Case No: 69464
Event No: 586184
Dec. No: 69/11/COL

EFTA SURVEILLANCE AUTHORITY DECISION

of 16 March 2011

on rescue aid to the Icelandic Housing Financing Fund (*Íbúðalánasjódur*)

(ICELAND)

The EFTA Surveillance Authority (the Authority)

HAVING REGARD to the Agreement on the European Economic Area (the EEA Agreement), in particular to Articles 61(3)(b),

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 Protocol 3 to the Surveillance and Court Agreement (Protocol 3), in particular to Article 1(3) of Part I and Article 4(3) of Part II,

Whereas:

I. FACTS

1. Procedure

The Icelandic authorities informed the Authority of their intention to urgently inject capital into the Icelandic Housing Financing Fund (*Íbúðalánasjódur*, hereinafter referred to as “HFF”) by a pre-notification letter dated 28 January 2011 (Event No 585137). Further documents were submitted by e-mail of 1 February 2011 (Event No 585315) and the case was subject to discussions between the Icelandic authorities and the Authority in a conference call on 1 February 2011 and a meeting held on 7 February 2011 in Brussels.

The measure was notified pursuant to Article 1(3) of Part I of Protocol 3 by letter of 15 February 2011 (Event No 587312). The case was subject to a telephone conference between the Authority and the Icelandic authorities on 21 February 2011. By e-mail dated 28 February 2011 (Event No 588799), the Authority requested additional information. By e-mail dated 2 March 2011 (Event No 589776), the Icelandic authorities replied to the information request.

2. Description of the proposed measures

2.1. Background

2.1.1. The Housing Financing Fund and its position on the residential mortgage market

HFF is a State-owned institution, which operates on an arms-length basis under the Icelandic Housing Act (Act No 44/1998). HFF is managed by a board of directors within the administrative purview of the Minister of Welfare. The primary task of the HFF is to provide mortgages to individuals to assist them in acquiring residential housing; and loans to municipalities, companies and non-governmental organisations to facilitate the provision of rental housing.

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 issuing HFF bonds (*íbúðarbréf*) which are listed on the Icelandic Stock Exchange and through service fees from the customers. The main investors in HFF bonds are pension funds (65%), money market funds (15%), foreign investors (10%) and financial undertakings (10%). HFF bonds are a significant part of the Icelandic bonds market, representing approximately 1/3 of traded Icelandic bonds in terms of turnover[1].

The interest rate charged by HFF for mortgages extended to individuals for residential housing purposes 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 a State guarantee which follows from the State's unlimited liability for HFF's debts as its owner[2]. This (implicit) unlimited state guarantee, as well as other measures in the form of interest support for rental housing, income tax exemption and lack of requirement of an (appropriate) rate of return on HFF's activities, are subject to an ongoing investigation[3] by the Authority into existing aid under Articles 17 to 19 of Protocol 3. The investigation concerns the definition of social housing in Iceland following a judgment of the EFTA Court in its case E-9/04 in which it indicated that the Authority should have had doubts whether HFF's system of mortgage provision fulfils the criteria for providing services of general economic interest ("SGEI")[4].

HFF is rated by international credit rating agencies and is subject to supervision by the Icelandic Financial Supervisory Authority (FME) and the Central Bank of Iceland. HFF's share of the market in residential mortgages (in terms of the proportion of loans currently outstanding) is 53%. Icelandic commercial banks and pension funds[5] make up 35% and 12% of the market respectively. According to the Icelandic authorities, the commercial banks have however not been engaged in any significant new residential mortgage lending since the beginning of the financial crisis in Iceland in the autumn of 2008.

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[1] Information presented by the Icelandic authorities in the meeting with the Authority on 7 February 2011.

[2] Case E-9/04 *The Bankers' and Securities' Dealers Association of Iceland* v *the Authority* [2006] EFTA Court Report, page 42, paragraph 72.

[3] See 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, OJ L 79, 25.3.2010, p. 41 and letter according to Article 17(2) in Part II of Protocol 3 to the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court, sent on 27 June 2008 (Event No 463629).

[4] Case E-9/04, cited above.

[5] According to data from 31.8.2010.

