153rd Legislative Session 2022–2023.

Report

The Minister of Finance and Economic Affairs on the HF Fund.

Summary

The purpose of this report is to inform Althingi about the process of winding down the HF Fund's assets and liabilities and the possible impact on the Treasury given its guarantee of collection for the Fund's debts. The HF Fund was established by law in December 2019 with the aim to minimise the Treasury's risk exposure regarding the processing and settlement of the accumulated financial difficulties of its predecessor, the Housing Financing Fund (HFF). The HF Fund was subsequently brought under the supervision of the Ministry of Finance and Economic Affairs.

This report briefly sets out the reasons for the HF Fund's financial difficulties, which are rooted in the HFF's activities and funding, and outlines how the Fund's affairs have been conducted since its inception. It also presents a projection of the Fund's financial position at different future points in time and the subsequent negative impacts thereof on the Treasury. The Minister of Finance and Economic Affairs considers it important to start preparations and debate in Althingi on when and how the Treasury is to settle its guarantee of collection for the issued debt currently on the Fund's balance sheet.

The HFF was established in 1998 and took over the implementation of housing policy from the State Housing Authority in accordance with a comprehensive review of housing legislation, with the resulting new legislation passed by Althingi on 3 March 1998. Since the HFF's inception, various changes have been made to its operations and funding.

The HF Fund's financial problems are mostly rooted in changes made to the HFF's funding arrangements in 2004 when the older Housing Bond System was transformed and HFF bond issuance began. Under the previous Housing Bond System, the HFF had the option of making repayments on its funding when prepayments on its loan portfolio were substantial, thereby maintaining a balance in the cash flow of its assets and liabilities. Under the new system, the HFF's funding, in the form of HFF bonds, became non-prepayable. Borrowers, on the other hand, have always been permitted to pay off their loans at any given time. Although a part of the loan portfolio is subject to a prepayment penalty, this only covers part of Fund's losses on prepayments.

Soon after this change in the HFF's funding, competition in the mortgage market increased and borrowers started to repay their HFF loans at a significant pace. That trend has largely continued to the present day. After the 2008 financial crisis, loan prepayments dropped, but driven by lower interest rates and increased availability of mortgages from banks and pension funds, the level of prepayments has been substantial ever since 2015. In addition, as a result of recommendations made by the EFTA Surveillance Authority (ESA) in 2011 and the enactment of legislation resulting therefrom in 2012, significant restrictions were placed on the HFF's lending activities. From that time onwards, its lending was mostly limited to a social role and its loan originations fell markedly.

It has long been clear that the HFF funding arrangements were ill-suited to the changed circumstances. As a result of declining interest rates in recent years, the interest income on the cash generated by loan prepayments is insufficient to cover the HF Fund's fixed interest expenses. All things being equal, it is foreseeable that the Fund, established in 2019, will continue to operate at a loss.

When the HFF bonds were issued, the Treasury undertook a guarantee of collection for the debt. The Fund owes the principal on the issued bonds plus accrued interest and inflation indexation. A guarantee of collection means that when there is confirmation that the principal debtor is unable to pay and does not have assets to secure the obligation, the guarantee is triggered. This is different from a surety, which may be enforced at any time in parallel with the principal debtor's liability.

Projections based on the Fund's position as presented in its interim results to 30 June 2022 show that it will be able to pay the principal and interest on its obligations until 2034, and that no later than that year the Treasury's guarantee of collection will be tested. The Fund's equity position at that point is projected to be negative by approximately ISK 260 billion, or a present value of ISK 170 billion. Continuing to fund and operate the Fund throughout its debt maturity horizon until 2044 is estimated to require the Treasury to inject into the Fund a total of ISK 450 billion, or ISK 200 billion at present value. If, on the other hand, the Fund were to be liquidated now and its assets sold and used to repay the debts at nominal value, the negative balance would amount to ISK 47 billion.

Figure 1: Estimated equity position at different time points at nominal and present value.

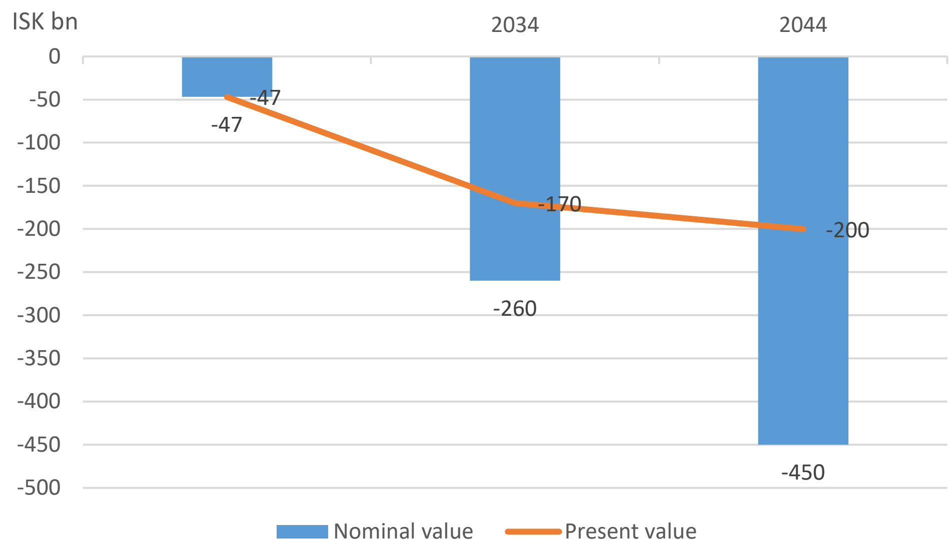


Figure 1 shows the estimated cost for the Treasury of settling its guarantee for the HF Fund's debt at these three points in time. Clearly, the cost of settling increases over time. Whilst projections of this type are naturally subject to considerable uncertainty, this provides an overall indication of how the Fund's financial position is set to deteriorate over time. Market movements affect the market value of both assets and liabilities, and hence the figures presented here are subject to change. The increases in market interest rates over recent months are liable to drive up the loss at settlement, i.e. the Fund's assets have decreased in value. They also affect the value of HFF bonds on their holders' books, which has declined correspondingly. Higher inflation also exerts a negative effect since the Fund's inflation-indexed liabilities exceed its indexed assets, and inflation in 2022 is clearly set to be higher than assumed in the model.

The division of the HFF in 2019 and the legislation establishing the HF Fund laid the foundation for the wind-down of the Fund's assets and liabilities. The fiscal uncertainty caused by the COVID-19 pandemic delayed action on this front, in addition to which analysing the Fund's position with a sufficient degree of certainty has proved time-consuming. As more clarity is gained on these matters, decision-making on the HF Fund's winding down that achieves the legislation's aim to minimise risk exposure and cost for the Treasury as guarantor is becoming increasingly pressing. In accordance with that legislation, a special advisory task force was appointed in March of this year to advise the Ministry on the work ahead.

Given the extensive nature of this issue and the impact on the Treasury and numerous other stakeholders, it is necessary to start preparations and discussion of how and when the Treasury is to honour the guarantee of collection. It is important to eliminate any uncertainty on this matter, ensure creditor equality and that taxpayer interests are respected.

Althingi must at some point adopt a position on how to handle this matter, including whether to inject additional capital into the HF Fund in an unchanged form or through other forms of settlement of its obligations. There are various arguments for seeking ways to liquidate the HF Fund so that its assets can be disposed of and its debts settled, so as to put an end to a loss-making operation whose continuation would harm the Treasury as guarantor. The cost of the settlement is projected to grow by approximately ISK 1.5 billion with every passing month.

Upon submitting this report, the Minister will make a presentation to Althingi on the matter and provide further details on the considerations underlying the work ahead. The aim of the report and its discussion is to inform Althingi on the background and main issues and implications in order to be able to make an informed decision and give feedback to the Minister before further parliamentary proceedings take place.

Introduction

The HF Fund was created upon the division of the HFF and established by Act No. 151/2019, which came into effect on 31 December 2019. The Minister of Finance and Economic Affairs is ultimately responsible for the HF Fund's affairs and oversees the processing and settlement of the assets and liabilities transferred to the Fund as part of the HFF's division. These assets and liabilities consist of the Fund's issued debt, for which the Treasury has provided a guarantee of collection, an older legacy loan portfolio and a portfolio of securities and deposits.

