that cannot act independently of its parent and is simply a passive holder of assets and liabilities (sometimes described as being on autopilot) is not treated as a separate institutional unit unless it is resident in an economy different from that of its parent...*”

2.3.1.3. The HFF as a financial intermediary

The analysis above point out that the HFF might be deemed to be a captive public financial institution.

The HFF was established as a non-profit government agency with specific tasks in the housing policy of government. According to the Icelandic law, the HFF did not have a status of a financial institution and thus could not accept deposits. All HFF liabilities benefit from a government guarantee. Due to its special character, the HFF was exempted from complying with capital adequacy requirements as well as from adhering to domestic or international banking regulations.

The lending activities of the HFF were to a significant extent determined by legislation. In particular, the Housing Act defined the main beneficiaries of the housing loans provided by the HFF, namely individuals, municipalities and selected organisations. Later on, following legislative changes, the HFF’s role was extended to the provision of housing benefits, the granting capital contributions in rental housing, etc. In general, the HFF provided mortgage loans to all complying with formal requirements, including those that were unable to obtain housing loans elsewhere in the market, due to various reasons. This is an indication of the non-market nature of the HFF activities.

¹ Under the Housing Bond system, the homebuyers applied to issue a mortgage bond, which was secured against the property to be bought. The HFF would acquire these individual mortgage bonds from homebuyers, and paid for them by issuing Housing Bonds (callable, CPI-linked) to the seller. These Housing Bonds could then be traded in the securities market.

Similarly, lending conditions of the HFF were always regulated by law. Accordingly, the Housing Act and the regulation issued by the Minister of Social Affairs determined the maximum amount of a loan and the maximum loan-to-value ratio. The maturity of loans was limited to 40 years. The loans bore a fixed interest rate, which however strictly followed the rate of financing costs of issued bonds plus an interest premium. In the beginning of the HFF's existence, this regulation implied more favourable financing terms for potential debtors. With increasing competition of commercial and savings banks offering better conditions, those restrictions on lending conditions resulted in a significant drop in the number of loans provided and, consequently, in an excess of liquidity due to continuing issuance of bonds. Additionally, the HFF was also restricted in seeking more flexible financing terms, which prevented it from reacting on market movements, i.e. fluctuations in the interest rate and thus, the conditions it could offer to borrowers. This is another strong indication of the non-market character of the HFF's activities – it did not compete on the market.

As concerns the constraints on the liability side, the Article 10 of the Act on the HFF defined the sources of funding of the HFF's activities. In particular, these were returns on the HFF's equity, bonds issued and contributions from the Icelandic Treasury. During its existence, the HFF received interest subsidies from government, which covered the difference between lower interest rates received by the HFF on loans and the financing cost incurred when borrowing. The HFF was therefore not exposed to any financial risk that could stem from lending at lower interest rates and the interest rate subsidies meant additionally that it was involved in fiscal operations.

The HFF also benefited from the unlimited and irrevocable guarantee of government on its liabilities. Due to the specific HFF's status of a government agency, it was able to borrow at interest rates similar to those of government.

It is also worth to mention that the HFF was exempted from the payment of income and property taxes as well as from the specific tax on financial corporations introduced after the financial crisis. As indicated by the Icelandic statistical authorities, the exemption from various payments including guarantee fees, constituted a considerable amount of government financing in an indirect form.

Given the arguments above, the HFF did not exercise control over its assets and liabilities and, accordingly, cannot be treated as a separate institutional unit. In accordance with ESA 2.23, the HFF, acting as an "autopilot", is to be consolidated with government, as the controlling unit, and classified in general government.

2.3.1.4. Conclusion

Eurostat considers that the HFF, existing over the period 1999-2019, complied with the definition of an entity having the features of a captive financial institution controlled by government and, as a passive holder of assets and liabilities (so-called 'autopilot'), should be classified in the general government sector (S.13) during the whole period of its existence. Its activities additionally exhibit a non-market character.

2.3.2. Sector classification of the HCA

After the merger, the newly created HCA took over administrative tasks from the former Iceland Construction Authority in the field of housing, civil engineering, electrical safety and

construction and fire protection. From the former HFF, the HCA assumed responsibilities relating to research on the housing market, supervision of public housing support and granting of social housing loans. The HCA is under the direct supervision of the Ministry of Social Affairs.

