

Regulatory proposal - cf. the Cabinet Resolution of 10 March 2017, Articles 1-4	
Item heading and no.	Winding up and settlement of the HF Fund
Ministry	Ministry of Finance and Economic Affairs
Transposition of EEA Act?	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
Date	31 March 2023

A. Issue under consideration

1. Background and rationale

Background

The HF Fund was established by Act No. 151/2019 at year-end 2019 with the aim to minimise the Treasury's risk exposure regarding the winding down and settlement of the accumulated financial difficulties of the Fund's predecessor, the Housing Financing Fund (HFF). The HF Fund was subsequently brought under the supervision of the Ministry of Finance and Economic Affairs, the HFF having previously been under the remit of the Ministry of Social Affairs.

In October 2022, the Minister of Finance and Economic Affairs submitted to Althingi a report on the Fund's situation, as stipulated by Article 3 of the Act. The purpose of the report was to inform Althingi about the process of winding down the Fund's assets and liabilities by setting out possible scenarios for the coming decades, all of which present an outlook of continued operating losses, and the possible impact thereof on the Treasury given its guarantee of collection for the Fund's liabilities, in particular the "HFF bonds".

Under the bonds' terms and conditions, the guarantee of collection entails that the Treasury guarantees repayment of the debts' principal plus accrued interest and inflation indexation until the settlement date, as further detailed in the report. The conclusion of the report's analysis is that the HF Fund will foreseeably not be able to meet all its obligations when they fall due and that the Fund is, therefore, *de facto* insolvent.

The Minister's report marked the first step towards Althingi adopting a position on how to react to this state of affairs. In continuation of that step, this document sets out the intention to submit to Althingi a bill for a legislative act on the winding up of the HF Fund and a settlement of the government guarantee of collection for the Fund's liabilities, as well as winding-down measures in furtherance of statutory objectives to minimise the Treasury's risk exposure and cost.

The purpose of the proposed legislation is to deliberate on and address the HF Fund's clear insolvency in a prudent and orderly manner affording the holders of the Fund's bonds, who are predominantly long-term professional investors, a good prospect of maintaining or improving their position, and whereby the Treasury would honour the government guarantee of collection stipulated by the bonds' terms. A parallel aim is to prevent, without further delay, enormous additional obligations from arising, without a legal basis, in the form of claims against the Treasury as a result of government inaction. Thereby, the growing problem will not be left to future resolution, but solved in a timely fashion before it escalates. Experience shows this to be the most effective way to ensure fiscal sustainability, which enables a fiscal position that can mitigate headwinds and meet social exigencies that arise from time to time.

This task can be compared to other major challenges of unsustainable obligations and government guarantees that the Icelandic authorities have resolved in past years. One example is the Pension Fund for State Employees, whose Division B was closed in 1997 by establishing a new Division A, which took over the functions permanently in a modified form. This was followed by annual and non-periodic advance payments into Division B, the continuation of which payments is now deemed to cover its funding until all pension payouts have been made. A major financial problem that had begun to arise in Division A was also resolved

by an agreement with trade unions and the enactment of legislation towards the end of 2016.

That solution included, firstly, a substantial financial contribution and, secondly, the termination of a government guarantee in parallel with transforming the pension fund to adopt the same arrangement as applies to private-sector pension funds. Another example is the heavy burden of debt that the Treasury had to shoulder following the collapse of the Icelandic banking system in the autumn of 2008. This was dealt with through extensive, long-term fiscal consolidation coupled with steadfastness in achieving a favourable agreement on stability contributions from the failed banks' winding-up estates. At the end of this process, Iceland's sovereign debt position was among the best of the OECD countries. What these examples have in common is that a failure by the government of the time to take action would have left future generations with enormous and ever-growing problems.

Regarding the discussion below, the qualification should be made that the amounts presented in this regulatory proposal are based on the assessment of the Fund's financial position set out in the Minister's October 2022 report to Althingi. As stated in that report, the assessment is subject to uncertain assumptions, including, however, that, other things being equal, the obligations that the Fund is unable to meet will increase over time if the government fails to take action, in particular when market interest rates are rising. It is practically a certainty that a recalculation of that assessment based on the current data would reveal that the HF Fund's unfunded liabilities have already increased significantly, as was considered highly probable in the report.