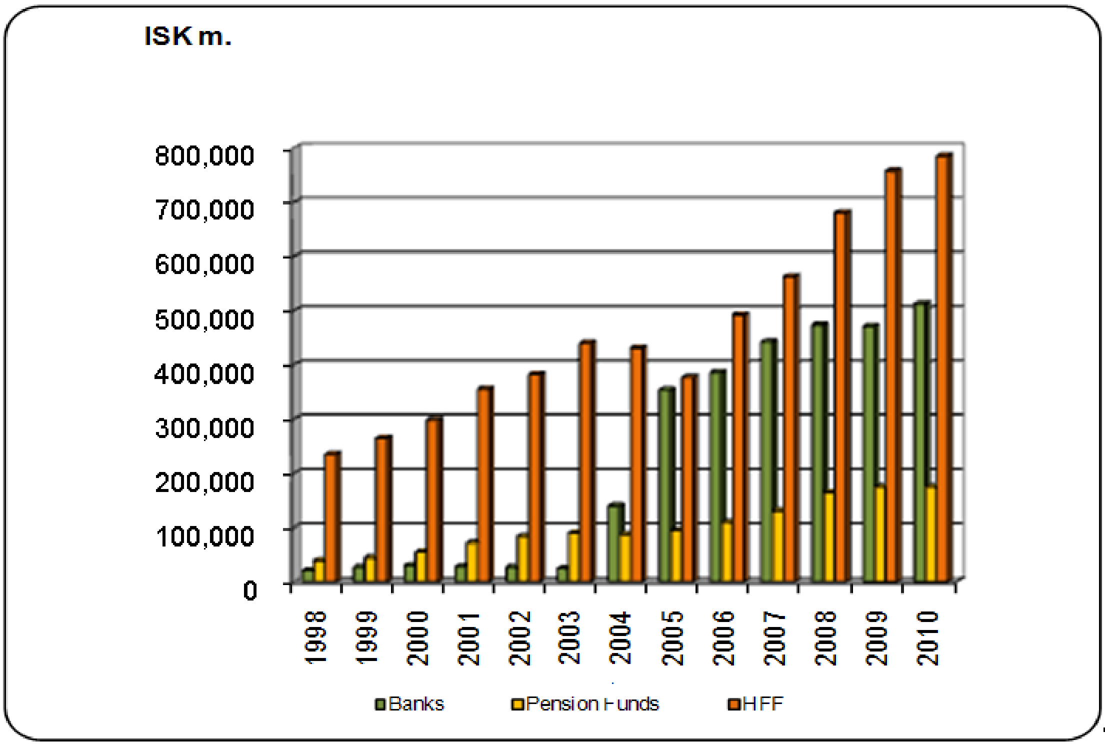

Figure 1: Market shares in residential mortgage lending in Iceland (in ISK million)[6].
Source: Presentation of the Icelandic authorities in the meeting with the Authority on 7 February 2011.

2.1.2. Payment difficulties of HFF mortgage holders and other debtors

Due to the financial crisis, many Icelandic households and businesses are experiencing difficulties in covering their mortgage repayments (further details will be provided below). On 31 December 2010, HFF's portfolio of mortgage loans granted to individuals and legal entities was made up as follows:

31.12.2010 (amounts in million ISK)	**Amount**	**Number of households/legal entities**	**Total Loan amount in suspension**	**Number of households/legal entities with loan(s) in suspension**	**Total loan amount in default**	**Number of households/legal entities with loan(s) in default**
Individuals	578,514	48,619	33,727	1,834	48,619	3,206
Legal entities	149,325	9,402	5,915	446	24,360	1,462
Total	727,840	58,012	39,642	2,280	72,979	4,667

Table 1: HFF's loan portfolio on 31 December 2010 (in ISK million).
Source: Presentation of the Icelandic authorities in the meeting with the Authority on 7 February 2011, as adapted by the Authority.

In addition, following the entry of the banks in the Icelandic residential mortgage market in August 2004, HFF experienced unprecedented redemption of existing mortgages in the following two years, as many customers changed their lender. HFF exploited some of the capital redeemed to enter into contracts with financial undertakings in Iceland to make investments on both a long and short term basis in order to maintain stability by evening

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6 As explained by the Icelandic authorities, the reason for the increase in the loan portfolio of the banks in 2009 and 2010 is indexation of the loans by Consumer Price Index.

out the maturity time of their debts and assets. The long term contracts were serviced by the cash flow of Consumer Price Index (CPI) indexed mortgages issued by the respective financial undertakings and consequently, relevant mortgage pools were put forward as collateral for each loan agreement. Those loan agreements now form part of the HFF's loan portfolio as follows:

	Amount	**Number of households**	**Total loan amount in default**	**Number of households in default**
Loan agreements	61,296	3,865	4,477	244

Table 2: HFF's loan portfolio on 31 December 2010 (in ISK million).
Source: Presentation of the Icelandic authorities in the meeting with the Authority on 7 February 2011.

In view of debt problems suffered by many households and companies in Iceland, the Icelandic Parliament adopted Act No 107/2009 on measures to assist individuals, households and businesses due to extraordinary circumstances in the financial market[7]. The aim of this legislation was to accelerate the restoration of the Icelandic economy following the financial crisis and to align mortgages to property value and the debt service capacity of debtors. Several measures have been attempted by Icelandic mortgage providers and the Government to implement the principles of Act No 107/2009. Such measures include voluntary debt mitigation, the establishment of a debtor ombudsman, legislative provisions on debt mitigation for individuals (Act No 101/2010) and on temporary solutions to overlapping ownership of property (Act No 103/2010). However, most of the proposed solutions have proved to be insufficient, partly because they required complete restructuring of the finances of debtors. Additional measures have therefore proved to be necessary. In the following sections, proposals of such measures as regards individuals and legal entities will be described. These have led to or are expected to lead to restructuring of outstanding HFF lending through writing down mortgage debts. This, in turn, has triggered the need for the State's intervention to inject capital into HFF.