The aim of the settlement and processing of the HF Fund's assets and liabilities is to minimise the risk and cost for the Treasury due to the HFF's accumulated financial difficulties. These financial difficulties are the result of prepayments on the Fund's loan portfolio, which it is not permitted to use to repay its issued bonds. Consequently, the Fund has invested the cash generated by prepayments on its loan portfolio in bonds and deposits bearing lower interest rates than its obligations as interest rates have in general been decreasing over time. These investments represented almost half of the Fund's total assets upon its establishment.

Since the HFF's division, work has been ongoing to conclude agreements with the Housing Fund, which assumed the social housing loans from the HFF, issuing bonds to the HF Fund in return, in parallel with valuing the HF Fund's total assets and projecting its future position. The Fund's loan portfolio has been the subject of litigation focusing on the legality of prepayment penalties. To date, the courts have ruled in the Fund's favour.

The COVID-19 pandemic made its mark on the Fund's performance, with the resultant interest rate cuts further driving up loan prepayments. This resulted in the Fund's loan portfolio representing only about 20% of its total assets in its 2022 half-year results. Since the HF Fund was established, its cash has been used to invest in bonds issued by the Treasury on terms linked to inflation indexed market interest rates, with the bonds' cash flow reflecting the Fund's assessed funding needed to meet debt repayments.

The Minister appointed a task force in mid-March 2022 to advise on the winding down of the HF Fund's assets and liabilities.

History of the HFF and mortgage lending

The HFF was established in 1998 and took over the implementation of housing policy from the State Housing Authority in accordance with a comprehensive review of housing legislation, with the resulting new legislation passed by Althingi on 3 March 1998.

Since the HFF's inception, various changes have been made to its operations and funding, in addition to which Iceland's mortgage market was transformed in the mid-2000s. The HFF's history is discussed in detail in the 2013 Report of Althingi's Special Investigation Commission on the Housing Loan Fund, which outlines the impact of various decisions made regarding the HFF's activities and organisational structure since its establishment. The following sets out the main factors that led the HFF into the acute financial situation in which it finds itself today.

Objectives of the HFF on its establishment in 1998

At the beginning of 1999, the HFF took over the activities of the State Housing Authority, including the then-existing Housing Bond System, as well as the activities of the State Housing Fund and the Workers' Housing Fund, upon which lending by these agencies was discontinued.

Article 1 of the Housing Act No. 44/1998 states:

"The purpose of this Act is, through the granting of loans and organisation of matters relating to housing, to contribute towards a situation in which Icelanders will enjoy security and equal rights as regards housing, and in which funds will be allocated specifically to increase people's chances of acquiring or renting housing on manageable terms."

At the time, the HFF, a public entity, was by far the largest lender in the private mortgage market, in addition to performing a social role.

For the first few years in operation, the HFF's funding and lending continued within the Housing Bond System introduced in 1989. Borrowers issued bonds to the HFF secured by a mortgage on their properties ("HFF mortgage bonds"), in return for which they received government-backed bonds ("housing bonds") issued by the HFF. The value of housings bonds was determined by market yields at any given time, and discounts on housings bonds (trading below par) were common and even substantial. The interest rate margin between the housing bonds and the HFF's mortgage loans was meant to cover the HFF's operating expenses.

The HFF made payments on the housing bonds by redeeming certain of these bonds, selected by drawing lots, from the series issued and paying them off, including accrued interest and inflation indexation. When housing bonds were dematerialised as of 2001, the repayments became more similar to those on annuity bonds, although some uncertainty remained about the final cash flow of the bonds.

Another important aspect of the Housing Bond System was an authorisation to redeem additional bonds if the volume of repayments of loans funded by the bonds' issuance exceeded expectations. This enabled a balance to be maintained, for the most part, in the cash flow of assets and liabilities, with the prepayment risk of the HFF's loan portfolio in effect borne by the holders of housing bonds.

New housing financing system introduced in 2004

Through legislation changes made in 2004, the Housing Bond System was abolished and a new funding regime introduced for the HFF's lending in the form of "HFF bonds". A key aim of these changes was for the HFF to issue bonds on terms attractive to foreign investors, in an attempt to increase their interest and share of the investor base, leading to lower cost of funding for the HFF. Less emphasis was placed on what terms were best suited for the HFF itself for the funding of its lending, with no concurrent measures taken to hedge the interest and prepayment risk stemming from these loans.

When HFF bonds were introduced, housing bond holders were given the opportunity to transfer to the new system and exchange their housing bonds for the new HFF bonds. A large portion of the HF Fund's debts can be traced to the 2004 Exchange Offer, lead-managed by Deutsche Bank, in which new series of HFF bonds were exchanged for older issues of housing bonds.

The terms of the series can be read in the HFF bond prospectus, of which three series remain outstanding: HFF150224, HFF150434 and HFF150644. These mature in 2024, 2034 and 2044, respectively. The principal of the bonds is CPI-indexed and they carry a fixed interest rate of 3.75%.

Instead of issuing housing bonds, the new loans took the form of direct cash loans to borrowers.

As commercial banks and savings banks increasingly made inroads into the mortgage market in that period, offering borrowers more diverse and attractive terms, the risks inherent in these changes soon materialised.

In a nutshell, the following factors were the most important:

- The HFF bonds were non-prepayable, which resulted in a prepayment risk for the HFF as its borrowers were able to pay off their loans at any given time. In contrast, the HFF was unable to make such prepayments, especially after it redeemed most of the outstanding housing bonds in exchange for the new HFF bonds.
- As market interest rates fell and competition stiffened, the impetus for borrowers to refinance older mortgages, whose terms were comparatively unfavourable, grew. This set of circumstances carried the inherent risk that the HFF would not be able to invest the cash generated by prepayments except at lower interest rates, whether through loan origination or in the market. That proved to be the case. This period also saw disputes and uncertainty about the HFF's authorisations to invest cash, as discussed

in, e.g., the Report of the National Audit Office to Althingi's Social Affairs Committee of 28 November 2005.

- The risk could have been mitigated to some degree by repurchasing the HFF's own bonds in the market or by charging prepayment penalties, but such penalties were not introduced until just over a year later when substantial prepayments had taken place and, moreover, did not extend to older loans. Subsequently, borrowers were invited to choose between loans with or without prepayment clauses, with the ones subject to prepayment fees carrying lower interest rates. The interest rate difference was designed to reduce the HFF's prepayment risk.
- At the time of the Exchange Offer, a decision was made to retain 31% of the prepayable housing bonds to meet expected future prepayments on the loan portfolio. The aim was thus to enable the HFF to meet growing prepayments on the loan portfolio by means of additional redemptions of housing bonds. But when the HFF intended to put this safety valve to the test, it proved to be impracticable and was met with strong opposition from housing bond holders. As a result, the authorisation for additional redemptions was interpreted narrowly. Such additional redemptions were deemed permissible only for prepayments on loans relating to a specific series of housing bonds, not prepayments on the entire portfolio.
- As part of the aforesaid exchange of housing bonds for HHF bonds, the maturity of the debt was also extended, whereas it would have been prudent to shorten the maturity profile given the HFF's risk exposure. The holders of housing bonds who exchanged them for HFF bonds were thereby handed a significant advantage, and clearly the prepayment risk from which they were freed through the exchange was priced too low.

The risks that materialised after the introduction of the HFF system and the Exchange Offer laid the foundation for the financial difficulties that the HFF soon found itself in, but there were also other factors at work.

