



# **Reduction of the Principal of Housing Mortgages**

**November 2013**



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## Introduction

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On 28 June 2013, the Icelandic parliament *Althingi* passed a Parliamentary Resolution on actions in connection with household debt problems in Iceland, cf. Parliamentary Document 9 – Item 9. Point 1 of the action plan in the Parliamentary Resolution provides for an expert group to be set up which will develop different ways to achieve a reduction in the principal of inflation-indexed housing mortgages and make proposals to implement them. The project is the responsibility of the Prime Minister and the Ministerial Committee on Solutions in Household Debt Problems. The Explanatory Notes to the Parliamentary Resolution explain in more detail the group's tasks as follows:

The proposals are to be aimed at correcting the failed premises which occurred with higher inflation in 2007-2010 in the wake of the financial system collapse. The change to the index had a considerable impact on the housing debt situation. Another objective is to encourage borrowers to convert their loans to non-indexed loans in return for a correction to the principal. Since the debt service burden on non-indexed loans is higher to begin with than on inflation-indexed loans, the possibility must be examined of households benefiting from a tax deduction in paying down loans so that their disposable income will not be reduced from its current level.

It is evident that borrowers' long-term interests are better served in the longer term by converting loans to non-indexed loans. In addition, there are economic arguments concerning management of monetary affairs to the effect that it is more effective to influence private consumption in a system where non-indexed loans are a large portion of household expenditures. It facilitates economic management if financing costs are paid as they arise instead of the current arrangements where financing costs are pushed into the future. Actions are needed to offset the increased debt service burden when accrued interest on loans is to be paid concurrently. Since the debt service burden on non-indexed loans is higher to begin with than on inflation-indexed loans, this action will have a limited expansionary and inflationary impact.

In tandem with an examination of the routes which are available to correct the failed premises, other routes which may be available need to be examined to take advantage of the leeway which in all probability will develop in tandem with settlement of the insolvent estates of the old banks, to address the needs of borrowers and persons who placed their savings in their homes, just as the emergency legislation ensured that the assets of the insolvent estates would be utilised to protect monetary assets and resurrect domestic banking activities.

According to the Parliamentary Resolution, the work of the expert group was to be based on the following premises:

- general actions which benefit all households who were affected by failed premises;
- what is involved is a correction of failed premises;

- clear incentives need to be created for borrowers to convert their financing to non-indexed loans;
- the advantages and disadvantages of setting a ceiling or cap on the amount of correction each household may enjoy to encourage equal treatment in implementation;
- an assessment will be made as to whether the correction will be optional on the borrower's initiative;
- the desirability of reducing the principal of loans through a tax deduction will be assessed. The implementation could take the form of borrowers being enabled to make payments on the principal of their loans and enjoy a tax deduction in return.

Point 2 of the action plan in the Parliamentary Resolution concerns an assessment which is to be made of the advantages and disadvantages of establishing a special debt relief fund for housing mortgages. This task was entrusted to the same group, as described in the Parliamentary Resolution:

If there is delay in concluding agreements with creditors, it should be possible to establish a correction fund in connection with housing mortgages, in order for actions to benefit borrowers to be implemented sooner and to ensure transparency and supervision of corrections. The amount of money in circulation is not expected to increase with the advent of such a fund. A team of professionals will submit proposals for financing the fund, especially concerning the Treasury's involvement and the involvement of lenders as well as cash flow. Proposals for possible arrangements to be available in November 2013.

The expert group was appointed on 16 August 2013. It is comprised of the following persons:

- Dr. Sigurður Hannesson, mathematician, Chairman
- Dr. Arnar Bjarnason, economist
- Einar Hugi Bjarnason, Supreme Court attorney
- Ingibjörg Ólöf Vilhjálmsdóttir, District Court attorney
- Lilja Alfreðsdóttir, international economist
- Sigrún Ólafsdóttir, international business administrator in the PM's Office
- Sigurður Guðmundsson, planner in the PM's Office

From the beginning of October onwards, Benedikt Árnason, economic advisor to the Prime Minister and Government ministerial committees, assisted the group. Secretary for the group was Steindór Grétar Jónsson, specialist in the Ministry of Finance and Economic Affairs.

The group summoned the following parties for discussions:

From the Althingi: Elsa Lára Arnardóttir and Líneik Anna Sævarsdóttir. From Arion Bank: Gísli Óttarsson, Jónína S. Lárusdóttir and Óskar Hafnfjörð Auðunsson. From the Financial Supervisory Authority: Jón Þór Sturluson. From the Prime Minister's Office: Páll Þórhallsson. Former economic advisor to the Prime Minister: Sigurður Snævarr. From the households' interest group *Hagsmunasamtök heimilanna*: Guðmundur Ásgeirsson, Pálmei Gísladóttir

and Vilhjálmur Bjarnason. From Statistics Iceland: Rósmundur Guðnason. From the Housing Financing Fund: Gunnhildur Gunnarsdóttir, Ingi Kristinn Pálsson, Sigurður Erlingsson, Sigurður Geirsson and Sigurður Jón Björnsson. From Íslandsbanki: Birna Einarsdóttir and Una Steinsdóttir. From Landsbankinn: Helgi Teitur Helgason and Nína Guðbjörg Pálsdóttir. From the National Association of Pension Funds: Arnar Sigurmundsson, Gunnar Baldvinsson and Þórey S. Þórðardóttir. From the Directorate of Internal Revenue: Páll Kolbeins and Ingvar J. Rögnvaldsson. From the Central Bank of Iceland: Jón Sigurgeirsson, Þorvarður Tjörvi Ólafsson, Þórarinn G. Pétursson and Örn Hauksson. From the Debtors' Ombudsman: Ásta Sigrún Helgadóttir and Lovísa Ósk Þrastardóttir.

## Summary

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This report presents a two-part proposal aimed at reducing household mortgage debt. Firstly, the principal of indexed housing mortgages is to be written down and, secondly, tax breaks are proposed for private pension savings contributions originating after the action is implemented. It will be possible to apply private pension savings to reduce the mortgage principal; this route will be open to all housing mortgage holders regardless of the form of the mortgage. People who take advantage of both routes can reduce the principal of their loans by as much as 20% over the next four years. The actions are as follows:

### Debt relief for inflation-indexed housing mortgages

Indexed housing mortgages will be written down by an amount equivalent to the indexation increase exceeding 4.8% which occurred during the period from December 2007 to August 2010. This is equivalent to a 13% adjustment to the consumer price index (CPI) used for indexation. The maximum amount of the write-down per household will be ISK 4 million. Around 90% of households entitled to debt relief will not be subject to a reduction because of this cap, i.e. the cap will not affect loans with an outstanding balance of up to ISK 30 million as of year-end 2010. Previous remedies reducing the loan principal from which the borrower has benefited will be deducted from the amount of the correction. Those loans which are entitled to debt relief are inflation-indexed housing mortgages for purchase of real property for personal use. Debt relief will be provided on the borrower's initiative; the borrower will have to apply for it from his/her mortgage lender holding first lien rights on the date of application. It is proposed that this lender will be the administrator of the debt relief and handle its implementation as provided for in the methodology described in this report.

### Tax exemption for private pension savings

Households with housing mortgages can use payments which would otherwise go to a private pension fund to pay down their housing mortgages. The Treasury will waive income tax on the wage earner's contribution of up to 4% together with the employer's contribution of up to 2%, if these funds are used to repay the principal of housing mortgages. The maximum tax exemption will be ISK 500,000 [per household] each year. This remedy will apply for three years. The action is limited to persons who owed housing mortgages prior to 1 December 2013. Persons who have already been granted debt mitigation can avail themselves of the tax exemption for private pension savings, enabling as many people as possible to benefit from the action.

### Scope of the action

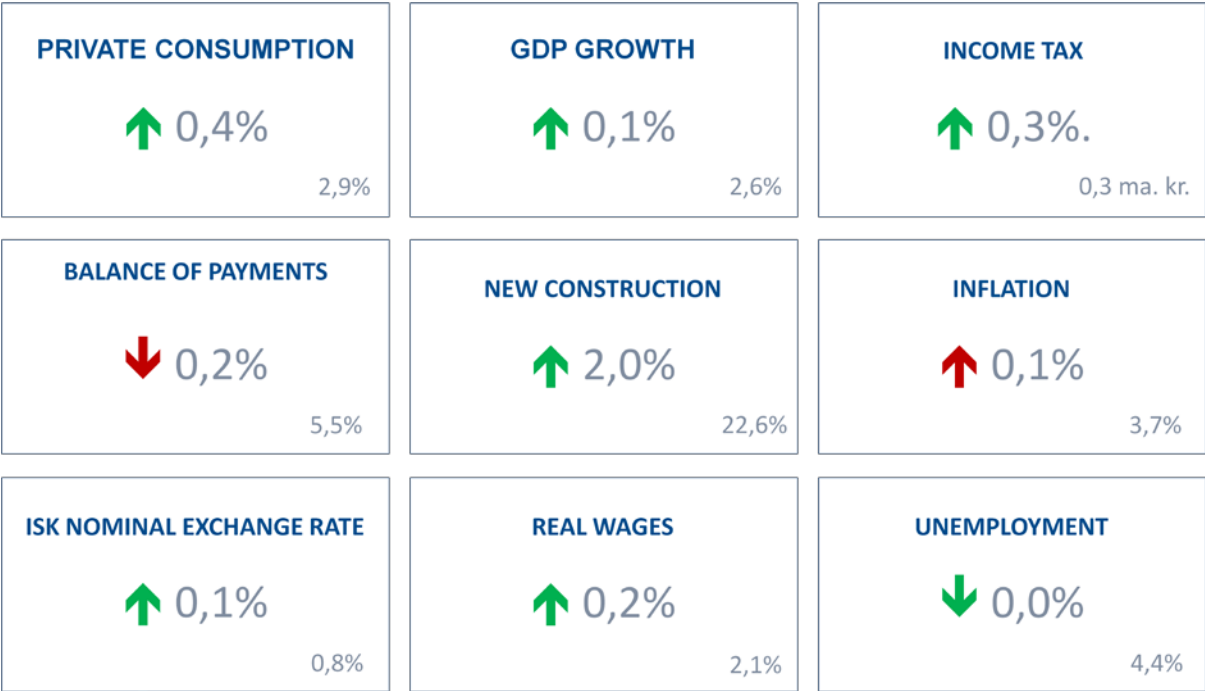
The total scope of these actions is estimated at around ISK 150 billion, spread over a four-year period. Of this, the debt relief applied to inflation-indexed housing mortgages is estimated at around ISK 80 billion and the reduction to loan principals through utilisation of private pension savings at around ISK 70 billion. It should be pointed out that this estimate is subject to some uncertainty. The action requires the Treasury to serve as an intermediary in financing and implementing it. There is no need to establish a debt relief fund, as the action

will be fully financed. The net impact on the Treasury is expected to be insignificant each year during the period 2014-2017.

**Economic impact**

The action relieves economic uncertainty concerning household debt issues. Currently, household debt is equivalent to 108% of GDP, which is high by international comparison. In tandem with the debt reduction, the action will boost household disposable income and encourage savings by exempting private pension savings from tax. This creates an additional incentive for investment, as households regain financial strength and have more scope for investment.

The principal conclusions of the analysis which the consultancy Analytica ehf. prepared for the group indicate that, based on the assumptions given, the macroeconomic impact of the actions proposed by the expert group will be relatively mild, although they could have a considerably stimulating effect on residential housing investment. The impact of the actions on individual economic indicators is based on Analytica's alternative scenario to the macroeconomic forecast of Statistics Iceland of November 2013.



**Time frame of the actions**

If the proposal is adopted as presented and the necessary amendments made to legislation, barring special difficulties, implementation of write-downs can be expected around mid-2014. Some preparatory time will be needed to recalculate mortgages. Actions regarding tax exemptions for private pension savings used to reduce the mortgage principal could commence at around the same time.



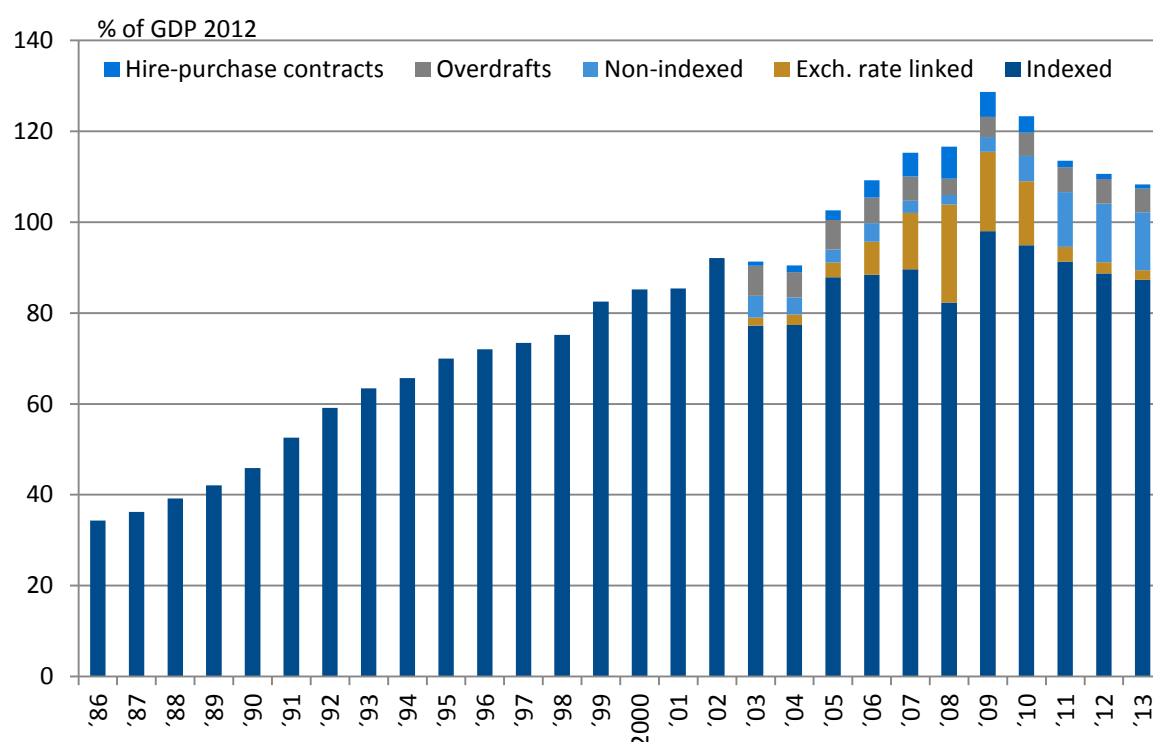
# 1 Household Debt and Economic Developments

## 1.1 The trend in household debt

The ratio of household debt to GDP has tripled during the past quarter century. Increased household indebtedness due to housing purchases and consumer loans peaked in 2007. Shortly thereafter the ISK exchange rate fell by more than half, greatly boosting exchange-rate-linked loans, while inflation-indexed loans ballooned in the subsequent inflation spike. Over the same period, housing prices dropped by one-third in real terms, leaving large numbers of households with negative equity, in tandem with higher unemployment and shrinking purchasing power. The ratio of household debt to GDP peaked at 133.5% in Q1 of 2009, while by comparison at the beginning of 2004 the ratio was 85.2% of GDP. In 1990, gross household debt was equivalent to 46% of GDP.

At year-end 2012, gross household debt totalled ISK 1,921 billion or around 110% of GDP, of which housing mortgages were ISK 1,325 billion or around 78% of GDP.<sup>1</sup> As of the end of June 2013, household debt is estimated to equal 108% of GDP, with inflation-indexed household debts 87% of GDP, non-indexed loans 13%, overdrafts 5%, exchange-rate-linked loans 2% and asset leasing agreements 1%.<sup>2</sup> The composition of household debt has undergone some changes in recent quarters, including a decrease in the share of inflation-indexed and exchange-rate-linked loans. The share of non-indexed loans rose substantially in 2012.

Chart 1. Household debt as a ratio of GDP 1986-2013<sup>3</sup>



<sup>1</sup> Central Bank of Iceland.

<sup>2</sup> Central Bank of Iceland. Financial Stability. 2013/2. P. 9

<sup>3</sup> Statistics Iceland, Central Bank of Iceland

Since year-end 2010, household debt as a ratio of GDP has decreased by 14%. The decline in household debt can be attributed primarily to recalculation of loan contracts which involved illegal exchange-rate indexation, paybacks on loans and instalments, the amount of which has exceeded that of new loans granted.<sup>4</sup> The principal of exchange-rate-linked loans was written down by around ISK 149 billion in 2010-2012 and further write-downs in 2013 are estimated at around ISK 39 billion. Financial undertakings wrote down other loans totalling around ISK 56 billion in connection with problem debt restructuring and the 110% route offered to overly indebted households. The total debt reduction resulting from these actions is around ISK 244 billion, or 14% of GDP. This does not include other actions undertaken by some financial undertakings before exchange-rate-linked loans were judged to be illegal and the government's remedies were announced.<sup>5</sup>

The great majority of housing mortgages are indexed amortised loans, most often granted for the maximum term, which has been 40 years since 1996. The share of inflation-indexed loans has dropped from almost 80% of GDP to 70%. The share of non-indexed loans rose from 0.1% of GDP at the beginning of 2010 to 5.5% at year-end 2012.

