

Case No: 70382 (former 64865)
Event No: 588493
Dec. No: 247/11/COL

EFTA SURVEILLANCE AUTHORITY DECISION

of 18 July 2011

on a proposal for appropriate measures in the financing of the Icelandic Housing Financing Fund *Íbúðalánasjóður* (HFF) (Iceland)

The EFTA Surveillance Authority (the Authority),

HAVING REGARD to the Agreement on the European Economic Area (the EEA Agreement), in particular to Articles 59(2) and 61 and Protocol 26,

HAVING REGARD to the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice (the Surveillance and Court Agreement), in particular to Article 24,

HAVING REGARD to Article 1 of Part I and Articles 18 and 19 of Part II of Protocol 3 to the Surveillance and Court Agreement (Protocol 3),

HAVING REGARD to the EFTA Surveillance Authority Decision No 405/08/COL of 27 June 2008 to close the formal investigation procedure with regard to the Icelandic Housing Financing Fund,¹

Whereas:

I. FACTS

1. Background and procedure

By letter of 20 November 2003 (Doc No: 03-8227 A, now Event No: 255584), the Icelandic authorities notified, pursuant to Article 1(3) in Part I of Protocol 3, an increase of the maximum level of lending by the Icelandic Housing Financing Fund *Íbúðalánasjóður* (HFF) up to 90% of the purchase price of housing.

On 11 August 2004, the Authority adopted Decision No 213/04/COL.² In this Decision, the Authority found, having carried out a preliminary examination under Article 1(3) in Part I of Protocol 3 to the SCA, that the Icelandic legislation pertaining to HFF entailed aid to HFF, but decided not to raise objections to this aid scheme as it was considered compatible with the state aid rules read in conjunction with Article 59(2) of the EEA Agreement.

¹ OJ L 79, 25.3.2010, p. 40 and EEA Supplement No 14, p. 20.

² OJ C 112, 15.5.2005 and EEA Supplement No 23.

On 7 April 2006, Decision No 213/04/COL was annulled by the EFTA Court on procedural grounds, following an application of the Bankers' and Securities' Dealers Association of Iceland; an association which has since merged with other financial and insurance associations, and which is now active under the name Icelandic Financial Services Association (SFF).³ The EFTA Court held that the aid scheme in question had raised "*doubts ... as to the compatibility with the functioning of the EEA Agreement*" within the meaning of Article 4(4) in Part I of Protocol 3 to the SCA and that the Authority, consequently, had been under an obligation to initiate a formal investigation procedure as provided for under Article 1(2) in Part I of that Protocol before making a decision.

As the Authority, on the basis of the information available to it, came to the preliminary conclusion that the contested aid measures constituted new aid, it adopted, on 21 June 2006, Decision No 185/06/COL to initiate the formal investigation procedure with regard to the HFF system.⁴

During the course of that formal investigation, however, information emerged to suggest that the state aid measures under assessment constitute existing, rather than new aid. Accordingly, by Decision No 405/08/COL⁵ of 27 June 2008, the Authority closed the formal investigation procedure based on Article 1(2) in Part I of Protocol 3 to the SCA finding that to the extent that the measures identified in the opening Decision No 185/06/COL amount to state aid, they constitute existing aid.

In turn, the Authority opened proceedings under Article 1(1) of Part I and Article 17 to 19 of Part II of Protocol 3, which concerns existing aid. A letter written in accordance with Article 17(2) of Protocol 3 was sent on 27 June 2008 (Event No 463629) (the Article 17(2) letter).

By letter dated 8 September 2008 (Event No 490699), the Icelandic authorities responded to the Authority's Article 17(2) letter.

By e-mail of 10 July 2008, the legal counsel of SFF had requested access to the Article 17(2) letter of the Authority. After consultation with the Icelandic authorities, access was granted and accordingly, the letter was forwarded to SFF by e-mail of 16 July 2008 (Event No 486745). On 2 September 2008 (Event No 489786), SFF submitted its comments concerning the Article 17(2) letter.

The case was subject to discussions between the Authority and the Icelandic authorities in the meeting in Brussels on 2 October 2008 and in the package meetings in Reykjavik on 4-5 November 2009 and 7 June 2011. As a follow-up after the 2009 package meeting, the Icelandic authorities submitted up-dated information concerning the case by letter dated 14 December 2009 (Event No 540116).

On 16 March 2011, following a separate notification by the Icelandic authorities on a proposed new capital injunction, the Authority adopted Decision No 69/11/COL on rescue aid to HFF.⁶ By that decision, the Authority temporarily approved, for six months, the

³ Case E-9/04 *The Bankers' and Securities' Dealers Association of Iceland v EFTA Surveillance Authority* [2006] EFTA Court Report, p. 42.

⁴ OJ C 314, 21.12.2006, p. 89 and EEA Supplement No 63.

⁵ See above footnote 1.

⁶ Not published yet. Full text of Decision No 69/11/COL is available on the Authority's website under the following link: <http://www.eftasurv.int/media/decisions/69-11-COL.pdf>.

notified capital injection in favour of HFF, conditional, however, upon submission of a detailed restructuring plan for HFF by 30 September 2011.

2. Icelandic market for mortgage lending

2.1 Situation before August 2004

According to information submitted to the Authority in the course of the investigation, between 1997 and 2003, HFF had a market share between 77.5% and 79%. The rest was shared between the pension funds (approximately 13% to 17%) and the commercial banks and savings banks (approximately 4.5% to 8%).

HFF operated under a state guarantee which follows from the State's unlimited liability for the HFF's debts as its owner.⁷ It securitized its lending by selling inflation-linked bonds with a very long maturity.⁸ The lending was capped by a political rule stipulating that, irrespective of income or value of the collateral, each customer could borrow only a certain fixed maximum amount from the fund. This was a part of an affordable housing policy initiated by the Icelandic Government. In this period, the commercial banks had to be content with collecting overflow business by offering second ranked mortgages with a relative short maturity and high interest rate.^{9 10}

2.2 Situation after August 2004

This situation changed in August 2004, when Kaupthing (now Arion) began to offer (first) mortgages at the same rate as the HFF, but allowing up to 80% loan financing (as opposed to the the 70% limit applicable to HFF at the time). Kaupthing's initiative led to a radical change in the housing market. It was a great success and attracted not only new customers, but also the valuable customers attractive to the banks; high income households unhappy with the credit rationing of the HFF. The other two large banks also began to offer mortgages on the same conditions and HFF responded by lowering the interest rate on its mortgages and lending on a higher loan to value ratio.

These actions were a major contributor to the Icelandic property boom, which until then had lagged behind similar booms happening elsewhere in the world. Within two years prices of property in Reykjavik had almost doubled.

⁷ Case E-9/04 *The Bankers' and Securities' Dealers Association of Iceland v EFTA Surveillance Authority*, cited above, paragraph 72.

⁸ Based on information submitted to the Authority, the average funding rates by financial institutions in the Icelandic housing finance market for the years 1999 to 2003 was 6.43% for banks (real interest rates), 3.50% for pension funds and 4.75% for the HFF.

⁹ In Iceland, a residential mortgage normally follows the residence, and not the owner of the residence. When the residence is sold, the new owner will take out a second mortgage to cover any difference between the new price and the old mortgage, and take over the original mortgage (which follows the house). The second mortgage will then rank second to the original mortgage. It is also normal to take out a second mortgage if the present owner would like to finance an upgrading or expansion of the residence. It follows from this system that a residence normally will have several mortgages connected to it, and that they will be ranked according to the time of origination.

¹⁰ According to information submitted to the Authority, all commercial banks in Iceland, savings banks, pension funds and some mortgage companies offered long-term housing mortgages to the public in this period. Those mortgages carried a real interest rate of between 5.9% and 7.9% depending on the security.

Figure 1: The Mortgage Market - Development

Source: Presentation of the Icelandic authorities in the meeting with the Authority on 7 February 2011 concerning Case No 69464.

2.3 After the financial crisis

After the financial crisis hit Iceland in October 2008, all of the three large banks and many of the smaller savings banks were taken over by the Financial Services Authority (FME), and many of them were significantly restructured. Moreover, the wholesale sources of finance for the Icelandic banks shrank significantly. This affected their willingness to lend to businesses and households. In addition, HFF took over the residential mortgages loan portfolios of three of the savings banks, as a part of a swap arrangement to relieve those banks from liquidity problems.¹¹

Furthermore, as both businesses and households had taken on significant debt during the boom years, it was considered risky to offer even more loans. This further affected the banks' willingness to lend to the businesses and to households. According to the information submitted by the Icelandic authorities, the banks' activity in offering residential mortgage loans almost disappeared.