The HF Fund's financial problems are rooted in changes made to the HFF's funding arrangements in 2004 when the older Housing Bond System was transformed and HFF bond issuance commenced. Under the Housing Bond System, the HFF had the option to make 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. The changes to the system involved financing the Fund with non-prepayable, fixed-interest, inflation-indexed bonds, called *HFF bonds*, which increased the Fund's prepayment risk substantially, since borrowers were permitted to pay off their loans at any given time. Although a portion of the loans was subject to a prepayment fee under the terms, the fee only partly compensated the Fund for its loss upon prepayment. At the time, the HFF was by far the largest player in the Icelandic mortgage market.

Soon after the aforesaid system change in the HFF's funding arrangements, competition in the mortgage market stiffened as banks and pension funds started to offer better interest rates, resulting in borrowers beginning to pay off their HFF loans at a significant pace. The prepayments started immediately after the system change, reaching their highest levels in the years that followed, until after Iceland's banking system collapse in 2008. Loan prepayments dropped after the financial crisis, but driven by the increased availability of mortgages from banks and pension funds as from 2015, and coupled with lower interest rates in recent years, prepayment levels rose again to substantial levels, thereby increasing the imbalance in the cash flow of the Fund's assets and liabilities. The Fund's loan portfolio currently accounts for less than 20% of its total assets.

In addition to the transformed market conditions, recommendations made by the EFTA Surveillance Authority (ESA) in 2011 based on the EEA Agreement's state aid rules, and the subsequent enactment of Icelandic legislation resulting therefrom in 2012, led to significant restrictions being placed on the HFF's lending activities. In ESA's opinion, the government guarantee of the HFF's liabilities, interest subsidies and tax exemptions constituted illegal state aid. Since that time, the Fund's lending has been restricted mostly to social support. Furthermore, banks and pension funds penetrated the mortgage market, meeting without public-sector involvement the needs of the population segment not requiring social support. These fundamental changes in the HFF's operating environment meant that its previous principal activities in the mortgage market were no longer viable, and the majority of its older legacy loan portfolio has now been paid off. This removed the need for the extensive funding arrangements that the Fund had established.

Rationale for legislation

As related above, the Icelandic government has been working for some time to lay the foundations for resolving the HFF's financial problems. Efforts to this end are already underway, including the establishment of a special winding-down fund, the HF Fund, which is the same legal entity as the HFF was previously, but only holds the assets and liabilities that belonged to the general mortgage lending activities carried out under public auspices. Based on a revaluation of those assets and liabilities, an operating model was devised to analyse the Fund's operations and project its future financial position. This analysis shows that the HF Fund

will continue to operate at a loss throughout its lifetime. The Fund's interest-rate margin is expected to be negative and is projected to generate a loss of ISK 1.5 billion per month, or ISK 18 billion per year. According to the calculations, the Fund has assets sufficient to make payments on its debts until 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, totalling about ISK 450 billion, or ISK 200 billion at present value. Further details on the assessment of the Fund's unsustainable situation are provided in the aforesaid report of the Minister to Althingi.

It should be noted here that in the years following the banking system collapse, the Treasury injected ISK 100 billion at present value into the HFF to strengthen the Fund's equity position.

This legacy problem is of such a magnitude that a structured winding down of the HF Fund's assets and liabilities will be among the most pressing near-term fiscal priorities. Continued uncertainty and the Fund's continued deficit operations would eventually lead to major financial outlays for the Treasury. The longer the time until a settlement is effected, the more substantially the obligations will increase. Furthermore, given the interests at stake for the bond holders, the importance of stability in financial markets, and the potential impacts of such a settlement on financial stability, it is necessary to establish well in advance how the Fund's assets will be disposed of and how its liabilities will be settled. It is in the public interest to ensure full certainty about the settlement and not to pass the problem on to future generations. Tackling this issue must not be avoided or delayed before it gets out of hand, whether for the Treasury, the holders of the HF Fund's bonds or the financial market as a whole.

Another important reason to submit the matter to Althingi is that fiscal credibility and government credit ratings are earned not least by demonstrating that the government is acting proactively and preventing the HF Fund's settlement from becoming a heavier burden than necessary for the Treasury and thereby for taxpayers.

In this context, it should not be overlooked that when the HFF bonds were issued, the Treasury undertook a guarantee of collection for the debt, and the Fund owes the principal on the bonds issued 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 sufficient 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.