**Table 1 Household mortgage debts owed to currently operating financial undertakings and pension funds<sup>6</sup>**

<i>ISK billion</i>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
Deposit money banks (DMBs)	285,104	308,776	302,687	365,270
of which, inflation-indexed	235,943	215,970	218,257	251,914
of which, non-indexed	1,614	28,713	79,548	111,409
of which, exchange-rate-linked	47,547	64,093	4,882	1,947
Housing Financing Fund (HFF)	616,362	641,887	658,301	669,048
Pension funds	174,436	171,889	181,352	181,195
Housing mortgages to households in institutional investor funds	91,146	124,235	109,968	110,280
of which, inflation-indexed	34,019	124,235	109,968	110,280
of which, exchange-rate-linked	57,127			
<b>Total</b>	<b>1,167,048</b>	<b>1,246,787</b>	<b>1,252,308</b>	<b>1,325,794</b>

The LTV ratio of household real estate was 50.2% at year-end 2012 and has dropped considerably in recent years from its peak of 59% at year-end 2010.<sup>7</sup>

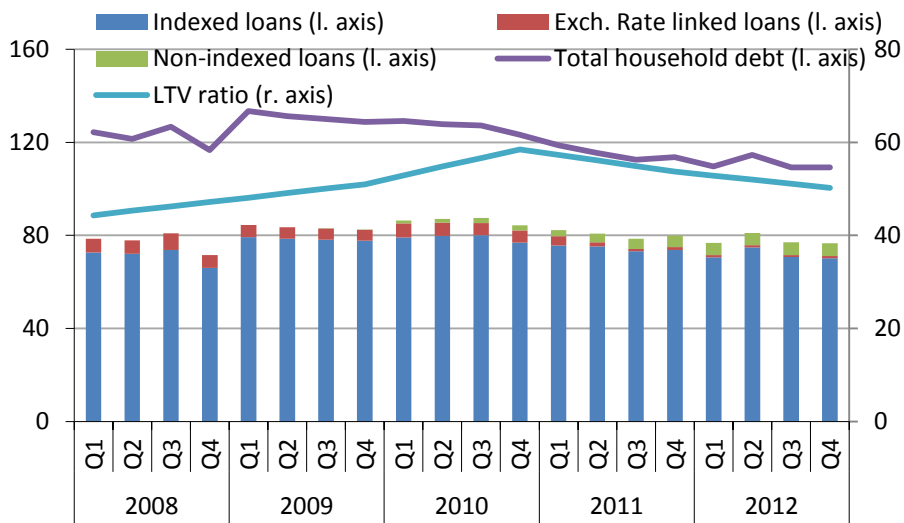
<sup>4</sup> Households' position in the financial crisis in Iceland. P. 93.

<sup>5</sup> Central Bank of Iceland Monetary Bulletin 2013/2. Box IV-1.

<sup>6</sup> Central Bank of Iceland

<sup>7</sup> Central Bank of Iceland Financial Stability. 2013/1. p. 43.

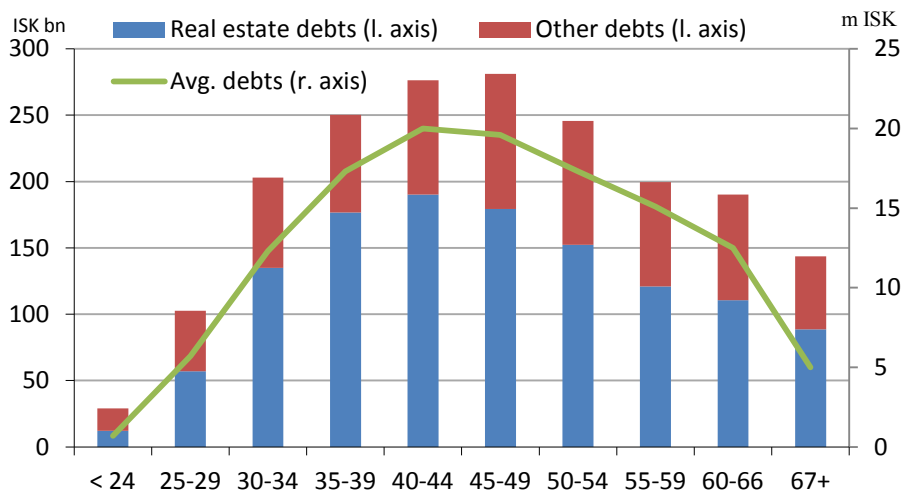
Chart 2. Household mortgage debt as a ratio of GDP and of real estate value<sup>8</sup>



At year-end 2012, debts of couples with children were ISK 799 billion, increasing by 0.5% over the previous year. Debts of single parents totalled ISK 171 billion and had decreased by 1.9% year-over-year (YoY). On average, couples with children owed ISK 25.1 million while the average debt of single parents was ISK 10.9 million. Single individuals owed on average ISK 4.6 million at year-end while childless couples owed on average ISK 13.8 million. Debts of single individuals rose by 2.8% over the previous year while debts of childless couples rose by 3.5%.<sup>9</sup>

Families in the age group 35-49 years [based on the age of the oldest family member] were the most indebted group at year-end 2013. Their total liabilities amounted to ISK 807.7 billion, or the equivalent of 42% of total debts, decreasing by 0.2% YoY. Debts of the 25-29-year age group decreased by 7.4% YoY.

Chart 3. Debt by family age at year-end 2012<sup>10</sup>



<sup>8</sup> Statistics Iceland, Central Bank of Iceland

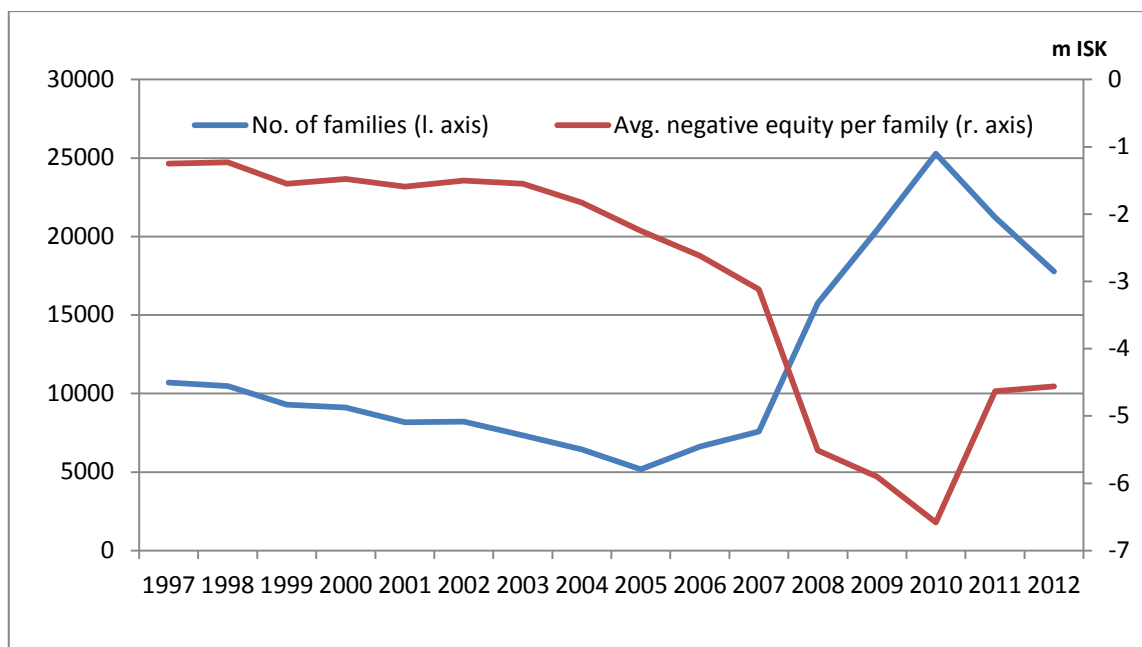
<sup>9</sup> Statistics Iceland. Debts, assets and asset position of individuals 2012. 30 August 2013. P. 3.

<sup>10</sup> Statistics Iceland, Central Bank of Iceland

In terms of gross debt, the most indebted age group is individuals aged 45-49 years, while individuals with the highest real estate mortgage debts are in the 40-44 year age group.

Households' equity position has improved in the past two years after deteriorating considerably in 2009-2010. The cumulative equity position at year-end 2012 was just over ISK 2,047 billion, after strengthening by 10.6% over the previous year. The real estate equity position, i.e. the value of real estate net of real estate mortgages, improved by 14.7%, amounting to ISK 1,604 billion at year-end 2012. Other equity, i.e. the value of other assets net of other debts, improved by 2%, amounting to ISK 443 billion at year-end 2012. A total of 129,193 families (68%) had positive equity at year-end 2012, a YoY increase of 4%. At year-end 2012 there were 57,157 families (30%) with negative equity, a decrease of around 2.8% YoY. The number of families with negative equity is considerable.

Chart 4. Number of families with negative equity<sup>11</sup>



The equity ratio of younger age groups is understandably often low or even negative, then strengthens with increasing age as debts are paid off. In 2008-2012 equity ratio developments were in accordance with age, but the negative equity position of the 25-34 year age group is striking – it is negative for almost the entire period.

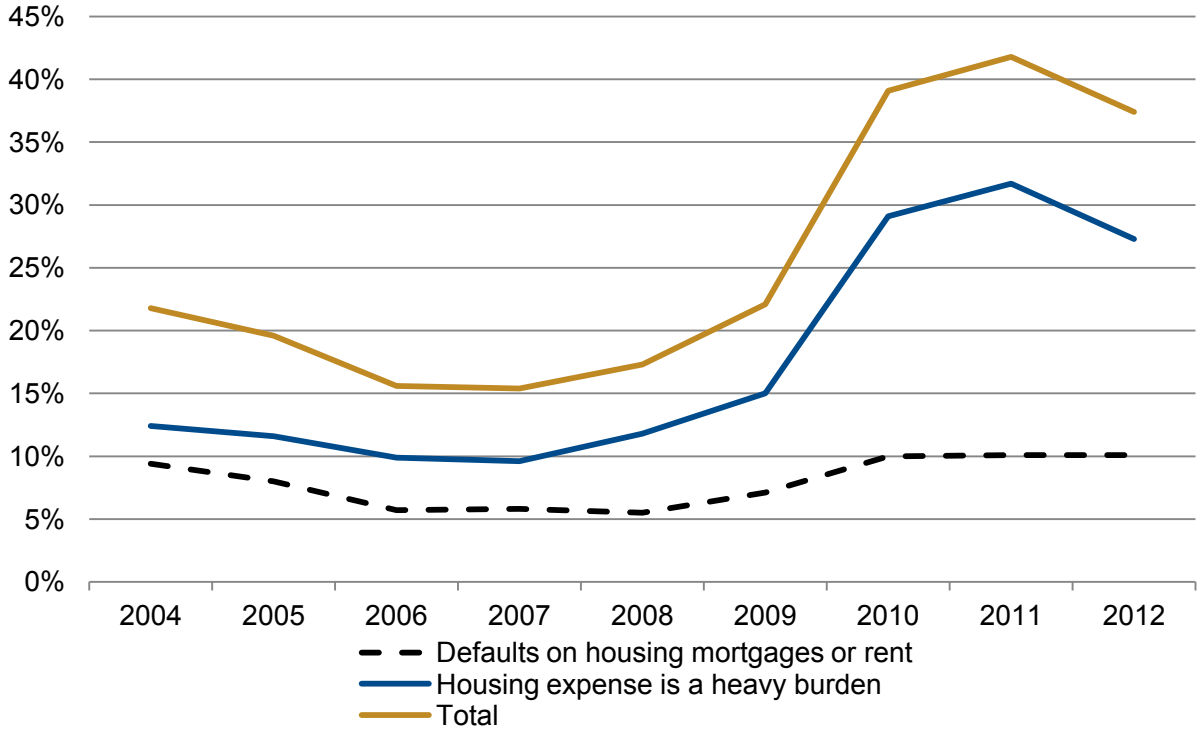
Equity ratios vary by family type. Childless couples are in a better position, as their equity ratio was 71% at year-end 2012 and the same is true of individuals, whose equity ratio is 54%. In families with children the ratio is somewhat lower: for couples with children it is 28% and for single parents the ratio is lowest, at around 9%.

Defaults by households rose greatly in the economic downturn, peaking in December 2010 at around 20% of the total lending of the three largest commercial banks and the Housing

<sup>11</sup> Statistics Iceland. Debts, assets and asset position of individuals 2012. 30 August 2013. P. 12.

Financing Fund, based on book value and the cross-default method.<sup>12</sup> Defaults have decreased since year-end 2010 and in August 2013 they were around 12% of total lending and have therefore decreased by 6% of lending.

Chart 5. Defaults and difficulties in making mortgage payments on time<sup>13</sup>

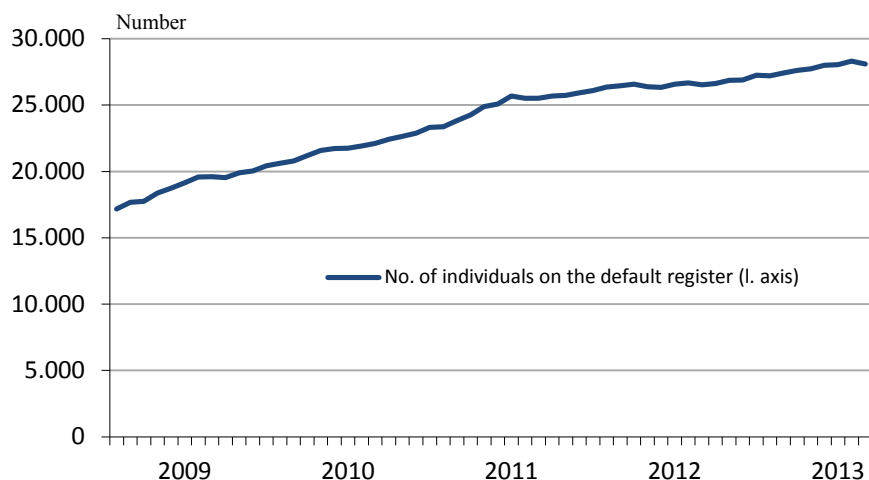


As Chart 5 shows, defaults have decreased considerably in the past two years, but are still high by international comparison. Individuals on the default register have increased in number, to 28,141 at the end of October. This represents around 11.6% of individuals 18 years of age and older. A major portion of the individuals on the default register has been there for a long time – some 60% of individuals have been two years or longer on the register and almost 30% have been four years or longer. Bankruptcies have also increased and at the end of October new bankruptcies of individuals numbered 343.

<sup>12</sup> According to the cross-default method, if one loan taken by a customer is in default, all of that customer’s loans are considered in default.

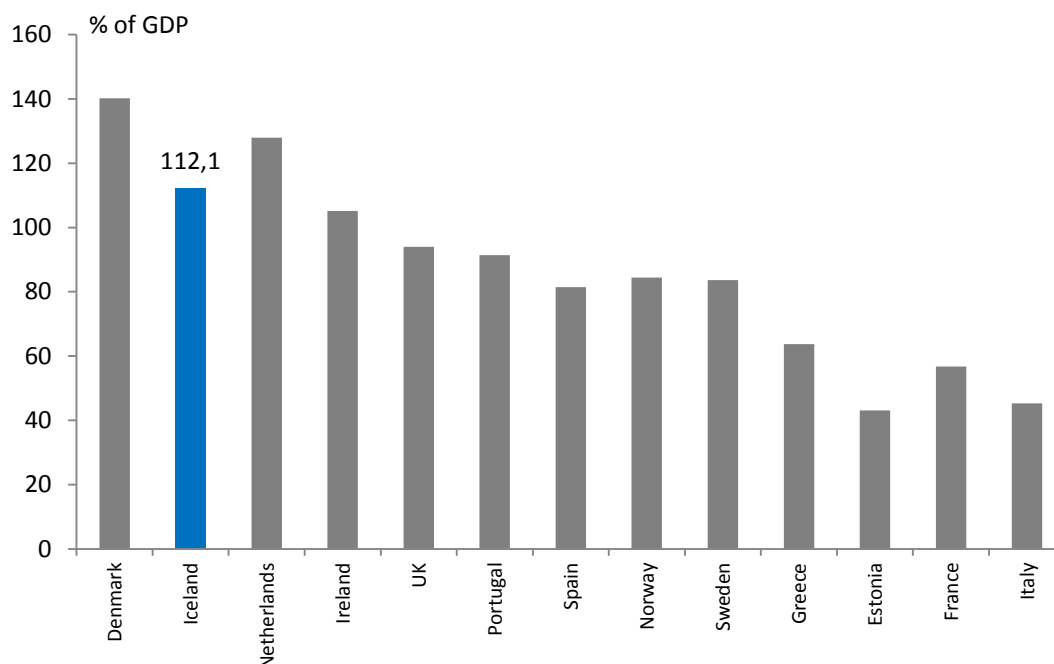
<sup>13</sup> Statistics Iceland.

Chart 6. Number of individuals on the default register<sup>14</sup>



The increase in household debt is an international trend, although in few countries is it greater than in Iceland. Chart 7 gives a comparison of household debt in Iceland and in several European countries. The indebtedness of Icelandic households, whether assessed relative to disposable income or to GDP, is among the highest by international comparison. In this comparison, regard must also be given to the high proportion of home ownership in Iceland. On the other hand, high indebtedness is a source of concern for the country's economic development, as research shows that it can impede economic recovery following a financial and banking crisis.<sup>15</sup>

Chart 7. Debts of Icelandic households compared to several European countries<sup>16</sup>



<sup>14</sup> Central Bank of Iceland

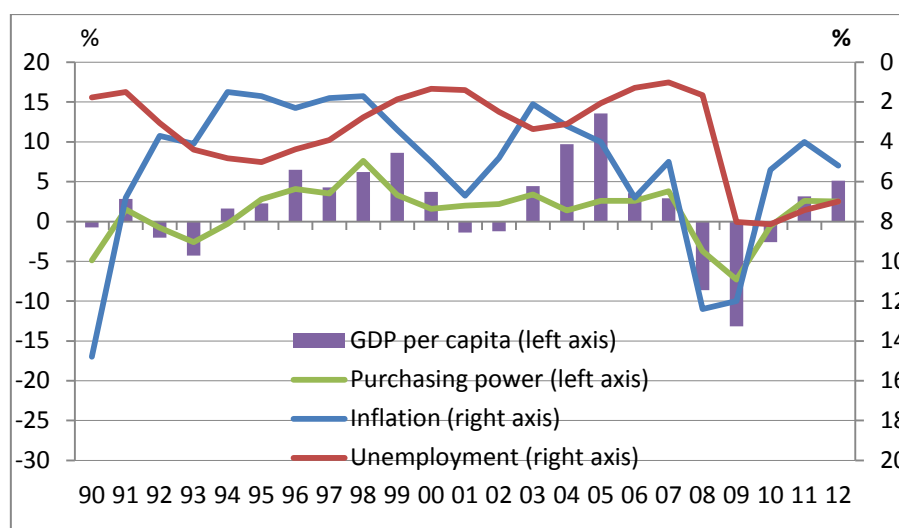
<sup>15</sup> Mian and Sufi: Household Leverage and the Recession of 2007 to 2009.

<sup>16</sup> Central Bank of Iceland

## 1.2 The imbalance 2007-2010

A major imbalance developed in the Icelandic economy during the period from 2007 to 2010; the ISK exchange rate plummeted, the inflation rate soared far above the inflation target of the Central Bank of Iceland and there was a substantial contraction in GDP. Although inflation has actually run rampant before in Iceland, and the exchange rate fallen sharply, what distinguishes the period from the end of 2007 to the end of 2010 from other periods of high inflation are aspects connected with the negative consequences of a financial crisis including the development of wages and asset prices. The shocks put strong pressure on the economy, which was reflected by the deteriorating situation of Icelandic households.