The economic downturn has led to lower real household income and to unemployment,¹² which made it difficult for households to service their debt. It is particularly hard for households for two reasons: firstly, the value of the assets (real estate properties) used as collateral for the loans fell substantially, increasing the loan-to-value ratios (LTV) significantly;¹³ secondly, the crisis resulted in significantly higher inflation, and, as most residential mortgage loans in Iceland are inflation indexed, this increased the amount repayable on the loans substantially. According to information submitted to the Authority, in a study on the financial situation of households,¹⁴ the Central Bank of Iceland found the following:

¹¹ See in this context EFTA Surveillance Authority Decision No 206/11/COL of 29 June 2011 on the Mortgage Loan Scheme, not yet published in the OJ.

¹² In January 2011, the unemployment rate was around 8.5%, see information on the webpage of the Directorate of Labour, <http://www.vinnumalastofnun.is/files/jan.11.pdf>

¹³ Since October 2008, the prices of real estate have decreased by around 20% and many mortgages now exceed the value of the property.

¹⁴ This study was presented in March 2009, and since then housing prices have decreased by 15% and cumulative inflation has been 10%.

- 25% of households have mortgages that are more than 500% of annual income (debt situation);
- Around 12% of households use over 50% of their disposable income to service their mortgages (debt service ability);
- The total debt service of 1/6 households is in excess of half of their disposable income (debt service ability);
- Around 20% of households have negative net assets and 22% have only a marginally positive net equity position (net assets of households).

HFF has, as a result, become the only lender still fully active on the Icelandic residential mortgage loan market, although both new and existing customers of HFF are facing increasing difficulties in servicing their debt.

3. Description of the beneficiary

The Housing Financing Fund (HFF) is a State-owned institution, which operates on an arms-length basis under the Icelandic Housing Act (Act No 44/1998).¹⁵ HFF is managed by a board of directors within the administrative purview of the Minister of Welfare. The purpose of HFF is to promote security of, and equal rights to, housing. This is done through the granting of mortgages to individuals and loans to entities that provide rental accommodation, and through general organisation of matters relating to housing. Funding is provided for the specific purpose of increasing people's prospects of acquiring or renting housing on manageable terms (cf. Article 1 of the Housing Act).

HFF is not directly funded by the State, but is financed through returns on its own equity (*i.e.* instalments, interest and price indexation payments on extended loans), through interests paid on issuing and sale of HFF bonds (*ibúðarbréf*) which are listed on the Icelandic Stock Exchange, and through service fees from its customers. HFF also benefits from the State guarantee which follows from the State's unlimited liability for the HFF's debts as its owner. Furthermore, HFF receives interest support directly from the State budget to cover losses resulting from lending below market rates to entities that construct and provide rental housing.

The main activity of HFF is to provide general mortgages to individuals for the purchase, construction or renovation of residential housing (cf. Article 15, paragraph 1, point 1 and Chapter VI of the Housing Act). HFF also provides loans to municipalities, associations and companies for construction and purchase of residential housing for the purpose of rental (cf. Article 15, paragraph 1, point 3 and Chapter VIII of the Housing Act).

According to the national legislation, HFF must always have adequate liquid funds to honour its obligations. It must balance its revenues and expenses and establish a risk management system. For these purposes, it is a legislative requirement that the equity ratio of HFF must be kept over 5%.¹⁶ HFF is subject to scrutiny through the provision of quarterly reports on its risk management policy and key accounting figures to the Minister of Welfare and the Financial Supervisory Authority. As HFF issues bonds on the Icelandic financial markets it is also rated by the international credit rating agencies.

As regards more detailed description of the HFF system under the Housing Act and the legal basis for the possible aid measures described below in section 4, the Authority refers to its Decision 405/08/COL.

¹⁵ The original predecessor of HFF, the State Housing Agency, was established in 1980.

¹⁶ Regulation No 544/2004 on the financing and risk management of HFF.

4. Description of the state measures under investigation

4.1 State guarantee

HFF is a state institution governed by public law and as such, under the general unwritten rules of Icelandic public law applicable to state institutions, it enjoys a state guarantee on all its obligations. The guarantee is applicable to all state institutions, regardless of when they were established or the type of their activities. Such guarantee follows from the State's unlimited liability for the HFF's debts as its owner.¹⁷ That means that the State is liable for the entirety of the HFF's obligations, since the guarantee is neither linked to any specific financial transaction of the HFF, nor limited to any fixed maximum amount. This is also reflected in paragraph 3 of Article 5 of the Insolvency Act No 21/1991 (*lög um gjaldþrotaskipti o.fl.*) which rules out bankruptcy or other insolvency procedures to institutions such as the HFF.

In the preamble to the bill which became Act No 121/1997 on State Guarantees (*lög um ríkisábyrgðir*) the following was stated: *"This is based on the unequivocal rule of Icelandic law that the State is liable for the obligations of its institutions and undertakings, unless the guarantee is limited by an explicit legal provision [...] or the liability of the State in a limited liability company is limited to the share capital contribution."*¹⁸

According to the Authority's State Aid Guidelines, enterprises whose legal form rules out bankruptcy or other insolvency procedures or which benefit from an explicit state guarantee or coverage of any losses by the State benefit from an open-ended exposure of the State which is referred to as an unlimited state guarantee.¹⁹

4.2 Interest support

As mentioned above, HFF receives interest support through direct budgetary contributions from the State to cover losses resulting from lending below market rates to entities that construct and provide rental housing.

Initially, the measures was provided for in Provisional Article IX of the Housing Act. Subsequently, it has been regulated by agreements between the Minister of Welfare and the Minister of Finance.

According to the information available to the Authority, budgetary contributions in the form of the interest support are targeted only at loans to rental housing available to certain socially disadvantaged groups of people.

4.3 Income tax exemption

HFF is exempted from the obligation to pay income tax by virtue of Article 4 of the Income Tax Act, under which the State Treasury, all state institutions and all state undertakings for which the State carries unlimited liability have been exempted from income and property taxes.²⁰

¹⁷ Case E-9/04 *The Bankers' and Securities' Dealers Association of Iceland v EFTA Surveillance Authority*, cited above, paragraph 72.

¹⁸ The Authority's unofficial translation. The original Icelandic text can be found at: <http://www.althingi.is/altext/122/s/0099.html>.

¹⁹ See Chapter 2.1.(3) of the Guidelines on state guarantees and Chapter 7.2.(2) and (3) of the State Aid Guidelines on the application of state aid provisions to favour enterprises in the manufacturing sector.

²⁰ However, property tax was abolished, *erga omnes*, by Act No 129/2004 and was levied for the last time on assets at the end of the year 2005.

4.4 No adequate rate of return/no requirement to make dividend payments

Under general principles of Icelandic public law, state institutions, such as HFF, are not required to pay dividends to its owner, the State.²¹ This general principle is, *inter alia*, a reflection of the fact that the objective of these institutions is not to make a profit but to provide services that Parliament has decided should be undertaken by the State. Under Icelandic public law, a state institution requires a legal basis to charge for its services and the charge may not exceed the cost of providing them.²² Where a state institution is permitted by law to charge more than costs or, as for example in the case of HFF, earn a return on funds it keeps, a separate legal basis is required for the institution to pay dividends to the Icelandic State.

This understanding of Icelandic law is confirmed in the Icelandic Government's letter of 15 April 2008 where the following is stated: "*In accordance with the Government Financial Reporting Act, No. 88/1997, the general practice is that public entities are only required to generate profit if they are obliged to do so by law. Furthermore, a legal basis is required if a public entity is required to pay dividends. If a public entity generates profits it shall turn in a normal share of the profits as dividends to the Treasury, as laid down in Article 42 of Act No 88/1997. Public entities which pay dividends, such as Landsvirkjun, for example, have a special legal obligation to do so. Reference can be made to Article 4 of Act No 42/1983 on Landsvirkjun. Therefore there is no general legal provision requesting public entities to pay dividends.*"

5. Current scope of activities of HFF

5.1 Introductory remarks

The Icelandic housing policy dates back more than 50 years and is based on the political goal to encourage private home ownership. To this end, public intervention in the Icelandic housing market has been aimed at making private housing affordable to a bigger proportion of the public. The Housing Act entrusts HFF with the task of management and implementation of the housing affairs and lays down in detail the tasks of HFF.

According to Article 1 of the Housing Act, the purpose of the Act is to promote security and equal rights as regards housing to Icelanders, through the granting of loans and through organisation of matters relating to housing, and that funds are provided for the specific purpose of increasing people's chances of acquiring or renting housing on manageable terms.²³

The Housing Act stipulates that, currently, HFF grants the following categories of loans:

- (i) general mortgages to individuals for the purchase, renovation or construction of residential housing;
- (ii) loans for rental housing to municipalities, associations and companies for the construction or purchase of residential housing to be rented out;
- (iii) loans for nursing homes granted to local authorities for the purchase or construction of nursing homes.

²¹ This is different when the State owns companies that are organised as limited liability companies and are governed by private law.

