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Subject: Advice on the classification of the Icelandic Student Loan Fund and recording of student loans

Ref.: Your letter of 14 February 2020
Your email of 13 March 2020

Dear Mr Axelsson,

Following your letter under reference, Eurostat would like to provide you with its opinion on the sector classification of the Icelandic Student Loan Fund (ISLF) and on the appropriate recording of the student loans provided by the ISLF, as requested by the Icelandic statistical authorities.

1. The accounting issue

The issue for which an opinion is being sought is the sector classification under ESA 2010 of the ISLF under the current legislative arrangements and a potential sector classification of the ISLF, following the changes proposed in the amended draft law. An advice is also requested on the recording of student loans provided by the ISLF according to the current legislation as well as according to the draft law.

1.1. Documentation provided

The Icelandic statistical authorities provided to Eurostat a copy of the following documents:

– Analysis of the ISLF classification and recording of the student loans

– Icelandic Student Loan Fund Act No.21/1995 – English version

– Regulation No. 478/2011 on the Icelandic Student Loan Fund - English version

– The Icelandic Student Loan Fund Allocation Rules 2019-2020 - English version

– Bill for new laws regarding the Icelandic Student Loan Fund - in Icelandic

– Summary of the Fund's annual accounts 1995-2018 - excel file

1.2. Description of the case

The ISLF was established by the Act No.21/1992 as a government agency with the aim to support Icelandic citizens in their university or similar studies, by providing low interest rate loans. The main objective is to guarantee sufficient funds to all students, irrespective of their financial situation to meet tuition and other costs and taking into account the size of the student's family.

The ISLF is currently classified in the financial corporations sector (S.12).

The main funding resources of the ISLF are government contributions, constituting more than 50% of total inflows on average, repayments of student loans and loans provided by the Treasury. According to the law, the ISLF is neither allowed to borrow on the market nor to issue bonds. According to the legislation, the Icelandic government unconditionally guarantees the liabilities of the ISLF.

In general, student loans provided by the ISLF are low interest rate loans, i.e. below the rates at which the Treasury acquires capital on the market. In the past, the ISLF ran several schemes, which mostly differed in parameters on the student loans schemes. Under the current scheme (in force since 2005), student loans are CPI-indexed with a 1% interest rate. The repayments that are income related are set at 3.75% of the aggregate municipal tax and capital income tax base. The repayment schedule usually begins two years after the completion of studies and is not limited in the number of years.

In 2019, the Icelandic government presented a draft law introducing certain changes in the mechanism of student loans that might come into force at the end of 2020. According to the draft, the new student loans can be non-indexed or CPI-indexed with floating interest rates. The interest rates will be based on the Treasury's terms of financing as well as on a fixed interest rate premium that is intended to meet the ISLF's expected write-offs due to default or death of borrowers. In specific circumstances, the interest rate might be capped by the decision of the Minister of Education.

The repayment period is limited by the age of a debtor and, in normal situation, it starts one year after the completion of studies. The debtors who complete their studies before the age of 35 might choose between fixed monthly instalments or income-related instalments that are currently set at 0.3125% of the income base.

The beneficiaries of the student loans who complete a degree within a specified period can receive a scholarship for an amount of 30% of the loan principal that is paid after the completion of studies. In certain cases, the Minister might decide to increase the grant over the common ratio of 30%.

Eurostat took note that the amended law, as described in the letter, does not introduce any changes to the institutional structure of the ISLF or to its governance. No changes are foreseen in the means of available financial resources and government support of the ISLF. Thus, the proposals for changes concern the mechanism of granting student loans.

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, Paragraph 3.19 on economically significant prices;
- ESA 2010, Paragraphs 20.32 and 20.22 on financial intermediation, paragraphs 20.18 and 20.309 on public sector control;
- MGDD 2019 in part 1.6.6 Entities having the features of captive financial institutions
- MGDD 2019 in part 4.7 Recording of income contingent loans.

2.2. Availability of national accounting analysis

The Icelandic statistical authorities focused the analysis provided to Eurostat on the ISLF compliance with the criteria of being an institutional unit defined in ESA 2.12, on control by government, as defined in ESA 2.38 and on the analysis of the market/non-market character of the ISLF or, alternatively, on whether the ISLF fulfils the criteria for being a financial intermediary.