Chart 8. GDP growth, purchasing power, unemployment and inflation<sup>17</sup>



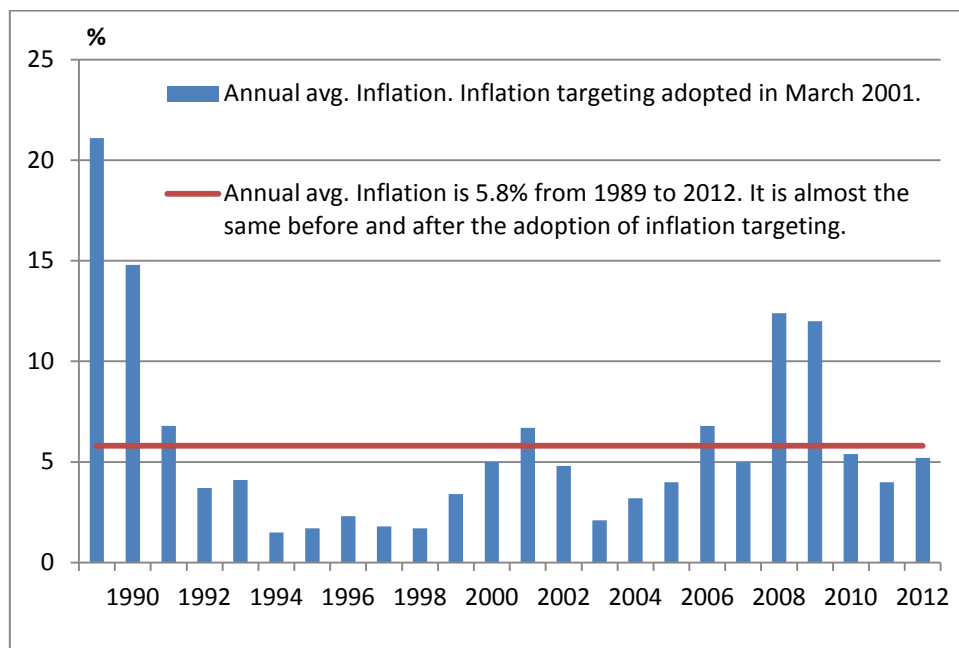
Around 1990, the annualised inflation rate exceeded 20%, but the situation then was considerably different from the period concerned here. The economic shocks of 2008 resulted concurrently in a drop in asset prices, increased unemployment, a GDP contraction, falling incomes and an inflation spike, which was to a large extent the result of strong ISK depreciation. While inflation was higher in 1990 than it was in 2008, unemployment was low then, GDP was in better balance and purchasing power was curtailed less. As a result, the circumstances were different in 2008 than around 1990.

In 2001 the Central Bank adopted inflation targeting as its monetary policy. This strategy is aimed at maintaining stable price levels, and an annual inflation rate averaging as close as possible to 2.5%, with 1.5% tolerance limits, i.e. a lower limit of 1% and upper limit of 4%.

Figure 9 shows the inflation rate from 1989 to 2013. The inflation rate peaked during this period at 25% in December 1989 and has been volatile during the entire period with the exception of the latter half of the 1990s.

<sup>17</sup> Statistics Iceland.

Chart 9. Inflation since 1989 – annualised rate by month<sup>18</sup>



The average inflation rate for the entire period is 5.8%, or the same average inflation rate as during the period since the introduction of inflation targeting and until the latter half of this year. If the period examined is limited to the time from the introduction of inflation targeting until year-end 2007, the average inflation rate was 4.8%. During the period following the conclusion of collective bargaining agreements in 1990 generally referred to as a “national consensus” and until year-end 2007 inflation averaged 4.0%.

Since 2007, household income has fallen markedly, by 21% if benefits and pension payments are excluded. The difference was even greater during the period from 2007 to 2010, or 24%. These figures include only income from employment on which national and municipal taxes are levied and exclude financial income. The real wage index also dropped sharply from year-end 2007 well into 2010.

Unemployment has generally been low in Iceland, but this changed dramatically following the economic collapse, rising from 1.0% in 2007 to 8.1% in 2010.<sup>19</sup> GDP also contracted considerably following the economic collapse, with per capita GDP at fixed prices falling by 22.7% from 2007 to 2010. In 2010 per capita GDP was similar to what it was in 2003-2004.

Household debt increased greatly during the first decade of this century, as explained earlier. The leveraging made household balance sheets more sensitive to shocks than before.

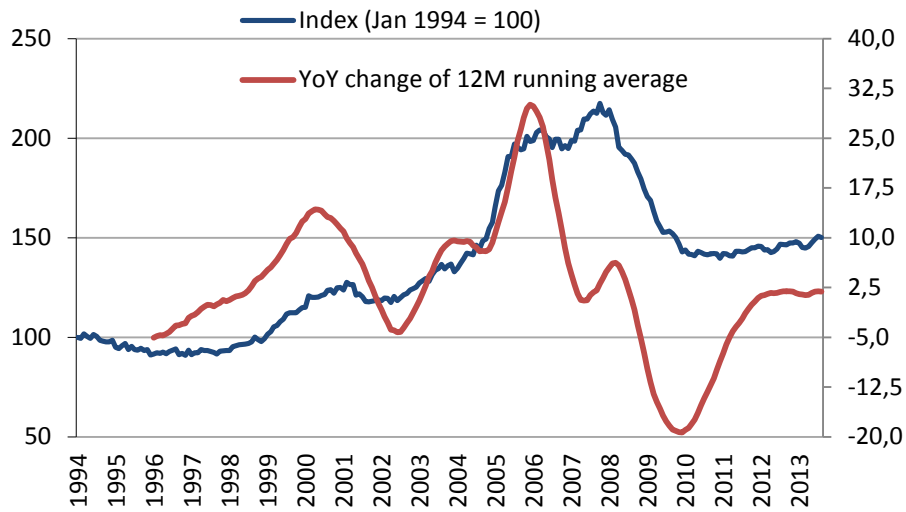
Housing prices fluctuated considerably during the period from 2004 to 2010. Real housing prices in the capital region rose by 34% until 2007, then declined once more until 2010 when real prices were almost identical to those of 2004.

<sup>18</sup> Statistics Iceland.

<sup>19</sup> Directorate of Labour.

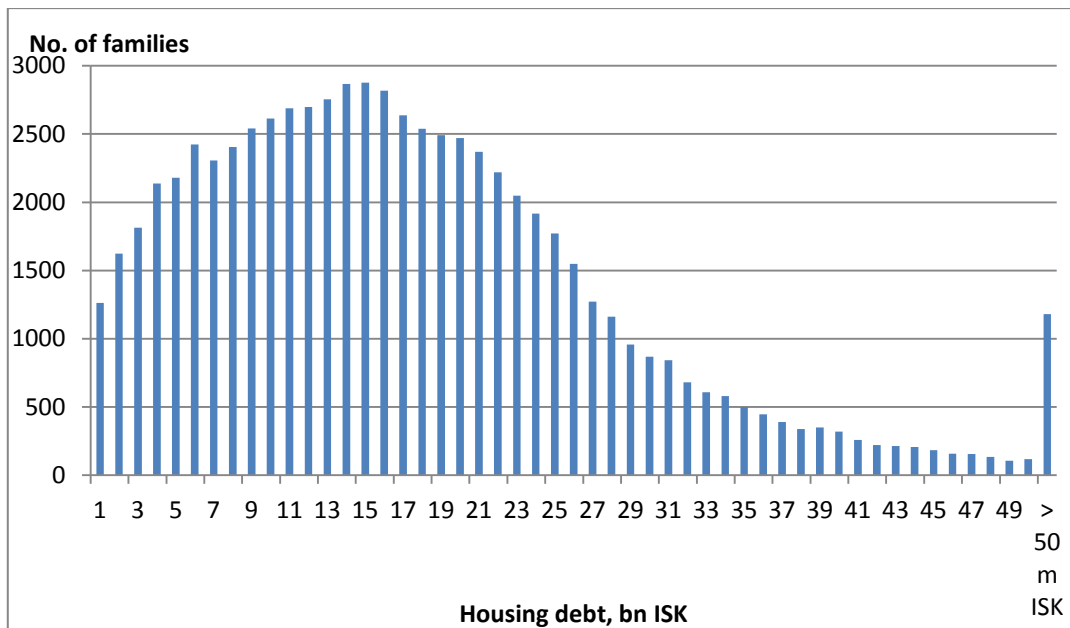


Chart 10. Housing prices in the capital area<sup>20</sup>



At year-end 2010, housing debt amounted to ISK 1,226 billion, owed by some 73,000 families. Average debt per family was ISK 16.8 million, but this debt was very unequally distributed, as is shown in Chart 11.<sup>21</sup>

Chart 11. Housing debt at year-end 2010 by amount<sup>22</sup>



As the chart shows the modal value is debt between ISK 12 and 13 million, if the 27,000 debt-free housing owners are excluded. One-quarter owed less than ISK 8 million and half less than ISK 14 million. One-quarter owed over ISK 22 million, and of them 1700 families owed more than ISK 50 million.

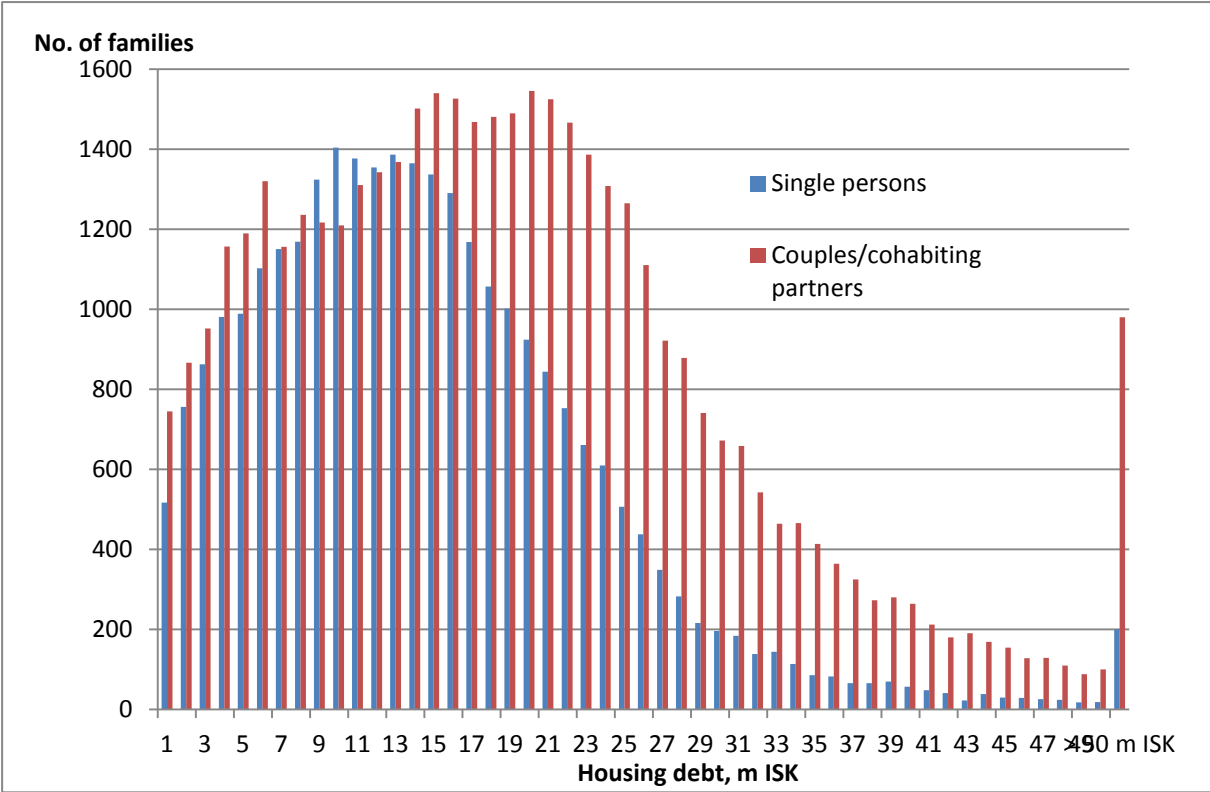
<sup>20</sup> Central Bank of Iceland

<sup>21</sup> Director of Internal Revenue

<sup>22</sup> Director of Internal Revenue

As pointed out in 1.1, households' debt position varied considerably by marital status, as Chart 12 illustrates.

Chart 12. Housing debt at year-end 2010 by amount of debt and marital status<sup>23</sup>



In 2010 the average debt of 28,000 single persons was ISK 14 million and the average debt of just over 44,000 couples was ISK 18.5 million. One-quarter of single persons owed less than ISK 7 million and half less than ISK 12 million, while one-quarter owed more than ISK 19 million and 1% of this group over ISK 50 million. One-quarter of couples owed less than ISK 9 million and half less than ISK 16 million, while one-quarter owed more than ISK 22 million and 3% of this group over ISK 50 million.

### 1.3 Relationship between debt and growth

Economic research indicates that household indebtedness has a significant impact on the magnitude of economic downturns. Economies where household debt rises greatly during the years preceding an economic shock are both longer in regaining balance and generally suffer a greater contraction in GDP than others where debt accumulation is more moderate.<sup>24</sup> This is due in particular to the fact that highly indebted households face a two-fold problem in a recession: a sharp drop in real estate prices erodes their asset position substantially and growing unemployment and lower income impairs their ability to make their payments. Highly indebted households therefore suffer substantial wealth and income effects when economic shocks like the international credit crunch strike.

<sup>23</sup> Director of Internal Revenue

<sup>24</sup> See e.g. IMF (2012): *Dealing with Household Debt* and McKinsey & Company (2012): *Debt and Deleveraging: Uneven progress on the path to growth*.

Research has also shown that targeted actions to assist indebted households accelerate economic recovery and stimulate growth, at least in the short term.<sup>25</sup> One of the reasons is that highly indebted (hand-to-mouth) households usually have higher marginal propensity to consume than those who owe less. This means that actions which boost disposable income of hand-to-mouth households, e.g. by lowering instalments on housing mortgages, will boost private consumption, which in turn stimulates general economic activity.

Excessive indebtedness can also result in a variety of inefficiencies. As an example, highly indebted households are less likely to undertake maintenance which increases the value of their assets. There are also indications that household bankruptcies cause damage of many sorts, not least socially. The benefits of relieving debt and preventing insolvencies can therefore be quite considerable.<sup>26</sup>

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<sup>25</sup> See e.g. Coenen et al. (2012).

<sup>26</sup> IMF (2012):

## 2 Reducing the Debt Principal

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Chapter 1 discussed the economic imbalance which prevailed in 2007-2010, when high inflation was accompanied by a strong economic contraction, drop in purchasing power and increased unemployment. The group was given the task of developing ways of achieving a reduction to the principal of inflation-indexed housing mortgages. It approached this task from two directions. Firstly, by proposing that loans be directly written down, and secondly, with a tax exemption enabling the use of funds which otherwise would go to private pension savings plans to pay down the mortgage principal. This chapter discusses the methodology for direct mortgage write-downs. Chapter 5 explains the details of utilising the private pension savings option.

### 2.1 Unforeseen economic circumstances and inflation developments

In a decision on investment in residential housing individuals use certain premises as their basis, which concern particularly the estimated disposable income of households, financing costs, estimated asset formation and the borrower's expectations regarding price level developments during the loan term. There are valid arguments that the inflation spike of 2007-2010 was unforeseen, as most of the increase resulted from events which were difficult to forecast.

The proposal is to correct the increase in households' inflation-indexed housing mortgages due to the mismatch resulting from the rise in the Consumer Price Index (CPI) or other reference index for borrowers' obligations in excess of average inflation since the introduction of inflation targeting. The debt relief will be implemented according to the rules explained in detail in Chapter 4 of the report. In the estimation of the group, this methodology is justified by the premises which underlie the group's work.

The difference between the reference inflation level and accrued indexation during the said period has been referred to in public debate as "failed assumptions" or "failed premises". Although the use of this concept is not in all respects appropriate, the report uses this concept in some instances to describe the inflation spike of 2007-2010. It should be pointed out specifically that despite the use of this concept the report does not in any way take a position as to whether material adverse change is involved in a legal sense, including whether the conditions for failure of legitimate expectations are fulfilled in general or in individual instances. On the contrary, what is involved here is an economic action which is directed at a specific group of people in the society who are in a similar situation and which is based on the Government's coalition platform and the above-mentioned Parliamentary Resolution. The action is in other words only directed at inflation-indexed housing mortgages of individuals and households which rose substantially because of higher inflation in tandem with the financial system collapse. It therefore involves a well demarcated, one-off action, intended to improve the situation of debtors with inflation-indexed housing mortgages as outlined in Chapter 3. The action therefore has neither legal effects towards other groups than those at whom it is directed, i.e. borrowers with inflation-indexed housing mortgages, nor does it set a precedent for the future, i.e. if similar circumstances were to arise in the future. Persons other than those who are directly covered by the action in accordance with the above can therefore neither base any right on it nor is it liable to create

legitimate expectations that obligations other than those referred to in Chapter 3 will also be reduced. It is reiterated that no position is taken in the report with regard to lenders' possible obligation for damages, as this involves a general economic action.

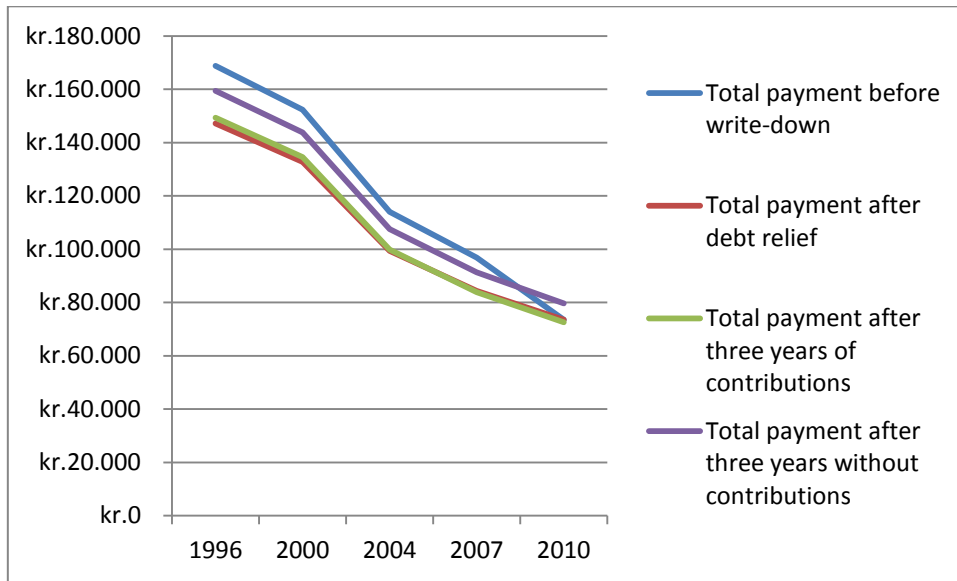
## **2.2 Methodology**

The proposed method is both general and targeted, includes positive incentives and rewards prompt payment. The direct write-down involves repayment and settlement of indexation accruing on inflation-indexed housing mortgages during the period from December 2007 to August 2010 in excess of the specified reference. Subsequent chapters explain what loans the action covers and its implementation. The Explanatory Notes accompanying the Parliamentary Resolution upon which the group's work is based discuss its task in more detail together with the premises upon which it is based. They state, among other things, that inflation is the measure to be used as reference for the write-down of the principal of inflation-indexed housing mortgages.