The default rates on HFF's operations are set out in Table 3 below:

Defaults as % of total loans outstanding (ISK million)	2002	2003	2004	2005	2006	2007	2008	2009	2010
Total lending (HFF)	387.173	439.974	429.757	379.790	409.941	470.704	578.360	677.414	727.840
Loan agreements			32.028	84.635	86.096	86.534	104.215	80.283	61.486
Total lending (HFF and loan agreements)	387.173	439.974	461.785	464.425	496.037	557.238	682.575	757.697	789.326
Defaults (3 months or longer - HFF and loan agreements)	566	551	372	228	183	229	646	2.225	3.930
Defaults (3 months or longer - HFF loans)	566	551	372	228	183	229	570	2.028	3.650
Defaults 3 months or longer - outstanding amount (ISK million)							25.498	50.828	72.980
Defaults as % of total loans (HFF loans and loan agreements)	0,15%	0,13%	0,09%	0,06%	0,04%	0,05%	0,09%	0,29%	0,50%
No. of borrowers	71.872	75.240	66.971	52.397	48.475	48.699	53.791	54.041	50.494
Total no. borrowers not in default (3 mos. or longer)	68.761	73.218	65.126	51.700	47.923	48.020	52.357	51.196	46.981
Total no. borrowers in default (3 mos. or longer)	3.111	2.022	1.845	697	552	679	1.434	2.845	3.513
% of borrowers in default of total no. of borrowers (HFF and LA)	4,33%	2,69%	2,75%	1,33%	1,14%	1,39%	2,67%	5,26%	6,96%
% of loans in default of total no. of borrowers (only HFF loans)	4,33%	2,69%	2,75%	1,33%	1,14%	1,39%	2,78%	5,43%	6,30%
Number of assets held for sale					48	80	196	347	1.068

Table 3: HFF's loans in default (in ISK million).
Source: Presentation of the Icelandic authorities in the meeting with the Authority on 7 February 2011.

[7] Act No 107/2009 expires on 31 December 2011.

2.1.3. Lending to individuals

The main activity of HFF is to extend mortgages to individuals for the construction, purchase or renovation of residential housing (cf. Article 15 and Chapter VI of the Housing Act).

Prior to the financial crisis, HFF's losses on loans to individuals were historically very low. According to the Icelandic authorities, they amounted to less than 0.05% of the loan portfolio and due to HFF's conservative lending policy, any debts written off were not substantial. Following the financial crisis in the autumn of 2008, a substantial number of households in Iceland experienced debt problems. In many cases, this was a direct consequence of a substantial fall in disposable income due to unemployment[8] or lowered or frozen wages; or an effect of considerable and rapid inflation increases (HFF mortgages in Icelandic Krona are inflation-indexed). The problem was exacerbated as house prices in Iceland had risen significantly over a period up to mid 2007 which resulted in much higher loan-to-value (LTV) ratios than before[9]. Since October 2008, the prices of real estate have decreased by around 20%[10] and many mortgages now exceed the value of the property. The standard payment postponement plan of HFF did not assist the situation as, according to the Icelandic authorities, interest and indexation on the mortgages loans accumulated by 30% during the postponement period.

In order to respond to debt problems of the Icelandic households, on 3 December 2010 the representatives of the Icelandic Government, HFF, pension funds and private banks operating in Iceland[11] entered into a Memorandum of Understanding aimed at adjusting existing mortgage balances to asset values and debt service capacity of the debtors. The Memorandum of Understanding was implemented under the terms of an Agreement among lenders on the housing mortgage market concerning working procedures for actions to assist over-mortgaged households, signed on 15 January 2011. The parties to the Agreement agreed to reduce the value of certain mortgage loans to 110% of the value of the property underlying the loan (referred to as the "110% mortgage alignment measure"), under the following main conditions:

i) the measure applies only to mortgage loans taken to acquire residential property prior to 2009;

ii) the property must be the mortgage holder's primary home (i.e. it does not apply to investment or second properties);

iii) the applicants have no other debt-free assets (netted out);

iv) the reduction of the loan can in principle amount to maximum of ISK 4 million for an individual and ISK 7 million for married/cohabiting couples or single parents;

i) alignment above ISK 4 or 7 million (as appropriate), up to a maximum ISK 15 million for individuals or 30 million for married/cohabiting couples or single parents, in the event that mortgage re-payments exceed 20% of gross income;

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[8] 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

[9] LTV ratio at HFF went up to 90% and at some of the banks even up to 100%.

[10] See letter of notification dated 15.2.2011 (Event No 587312), p. 3.

[11] Assets of the newly established private banks had already been re-valued as part of the process of transferring them from the failed banks.

ii) the residential property value is based on the official tax valuation housing price or a real estate agent's valuation, whichever is higher; and

iii) only applications submitted until 1 July 2011 will be considered.

This will be further implemented through changes to the Housing Act.

