

# **Final Opinion of Steering Committee**

## **on future policy making concerning government role and involvement on the housing loan market**

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### **Introduction**

In a letter dated 21 February, 2006, the former Minister of Social Affairs created a three-man steering committee with instructions to call for extensive consultation on the future planning of the government's role and involvement on the housing loan market. The steering committee consisted of Ármann Kr. Ólafsson, assistant to the Minister of Finances, Jóhann G. Jóhannsson, department head at the Housing Financing Fund, and chairman Sigurjón Örn Þórsson, assistant to the Minister of social affairs at the time. Solicitor Árni Páll Árnason was also hired to work for the group. The steering committee was instructed to plan and oversee formal consultation with stakeholders on the pros and cons of an unchanged Housing Financing Fund and possible changes to government involvement with the housing market. The committee was also briefed to report to the minister and develop proposals based on the consultation.

### **First part of the work - February and March, 2006**

The committee began its work at the end of February and started by extensively familiarising itself with the preparation work already done by the Ministry of Social Affairs and the Housing Financing Fund, preparing the ground for ideas on a new form of government involvement in the housing loan market. In the preceding months, experts from the HFF and the Ministry of Social Affairs had especially looked at the situation of

wholesale banks in Europe and the United States of America and sought out the main trends and innovations in product supply and financing options of such banks. The experts had met with experts and directors from Fannie Mae and Freddie Mac in the USA, SBAB in Sweden, and Nykredit, Totalkredit and Realkredit in Denmark. The experts had also worked on the development of ideas for the structure of a potential wholesale bank and sought advice and opinion from foreign experts, including Deutsche Bank, JP Morgan and Capto Financial Consulting.

Following this preparation work the committee consulted with over 20 interest parties. The committee thus met and sought information from representatives from the Icelandic Federation of Labour (ASÍ), the Confederation of Icelandic Employers (SA), the Federation of State and Municipal Employees (BSRB), the Consumers' Association of Iceland, the Official Consumer Spokesman, the Association of Estate Agents (FF), The Bankers' and Securities Dealers' Association of Iceland (SBV), KB banki Bank, Landsbanki Bank, Glitnir Bank, the Association of Icelandic Savings Banks, MP Investment Bank, VBS Investment Bank, the National Federation for the Aid of People with Learning Disabilities (Þroskahjálp), the Housing Fund of the Association of the Disabled (ÖBÍ), The Association of Local Authorities in Iceland, the Association of Local Authorities in the Greater Reykjavík Area, Reykjavík Social Housing, BN Student Housing, Icelandic Student Services, the Central Bank of Iceland, the Institute of Economic Studies and the Housing Research Institute at Bifröst School of Business. It should however be noted that when these parties were contacted the ideas for the exact realisation of the wholesale system had not been presented.

The stance of the consulted to the HFF and government involvement with the housing loan system can somewhat be divided in two. On the one hand, many agreed that HFF's current role was an important one in securing competition on the housing loan market and therefore they felt it worrying to lose the Fund's control toward the banking system as a result of potential changes. On the other hand, many felt that the HFF as such may already have served its purpose and that the authorities could find easier and more efficient means of obtaining the goals of the government's housing policy than by operating a large housing financing fund in competition with the banking system. For

instance, this could be done through the tax system and by facilitating the market for those in most need.

The general stance of the consulted financing institutions was that the government no longer has a role to play in the financing retail market in competition with private companies. Most of those consulted from that field thought it would be somewhat beneficial for the government to develop the fund toward a role as housing loan sponsor for banks and savings banks. They emphasised that the privileges of such a sponsor must not interrupt normal market trade of financial services or disturb the competition balance on the market.

Most of the consulted felt that the most important thing was not who would grant housing loans but how to ensure the facilities and environment of consumers on the market. Thus, nothing should hinder the HFF as such to stop granting loans straight to borrowers. More emphasis was put on the terms of such loans and to guarantee consumer rights in a new system.