In 2001, a new monetary policy was adopted and inflation targeting formally introduced along with a floating exchange rate. This action altered the basis of economic developments, as monetary policy was aimed at maintaining stable price levels and the Central Bank of Iceland's policy rate applied to this end. As stated in Chapter 1, during the period from the introduction of inflation targeting in 2001 until the end of 2007 the average inflation rate was 4.8%. The group considers it appropriate to use this reference as a basis for calculating the write-down of the principal of inflation-indexed housing mortgages.

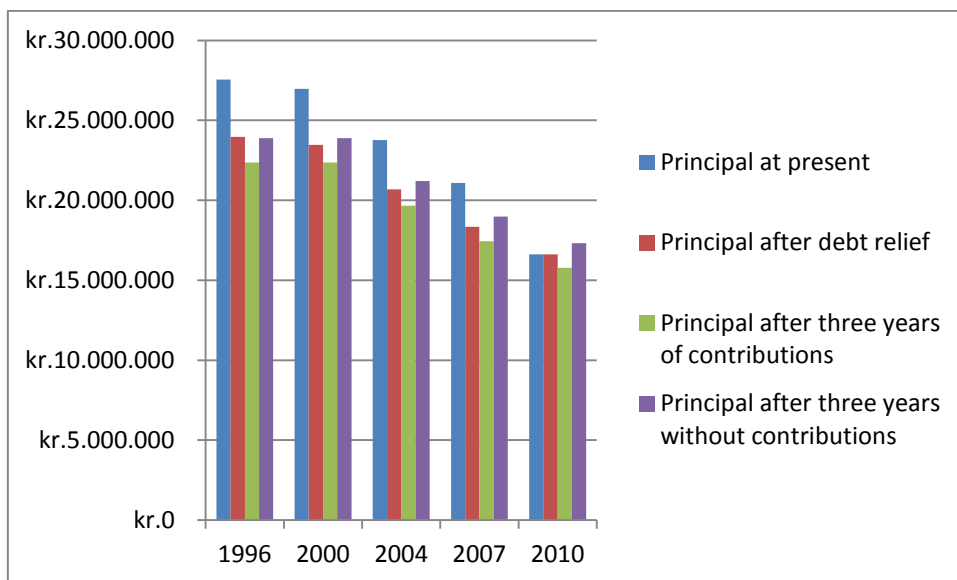
During the period 2007-2010 inflation averaged 8.4%. The methodology comprises an adjustment of around 13% of the CPI used for indexation during this period. It should be reiterated that this does not involve a fixed percentage write-down of the loan principal; instead, regard will be had for the indexation which accrued on the loan in excess of the reference level. Nor does this methodology take into consideration when payments were made, whether they were frozen or paid when due; the focus is rather on when payments were due according to the loan contract and its other terms. Therefore those factors which are of significance include when the loan was taken out, what the contractual interest rate was, the initial index value and the dates for payments.

Chart 13. Comparison of payments prior to and after debt relief and payment of private pension contributions<sup>27</sup>



Since inflation targeting was introduced in 2001 and until year-end 2007 the annual inflation rate averaged 4.8%. The intention is to reduce indexed housing mortgages by the amount of inflation-indexation exceeding 4.8% from December 2007 to August 2010 to a maximum of ISK 4 million per household. Around 90% of households entitled to debt relief will not be subject to a reduction because of this cap, i.e. the cap will not affect loans with an outstanding balance of up to ISK 30 million as of year-end 2010.

Chart 14. Comparison of principal prior to and after debt relief and payment of private pension contributions



<sup>27</sup> Actions concerning private pension savings are discussed in more detail in Chapter 5.

The debt relief will be implemented by splitting those housing mortgages which are to be reduced into two parts: On the one hand, the primary portion of the original mortgage and, on the other, the debt relief portion of the mortgage. The credit which the borrower is to receive due to the failed premises is applied towards the debt relief portion of the loan according to the rules laid down in Chapter 4. The same terms and conditions apply to both parts as applied to the original mortgage. The Treasury is the payer of the debt relief portion of the loan, while the borrower retains responsibility for it until this is fully paid up in four years' time. The borrower's debt service is therefore reduced, as he/she pays only the primary portion of the loan once the debt relief is implemented.

### **2.3 Agreements with lenders and cost of this action**

According to the first paragraph of Art. 72 of the Icelandic Constitution, Act No. 33/1944, property rights are inviolable. The Article also states that no one may be obliged to surrender his/her property unless this is necessitated by the public interest; such a measure must be provided for by law and full compensation shall be paid. The concept of expropriation as such is not mentioned in Art. 72 of the Constitution, but a description of its substantial content is given in the first paragraph of this Article with reference to the conditions stated there. Expropriation occurs when a party is obliged to relinquish its property right to specific assets in part or in full. Expropriation must rest on a legal basis and full compensation must be paid.

It goes without saying that a lender's inflation-indexed loan portfolio is considered an asset in the sense referred to in the constitutional provision on property rights. It should therefore be evident that lenders cannot be obliged to write down inflation-indexed housing mortgages unless the requirements of the first paragraph of Art. 72 of the Constitution are satisfied.

The debt relief proposed in this report comprises to some extent a reduction to the lender's property. In the group's estimation there is no doubt that the conditions for expropriation are satisfied with regard to the debt relief on inflation-indexed housing mortgages. Naturally it is a simple matter for the legislature to adopt legislation providing for such debt relief, and in addition the requirement that this be necessitated by the public interest is without a doubt satisfied in this instance, as the general view is that the legislature's assessment of the public interest cannot be challenged.

The final condition of the first paragraph of Art. 72 of the Constitution stipulates that full compensation must be paid when a party is deprived of its property. It is generally recognised that the reference to full compensation in the first paragraph of Art. 72 means that compensation shall only be made for financial loss and that no compensation shall be made for non-financial loss. However, the victims of expropriation are not only entitled to compensation for the value of the asset expropriated but also to compensation for the inconvenience which the expropriation causes in other respects and consequential financial loss to them. No one is obliged to relinquish an asset which is expropriated unless compensation is paid or a satisfactory guarantee provided for this payment.

It is important that, before the debt relief is implemented, lenders are fully consulted and an attempt made to reach an agreement on compensation for the reduction to the lenders'

assets resulting from the debt relief on inflation-indexed housing mortgages. It is appropriate for the authorities to take the lead in such negotiations and make every effort to reach an agreement, so that expropriation as provided for in Act No. 11/1973 will not be necessary. Obviously, in such negotiations a variety of perspectives need to be considered, in particular, what is considered full compensation in this sense. As far as the Icelandic state is concerned, it will obviously maintain that consideration must be given to the fact that in some instances inflation-indexed mortgages were transferred from the failed commercial banks, Glitnir, Kaupthing Bank and Landsbanki Íslands, to the new banks established from the older ones at a considerable discount. No doubt it also needs to be considered that the quality of the lenders' loan portfolios in general will probably improve with the debt relief.

In the group's estimation, based on calculations by the Ministry of Finance and Economic Affairs, the cost of this action in its entirety will amount to ISK 80 billion, spread evenly over a four-year period. The cost will appear in Class A Treasury operations. Since it is not the group's task to determine the Treasury's income generation routes, it assumes that the cost of the debt relief will be covered and the net impact on the Treasury will be insignificant.

The route proposed by the group does not require the establishment of a special debt relief fund for housing mortgages and therefore there is no reason to discuss specifically the advantages and disadvantages of such a fund, as Point 2 of the Parliamentary Resolution proposes.



## 3 Scope

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The Parliamentary Resolution states, among other things, that it should be a premise for the group's work that these will be general actions to deal with household debt problems in Iceland, which have arisen from the unforeseeable increase in the principal of indexed housing mortgages in 2007-2010. It is stated that these are general actions, independent of when the loan was taken, emphasising equal treatment and efficacy of remedies, which are to benefit all households which were subject to failed premises. The correction is to be the same whether loans have always been paid on time or not. Having regard to the above, the group proposes that the obligations which will be entitled to debt relief be defined as described in this chapter.

On the part of the group, it is emphasised that this is a concessionary action towards borrowers and that the debt relief is optional on the borrower's part. It must be pointed out clearly that it is not the intention to exclude better rights of individual to whom such is available, whether this may result from agreements of borrowers with lenders, court precedents or other reasons.

### 3.1 General definition

The eligibility of those obligations covered by the reduction to the principal of inflation-indexed housing mortgages shall be as follows:

Entitlement to debt relief is restricted to fully or partly inflation-indexed loans granted to individuals for the purchase or construction of residential housing for own use, including for the purchase of permanent residence rights (Icel. *búseturéttur*) and purchase of a holding in a public hire-purchase residence (Icel. *kaupleiguíbúð*), regardless of when the mortgage was taken out and whether the payments were made on time for the entire loan term or not, provided the borrower has been subject to failed premises, in part or in full, as defined in Chapter 2. In addition, the requirement is set that the borrower had reported the loans and interest expenses, providing the specific information on them, on his/her tax return in the format determined by the Directorate of Internal Revenue.

### 3.2 Further specification of those obligations entitled to debt relief

#### 3.2.1 Inflation-indexed loans

The adoption of the Act on Economic Management etc., No. 13/1979, authorised the general inflation indexation of deposits and loans, as well as the inflation indexation of wages. To begin with, indexed loans were linked to the Credit Terms Index, which consisted of a mixture of the CPI and the Construction Terms Index, and later also of the wage index. From 1995 onwards, indexed loans have been linked exclusively to the CPI. Art. 13 of the current Act on Interest and Indexation, No. 38/2001, states for instance that the provisions of Chapter VI of the Act shall apply to obligations concerning savings and loans in ISK where the debtor promises to pay monies and where it is agreed or required that the payments be inflation-indexed. It also states that the indexation means a change proportional to a domestic price index and that the authorisation for indexation is subject to Art. 14 of the Act unless otherwise provided for by law. Art. 14 of the Act states that indexation of savings and

loans is authorised as provided for in Art. 13 if the basis of the indexation is the CPI calculated by Statistics Iceland in accordance with the law applicable to the index and published each month in the Legal Gazette (Icel. *Lögbirtingablaðið*). The second paragraph of Art. 14, states that for a loan contract, however, an equity index, domestic or foreign, or a collection of such indices, may be used which does not measure general price level changes. Further details of the indexation of savings and loans can be found in the Rules of the Central Bank of Iceland, No. 492/2001, on the Indexation of Savings and Loans. The first paragraph of Art. 4 of the Rules states that indexation of loans providing for the loan principal to be based on the CPI is only authorised for a loan with a tenor of at least five years.

It is appropriate to remove any ambiguity by stating that references to inflation-indexed loans which may be entitled to debt relief apply to loans which change proportionally to a domestic price index both in accordance with the current Act No. 38/2001, on Interest and Indexation, as well as in accordance with older Acts. In the case of the so-called mixed real estate mortgages, i.e. mortgages which are partly but not fully inflation-indexed, the debt relief by its nature applies only to the inflation-indexed portion of the mortgage.

It should be specifically mentioned that it makes no difference regarding the entitlement to debt relief by what means the finalisation of documents or money transfers in connection with the loan granted have been effected. In other words, the entitlement to debt relief is independent of whether the granting of the loan was made through the issuance of a mortgage bond or, as the case may be, with a special loan contract on the occasion of a housing purchase, and the debt as the case may be secured with a mortgage on the property based on a guarantee security. On the other hand, it is considered appropriate to make it a condition that the loan was granted by an undertaking or public entity which carries out lending activities on a commercial basis or as provided for by law. This covers the Housing Financing Fund (HFF), financial undertakings, including those directed by a Resolution Committee, Winding-up Board or provisional Board of Directors as provided for in the Act on Financial Undertakings, No. 161/2002, pension funds and other undertakings and public entities which have granted individuals loans for housing purchases.

### **3.2.1.1 Payment smoothing of individuals' housing mortgages**

Following the banking and economic collapse, individuals have been offered to link their inflation-indexed loans to a payment equalisation index. In October 2009, Act No. 107/2009, on Actions to the Benefit of Individuals, Households and Undertakings due to the Banking and Currency Collapse, was adopted, which provided among other things for all real estate mortgages to be subject to payment equalisation from November 2009 onwards, unless the borrower in question declined specifically. The Act thus revived a remedy originally introduced by Act No. 63/1985, on Payment Smoothing of Real Estate Loans to Individuals. It is established that just under half of borrowers declined the payment smoothing, with the result that around half of real estate mortgages currently have payment smoothing.

There is reason to mention specifically that those borrowers who benefited from payment smoothing on the basis of the above-mentioned statutory provisions are entitled to debt relief in the same manner as persons who requested specifically to be exempt from payment smoothing.

### ***3.2.2 Loans to individuals for purchase or construction of residential housing for own use – more than one home – guarantor mortgages etc.***

#### **3.2.2.1 General**

The entitlement to debt relief in connection with the purchase or construction of residential housing for own use is restricted to individuals and excludes therefore all loans to legal entities, whether taken to acquire real estate or for other purposes. It is deemed appropriate to make it a condition that the individual, during the period included in the failed premises, was subject to unlimited tax liability in Iceland or had his/her domicile in the country for tax purposes. However, individuals residing in the European Economic Area, member states of the European Free Trade Association (EFTA) Treaty or the Faroe Islands, may be entitled to debt relief if they have utilised their contingent right to be taxed in Iceland.

In the group's estimation there are tangible and objective arguments for distinguishing between loans to individuals and legal entities, as well as for limiting entitlement to debt relief to loans taken for the purchase of residential housing for own use.

There is therefore nothing to prevent stipulating different treatment of the cases of individuals and those of legal entities. Reference is made to the fact that legislation has in many cases special rules on loans to individuals providing for more extensive rights in the case of individuals than for legal entities, cf. for example the Act on Consumer Loans, No. 121/1994, Act No. 63/1985, on Payment Smoothing of Real Estate Loans to Individuals, Act No. 107/2009, on Actions to the Benefit of Individuals, Households and Enterprises due to the Banking and Currency Crisis etc. The tax treatment of loans to individuals and legal entities also differs, for instance, in limiting rules on interest benefits to individuals' housing mortgages. In addition, it should be pointed out that the majority of financial undertakings have different rules for settlement of debt problems for individuals and for legal entities.

The group is also of the opinion that the considerations of equal treatment underlying the private property provisions of Art. 72 of the Constitution, Act No. 33/1944, do not prevent the making of a distinction between loans to individuals for the purchase or construction of residential housing for own use and loans taken for other purposes. In this connection reference is made to the precedent of passing legislation which gives housing mortgage debtors preferential treatment over other debtors, as it is generally recognised that a mortgage to purchase residential housing is an important aspect of social structure, in addition to which the objective is to protect individuals' homes from the failed premises. Examples of such which could be mentioned are Act No. 63/1985, on Payment Smoothing of Real Estate Loans to Individuals, Act No. 50/2009, on Temporary Mitigation of Residential Mortgage Payments, Act No. 151/2010, amending the Act on Interest and Indexation, the Act on Actions to the Benefit of Individuals, Households and Enterprises due to the Banking and Currency Crisis, and the Act on a Debtors' Ombudsman. In addition, various special rules apply to mortgages, such as the rules on interest benefits, which are limited to loans taken for purchase of own residential property, as will be recounted in detail below. It should therefore be apparent that individuals' loans for purchase of housing enjoy a somewhat special status compared to other loans from the perspective of the public good and welfare

which justifies, in the group's estimation, that entitlement to debt relief be restricted to the above-mentioned loans solely.

It should be pointed out specifically that, in accordance with the objective stated in the Explanatory Notes accompanying the Parliamentary Resolution that this should be general actions emphasising equal treatment, entitlement to debt relief is independent of the asset and income position of the individual borrower concerned. On the other hand, it is considered appropriate to propose a specific cap to the amount of debt relief, as explained in more detail in Chapter 4.

### **3.2.2.2 Loans for purchase or construction of residential housing for own use**

A more detailed specification of the obligations which may be entitled to debt relief is based on the requirements of the provision in Part B of Art. 68 of the Income Tax Act, No. 90/2003, which contains rules on interest benefits which are restricted to loans to individuals taken for purchase of own residential housing. In the group's estimation it is appropriate, in specifying those obligations which are entitled to debt relief, to use a reference which is already codified in law and has been applied for a long period. By so doing, an attempt is made to set a clear reference which applies to everyone in a similar position.

Accordingly, the requirement is set for debt relief that it applies to inflation-indexed loans to individuals, taken for the purchase or construction of residential housing for own use, including purchase of permanent residence rights (Icel. *búseturéttur*, as provided for in Act No. 66/2003, and purchase of a holding in a public hire-purchase residence (Icel. *kaupleiguíbúð*), as provided for in previous legislation, provided the borrower has reported the loans and interest expense on them in a special section of his/her income tax return, providing the specific information, as required in the first paragraph of Art. 90 of the Income Tax Act, in the format determined by the Directorate of Internal Revenue.

To clarify this further, it should be pointed out specifically that "own use" means that the housing is used as the residence of the owner him-/herself. In other words, an individual only satisfies the requirements of Part B of the Income Tax Act, No. 90/2003, if the property in question is his/her legal domicile, cf. however, the special rule on more than one residential property below. This restriction accords with the tax authorities' interpretation of the said legal provision.

A borrower may also be entitled, if other requirements are satisfied, to debt relief on loans from the Housing Financing Fund taken for major renovations on housing for own use. In such instances as in other cases, the requirement is set that the loan was reported in a special section of the income tax return providing specific information and, in addition, that the right to interest benefits has been recognised by the tax authorities during the period of the failed premises.