²² For an application of this principle, see e.g. judgment of the Icelandic Supreme Court of 5 November 1998 in case No 50/1998.

²³ The Icelandic version reads: "*Tilgangur laga þessara er að stuðla að því með lánveitingum og skipulagi húsnæðismála að landsmenn geti búið við öryggi og jafnrétti í húsnæðismálum og að fjármunum verði sérstaklega varið til þess að auka möguleika fólks til að eignast eða leigja húsnæði á viðráðanlegum kjörum.*"

In addition, based on Article 16 of the Housing Act, the State Housing Board may decide new loan categories to be extended by HFF following approval by the Ministry of Welfare. Accordingly, regulation No 458/1999, as amended, on the loan categories of the Housing Financing Fund specifies further loan categories, such as for example loans for the construction or purchase of homes and day-care institutions for the elderly, special loans to those with special needs, maintenance loans.

It is the Authority's understanding that the above loan categories, as described in more detail below, including the open loan category, constitute the current scope of the HFF's activities in the area of housing, for which public service compensation is provided in the form of the unlimited state guarantee, interest subsidy, tax exemption and no requirement to make a dividend payment.

5.2 General mortgages system

The general mortgages system is available on equal terms to all residents in Iceland, regardless of nationality, and applies to the entire territory of Iceland, including sparsely populated areas (with different asset evaluation terms).

The current fixed interest rate on general mortgages amounts to 5% without a pre-payment fee or a fixed rate of 4.5% with a pre-payment fee.²⁴ Indexation occurs in line with the Consumer Price Index. Loans are granted for 20, 30 or 40 years.²⁵

According to the legislation, the relative lending cap amounts to 90% of a dwelling's appraised market value.²⁶ The absolute lending cap, as specified by secondary legislation, is ISK 20 million. However, there is no rule which limits the size or value of dwellings for which HFF general mortgages are available. Neither are the mortgages limited to those with income below a certain income bracket or with limited assets.

The general mortgage scheme is currently limited to financing one dwelling per borrower or group of borrowers (*e.g.* family). This rule is laid down in Article 21 of the Regulation No 522/2004 on HFF Mortgages and HFF Bonds, as amended, which stipulates that the same person or persons may not simultaneously own more than one residential housing unit subject to mortgage financing by the HFF. Moreover, in order to rule out the possibility of financing by the HFF of dwellings purchased for investment purposes, each borrower should declare in the loan application that the housing is intended for his or her own use.

Exemptions from the above mentioned rule of one residential property apply only in exceptional circumstances, in the following situations of special nature:²⁷

- i. children studying away from their parents' home;
- ii. illness or disability of applicant or applicant's children which requires extended periods away from home;
- iii. employment of applicant or spouse requiring extended stays away from home (for instance Members of Parliament);

²⁴ www.hff.is.

²⁵ According to information available to the Authority, extensions up to 70 years are possible.

²⁶ See Article 19 of the Housing Act. However, according to the HFF's website, maximum 80% of accepted bid price or construction costs are possible to be financed.

²⁷ See Rules for exemption from rule concerning one residential property, approved by the HFF Board on 10 August .2006.

- iv. co-ownership of property (less than 30%) with children or other close relatives with the purpose of assisting those persons' ownership and at the same time reassuring their contribution;
- v. co-ownership of property due to inheritance;
- vi. unsuccessful sale of previous property financed by the HFF's loan within the specified general time limit of one year;
- vii. planned consolidation of two apartments in the same house.

5.3 Loans for rental purposes

According to the information provided by HFF during the package meeting on 7 June 2011 in Reykjavik, there are two loan categories of HFF with the purpose of financing rental housing. One of them is limited to certain conditions imposed on both the rental housing provider and the tenant (see the description below) and the other one is not subject to such limitations. The Authority understands that the interest subsidy is only granted in favour of the former loan category.

The borrowers under this loan category, apart from municipalities, are subject to regulation by the Ministry of Welfare as regards (among other matters) their equity ratio, financial liability, and composition of their boards. There is a register of such companies and associations accredited by the Minister, who is also responsible for the approval of their articles of association.

Unlike the general loans system, granting of loans for rental housing has been made dependent on certain conditions, namely the social circumstance of persons who rent the apartments. Housing constructed or purchased property for the purpose of renting it under this loan category, is available to (though not exclusive to) socially disadvantaged groups of people. For that reason, limits on income and assets of tenants as well as other conditions for rental housing loans, including as regards apartment types and sizes, suitability and construction costs, and the means available to ensure as low unit prices as possible have been laid down in Regulation No 873/2001 on the provision of loans for rental housing, their allocation and administration.

Rental apartments are allocated to individuals living in difficult circumstances who need assistance in acquiring accommodation.²⁸ The apartment size cannot exceed certain limits²⁹ and the maximum price of rental apartments is regulated by the Board of HFF, subject to annual adjustments. Moreover, the right to rental housing is allocated according to restrictions on earning and assets³⁰ and the social circumstances of the applicant. In the assessment of social circumstances, the following elements are taken into account:

1. current housing circumstance;
2. family circumstances, including family size and number of children and
3. health and work capacity.

A further important feature of rental housing loans is a regulated amount of rent to be paid. The charge is calculated on the basis of instalments and interest of the loan and

²⁸ Regulation No 873/2001, as amended by Regulation No 56/2009.

²⁹ See Article 19 of the Regulation No 873/2001: one-room apartment: 60m², two-room apartment: 70m², etc. up to six-room apartment: 130m².

³⁰ The limits on earning and assets as well as the method for their annual adjustments are set in Article 23 and 24 of the Regulation 873/2001, respectively. Exemptions are granted in cases of major disruption of applicant's circumstances and finances as a result of unemployment, illness, death of a spouse or other circumstances.

returns on the owner's contribution, in addition to the general operational costs of the rental establishment.³¹ If the rent exceeds the maximum as specified by law, the board of the HFF is empowered to declare the rental housing loan due.

5.4 Loans for nursing homes

This category of loans is available to local authorities and cover up to 100% of building costs or purchase price of a nursing home for the elderly, under an agreement on the construction and leasing of nursing homes for the elderly, made between the Ministry of Welfare and the Ministry of Finance, on the one hand, and the relevant local authority, on the other hand.

Loans for nursing homes are secured by the first mortgage right in the nursing home in question. The loan is price-indexed, with a fixed interest rate and without the possibility of prepayment. The term of the loan is set at up to 40 years.

Further details of this loan category, such as loan applications, loan terms and the granting of loans, are laid down by means of a Regulation No 355/2010 issued by the Minister of Welfare.

6. Article 17(2) letter

In its letter dated 27 June 2008, according to Article 17(2) of Part II of Protocol 3, the Authority informed the Icelandic authorities that it took the preliminary view that the potential aid measures were not compatible with the functioning of the EEA Agreement. Accordingly, the Authority initiated the review procedure for existing aid according to Article 1(1) of Part I of Protocol 3 as regards the alleged state support in favour of the HFF.

In particular, the Authority preliminarily concluded that the general loan scheme of HFF did not comply with all the conditions laid down in Article 59(2) of the EEA Agreement. In its analysis, the Authority has closely followed the reasoning of the EFTA Court in its judgment. In the assessment of the extent of the HFF's activities in light of the requirements of Article 59(2) EEA, the Authority has focused on three elements: manageable terms, the social element and territorial cohesion.

As regards the concept of "manageable terms", instead of trying to define it in general terms, the Authority linked it to certain general parameters of the national economy, while at the same time recognising the margin of discretion exercised by the EFTA State's authorities. In a well-functioning economy, the market interest rates would seem to be "manageable" for the population at large and only in situations of market failure would there be a justified reason for State's intervention. In this respect, the Authority asked the Icelandic authorities to submit up-dated information on the market shares of mortgage loans provided by different lenders. The Authority also invited the Icelandic authorities to present arguments or factual information on whether the market would be able to develop satisfactorily without any state aid distorting the competitive situation between the mortgage loan providers.

As regards the social element, the Authority noted that in the meantime the two dwellings per applicant rule had been amended and the system at that time allowed for financing of only one dwelling per applicant under the general loans system of HFF. This was, however, subject to exceptions, as provided by the HFF board. The Authority therefore

³¹ See for further details Article 28 of the Regulation No 873/2001.

requested the Icelandic authorities to explain those exceptions and their application and how HFF would monitor that residential housing financed by the HFF's loans was actually used for purposes of being the applicant's own dwelling. In addition, the Authority requested that the Icelandic authorities demonstrate that the general loan scheme at that time was in compliance with Article 59(2) EEA. In this context, the Authority referred to the Commission's practice regarding systems of social housing, which showed that the Commission has never accepted systems of social housing without limitations on who could qualify for loans under the system. In conclusion, in the Authority's preliminary view, the general loan scheme of the HFF did not pursue a sufficiently restricted social objective.