In these circumstances, and in accordance with the objectives of the current Act on the HF Fund, the natural conclusion is, therefore, that the work must begin to methodically allocate assets for the settlement of the obligations and terminate the Fund's activities in a clear manner, either by agreement with the holders of the Fund's bonds or through formal winding-up proceedings. The government considers it important to start the preparations and debate in Althingi regarding when and how the Treasury should settle its guarantee of collection for the issued debt currently on the Fund's balance sheet.

In view of these facts, the Minister's presentation accompanying the aforesaid report set out three options deemed the most viable ways for the government, working in tandem with Althingi, to address the Fund's problems and fulfil the government guarantee for its debts:

1. Injecting capital into the Fund to enable it to make payments on its debts throughout their maturity horizon until the year 2044, estimated to cost approximately ISK 200 billion at present value.
2. Enacting legislation to confirm and authorise the HF Fund's bankruptcy or winding-up proceeding and settlement of the government guarantee, in which case the Minister's report estimates that the Treasury would have to contribute ISK 47 billion.
3. An agreement with the bond holders on the Fund's settlement, which may be assumed to entail the cost of fulfilling the government guarantee, cf. point 2, and possibly various asset exchange for the benefit of the HF Fund's bond holders.

As regards the first option, postponing the problem and passing it on to future generations is deemed unviable. Another important consideration when evaluating this option is that if the Treasury paid interest and inflation indexation throughout the bonds' maturity, it would be going beyond what the terms of the bonds stipulate and allocating Treasury funds to payments in excess of its express obligations. This would involve outlays of

Treasury funds to the HF Fund's bond holders, which would not be authorised unless such authorisation were granted by law with Althingi's participation. A decision to exceed the government guarantee coverage to settle the claims could have a disadvantageous impact on expectations with regard to Iceland's government guarantees. It would also bring about a substantial increase in the Treasury's long-term indebtedness.

As for the third option, the overall public interest must be considered best served by reaching an agreement with the bond holders on a settlement of the HF Fund's obligations. Such an agreement and the allocations of assets that it could involve would need to be discussed in Althingi. Depending on the circumstances, the agreement could include the Treasury honouring its guarantee of collection in accordance with the HFF bonds' terms and conditions by transferring other assets to creditors in lieu of the debt's principal plus interest and inflation indexation up to the settlement date. The vast majority of the HF Fund's bond holders are long-term professional investors. Most of them are well positioned – and operating under completely different conditions from the Treasury – when it comes to investing funds and managing the assets that they might receive. The returns on such an asset portfolio in the hands of these investors could be as good or better than on the HF Fund's bonds, using as a reference the returns achieved by asset management entities over several years. In the current circumstances, neither the HF Fund nor the Treasury are in a position to engage in active asset management and investment.

It is important to understand the fundamental lack of context between the HF Fund's negative future outlook and the supposed loss for the recipients of the payments made upon the settlement of the government guarantee. In recent months, the government has been seeking such an agreement, but the talks have not borne fruit and that option seems to be off the table for the time being. This agreement option is discussed in more detail under point 2 in section C, entitled "Options", in this document.

This leaves the option generally prescribed by the law when legal entities are unable to meet their financial obligations, which is to initiate winding up and settlement, but in this case by means of special legislation for the HF Fund as a central government entity. Since the HF Fund is *de facto* insolvent within the meaning of the law, its representatives would be obliged to file a petition for bankruptcy in accordance with the general rules of Article 64 of the Act on Bankruptcy No. 21/1991, if that Act were fully applicable. However, under paragraph 3 of Article 5 of the Act on Bankruptcy, government-guaranteed public agencies cannot be subjected to bankruptcy proceedings "unless otherwise provided for by law". Therefore, a special authorisation under law is required to bring about bankruptcy proceedings or winding up of the HF Fund, since the government guarantees the Fund's obligations. No such legal authority currently exists, which is the main reason for the intended bill authorising special winding-up proceedings. In point 2 below, reference is made to the issues to be targeted by the legislation.

It should be reiterated here, as should be clear from all the foregoing, that whatever path is taken, the honouring of the HF Fund's debts will in any event require Althingi's participation and thereby constitute a distinct rationale for legislation to that end.

