1 Executive summary

This report proposes that, commencing on 1 January 2015, major steps be taken towards eliminating the inflation indexation of new consumer loans by:

- prohibiting the provision of indexed, consumer annuity loans with a term longer than 25 years;
- extending the minimum term of new indexed consumer loans to up to 10 years;
- placing restrictions on mortgaging in the case of indexed housing mortgages; and
- increasing incentives to take out and provide non-indexed credit.

It is important to reduce the share of inflation-indexed, annuity loans. This will reinforce long-term financial stability, increase the efficacy of the Central Bank's policy rate and provide a foundation for balance in the economy. The repayment profile of 40-year inflation-indexed annuity loans creates a risk of excess leveraging during the first part of the loan term while increasing the total interest cost for the entire loan term because indexation is added to the principal. This disadvantage of such loans is aggravated the longer the term of the loan.

The principal impact of eliminating long indexed annuity loans for consumers is the increased debt service burden and more restricted access to credit for low-income earners. For this reason, assistance is needed for low-income earners and first-time buyers through actions such as more focused homebuyers' interest benefits, tax deductions and withdrawals of personal pension savings.

Inflation indexation has been at the core of the Icelandic economy for 35 years. Since 1998 no restrictions have been placed on indexation despite good intentions and promises to do so. The amendments proposed here are therefore the first restrictions to be imposed on the use of inflation indexation for a lengthy period.

The complete elimination of indexation on new consumer credit, however, requires more time and consideration. Without careful preparations, its elimination could jeopardise financial stability and erode the position of both consumers and lenders. The premises for the full elimination of inflation indexation include in particular establishing a foundation for a new housing system, clarifying the position of the Housing Financing Fund and reforming the pension fund system. Work is already underway on this under the government's auspices and it is important that it proceed smoothly.

It is proposed that an assessment begin, no later than in 2016, of the experience gained from the major steps set out here towards elimination of indexation, followed up by the drafting of a programme for its complete eradication.

All members of the expert group expressed their support for these conclusions with the exception of Vilhjálmur Birgisson, who will deliver his own separate report.

2 Proposals and time schedule

The expert group's task was to map out the details for the removal of indexation on new consumer credit, with proposals and a time schedule for actions. The group was also to assess the impact of such changes in a wider context. Furthermore, it was to make proposals for minimising the negative effects, as reflected in its analysis.

Icelanders have lived with wide-reaching inflation indexation for 35 years. Its elimination from consumer lending is an action of previously unseen magnitude. The group therefore considered there to be every reason to carry out extensive analytical work. This analysis was carried out with a view to eventual complete elimination, as is evident from the later sections of the report. The group also had three specific analyses carried out, as described in Annexes 1-3.

The first subchapter below points out that removing the indexation of consumer financial obligations will be the first stage en route to eradicating the nation's deep-rooted indexation mind-set. The second subchapter describes the group's analyses of the principal risks involved in eliminating indexed consumer credit in a single step. In the third subchapter are proposals for a time schedule for eliminating inflation-indexation of consumer credit while the fourth subchapter concludes by describing the mitigating measures proposed in connection with the first stage of removing indexation.

2.1 Stopping the automatic effects of indexation

The group is of the opinion that it is necessary to put an end to the deep-rooted indexation mind-set which has characterised the Icelandic economy more than most others in recent decades. Examples could be taken, for instance, of automatic increases in the prices of goods and services to reflect inflation and various types of indexed short-term contracts, such as contractors' agreements and service level agreements. The same applies to price increases in the cost of public services, for instance, in accordance with a specific Bill passed each year. Such automatic increases fuel inflation and as a result indexed debts directly and non-indexed debts indirectly. This in return hurts households especially, since they are the largest inflation-indexed debtors. Stability in the economy, which consists especially of restraining inflation to within the Central Bank's inflation target, is a prerequisite for positive long-term economic development.

Eliminating indexation of consumers' financial obligations is the largest step towards eradicating the above-mentioned entrenched indexation attitude of Icelanders.

However, it makes a major difference how we go about doing so. As radical a system change as this can have a very negative impact on consumers and lenders and can threaten stability if implemented at one stroke.

2.2 Full elimination in a single step?

Within an historically unstable economy, the Icelandic financial system has been built on inflation indexation to ensure the general public access to long-term financing for housing purchases. Inflation-indexed housing mortgages as a result form the basis of the Icelandic financial market. It is therefore evident that removing indexation from consumer loans all at once would have a wide-reaching impact.

The group's analyses indicate that, were inflation-indexation to be eliminated, loans with highly variable non-indexed interest rates would become the dominant type of housing mortgage. As the debt service on non-indexed loans is higher than for indexed loans at the beginning of the mortgage term, this would reduce consumers' accessibility to funding and the lowest income earners would be less likely to satisfy credit assessment. This would lower housing demand, and with it real estate prices; a higher debt service burden also dampens private consumption and thereby GDP growth.

An analysis by the Central Bank of Iceland conducted at the group's request of the economic effects of a ban on indexed consumer credit indicates that such a ban could have an extremely negative short-term impact on the economy and negative effects would be felt even in the medium term. The conclusions of the Central Bank and Analytica, which was also enlisted for analysis by the group, are in many respects similar, although the extent of the macroeconomic effects assessed by each varies, with Analytica's analysis suggesting milder effects.