As regards the element of territorial cohesion (*i.e.* justification for eligibility for different loan categories in certain regions of Iceland), the Authority stated that at that time the general loans system operated without any criteria related to territorial cohesion. In addition, the Icelandic authorities and the interested parties (SFF) had submitted conflicting evidence as to the extent the commercial banks had offered mortgage loans in rural areas in the past, thus making it impossible for the Authority to conclude on the need for different treatment of certain territories of Iceland when it comes to the definition of social housing activities.

The Authority has moreover stated that it would be up to the Icelandic authorities to define their own housing policies, including aid measures and definitions of what is to be considered services of general economic interest (SGEI) in the field of housing, referring in this context to the Authority's State Aid Guidelines on public service compensation.³² If HFF offers both services which may be classified as SGEI and commercial lending services, the Transparency Directive³³ provides for an obligation to keep separate accounting for both types of activities. Furthermore, in such case, a legal separation between these activities would be one way to ensure transparency and avoid cross-subsidisation.

7. Comments made by the Icelandic authorities

In their submission of 8 September 2008, the Icelandic authorities present several comments to the Authority's 17(2) letter. Firstly, the Icelandic authorities submit that they are currently reviewing possible changes which would ensure the HFF system's compliance with the EEA law.

Secondly, the Icelandic authorities put forward that they are currently looking into how to articulate more adequately the social objective of HFF to address the Authority's concerns as presented in the Article 17(2) letter.

Thirdly, the Icelandic authorities submit that home ownership and housing finance is an important policy area and the Icelandic authorities are of the opinion that the HFF system displays features of universality of social housing that can be found in other EEA countries, such as Denmark, Norway, Germany and The Netherlands.

³² OJ L 109, 26.4.2007, p. 46.

³³ Act referred to at point 1a of Annex XV to the EEA Agreement (*Commission Directive 2006/111/EC of 16 November 2006 on the transparency of financial relations between Member States and public undertakings as well as on financial transparency within certain undertakings*, OJ L 318, 17.11.2006, p.17), as adapted to the Agreement by Protocol 1.

Fourthly, the Icelandic authorities see private home ownership as an important public task. The Icelandic authorities are of the opinion that in view of a relatively small economy of Iceland, which traditionally has not attracted foreign investors, citizens would have had to pay higher interest rates and would have been granted less favourable terms in the absence of HFF. Further, The Icelandic authorities are of the opinion that a private scheme would not be more effective than the HFF system.

Fifthly, the Icelandic authorities claim that Iceland has a volatile economy which does not benefit home owners and borrowers which are in need of stability and competitive funding for loans. Therefore, the Icelandic authorities, argue that there is need of governmental intervention to secure the public policy aim. Furthermore, the Icelandic authorities point out that consumers as well as the Government are in need of a stable credit market and that the “universal scheme” of HFF must be appreciated against this background.

Sixthly, the Icelandic authorities submit that it is for the individual EFTA State to define what constitutes a service of general economic interest and they emphasise the diversity of services that can constitute a SGEI.

Seventhly, the Icelandic authorities refer to the EFTA Court’s judgment in Case E-9/04³⁴ and the comments made by the EFTA Court on SGEI. The Icelandic authorities argue, with reference to paragraphs 67-68, that the EFTA Court held that the overall mission of HFF was in compliance with Article 59(2) of the EEA Agreement provided that the remaining conditions of Article 59(2) were complied with. Further, the Icelandic authorities refer to the proportionality test carried out by the EFTA Court.

Eighthly, the Icelandic authorities submit that the EFTA Court’s judgement cannot be read as to mean that, even though the EFTA Court objected to some of the elements of the HFF system, the overall mission of the HFF is invalid or that it is required by the EEA law to change HFF from being a lender with a universal mission to a charitable entity. Furthermore, the Icelandic authorities put forward that the EFTA Court’s reaction to the features of the HFF system appear to be excessive as in practice the system is not being abused.

Ninthly, the Icelandic authorities submit that the proportionality tests under Article 59(2) of the EEA Agreement are assumed to be less stringent than the proportionality test conducted under the general provisions of EEA law.

Finally, the Icelandic authorities submit that with regard to second proportionality test, a workable hypothesis would appear to be necessary to structure any given study of the impact on the wider financial market.

8. Comments from third parties

In its letter submitted on 2 September 2008, SFF maintained the view that SGEI always should concern “basic” or “essential needs” and that, as regards the housing sector, the public service criterion referred solely to social housing for low income persons. In this regard, SFF referred to the practice of the European Commission (the Commission), showing that the Commission’s essential requirement with regard to social housing measures was that such measures be restricted to socially disadvantaged persons.

³⁴ See footnote 3 above.

SFF further submitted that the market for housing loans in Iceland would develop satisfactorily if HFF limited its activities to social housing. First of all, the Icelandic market for housing loans was highly competitive with three major banks and saving banks. Secondly, Iceland had a powerful competition authority and an efficient Competition Act.

As regards territorial cohesion, SFF maintained that the private banks had always offered housing loans on manageable terms in all parts of Iceland. Against this background, no market failure for the provision of housing loans at affordable prices existed even prior to 2004. At the moment of SFF's submission, all private banks, including the savings banks, offered housing loans up to 80% of market price or construction costs all around Iceland. SFF further submitted that the universality of the mortgage lending offered by the SFF member banks could be demonstrated by their mortgage loan portfolio, for example, the loan portfolio of Glitnir included 12% of loans in the rural areas and about 33% of the loans are outside the greater Reykjavik area.

SFF maintained that, as opposed to the SFF member banks' practice, the practice of HFF was not in line with providing equal rights in relation to lending on manageable terms for remote areas. This was particularly true for areas in the remote regions of Iceland as properties in such areas often lacked the required creditworthiness. However, even in remote areas, the private banks and the savings banks offered loans on the same terms as everywhere else they operate. SFF was therefore of the opinion that the market situation in rural areas did not justify exceptional treatment of certain territories as regards the conditions of eligibility of loans from the HFF.

Finally, SFF submitted that the Government of Iceland needed to define the scope of national social housing policy and to distinguish it from commercial building activity and real estate market. A broader definition of the social loan scheme would not comply with the EEA Agreement, unless the authorities ensured equality for all players on the market.

II. ASSESSMENT

1. The presence of State aid within the meaning of Article 61(1) EEA Agreement

Article 61(1) of the EEA Agreement reads as follows:

“Save as otherwise provided in this Agreement, any aid granted by EC Member States, EFTA States or through state resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Contracting Parties, be incompatible with the functioning of this Agreement.”

This implies that for measures to be classified as state aid within the meaning of Article 61(1) of the EEA Agreement, they must involve a grant by the state or through state resources, confer an advantage on the recipient undertaking, be selective, distort competition and be liable to affect trade between the Contracting Parties.

1.1 Presence of state resources

The aid measures must be granted by the State or through state resources. In other words, in order to qualify as state aid, the HFF system must imply a transfer of state resources.

1.1.1 State guarantee

On the basis of the general rules of Icelandic public law, the HFF as a state institution enjoys a state guarantee on all its obligations. That means that the State is liable for the entirety of the HFF's obligations, since the guarantee is neither linked to any specific financial transaction of the HFF, nor limited to any fixed maximum amount. This is also reflected in paragraph 3 of Article 5 of the Insolvency Act No 21/1991 (*lög um gjaldþrotaskipti o.fl.*) which rules out bankruptcy or other insolvency procedure of institutions such as the HFF.

In line with the Authority's Guidelines on state guarantees,³⁵ enterprises whose legal form rules out bankruptcy or other insolvency procedures or which benefit from an explicit state guarantee or coverage of any losses by the state, can be regarded as beneficiaries of aid.³⁶ Such exposures of the state are open-ended and are generally referred to as an unlimited state guarantee.

The Authority's Guidelines on state guarantees build on case law concluding that guarantees provided by the State, namely by central, regional or local authorities may constitute state aid within the meaning of Article 61(1) of the EEA Agreement.³⁷ Moreover, it is not necessary that the state makes any payments under the guarantee in question. The aid is granted continuously from the moment when the guarantee is given and not just at the moment at which the guarantee is invoked or the moment at which payments are made under the terms of guarantee.

A state guarantee on a specified, quantifiable financial obligation would not amount to state aid if the benefiting undertaking paid a market premium. Such a premium can be established by investigating what market operators (banks or other institutions) would charge. The premium would depend on the guaranteed amount and the financial parameters of the beneficiary (balance sheet, solidity etc.). However, for an open-ended, unlimited guarantee, as in the case at hand, it is not known what the guarantee amounts to. It does not only cover explicit and quantifiable financial liabilities, but any obligation incurred by the undertaking. In such a situation, the Authority cannot see how a market guarantee premium could be established. The lack of payment of a premium represents a drain on state resources.