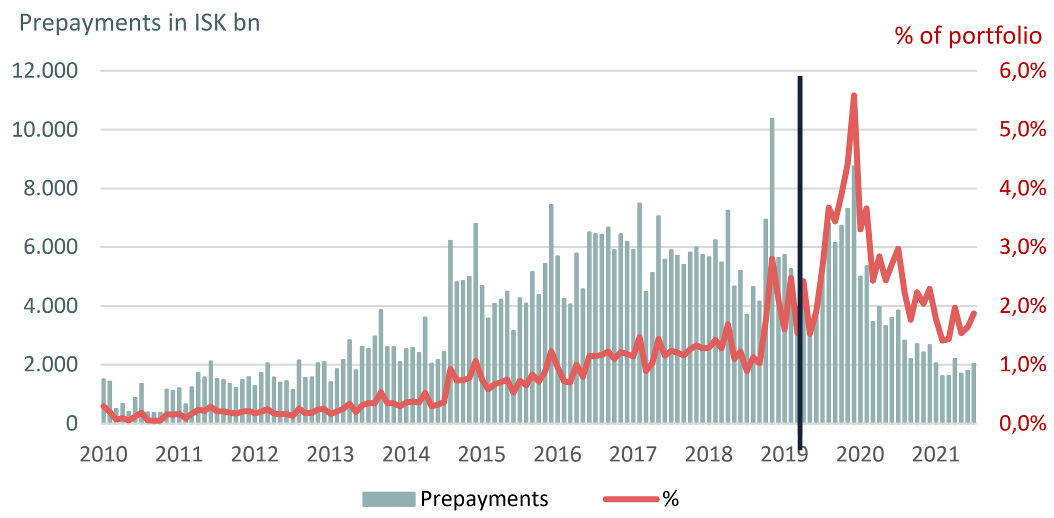
Banks and pension funds enter the mortgage market

The Icelandic banks started to offer more attractive mortgage deals in the autumn of 2004. At the same time, loan prepayments began to rise at the HFF, which responded to the competition by increasing its loan-to-value ratio to 90% and raising its loan ceiling. Notwithstanding these measures, prepayments on the HFF's loan portfolio exceeded its loan originations in 2004-2006 by a total of ISK 112 billion, in addition to which the HFF issued HFF bonds for ISK 69 billion, leaving it with cash worth ISK 181 billion for which there was no demand in the credit market.

At year-end 2004, the HFF started to make loans to banks and savings banks using this cash surplus – a year later, these loans stood at ISK 95 billion. This lending enabled the banks to grant more mortgages, which in turn led to more prepayments on the HFF's loan portfolio.

After the financial crisis that began in 2008, prepayments at the HFF dropped and its loan originations picked up again because of the market failure. Prolonged capital controls in the wake of the financial crisis restricted the investment options for pension funds, which made another foray into the mortgage market, again driving up prepayments at the HFF as of 2015. Around the same time, interest rates began to fall, which enabled the pension funds to offer more attractive mortgage rates than the HFF. The rapid drop in market interest rates during the pandemic sped up prepayments even further, as shown in Figure 2. The black line marks the establishment of the HF Fund, from which time loans transferred to the Housing Fund are not included.

Figure 2: Monthly loan prepayments from 2010 to 2022; left axis: ISK billions; right axis: % of loan portfolio.



Changed lending authorisations following recommendations by the EFTA Surveillance Authority

Ever since 2003, the HFF's lending activities have come under various scrutiny by the EFTA Surveillance Authority (ESA). ESA's investigations have largely focused on the rules of the European Economic Area (EEA) Agreement on the prohibition of state aid in a competitive market and whether the criteria for exemption from those rules have been met. These rules became a focus of attention because of Iceland's government guarantee and exemptions from tax and profitability requirements. Market players also complained to ESA that the HFF's activities were incompatible with competition rules, the freedom to provide services, etc.

There was a lull in ESA's interventions after the 2008 financial crisis, in the wake of which the HFF was effectively the sole lender in the mortgage market for a number of years. During that period, the HFF offered two types of mortgages to home buyers: first, indexed loans carrying a 5% interest rate, with no prepayment penalty; second, loans carrying a 4.5% rate, which were only prepayable for a fee. Loans were also made for the construction of rental properties under certain conditions.

In July 2011, ESA made a recommendation to the Icelandic government to take necessary measures ensuring that HFF's loans system would be in accordance with Iceland's obligations under the EEA Agreement. According to ESA's opinion, the HFF was receiving state aid in the form of owner liability, interest subsidies and exemption from the profitability requirement and payment of income tax. ESA's recommendations included changing the HFF's lending activities to no longer offering loans for the purchase of high-priced and large properties, further restrictions on lending to rental companies and better segregation of government-supported activities from other operations.

In 2012, amendments were made to the Housing Act (by means of Act No. 84/2012) to accommodate ESA's recommendations. The HFF's lending authorisations were restricted and its lending activities from that time onwards defined principally as social lending. These changes placed further constraints on the HFF's allocation of funds from prepayments, and subsequently its loan origination decreased markedly.

These changes in HFF's operating environment further exposed it to the weaknesses that the extensive and fixed, long-term funding on its debt side had created. The rationale for such extensive funding no longer existed.

Prepayment authorisations and penalties

Prior to the 2004 change in legislation, provisions had been added to the law permitting HFF mortgage borrowers to make additional repayments and pay off their debt in full before maturity. By the same token, it was stipulated that in order to "balance out cash flows due to such repayments", the HFF was authorised to redeem issued housing bonds on its funding side and retire debts by an amount equal to that of prepayments on its loan portfolio.

The 2004 system change retained the arrangement whereby borrowers were permitted to pay off their mortgages without incurring a prepayment penalty. In parallel, however, a provision was introduced authorising the Minister to stipulate in a regulation, in special circumstances and after receiving the opinion of the HFF's board, that prepayments were subject to a prepayment fee that partially or fully balanced out the difference between the prepayment price of an HFF mortgage bond and the market terms of a comparable HFF bond. This authorisation was to be specified in the terms of HFF mortgage bonds.

The notes to the legislative bill that became Act No. 57/2004 stated that the power to introduce prepayment fees could be exercised when unforeseen events threatened the HFF's position, and that it would only be used as an "emergency measure" when conventional risk management techniques and the HFF's scope to set interest rates were insufficient to protect its interests.

No decisions were made to introduce prepayment fees on the basis of an emergency situation or unforeseen events as provided for under paragraph 2 of Article 23 of the Housing Act after an amendment made in the spring of 2014. In this context, it should be noted that Article 7 of Regulation No. 544/2004 on the Finances and Risk Management of the Housing Financing Fund sets out the board's duties regarding the HFF's equity ratio in more detail. This includes that if the equity ratio is heading below 4%, the HFF's board must notify the Minister. The Article also provides that the board shall submit proposals on ways to achieve the long-term equity ratio target, including whether to increase the interest margin or use the aforesaid authorisation to introduce a prepayment fee.

It is clear that the HFF board did not propose to use the authorisation to impose a prepayment fee in 2004-2006, and it was not until 2009 that the HFF's equity ratio fell below 4%.

Since the Regulation was not issued in 2004-2006 when prepayments were at their highest, it is unlikely that the criteria for applying the provision can be deemed to have been met in the years that followed, as these criteria include emergency measures, and quite clearly, unforeseen events were no longer taking place and prepayments were no longer rising.

In December 2004, further legislation changes were made in this respect and it was decided to authorise the HFF to invite HFF mortgage bond borrowers to waive the right to pay off their loans without incurring a fee, in return for a lower interest margin. The Minister then issued two regulations in 2005 further defining this provision, subsequent to which the HFF started to offer two types of loans: with or without the prepayment option and at different interest rates depending on whether the prepayment option was present or not. The significance of this authorisation was limited by the fact that a prepayment fee on the basis of the Regulation would only have covered part of the HFF's loan portfolio, i.e. loans granted after the 2004 legislation change.

The charging of such a fee could not have applied to loans taken out by debtors prior to that time, although it was the prepayments of those very loans that largely caused the present problem. It should also be noted that part of the HFF's loan portfolio included loan agreements transferred from other lenders, e.g. savings banks, and these vary as to whether and how the terms of the bonds provide for prepayment fees.

The HFF's prepayment fees have been the subject of litigation, in which the Supreme Court confirmed their legality and the authorisation to charge prepayment fees on the basis of the Regulation if the borrowers had opted for a more favourable interest rate in lieu of that right, in Case No. 3/2021. In Case No. 4/2021, the Supreme Court referred the case back to the Reykjavík District Court, which ruled in the HFF's favour in Case No. E-3061/2020 in September 2021. The case was appealed to the Court of Appeal, which confirmed the District Court's judgment in early April. In June 2022, the Supreme Court agreed to hear the case again given its precedential value, with a decision expected in the coming months (Case No. 37/2022). Thus, uncertainty still exists around some of the HFF's loans with prepayment clauses, and the potential financial impact of any judgments unfavourable to the HFF in this respect remains to be quantified. However, this concerns fewer borrowers than before, which also makes the amounts lower. Another factor to bear in mind is that even if the prepayment fees are found to be legitimate, they only apply to a portion of the HFF's loan portfolio and only partially cover the damage sustained by the HFF as a result of prepayments.

Balance sheet and performance

Main factors

As set out above, the HFF was exposed to considerable risk soon after the 2004 legislation change. Income on assets in the form of returns was declining and eventually no longer covered the fixed cost of funds. According to analysis set out later in this report, if appropriate action is not taken, this deficit will continue to increase the HFF's losses and thereby the Treasury's risk exposure throughout the life of the debt.