Financial experts emphasised the importance of this project in order to relieve inflation pressure and secure the foundations of the financial system. According to them, the current inflation can partly be traced back to the increase in housing prices, a development which must be halted. Financial experts and many others also mentioned the importance of securing the continued issuance of large bond classes on the market. Such an issuance, they say, can strengthen and add depth to the Icelandic bond market, thereby supporting the natural interest formation in the country, which could then lead to lowering real interest rates in the long term. Without the issuance of HFF bonds the most likely outcome would be the emergence of many smaller bond classes, which in turn would have a negative impact on the interest rate in the country in the long term, should the government not issue any other bond classes. A great number of consultees also pointed out that in this context the government must bear in mind that its job includes the responsibility to support the interest formation on the bond market, and therefore the authorities should consider increasing their bond issuance in a regular manner.

After the consultation process the steering committee handed in its interim opinion to the Minister of Social Affairs on the third of April. This opinion stated that the

committee had followed the government's policy of not sacrificing the current role of HFF in any way while changing the housing loan system. In that context the following is most important:

- That the authorities guarantee the public's access to housing loan capital on the best terms available at any time.
- That the government facilitate the equal involvement of those of less means on the property market.
- That all Icelanders can trade in housing all over the country. This entails guaranteeing equal access to housing loans on equal terms anywhere in the country.
- That the authorities secure the supply of loan capital to strengthen and maintain the rental market.
- Not to sacrifice the consumer protection currently provided by HFF.

In the interim report, the steering committee stated that many factors recommend the development of HFF's role toward the role of sponsor or wholesale bank on the housing loan market. A new system would be preferential, wherein HFF would sponsor lending to the public. This would increase financial stability, support competition on the housing loan market, ensure equal access to housing loans and reduce the use of government guarantees in the housing loan system. The basic concept of such a system would involve:

- That a new housing bank should enable banks and savings banks to offer loans according to the terms of the housing bank.
- That banks and savings banks would provide all sales and delivery of loans granted by the housing bank, as well as individual service.
- That the loan terms given by the housing bank should ensure that borrowers can still be offered loans on the same conditions, irrespective of residence and social standing and that the interest subsidy of social housing be maintained.
- That borrowers retain the rights currently granted upon borrowing from HFF, to solutions in case of payment difficulties, such as debt reconstruction, maturity extensions and freezing payments.

- That such a sponsor should not enjoy a general government guarantee for its liabilities and that any facilitation otherwise granted by the government would be in direct correlation and proportion to the specific duties bestowed upon the bank by the legislature. There is reason to believe that a well realised financing way could result in lending terms comparable to the terms currently offered by HFF.

On this foundation the steering committee suggested that it be assigned to continue to develop a future system, assisted by experts and seeking consultation with those with a stake in the future setup. The committee's proposals on a future arrangement were scheduled for the end of May, addressing the structure of the new housing bank, its operation form, funding and the organisation of its communication with cooperating market partners. The proposals were also meant to include the arrangement of how to achieve government aims of supplying loans on equal terms, regardless of place of residence or social standing.

### **The latter part of the work - April through June, 2006**

Following the interim report the steering committee presented its conclusions to the Minister of Finances and the Minister of Social Affairs at the time. In this presentation the steering committee put forward some ideas for an execution rooted in the above government aims and based on successful wholesale system in the neighbouring countries. On April 18, the Minister of Social Affairs extended the committee's authority, citing the interim report's premise and the presentation. It was decided to aim for a political decision on the issue, negative or positive, by the end of May.

As soon as the extended authority had been granted the committee consulted the spokespeople of retail banks and savings banks on cooperation on the project, seeing as they had emphasised that the matter be concluded quickly. The committee asked them to nominate experts for an expert group which would receive more detailed information on the committee's ideas and work on the further execution of its ideas with the group.

On Friday April 21 bank and savings banks experts received an e-mail informing them of the extended authority of the steering committee, with copies sent to bank

managers. The e-mail stated that the steering committee aimed to reach a conclusion on the major factors in the execution of its idea of a new housing bank before May 19, and that in order to reach its goal the committee had formed the following work schedule:

1. Meeting with group of experts April 25.
2. Steering committee meetings with bank and savings banks directors, one at a time, discussing in detail the stance of each party toward the project, May 2.
3. Further processing of ideas on a new housing bank should begin Monday May 8.
4. A final execution plan should be ready by May 19. The proposals were supposed to be published May 30.