1.1.2 Tax exemption

The HFF is exempted from the obligation to pay income tax by virtue of Article 4 of the Income Tax Act.

Foregoing of revenue through tax derogations in favour of certain undertakings constitutes a drain on financial resources of the State. As also recognised in the Authority's State Aid Guidelines, a loss of tax revenue is equivalent to consumption of state resources in the form of fiscal expenditure.³⁸

1.1.3 Interest support

Since the interest support to cover losses resulting from lending below market rates to entities who construct and provide rental housing to certain socially disadvantaged groups

³⁵ Available at <http://www.eftasurv.int/?1=1&showLinkId=15646&1=1>

³⁶ See Chapter 1.2. point 4 of the Guidelines on state guarantees and Chapter 7.2.(2) and (3) of the State Aid Guidelines on the application of state aid provisions to favour enterprises in the manufacturing sector.

³⁷ Chapter 2.1. of the Guidelines on state guarantees.

³⁸ See paragraph 3 (3) of the Chapter of the Authority's State Aid Guidelines *Application of state aid rules to measures relating to direct business taxation* adopted on 30.6.1999.

of people is granted directly from the State's budget, the measure is clearly granted by the State.

1.1.4 Rate of return on capital

A market economy investor would normally require an appropriate return on the capital invested in an undertaking.³⁹ In the present case, HFF shall preserve and earn a return on the money in its charge (cf. Article 11(1) of the Housing Act).⁴⁰ The Authority understands that the return is solely intended to sustain HFF's lending operations and to cover losses on loans. The Housing Act provides that HFF may claim an interest margin to cover its operating expenses, estimated losses of outstanding loans, and its interest risks, cf. Article 28 of the Act. The Minister of Welfare, having obtained the proposals of the HFF board, determines the interest margin.⁴¹ It appears that the interest margin does not include an element of profit. Moreover, to the Authority's knowledge, under the general principles of Icelandic public law, the HFF as a public institution is not required to pay any dividends to its owner, the Icelandic State.

Against this background, the Authority's conclusion is that the Icelandic State does not require a return on capital invested in HFF corresponding to that which would be acceptable to a private investor in a comparable private enterprise operating under normal market conditions. Given this lack of an adequate rate of return, the Authority takes the view that the Icelandic State forgoes revenue, and hence, that state resources within the meaning of Article 61(1) of the EEA Agreement are involved.

1.2 Favouring certain undertakings or the production of certain goods

1.2.1 Economic advantage

The measure must confer on HFF a financial advantage that it could not have obtained through the normal course of its business. The definition of aid is more general than that of a subsidy. The concept of aid not only includes positive benefits, such as subsidies themselves, but also measures which, in various forms, mitigate the charges which are normally included in the budget of an undertaking and which, thus, without being subsidies in the strict sense of the word, are similar in character and have the same effect.⁴²

1.2.1.1 State guarantee

The open-ended guarantee that is accorded to HFF as a state institution enables it to raise money (*i.e.* to issue HFF bonds) at more favourable costs than it would have been able to do without the guarantee. HFF does not pay a market premium for the guarantee which could have neutralised the advantage. Indeed, as stated above, a market premium might be difficult to establish for such an unlimited guarantee. The Authority therefore considers that the state guarantee gives the HFF an economic advantage.

³⁹ See e.g. the Authority's Decision No 142/03/COL of 16.7.2003 regarding reorganisation and transfer of public funds to the work research institute; Commission Decision 2006/737/EC of 20 October 2004 *Westdeutsche Landesbank* (OJ 2006 L 307), paragraphs 191-193.

⁴⁰ In addition, paragraph 3 of the Article provides that the Fund shall keep its revenues and expenses in balance and make advance planning in that regard.

⁴¹ At the end of 2010, the margin was either 1.4% or 0.8%, the latter being applicable when the loan recipient relinquishes his right to redeem the loan in full without incurring a penalty payment (www.hff.is).

⁴² Joined Cases E-4/10, E-6/10 and E-7/10 *Liechtenstein and others v EFTA Surveillance Authority*, judgment of 10.5.2011, not yet reported, paragraph 69 and the case law cited.

1.2.1.2 Tax exemption

Tax exemptions granted in favour of HFF reduce its operating costs, thereby providing the company with an economic advantage that would have not been available to it without the state intervention.

1.2.1.3 Interest support

Direct budgetary contributions in the form of the interest support give HFF a financial advantage which would have not been available to it under normal market conditions.

1.2.1.4 Rate of return on capital

Under general principles of Icelandic public law, state institutions, such as HFF, are not required to pay dividends to its owner, the Icelandic State.⁴³ This general principle is, *inter alia*, a reflection of the fact that the objective of these institutions is not to make a profit but to provide services that Parliament has decided should be undertaken by the State. Under Icelandic public law, a state institution requires a legal basis to charge for its services and the charge may not exceed the cost of providing them.⁴⁴ Where a state institution is permitted by law to charge more than costs or, as for example in the case of HFF, earn a return on funds it keeps, a separate legal basis is required for the institution to pay dividends to the Icelandic State. To the Authority's knowledge, such provision does not exist under the legislative framework governing HFF. This translates into an economic advantage to the benefit of HFF.

1.2.2 *Applicability of Altmark jurisprudence*⁴⁵

In the following, it will be addressed whether any advantages could be offset by public service obligations imposed on HFF.

In the *Altmark* judgment, the European Court of Justice held that provided that the following conditions are cumulatively fulfilled, a measure does not confer an advantage on the beneficiary and, thus, does not qualify as state aid in the meaning of Article 87(1) of the EC Treaty, corresponding to the provision of Article 61(1) of the EEA Agreement:

- First, the recipient undertaking must actually have public service obligations to discharge, and the obligations must be clearly defined.
- Second, the parameters on the basis of which the compensation is calculated must be established in advance in an objective and transparent manner, to avoid conferring an economic advantage which may favour the recipient undertaking over competing undertakings.
- Third, the compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of public service obligations, taking into account the relevant receipts and a reasonable profit for discharging those obligations.
- Fourth, where the undertaking which is to discharge public service obligations in a specific case, is not chosen pursuant to a public procurement procedure

⁴³ This is different when the State owns companies that are organised as limited liability companies and are governed by private law.

⁴⁴ For an application of this principle, see e.g. judgment of the Icelandic Supreme Court of 5 November 1998 in case No 50/1998.

⁴⁵ Case C-280/00 *Altmark Trans and Regierungspräsidium Magdeburg* [2003] ECR I-7747.

which would allow for the selection of the tenderer capable of providing those services at the least cost to the community, the level of compensation needed must be determined on the basis of an analysis of the costs which a typical undertaking, well run and adequately provided with means so as to be able to meet the necessary public service requirements, would have incurred in discharging those obligations, taking into account the relevant receipts and a reasonable profit for discharging the obligations.⁴⁶

With regard to the first condition, *i.e.* the definition of public service obligations discharged to the HFF, it is highly doubtful, in light of the EFTA Court's judgment,⁴⁷ that the general loans system of the HFF as defined today fulfils the criteria for qualifying as a service of general economic interest. The question of qualification of the rental housing schemes as properly defined public service obligations will be left aside at this stage.

Concerning the second condition, the General Court recalled in *BUPA*⁴⁸ that the Member States have wide discretion not only when defining a public service mission but also when determining the compensation for the costs, which calls for an assessment of complex economic facts. In the same ruling, the General Court also held that the second *Altmark* condition requires that the Community institutions must be in a position to verify the existence of objective and transparent parameters, which must be defined in such a way as to preclude any abusive recourse to the concept of a public service on the part of the Member State. The Icelandic Government has so far not demonstrated to the Authority that a methodology exists for calculation of public service compensation to the HFF. Moreover, to the Authority's knowledge, the Icelandic Government did not establish in advance the criteria on the basis of which the compensation for public service activities of the HFF was to be determined.

With regard to the third *Altmark* condition, the General Court found in *BUPA* that a public service compensation system which operates independently of receipts does not require a strict interpretation of this criterion, in particular as regards taking into account the relevant receipts for discharging public services.⁴⁹ Nevertheless, as, in the case under investigation, the aid measures benefit the entirety of the operations of the HFF, it cannot be established at this stage whether the level of compensation is limited to what is necessary to cover all or part of the costs incurred in the discharge of properly limited public service obligations.

Furthermore, with regard to the fourth condition set forth in *Altmark*, the HFF has neither been chosen by way of a public procurement procedure nor did the Icelandic authorities determine the level of compensation by way of a comparison between the HFF and a privately run efficient operator as a reference undertaking. As held by the General Court in *BUPA*, the purpose of the fourth *Altmark* condition is to ensure that the compensation does not entail the possibility of offsetting any costs that might result from inefficiency on the part of the beneficiary undertaking.⁵⁰

In conclusion, the Authority takes the view that the four cumulative *Altmark* conditions are not fulfilled and that, accordingly, the measures at issue do not escape the notion of "economic advantage".