The HCA manages the Housing Fund (HF-Fund), one of two funds created by transferring loans granted by the former HFF after 1 January 2013 and an equivalent portion of debt and equity. It also took into its portfolio the management of the rental company Bríet, established by the HFF in 2018.

The remaining assets and liabilities of the former HFF, i.e. tradeable issued bonds and mortgage loans provided before 1 January 2013, remained with the second fund – the so-called IL-Fund. Unlike the HCA, the IL-Fund is under the supervision of the Ministry of Finance.

Eurostat took note that the governing structure of the HCA remained similar to that of the HFF with some minor changes. According to Article 4 of the Act, the Minister of Social Affairs appoints four out of five members of the Board of Directors, including its Chairman. The remaining member is nominated by the Icelandic Association of Local Authorities. Similarly to the HFF, none of the Board members is a government official, however, all members were actively or otherwise connected to the ruling political party.

The law regulates all activities of the HCA. Three main types of activities of the new HCA might be distinguished:

- Administration and regulation (formerly in the agenda of the Iceland Construction Authority)
- Granting of social housing loans (former HFF's activity taken over by the HF-Fund)
- Separating from lending activities the portfolio management of those assets and liabilities that could potentially imply financial difficulties due to its portfolio structure (former HFF taken over by the IL-Fund)

Eurostat took note that, under the HCA, the main features of those three activities remained unchanged and were merged under one institution. In addition, the IL-Fund is under the supervision of the Ministry of Finance.

The HCA is financed from government contributions, contributions received from the HF-Fund and from service fees. The administration and regulation tasks of the HCA are, however, solely financed by the HF-Fund, which, according to law, transfers to the HCA most of the interest income received on loans granted for this purpose.

Given the elements above, the HCA can be considered a government controlled entity.

2.3.2.1. Administrative and regulatory activity of the HCA

In relation to the administrative tasks of the HCA in certain areas such as construction, fire protection and electricity safety, the HCA acts as a pure government agent and, similarly to its predecessor, the Iceland Construction Authority, the entity performs regulatory government functions, in particular the administration and preparation of law, the regulation and the issuing of guidelines. This is in line with ESA 20.06: *“Government units are legal entities established by political process which have legislative, judicial or executive authority*

over other institutional units within a given area.” and with ESA 20.204: “Fiscal operations are carried out by government and financed through the budget under the usual budgetary procedures. However, some operations originated by government units may involve the intervention of entities not ruled by the legal government framework, including public corporations. Though they will not be reported in the budget, and might escape the usual control procedures, it is appropriate to record them within government revenue and expenditure. This is because the ESA recognises when government is the principal party to an operation and the public corporation is acting as an agent.”

2.3.2.2. Granting of social housing loans (HF-Fund)

The HF-Fund was created as one of the HCA’s funds that took over the social housing loans granted by the former HFF after 1 January 2013 and an equivalent portion of debt and equity. According to law, the supervision of the HF-Fund is assigned to the HCA’s Board of Directors that also manages the loan portfolio, the accounting and the preparation of annual accounts. The law does not foresee any governing body that would deal with a separate management of the HF-Fund.

The main role of the HF-Fund is to support the government housing policy, in particular by granting social housing loans to specific beneficiaries and by other functions aiming to pursue public policy objectives. As in the case of the HFF, it is the law that stipulates conditions and beneficiaries of the social housing loans provided by the HF-Fund, in particular the maximum amount and maturity of loans, the maximum loan-to-value ratio and some limitations on interest rates that are fixed and linked to the CPI index. The allocation of funds outside the scope defined by the law is prohibited.

The Icelandic statistical authorities specified that the interest (or a majority of it) received by the HF-Fund on social housing loans was intended to finance the operational activities of the HCA, i.e. expenses relating to the supervision of construction projects, fire protection, etc. The remaining interest income will be transferred to the IL-Fund and is intended to cover the interest expenditure accrued on the loan provided by the IL-Fund to the HF-Fund at inception to finance the transfer of housing loans portfolio. The interest payments to the IL-Fund are not proportionate to any interest rates and, therefore, should be seen rather as a regular levy to the HF-Fund than accrued interest.

The main resources of the HF-Fund are loan instalments including the interest and the return on equity. It might additionally receive loans from the Treasury to increase the lending capacity. Additional rules regarding the operation and funding are stipulated in the Minister’s regulation. It has to be stressed that the HF-Fund also benefits from the unlimited and irrevocable government guarantee on liabilities.