The committee met with the group of experts Tuesday April 25. During the meeting the ideas developed by the committee on a new housing bank and its role on the housing loan market were presented to the bank experts, ideas that the committee had already presented to the ministers. Following this first meeting the committee met with bank and savings bank directors, discussing the contents of the committee's proposals. The attitudes of the consulted differed from each individual to the next. Some were positive toward the proposals but others reckoned it would be better to base them on another methodology. One of the consulted was undecided toward the proposals and felt it did not serve own interests to contribute to the project.

Following this series of meetings, on May 10 and 11, the committee's employee sent further explanations to representatives of the banks and savings banks interested in cooperation. At the same time information was requested on: "*whether consultees were ready to cooperate on the basis of what has been discussed no later than by the end of the week. This does not entail that all issues must be settled at that point but we consider it necessary that by then a general statement of intent should be available, pending the agreement of terms and conditions. Therefore we enclose the attached draft for a statement of intent.*" By afternoon, May 11, representatives of all the parties concerned replied that they could not settle any agreement before the weekend, i.e. May 12, but promised to respond further as soon as possible.

In light of this response the steering committee decided to sway from the work schedule and wait. Representatives for banks and savings banks were contacted on Monday, May 15, only to find out that they still did not consider themselves ready to commit to any cooperation. Therefore the bank representatives were sent a message in the evening of May 15, which stated the following: *“After consulting with the Minister of Social Affairs the steering committee is ready to give the bank representatives further reprieve into the week. Nevertheless, the steering committee plans to start preparing to hand in its final proposals no later than midweek. Therefore we request to receive the formal response of all parties concerned no later than by closing time on Wednesday.”* Banks and savings banks were told that it was important that their attitude was made known, be it positive or negative. However, no further response or information was received from representatives of the retail banks and savings banks.

### **The response of the banks - June through August 2006**

At the beginning of June bank directors conveyed the message to government ministers that experts from the retail banks and savings banks were preparing their own proposals. The conclusion was that their experts and the steering committee should discuss these proposals once published.

To facilitate informed discussions on the issue the steering committee set up a meeting with Nils Tørslev, CEO of Totalcredit in Denmark, at Hótel Nordica on June 28. Representatives from banks and savings banks were invited to the meeting along with senior officials from the ministries of finances and social affairs. Nils Tørslev is one of the key men that the steering committee consulted and its proposals were in large parts based on the concept behind Totalcredit. At the meeting Mr. Tørslev explained the structure of Totalcredit and the fundamental issues to be kept in mind when setting up a wholesale bank for financing housing loans.

Once experts from banks and savings banks had gathered their proposals via the Bankers' and Securities Dealers' Association of Iceland (SBV), a meeting was planned with representatives from SBV and the steering committee. The meeting took place July 19. At the meeting the SBV experts presented their ideas on a wholesale system and

explained the aspects differing from the committee's ideas. The SBV proposals were unanimous with the committee's ideas on many issues. The main differences were the following:

- *Ownership.* SBV's proposals entailed that a wholesale fund should be co-owned by the Housing Financing Fund, banks and savings banks, pending further agreement.
- *Social role and consumer protection.* The SBV raised objections to the proposed social responsibilities carried by a wholesale fund. The ideal situation would be that the HFF retained that role, in order to grant loans for rental housing based on income and asset limitations. Any lending by the new fund should be based on marketary assumptions.
- *Arrangement of wholesale method.* SBV's proposals entailed that a new wholesale fund would determine the loan formats that retailers could sell to the fund, much like the steering committee's proposals suggested. However SBV wanted that retail banks and savings banks had contract relation with the borrowers, selling the loans to the wholesale fund if necessary, opposing the committee's ideas that contract relations were directly between the wholesale bank and the borrowers. Retail banks and savings banks thus wished for autonomy over whether and to what extent they would sell loans already granted on to such a fund.

Following this meeting the ministers were informed of SBV's observations. Concerning individual comments by SBV the steering committee reckoned the following should be pointed out:

- *Ownership.* The steering committee pointed out that its authority assumed that a new housing bank would be exclusively owned by the state. Therefore a political decision was needed to change course in that issue.
- *Social Role and consumer protection.* The steering committee pointed out that its brief had emphasised the integration of the social role with general lending, similar to HFF's current workings, and to ensure housing

equality regardless of residence and financial standing. The steering committee reiterated the obvious social rationale behind the facilitation of equal participation of those of less means on the property market. From an economic viewpoint this makes the most sense, since any other arrangement would reduce scale economies in a new system and increase the likelihood of higher interest rates in the long term. The steering committee also pointed out that its brief specifically stated that the group should take care to retain existing legal provisions ensuring the borrowers' right to freeze payments, extend loan periods and other solutions to payment difficulties. The banks' position, that all lending should be based on marketary assumptions, seemed to thwart this.