2.1.4. Lending to legal entities

Apart from lending to individuals, HFF also provides loans to municipalities, associations and companies for construction and purchase of residential housing for the purpose of letting (cf. Article 15, paragraph 1, point 3 and Chapter VIII of the Housing Act). 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.

Housing constructed or purchased for the purpose of rental under this loan category is available to (though is not exclusive to) socially disadvantaged groups of people. In disposition of rental housing, account is taken of applicant's income and assets and the rent charged is regulated and cannot exceed certain specific categories of costs (cf. Article 39 of the Housing Act). Certain limitations are also applied through subordinate legislation[12].

According to the Icelandic authorities, in 2009 a new loan category applicable to *inter alia* undertakings for purchase or construction of rental apartments was added to the HFF loans system. These apartments can be rented to anyone, regardless of income and assets[13], although in practice the tenants are almost exclusively those with inadequate means to purchase an apartment either on the private market or through a housing society.

The financial crisis has also affected the Icelandic business sector in general and undertakings active in the real estate sector have also experienced payment difficulties. The financial difficulties of undertakings stem from a mix of rapid increase in debt due to inflation indexing of loans, lower rental income[14], lower value of housing which resulted in deteriorating LTVs, and a general inability to service debt. Moreover, some of the undertakings concerned were involved in large investment projects when the financial crisis hit Iceland. It is anticipated therefore that entities who have received loans from HFF may experience difficulties in repaying their debt and some are likely to be forced into liquidation. In the event of liquidation, debts are expected in certain cases to exceed the value of assets secured against those debts. HFF may write-down the debt of entities facing financial difficulties based on Article 47 of the Housing Act, which enables the HFF board to reduce part of an undertaking's debt in the context of a financial restructuring of that entity, in co-operation with other creditors and following an approval from the National Audit Office, the Ministry of Welfare and the Ministry of Finance[15].

Since it was felt that the temporary payment relief measures for undertakings are not sufficient to properly address their financial difficulties, in response to problems experienced in particular by small and medium sized companies, the Icelandic Financial

[12] Regulation No 873/2001, as amended by Regulation No 56/2009.
[13] Regulation No 57/2009.
[14] As a result of lower rental fees and lower occupancy rate.
[15] The Icelandic authorities explained that this provision has only been used so far in case of financial difficulties of a few municipalities.

Services Association, Ministry of Economic Affairs, Ministry of Finance, Confederation of Icelandic Employers, Iceland Chamber of Commerce and Icelandic Federation of Trade entered into an agreement in December 2010 on debt restructuring of small and medium sized enterprises (“the Agreement on SMEs”)[16]. This Agreement applies in cases in which the maintenance of operations is most likely to ensure the best interests of creditors, employees and owners. According to the information submitted by the Icelandic authorities, the aim is that a company’s debt does not exceed its re-appraised value following debt restructuring, i.e. no equity value is created in the process.

HFF is not directly a party to the Agreement on SMEs, but paragraph 12 states that the Government will endeavour to ensure that public credit institutions work towards the resolution of the credit issues of businesses. As confirmed by the Icelandic authorities, HFF is currently in the process of drafting its own rules on financial restructuring of legal entities who are parties to loan agreements with HFF, based on the principles of the Agreement on SMEs. The Icelandic authorities have in any event committed to limit any write down by HFF of debts of undertakings to circumstances where it can be reasonably anticipated that the write down will help protect the undertaking from liquidation and in consequence will lead to HFF securing a higher return than would have otherwise been the case.

2.2. The need for intervention and the measures to be implemented by the Icelandic State

2.2.1. Write-downs in the value of HFF’s assets

Mainly as a result of the 110% mortgage alignment measure but also in anticipation of possible future payment difficulties of legal entities which have received loans from HFF, HFF is to suffer a considerable reduction in the value of its assets. This will substantially decrease HFF’s equity. In Q4 2010, HFF’s loss provisions were made up as follows:

Provision due to the 110% alignment measure	ISK	21.8	billion
Other provision in respect of individuals	ISK	1.3	billion
Losses on the value of repossessed properties	ISK	3.0	billion
Provision in respect of legal entities	ISK	7.3	billion
Total loss provisions	ISK	33.4	billion

The provisions for legal entities are only precautionary and are based on an estimate of the deficit between the value of assets secured and the amount of the debt in the event of entities going into liquidation.

A further breakdown of estimated loss provisions in respect of legal entities has been provided as follows:

Associations of tenants	ISK	0.3	billion
Building contractors	ISK	0.0	billion[17]
Municipalities	ISK	0.1	billion
Rental housing	ISK	4.7	billion
Student associations	ISK	1.8	billion
General provisions	ISK	0.3	billion
Total	ISK	7.3	billion

[16] The agreement was signed on 15.12.2010 and is available at http://en.sff.is/news/news/nr/820.
[17] The exact provision for building contractors is ISK 6,515,088.

2.2.2. Capital injection into HFF

The Icelandic authorities intend to inject 33 billion ISK in order to maintain the solvency of HFF as well as to enable the implementation of the terms of the 110% mortgage alignment measure for the mortgage holders of HFF.