Based on the elements above, Eurostat considers that the HF-Fund is not able to take economic decisions or incur liabilities on its own behalf and it is fully under the control of the HCA and, therefore, of government. The entity cannot be deemed a financial intermediary either, as it does not place itself at risk by acquiring financial assets and incurring liabilities on its own account. As a result, risks and rewards remain with the controlling unit, i.e. with the HCA, and the HF-Fund should be included in the general government.

2.3.2.3. *Public defeasance structure (IL-Fund)*

The IL-Fund was established with the main objective of undertaking the processing and settlement of the assets and liabilities of the former HFF issued before 1 January 2013. According to Article 1 of the Law on the IL-Fund, this means to minimize the risks and costs of the Treasury due to the cumulative financial difficulties of the former HFF. As clarified by the Icelandic statistical authorities, it is not the loans that are considered risky or unlikely to be paid but rather the assets that are not considered sufficient to cover the future obligations of the IL-Fund. Currently, the IL-Fund's net equity is estimated to be negative approximately by ISK 130 billion.

Concerning the financing, in the last years of its existence, the former HFF has cumulated a considerable amount of liquidity due to the constant overflow of loans repayments, exceeding the loans granted. It is expected that these funds will be invested by the IL-Fund to cover in the future potential losses resulting from the difference between interest paid on issued bonds and lower interest accrued on social housing loans. Currently, it is not foreseen to have any additional funding. There is a government guarantee provided on assets and liabilities of the IL-Fund.

The IL-Fund is under the direct supervision of the Ministry of Finance, which determines the investment strategy and risk management. The Minister also appoints a three-person committee to advice on the processing of assets and liabilities of the IL-Fund. Furthermore, the law stipulated that the IL-Fund would operate without the supervision of the Financial Regulation Authority.

Given the characteristics above, Eurostat agrees with the proposal of the Icelandic statistical authorities that the IL-Fund is considered a special purpose unit, as defined by ESA 2.27: *“General government may also set up special purpose units, with characteristics and functions similar to the captive financial institutions and artificial subsidiaries. Such units do not have the power to act independently and are restricted in the range of transactions they can engage in. They do not carry the risks and rewards associated with the assets and liabilities they hold. Such units, if they are resident, shall be treated as an integral part of general government and not as separate units.”* Therefore, the entity should be classified inside general government.

2.3.2.4. *Conclusion*

After the merger, the HCA took over three main activities. With regard to the regulatory and administrative powers, the HCA acts as a government controlled entity, substituting legislative, judicial or executive authority over other institutional units within a given area. In relation to the granting of social housing loans (HF-Fund), the entity does not exercise control over its assets and liabilities and cannot be deemed as being a financial intermediary. Concerning the management of assets and liabilities, implying potential financial difficulties of the HCA due to its portfolio structure (IL-Fund), the entity acts as a financial defeasance structure controlled by government. All arguments previously mentioned point out to the fact that the HCA cannot be treated as a separate institutional unit and should be classified with a controlling unit inside general government.

3. Conclusions

Eurostat considers that the HFF, existing over the period 1999-2019, complied with the definition of an entity having the features of a captive financial institution controlled by government and, as a passive holder of assets and liabilities (so-called ‘autopilot’), should be classified in the general government sector (S.13) during the whole period of its existence.

Concerning the classification of the newly created HCA, Eurostat considers that activities of the HCA are assigned to a government unit performing regulatory powers or to an entity acting on behalf of government in the area of the granting of social housing loans (HF-Fund) and to a financial defeasance entity (IL-Fund). Accordingly, the HCA cannot be deemed as being a separate institutional unit and should be classified with the controlling unit inside general government.

4. Procedure

This view of Eurostat is based on the information provided by the Icelandic statistical authorities. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information presented, Eurostat reserves the right to reconsider its view. In this context, we would like to remind you that Eurostat is committed to adopt a fully transparent framework for its advice on debt and deficit matters in line with Council Regulation 479/2009, as amended, and the note on ex-ante advice, which has been presented to the CMFB and cleared by the Commission and the EFC. In this context, Eurostat is providing advice under the provisions of Regulation 549/2013, Article 2(3).

Eurostat is therefore publishing all official methodological advice (ex-ante and ex-post) given to the European Statistical System Members on its website.

Yours sincerely,

(eSigned)

Luca Ascoli
Director