2. What is the issue to be resolved?

In the event that no agreement on the processing of the assets and liabilities is reached between the HF Fund and the holders of its bonds, the Fund will foreseeably be unable to make payments on its obligations. Without changes in the law, the Treasury's guarantee of collection would not be triggered until the creditors had unsuccessfully sought satisfaction from the HF Fund, e.g. by means of an unsuccessful attachment attempt or forced sale of the Fund's assets. In such a case, late-payment penalty interest and default costs would apply, in addition to the added uncertainty around cost-effective divestment of the Fund's assets in such circumstances and how long the enforcement of claims could take. Credibility is at stake in effecting the settlement of the guarantee of collection through an organised and smooth process affording all creditors a settlement of their claims in a consistent manner, without undue delay or uncertainty as to when this takes place. The Act on State Guarantees does not provide an adequate framework when it comes to the government fulfilling its guarantee of the HF Fund's bonds.

The proposed legislation would aim to prevent further losses from the HF Fund's negative operating performance and prevent a possible chaotic situation during the settlement of its assets and liabilities, thereby eliminating uncertainty for the bond holders and the financial market as a whole. Concurrently with the Fund's winding up, the government's guarantees would need to be settled through payments to creditors.

Direct write-offs of claims are not envisaged, but rather that the outstanding principal and accrued interest plus inflation indexation will be paid in full, although sooner than the loan terms stipulate. Other things being equal, however, this would result in no interest being payable on the debt for the remainder of its maturity, as all claims against the debtor would automatically become due and payable during the winding up proceedings. Nothing has been established as to whether this measure would result in losses for creditors. In this regard, particular attention should be paid to the potential returns on assets in the market and the amount of any consideration paid upon the HF Fund's winding up and the settlement of the Treasury's guarantee.

The main task is thus devising a legal framework that adequately provides for a settlement vis-à-vis the Fund's creditors and for how the State settles its guarantee.

The Minister of Finance and Economic Affairs is obliged under law to minimise risk exposure and costs for the Treasury as guarantor. Given the extensive scope of this matter and the impacts on the Treasury and numerous other stakeholders, it is important to achieve clarity as to how and when the Treasury is to honour the guarantee of collection. The aim of the intended bill is, therefore, to effect a settlement of the HF Fund's affairs in an orderly manner concurrently with fully settling the government's guarantee of collection for the Fund's debts.

3. To what extent are existing legislation and regulations not sufficient?

Legal framework for the settlement and winding up of entities for which the State is liable

The law provides that the State's liability can be either direct or indirect. The Explanatory Notes to the Bill that became Act No. 121/1997 on State Guarantees discuss owner liability borne by the Treasury, which can be direct, whereby the Treasury may be pursued directly to pay the claim, or indirect, in which case collection must first be attempted from the State company or agency in question. The general rule for State entities with independent finances is that the State's liability for their obligations is indirect. The Explanatory Notes state that these concepts partly correspond to sureties and guarantees of collection, but are better applicable to the Treasury's liability for the obligations of central government entities. They also state that the Treasury's liability for housing bond issuance is considered *indirect*, since the State Housing Fund issued the bonds and is the debtor thereunder.

The HFF bonds' terms and conditions explain the nature of the State's liability for the Housing Financing Fund's bond issuance in some detail and define it as a guarantee of collection within the meaning of claims law. The nature of the guarantee of collection can be explained as that of a guarantee whereby all remedies against the bond issuer must be exhausted before any claim is made against the guarantor. The terms and conditions 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 Regulation stipulates that the Treasury has a certain choice as to whether a debt in arrears is paid in full or the Treasury decides to make use of the repayment terms agreed by the borrower.

With the proposed bill, a different process from that outlined above is envisaged. The proposed process would not require ascertainment of the HF Fund's insolvency through enforcement action by each creditor individually, nor that the settlement of the Treasury's liability be directly related to general winding-up proceedings. It would not involve direct deprivation of ownership interests in the form of expropriation of claims, but would alter the enforcement of the claims because of the circumstances that transformed the HFF's operational basis and for the other reasons outlined above.

Claims are protected as property rights within the meaning of Article 72 of the Constitution. It should be reiterated that no deprivation or impairment of these claims is being proposed, but rather that the settlement of the claims be governed by special rules for an important purpose. The creditors would lose the interest that would otherwise have accrued after a certain time limit connected with the winding-up proceedings, but in lieu thereof the repayment of the principal would be expedited, from which the creditors could earn returns.