On the issue of the sector classification, the Icelandic statistical authorities concluded that the ISLF should be classified with the controlling unit, i.e. inside the general government sector (S.13). The Icelandic statistical authorities further considered that, in their view, the proposed changes in the amended act that are foreseen to come in force in 2020 did not have implications on the sector classification of the ISLF.

In the second part of the analysis, the Icelandic statistical authorities provided a proposal for the treatment of ISLF's operations. Assuming that sufficient information is available to determine in a satisfactory way the potential losses of the loan portfolio and expected loss at inception due to contingency elements, they proposed to apply the MGDD rules for the recording of income contingent loans and, accordingly, to record part of loans provided by the ISLF as a financial transaction (AF.4/F.4) and part as a government expenditure (D.9).

According to the Icelandic statistical authorities, the proposed legislative changes did not foresee any implications in the treatment of loans provided by the ISLF, as explained above.

2.3. Analysis

2.3.1. Sector classification of the ISLF

<u>The ISLF as an institutional unit</u>

ESA 2.12 sets out the rules according to which an entity is to be considered an institutional unit. According to the Icelandic statistical authorities, the ISLF is *able to draw up a complete set of accounts, as well as a balance sheet of assets and liabilities* and, therefore, it does comply with the letter (d) of paragraph ESA 2.12.

The ISLF does not fulfil another two criteria, i.e. *to be entitled to own goods and assets in its own right; to be able to exchange the ownership of goods and assets in transactions with other institutional units* (letter (a)), and *to able to take economic decisions and engage in economic activities for which it is responsible and accountable at law* (letter (b)).

By legislation, the ISLF was created with the aim to pursue public policy objectives, i.e. to guarantee to interested persons an access to university or similar studies by way of providing student loans regardless of their financial situation. The article 5 of the Act on ISLF strictly limits the activities of the ISLF that are carried out via the Board of Directors of the ISLF.

The student loans are granted to all applicants complying with formal conditions, irrespective of the creditworthiness of a client or of the expected recoverability of the loan, which usually depends on the expected future income of the debtor or collateral provided. It is government that provides guarantees to cover potential losses of the ISLF in case loans turn to be non-performing.

The Article 4 of the Act stipulates that the Minister of Education appoints the Board of Directors of the ISLF. The Board consists of four members nominated by students associations, one member appointed by the Minister of Finance and three remaining members without nomination. The appointment of a representative of the Minister is limited to the term of the Minister's appointment.

The Minister of Education may issue further provisions on the implementation of the Act. All rules stipulated by the Board itself, including on the allocation of student loans, are subject to the approval of the Minister. The Minister also appoints the Director General of the ISLF, upon receiving proposals from the Board.

The main tasks of the Board include determining various rules of the Fund, overseeing daily operations and dealing with requests regarding exemptions to the rules of the ISLF (such as delayed payments, irregular applications e.c.t.).

In order to be an institutional unit, the ISLF should further be *able to incur liabilities on its own behalf, to take on other obligations or further commitments and to enter into contracts* (ESA 2.12, letter (c)). By the legislation, the ISLF is not permitted to seek financial resources on the market nor to issue bonds. The article 15 of the Act defines that the ISLF is funded from the student loan repayments, including interest, contributions from the State and loans, which are de facto limited to credits granted by the Treasury. The liabilities of the ISLF are guaranteed by the State, which acts as the entity of last resort in case of any potential credit default of the ISLF.

On the basis of the above, Eurostat considers that the ISLF does not fulfil the definition of institutional unit, as defined by ESA 2.12. The ISLF was established as a special purpose entity with a narrow scope of activities defined by legislation. It owns assets and incurs liabilities, however, it has a limited control over them that is demonstrated by a restricted decision-making powers on daily activities such as lending and borrowing operations, i.e. on the core activity of the ISLF. The ISLF rather acts as a kind of accounting tool or as an '*auto-pilot'* and, therefore, it cannot be recognised in national accounts as an institutional unit and should automatically be included in its controlling unit in the general government sector (S.13).