- *Arrangement of wholesale method.* The steering committee pointed out that its proposals of pricing transparency and contract relation between the wholesale bank and borrowers, i.e. that loans would always be owned by the new wholesale bank, were fundamental in order to guarantee consumers the benefits of a new system. The proposals were based on successful models tried and tasted abroad for decades, where these factors are considered key. Removing the transparency and contract relation would reduce the benefits of the system for the consumers. To name a few examples:
  - Broken relationship of lending and financing. A direct relation between lending and financing is important. It is generally considered the most efficient way in wholesale housing loan systems, since it ensures lower operating costs, more efficient and better services and less expensive financing. Such a system is generally used by wholesale banks such as Totalkredit, SBAB and Freddie Mac and Fannie Mae. If this relationship is not in practice there is an added risk of retailers accumulating loans. This increases the market and interest risk of retailers and the operating and competition risk of wholesalers as a result of fluctuations in loan flow from retailers to wholesalers, depending on the current

market situation. In such circumstances it is probable that both parties would need a higher interest premium in order to defend themselves from uncertainty and market fluctuations. Ambiguities would thus in general lead to higher interest cost for consumers.

- Less normalisation of financial products. It is important that lending by retailers be normalised. This will generally lead to better financing conditions and lending terms as a result. Lack of normalisation causes unnecessary cost of reviewing, classing and diligence examinations of any loans purchased by the wholesale bank, interrupting cost-effective construction of bond issuance.
- Worse negotiating position of wholesale bank toward retailers. If a commitment to price formation between retailer and wholesaler has not been agreed it is probable that the wholesaler would be pressured to offer different terms. Different situations under such negotiations would be overwhelming since the banks would totally control the customer flow to the wholesale bank, making the wholesale bank's bargaining position unacceptable. In these circumstances it would be difficult to retain equal terms regardless of place of residence.
- Less loan quality. Should the banks be autonomous as to whether to sell their loans on they would also be in the position to hand-pick the best customers and to sell only those loans with added lender's risk. This would increase the operating risk of the wholesale bank and lead to worse terms.

Representatives from SBV and the steering committee met again August 9. At that meeting the steering committee discussed the proposals handed in by SBV July 19. SBV expressed its clear position, that should the government be unwilling to accept the three key factors mentioned above - i.e. that the wholesale bank would be co-owned by the state and the banks, that social lending be kept out of the wholesale bank and that banks and savings banks held ownership of loans, selling them on to the wholesale bank -

there would be no agreement between the banks and the government. The powers vested in the steering committee made it unable to accept SBV's emphases in that way.

## **Conclusion**

As stated above the steering committee has presented its proposals and BSDI's observations to the government. Some of BSDI's comments are of such a nature that a decision to follow the banks' proposals is a political issue and therefore not within the steering committee's working scope. Concerning the financing system the steering committee emphasises that any new wholesale format, if chosen, shall be based on pricing transparency and that the contract relation of loan contracts will be between the wholesale bank and the borrower, as has been the standard in comparable systems abroad. Such a system is of great interest to consumers and ensures financing efficiency and the best terms available. Other methods are less practical, more expensive and would place the new wholesale bank in an unacceptable negotiating situation toward the retailers.

The steering committee emphasises that although it has quite extensively covered the issues disputed by the committee and the BSDI, the parties agreed on various factors concerning the structure of a new wholesale bank. For instance, all parties agreed upon the importance of a general legislation on covered bonds. Such legislation would facilitate and optimise housing loan financing. The parties also agreed that a new wholesale bank should not enjoy any competition-inhibiting privileges.