Legal authority to enter into an agreement and allocate funds from the Treasury

The Act on the HF Fund entrusted the Minister with the Fund's supervision and the management and processing of its assets and liabilities. The aim of the settlement and processing of the Fund's assets and liabilities is to minimise the Treasury's risk exposure and costs. The allocation of cash and other assets of the Fund in accordance with those aims is authorised. Authorisation under the Government Budget must be obtained for the processing of assets and liabilities requiring the direct involvement of the State.

Current law contains no specific authorisations of the allocation of the Fund's assets to the settlement of liabilities, nor any special provisions authorising agreements with the Fund's creditors.

The government has stated that there is no dispute that the Treasury guarantees the principal and accrued inflation indexation and interest on the Fund's liabilities. If the HF Fund enters winding-up proceedings, a final calculation will have to be made of the amount of the Treasury's liability, i.e. the difference between the HF Fund's assets and its liabilities. Once that amount has been determined, it becomes necessary for Althingi to provide the budget appropriations to make up for the difference in order to honour the guarantee in full.

It is envisaged that the proposed bill will provide authorisation to forge an agreement on the settlement of the claims before the actual winding-up proceedings commence. To that end, it may be considered preferable to alter the composition of the HF Fund's portfolio in order to facilitate such a special agreement, provided that this does not impair the Fund's ability to meet its obligations. This would also entail the Minister having the authority to allocate the State assets in question. It is clear that any allocations of Treasury assets in connection with a possible settlement are always subject to authorisations granted by Althingi in the Government Budget or Supplementary Budget.

B. Objectives

1. Public policy in the respective field/function

Fiscal policymaking is based on a set of principles enshrined in the Public Finance Act No. 123/2015. The principles in question are sustainability, prudence, stability, predictability and transparency. Short-term and long-term fiscal target-setting, which Althingi decides and appears in numerical fiscal rules based on the aforesaid principles, is informed by an imperative to ensure social security and government resilience, supported by moderate public indebtedness and active and targeted debt management. The effort to unwind the unsustainable obligations undertaken by the HFF to fund its mortgage lending over past years and decades, and the intention to eliminate uncertainty in this respect, is fully in accordance with the aforesaid principles and objectives.

Althingi's policymaking referred to here is reflected in the current Act on the Processing of the Assets and Liabilities of the HF Fund, enacted in 2019 and rooted in the HFF's accumulated financial difficulties. Paragraph 2 of Article 1 of the Act states the aim of the settlement and processing of the HF Fund's assets and liabilities as minimising the Treasury's risk exposure and costs stemming from the aforesaid difficulties. This is the objective, in parallel with meeting the Treasury's obligations to the HF Fund's creditors.

2. Objectives of the legislation, in view of the issue to be resolved and government policy

The aim of the proposed legislation is to provide for an orderly winding-down of the HF Fund and the settlement of its assets and liabilities, with a favourable outcome for the stakeholders. This includes eliminating or reducing uncertainty over an issue where major interests are at stake, namely the settlement of the HF Fund's debts, whilst ensuring creditor equality and taxpayer interests in the present and future.

If the conditions arise for concluding an agreement with the Fund's creditors at any stage, it may be possible to pursue alternative avenues to reach an acceptable conclusion for all parties.

C. Options

1. What would be the consequences of no action?

Other things being equal, the HF Fund's insolvency will occur no later than 2034 based on currently available calculations and assumptions. The Treasury's guarantee of collection would be tested no later than that year. As related above, however, significant uncertainty exists as to how it would be settled.

The status of the Fund's creditors would also vary depending on whether their claims fell due before or after the insolvency occurred. The risk for creditors whose claims fell due after the insolvency occurred would be

greater, creating disparities.

As for the interests of the Treasury and taxpayers, the amount of the guarantee of collection would grow year by year, given the Fund's foreseeable operating losses.