⁴⁶ Case C-280/00 *Altmark Trans and Regierungspräsidium Magdeburg*, cited above, paragraphs 89-93.

⁴⁷ Case E-9/04 *The Bankers' and Securities' Dealers Association of Iceland v the Authority*, cited above, page 42, paragraph 79.

⁴⁸ Case T-289/03 *BUPA and others v Commission* [2008] ECR p. II-81, paragraph 214.

⁴⁹ Case T-289/03, *BUPA and others v Commission*, cited above, paragraph 241.

⁵⁰ Case T-289/03, *BUPA and others v Commission*, cited above, paragraph 249.

1.2.3 Selectivity

The advantage provided by the measure must also be selective in that it must favour “*certain undertakings or the production of certain goods*”.

HFF is an undertaking within the meaning of the EEA state aid rules, as that notion encompasses every entity engaged in economic activity, regardless of the legal status of the entity and the way in which it is financed.⁵¹

Further, a selective economic advantage is considered to exist when it is found that a measure does not apply generally to all the undertakings in an EEA State.⁵² The state guarantee, the tax exemption and the relief from earning a market rate of return and make dividend payments to HFF’s owner only favour certain public undertakings, and not all undertakings regardless of ownership. The measure in the form of interest support is only granted to HFF. The tax advantage does not seem justified by the nature and logic of the tax system.

Those measures, hence, are selective in nature.

1.3 Distortion of competition and effect on trade between Contracting Parties

To constitute aid within the meaning of Article 61(1) of the EEA Agreement, a measure must distort, or have the potential to distort, competition within the EEA, and affect trade between the Contracting Parties to the EEA Agreement. The Authority is, however, not required to establish that an aid measure actually has an appreciable effect on trade between Contracting Parties or that competition is actually being distorted, but only to examine whether such aid is *liable* to do so.⁵³

HFF provides services on the market for housing mortgage loans, *i.e.* long-term house financing for residential accommodation. The economic advantages provided for under the measures have strengthened the competitive situation of HFF within that market in the European Economic Area, where HFF actually or potentially competes with other financial service providers. Accordingly, the aid measure is liable to distort competition in that support granted to HFF may make it more difficult for banks in the EEA to enter the Icelandic housing mortgage market. Also, markets related to the mortgage market, such as other financial markets that are equally subject to EEA-wide trade, may be affected.⁵⁴

In light of the above, the aid measures in support of HFF are liable to distort competition conditions and affect trade between the Contracting Parties.

1.4 Conclusion

In light of the above considerations, the Authority concludes that the aid measures granted to HFF in the form of an indefinite and unlimited state guarantee, an exemption from

⁵¹ See Case E-5/07 *Private Barnehagers Landsforbund v EFTA Surveillance Authority* [2008] ECR p. 62, paragraph 78, and Joined Cases E-4/10, E-6/10 and E7/10 *Principality of Liechtenstein, Reassur Aktiengesellschaft and Swisscom RE Aktiengesellschaft v EFTA Surveillance Authority* (not yet reported), paragraph 53.

⁵² Case C-256/97 *Déménagements-Manutention Transport SA* [1999] ECR I-3913, paragraph 27.

⁵³ Joined Cases E-5/04, E-6/04 and E-7/04 *Fesil and Finn fjord and Others v EFTA Surveillance Authority*, [2005] ECR p. 117, paragraph 93.

⁵⁴ See also, Case E-9/04 *The Bankers’ and Securities’ Dealers Association of Iceland v the Authority*, cited above, paragraphs 80-81. Furthermore, in its *Concluding Report on the Retail Banking Sector Inquiry* (page 67) the Authority concluded that tying of different retail banking products is a common practice of financial institutions across EEA. In particular, in the above-mentioned report, the Authority underlined bundling of current accounts and other products such as mortgages or loans.

income tax, interest support and lack of adequate rate of return and dividend payments constitute state aid within the meaning of Article 61(1) of the EEA Agreement

2. Existing aid

According to Article 1(b) of Part II of Protocol 3, existing aid includes “*all aid which existed prior to the entry into force of the EEA Agreement in the respective EFTA States, that is to say, aid schemes and individual aid which were put into effect before, and are still applicable after, the entry into force of the EEA Agreement*”.

The Authority considers the aid measures specified above to be existing aid for the reasons set out in detail in Part II, sections 2.2 – 2.4 of its Decision No 405/08/COL, to which reference is made. In essence, the measures were already in place at the time of the entry into force of the EEA Agreement in Iceland on 1 January 1994 and have not been subject to substantial alterations since.⁵⁵

3. Procedural requirements regarding the review of existing aid schemes

Article 1(1) of Part I of Protocol 3 provides that: “*The EFTA Surveillance Authority shall, in cooperation with the EFTA States, keep under constant review all systems of aid existing in those states. It shall propose to the latter any appropriate measures required by the progressive development or by the functioning of the EEA Agreement*”.

According to Article 17 of Part II of Protocol 3, the Authority must obtain from the EFTA State concerned all necessary information for the review, in cooperation with the EFTA State, of existing aid schemes pursuant to Article 1(1) of Part I of Protocol 3.

In accordance with Article 17(2) of Part II of Protocol 3, by letter dated 27 June 2008 (Event No 463629), the Authority informed the Icelandic authorities that it does not consider the above described measures granted to HFF to be compatible with the functioning of the EEA Agreement. The Authority gave the Icelandic authorities the opportunity to submit comments in response and the Icelandic authorities did so by letter dated 8 September 2011 (Event No 490699).

On the basis of the information before it, the Authority concludes that its obligation to review existing systems of state aid was satisfactorily undertaken as required by Article 17 of Part II of Protocol 3.

4. Compatibility assessment

4.1 Legislative framework on possibilities to declare aid for housing purposes compatible

As stated in the Article 17(2) letter, the EEA Agreement does not prevent state owned institutions, operating on an equal footing with private credit institutions, from providing ordinary housing finance on commercial terms. The Agreement neither prevents EEA States from giving state aid to undertakings granting social loans for housing purposes falling within the notion of services of general economic interest if the requirements laid down in Article 59(2) of the EEA Agreement are respected.

Article 59(2) of the EEA Agreement reads:

⁵⁵ Decision quoted in footnote no 1 *supra*. The Authority concluded that to the extent the measures in favour of HFF in the form of a state guarantee (section II 2.3.1), interest support (section II 2.3.2), tax exemptions (section II 2.3.3) and lack of a requirement to make dividend payments (section II 2.3.4) constitute state aid, they are to be classified as existing aid.

“Undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly shall be subject to the rules contained in this Agreement, in particular to the rules on competition, in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them. The development of trade must not be affected to such an extent as would be contrary to the interests of the Contracting Parties.”

Compliance with Article 59(2) of the EEA Agreement requires the fulfilment of the following conditions:

- that the aid is a compensation for the provision of services of general economic interest,
- that the undertaking receiving the aid is entrusted to provide such services,
- that the aid is necessary, and not more than necessary, to carry out the entrusted tasks, and
- that the aid does not affect trade against the interest of the Contracting Parties to the Agreement.

Concerning requirements for compliance with Article 59(2) of the EEA Agreement, Point 12 of the Chapter on state aid in the form of public service compensation of the Authority’s State Aid Guidelines provides that:

“Responsibility for operation of the service of general economic interest must be entrusted to the undertaking concerned by way of one or more official acts, the form of which may be determined by each EFTA State. The act or acts must specify, in particular:

- a) the precise nature and the duration of the public service obligations;*
- b) the undertakings and territory concerned;*
- c) the nature of any exclusive or special rights assigned to the undertaking;*
- d) the parameters for calculating, controlling and reviewing the compensation;*
- e) the arrangements for avoiding and repaying any overcompensation.”*

In the present case, it is for the Icelandic authorities to ensure compliance with these criteria.

4.2 Definition

EFTA States enjoy wide discretion in defining any services they consider to be of general economic interest, subject, nonetheless, to a manifest error review by the Authority.⁵⁶ *“In*

⁵⁶ Case E-9/04 *The Bankers’ and Securities’ Dealers Association of Iceland v EFTA Surveillance Authority*, cited above, paragraph 65.

this assessment, the nature of the undertaking entrusted with the services is not of decisive importance, nor whether the undertaking is entrusted with exclusive rights, but rather the essence of the services deemed to be of general economic interest and the special characteristics of this interest that distinguish it from the general economic interest of other economic activities."⁵⁷ Furthermore, the EFTA States may take account of objectives pertaining to their national policy when defining the SGEI which they entrust to certain undertakings.⁵⁸

However, the SGEI must be clearly defined by the State in question⁵⁹. The concept of SGEI within the meaning of Article 59(2) of the EEA Agreement means that the undertaking in question has been entrusted with a special task by the State. Public authorities remain responsible for setting the framework of criteria and conditions for the provision of services (cf. point 11 of the Chapter on public service compensation of the Authority's State Aid Guidelines).