Despite the general principle that entitlement to debt relief is restricted to residential housing for own use, there may be instances where the entitlement to debt relief exists where a property was not used by the owner due to special provisional circumstances, such as study, illness or employment reasons. Under such circumstances, entitlement is subject to

the condition that the right to interest benefits was recognised by the tax authorities during the period to which the failed premises apply.

Finally, it should be mentioned that according to Part B of Art. 68 of Act No. 90/2003, it is a condition for interest expenses to create a right to interest benefits, that the term of the housing mortgage be at least two years. This last requirement, however, can hardly be restrictive, as the indexation of a loan principal in ISK is only authorised if the tenor of the loan is at least five years, cf. the Rules of the Central Bank of Iceland, No. 492/2001, on the Indexation of Savings and Loans.

### **3.2.2.3 More than one residential property**

If an individual owns more than one residential property, he/she is only entitled to debt relief on loans of one of them, the one intended for own use. This also applies to jointly taxed cohabiting partners who each own their own home.

A borrower may, however, if other conditions are satisfied, be entitled to debt relief on loans taken out for housing under construction or for purchase of existing housing which is being renovated directly following the purchase and is intended for own use, despite at the same time owning a residential property for own use, and benefit from debt relief on loans in connection with the acquisition of that property. Similarly, a borrower may be entitled to debt relief due to temporary ownership of two properties regardless of their stage of construction if it proved impossible to sell one due to extraordinary circumstances on the real estate market.

The above specification accords with the provisions of Regulations Nos. 266/2009 and 693/2011, amending Regulation No. 990/2001, on Payment of Interest Benefits, as subsequently amended, which was issued with reference to Part B of Art. 68 and to Art. 121 of Act No. 90/2003, on Income Tax, as subsequently amended. As before, it is a mandatory requirement for debt relief that the loan and interest expense on it was reported in a special section of the borrower's income tax return, providing the specific information. The right to interest benefits has to have been recognised by the tax authorities during the period to which the failed premises apply.

### **3.2.2.4 Guarantor mortgages**

Inflation-indexed housing mortgages taken by a borrower for purchase or construction of residential housing for own use, secured by a mortgage on a property of *another* individual, are entitled to debt relief provided the borrower has reported the loans and interest expenses on them in a special section of his/her tax return, providing the specific information in the format determined by the Directorate of Internal Revenue.

This approach is, in the group's estimation, in accord with the wishes of the legislature, which has endeavoured to accommodate the so-called guarantor mortgage group, in part with a recent amendment to provisions of Act No. 90/2003, on Income Tax. Specifically, a new Temporary Provision LII was added at the beginning of April 2013 to Act No. 90/2003, on Income Tax, cf. Art. 1 of Act No. 43/2013, providing for the Directorate of Internal Revenue, given that various conditions are satisfied, to determine special interest benefits, guarantor mortgage interest benefits, for a person who has taken out a real estate mortgage

for the purchase or construction of residential housing for own use which is secured by a mortgage on the real property of another individual.

### ***3.2.3 Independent of when the loan was taken out and whether payments have been made on time***

The right to debt relief does not depend on when the loan was taken. It is necessary, however, that the basic condition for the debt relief is satisfied, that the borrower has been subject to failed premises, in part or in full. Due to the nature of the issue this means that if the term of the loan had concluded before the period to which the failed premises apply or if the loan was taken after the period of failed premises, the borrower in question is not entitled to debt relief. The entitlement to debt relief shall also be independent of whether the loan is considered to have always been paid up to date or not. In addition, payments made on loans, during the period subject to the failed premises, shall not affect the entitlement to debt relief, apart from the fact that the payments naturally affect the amount of the write-down, i.e. if a borrower has reduced the principal of a loan in part or in full this affects the indexation which has accrued on the loan or loans.

As recounted in more detail in Chapter 4, however, the debt relief applied to a loan shall be based on the position of the loan as if it had been paid up-to-date during the entire loan term. Any other method would lead to unequal treatment, as otherwise persons who did not make their payments would receive proportionally higher debt relief than persons who paid on time and fulfilled their obligations.

### ***3.2.4 Failed premises – Change of ownership etc.***

The basic requirement for a borrower to be entitled to debt relief is that the loan in question was subject fully or partly to failed premises, as the failed premises are defined in Chapter 2 above.

If the borrower, for some reason, has only been partly subject to failed premises, he/she shall only have a corresponding partial entitlement to debt relief. If, for example, one or more changes have occurred to the holder or debtor of a loan contract during the period subject to the failed premises each borrower shall have an independent right to proportional debt relief based on the length of time the person concerned was the debtor of the loan contract. Changes to the mortgage principal resulting from failed premises which have been calculated on the principal of a loan while each party was the debtor of the loan shall be settled according to the rules discussed in Chapter 4, based on the date of the change in ownership; the right of each party to debt relief shall be based on that date.

Chapter 4 will discuss in more detail the group's proposals for implementation of the debt relief, including the application process and rules on the debt relief write-down and disposition of any credit created.

### ***3.2.5 Loans must be reported on tax returns***

It is a mandatory condition for debt relief that a borrower reported inflation-indexed loans which satisfy the requirements for debt relief and the interest expense on them in a special section of his/her tax return, providing specific information in the format determined by the Directorate of Internal Revenue, as provided for in detail in Art. 90 of Act No. 90/2003, on

Income Tax. Specifically, it is made a requirement that inflation-indexed housing mortgages of individuals have, during the period of the failed premises, been reported by the borrower in Section 5.2, “Interest expense for a residence for personal use”, providing the specific information.

If an individual has for any reason not reported inflation-indexed housing mortgages which could serve as a basis for interest benefits in Section 5.2 of his/her income tax return for the years subject to failed premises, the group wishes to draw attention to the fact that the person concerned has the option of sending a request to the Directorate of Internal Revenue requesting a change to the tax return or tax returns in accordance with the rules of Chapter XI of Act No. 90/2003, on Income Tax. The Directorate of Internal Revenue can accept such requests up to six years previous to the year a request is made, provided significant interests lie behind such a request, cf. Art. 101 of Act No. 90/2003. If the Directorate of Internal Revenue agrees to make changes in accordance with the above, those loans which are entered in Section 5.2 of the corrected tax returns during the period of failed premises can be the object of debt relief on the failed premises if other requirements are satisfied.

## 4 Implementation

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### 4.1 Introduction

As related in the chapter on the scope of the actions and eligibility of obligations, it is a mandatory requirement for debt relief that the borrower has reported inflation-indexed loans which satisfy the requirements for debt relief in Section 5.2 of his/her tax return for those years to which the debt relief applies. In those instances where individuals are jointly taxed, i.e. couples and co-habiting partners who have specifically requested joint taxation, the debt relief shall apply to their joint debts as reported in Section 5.2 of the tax return, regardless of which of them is the registered borrower of the loan or loans concerned. In other instances the debt relief shall naturally only apply to those loans in the name of the individual concerned which were reported in Section 5.2 of the tax return.

It is appropriate, to dispel any ambiguity, to point out that all inflation-indexed housing mortgages entered in the last-mentioned section of the tax return which existed, fully or partly, during the period of the failed premises from December 2007 until August 2010 create an entitlement to debt relief provided other requirements are satisfied. Thus a debtor may, for instance, have a proportional entitlement to debt relief if a change of debtors occurred during the period of the failed premises, as the case may be, together with a subsequent debtor, as is explained in detail below. The same applies to loans which have been paid off during the period of the failed premises, i.e. the debtor is then entitled to debt relief for the period until the loan was repaid. In other words, a borrower is entitled to debt relief even though the obligation which gave rise to the entitlement to debt relief has been cancelled for some reason during the period of the failed premises or afterwards, e.g. due to a change in debtor, refinancing, payback and the like.

The example can be taken of a couple who held three inflation-indexed loans with the first three lien rights on their property at year-end 2010, which were taken at the beginning of 2006. The couple had downsized, purchasing a smaller property around mid-2009, and repaid a loan with fourth lien rights on the property. According to the above, all the loans can be the object of debt relief, but the repaid loan with fourth lien rights only proportionally up until the time it was repaid. It makes no difference in this connection which of the partners was registered as the borrower of the loans in question and/or whether either of them had undertaken the obligations concerned prior to marriage. A couple's entitlement to debt relief shall be equal and independent of the formal registration of the loan obligation. Here as in other instances, it should be borne in mind that the amount of the write-down which individuals can benefit from is capped, as explained in more detail later in this chapter.

#### *4.1.1 Change of debtors in loan contracts during the period of failed premises*

If one or more changes have occurred to the debtor of a loan contract during the period subject to the failed premises each borrower shall have an independent right to debt relief in proportion to the length of time the person concerned was the debtor of the loan contract. The entitlement of each party to debt relief is based on the date of the loan novation.



Should a dispute arise as to entitlement to debt relief between a debtor and former debtor, the parties concerned may refer their dispute to a Complaints Committee on Debt Relief for Inflation-indexed Housing Mortgages, as discussed later in this chapter.

#### ***4.1.2 Loans paid off with the debt relief***

If the borrower's credit due to the failed premises results in the loan obligation in question being repaid in full, the lender shall issue a final receipt, see to the removal of charges and issue any statements necessary, such as cancelling entries on the default register.

#### ***4.1.3 Impact of relief cap***

As discussed later in this chapter, the group's proposals assume that a cap be set to the amount of debt relief that each household can enjoy. It is proposed that the maximum write-down of real estate mortgage claims be up to ISK 4 million. In implementing the debt relief regard must be had for the above limit so that the total debt relief will never exceed the maximum amount.

#### ***4.1.4 Couples separating***

If a couple separated during the period to which the debt relief applies, the party who took over the loan for which the couple was jointly responsible is entitled to a reduction from the date of his/her takeover of the obligation onwards. Up until that point in time the couple is jointly entitled to a reduction.

As an example, the couple M and K were jointly responsible for a loan obligation which they undertook at the beginning of 2007. On 15 June 2009, M and K separated. When their assets were divided, it was decided that K should take over the said obligation from the date of separation. The entitlement of M and K to debt relief shall, in accordance with the above, be equal up until the reference date of their separation, or until 15 June 2009, while on the other hand K shall benefit from the debt relief arising from the date of takeover. In other respects the rules referred to above shall apply to such changes of debtors.

#### ***4.1.5 Deceased borrower***

If a borrower entitled to debt relief is now deceased, the credit shall accrue to his/her spouse if the latter has been granted a deferred estate settlement. The surviving spouse must then take the initiative to apply for debt relief in accordance with the rules referred to below. If the probate has not concluded, the executor of the estate may apply for debt relief. If a deferred settlement has not been granted and the probate of the estate in question has concluded, the right to debt relief shall be cancelled.

#### ***4.1.6 Emigration abroad***

As discussed in Chapter 3 on the eligibility of obligations granting entitlement to debt relief, the condition is set for entitlement to debt relief on inflation-indexed housing mortgages that the borrower was, during the period included in the failed premises, subject to unlimited tax liability in Iceland or was domiciled in the country for tax purposes. Emigration abroad after the conclusion of the period of the failed premises does not affect the entitlement to debt relief. Parties domiciled abroad who held inflation-indexed housing mortgages in Iceland during the period of the failed premises are therefore entitled to, if

other conditions are satisfied, write-downs of those loans or, as the case may be, a credit with the Directorate of Internal Revenue as explained in more detail below.

#### **4.1.7 Enforcement actions**

The group examined in particular arguments for and against providing for special authorisation to re-examine enforcement actions which have already taken place based on inflation-indexed loan contracts. The question to be examined is actually whether circumstances are so extraordinary now that there is deemed reason to derogate from the time limits and strict conditions which generally apply to such authorisation for re-examination.

It should be pointed out that there are precedents for a special authorisation for re-examination in Icelandic law following the economic collapse. Provision is made for re-examination in Temporary Provision XIII of Act No. 38/2001, on Interest and Indexation, cf. Act No. 151/2010, in connection with loan contracts with unlawful exchange-rate indexation. According to the final sentence of the Temporary Provision, authorisation for re-examination under the provision expired after nine months had passed from the entry into force of the Act and this authorisation is now no longer valid.

The group is of the opinion, however, having regard to the different nature of inflation-indexed housing mortgages, which have not been pronounced illegal by Icelandic courts, and foreign currency loan contracts, containing provisions on exchange-rate indexation which have repeatedly been pronounced illegal, that it would not be appropriate at this time to propose that special statutory authorisations for re-examination be adopted regarding inflation-indexed loan contracts. In this connection consideration should also be given to the fact that the reduction to the principal of indexed loans proposed in this report is an optional and concessional action, which does not comprise recognition that the unforeseen inflation spike in 2007-2010 comprises a material adverse change in a legal sense, for which lenders can be responsible.

If a lender has appropriated a borrower's real property by forced auction before the legislation on debt relief enters into force, it is proposed that any credit resulting from a reduction to the inflation-indexed mortgage principal, if other conditions are satisfied, be used to write down the outstanding balance of the mortgage on the property which was not fully paid with the selling price of the real estate, if this has not been written off or paid back, e.g. in accordance with a Regulation on handling of HFF claims which have lost their collateral, No. 359/2010.

## **4.2 Methodology of the Debt Relief**

### **4.2.1 Introduction**

It is evident that following the work which has now been done by the group the legislature must intervene with legislation to enshrine in law rules, for instance, on the manner by which the debt relief for inflation-indexed housing mortgages shall be effected. In tandem with this, the legislature must consider the amendments necessary to other Acts. Amendments need to be made, for instance, to Act No. 90/2003, on Income Tax, since according to the group's proposals in certain instances the calculated amount for debt relief for the failed premises will be in the form of a tax reduction. It is also necessary to ensure

legally that the debt relief will not be considered a waiving of debt as defined by Act No. 90/2003, and thereby create a tax liability. Amendments also need to be made to Act No. 44/1998, on Housing Affairs, in order to authorise the Housing Financing Fund to write down the Fund's mortgage claims against individual if certain requirements are fulfilled.

It is naturally important to fully consult with lenders on how the implementation of debt relief is to be effected and to have realistic time limits to conclude settlement. In this connection the group proposes that the authorities take the initiative in establishing a joint forum of lenders, to draft procedures for lenders in the housing mortgage market on write-downs to inflation-indexed housing mortgages. On the group's part, it is emphasised that such procedures should be based on proposals made in the report. It is important that co-operation of lenders be limited to the task concerned here, i.e. write-downs of inflation-indexed housing mortgages to individuals due to the failed premises as defined in Chapter 2. It is also necessary to consider specifically co-ordinated treatment of penalty interest in connection with disposal of borrowers' credits, to ensure that borrowers enjoy the best possible terms. Finally, special consideration must be given to the implications of such collaboration for competition law, including whether it is necessary to request an exemption from the Icelandic Competition Authority as provided for in Art. 15 of the Competition Act, No. 44/2005.

It is no less important that the implementation of the debt relief be thoroughly advertised to the public, including the requirements which must be satisfied for debt relief to be feasible, the limits to the amounts, the impact of previous debt mitigation on the calculations, the application process, time limits etc.

#### *4.2.2 Application, co-ordinating party etc.*

In the group's estimation the only route possible to implement the debt relief on inflation-indexed housing mortgages is to have the borrower apply specifically for debt relief, as it is necessary to have a clear statement of intent from the borrower, requesting a reduction and agreeing to the terms and conditions which apply to it. Borrowers will thereby apply electronically for debt relief from the creditor who, on the date of application, holds the claim which is foremost in the lien rights of mortgages on the applicant's property by filling out an application for this purpose on the lender's website. The creditor holding first lien rights shall be the co-ordinator of the debt relief, manage the case and communicate with other creditors in connection with the application as necessary. If a borrower has a mixture of loan types, i.e. a foreign currency loan and an inflation-indexed loan, the borrower shall apply to the creditor holding the inflation-indexed loan or loans, even if the foreign currency loan has a prior right.

The application must include the name or names and addresses of persons applying. It must also include basic details of the applicant's inflation-indexed loan obligations, including the loan number, purpose of the loan, tenor of the loan, loan amount and any change in debtors of the loan. If the borrower cannot for some reason submit an application electronically he/she may also submit an application to the lender by registered letter or general mail, or fill out an application at an establishment of the lender in question. The last-mentioned shall, however, be an exception from the general rule that applications shall be submitted

electronically and lenders shall make every effort to instruct applicants on electronic submission of applications as much as possible.

If an application is submitted by a party other than the actual borrower, it must be stated who has submitted it and his/her Id. No., power of attorney from the borrower, residence permit etc., to submit a request for debt relief on the borrower's behalf.

If there has been a change in the debtors of an applicant's loan or loans the date of the novation must be stated in the application. If a novation occurred during the period of the failed premises, each and every debtor shall have a proportional entitlement to debt relief, as explained in detail above.

If an applicant has inflation-indexed housing mortgages from more than one lender, he/she must explain this in the application. In such cases the applicant must authorise the co-ordinator, by placing a check mark in the relevant box on the application form, to obtain the data and information from other lenders necessary in connection with the request for the reduction of the principal of inflation-indexed housing mortgages. The applicant must furthermore give an account of those loans which have been repaid in full or in part during the period of the failed premises or, as the case may be, after that.

If the applicant has previously benefited from remedies which have reduced the principal of an inflation-indexed housing mortgage, such as payment mitigation, problem debt restructuring or the so-called 110% route, the applicant must account for this in the application. Recalculation or reduction of the principal of foreign currency loans is not considered a write-down in this sense. The applicant must also explain what lender looked after implementing the remedy or remedies towards other lenders. Details must also be given as to when the remedy in question was applied for and whether, and if so when, a write-down based on the remedies took place. A detailed account shall also be given of the total write-down of mortgage debts in the application, with a breakdown as appropriate by lender. If the total write-down on the basis of such remedies exceeds the maximum amount, the application for debt relief shall be rejected. If the remedy from which an applicant has benefited has not concluded when the application is submitted to the co-ordinator, the application shall be rejected provisionally, as in such cases it is impossible to evaluate the application because it is not finally clear whether and if so how much of the applicant's loan principal or principals will be written down. This applies e.g. when the debt mitigation period provided for in Act No. 101/2010, on Payment Mitigation for Individuals, has not concluded or when the period of problem debt restructuring is not complete. The co-ordinator shall, under such circumstances, instruct the applicant as to when he/she may renew the application.