2. Actions other than legislation that have been considered

Agreement with HF Fund's bond holders

Following the submission of the Minister's report in October 2022, an effort has been made to engage in dialogue with the parties known to be the holders of the largest part of the HF Fund's bonds, with the aim of reaching an agreement on the settlement of their claims. The intention was to reach out to other bond holders subsequently. Discussions have taken place regarding a transfer of Fund assets in conjunction with a settlement of the government guarantee to the extent that these assets would fall short of covering the payment of all liabilities. The Treasury's main aims in the negotiations were presented on 18 November 2022 as follows:

1. A settlement based on the outstanding balance of the HF Fund's obligations plus inflation indexation and accrued interest. Winding up of the HF Fund and settlement of the government guarantee.
2. Financial stability not to be compromised.
3. Creditor equality ensured for the holders of the HF Fund bonds.
4. Financial settlement to be transparent with respect to the value and composition of transferred assets.
5. Treasury's position as an issuer in the market not to be compromised.
6. Negotiation of the agreement to endeavour to meet counterparty interests and needs to the extent possible.
7. Agreement to constitute the final result.

Although Icelandic pension funds are by far the largest creditor group of the HF Fund, investment funds also hold significant quantities of the bonds. The scope of activities of pension funds and other relevant professional investors will be very substantial in the coming years. For example, pension funds' asset portfolios are large and therefore generate high payment inflows that need to be reinvested, for at least as long as their contribution payment inflows exceed outflows. Hence, the assumption may be made that the pension funds as a whole will need to reinvest their payment inflows from HFF bonds in the coming years, for which reason exchanging assets at this juncture could be seen as part of reinvesting those payment inflows earlier than would otherwise be the case.

The government has presented its ideas for a possible settlement in its communications with pension fund representatives, including offering to the holders of the HF Fund's bonds to exchange them for a well-diversified portfolio that, according to experts, has all the potential to provide them and other creditors with good returns compared with the bonds' interest rates, and should be a good fit for their asset mix. This takes account of the fact that the pension funds have been very successful at generating returns on their assets over the past few decades, so their expertise in the management of large asset portfolios would be useful in generating continued returns on the HF Fund's assets or other assets exchanged for those. An agreement could thus include providing long-term professional investors, in consideration for their claims, with assets that could generate long-term returns, potentially with less risk and better long-term return possibilities than would otherwise be the case.

In other words, the assertion may be made that, if such negotiations were to prove successful, the loss from the HF Fund's insolvency thereby avoided by the Treasury would not entail a commensurate loss for the holders of the HF Fund's bonds, since a well-executed transfer of assets could provide them with as good or better returns, in addition to eliminating a high level of uncertainty about the consequences of the Fund's insolvency. It should therefore be in the interest of both sides to effect an orderly settlement of the Fund's affairs as soon as possible. The government's overall assessment is that such a settlement is the best way of protecting the overall interests of the Icelandic public.

Attempts to enter into negotiations have so far been unsuccessful. The aim of this regulatory proposal includes eliciting the viewpoints of the different stakeholders and creating an appropriate framework to resolve the issue.

Measures to improve the HF Fund's performance

Another area of focus has been the feasibility of reversing the Fund's loss-making performance by altering its investment authorisations and asset composition in order to increase its returns significantly and thereby enable it to service its debts for the remainder of their maturity. Reference may generally be made here to the above rationale for legislation.

In this context, it should be borne in mind that the repayment schedules for the issued bonds place substantial restrictions on the Fund's investments, since they are annuity bonds. A sufficient cash balance to make the repayments, of which there are six per year, must be ensured at all times. Therefore, the Fund's assets and investments have had to be mostly in low-risk debt instruments with predetermined payment flows and in deposits available at short notice. As a result, the returns on investment are rather low. If higher returns were to be the aim, that would involve tying up funds as well as high risk and uncertainty regarding resale possibilities and market prices at the time of divestment.

Transforming a former public mortgage fund into a leveraged investment fund would have various ramifications that could be controversial and unusual in light of the requirements and restrictions that apply to government activities. Objectivity, equality and transparency need to be ensured in all asset disposals and investments. The government is also obliged to consider potential conflicts of interest in markets, state aid rules and competition aspects when investing in commercial enterprises in a market environment.

Hence, the government has deemed such a solution to the HF Fund's financial problems to be unviable. Increasing the returns on the Fund's assets to the extent offsetting the loss-making operations would be a major challenge.

Possible legislation options

All the options presented by the Minister in connection with the report on the HF Fund's financial position require the involvement of Althingi.

1. Capital injections into the Fund to make payments on its debts as necessary throughout their maturity horizon until the year 2044. Those obligations would have to be formally accounted for in the public finances.
2. Legislation defining the HF Fund's winding up and the settlement of the government guarantee.
3. Agreement with the bond holders on the settlement of the liabilities and government guarantee.