According to Article 1 of the Icelandic Housing Act, the purpose of the Act is to promote security and equal rights as regards housing to Icelanders, through the granting of loans and through organisation of matters relating to housing, and that funds are provided for the specific purpose of increasing people's chances of acquiring or renting housing on manageable terms. As described above, the loans system comprise general loans for individuals, loans for municipalities, associations and undertakings for the purpose of rental housing, loans for nursery homes and other loan categories to be defined by the responsible minister.

In *Husbanken*⁶⁰, the EFTA Court found that providing housing loans on more advantageous terms than are available on the open, general Norwegian capital market is covered by Article 59(2) of the EEA Agreement, since the services concerned were specifically defined by Norway, limited to certain categories of houses and available to everyone on an equal basis.

In *HFF*,⁶¹ the EFTA Court found that the HFF general loans system is intended to promote security and equal rights as regards housing in Iceland by providing loans on manageable terms to the general public throughout the territory of Iceland and thereby foster private home ownership. This, the EFTA Court held, goes beyond the normal economic interest of operators in the financial sector. Accordingly, a service with this objective may qualify as an SGEI, provided that the service fulfils the requirements laid down in Article 59(2) EEA.

As regards the general loans system of HFF, the EFTA Court first concluded that it can be a suitable means of attaining its objective.⁶² Secondly, it has been assessed whether HFF,

⁵⁷ Case E-4/97 *Norwegian Bankers' Association v EFTA Surveillance Authority* [1999] Report of the EFTA Court, p. 3, paragraph 47 and Case E-9/04 *The Bankers' and Securities' Dealers Association of Iceland v EFTA Surveillance Authority*, cited above, paragraph 67.

⁵⁸ Case E-9/04 *The Bankers' and Securities' Dealers Association of Iceland v EFTA Surveillance Authority*, cited above, paragraph 67.

⁵⁹ Case E-9/04 *The Bankers' and Securities' Dealers Association of Iceland v EFTA Surveillance Authority*, cited above, paragraph 67.

⁶⁰ Case E-4/97, cited above, paragraph 48.

⁶¹ Case E-9/04 *The Bankers' and Securities' Dealers Association of Iceland v EFTA Surveillance Authority*, cited above, paragraph 68.

⁶² In this regard, the EFTA Court did not accept the applicant's argument that it can be established that the effect of the low interest rate on HFF general loans has been completely neutralised by an increase in housing prices. Moreover, it belongs to the EFTA State's margin of discretion to decide what constitutes

or a different provider, could have provided loans at the same “manageable terms” as the HFF provided at the relevant time without, or with less, state aid. The EFTA Court first recalled that the interest rate on the HFF’s general loans is calculated on the basis of its funding costs (*i.e.* the interest paid on bonds issued by HFF), with an added margin. Whereas the latter is set by the responsible minister, the level of the interest rate on HFF bonds is influenced by the fact that HFF benefits from the State guarantee which follows from the State’s unlimited liability for the HFF’s debts as its owner.⁶³ In this context the EFTA Court addressed the question of whether the conditions under which the loans were granted (“manageable terms”) did not go beyond what was necessary for HFF to perform the tasks entrusted to it.

In this regard, the EFTA Court has in particular criticised that, unlike the cost and size limitations in the *Husbanken* case, HFF’s relative and absolute lending caps do not limit the subsidised lending scheme to dwellings which fulfil certain criteria. There is no limit on size or value of eligible dwellings and the applicable limit of how much HFF may grant as a general loan does not seem to be sufficient.⁶⁴ Furthermore, initially, there was no limitation on the number of units of residential housing for each borrower to be financed through HFF’s general loans system. Thus, in principle, the system could provide financing for houses or apartments built or purchased for investment purposes. Moreover, the rule of two units per applicant introduced in 2004 for social policy reasons had not been made dependant on the applicant fulfilling certain criteria relating to such reasons.⁶⁵ In conclusion, HFF’s general mortgages scheme provided subsidised financing, up to a certain limit, for any house or apartment regardless of size and value, and also for construction or purchase of residential units for investment purposes. Since the scheme was not formally limited to assisting the average citizen in financing his or her own dwelling, it is not clear whether it goes beyond its objectives.⁶⁶

The Icelandic authorities have in the meantime addressed some of the shortcomings of the general loans system criticised by the EFTA Court. Currently, the scheme is limited to financing one dwelling per borrower or group of borrowers (*e.g.* family). In order to rule out the possibility of financing by the HFF of dwellings purchased for investment purposes, each borrower should declare in the loan application that the housing is intended for his or her own use. Some exemptions from this rule have been foreseen for exceptional situations, as described above in section 5.2.).

The Authority welcomes the amendments introduced by the Icelandic authorities subsequent to the EFTA Court judgment in Case E-9/04 as regards the rule of one dwelling per borrower in the system of general loans. In addition, the Authority proposes that the Icelandic authorities introduce further changes, in light of that judgment, to the definition of the public service, such as cost and size limitations of the eligible dwellings, in order to reflect the nature of the SGEI entrusted to HFF, which is to assist an average citizen in financing of his or her own housing.

a sufficient effect of the low interest rates on the real burden on borrower’s economy (cf. Case E-9/04 *The Bankers’ and Securities’ Dealers Association of Iceland v EFTA Surveillance Authority*, cited above, paragraphs 70-71).

⁶³ Case E-9/04 *The Bankers’ and Securities’ Dealers Association of Iceland v EFTA Surveillance Authority*, cited above, paragraph 72.

⁶⁴ Case E-9/04 *The Bankers’ and Securities’ Dealers Association of Iceland v EFTA Surveillance Authority*, cited above, paragraph 77.

⁶⁵ Case E-9/04 *The Bankers’ and Securities’ Dealers Association of Iceland v EFTA Surveillance Authority*, cited above, paragraph 78.

⁶⁶ Case E-9/04 *The Bankers’ and Securities’ Dealers Association of Iceland v EFTA Surveillance Authority*, cited above, paragraph 79.

As regards the HFF's rental housing loans, to the Authority's knowledge, they are available to everyone regardless of any limitations on the features of the dwelling or the income or other characteristics of the tenant. Thus, the Authority proposes to limit the definition of SGEI entrusted to HFF in the field of rental housing loans to financing of purchase or construction of rental dwellings for the specific purpose of increasing people's chances of renting housing on manageable terms. This could be done by introducing certain caps on the cost and size of the house or the apartment and on the income (or other relevant characteristics) of the eligible tenants.

Furthermore, currently, HFF has a possibility to introduce other loan categories following an approval by the Minister of Welfare. The Authority requests the Icelandic authorities to revise those further loan categories approved by the Minister by means of Regulation No 458/1999, as amended, with a view of bringing them in line with the changes to be made to the general loans scheme and the loans for rental housing of HFF, as stipulated above. The Icelandic authorities should inform the Authority about any changes of the definition of public service entrusted to HFF, for instance through introduction of new loan categories considered to form part of SGEI, for which compensation is granted by the Icelandic State.

Finally, the Authority considers that it is not clear at this stage, whether the Icelandic legislation on housing policy aims at benefiting Icelandic citizens only or all residents of Iceland (in particular including foreigners from other EEA States) regardless of their nationality. Therefore, the Icelandic authorities are requested to clarify this point and in particular confirm that the application of the Icelandic housing policy does not discriminate other EEA citizens than Icelanders.

4.3 Entrustment

HFF has been entrusted to perform its public service tasks by means of the Housing Act and further laid down by regulations and ministerial decisions.⁶⁷ The SGEI has been entrusted for an indefinite period and the entrustment concerns the entire territory of Iceland. To the Authority's knowledge, HFF has so far not been assigned with any special or exclusive rights. Based on the fact that the public service obligations have been entrusted to HFF by way of an official act in the form of the Housing Act, the Authority considers that the requirements of the State Aid Guidelines as far as the entrustment is concerned have been complied with (cf. Point 12 of the Chapter on state aid in the form of public service compensation of the Authority's State Aid Guidelines).

4.4 Proportionality

In its proportionality assessment, the Authority takes into account whether the EFTA State concerned established parameters for calculating, controlling and reviewing the compensation and whether there are arrangements for avoiding and repaying any overcompensation.

The amount of compensation should be limited to what is necessary to cover the costs incurred in discharging the SGEI, taking into account the relevant receipts and reasonable profit and including all advantages granted by the State.

⁶⁷ Case E-9/04 *The Bankers' and Securities' Dealers Association of Iceland v EFTA Surveillance Authority*, cited above, paragraph 68.