The ISLF as a financial intermediary

The ISLF is currently classified in the financial corporation sector (S.12). ESA defines the financial intermediation as the activity in which an institutional unit acquires financial assets and incurs liabilities on its own account by engaging in financial transactions on the market. As mentioned above, lending activities of the ISLF are in principle automatic, i.e. beneficiaries are granted student loans after complying with minimum formal requirements, regardless of their future income expectancy or expected recoverability of the loan. The interest rates accrued on the student loans are low, mostly below those paid by the Treasury when borrowing financial sources on the market. In certain circumstances, the interest rate charged on student loans might be capped by the decision of the Minister.

The ISLF's capital is limited by legislation to contributions from government, repayments of student loans and other loans. The latter is restricted to loans received from the Treasury, as the ISLF is not allowed to borrow on the market or issue bonds. The liabilities of the ISLF are, in addition, fully guaranteed by the government.

The ISLF might be associated with the definition of a captive financial institution. According to ESA, captive financial institutions are not considered financial intermediaries as they do not really place itself at risk and, in addition, most of their assets or their liabilities are not transacted on open markets. In other words, their assets might not be marketable and the financial resources are provided by the controlling unit, as those entities are not able to obtain resources on the market, which is the case of the ISLF.

The MGDD in part 1.6.6. says: "*Captive financial institutions are considered institutional units according to ESA 2010 criteria (see ESA 2010 paragraph 2.12), but have a limited capacity of decision as regards their current management and are very much dependent on their parent (controlling unit) as regards the conduct of their activity. Thus, the influence of their controlling unit goes beyond the coverage of the notion of control in national accounts, which refers to the influence on the general policy and the strategy of the unit, i.e. the parent control goes beyond key decisions and a significant influence is also observed in 'day-to-day' activities, implementing the defined strategy*."

ESA 2.22 explains that an entity that exercises "*some substantive control over its assets and liabilities*" is classified in the financial corporation sector. In the case of ISLF, the entity exercises no control over its liabilities (not being able to incur liabilities on the market) and very little control over its assets (its lending policy being determined by government through legislation). Accordingly, ESA 2.23 explains further that such entities acting on "autopilot" are to be consolidated with their controlling unit: "*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. If it is resident in the same economy as its parent, it is treated as an 'artificial subsidiary' as described below*."

Following the arguments above, Eurostat considers that the ISLF does not comply with the definition of a financial intermediary, i.e. the entity does not places itself at risk by acquiring financial assets and incurring liabilities on its own account. Instead, the ISLF acts as a government agent implementing the public policy objectives, with a limited control over its assets and liabilities and over its operations on the financial market. Therefore, the ISLF should be classified in the general government sector (S.13).

Eurostat considers that the changes foreseen in the amended Act on the ISLF, as presented by the Icelandic statistical authorities, do not seem to have implications on the classification of the ISLF inside general government.

The ISLF as a non-market producer

Concerning the market/ non-market character of the entity, it can further be considered that the ISLF is non-market. The reason is that it continuously lends at conditions and rates, which lead to losses and which are determined by public (social) policy rather than the aim of *"breaking even in the long-run*" (ESA 3.19).

2.3.2. Recording of income contingent loans provided by the ISLF

To guarantee equal opportunities to pursue studies, the ISLF provides student loans to beneficiaries irrespective of their financial situation. The granting of student loans is part of the public policy objectives of the ISLF that was specifically created for this purpose.

The interest rates accrued on the student loans are below those prevailing on the financial market. The student loans provided under the current scheme bear the interest of 1% and are indexed to the CPI. After the completion of studies, the beneficiaries start repaying the loans, after two years grace period.

The repayment period is currently unlimited. In the course of repaying the debt, some relief might be requested due to serious circumstances such as invalidity, illness, etc. Instead of the outstanding amount, the repayments are dependent on the debtor's income, although a minimum annual instalment must be repaid. The instalments currently consist of a fixed part and supplement as a % (3.75 currently) of the tax base for municipal income tax.

In the publicly available analysis of the Ministry of Education, it is estimated that, in the current scheme, on average 47% of the loans provided by the ISLF each year is in fact an implicit grant to beneficiaries of the student loans. As explained by the Icelandic statistical authorities, this is an estimate based on known write-offs in addition to interest rate discounts. The ISLF's losses incurred on granting the student loans are covered by the funds that are provided by the Treasury each year.