D. Which option is being proposed and why?

1. Brief description of the option being proposed and its rationale

Option (2) is expected to be selected given that option (3) has not delivered results.

Option (2) would entail creating a legal framework for the further processing of assets and liabilities. It would enable the creation of a stronger framework for making offers and concluding agreements, in addition to authorising the HF Fund's entering into winding-up proceedings. Furthermore, this option would enable the Treasury to honour its obligations to the HF Fund's creditors to the extent that the Fund's assets were insufficient to settle liabilities covered by the Treasury's guarantee of collection. It is envisaged that, before the actual winding-up proceedings were to begin, every effort would be made to reach an agreement with the Fund's creditors, for which purpose the legal framework would provide stronger powers.

2. Main amendments (additions or deletions) proposed to existing legislation and rules

The submission of a bill for a special legislative act on the HF Fund's winding up and settlement is envisaged. This entails repealing Act No. 151/2019 on the Processing of Assets and Liabilities of the HF Fund.

E. Constitutional conformity and international law – other basic considerations

1. Do these plans affect constitutional and international obligations?

In general

Legal opinions and public discourse have raised concerns that the enactment of legislation leading, directly or indirectly, to the acceleration and settlement of the HF Fund's bonds could be incompatible with the property rights provisions of Article 72 of the Constitution. The changes envisioned with regard to the fulfilment of the claims are not expected to entail impairment or deprivation of property within the meaning of the aforesaid provisions of the Constitution. Any analysis of this matter must take into account that the Icelandic State will eventually have to honour its guarantee of collection.

As regards the concerns mentioned above, the possibility of a conflict between legislation of the type envisioned and the property rights provisions of Article 72 of the Constitution being tested in a court of law cannot be excluded. Such a scenario could play out after the State's liability as guarantor had been tested.

In the Ministry's opinion, the Constitution and international law obligations place no restrictions against the stipulation of winding-up proceedings expediting the settlement of claims. It has been established, among other things, that the HF Fund is insolvent and there is no possible scenario where the Fund's fulfilment of the claims could remain unaltered. Based on existing facts, it is not clear that the legislation would result in loss within the meaning of property and tort law. The legislator has the authority to stipulate that entities for whose activities the State is liable enter winding-up or bankruptcy proceedings, as expressly provided for by the Act on Bankruptcy.

One option is to provide for special expedited court proceedings or a mechanism to assess any alleged future loss, cf. the discussion below, in which case the Treasury would pay damages if found liable by a court of law.

Position of HF Fund's bond holders – special remedies

Communications between government representatives and the holders of HF Fund bonds have revealed that the latter consider that a settlement of the outstanding principal and accrued interest would constitute an unlawful deprivation of their property rights within the meaning of Article 72 of the Constitution. The government, on the other hand, has pointed out that it is proposing a settlement of a guarantee, not a write-off or impairment of claims. Thus, the proposed measures or agreements are not designed to result in any loss.

It has also been argued that legislation on the Fund's winding up could incur the Treasury's liability for compensation because the interest on the HF Fund's bonds would not be paid to the end of their maturity. In this context, however, account needs to be taken of the possibility of investing in the markets using the funds or assets received through the settlement, which would reduce the potential loss or prevent it altogether. The proof of a loss would be subject to general rules, including the requirement to demonstrate a real loss and that appropriate steps had been taken to limit it.

The law already contains provisions on how to assess the value of future income, which could serve as guidelines when resolving such questions. The government also considers it important to provide a smooth and accessible way for those who believe they have sustained loss owing to impairment or deprivation of their property rights to pursue their rights. The intention is for the legislation to authorise expedited court proceedings for those who so wish. Another possibility would be for the law to specify how to evaluate compensation claims, for which there are precedents.

2. Do the plans concern provisions of the EEA Agreement concerning state aid, technical rules on goods and distance services, or freedom to provide services?

No.

3. Is there any other basic legislation that needs to be considered?

No.

F. Consultation

1. Who are the principal stakeholders?

Holders of the HF Fund's bonds, financial market participants, the general public in Iceland.

2. Is there any overlap with the administrative functions of other Ministries?

The final bill may overlap with the areas of debt collection law or procedural law, which come under the remit of the Ministry of Justice, as well as government guarantees and the HF Fund's affairs, which come under the remit of the Ministry of Finance and Economic Affairs. The extent to which such overlap would call for consultation or division of responsibilities between ministries would therefore be examined.