In the present case, the advantages granted to HFF in the form of a state aid guarantee, a tax exemption, interest support for rental housing and no adequate rate of return/the lack of dividend payments must be limited to the activities performed in the provision of services of general economic interest. Since it is not clear whether the loan categories under the general loans system and the rental housing currently offered by HFF properly address the objective of the SGEI entrusted to the housing agency by the Icelandic State, it is impossible for the Authority to conclude at this stage whether the amount of compensation does not go beyond what is necessary to cover the costs of public service. The Authority therefore requests the Icelandic authorities to clarify the details of compensation of HFF, once the loan categories have been defined in accordance with the requirements of Article 59(2) of the EEA Agreement, in line with the Chapter on public service compensation of the Authority's State Aid Guidelines (cf. points 14-19 of the Chapter on public service compensation). Moreover, appropriate mechanisms must be put in place to avoid overcompensation and to recover any overcompensation which is not in line with the Authorities guidelines (cf. points 20-23 of the Chapter on public service compensation).

In this regard, the Authority draws the attention of the Icelandic authorities to the fact that, provided HFF will continue to be engaged in economic activities, the entity is required to operate separately from the state on an arm's length basis. Its financing must also be transparent in accordance with the Transparency Directive⁶⁸. If HFF will offer both services which may be classified as SGEI (assuming it will receive state aid to perform those services) and commercial lending services, Article 1(2) of the Transparency Directive provides for an obligation to keep accounting for both types of activities: *"the EFTA States shall ensure that the financial and organisational structure of any undertaking required to maintain separate accounts is correctly reflected in the separate accounts, so that the following emerge clearly: (a) the costs and revenues associated with different activities; (b) full details of the methods by which costs and revenues are assigned or allocated to different activities."* It follows from Article 5(2) of the Directive that Iceland would be obliged to ensure that HFF keep separate accounts.

The issue of separation of accounts for undertakings providing both services of general economic interest and commercial services, is also dealt with in the Chapter on state aid in the form of public service compensation. Point 18 provides *"[w]hen a company carries out activities falling both inside and outside the scope of the service of general economic interest, the internal accounts must show separately the costs and receipts associated with the service of general economic interest and those associated with other services, as well as the parameters for allocating costs and revenues"*.

If Iceland would like to establish a system whereby the HFF provides both commercial loans and social loans for which it receives state aid, a legal separation between these activities would be one way to ensure transparency. In any event, it must be ensured that the commercial activities are not subsidised by the Icelandic State.

4.5 Development of trade and the interest of the Contracting Parties

Article 59(2) of the EEA Agreement further requires an assessment of whether the specific service in question affects the development of trade to an extent contrary to the interests of the Contracting Parties. The Authority is charged with striking a balance between the right

⁶⁸ See above footnote 33.

of Iceland to invoke the derogation and the interest of the Contracting Parties to avoid distortions of competition and restrictions to the “four freedoms”.⁶⁹

This entails that it must be established that the performance of the SGEI does not disproportionately affect competition and the internal market. In light of the EFTA Court’s conclusions on this point in Case E-9/04,⁷⁰ the Authority has to assess to what extent the aid granted to the HFF could affect other parts of the EEA internal market, in particular other financial markets, such as, for example, the private lending market. However, as outlined above, the Authority is of the opinion that the current lending scheme is not compatible with Article 59(2) as it is too widely defined. In light of that, the Authority does not consider it necessary to assess whether the service affects the development of trade to an extent contrary to the interest of the Contracting Parties. In any event, an amended scheme will have to strike the right balance between the interests at stake.

5. Recommendation of appropriate measures

In light of the foregoing considerations, the Authority hereby proposes that the Icelandic authorities take the following appropriate measures:

- 1) To introduce changes to the general HFF loans system, as identified in the judgment of the EFTA Court in Case E-9/04, such as cost and size limitations of the eligible dwellings, in order to reflect the nature of the service of general economic interest entrusted to HFF, which is to assist an average citizen in financing of his or her own housing;
- 2) To limit the definition of SGEI entrusted to HFF in the field of rental housing loans to financing of purchase or construction of rental dwellings for the specific purpose of increasing people’s chances of renting housing on manageable terms. This could be done by introducing certain caps on the cost and size of the house or the apartment and on the income (or other relevant characteristics) of the eligible tenants;
- 3) To revise loan categories approved by the Minister by means of Regulation No 458/1999, as amended, with a view of bringing them in line with the changes to be made to the general loans scheme and the loans for rental housing of HFF, as requested by means of the present Decision. The Icelandic authorities should inform the Authority about any changes of the definition of public service entrusted to HFF, for instance through introduction of new loan categories considered to form part of SGEI, for which compensation is granted by the Icelandic State;
- 4) To clarify whether the Icelandic legislation on housing policy aims at benefiting Icelandic citizens only or all residents of Iceland (in particular including foreigners from other EEA States) regardless of their nationality. In this context, the Icelandic authorities are requested to confirm that the application of the Icelandic housing policy does not discriminate other EEA citizens than Icelanders;
- 5) To clarify the details of compensation to HFF, once the loan categories have been defined in accordance with the requirements of Article 59(2) of the EEA Agreement, in line with the Chapter on public service compensation of the

⁶⁹ See similar Case E-4/97 *Norwegian Bankers’ Association v the Authority*, cited above, paragraph 70.

⁷⁰ Case E-9/04 *The Bankers’ and Securities’ Dealers Association of Iceland v the Authority*, cited above, paragraph 81.

Authority's State Aid Guidelines (cf. points 14-19 of the Chapter on public service compensation). Appropriate mechanisms must be put in place to avoid overcompensation and to recover overcompensation which is not in line with the Authorities guidelines (cf. points 20-23 of the Chapter on public service compensation);

- 6) To ensure separation of HFF's accounts in line with the transparency Directive, provided that HFF will continue to be engaged in economic activities other than the provision of services of general economic interest entrusted to it.

HAS ADOPTED THIS DECISION

Article 1

The state guarantee, income tax exemption, interest support and lack of adequate rate of return/lack of dividend payments constitute existing state aid which is incompatible with the EEA Agreement.

Article 2

The Icelandic authorities are recommended to implement the following measures, appropriate to facilitate the proper functioning of the internal market within the EEA:

- a) To take all legislative, administrative and other relevant actions necessary to eliminate with effect from 1 January 2012 any incompatible aid resulting from the state guarantee, income tax exemption, interest support and the lack of dividend payments.
- b) To inform the Authority of the actions it will take to discontinue the aid as soon as possible and in any event not later than six weeks from the date of this decision.

Article 3

The Icelandic authorities shall inform the Authority within six weeks of the date of this decision whether they accept this proposal for appropriate measures.

Article 4

This Decision is addressed to the Republic of Iceland.

Article 5

Only the English language version is authentic.

Done at Brussels, 18 July 2011.

For the EFTA Surveillance Authority

Oda Helen Sletnes
President

Sverrir Haukur Gunnlaugsson
College Member

TABLE OF CONTENTS

I. FACTS	1
1. Background and procedure	1
2. Icelandic market for mortgage lending	3
2.1 Situation before August 2004.....	3
2.2 Situation after August 2004	3
2.3 After the financial crisis.....	4
3. Description of the beneficiary	5
4. Description of the state measures under investigation	6
4.1 State guarantee	6
4.2 Interest support.....	6
4.3 Income tax exemption.....	6
4.4 No adequate rate of return/no requirement to make dividend payments.....	7
5. Current scope of activities of HFF	7
5.1 Introductory remarks	7
5.2 General mortgages system	8
5.3 Loans for rental purposes.....	9
5.4 Loans for nursing homes.....	10
6. Article 17(2) letter	10
7. Comments made by the Icelandic authorities	11
8. Comments from third parties	12
II. ASSESSMENT	13
1. The presence of State aid within the meaning of Article 61(1) EEA Agreement	13
1.1 Presence of state resources.....	13
1.1.1 State guarantee	13
1.1.2 Tax exemption.....	14
1.1.3 Interest support.....	14
1.1.4 Rate of return on capital.....	15
1.2 Favouring certain undertakings or the production of certain goods.....	15
1.2.1 Economic advantage.....	15
1.2.2 Applicability of Altmark jurisprudence.....	16
1.2.3 Selectivity	18
1.3 Distortion of competition and effect on trade between Contracting Parties	18
1.4 Conclusion	18
2. Existing aid	19
3. Procedural requirements regarding the review of existing aid schemes	19
4. Compatibility assessment	19
4.1 Legislative framework on possibilities to declare aid for housing purposes compatible	19
4.2 Definition	20
4.3 Entrustment	23
4.4 Proportionality.....	23
4.5 Development of trade and the interest of the Contracting Parties.....	24
5. Recommendation of appropriate measures	25