The steering committee reiterates that it was instructed to reduce future government guarantees in the housing loan system. The steering committee believes that well-organised financing of housing loans based on the issuance of covered bonds should result in loan terms similar to those currently offered by the Housing Financing Fund. Thus it would be possible to reduce government assistance for housing loans without negative effects on loan interest terms. In light of this the steering committee deems it feasible to move toward new solutions to finance housing loans, even though the authorities and the banks have not reached an agreement on a methodology in this attempt.

Therefore the steering committee proposes that the government advocate amendments, permitting the HFF to establish a financing system on a wholesale level based on the rationale proposed by the steering committee, described in more detail in the appendix. Such a system, based on the issuance of covered bonds, can be established without government assistance, as an independent unit within the HFF. The HFF could then sell loans granted by the Fund to the legal entity, which then would bear sole responsibility for repaying the financing bonds. The proposals put forward by the committee are modelled after systems that have been successful in neighbouring countries for decades. If the creation of such a financing system is a success it could lead to a new financing method for the HFF, where funds for housing loans could be raised efficiently and on practical terms, without government assistance. That way the government would manage a fortunate step toward the future development of the housing loan market and support competition on said market while protecting the political aims behind the government's housing policies.

Reykjavík, September 11, 2006.

Sigurjón Örn Þórsson  
Chairman

Ármann Kr. Ólafsson

Jóhann G. Jóhannsson

Árni Páll Árnason

## **Appendix - Steering committee's approach to a new Housing Bank**

### **Introduction**

The steering committee's variation was modelled on successful wholesale methods from neighbouring countries. The variation was developed with regard to the government's housing policy.

#### **■ Political aims:**

- Providing Icelanders with the best available terms for housing financing, irrespective of personal finances and residence
- Ensuring a reasonable government role on the market for the good of consumers
- Reducing unrest on the mortgage market as this can lead to increased economical instability

#### **■ Marketary aims:**

- Providing the market with the best terms on offer at any time for the acquisition of residential housing
- Being at the forefront of product development
- Maintaining necessary scale economies
- Maintaining economic strength and acceptable performance
- Diversifying distribution methods

### **Basic rationale**

The steering committee's ideas propose variations concerning the creation of a new Housing Bank, acting as sponsor for housing loans, which would then be granted through banks and savings banks. The ideas made the following basic assumptions:

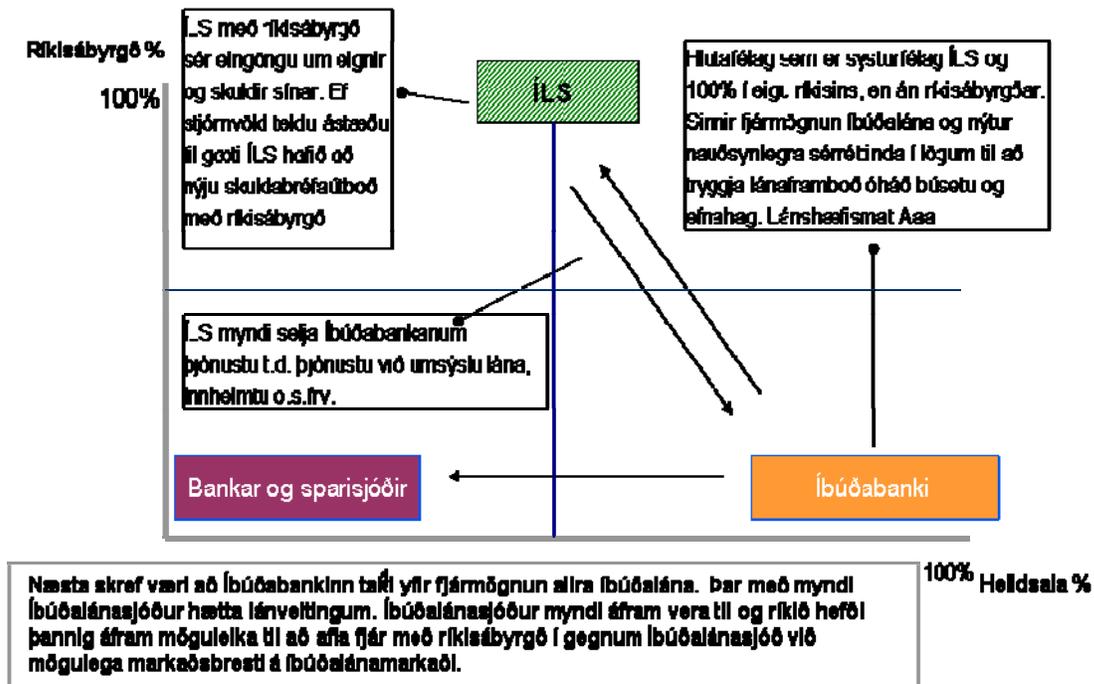
- Banks and savings banks shall exclusively handle individual lending and shall be able to provide loans according to the Housing Bank's conditions.
- Banks and savings banks shall provide the loans on the best available terms.
- Such a sponsor shall not enjoy a general government guarantee for its liabilities and any other facilitation on behalf of the state shall be in direct context with and correct proportion to the specific duties bestowed upon the bank by the legislature.
- The loan terms of the Housing Bank shall ensure that borrowers can still obtain loans on equal terms irrespective of residence and social status.