Iceland's 2008 financial crisis also took its toll on the HFF's balance sheet. The HFF sustained high credit losses, and various measures taken to protect debtors led to additional write-offs. The HFF also lost considerable funds relating to claims on the failed banks.

In 2010-2016, Althingi approved budgetary allocations of ISK 60 billion to the HFF as capital or operating contributions. Out of this amount, ISK 53 billion were disbursed to the HFF, in addition to which an equity write-off of ISK 7 billion was recognised in the 2012 Government Accounts. Converted to present-day values using the average yield of the longest HFF bond series of this period, these contributions are worth almost ISK 100 billion at today's prices.

In this period, the HFF's interest rate margin was still positive but usually sufficient only to cover operating costs, not impairment and/or necessary write-offs. Without the aforesaid capital injections, the HFF's negative equity position would be correspondingly worse.

Division of the HFF

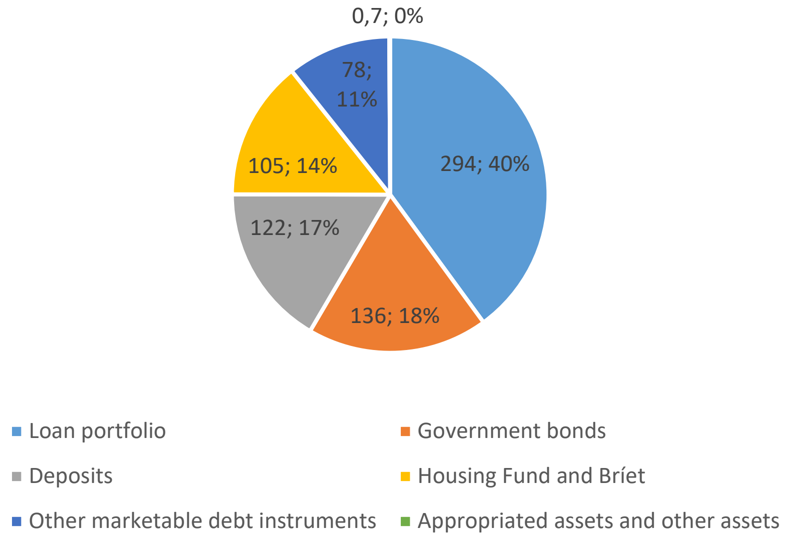
Prepayments on the HFF's loan portfolio and the management of the cash generated by these became an increasingly large part of its activities and, eventually, its main task. The HFF's investment strategy was conservative, with cash from prepayments invested mostly in low-risk debt instruments issued by the Treasury or local authorities, and in the banks' covered bonds. At year-end 2018, the HFF's securities holdings and deposits stood at over ISK 300 billion, roughly on par with those of Iceland's largest pension funds, with the resulting administrative load for HFF effectively exceeding its capacity. In the autumn of 2018, a working group was appointed to seek ways to reduce the Treasury's risk exposure from the accumulated prepayments. The working group proposed a legal separation between the financial management of funds and the implementation of housing policy.

The HFF was divided into separate entities by the enactment of Act No. 151/2019 on the Processing of Assets and Liabilities of the HF Fund and Act No. 137/2019 on the Housing and Construction Authority. The Act on the Housing and Construction Authority defined the Authority's activities and the HFF's mortgage lending as having exclusively a social role, which was in accordance with EFTA's recommendations.

The division process included determining the fair value of the HFF's assets and liabilities. The assets and liabilities transferred to the HF Fund were valued at ISK 180 billion in negative equity. Of the HF Fund's negative equity upon its establishment, ISK 17 billion were due to the capital funding of the Housing Fund and the rental company Bríet, which are now assets on the Treasury's balance sheet. The HFF's financial reporting up to that point had been on an amortised cost basis, which did not reflect the underlying loss in an obvious way, although it had long been clear that the HFF's operation was unsustainable and that there was significant underlying risk.

The debts transferred to the HF Fund amounted to ISK 916 billion and consisted of all debt issued by the HFF, including HFF bonds, housing bonds and Housing Authority bonds. The Fund's liabilities are government-backed with a guarantee of collection, as stated in the HFF bond prospectus, with HFF bonds making up 96% of the Fund's debts. The Fund's assets amounted to ISK 737 billion.

Figure 3: HF Fund's asset composition upon the HFF's division at year-end 2019 (ISK bn; % of total assets).



- The HFF's older legacy loan portfolio stood at around ISK 294 billion, or approximately 40% of total assets. It consisted mostly of loans to individuals but also portfolios acquired from commercial banks and savings banks.
- Treasury bonds and bills amounted to approximately ISK 122 billion, or 17% of total assets, as HFF was a long-time participant in the Treasury's funding through investment, and the HFF's investment policy placed no restrictions on this asset class.
- Deposits amounted to ISK 78 billion or 11% of total assets, of which ISK 43 billion were kept in a current account with the Central Bank, to which the HFF had access at the time.
- Other assets consisted mainly of the Icelandic banks' covered bonds and bonds issued by Municipality Credit Iceland, totalling ISK 105 billion or 14% of total assets.
- The Fund was also to receive bonds issued by the Housing Fund in consideration for the social loan portfolio transferred to the Housing Fund and by the rental company Bríet for properties acquired by the company, totalling ISK 137 billion or 19% of total assets.
- Appropriated assets and other assets amounted to ISK 700 million.

It should be noted that several aspects of the division proved more complex than initially assumed, and hence the final processing of these assets of HF Fund has taken some considerable time. Shaping the terms of the bonds issued by the Housing Fund in consideration for the social loans acquired by it proved particularly time-consuming, with these bonds finally delivered to the HF Fund this past summer. The Fund's loan portfolio has also been the subject of litigation focusing on the legality of prepayment penalties, as set out in section 2 hereinabove.

HF Fund

The Act on the Processing of Assets and Liabilities of the HF Fund entrusted the Minister of Finance and Economic Affairs with supervision of the Fund and management of the processing of the assets and liabilities transferred to it as part of the HFF's division. The aim of winding down the Fund's assets and liabilities is to minimise the risk exposure and cost for the Treasury stemming from the HFF's accumulated financial difficulties. The winding-down process consists of seeking ways to manage the Fund's assets and liabilities in a methodical manner mitigating risk exposures by reducing the Fund's balance sheet as well as the negative interest margin and expected losses.

Under the Act, a task force is to be appointed, composed of experienced persons able to advise the Minister on possible ways to minimise operating losses. A regulation is also to be issued further providing for the implementation of the winding-down process.

The Fund's winding down since its inception

Following the first wave of the COVID-19 epidemic in the spring months of 2020, a decision was made to suspend policymaking on the Fund's legacy issues until more clarity was obtained on the epidemic's impact on the Treasury. Given the high level of uncertainty both in the domestic and international financial markets, it was deemed imprudent for the HF Fund to embark on investment in the market at that time. It was also clear that the Treasury would have to raise significant funds in the market. It was not considered justifiable for the Fund to participate in Treasury debt offerings, with the resultant effect on demand and terms, particularly since the winding-down process now comes under the remit of the Minister of Finance.

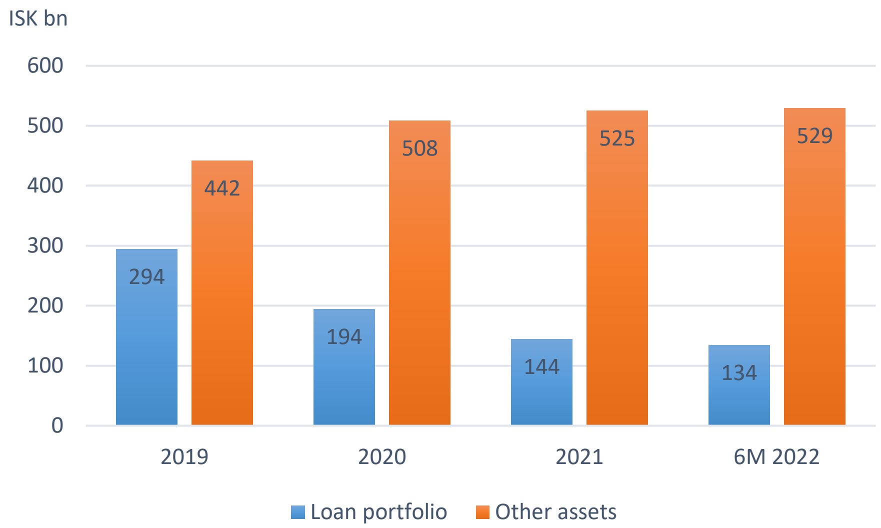
This arrangement and other aspects of the Fund's winding down since its establishment have been discussed in the Fiscal Strategy Plans for the preceding three years, first in the 2021-2025 Plan. The Fund's position and the Treasury's risk exposure are outlined in detail in the 2022-2026 Fiscal Strategy Plan. In addition, the Fund's annual financial statements are made public on a stock exchange and the Fund's website.