The national legal basis for the measure is the Supplementary Budget Act for 2010, adopted by the Icelandic Parliament (*Althingi*) on 6 December 2010. The capital injection is intended to be reflected in HFF's accounts for 2010.

2.2.3. Capital adequacy ratio

HFF is obliged by domestic law to maintain adequate liquid funds in order to honour its lending obligations (cf. Article 11 of the Housing Act). HFF's long term objective, which is also stipulated in Regulation No 544/2004 on HFF's funding and risk policy, is to maintain a capital ratio over 5% of its risk adjusted assets. The calculation of the capital ratio is in accordance with the international rules (Basel II), although HFF is itself exempt from European legislation on capital adequacy requirements[18].

The equity of HFF according to its 2010 interim accounts was positive (ISK 8.4 billion), but the equity ratio was only 2.1%, *i.e.* below the legal requirements. Following the anticipated capital injection of ISK 33 billion which is the subject to the current decision, it is not expected that this ratio will increase due to the counter effect of the write down in asset values referred to above.

In order to fulfil the long term goal of a 5% equity ratio, a second capital injection is foreseen by the end of 2011 of an estimated ISK 8-12 billion. This will be subject to separate notification and assessment by the Authority as restructuring aid in conjunction with a restructuring plan for HFF's activities.

3. Comments from the Icelandic Financial Services Association

On 7 February 2011 the Icelandic Financial Services Association expressed its views on the capital injection subject to the present notification. The Association does not oppose in principle the measure given that it enables HFF to fully participate in the 110% mortgage alignment measure, which it considers to be a vital part of harmonising debt restructuring of Icelandic homes. Furthermore, the Association takes the view that the measure is compatible with the EEA state aid rules.

4. Comments of the Icelandic authorities

The Icelandic authorities accept that the measure may contain elements of state aid within the meaning of Article 61(1) of the EEA Agreement but maintain that such aid should be considered compatible with the Agreement on the basis of Article 61(3)(b) and the Authority's temporary rules regarding the financial crisis.

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[18] Act referred to at point 14 of Chapter II of Annex IX to the EEA Agreement *(Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions*, as amended). The Act was incorporated by Decision No 15/2001 of the EEA Joint Committee and entered into force 1 October 2001. Article 2(3) of the Directive contains a catalogue of institutions exempted from its application. In the decision of the EEA Joint Committee this list was expanded, *inter alia*, by adding the predecessor of the Icelandic Housing Financing Fund. Accordingly, Article 116 of Act No 161/2002 on Financial Institutions (*lög um fjármálafyrirtæki*) exempts the HFF from the application of this Act, which is among the measures implementing the Directive into Icelandic law.

II. ASSESSMENT

1. The presence of state aid within the meaning of Article 61(1) of the 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."

The Authority must assess whether the measure constitutes state aid within the meaning of Article 61(1) and notes in this context that the Icelandic authorities do not dispute that it does.

1.1. Aid at the level of HFF

1.1.1. Presence of state resources

The new capital is provided entirely by the Icelandic State and in consequence the aid measure involves state resources.

1.1.2. Favouring certain undertakings or the production of certain goods

Firstly, the aid measure must confer on HFF advantages that relieve it of charges that are normally borne from its budget. The initial capital injection is largely intended to compensate HFF for measures taken by all Icelandic mortgage providers under the 110% mortgage alignment measure that are primarily intended to benefit individuals. However, in the absence of the 110% mortgage alignment measure and the related capital injection, HFF would in any event have suffered impairments on their mortgage assets. The measure enables HFF to absorb these losses with state support and therefore provides it with an advantage that would not otherwise be available.

It is evident that the proposed recapitalisation would not have been provided by a market economy investor expecting a reasonable return on the investment. The State is only providing the capital as it would not be available through any other source. The recapitalisation is also required in order to protect the credit rating of HFF and in order to enable it to continue to raise finance through issuing bonds.

Secondly, the aid measure must be selective in that it favours "certain undertakings or the production of certain goods". The state capital injection is only available to HFF and is intended both as compensation for losses it would otherwise have faced as a result of actions taken under the 110% mortgage alignment measure and as part of a further package to enable it to increase its equity and restructure. Since HFF offers mortgages on the open market, provides loans to companies and public sector bodies engaged in the rental market, and raises funding mainly through issuing bonds, it is clear that it is engaged in economic activity and is therefore an undertaking within the meaning of Article 61(1) of the EEA Agreement.

1.1.3. Distortion of competition and effect on trade between Contracting Parties

The aid measure must distort competition and affect trade between the Contracting Parties to the EEA Agreement. Although HFF only operates in Iceland, financial support to HFF may distort competition and affect trade between undertakings within the European Economic Area by making it more difficult for them to enter the Icelandic housing mortgage loan market. Bonds issued by HFF are also traded on the Icelandic financial market and are therefore potentially subject to EEA-wide trade.

1.2. Aid at the level of the beneficiaries of the 110% mortgage alignment measure and other debtors of HFF

The Authority also notes that mortgage holders and certain other debtors of HFF also benefit indirectly from the state intervention as the capital injection enables HFF to implement the terms of the 110% mortgage alignment measure and can also enable HFF to write-down the debt of legal entities who have received loans from it for the purposes of providing rental accommodation.