- Borrowers shall retain their rights to payment crises solutions, currently included in HFF loans, such as the right to extend loan periods and freeze payments.
- The Housing Bank shall be a public limited company entirely owned by the state, comparable to SBAB in Sweden.
- The Housing Bank shall be able to enforce the political aims of the government housing policy at any time, comparable to Fannie Mae and Freddie Mac in the USA, and be remunerated accordingly.
- The Housing Bank would finance housing loans for domestic financial institutions according to predefined rules.
- The loans of the Housing Banks would bear a predefined interest premium to increase pricing transparency, similar to the workings of Totalkredit in Denmark.
- The Housing Bank would have to operate in accordance with the general rules of the Financial Supervisory Authority on finance institutions.
- The Housing Bank would need to return profit on equity exceeding risk free interests.

## The Housing Bank

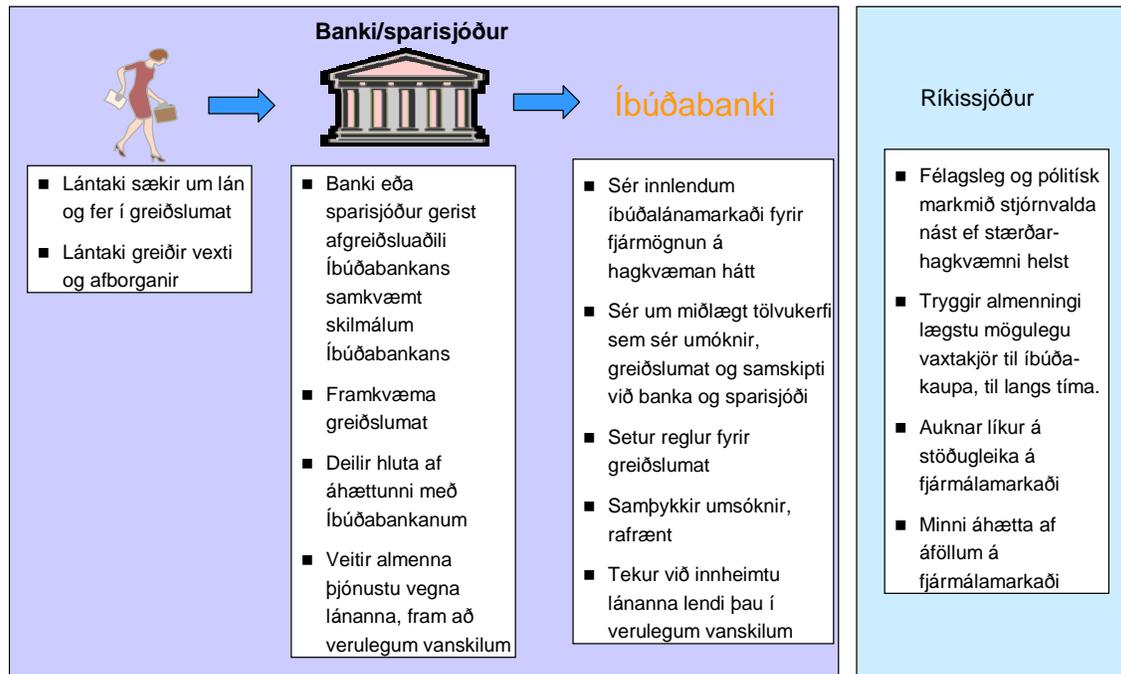
The figure below shows the steering committee's proposals for the founding of a Housing Bank, starting its operations at the beginning of 2007. The Housing Bank was only meant to act as a wholesale loan provider without any government guarantees for its liabilities. For details see Figure 1:

Figure 1: The Housing Bank and its relation to HFF and banks and savings banks



The proposals assumed that the Housing Bank would set loan purchase conditions regarding issues such as credit rating, terms, mortgage ratio and maximum loan amounts. The Housing Bank would finance the purchases through bond issuance. The legal contract relation between borrower and lender would be between the borrower and the Housing Bank. The Housing Bank would monitor that the cooperating banks follow regulations on borrower evaluation and mortgage rating and take over payment collection once the borrower hits significant repayment difficulties. The Housing Bank would, in such a situation, ensure that borrowers retain their rights to payment assistance, according to the Housing Act, i.e. the right to freeze payments and extend loan periods etc.

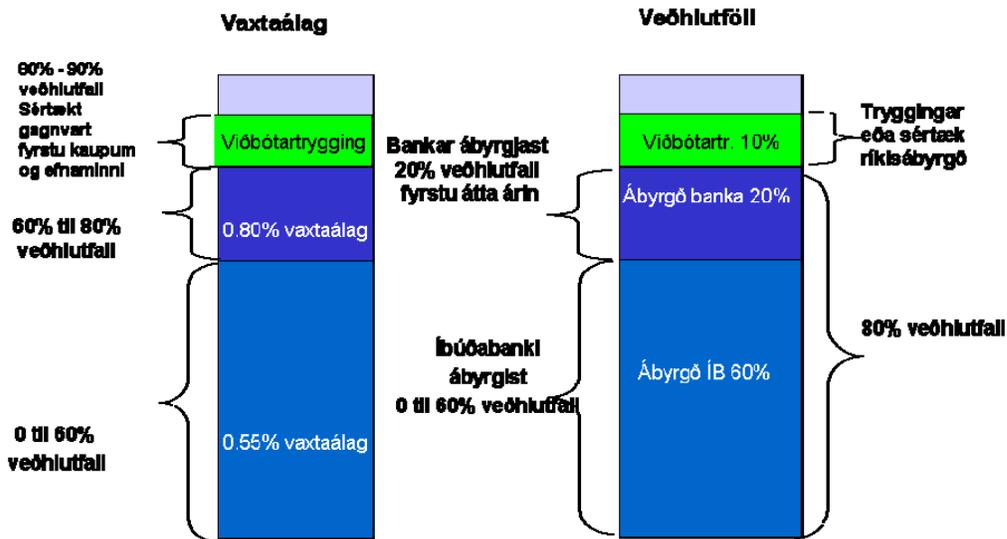
**Figure 2: The Role of the Housing Bank and the Banking System**



The figure shows the relation of banks and savings banks to the new Housing Bank according to the steering committee's proposals. The committee concluded that a good realisation of the idea of a wholesale bank would lead to the achievement of the government's aim with the change. Such a bank would also continue to provide the public with the lowest available interest rates for long-term housing purchases. A successful solution would also more than likely lead to increased stability on the financial market and thus reduce possible setbacks.