The borrower shall also confirm in the application that he/she authorises the co-ordinator to obtain from the Directorate of Internal Revenue certain information from the applicant's tax returns for those years to which the failed premises apply. This the applicant does by placing a check mark in the relevant box in the application where it is stated that the applicant authorises the Directorate of Internal Revenue to provide the co-ordinator with information on all the debts which are listed in Section 5.2 of tax returns for the years 2008 to 2011 inclusive for the years 2007 to 2010 under the heading "Interest expense for a residence for personal use". The authorisation is restricted to this information solely and the lender will

not receive other information on the lender, such as concerning his/her assets or income. Furthermore, the applicant must confirm that, if his/her credit from the debt relief for some reason cannot be used to write-down loans then the co-ordinator is authorised to send the Directorate of Internal Revenue a summary of the applicant's credit and other documentation deemed necessary by the Directorate of Internal Revenue to determine a special personal deduction, cf. the specific rules on write-downs in connection with a credit as discussed below.

An applicant must furthermore confirm in the application that he/she authorises, if necessary for the disposition of any credit, that changes be made to the terms of his/her housing mortgage or mortgages on the date of application, dividing them into two parts, a primary portion and a debt relief portion, as will be explained in more detail below. It is necessary that the legal effects of such changes in terms be stated clearly in the application, i.e. that the borrower's credit resulting from the failed premises will be entered against the debt relief portion and any arrears which may have been incurred will be deducted from the credit. Both loans, the primary portion and the debt relief portion, remain as a charge against the applicant's property, but following the change in terms the payer of the debt relief portion will be the Treasury. The debt of the debt relief portion enjoys the same terms and lien priority as that of the primary portion. This does not therefore comprise a novation, where the Icelandic state becomes the debtor of the debt relief portion, but instead the applicant remains the debtor while the Treasury pays the instalments and financing cost on the debt relief portion. This means that the applicant's debt service burden decreases immediately as after an application is approved he/she only has to pay the instalments and interest on the primary loan portion. As described in Chapter 2.2 the Treasury will pay off the debt relief portion in full in four years and once the loan is fully repaid the lender shall issue a final receipt and remove the charges of the debt relief portion.

The borrower must confirm the application, stating that all the information provided in the application is correct according to his/her best knowledge and that the applicant is legally competent and sufficiently *compos mentis* to understand the significance and consequences of such consent. The co-ordinator shall preserve the application and documentation in connection with it and record whether the request for debt relief is accepted, with the informed consent of the borrower. The co-ordinator is to preserve documentation in electronic format.

If reason arises to suspect that the co-ordinator or other creditors have been deliberately given incorrect information the application shall be rejected. If the information or documentation provided are insufficient, the co-ordinator shall contact the borrower and urge the applicant to rectify this and provide the explanations and documentation which the co-ordinator regards as necessary. If the flaws in an application are not rectified it shall be considered to be cancelled.

After an application has been submitted to a co-ordinator it shall, if all requirements are satisfied and the necessary information is available, see to the calculation of the credit of the borrower concerned for reduction of the loan principal and inform the borrower of these calculations and their premises. The co-ordinator shall endeavour to complete its processing of applications within a reasonable length of time after the applicant has submitted his/her

application. The co-ordinator shall calculate the indexation which has accrued on the loan contract or contracts in question during the period of the failed premises in excess of 4.8% inflation. The amount thus obtained shall be used for debt relief and forms the credit due the borrower in question. If the borrower has previously benefited from remedies which have affected the principal of an inflation-indexed housing mortgage the total amount of write-downs made through such remedies shall be deducted from the borrower's credit. The total amount of the debt relief may never exceed the maximum stated in Chapter 4.4. If the borrower has inflation-indexed housing mortgages which fulfil the requirements for debt relief from more than one lender the co-ordinator shall communicate to them or obtain from other lenders information if a write-down is required by other creditors in addition to the co-ordinator.

#### *4.2.3 Rules on write-downs resulting from the debt relief and the disposition of a credit*

The co-ordinator's calculations shall indicate the total amount of the write-down to which the applicant or applicants, in the case of jointly taxed persons, are entitled with a breakdown as to how this figure was arrived at, including what loan obligations form the basis for the debt relief. These consist of loans which fulfil the requirements for a reduction of the amount of the principal as of year-end 2010 according to tax returns for that year. The reduction will appear in those housing mortgages which the applicant owes on the date of the application. Furthermore, deductions shall be listed as appropriate, including those resulting from previous debt mitigation and the impact of the debt relief cap on the outcome. The co-ordinator shall also state how the credit is to be disposed.

The debt relief for failed premises shall not be regarded as a prepayment on the loan concerned or payback of the loan. The co-ordinator shall not therefore include a pre-payment charge in its calculations under any circumstances, even if the contract which is written down as a result of the debt relief may contain a provision on a pre-payment charge, as the lender receives a completely equivalent payment in return just as if the borrower had continued to make payments on the loan.

Once the applicant has received the co-ordinator's calculations in electronic format the applicant shall confirm the co-ordinator's calculations in the same manner if he/she has no objections to the outcome or the premises upon which it is based. If the applicant has objections, he/she will have a reasonable time limit to communicate these and express him-/herself. If the applicant raises no objections he/she is considered to have accepted the co-ordinator's calculations.

If an applicant raises objections the co-ordinator must take a reasoned decision regarding them and inform the applicant of its conclusion. If disagreement between the parties cannot be resolved in this manner the applicant may refer the dispute to the Complaints Committee on Debt Relief for Inflation-indexed Housing Mortgages, as explained below in more detail.

Once the applicant has accepted the co-ordinator's calculations or, as the case may be, the time limit for raising objections has expired without any objections from the applicant being received, the co-ordinator shall dispose of the credit as follows:

The credit shall first be applied to write-down the applicant's housing mortgage which has on the date of settlement, i.e. when the debt relief is effected, highest priority of lien rights, i.e. the loan or loans held by the co-ordinator. This shall be done by dividing the loan with highest priority of lien rights in two parts, with the applicant's consent, a primary portion and debt relief portion. The Treasury undertakes to pay the debt relief portion as has been explained above. The debt relief portion shall include any outstanding unpaid interest and arrears on the original loan, if they exist, which are deducted from the applicant's credit. The same applies, as the case may be, to any debt owed on an equalisation account for payment smoothing of real estate mortgages, i.e. any debt of the applicant owed to the payment equalisation account is transferred to the debt relief portion and this debt is deducted from the applicant's credit. The amount of the applicant's remaining credit shall be deducted from the principal of the original loan and transferred to the debt relief portion of the loan.

A simple example is taken here of a loan with first lien rights with an balance of ISK 10 million, including outstanding interest, default and debt owed on an equalisation account on the date of the settlement. The applicant is entitled to a reduction amounting to ISK 1.5 million. Outstanding unpaid interest and arrears amount to ISK 100,000 and the amount owed on the equalisation account is ISK 50,000. Therefore ISK 150,000 would be transferred to the debt relief portion of this account, comprising a settlement of the outstanding interest, arrears and amount owed on the equalisation account. Then an additional ISK 1.35 million would be transferred to the debt relief portion, reducing the original loan with first lien rights by this amount as of the settlement date. Through this action the original loan in this example has been divided into two parts. One is the primary loan portion, which on the settlement date acquires a new principal in the amount of ISK 8.5 million (ISK 10 million – ISK 1.5 million). The applicant continues to be responsible for making payments on the primary loan portion, which continues to have the same terms and mortgage rights as the original loan. The second part is the debt relief portion, with the same lien right and the same terms as the original loan. As of the settlement date, the debt relief loan has a principal amounting to ISK 1.5 million. The Treasury shall make payments on the debt relief portion as previously mentioned, while the applicant continues to be the debtor of the loan until it is fully repaid. The method described here, by its nature, results in reducing the applicant's debt service immediately, as he/she then need only make payments on the primary loan portion.

If it is necessary to make write-downs with creditors other than the co-ordinator any credit remaining shall first be used in the same method to write down the loan with next priority after the loan or loans of the co-ordinator as of the settlement date. By this means the original loan or, as the case may be, loans following the loan or loans of the co-ordinator would be divided into a primary loan portion and debt relief loan portion, which would be subject to the same rules as described above, including regarding the payer of the obligations and the disposition of the credit.

As an example, if a borrower had a housing mortgage from the Housing Financing Fund with first lien rights and a loan from a commercial bank with second lien rights the borrower must turn to the Housing Financing Fund to apply for debt relief. The Housing Financing Fund is then the co-ordinator of debt relief for the applicant in question. If the debt relief which this borrower receives from the Housing Financing Fund results in repaying the primary loan portion in full, the borrower will also be entitled to debt relief on the loan with the

commercial bank, provided the debt relief has not already reached the maximum limit stated in Chapter 4.4. The Housing Financing Fund shall then pass on the necessary information to the commercial bank which will then write down its mortgage based on the information, in accordance with the rules explained above.

If a credit for some reason cannot be used to write down the principal of an applicant's loan or loans by the method described above, such as because an applicant has paid off all his/her loans by the settlement date or the debt relief on the failed premises results in loans being fully repaid, the co-ordinator shall send the Directorate of Internal Revenue a summary of the applicant's credit and other documentation which the Directorate considers necessary to determine his/her special personal deduction. The same applies if only part of a credit can be used to write down loans. This credit shall be calculated as an addition to the applicant's personal tax credit as provided for in the first paragraph of Art. 66, cf. Part A of Article 67 of Act No. 90/2003, on Income Tax. In other respects provisions of the Income Tax Act on personal tax credit shall apply, including on the disposition of the personal tax credit, with the exception however that the special personal tax credit is distributed over four years and can be carried over from one year to the next. Any portion of the personal tax credit which then remains unused shall be cancelled.

In the group's estimation it is advisable in light of the debt relief proposed in the report, which results in a reduced debt service burden on inflation-indexed housing mortgages, to transfer any amount owed by the applicant to an equalisation account to the debt relief loan portion in the manner described above, as payment smoothing of loans results in an increase in the borrower's overall interest and indexation cost of the loan in the end. In this connection it should also be borne in mind that debts owed to equalisation accounts are a small proportion of the total outstanding balance on loans with payment smoothing. In this manner the group proposes that an applicant's payment smoothing be simultaneously cancelled when the debt on the equalisation account is transferred to the debt relief loan portion.

### **4.3 Previous actions which result in deductions**

If an applicant, prior to submitting an application to a co-ordinator, has benefited from remedies to assist debtors who could not make payments of their obligations on time, whether these were legislated measures or remedies established through a special agreement between the authorities and lenders, such write-downs shall be deducted from the debt relief proposed in this report. This applies specifically to those remedies discussed in an annex to the report to the extent they reduced the principal of such loans or were based upon it. Temporary remedies for payment difficulties which did not comprise any adjustment to debts but merely modified the arrangements for payment, extending the loan term and such like, shall naturally not be deducted from the debt relief. It should be pointed out especially that recalculation or reduction of the principal of foreign currency loans are not considered write-downs in this sense and therefore shall not be deducted from the debt relief proposed in this report. The co-ordinator shall take special care in processing applications to ensure that write-downs which applicants have already benefited from are taken into consideration.



In accordance with the above, an applicant's credit shall be reduced by the amount of an adjustment to inflation-indexed real estate mortgages made in connection with problem debt restructuring, cf. Act No. 107/2009, on Actions to the Benefit of Individuals, Households and Enterprises due to the Banking and Currency Crisis. The same applies to adjustments to inflation-indexed housing mortgages based on the so-called 110% route, cf. the Agreement among Lenders on the Housing Market Concerning Working Procedures to Assist Over-mortgaged Households of 15 January 2011. Also deducted from the debt relief are adjustments to inflation-indexed housing mortgages made in accordance with temporary debt mitigation measures provided for in Act No. 50/2009, on Temporary Mitigation of Residential Mortgage Payments, and as provided for in Act No. 101/2010, on Payment Mitigation for Individuals. In addition, a corresponding deduction shall be made from the debt relief provided by this action if an applicant has benefited from special interest benefits, which supplemented traditional interest benefits, in income tax assessment for the years 2011 and 2012, cf. Temporary Provision XLII of Act No. 90/2003, on Income Tax.

## **4.4 Maximum Amounts**

### ***4.4.1 Introduction***

The Explanatory Notes to the Parliamentary Resolution which forms the basis of the group's work state among other things that the group is entrusted with assessing the advantages and disadvantages of setting a cap or maximum amount of debt relief which each household can enjoy to encourage equal treatment in its implementation. In accordance with this, the present chapter attempts to summarise the chief advantages and disadvantages of such a cap on the amount.

### ***4.4.2 Disadvantages of a setting a maximum amount***

In assessing the arguments for and against such a cap, it is clear that the question must always be asked as to whether such a limit has a sound basis and complies with provisions of the Constitution, Act No. 33/1944. As will be explained in more detail below, it was the group's opinion that there were sound arguments for such limits and that constitutional provisions did not prevent this.

The main disadvantage of applying such limits, on the other hand, concerns the implementation for the debt relief by the lenders concerned. It should thus be evident that if such a cap is set for the amount of debt relief, it will inevitably increase the level of complexity in implementing the debt relief. It is evident, for example, that in those cases where borrowers have inflation-indexed housing mortgages from more than one credit institution lenders will have to communicate between themselves with regard to the debt relief to ensure that the total debt relief does not exceed the limits for the amount which each household can enjoy. It is foreseeable that limits to the amount of debt relief will affect the speed of processing and are liable to delay the implementation of the debt relief. This is naturally unfortunate, as it is important to complete the settlement as soon as possible so that the country's households can make their plans and certainty can be achieved regarding future obligations.

These arguments by themselves, however, are not sufficient in the group's estimation to decide that the debt relief should be without any limits. On the contrary, the group

emphasises that the legislature should see to applying mitigating measures to offset the concerns regarding the speed of the actions which have been described. For instance, specific time limits for settlement could be set in the proposed legislation concerning the reduction on inflation-indexed loans, and provision made for supervision of the settlement by public institutions. It is important to fully consult with lenders in this regard and that time limits to conclude settlement are realistic. In this manner equal treatment and consistency in implementation can be best ensured.

#### *4.4.3 Advantages of setting a maximum amount*

It is the group's opinion that there are objective arguments for setting a cap on the amount of debt relief which each household can enjoy. In the group's estimation such a limit does not conflict with the concerns of equal treatment underlying the private property rights provision of Art. 72 of the Constitution, as what is concerned is a concessional and optional action on the part of the authorities.

In this connection it should be borne in mind that the eligibility of those obligations which are entitled to debt relief is based on, as is explained in Chapter 3, the mortgage fulfilling the requirements for interest benefits as provided for in Part B of Art. 68 of Act No. 90/2003, on Income Tax, as subsequently amended. From the said provision it can be concluded that interest benefits are subject to a certain maximum amount.

In this connection it should also be pointed out that considerations of this sort have generally be recognised by the legislature, the government and financial undertakings in the numerous actions which have been taken following the economic collapse. It was the general rule, for instance, under the so-called 110% route that the maximum write-down was ISK 4 million for individuals and ISK 7 million for couples, co-habiting partners and single parents. As a recent example of a cap of this sort in legislation adopted by the Althingi, mention could be made of an amendment to Act No. 44/1998, on Housing Affairs. At the end of March 2011, Temporary Provision XIV was added to the Act, cf. Art. 1 of Act No. 29/2011, authorising the Housing Financing Fund to write down the Fund's mortgage claims against individuals if certain conditions were satisfied, provided the updated outstanding balance on the claims as of 1 January 2011 exceeded 110% of the value of the real estate owned by the borrower or his/her spouse. The second paragraph of the Temporary Provision contains a similar principle limiting the write-down as is found in the above-mentioned agreement on the so-called 110% remedy.

Finally, consideration must be given to the risk that the sense of justice of the vast majority of the general public would be affronted if the debt relief were without any limit, since it is evident that in many instances debt relief would be provided for loans to residential housing which does not in any way correspond to the family size of the individuals concerned. Concerns of this sort prompted, for instance, the condition set for approval of problem debt restructuring that the borrower and/or his/her spouse be able to make payments on obligations equalling at least 100% of the market value of the mortgaged assets, cf. the first paragraph of Art. 11 of the Agreement Concerning Working Procedures for Implementation of Problem Debt Restructuring. The final sentence of the first paragraph of the last mentioned Article states specifically that mortgaged properties refer to residential housing

which accords with family size. It is also clear that the actions would involve considerably greater cost for the Treasury if no limit were set on the debt relief.

#### **4.4.4 Conclusion of the group**

Having regard to the above, including the group's assessment of the advantages and disadvantages of setting a maximum amount, the group proposes that a cap be placed on the amount of debt relief which each household may enjoy. The group therefore proposes that the maximum write-down of real estate mortgage claims be up to ISK 4 million.

It should be pointed out that this maximum must be considered fairly high and it is foreseeable that capping the amount of debt relief will not cause a reduction for the great majority of borrowers of inflation-indexed housing mortgages. The cap will therefore only affect a relatively small group of individuals who purchased large and expensive properties and financed them with inflation-indexed loans.

### **4.5 Complaints Committee on Debt Relief for Inflation-indexed Housing Mortgages**

The group proposes that a special complaints committee be established to resolve disputes which may arise in connection with the implementation of debt relief for inflation-indexed housing mortgages. The committee shall be entrusted with resolving disputes whether they arise between creditor and borrower concerning the write-down of the borrower's debts or, as the case may be, between borrowers including earlier and later debtors of a loan contract.

The parties to a case shall provide the Committee with all the case documentation, as well as any information and explanations the Committee deems necessary. The provisions of Art. 58 of Act No. 161/2002, on Financial Undertakings, shall not prevent delivery of documentation to the Committee. The Complaints Committee shall be bound by obligations of confidentiality concerning documentation and information of which it may become aware in the course of its work.