The draft law proposed by the government in 2019 introduced some changes in the future mechanism of granting the student loans. The new system foresees that grants will be directly provided to beneficiaries for 30% of the loan principal after the completion of studies, which means, in practical terms, that an equal amount of their debt would be written-off. According to the Icelandic statistical authorities, the Treasury's annual expenditure relating to the coverage of losses is estimated to remain largely unchanged.

As further explained by the Icelandic statistical authorities, the remaining principal of the student loans, i.e. after the 30% cancellation, would bear interest rates determined on the basis of the ISLF's terms of financing, plus interest premium that is to meet the estimated depreciation due to e.g. death of borrowers and other defaults.

Other changes proposed by the amended law introduce amendments in parameters such as the interest rate, loan maturity, grace period or percentage in the income-related part of the annual instalment. In general, they do not have implications on the recording of student loans.

Concerning the income contingent loans, the MGDD says: "*Such funding is mainly provided by government to households, but can also be provided to other institutional units. The aim of it is to support public policy, so the terms for the beneficiaries will be more favourable than in case of taking a loan from a financial institution."* And it continues further: "*Income contingent loans are often granted by governments for relatively small amounts to a large number of debtors under standard conditions. Therefore, the analysis in national accounts can apply to the whole loan portfolio and not to each individual loan granted*."

From the national accounting point of view, the issue has potential implications in two aspects. First, interest receivable accrued on student loans and unlikely to be paid might overestimate the government deficit/ surplus and, second, due to the long term nature, write-offs and/or debt cancellation will only occur after a long period and, therefore, not reflecting the economic reality at the time of operations.

The MGDD proposes three scenarios depending on whether the expected loss at inception due to contingency elements is low, extremely high (i.e. almost all of the provided funds) or significant (i.e. large fraction of the provided funds). The estimates of the loss provided by the Icelandic statistical authorities cannot be considered extremely high since they do not range between 90-95% of the provided funds, nor low, since the expected losses currently amount to almost half of the funds provided.

Eurostat therefore considers that the recording of the student loans should be partitioned between financial and non-financial transactions. For the part estimated on the basis of expected losses arising from the contingency, government expenditure (D.9) should be recorded at the time of the new lending by the ISLF. In this particular case, this proportion was estimated at 47% of loan principal in the current scheme and 30% in the new proposed scheme. Eurostat expects that, under the new scheme, the grant component will be included as a regular expenditure of government. Taking into account the time lag between the new lending of the ISLF and the time of the grant expenditure in public accounts, imputations in the recording of flows and stocks of the student loans are expected in the non-financial and financial accounts.

The remaining part of the student loans granted by the ISLF should be recorded as a loan (F.4), i.e. a financial transaction without any impact on government net borrowing/net lending (B.9).

Eurostat would like to emphasise that, if this will be the case in the new proposed scheme, the Icelandic statistical authorities should in addition estimate the part of loans unlikely to be repaid, after the 30% cancellation of principal in the form of the direct grants.

As concern the recording of income contingent student loans in the current scheme, Eurostat considers that the recording according to the MGDD 2019, as explained above, should be applied retrospectively and the expenditure relating to expected losses should be spread backwards.

3. Conclusions

On the basis of the above considerations and analysis, the ISLF should be classified inside the general government sector. Eurostat considers that the amended act proposed by government in 2019, as presented to Eurostat by the Icelandic statistical authorities, would not have implications on the sector classification of the ISLF inside general government.

Concerning the recording of student loans provided by the ISLF, Eurostat considers that the MGDD rules for the recording of income contingent loans should be followed. Accordingly, if the expected losses due to contingency elements are significant, the recording of the student loans granted by the ISLF should be partitioned between financial and non-financial transaction, applying the experts' estimate of expected losses to be recorded as government expenditure. Eurostat noticed that the size of the expected losses differed between the current scheme and the scheme proposed in the draft law introduced in 2019, so that separate estimates should be considered for different schemes. The revised recording of the income contingent student loans provided by the ISLF should be applied retrospectively through the whole life of the student loans.

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)

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Director