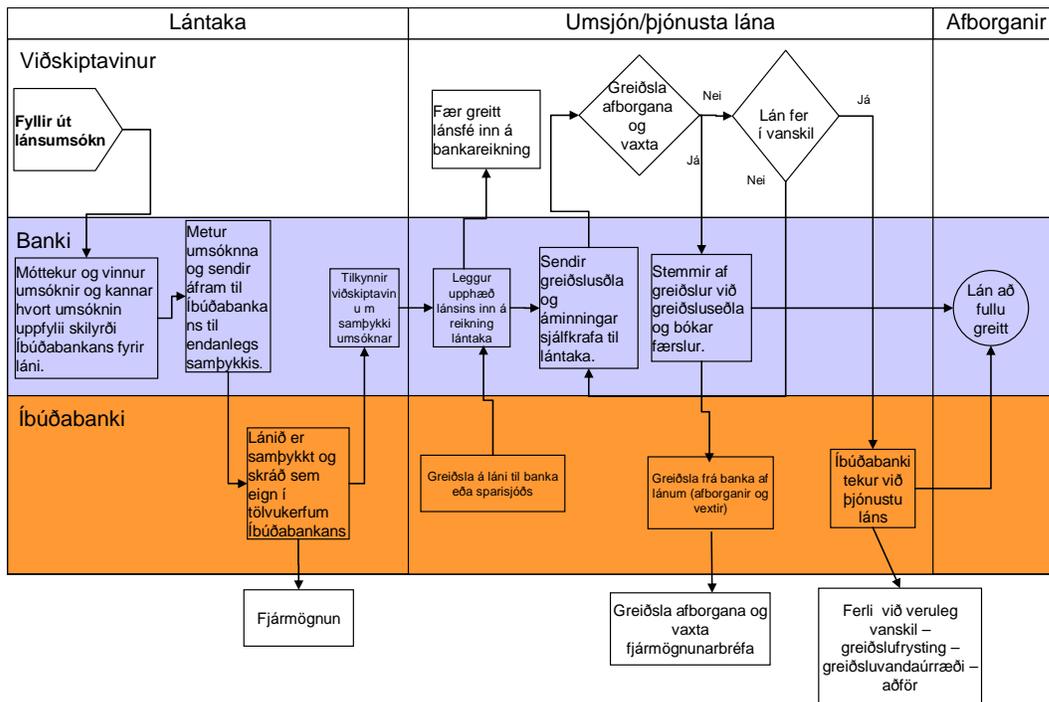
Regarding interest premium and loan ratio the idea was that the interest premium would differ in accordance with property mortgaging ratio. Thus a lower interest premium would follow a lower mortgage ratio. Banks and savings banks are also assumed to accept a part of debtor risk concerning own lending. Such a system is in effect in Denmark and is considered conducive to a responsible lending policy. It is very important to arrange this so that cooperating retail banks bear some part of the lending risk, because otherwise there is a danger of retailers embarking on irresponsible lending competitions. The steering committee proposes that banks and savings banks accepted the risk of the remaining 20% of the loans for a few years, and would be reasonably compensated for this. The Housing Bank was assumed to finance loans for up to 80% of market prices, but that those borrowers seeking a 90% financing could have such loans by accepting additional payback insurance. It was also assumed that buyers of less income and assets would have access to loans for up to 90% and that the government would shoulder the debtor risk in such cases. This arrangement is explained in detail in Figure 3.

Figure 3: Interest premium and loan ratio



In the opinion of the steering committee the process and service of the loans would have been relatively easy seeing as a central payment and information system exists in the country, operated by the Icelandic Banks Data Centre. Such a central system is very important in order for the wholesale system to work fast and well. Figure 4 shows the payment flow and responsibilities of parties under the wholesale solution.

Figure 4: Process of borrower, service of loan and payment flow



## **Financing method**

The proposals of the steering committee were based on the usage of covered bonds for financing in a new wholesale system. Covered bonds are increasingly being used to finance housing loans abroad and issuance of such bonds is steadily increasing. Currently most European countries use this financing method to fund housing loans, partly or exclusively. The committee's proposals were based on the following method:

- Housing loans would be collected in the Housing Bank's balance account.
- When a certain amount of housing loans have been gathered the Housing Bank can issue covered bonds to finance those insured by the housing loan collection.
- Housing loan ownership is ensured to be separated from the Housing Bank so that buyers of covered bonds can claim the housing loans exclusively in case of defaults on covered bonds issued by the Housing Bank. The Housing Bank can thus never appropriate the housing loans specified as insurance for the covered bonds during their useful lives, unless in order to repay the covered bonds.
- Covered housing bonds are very popular among foreign investors; they are considered very safe and usually gain good credit ratings. However, they must fulfil certain conditions to obtain top marks from credit rating companies.
- The covered bonds are sold to investors who are given repayments reflected mostly by the payment flow of the housing bonds.
- It is important to pass legislation on covered bonds in Iceland to facilitate the issuance of such bonds. Many neighbouring countries have passed such legislation or are planning to, such as Finland, Sweden, Ireland, UK, Norway and Denmark. Such a legal framework makes the covered bonds more marketable internationally and can thus have a positive impact on interest rates.

**Figure 5: Financing with emphasis on an active bond market**