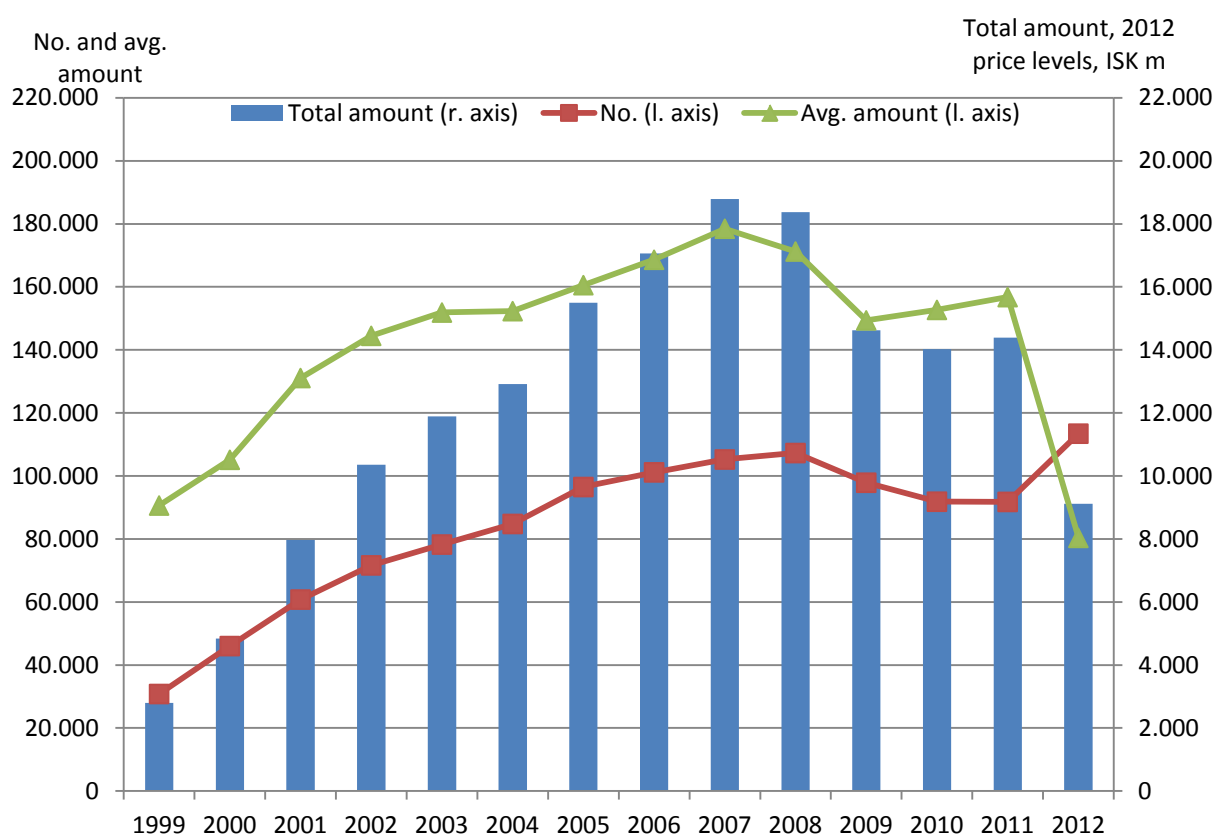
It is proposed that in tandem with legislation on debt relief for inflation-indexed housing mortgages the Minister issue a Regulation on the composition and activities of the Complaints Committee, including procedures for resolving disputes, protocols, location, employees of the Committee, expert assistance, referral fees, sharing of costs and other aspects concerning the Committee's working environment.

## 5 Use of the Tax System in Debt Relief for Housing Mortgages

The group has examined two different methods to facilitate households reducing the principal of their loans with support from the tax system. Firstly, individuals can be allowed to use their private pension savings for the next three years to reduce the principal of housing mortgages and secondly, to reduce the principal with an advance payment which would be exempt from normal income tax. The conclusion is that temporary utilisation of private pension contributions to reduce the loan principal is a very effective way of supporting households in reducing their housing mortgage debt. It encourages savings and improves the situation and living standards considerably as a result of the lower debt service when the action concludes. The group also examined a direct write-down of the principal with a tax reduction, but does not propose that this route be taken at the present time.

Private pension savings have in recent years become established as a third pillar of the pension system, although the economic collapse has had an effect on this as on most other things. Chart 15 shows how the main indicators of private pension savings have developed since this was introduced in 1999.

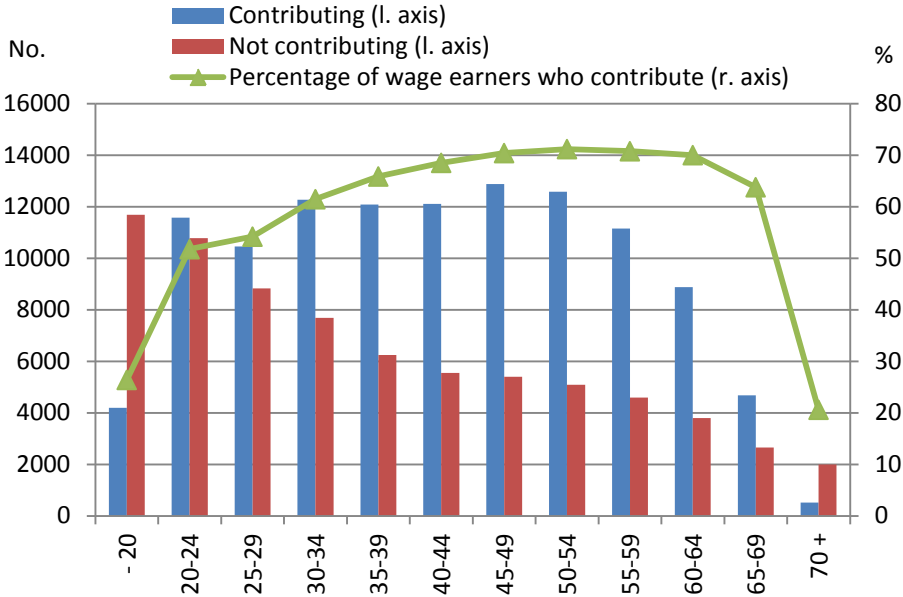
Chart 15. Development of private pension savings 1999-2012 at 2012 price levels



The average amount of savings and number of savers increased strongly from the inception of the programme and until the collapse, but then savers decreased in number, in part due to unemployment and falling wages, but never fell below 90,000 persons. The average amount dropped by 16% in real terms, which accords with the real drop in wages. The

number of savers since then has been practically unchanged and there was a real increase in the savings of each individual until 2012. That year the proportion of wages which could be contributed tax-exempt to a private pension fund was lowered from 4% to 2%. The average savings in private pension funds dropped by almost half, but the number of savers increased by 22,000 or 24%.

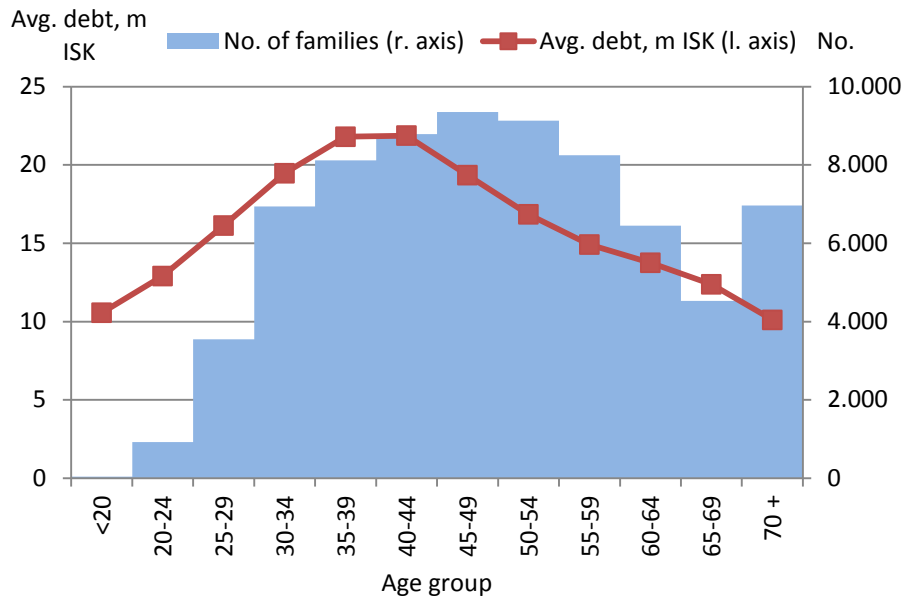
Chart 16. Number and proportion of wage earners who contribute to a private pension fund by age in 2012



As the chart shows, around or just over 2/3 of wage earners contribute to a private pension plan during the greater part of their working life. The proportion is more than half of those who have had any wage income from age twenty. Information on the accumulated private pension savings by age are not available but the proportion of income is close to 1.8% on average and has decreased after the tax exemption for contributions was reduced from 4% to 2%. Prior to that those who did contribute saved on average 3% of their income, with the proportion tending to increase with increasing age. There are no limits on employers' contributions. Although the savings percentage in 2012 did not vary significantly by age, the amount which the employee contributes does vary greatly by age because of how greatly wage income varies with age. The average contributions increase strongly with increasing age up until the 45-49-year age group, then declines after that, as income decreases with increasing age. These amounts have decreased considerably after the maximum tax exemption for contributions was lowered.

Chart 16 shows the debts of persons who owe housing mortgages by age group. The average debt increases up until the 35-39-year age group, then begins to decrease steadily from 45 years of age onward. Taken together, this information gives support for the conclusion that considerable success could be achieved by authorising persons who are contributing to private pension funds to use their savings immediately to reduce their housing debts when they are greatest. Here the group younger than 40 years of age appears to be the one which would make the most difference. Debts are highest in this age group, while persons of this age still have 30 years more to work (and contribute) before retiring from the labour market.

Chart 17. Average residential housing debts of families by age group in 2012



Private pension savings are closely linked to income. The proportion rises steeply to ISK 8-9 million in annual income, then remains at this level up the entire income ladder above that. The propensity to save while income is increasing up to this amount is practically 2%, i.e. with each increase in wages 2% of the increase is contributed to private pension savings. While it was possible to postpone the taxation of up to 4% of income, the savings propensity was 3% for the range of increasing income, the same as the average contribution percentage.

In 2012 real estate owners can be divided into the following categories, based on their private pension savings, home ownership and debts.

Table 2 Private pension savings

Housing owners	With pension contributions		Without pension contributions	
	No. of families	Average debt, ISK m	No. of families	Average debt, ISK m
Real estate debts	47,995	18	24,285	15.1
No mortgage debts	9416	0	17643	0

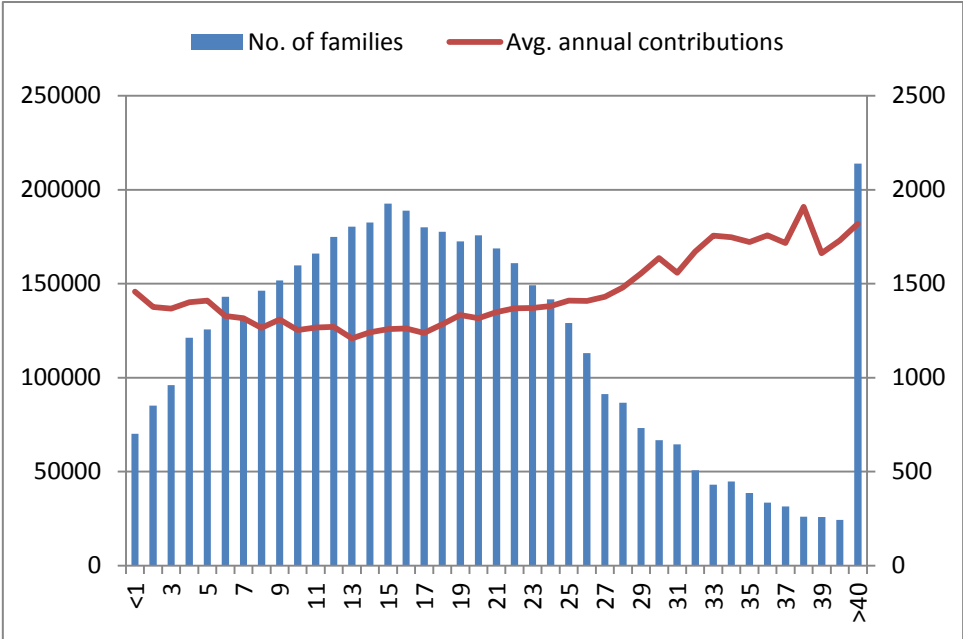
Of those close to 100,000 families who own real estate, over one-quarter are in the position where they do not owe debts because of purchasing it. One-third of them contribute to private pension funds while two-thirds do not. Of the more than 70,000 families who own real estate on which they have a mortgage, the situation is also that one-third, or around 24,000 families, do not contribute to private pension funds while 48,000 have both mortgages and private pension savings. There is some difference between the average housing mortgage debt of those who contribute to private pension savings and those who do not, as the debts of those who contribute are 19% higher than those without savings.

Those who contribute and who do not contribute also differ in their incomes. The average [annual] wage income of a family in the group with housing mortgages and pension savings was ISK 8.7 million in 2012, while the average wage income of those without pension savings

was ISK 2.6 million. Generally speaking, the income of those who contribute to private pension funds is considerably higher than of those who do not. Marital status explains part of this difference. Almost 60% of those without private pension savings are single, while the proportion of single real estate owners in the group with savings is 30%. On the other hand, the average wages of single persons without pension savings are ISK 1.7 million while the comparable figure for those with savings is ISK 5.3 million. Couples without pension savings have an average income of ISK 3.9 million, while couples with pension savings have an average wage income of ISK 10.3 million. The income difference between those contributing and those not contributing is large for all age groups. All references are to real estate owners with some housing debts.

As has previously been mentioned, real estate debts on average correlate with income and the proportion of income devoted to private pension savings does so as well. By examining the ratio of one year's savings to the mortgage principal, an attempt can be made to assess how much debt could be reduced by converting private pension savings to housing assets.

Chart 18. Private pension savings per year by housing mortgage debt, 2012



This chart shows that by far the greatest portion of debtors contribute between ISK 125,000 and ISK 140,000 per year, exclusive of employers' contributions. Furthermore, it shows that while the debt is increasing up to the modal value, which is a debt of around ISK 15 million, savings on average are decreasing, while above that level savings are increasing.

The conclusion is that it would be possible to achieve considerable success in lowering the principal of housing mortgages if those persons who own housing mortgages were offered to deduct up to 4% of their wages from their income together with an employer's contribution of up to 2% for three years, if the funds were used concurrently to reduce the principal of housing mortgages in excess of what was provided for in loan contracts, and thereby convert pension savings into real estate savings. Central and local government must waive permanently the income tax on these funds, however, with the limit that each family

would not be authorised to allocate more than ISK 500,000 of savings annually in this manner. It is estimated that this could reduce the principals of housing mortgages by a total of around ISK 67 billion over three years, without including persons who do not currently contribute to private pension savings but would begin to do so specifically for this purpose. Almost 40% of households could reduce their principal by more than 10%, half of them by more than 8% and two-thirds by more than 7%. If this measure were authorised for all of 2014, the loss of Treasury revenue would be around ISK 5 billion and municipalities would lose permanently ISK 3 billion. On the other hand, legislation already exists providing for an increase in the tax exemption for private pension contributions to 4% once more from 2015 onwards, and the Treasury's long-term fiscal planning has anticipated this. The tax revenues which are finally lost through this action would otherwise not appear in government revenues until many years have passed.

The entire foregoing discussion has only included persons already contributing to private pension savings from their income. However, it is not unlikely that, if such an action is introduced, it will result in increasing the numbers of people who wish to take advantage of it. It functions as a temporary tax reduction to pay off the loan principal more rapidly than otherwise. As previously mentioned, the average incomes of persons who do not contribute to private pension funds are considerably lower than of persons who do so. A rough survey of the magnitude of possible temporary pension contributions by persons who do not currently contribute suggests that this could result in a reduction of their loan principals amounting around ISK 5 billion annually. This estimate does not assume the participation of the persons with highest incomes or with lowest incomes in the action. In total, such an increase in number of persons contributing to private pension funds could result in a reduction of mortgage principals of ISK 15 billion over a three-year period.

This proposal is conceived as part of government actions to facilitate households in reducing their housing mortgage debts and increasing their disposable income instead of paying interest. There are no specific arguments for restricting such an action to reducing inflation-indexed debt. However, it would be appropriate to limit possibilities of using this support to reduce new loans taken out after the announcement of the action, as this encourages creating debts for the sole purpose of taking advantage of the action.

On the other hand, it would be easy to have part of such disposition of private pension contributions benefit people who do not own their homes, by enabling those who so choose to have pension funds invest their private pension contributions and subsequently be authorised to withdraw whatever had accumulated, tax exempt, over 3-5 years to make a down payment on a residence. It is proposed that the committee on the future structure of housing affairs examine a detailed implementation of this.

The authorities need to authorise private pension funds to transfer those savings which families decide to use to reduce their housing mortgages directly towards the principal of the housing mortgage taken to acquire housing for own use. This must be based on applications to the custodian of the private pension fund and a confirmation from the Directorate of Internal Revenue that the loans which are to be prepaid have been reported as such on tax returns. Furthermore, credit institutions must provide the Directorate of



Internal Revenue with the usual information on payments towards the loans. The debtor must be able to terminate the measure.

It is necessary to reach agreements with those parties authorised to receive private pension contributions on participating in this action. It is important to have the action as simple to implement as possible.

## 6 Incentives to Take Non-indexed Loans

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This section will explain the incentives to convert indexed loans to non-indexed in connection with the debt reduction. It must be borne in mind that there is a basic difference between indexed and non-indexed loans, as the financing cost of non-indexed loans is paid concurrently while the financing cost of inflation-indexed loans is pushed forward into the future. As a result of this the debt service on indexed loans is lower than on similar non-indexed loans. Further discussion of this can be found in Box article IV-1<sup>28</sup> of *Financial Stability 1/2013* and in the publication *Nauðsyn eða val?* (Necessity or Choice?),<sup>29</sup> issued by the Icelandic Financial Services Association.

The Explanatory Notes with the Parliamentary Resolution discuss incentives to convert inflation-indexed loans to non-indexed loans in connection with the principal write-downs. A direct write-down of inflation-indexed loans reduces their debt service burden while, on the other hand, the conversion of the loans to non-indexed loans increases the debt service. This effect could be mitigated by extending the term of the loans, thereby reducing the debt service. It is also possible to offer lower interest rates to begin with which then increase over a period of several years.

Since non-indexed interest rates are higher than indexed rates and the financing cost of the former type of loans is paid concurrently while that of the latter is not, the interest paid is higher. This could result in a borrower being entitled to higher interest benefits from the Treasury if other conditions for those payments are satisfied. As a result, there is already an embedded incentive to owe non-indexed rather than indexed debt.

The following examples show the extent to which the government will offset the additional cost which non-indexed loans imply for borrowers. The example is taken, firstly, of a couple with annual income of ISK 6 million and, secondly, of a couple with annual income of ISK 10 million. It is assumed that interest benefits will not be reduced because of assets owned, which means that their net assets are less than ISK 6.5 million.