3. Consultation that has already taken place

Some consultation was undertaken during parliamentary proceedings in connection with the enactment of the Act on the Processing of Assets and Liabilities of the HF Fund.

In connection with the presentation of the Minister's report on the HF Fund's position in Althingi, parliamentary debate on the issue has taken place, and stakeholders have presented their views on possible options. The Fund's situation has also been presented to various bond holders, as related above.

- [Legal opinion by law firm Logos of 23 November 2022.](#)
- Legal opinion by law firms Lex and BBA/Fjeldco of 24 November 2022.
- [Legal opinion by Róbert R. Spanó of 4 December 2022.](#)

4. Consultation envisaged

After a consultation process on these plans via the government's Consultation Portal, an assessment will be made of whether and to what extent changes to the plans for the bill are warranted.

G. Assessment of the impact of the option envisaged

1. Result of preliminary impact assessment, cf. attached document

Different timings of the settlement of the government guarantee for the HF Fund's liabilities would have different impacts on the Treasury's financial position, as already outlined, but the Treasury will in any case have to disburse large sums for the settlement. The impacts on the Treasury's debt ratios and annual interest expenses have been calculated based on the assumption that the Fund's estimated loss according to its position as at 30 June 2022 would be funded by issuing government bonds and the Fund would be provided with financial resources to prevent its insolvency. Three different time points in the Fund's activities were used for reference, as discussed in the Minister's report: an immediate settlement, a settlement in 2034, when the assets will be exhausted, or thirdly, capital injections throughout its debt maturity horizon until 2044. These assumptions are used for quantification, without regard to the legitimacy of the different options.

<i>Winding up at certain time point</i>	30.6.2022	2034	2044
<i>Projected figures in ISK bn</i>			
Increase in Treasury liabilities, % of GDP	1.2%	4.6%	5.3%
Discounted cost at constant prices	47	170	200
Accumulated costs at each year's prices	47	260	450
Annual interest expenses assuming 5% nominal rate*	2.35	8.65	10

*Depends on inflation, interest rates and the ratios of inflation-indexed and non-indexed government bonds issued

Another important consideration is which assets would be used in the settlement, i.e. whether the funding of the government guarantee would be entirely through the issuance of new government bonds, or whether other Treasury assets would be used. These different scenarios would have different financial impacts on the Treasury, but overall the use of assets on the Treasury's balance sheet may be considered more prudent for such a settlement than issuing debt.

H. Next steps, implementation

1. Has a project plan been prepared for drafting the bill?

Yes.

2. How will the Act be implemented? How much time are the parties who will be affected, public institutions/stakeholders/the general public, expected to need for preparation/adaptation?

The proposed legislation will entail a winding up process or settlement for the HF Fund by means of a special procedure due to the nature of the issue to be resolved.

The assumption is that the creditors will lodge their claims against the bankruptcy estate and its assets will be used in payment thereof. The winding-up process will require some preparation and will be designed to take as little time as possible.

3. What prerequisites need to be in place for the legislation to be successful?

The intended bill essentially comprises two possibilities: (i) that an agreement will be reached on the performance of the government guarantee using the Fund's assets or (ii) that winding-up proceedings commence, entailing the lodging of claims and the allocation of assets for settlement. For the first option to work, an agreement on a settlement must be reached between the parties; otherwise, the second option is activated. There are no other prerequisites that need to be in place.

4. Benchmarks for results and outcomes

The level of success and the outcomes achieved will be reflected in the impacts on the government's debt ratios and interest expenses, and thereby on the Treasury's credit ratings. As regards the bond holders, the indicators will include the performance of pension funds and other investors with respect to returns on assets.

5. Has attention been paid to collecting data to assess the level of success when the time comes?

When the manner in which the Treasury will participate in the settlement has been established, it will be clearly recorded in accordance with the law and international financial reporting standards, including with regard to the submission of the Government Accounts, Fiscal Strategy and Budget Bill.

I. Miscellaneous

A link to the Minister's report on the HF Fund and news relating to the Fund can be found here:

<https://www.stiornarradid.is/verkefhi/rekstur-og-eignir-rikisins/eignir-rikisins/uppgior-il-siods/>

J. Attached documents

Assessment of the impact of the legislation – preliminary assessment