Around the time the COVID-19 epidemic hit, the Central Bank of Iceland was preparing changes to access to current accounts offered by the Bank, which included closing down the account that the Fund had held there. The Fund's account with the Central Bank had been used as a demand deposit account, into which the Fund deposited the cash that it was unable to invest in loan origination, securities or term deposits. At the same time, prepayments on the Fund's loan portfolio continued to grow in tandem with falling interest rates, so its cash position was growing at a fast rate.

In April 2020, a loan agreement was concluded granting credit from the HF Fund to the Treasury. Subsequently, the Treasury began to draw on the loan from the HF Fund and thereby use the ample cash at the Fund's disposal on its account with the Central Bank, which then stood at ISK 59 billion. At the same time, the Fund discontinued almost all direct investment in the market. It has used the cash flow generated by securities holdings and prepayments on its loan portfolio mostly to make loans to the Treasury and repay debts.

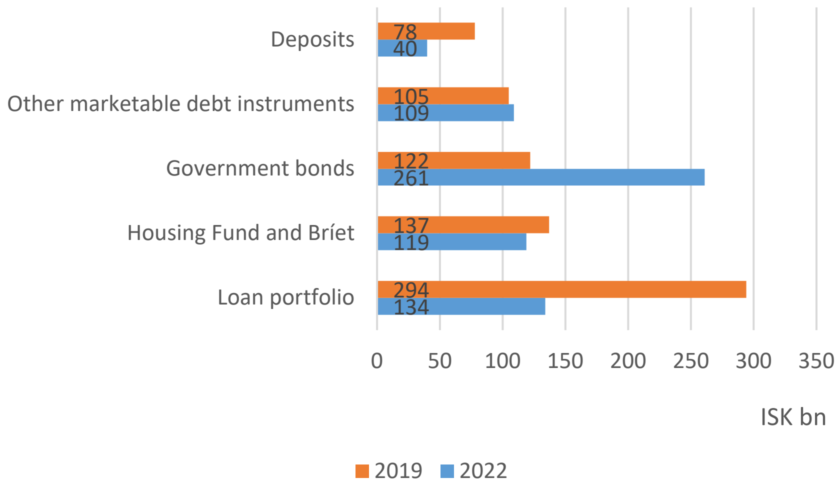
Prepayments on the Fund's loan portfolio from 2020 to June 2022 proved to be substantial. As shown by Figure 4, the loan portfolio shrank from ISK 294 billion at year-end 2019 to ISK 134 billion in June 2022, exceeding projections by a considerable margin. At the end of June 2022, the loan portfolio accounted for only about 20% of the Fund's total assets.

Figure 4: Development of loan portfolio and other assets.



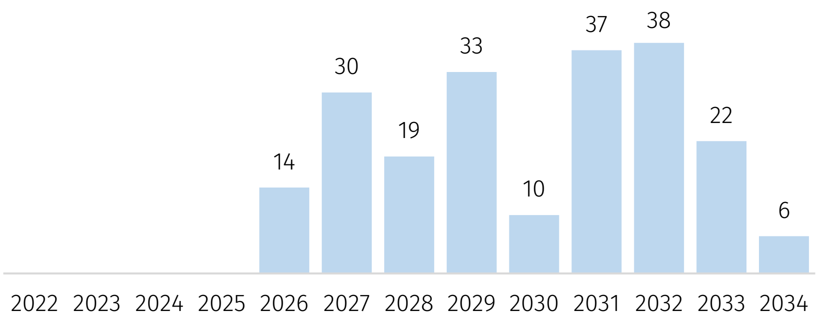
The composition of the Fund's asset, which according to its 2022 half-year results stood at ISK 663 billion, has thus changed considerably since the HFF's division, as shown in Figure 5.

Figure 5: HF Fund's asset composition upon its establishment in 2019 and in its 2022 half-year results



The Fund extended credit to the Treasury worth ISK 190 billion in 2020-2021, thereby easing the Treasury's funding pressures in that period. The loans carry inflation indexed interest reflecting the market interest rates enjoyed by the Treasury until the time that the Fund is estimated to need the funds to make payments on its debts. The Treasury is scheduled to start repayments in 2026, which are expected to be fully completed in 2034. The cash flow of these assets is thus tailored to the Fund's needs to meet its obligations, which is convenient for the management of its assets. It may also be noted that these timings and amounts are based on, among other things, certain assumptions about prepayments on the loan portfolio, so the Fund's eventual funding requirements, and thereby the repayment horizon, may change if those assumptions change.

Figure 6: Scheduled payments on the Treasury's loan at present-day prices (ISK bn).



When the HF Fund was established in 2019, its asset portfolio included Treasury notes worth ISK 122 billion, and the balance on its current account with the Central Bank stood at ISK 43 billion. The Fund's total holdings of Treasury notes and Treasury bonds according to the 2022 half-year results amount to ISK 261 billion. On this comparison, the Fund has increased its investment by ISK 96 billion in debt instruments issued by the Treasury at a time of considerable risk and uncertainty in the economy and a dearth of low-risk, indexed investment options. Concurrently, the indexation imbalance between assets and liabilities was reduced. These investments are in line with the investment policy that had been adopted by the Fund.

The Treasury's need for credit has decreased significantly on the back of its improving performance after the pandemic subsided, and is set to decrease even further in the coming years if projections hold. Therefore, the need for or possibility of using the aforesaid credit arrangement in the management of the HF Fund's assets is likely to diminish. Over the course of 2022, a clearer picture has also emerged of the Fund's final asset portfolio, the Housing Fund's bonds, and litigations relating to the loan portfolio, although these have not been put to a final close in all respects. Therefore, the Ministry of Finance and Economic Affairs has started the journey towards actually winding down the Fund's assets and liabilities.

The Minister appointed a task force in mid-March 2022 to advise on this winding-down process. The task force consists of Perla Ösp Ásgeirsdóttir, Stefán Pétursson and Lúðvík Örn Steinarsson. It has provided the Ministry with advice on various issues relating to resolving the Fund's affairs and took part in drafting a Regulation under the Act on the HF Fund. The Regulation further details how to conduct the Fund's winding down, defines its risk policy and clarifies the arrangement for the management of its assets. The Regulation, No. 759/2022, was issued in June 2022.

Assessment of the Fund's position

As previously stated, the HF Fund's assets and liabilities were recognised at fair value in its initial financial statements, but thereafter on an amortised cost basis with the exception of marketable instruments linked to market yields. The Fund's results for the first operating year of 2020 were marked by positive revaluations of securities holdings by almost ISK 10 billion, with the Fund posting a loss of ISK 2.8 billion. The year 2021 saw little change in market interest rates, with minor changes in the value of the Fund's securities holdings. The Fund posted a loss of ISK 13.9 billion, with inflation developments impacting unfavourably on its performance. Since the Fund's indexation balance is negative and the indexation component of indexed loans is expensed in its accounts, higher inflation has a negative impact on its income, although this has been mitigated by the said indexed lending to the Treasury. In the first six months of 2022, high inflation and interest rate hikes made their mark on the Fund's performance, which posted a loss of ISK 16.6 billion, with the value of its securities holdings down by ISK 3.9 billion.