Those who benefit under the 110% mortgage alignment measure are primarily householders in Iceland, and benefits to individuals do not fall within the ambit of the state aid rules.

Any write-down of debts owed to HFF by legal entities may however benefit undertakings within the meaning of Article 61(1) of the EEA Agreement. The legal entities borrow from HFF for the purposes of developing and managing rental properties and in consequence are likely to be undertakings engaged in economic activity. Any benefit received would involve state resources and for the same reasoning as provided in paragraph 1.1.3 above may also affect trade within the EEA and distort competition.

According to the Icelandic authorities, HFF has made a loan loss provision of ISK 7.3 billion for legal entities who have received finance from HFF. The provision (which is described as being "precautionary" only) is based on an estimate of the impact on HFF should the entities be forced into liquidation. The loss provision is therefore based on the negative difference in the case of each entity between the amount lent to it and the value of the assets secured against the debt. In such cases it is clear that aid remains within HFF. The Icelandic authorities have however also indicated that the loan loss provision may be utilised by agreeing to write down the debt of the legal entities. The Icelandic authorities have however committed to do so only where the write down would enable the entity to viably continue its operations and lead to HFF suffering a lower loss than would otherwise be the case had the company be forced into liquidation. HFF would in such cases be operating in accordance with market creditor principle[19] and the undertakings would not receive an advantage that it could not have received from a normal private creditor.

On the basis of the commitment made by the Icelandic authorities, the Authority concludes that legal entities who have received loans from HFF should not receive state aid indirectly as a consequence of the loan loss provision within the capital injection to be granted to HFF.

1.3. Conclusion

The Authority therefore concludes that the capital injection proposed is state aid to HFF within the meaning of Article 61(1) of the EEA Agreement.

2. Procedural requirements

Pursuant to Article 1(3) of Part I of Protocol 3, "*the EFTA Surveillance Authority shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid (…). The State concerned shall not put its proposed measures into effect until the procedure has resulted in a final decision*".

[19] See judgment of the European Court of Justice in Case C-342/96 *Tubacex* ECR [1999], I-02459.

By submitting a notification of the capital injection to HFF with a letter dated 15 February 2011 (Event No 587312), the Icelandic authorities have respected their obligations pursuant to Article 1(3) of Part I of Protocol 3.

3. Compatibility of the aid

3.1. Legal basis for the compatibility assessment

In so far as the potential compatibility of the aid measure is concerned, the Authority will first of all consider whether the measure is suitable for assessment under Article 61(3)(b) of the EEA Agreement. State aid may be considered compatible with the EEA Agreement on the basis of Article 61(3)(b) if it is necessary to *"remedy a serious disturbance in the economy of an EC Member State or an EFTA State"*.

Although it is now some time since the onset of the global financial crisis and over two years since the collapse of the Icelandic financial system in October 2008, the Icelandic economy remains fragile. Iceland was one of the countries severely hit by the financial crisis and the effect is still there. A combination of a significant temporary increase in inflation and reduced economic activity (and increased unemployment) has reduced the average real income of Icelandic households significantly. This has, indirectly, reduced Icelandic households' ability to service their debt. Furthermore, a combination of high indebtedness of households to begin with, a significant increase in the value of the residential mortgage loans (as most of these are inflation indexed) and major reductions in property prices have increased the potential loss from default on debt significantly, both for borrowers and lenders. Mortgage providers have suffered significant impairments on their loan portfolios and a withdrawal by commercial lenders from new business. The 110% mortgage alignment measure agreed between financial institutions in Iceland is intended to alleviate negative equity problems and restart the property market.

With or without the participation of HFF in the 110% mortgage alignment measure and the associated write down of mortgage debt, the financial position of HFF is precarious. Although HFF benefits from an implicit unlimited state guarantee, as described above, this guarantee would not be credible without recapitalisation and restructuring. A failure by the Icelandic State to intervene to assist HFF could also cast (further) doubts on the solvency of the Icelandic State and impact negatively upon its credit rating. Of significance in this respect also is HFF's role in issuing bonds on the Icelandic bond market as bonds issued by the Icelandic Government and HFF make up the vast majority of the domestic market.

Changes in the Icelandic domestic mortgage market since the financial crisis also mean that (for a temporary period at least) HFF dominates the market for new mortgages in Iceland. The demise of HFF would therefore inevitably lead to a further reduction in the supply of mortgages in Iceland which is likely to lead to further downward pressure on house prices in Iceland and increased negative equity.

For these reasons the Authority accepts that the measure under investigation is necessary to avoid a further serious disturbance in the economy of Iceland[20].

[20] Under the Chapter on aid for rescuing and restructuring firms in difficulty, rescue aid must be temporary and reversible in nature (paragraph 14). However, due to the particular circumstances faced by financial institutions as a result of the financial crisis, measures in favour of financial institutions which may be permanent, such as a recapitalisation, can be temporarily approved as rescue aid subject to the submission of a restructuring plan (see paragraphs 10 and 42 of the Chapter on the application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis of the Authority's State Aid Guidelines).