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<sup>28</sup> Central Bank of Iceland *Financial Stability 2013/1*.

<sup>29</sup> Ásgeir Jónsson et al. *Nauðsyn eða val?*

Table 3 Interest benefits on inflation-indexed and non-indexed loans

Income ISK 6 million	ISK 15 million loan		ISK 20 million loan	
	Indexed plus 4.5% interest	Non-indexed plus 7.5% interest	Indexed plus 4.5% interest	Non-indexed plus 7.5% interest
Gross interest	675,000	1,125,000	900,000	1,500,000
Interest benefits	195,000	570,000	420,000	600,000
Net interest	480,000	555,000	480,000	900,000

Income ISK 10 million	ISK 15 million loan		ISK 20 million loan	
	Indexed plus 4.5% interest	Non-indexed plus 7.5% interest	Indexed plus 4.5% interest	Non-indexed plus 7.5% interest
Gross interest	675,000	1,125,000	900,000	1,500,000
Interest benefits	0	250,000	100,000	400,000
Net interest	675,000	875,000	800,000	1,100,000

The table shows clearly to what extent the Treasury contributes towards the increased interest burden resulting from the non-indexed loan. For instance, 83% of the ISK 450,000 increased interest expense on an ISK 15 million non-indexed loan over that of an indexed loan would be paid by interest benefits if annual income were ISK 6 m and 55% if annual income were 10 million. This offsets to a considerable extent the increased debt service on the non-indexed loan. The example does not take into consideration interest benefits on indexation paid, which is minimal at the beginning then increases as the loan term progresses.

The group considers it inappropriate to make it a condition of direct write-downs that the loan be converted to non-indexed, as this would result in a system change on the housing mortgage market that the Housing Financing Fund, for example, is not able to deal with at the moment. It must be borne in mind that Housing Financing Fund, which is the leading party on the housing mortgage market, does not offer non-indexed mortgages. That alone means that the time frame concerned here is too short to accommodate such a change. The share of inflation-indexed mortgages in the housing market must decrease gradually, and this trend has already begun.

The expert group examining the elimination of inflation-indexation on consumer loans will deliver its report before the end of 2013, discussing the difference between non-indexed and indexed loans. The project management on the future structure of housing affairs is also at work and will deliver its proposals at the beginning of 2014.

## 7 Economic Impact of the Actions and Mitigating Measures

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The group requested an analysis of the macroeconomic impact of the proposals from the consultancy firm Analytica. Economist Yngvi Harðarson directed the work on behalf of Analytica.

The methodology applied in the analysis is based on a statistical assessment of the macroeconomic impact of the debt mitigation actions which have already been undertaken in 2010-2012 following the Supreme Court judgements on exchange-rate-linked loans, the so-called 110% route etc. It was based on tax return data from the Directorate of Internal Revenue and data on the scope of those actions, their time distribution and their impact on varying age groups. The data cover the period 1992-2012.

Analytica's conclusions are based on the outcome of econometric assessment of the actions, mapped on the macroeconomic context using a model developed for the purpose. The conclusions are naturally drawn based on the probability and not the certainty of correlations between indicators which are considered to be of importance.

A specific examination was made of the correlation between previous loan write-downs and household consumption spending and changes in housing assets. Information on consumer spending is not available from tax returns but a statistical approximation was prepared based on disposable income and changes to the asset and liability position as well as information on loan write-downs. Fairly good data is available, however, on housing assets in tax returns. Information on both estimated consumption and housing assets was updated to current values, firstly, using the CPI and, secondly, based on assumptions of assessed housing values reflecting housing price developments.

To put it briefly, the conclusions were that previous debt mitigation actions (write-downs) do not appear to have had a major impact on household consumption but a considerable impact can be seen on gross housing assets. It cannot therefore be denied that the financial leeway created by write-downs of household housing mortgages may have brought an equal or even greater increase in housing assets.

Table 4 Impact of actions on economic indicators<sup>30</sup>

<i>%, unless otherwise indicated</i>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>
GDP growth	0.1	0.2	0.2	0.2	0.1
Private consumption	0.4	0.3	0.2	0.2	-0.1
Purchasing power of employment income	0.2	0.2	0.2	0.1	0.0
Balance of trade in goods and services – minimum	-0.2	-0.4	-0.6	-0.8	-0.9
Balance of trade in goods and services – maximum	-0.2	-0.4	-0.7	-0.9	-1.0
Inflation	0.1	0.0	0.0	0.0	0.0
Unemployment	0.0	-0.1	-0.1	-0.1	-0.1
Treasury tax revenues (ISKm)	265	669	1,022	1,312	1,308
Housing investment – minimum	1.1	5.2	6.8	5.3	3.4
Housing investment – maximum	3.0	8.1	8.3	6.7	3.7

In the analysis the impact of the above-mentioned actions appears directly in private consumption and as a change in housing assets following debt reduction. The impact of applying private pension savings to pay back housing mortgages appears primarily in the form of lower debt service on loans, i.e. a larger share of household income is available for discretionary disposal. Such impacts also arise from direct debt relief.

Over the period upon which the analysis is based, i.e. 2014-2018, the total reduction in housing mortgages is estimated to be around ISK 150 billion, at fixed prices as of year-end 2012. According to Analytica's estimate, the debt service burden on housing loans will decrease gradually to the end of the period by as much as ISK 11 billion per year, if indebtedness remains unchanged in other respects.

Analytica presents its assessment of the macroeconomic impact as a deviation from the baseline scenario which in this instance is the Statistics Iceland forecast of 15 November 2013. Table 5 shows the deviations concerned added to the Statistics Iceland forecast.

The principal conclusions of the assessment are summarised in Table 4. On the whole the impact of the actions according to the expert group's proposals are relatively mild, except perhaps on investment in residential housing. It should be pointed out, however, that housing investment has been at an historical low in recent years.

The impact on inflation is practically nil, but in the model the real exchange rate rises by as much as 0.4% from the baseline scenario. There is uncertainty as to whether this effect will appear in the form of a higher nominal exchange rate or a slight increase in inflation, but in this scenario it appears as a slightly higher nominal exchange rate.

One important assumption of the analysis is that an output gap exists which can be availed of without fanning inflation. In this connection it is likely that the potential production

<sup>30</sup> Analysis by Analytica

capacity of the construction industry will be tested if the conclusion of this analysis proves correct. There is some uncertainty concerning new investment in residential housing, and therefore two alternatives are presented, as are also given for the balance of trade in goods and services which is a derived figure.

Another important assumption of the analysis is that nominal wages are a fixed figure in the calculations. This means that the outcome indicates a scenario where wage increases will not be significantly more or less than in Statistics Iceland's baseline forecast. This could change in various unforeseen directions if that premise proves incorrect as it, in turn, affects most other figures.

In Analytica's communications with the expert group on the reduction to the principal of inflation-indexed housing mortgages, and the advantages and disadvantages of a debt relief fund, several suggestions have been made concerning the implementation of the actions proposed by the group.

- Consideration must be given to pre-payment risk faced by the Housing Financing Fund in connection the actions. There is a possibility that action on the housing market will increase refinancing of the Housing Financing Fund's loans and cause losses to the Fund which will negatively affect Treasury finances. It is difficult to get an idea of the possible amounts involved in this respect. The removal of stamp duty at the end of the year could boost refinancing.
- Since the Housing Financing Fund is the lender for a large portion of inflation-indexed housing mortgages, attention must be given to the Fund's opportunities to reinvest the value of those loans paid off in connection with the actions.
- The analysis indicates that real estate prices will rise although there is considerable uncertainty concerning how much and how the increases will be distributed over the forecast period.

The analysis assumes that the amount of funds used for debt relief after consideration has been given to previous debt mitigation measures will amount to around ISK 80 billion, spread equally over a four-year period. This part of the actions will not be financed by printing money or similar measures. Deviations from the amounts, dates and funding arrangements alter the outcome of the analysis.

Table 5 Statistics Iceland's baseline forecast and Analytica's deviations

**Statistics Iceland's baseline forecast**

<i>Volume change from the previous year (%)</i>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>
GDP growth	2.5	2.8	2.6	2.6	2.7
Private consumption	2.5	2.7	2.8	2.8	2.9
Residential housing investment	20.6	16.3	15.3	13.1	9.1
<i>YoY change in annual averages (%)</i>					
Purchasing power of employment income	1.9	1.9	1.9	2.6	2.3
Inflation	3.6	3.0	2.5	2.5	2.5
Unemployment (% of workforce)	4.4	4.1	3.8	3.6	3.5
Bal. of trade in goods and services (% of GDP)	5.7	4.1	4.2	4.6	4.2

**Total with Analytica's alternative estimate**

<i>Volume change from the previous year (%)</i>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>
GDP growth	2.6	3.0	2.8	2.8	2.8
Private consumption	2.9	3.0	3.0	3.0	2.8
Housing investment – minimum	21.7	21.5	22.1	18.4	12.5
Housing investment – maximum	23.6	24.4	23.6	19.8	12.8
<i>Change in annual averages (%)</i>					
Purchasing power of employment income	2.1	2.2	2.0	2.8	2.3
Inflation	3.7	3.0	2.5	2.5	2.5
<i>% of GDP</i>					
Balance of trade in goods and services – minimum	5.5	3.7	3.6	3.8	3.3
Balance of trade in goods and services – maximum	5.5	3.7	3.5	3.7	3.2
Unemployment (% of workforce)	4.4	4.0	3.7	3.5	3.4

In the light of the analysis, the group considers it important to point out that circumstances could develop where real estate owners would wish to refinance their loans from the Housing Financing Fund due to the additional scope for mortgaging which was created by a debt write-down. For this reason it could be considered making it a condition for the government's actions that the borrower waive the right to take part in the government's actions if he/she intends to refinance a housing mortgage. This would be a temporary measure.

If there is a prospect of an asset bubble developing in the housing market, it is urgent that suitable management tools be applied, such as setting maximum leverage ratios and LTV

ratios.<sup>31</sup> For this reason the adoption might need to be considered of legislation or guidelines on a temporary prohibition on granting housing mortgages with an LTV ratio above a certain level, together with special treatment for first-time buyers. The framework of the interest benefit system might be examined in this connection. It is important to monitor lending growth closely during this period of the actions.

One of the main objections of the government's actions is to adjust and reduce the housing debts of Icelandic households. For this reason care must be taken to prevent circumstances from developing which could result in households beginning to increase their debt once more. It is important to reach the inflation target of the Central Bank of Iceland and not to upset financial stability. The government is strongly urged to take suitable measures so that these objectives will not be endangered.

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<sup>31</sup> Statistics Iceland. Macroeconomic forecast, winter 2013. 15. P. 4.



## Annex I - Previous Measures

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During the years following the economic collapse, various responses were made to the debt and payment problems of households. Special payments have been made to households, on the one hand on the initiative of the government and on the other hand on the initiative of financial undertakings.

This chapter aims at giving a brief summary of those actions which have been taken and which have been directed specifically at reducing the principal of inflation-indexed housing mortgages. These actions are temporary mitigation of mortgage payments, cf. Act No. 50/2009, problem debt restructuring, cf. Act No. 107/2009, the Agreement Concerning Working Procedures for the so-called 110% route, which was adopted by lenders in the housing mortgage market based on a Memorandum of Understanding of December 2010 between the government and lenders in the housing mortgage market, and payment mitigation for individuals, cf. Act No. 101/2010, in addition to which mention will be made of the special interest subsidy which was added to the traditional interest benefits in income tax assessment for 2011 and 2012.

Annex table. Summary of remedies, numbers benefiting from them and amounts as of year-end 2012

Remedy	Number	Amount
Payment smoothing for individuals by the Housing Financing Fund	21,241	7,633
Temporary mitigation of residential mortgage payments	176	
Temporary remedies for individuals owning two residential properties	101	
Postponement of payments*	3,056	33,139
Problem debt restructuring*	824	7,313
110% route*	11,737	46,000
Payment mitigation for individuals	2,736	
Interest benefits**	37,400	9,193
Special interest subsidy	65,500	12,296

\* The situation as of the end of January 2012 at the three largest commercial banks and Drómi/Frjálsi hf. The situation at the Housing Financing Fund and pension funds is as of November 2012.

\*\* Disbursement of interest benefits in 2012

### Temporary mitigation of residential mortgage payments

According to the Act on Temporary Mitigation of Residential Mortgage Payments, No. 50/2009, the owner of residential housing could request payment mitigation for real estate mortgages. The premise for this was that it was demonstrated that the person concerned was and would be for some time incapable of making full mortgage payments on time and that other available remedies for payment difficulties were or had proved to be insufficient.

### Problem debt restructuring

Act No. 107/2009, laid the basis for actions on behalf of individuals, households and enterprises due to the banking and currency crisis. The Act established problem debt restructuring. The details of the action are available in the *Agreement Concerning Working Procedures for Individuals' Problem Debt Restructuring* which applied until 31 December 2012 and comprised harmonised procedures for regulated entities in the financial market for debt restructuring.

Problem debt restructuring involved a three-year agreement concluded between lenders and a borrower to adapt the borrower's assets and liabilities to its payment capacity. Persons who concluded an agreement on problem debt restructuring are/were not placed on the default register because of debts covered by the agreement. If the borrower makes his/her payments on time throughout the period of the agreement, any outstanding balance on the debts is cancelled after the three years have passed. If the borrower does not make the payments provided for in the problem debt restructuring creditors can decide to cancel the agreement. Those agreements which have been concluded remain valid until they are either invalidated or the outstanding balance on the debts they cover are cancelled.

#### 110% route

On 15 January 2011, an agreement was signed between lenders on the housing mortgage market Concerning Working Procedures to Assist Over-mortgaged Households following a Memorandum of Understanding in December 2010 between the government and the above parties. The agreement lays down the procedures for the implementation of the government's 110% route for creditors who are parties to this agreement. Under the agreement, borrowers with over-mortgaged housing were offered to have the outstanding balance on their housing debts reduced to 110% of the value of the property.

The write-down could amount to a maximum of ISK 4 billion for an individual and ISK 7 billion for a married couple/co-habiting partners and single parents. A considerably more detailed assessment of assets and payment capacity was required for a larger write-down, which could amount to a maximum of ISK 15 million for an individual and ISK 30 million for a married couple/co-habiting partners and single parents.

#### Payment mitigation for individuals

Payment Mitigation for Individuals was one of the main tasks of the Debtors' Ombudsman under the Act on Payment Mitigation for Individuals, No. 101/2010. The Act is intended to facilitate debtors in restructuring their finances and adapting their debts to their payment capacity, so that they can realistically fulfil their commitments in the foreseeable future. If an individual fulfils the requirements of the Act, he/she is appointed a supervisor who drafts an agreement on payment mitigation. The length of the payment mitigation period is generally one to three years. When an application has been approved by the Debtors' Ombudsman postponement of payment commences. The payment postponement places certain obligations on the creditors and applicants.

Payment mitigation for individuals is actually an overall restructuring of the finances of the person concerned and often involves considerable amounts which have been written off following such restructuring. In many instances individuals, married couples/cohabiting

partners are still in the negotiation process and/or bound by agreements. In such cases it is not possible to assess the deductions and/or write downs to the principal of inflation-indexed housing mortgages until the agreement has ended.

#### Special interest subsidy

In 2011 and 2012, in addition to the normal interest benefits, income tax assessment included a special interest subsidy equivalent to 0.6% of debts on residential housing for own use. The subsidy could amount to a maximum of ISK 200,000 per individual and ISK 300,000 per married couple, co-habiting partners or single parent each year. In addition, the subsidy plus interest benefits could not exceed interest expenses for the year concerned arising from the purchase or construction of residential housing for own use.

## Annex II - Actions in Other Countries

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In other countries struggling with household debt problems a variety of actions have been taken with varying degrees of success, although in the estimation of the IMF few countries have done as much to assist debtors as Iceland. Global economic history also has some examples of special measures taken to reduce household debt in various countries.

The following section discusses various actions to benefit debtors in other countries. It should be borne in mind that the structure of housing and mortgage markets varies greatly from one country to the next and therefore caution is required in comparing actions in different countries.

- The US in the Great Depression
  - A debt relief fund was established which received a specific funding allocation for its disposal. A special institution, the Home Owners' Loan Corporation (HOLC), administered the action.
  - A maximum write-down of 20% if very strict conditions were satisfied and in some instances loan extensions.
  - Managed to avoid 800,000 bankruptcies.
  - Total scope approximately 5% of GDP.
- US in recent years
  - Various remedies for those in the worst situation and an institution established, the Home Affordable Modification Program (HAMP), which handles applications.
  - Remedies of the payment mitigation type and interest reductions and in exceptional instances write-downs of the loan principal.
  - Has brought limited results up until now, in the assessment of the IMF, and the total scope is only USD 2.3 billion.
- Columbia in the 1980s
  - Banks were required to take over properties where the mortgages exceeded market value and regard this as the loan having been paid in full. In some instances credit institutions were made to reduce the interest rates on loans.
  - Actions were not regarded as very successful and in fact to have created a major financing shortage.
- Hungary in recent years
  - Households are offered a 30% discount on the exchange rate if they repay real estate mortgages in foreign currencies. The entire cost is borne by the credit institutions.
  - Has brought limited results in the estimation of the IMF, in part because many households have no access to funding to pay down the principal at the discounted exchange rate. The action also weakens the banking system, which is made to bear the entire cost.
  - According to estimates up to 15% of households have availed themselves of the remedy.
- Finland, Norway and Sweden in the 1990s

- Very little direct action, primarily interest rate cuts and a strong welfare net to support households.
- Very generous unemployment benefits, for example, which ensured that most people could pay their loans despite unemployment. Floating interest rate loans were also very popular with the result that interest rate cuts resulted directly in lowering debt service.

Interest rate cuts are the general economic action which most western states have applied to wrestle with the economic recession of recent years. In a non-indexed mortgage system, this has had the result of increasing households' disposable income at the same time as economic activity has declined. This characteristic has not benefited Icelandic households, and in fact just the opposite is true, as households' mortgage payments have risen – contrary to what would have happened in the case of non-indexed loans. A recent report by McKinsey Global Institute<sup>32</sup> discusses, among other things, the consequences of lowering interest rates and its effects on various groups. In the first place, it reduces the financing cost of the Treasury in the state concerned. It helps younger people more at the cost of those who are older. The opposite occurred in Iceland after 2008, as indexation moved funds to the older generation at the cost of younger generations through pension funds.

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<sup>32</sup> QE and ultra-low interest rates: Distributional effects and risks.

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