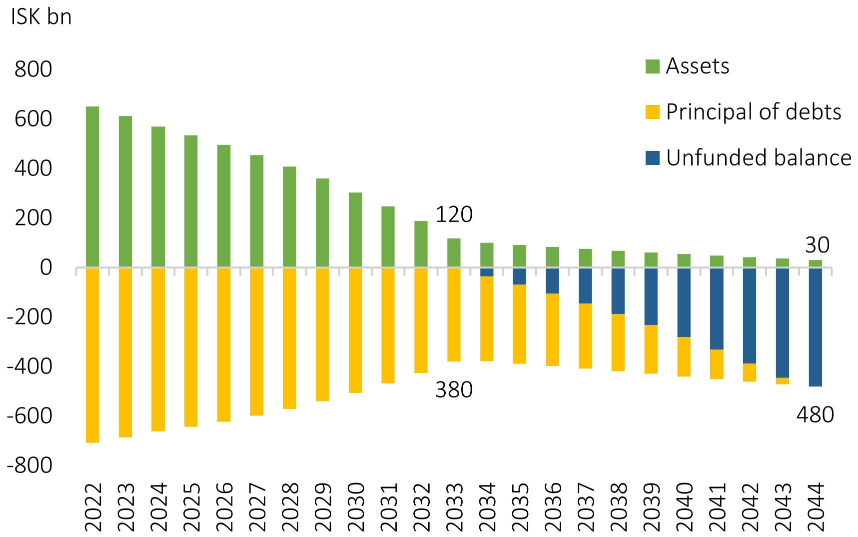
Deloitte has prepared an operating model designed to provide a clear overview of the Fund's activities and to project its future financial position. The model is based on the figures from the 2022 half-year results. The model assumes a conservative investment strategy and that returns on the Fund's cash holdings in the short term will reflect the assumptions underlying the macroeconomic forecast regarding policy rates, whereas in the long term, returns are assumed to be in line with the long-term equilibrium real interest rate of Iceland's economy, with inflation in keeping with the macroeconomic forecast's assumptions, and a continued high level of prepayments. On this basis, the Fund's operating losses throughout its debt maturity horizon are projected to amount to ISK 450 billion, or ISK 200 billion at present value. Projections of this type are naturally subject to considerable uncertainty, but this clearly indicates that the Fund is in a very challenging position and that the government guarantee of its debts will be tested, all else being equal.

The Fund's income statement entails a negative interest margin, i.e. its assets generate lower interest than it is paying on its debts. Losses can possibly be reduced by taking more risk with the Fund's assets to narrow the interest rate margin. However, the duration of investment must allow for the servicing of the Fund's debts, bearing in mind the above discussion of repayments of the loan granted to the Treasury, with the baseline scenario assuming that the loan's repayment needs to start in 2026.

As at 30 June 2022, the Fund's securities holdings stood at ISK 162 billion and its claim on the Treasury at ISK 208 billion. If a decision were made to sell the Fund's assets, the resulting impact on financial stability would have to be considered, since substantial amounts would be involved that could affect pricing in the securities market. There is also uncertainty regarding the demand side of large asset classes. Analyses show that if a decision were made to pay off the claim on the Treasury (ISK 208 billion) and spend the resulting inflow of funds on higher-risk assets, those assets would have to generate a real rate of return of approximately 9% to make up for the expected losses over the Fund's lifetime. In comparison, the return requirement for pension funds is 3.5%. A rate of return exceeding present-day interest terms would make up for the loss in part, but a decision to that end would have to take account of the Fund's risk exposure and the duration of investment.

The Fund has assets to service its debts throughout 2033. In 2034, its funding need will amount to approximately ISK 36 billion at that year's prices, which will continue to increase year-by-year until 2044, when all its current debts will have matured. When this funding need materialises, the Fund will have assets worth just over ISK 100 billion, enabling the funding need to be pushed back by 2-3 years by selling assets. These trends are outlined in Figure 7, which sets out how the Fund's assets will decrease faster than its liabilities over the coming years. As of 2034, unfunded losses will start to accumulate if nothing is done.

Figure 7: Development of assets and liabilities at each year's prices and unfunded losses accumulating as of 2034.



The total guarantee amount recognised in the State Guarantee Fund's accounts at restated nominal value was ISK 729 billion at the end of the first half of the year, according to the Government Debt Management's *Market Information* publication for August. This does not take into account the Fund's holdings of its own bonds; after deducting those, the debts' nominal value comes to ISK 710 billion. This excludes the Fund's asset position in other respects and performance developments. Total assets according to the Fund's 2022 half-year results stood at ISK 663 billion, which is ISK 47 billion lower than the nominal value of liabilities.

The negative balance reflected in the Fund's financial statements will appear very clearly in the Treasury's 2022 financial reporting, when account has been taken of the changed classification of central government entities in Group A of the Government Accounts, in which the Fund will be defined as part of the general government. This will have a significant effect on the presentation of liabilities and interest expenses in the central government consolidated statements, and has in fact already done so in international comparisons by economic statisticians.

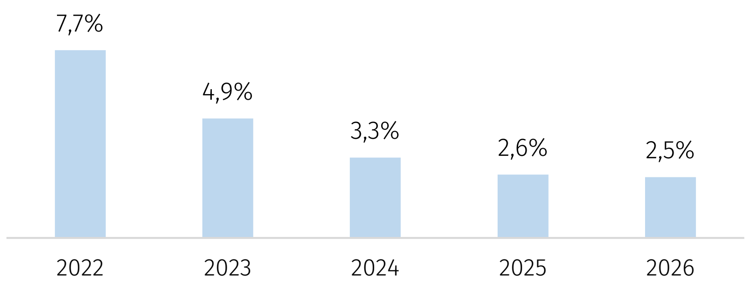
Performance scenarios for the next few years

Deloitte's operating model is based on a number of baseline assumptions. There is uncertainty as to how the Fund's performance and financial position will develop throughout the life of its debts, but the model's aim is to set out a baseline scenario drawn from current market conditions. The model's main assumption components are the expected inflation over the debt's life, expected interest rates and the loan portfolio's prepayment speed. The inflation and interest rate assumptions are based on Statistics Iceland's latest macroeconomic forecast of June 2022.

Inflation

Inflation as of 2026 is assumed to be in line with the Central Bank's inflation target of 2.5%. Higher inflation would impact negatively on the Fund's performance over the life of its debts: a 1% rise in annual inflation would increase the Treasury's expected loss, assuming that the Fund would continue to operate throughout its debt maturity horizon, from ISK 450 billion to ISK 510 billion (converted from ISK 200 billion to a present value of ISK 220 billion).

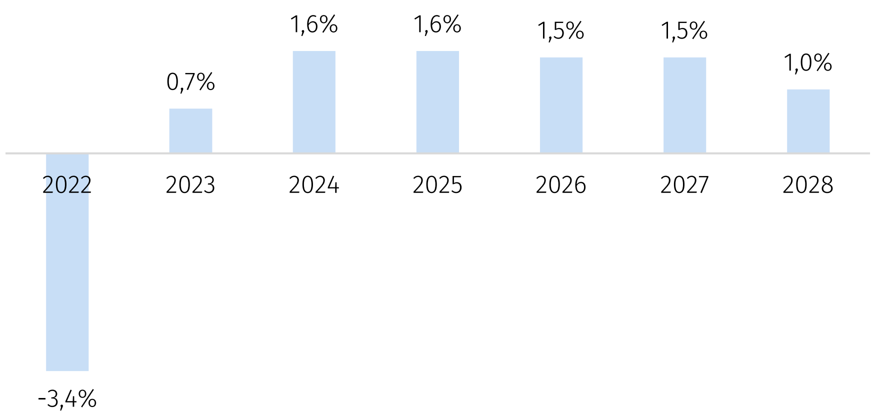
Figure 8: Model's inflation assumptions



Interest rate levels

The model assumes a real interest rate of 1.0% as of 2028. Since the Fund's cash is mostly tied up from 2023 and the interest rates on its assets and liabilities are fixed, a change in the real yield curve would have only a minor effect on the Fund's performance. The effect would be felt in the second half of the period when the Fund will be unfunded, as interest is calculated on its unfunded balance. If interest rates were to rise by 1% on average until 2044, the State's expected loss at 2044 prices would increase by ISK 30 billion, or from ISK 450 billion to ISK 480 billion, whereas the impact would be insignificant if a settlement were made in 2034. Since the expected loss is discounted based on the same real-interest-rate assumptions, a higher interest rate level would reduce the discounted loss. A 1.0% increase in the interest rate level over the life of the debt would reduce the Fund's discounted loss from ISK 200 billion to ISK 170 billion.