3.2. Compatibility assessment under Article 61(3)(b) of the EEA Agreement

In line with the general principles underlying the state aid rules of the EEA Agreement which require that the aid granted does not exceed what is strictly necessary to achieve its legitimate purpose and that distortions of competition are avoided or minimised as far as possible, and taking due account of the current circumstances, support measures must be:

- well-targeted in order to be able to achieve effectively the objective of remedying a serious disturbance in the economy,

- proportionate to the challenge faced, not going beyond what is required to attain this effect, and

- designed in such a way as to minimise negative spill over effects on competitors, other sectors and other EEA States[21].

In assessing the rescue measure, therefore, the Authority takes into account the following.

3.2.1. The necessity of the measures

The 110% mortgage alignment measure without the capital injection as currently envisaged would leave HFF with major negative equity at the year end 2010[22]. Given that HFF is one of the two main bond issuers on the Icelandic Stock Exchange (along with the national Treasury), this could negatively influence the assessment of HFF (and, in turn, the Icelandic State) by the international credit rating agencies and could lead the Icelandic Stock Exchange to impose warning status on HFF. In addition, the household debt restructuring could be put on hold as the HFF could face legal action for breach of Icelandic domestic law if it proceeded with the write downs in the absence of the corresponding equity provision.

A large proportion of the capital provided is intended to compensate HFF for the effect of implementing the 110% mortgage alignment measure intended to benefit individual mortgage holders in Iceland. As referred to at section 1.1.2 of this Decision (Part II Assessment), the Authority is of the view that this is state aid to HFF as it has the effect of negating impairments that it may have experienced in any event had the 110% mortgage alignment measure not been implemented. The Authority is conscious, however, that to the extent that HFF would *not* have suffered impairments in any event in the absence of the implementation of the 110% mortgage alignment measure, the benefit of the funding provided by the State in reality filters through HFF to individual mortgage holders.

The Authority accepts that a capital injection is required by HFF in order for it to avoid it becoming (technically) insolvent, in view of the fact that HFF is currently operating below domestic law capital requirements[23], and in order to effectively implement the 110% mortgage alignment measure which benefits the Icelandic mortgage holders. The Authority understands that a further capitalisation is also planned which will be assessed in conjunction with a restructuring plan for HFF's activities.

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[21] Chapter on the application of state aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis of the Authority's State Aid Guidelines.

[22] According to estimations of the Icelandic authorities, the negative equity of HFF would be at the level of ISK 25.5 billion.

[23] Although this is likely to remain the case after this initial measure is implemented.

3.2.2. The appropriateness of the means employed to achieve the objective

The aim of the capital increase of ISK 33 billion to HFF is to maintain the solvency of HFF and through that avoid turbulences on the Icelandic financial and real estate market, on which HFF maintains a significant position. Indeed, the HFF bonds make up 1/3 of traded bonds in Iceland. In addition, as confirmed by the Icelandic authorities, since the onset of the financial crisis, the commercial banks have not been engaged in any significant mortgage lending in Iceland. Moreover, a very low (or even negative) solvency ratio of HFF could also possibly adversely impact other neighbouring markets, such as the real estate market.

As a secondary objective, the measure intends to enable the implementation of the terms of the 110% mortgage alignment measure for the mortgage holders of HFF and through that to secure social benefits and bolster the Icelandic property market.

The Authority accepts the argumentation of the Icelandic authorities that the State has to intervene in order to rescue HFF given its economic situation (post implementation of 110% mortgage alignment measures) and its position on the financial markets. It also accepts that a recapitalisation was required in order to implement the terms of the 110% mortgage alignment measure and thus indirectly benefits the Icelandic mortgage holders, *i.e.* a large part of the Icelandic population. In this context, the Authority has taken into consideration the fact that the Icelandic authorities put forward a number of alternative solutions in order to relieve in particular individuals and households experiencing debt problems. Since the Icelandic population chose not to participate in these measures, the providers of mortgage loans have agreed to implement the 110% mortgage alignment measure, which is a major reason for needing to inject capital into HFF. The measure under investigation is, therefore, considered to be an appropriate means to maintain some degree of stability on the financial and real estate markets in Iceland and to assist Icelandic householders in their payment difficulties.