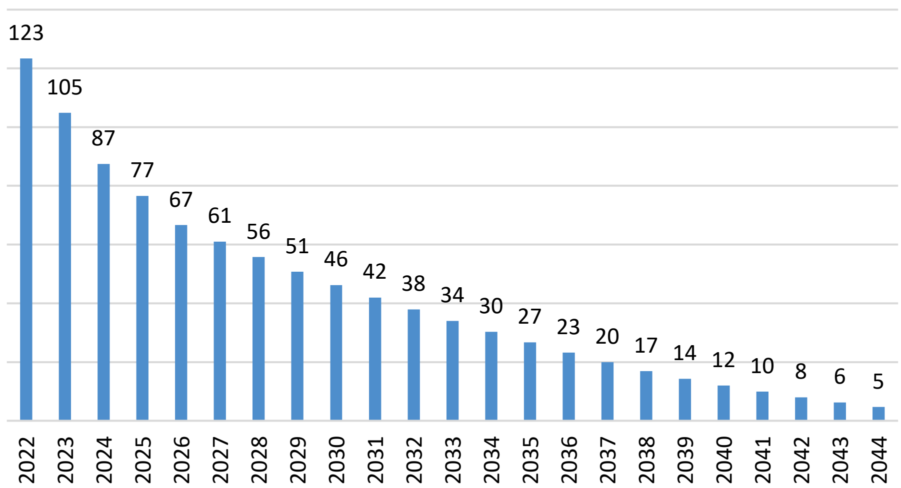
Figure 9: Model's real-interest-rate assumptions



Loan portfolio's prepayment speed

The model's assumptions for prepayment speed are conservative and envisage continued prepayments in the short term. Prepayments are assumed to equal 20% of the principal in 2022, 15% in 2023 and 2024 and 10% in 2025 and 2026. The model assumes 5% annual prepayments as of 2027.

Figure 10: Projected loan portfolio size (ISK bn at each year's prices)

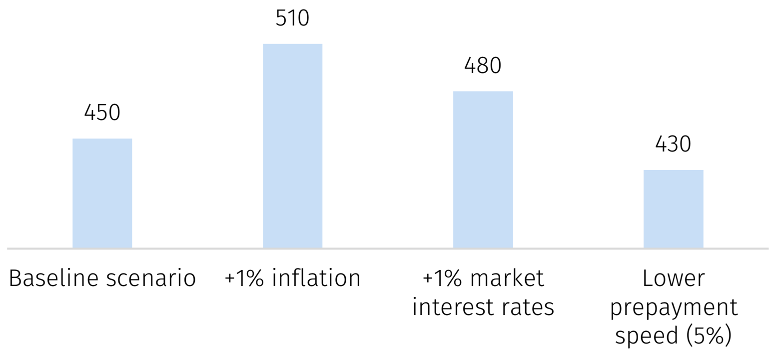


If prepayments slow down more than assumed in the model, the Fund's projected loss decreases because the loan portfolio generates a higher return than cash does in the current interest rate environment. If the prepayment rate drops significantly to 5% per year, the projected cost for the Treasury, assuming that the Fund will operate throughout the life of its debt, becomes ISK 430 billion, or ISK 190 billion at present value, i.e. ISK 10 billion lower at present value.

Slower prepayments on the loan portfolio would affect the Fund's cash flow and thereby its need for repayment of the loan granted to the Treasury. As previously stated, the Treasury is assumed to make repayments on the loan in line with the Fund's funding needs, with repayments assumed to start in in 2026 and end in 2034, as set out in the figure in section 4.1. If prepayments were to slow down to the aforementioned 5% scenario, the Treasury would have to start repayments in 2023.

Summary

Figure 11: Fund's expected loss throughout the life of its debt, ending in 2044. The first column shows a baseline scenario, the second a scenario assuming 1% higher inflation each year, the third a 1% higher real interest rate each year, and the fourth an annual prepayment speed of 5%.



From the above, it is clear that changes in the main assumptions of the HF Fund's operating model do not significantly change the Fund's position throughout the life of its debt. The Fund is clearly in a poor financial position, and although favourable changes in external conditions could mitigate the damage to some extent, unfavourable developments could also exacerbate it, even with minor deviations from the baseline scenario.

Government guarantee for the HF Fund's obligations

As outlined above, the HF Fund's position is such that there is a high probability of the Treasury's guarantee of collection being tested. It is important to take timely decisions on the shape of the process for settling this guarantee. Consideration must be given to the interests of the Treasury as guarantor, of the public as taxpayers, creditor interests, creditor equality and how best to ensure that such a settlement does not cause undesirable ripple effects in the financial system. It is important for the government to formulate a clear policy on this issue with the public interest as the guiding principle.

The Icelandic State is clearly a guarantor of collection for the HF Fund's liabilities and will meet its obligations in full by settling the guarantee. The issue on which a position currently needs to be taken is the appropriate time at which to carry out the settlement and in what manner.

Generally on the HF Fund's debts

The HF Fund owes the principal of the bonds issued plus accrued interest and indexation, which in mid-2022 stood at ISK 710 billion, taking into account the Fund's own bond holdings. This situation will not change even if market participants or the Fund itself value the liabilities differently, whether downwards or upwards. Different pricing of HFF bonds in trading will have no effect on the obligations of the Fund or of the Icelandic State as guarantor.

A general increase in interest rates and yields will serve to reduce HFF bonds' market value, but this will likewise have no effect on the Fund's obligations to the bond holders. The same applies if market interest rates fall, in which case the valuation of the bonds' prices increases, but the Fund's obligation to the bond holders remains the same.

The yield on HFF bonds has been on a downward trend since 2009 in parallel with the overall fall in interest rates in Iceland and reached its lowest point in the autumn of 2020. This was driven by falling inflation and lower public indebtedness for most of this period, coupled with measures taken in response to the COVID-19 epidemic leading to further interest rate cuts. The yield on the HFF150644 series reached its lowest point at 0.15% in September 2020. This year, foreign and domestic interest markets have seen major fluctuations as the consequences of the war in Ukraine in Europe, rising commodity prices and increased supply of money in circulation have pushed up inflation and interest rates. The yield on the HFF150644 series was 2.15% at the end of September.

According to estimates based on the 30 June 2022 figures, the difference between the nominal value of the debt and the fair value or estimated market value of the HF Fund's liabilities is approximately ISK 170 billion, with the fair value of HFF bonds estimated at around ISK 860 billion. In September 2020, this difference stood at ISK 260 billion, and at the end of September 2022, it was ISK 110 billion.

In this context, however, it should be borne in mind that the book value of liabilities on the HF Fund's accounts is based on interest rates and market values at the time of the HFF's division.

Nature of the government guarantee

The Ministry of Finance and Economic Affairs has had the nature of the Treasury's guarantee examined. Important considerations in this respect include how the HFF's obligation was created upon the issuance of the HFF bonds, the involvement of the Treasury, and the general rules on government guarantees.

As set out above, an Exchange Offer took place in 2004 whereby older housing bonds and Housing Authority bonds could be exchanged for HFF bonds, as authorised under a new temporary provision of the Housing Act. On 5 June 2004, the Minister of Social Affairs issued a Regulation (No. 522/2004) on the terms of the new bonds, which stipulated, among other things, that the HFF's board should make a proposal to the minister on the terms of each HFF bond series, such as interest rates, indexation, the form of repayment and the term to maturity. The Regulation specifically stipulated that the interest rate of each series should be "unchanged for the entire period of the loan". The Regulation did not specifically refer to the Icelandic State's guarantee.

The HFF proceeded to prepare a prospectus for the new bonds, which was issued on 10 June 2004 and stated that the Minister of Social Affairs had approved the terms in accordance with the then newly issued Regulation.

These documents explained the nature of the Icelandic State's guarantee for those who participated in buying the bonds at the outset. These terms have been accessible and formed part of the obligations of the HFF, and later the HF Fund, ever since. They state, among other things, that the new notes are guaranteed by the Icelandic State under a guarantee of collection.

The terms clarify the nature of the guarantee as such that all remedies against the HFF must be exhausted before any claim is made against the guarantor. They also specify that the HFF's insolvency has to be proven for the guarantee of collection to become enforceable. This type of guarantee thus differs from a surety (*sjálfskuldarábyrgð*), which is the most common form of guarantee of financial obligations in Iceland.

The Treasury's guarantee of collection is in accordance with what has generally been deemed to apply to guarantees for central government agencies, as reiterated in the Regulation on State Guarantees, the State Guarantee Fund and Treasury Relending No. 557/2001.

The State is generally liable for its agencies unless its liability is in some way limited, such as when the government establishes a public limited company. However, the State's liability only applies if the agency's original obligation was established in a proper and lawful manner. This is considered to have been the case here, as the Housing Act provides for an authorisation to issue HFF bonds and the 2004 Government Budget confirms that the HFF was authorised to refinance its debts and raise new funds or refinance itself in this manner.

Government guarantee's status upon insolvency

As previously related, no creditor could enforce the Treasury's guarantee without first establishing the HF Fund's insolvency. Before such an event, Althingi could, e.g., decide by legislation to:

a) inject more capital into the Fund

b) decide annual budget provisions equal to debt repayments

c) assume the Fund's obligation directly.

In the above scenarios, the guarantee would not be tested in a way requiring prior formal ascertainment of the HF Fund's insolvency. However, Althingi's involvement would inevitably be needed to decide budget provisions for this purpose. Another option would be for the HF Fund and its creditors to agree on a settlement arrangement with or without the Treasury's involvement.

Barring these options, the general rules of bankruptcy law and rules on government guarantees may come into consideration. Both can come into play if the Treasury's guarantee is tested in the event of the HF Fund's insolvency.

It should be noted here that the Treasury's loan terms contain no provisions to the effect that default by central government agencies will cause the government's obligations to become due or payable or alter them in any other way. Another consideration is the indirect impact of such an insolvency of a public entity, which could trigger instability in financial markets.

Act on Bankruptcy, etc.

The Act on Bankruptcy states that a company's estate must be subjected to bankruptcy proceedings if the company is clearly unable to meet its obligations to creditors in full when their claims fall due and payable and the payment difficulties cannot be considered likely to be resolved within a short time. Other things being equal, this appears to be the situation in which the HF Fund finds itself. It is foreseeable that the Fund will not have sufficient funds to pay its debts with interest, even if it sells assets.

In bankruptcy proceedings, all obligations fall due at the same time regardless of any previous agreements on repayment. The creditors then lodge their claims against the bankruptcy estate as if they are due and payable, with previously due payments and interest adding the part of the claim that was not due. In bankruptcy proceedings, unaccrued interest is unclaimable.

However, public agencies enjoying a government guarantee cannot be subjected to bankruptcy proceedings under paragraph 3 of Article 5 of the Act on Bankruptcy "unless otherwise prescribed by law". It follows from this provision that a special authorisation under law is required to compel a bankruptcy proceeding or liquidation of the HF Fund, since the State guarantees the Fund's obligations. No such legal authorisation currently exists, although arguably an authorisation to liquidate the Fund could be desirable from the viewpoints of creditor equality and orderly settlement of the government guarantee.

Rules on government guarantees

The granting of State guarantees is governed by Act No. 121/1997. This Act applies to all guarantees granted by the Treasury. In principle, a guarantee fee is payable for guarantees arising through Treasury ownership, cf. Article 6 of the Act.

On the basis of the Act, a Regulation on State Guarantees, the State Guarantee Fund and Treasury Relending was issued on 15 April 1998. The Regulation further details the rights and obligations of the Treasury as guarantor and the rights of those seeking payment from the Treasury on the basis of such guarantees. In the event of default, a creditor may seek payment and the Treasury has the right to pay the amount of debt outstanding as it arises (preventing it from being called).

For a guarantee of collection to become enforceable, a default must have been established, all reasonable efforts must have been pursued to enforce any security and it must have become "apparent during bankruptcy proceedings or by other verifiable means that the debtor is unable to pay the debt". Article 12 of the Regulation provides that the State Guarantee Fund may opt to assume "the entire debt to itself" if it so wishes. That Article deals with sureties and does not state explicitly whether the same rule applies to guarantees of collection.

Enforcement action against the HF Fund and the government guarantee

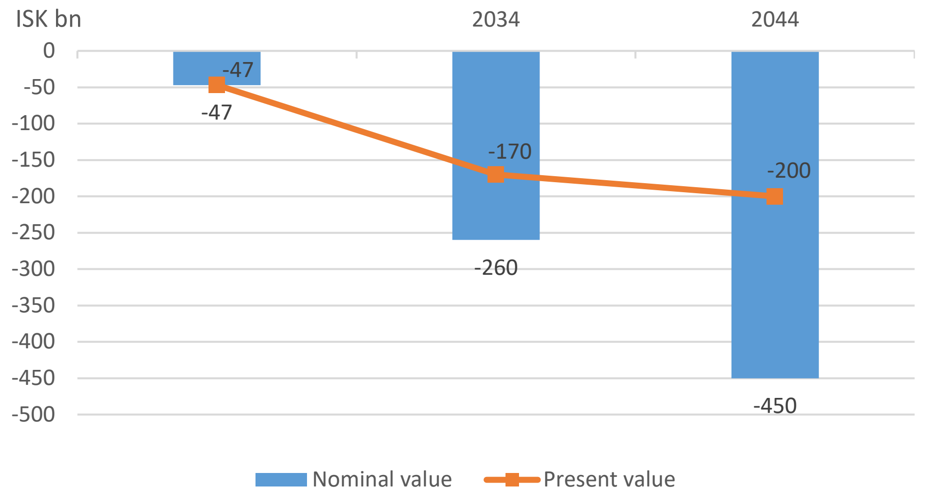
In the event that Althingi decided neither to grant special budget provisions nor to assume the HF Fund's obligations, with no agreement reached on a settlement, the government guarantee would be tested, as previously stated. This could occur in circumstances where creditors claimed payments from the Treasury, having already pursued the HF Fund, e.g. by means of an unsuccessful attachment attempt, which would involve the HF Fund declaring in a hearing before a district commissioner not to have sufficient assets to ensure fulfilment of the claim of the party requesting the attachment. That would trigger the Icelandic government's guarantee of collection and, in the event of non-payment by the government after the lodging of a claim, the creditor could either seek a judgment on the payment obligation or attempt attachment on the basis of paragraph 2 of Article 3 of the Enforcement Act No. 90/1989, which states that execution may be levied against the party automatically liable for an obligation under the law. Second, the HF Fund's creditors could direct a claim against the Treasury for each principal payment and interest for the remainder of the bonds' life. They could then initiate legal proceedings if the Treasury failed to make each such payment. But this is merely to set out a possible scenario, which all stakeholders will wish to avoid.

Conclusion

It is now well established what HF Fund's financial position looks like. Litigations relating to disputed loan terms have mostly been resolved and a conclusion has been reached on the Housing Fund's funding arrangements for the older legacy loan portfolio, with Housing Fund bonds having been issued. Given the development of the Fund's asset portfolio and overall financial market trends, ongoing operating losses are clearly expected, and hence the amount that the State will have to shoulder through its guarantee of collection is set to grow over time, other things being equal.

Figure 12 shows the Fund's estimated equity at different settlement time points. The Fund's assets and liabilities are valued for each time point, with the difference reflecting the negative equity or cost for the Treasury of completing the settlement at that point in time. The amounts at stake are high regardless of the chosen settlement timeframe and will be of significance for government finances, in addition to which such a major debt settlement will affect the financial markets when it happens.

Figure 12: Estimated equity position at different time points, at nominal and present value.



The Fund's position is somewhat unusual in that it has sufficient cash to make payments on its debts until 2034 as scheduled. If a settlement were to be made at that point, the Treasury would have to contribute ISK 260 billion, or 170 billion ISK at present value. If a decision is made to inject capital into the Fund to meet interest and outstanding principal payments throughout the life of its obligations, the total amount payable by the Treasury is estimated at approximately ISK 450 billion, or ISK 200 billion at present value.

All the available options for settling the government guarantee are unappealing and involve a major financial outlay for taxpayers, regardless of the path taken to this end. However, it is in their interest to complete the settlement sooner rather than later, which would put a stop to the continuing lossmaking and growth in the amount to be covered by the guarantee. Based on the Fund's position as set out in its 2022 half-year results, the Treasury would have had to contribute ISK 47 billion to the settlement of the guarantee at that point. With each passing month, the cost of the settlement for the Treasury can be expected to grow by ISK 1.5 billion, or ISK 18 billion per year.

It is also important for the Fund's creditors to have timely and clear information on how the Treasury intends to deal with these issues. Given all these circumstances, Althingi needs to decide and take a position on how best to serve the interests of the Treasury and of the public. Adopting a policy on how to handle this issue cannot be avoided much longer.

In the upcoming work on this matter, account will need to be taken of considerations relating to impacts on financial markets, creditor interests, creditor equality, and other considerations. The Ministry will continue to analyse the situation and the aforesaid possible remedies in an aim to ensure that the drafting of a legislative bill to this end can begin as soon as possible.

This report is submitted to Althingi on the basis of Article 53 of Act No. 55/1991 on the Standing Orders of Althingi, and the Minister requests that the report be placed on Althingi's agenda for debate.