The Authority is, however, also aware of the fact that, as referred to above, HFF already benefits from state support through an unlimited state guarantee on its activities and other measures. Assessment of these measures relies upon the extent to which HFF provides clearly defined SGEI only or is also engaged in commercial activities. While the Authority accepts that these measures should have little bearing on a temporary approval of the urgent rescue measure under assessment, the Authority is of the view that these issues must be addressed in the context of the assessment of the long term viability of HFF under the terms of a restructuring plan. The Authority will not be able to assess a long term future viability of HFF without there being clarity on HFF's future structure and social housing role. For this purpose therefore, it is imperative that a clear definition of genuine SGEI is established and entrusted upon HFF, in line with indications of the EFTA Court[24] and the requirements of the Authority in its letter according to Article 17(2) in Part II of Protocol 3, addressed to the Icelandic authorities on 27 June 2008. This will enable the Authority to examine to what extent any future aid to HFF (including, potentially, any future restructuring aid) can be declared compatible on the basis that it constitutes the minimum level of compensation required for the provision of SGEI. In the event that HFF will be engaged in commercial activities outside the scope of the SGEI, these operations must be financed and provided on market terms and separated in HFF's accounts. Accordingly, HFF must operate in accordance with the 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*

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[24] Case E-9/04, cited above.

undertakings as well as on financial transparency within certain undertakings)[25], as adapted by Protocol 1 to the Agreement[26].

3.2.3. The proportionality of the measures - limiting distortions of competition to the minimum necessary

In so far as the lack of remuneration of the capital is concerned, as a preliminary remark, the Authority is of the view that this could potentially (at least in part) be declared compatible aid on the basis that it constitutes an element of the State's compensation for the provision of SGEI. However, since the Icelandic authorities have not to date established a clear definition of the SGEI of HFF, it is not possible at this stage to demonstrate whether the lack of remuneration can form part of the SGEI compensation. It will therefore be necessary to reconsider this possibility at a later stage, once the Icelandic authorities have presented the future business model of HFF, including a precisely defined scope of SGEI obligations, in the restructuring plan.

The Authority's rules on the recapitalisation of financial institutions[27] envisage that financial institutions that have received state funding should normally pay an appropriate level of remuneration for it. HFF will not remunerate the State for the capital provided and therefore the Authority will further assess the aid granted in the recapitalisation (including the lack of remuneration) as part of its full assessment of the restructuring of HFF[28] and the clarification of the scope of the SGEI that it provides.

The overall amount of the capital injection has been calculated with reference to the provisions for write downs according to the 110% mortgage alignment measure for individuals and a similar agreement on debt restructuring for SMEs. The criteria of the 110% mortgage alignment measure, as established by HFF which will be further implemented in the Housing Act, foresee certain limitations in terms of timing for application for the measure and, to a certain extent, caps on reduction of householders' debts towards HFF. The Authority has therefore taken into consideration that the maximum exposure of the State has been based on an assessment of current debts and the possibility to pay and is therefore limited to what is necessary at this stage.

On that basis the Authority accepts that the current measure does not involve more aid than is necessary. Again in this context, however, the fact that the SGEI remit of HFF remains very broad[29] means that there is further potential for distortions of competition than would otherwise be the case. Thus, as already stated above, the issue of compensation for clearly defined SGEI to be performed by HFF must be properly addressed in the restructuring plan for HFF.

3.3. Conclusion

The Authority concludes that the aid measure is compatible with the EEA Agreement as rescue aid required as a consequence of the impact of the financial crisis upon Iceland. This is however subject to the submission of a detailed restructuring plan for HFF, following which the Authority will assess whether aid granted is proportionate and the

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[25] OJ L 318, 17.11.2006, p.17.

[26] Joint Committee Decision No 55/2007, OJ No L 266, 11.10.2007, p. 15 and EEA Supplement No 48, 11.10.2007, p. 12, entry into force on 9.6.2007. The provisions of the Directive 2006/111/EC have been transposed into the Icelandic legal order by means of Regulation No 430/2008.

[27] Chapter on the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition of the Authority's State Aid Guidelines.

[28] See paragraph 44 of the Authority's rules on recapitalisation of financial institutions.

[29] Case E-9/04, cited above.

minimum necessary to ensure the viability of HFF. The restructuring plan should be drafted in conformity with the Authority's guidelines on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the state aid rules[30]. The restructuring plan must be submitted to the Authority by 30 September 2011.

As mentioned above, the medium to long term viability of HFF cannot be assessed without having a clear view on the future business model of HFF. Therefore, in addition to providing for the financial restructuring required to ensure HFF's viability, the restructuring plan should clearly define the type of activities to be performed by HFF as genuine SGEI in the field of social housing, entrusted to it by way of an official act by the State, as required by the Authority in separate procedures concerning the financing of HFF investigated under Articles 17 to 19 of Protocol 3. In the event that HFF's business model involves it being engaged in commercial activities outside the scope of the SGEI, these operations must be financed and provided on market terms and separated in HFF's accounts.

HAS ADOPTED THIS DECISION:

Article 1

The EFTA Surveillance Authority approves temporarily for six months the notified capital injection in favour of the Icelandic Housing Financing Fund (*Íbúðalánasjódur*).

Article 2

The Icelandic authorities must submit a detailed restructuring plan for HFF by 30 September 2011.

Article 3

The implementation of the measure is authorised accordingly.

Article 4

This Decision is addressed to the Republic of Iceland.

Article 5

Only the English language version of this Decision is authentic.

Decision made in Brussels, on 16 March 2011.

For the EFTA Surveillance Authority

Per Sanderud
President

Sabine Monauni-Tömördy
College Member

[30] As prolonged and amended on 2 March 2011.