It is evident, however, that there is considerable uncertainty concerning the consequences and in the later chapters of its report the group points out the probability that eliminating indexation all at once would have substantial consequences for consumers, lenders, the real estate market and the economy as a whole. In an overall perspective, such consequences can jeopardise financial stability.

Elimination of indexation in a single stroke leaves households exposed to a series of sharp interest rates increases, as fixed-rate loans for a longer period are unlikely to be offered. Fixed, longer-term interest rates would provide security for households but given the immature Icelandic mortgage market the availability of such loans cannot be envisaged for certain. Suggestions have been made for interest rate capping. A mandatory interest rate cap would, however, reintroduce arrangements which existed prior to 1979, with the risk of negative real interest rates, stagnant granting of credit and shrinking savings. It is hardly possible to contravene the rules of the market in such a manner without causing a major market failure.

The group discussed extensively the possibility of an interest rate cap with prices and payments negotiated freely by contracting parties. Details of ideas by Ásgeir Jónsson and Hersir Sigurgeirsson on the imputed cost of an interest rate cap in an Annex show that possibly some portion of housing mortgages could be capped for a price. Applying universal protection for all housing mortgages, paid for by the Treasury, however, would be too costly and too risky, as the estimated cost of a 9% interest rate cap would be around ISK 20 billion annually, and it is not clear who would bear the counterparty risk.

The Housing Financing Fund is by far the largest housing mortgage lender. Its situation is among those aspects impeding the development of a programme for eliminating indexation. The Fund's current difficulties arise from older mortgages, most of which are prepayable while the notes issued by the Fund to finance them are mostly non-callable. The Fund has already lost substantial amounts requiring equity injections of almost ISK 50 billion from the Treasury. It would further aggravate these difficulties if eliminating indexation were to prompt more borrowers to pay off their mortgages to take out non-indexed ones instead, with the accordant cost to the Treasury.

Elimination of inflation-indexation would also transform pension funds' investment landscape. According to legislation, pension rights must be indexed, and as a result pension funds have emphasised inflation-indexed investment options. Considering the dominance of pension funds in the Icelandic financial market it is important to ensure their continuing involvement in housing mortgage financing; they are by far the largest financiers of inflation-indexed consumer housing mortgages, with a market share of around 70% or ISK 800 billion. In summary, the elimination of inflation-indexation of consumer credit would result in ending the vicious circle of indexation in the Icelandic economy, but would create substantial uncertainty as to whether pension funds would continue to finance household housing mortgages if they were not indexed, at least if their legal framework remained unaltered.

Due to the above-mentioned effects on the economy, consumers, the Housing Financing Fund and pension funds, which in turn could threaten financial stability, the group regards it as more advisable to implement the removal of inflation-indexation in stages.

2.3 Elimination in stages

The following are the group's proposals, in five parts, for the elimination of inflation-indexation on new consumer credit.

Proposal 1: Elimination of inflation-indexed, annuity loans with term of over 25 years

The first and most important step which the group proposes for eliminating indexation of consumer credit is to prohibit the granting of new inflation-indexed, annuity loans with a term of over 25 years. As demonstrated later in this report, the combination of annuity amortisation, inflation-indexation and a long maturity is the worst type of indexation; the repayment profile of such loans creates a risk of over-leveraging during the early period of the loan term and results in higher overall interest cost, as indexation is added to the loan principal. This disadvantage of such loans is aggravated the longer the term of the loan. Elsewhere borrowers are cautioned against such loans with "negative amortisation" or "negam" loans.

The impact of this action alone could be considerable in increasing the debt service burden at the beginning of the loan term, and it therefore invites mitigating measures, which are discussed in section 3.4.

The group proposes that offering inflation-indexed equal instalment loans with a 40-year term remain authorised, as well as inflation-indexed annuity loans with terms of up to 25 years, however, with the limitations resulting from Proposal 3 on mortgaging restrictions for inflation-indexed residential housing mortgages.

Proposal 2: Lengthening the minimum term of inflation-indexed consumer loans from 5 years to up to 10 years

It is proposed that the minimum term of inflation-indexed consumer loans be lengthened from 5 years to up to 10 years in a single step. This will prevent the indexation of all or most conventional types of consumer credit, i.e. other than housing mortgages. In the group's estimation, such a change is unlikely to have a major negative impact on the financial system or the overall economy, and is an important step towards eliminating indexation.

Proposal 3: Placing restrictions on mortgaging in the case of indexed housing mortgages

It is proposed that inflation-indexed lending against mortgages on residential property for own use be limited, and that such loans be prohibited when the borrowed funds are intended for any use other than financing the housing in question.

It is also proposed that a ceiling be placed on the loan-to-value (LTV) ratio of inflation-indexed housing mortgages. The LTV could be flexible depending upon the economic situation and the type of instalments, i.e. amortised or equal instalment loans, and/or term of the loan.

Proposal 4: Increasing incentives to take out and provide non-indexed credit

The following incentives are proposed to encourage borrowers and lenders to choose non-indexed rather than indexed credit options:

- Tax incentives will be utilised to an even greater extent than under the current homebuyers' interest subsidy system, e.g. by authorising payment of benefits only for interest payments and not for payment of indexation.
- Financial undertakings will be obliged to keep a level indexation balance, with long-term imbalances prohibited.
- Effective supervision of LTV ratios of existing loans will be ensured so that risk classification will comply with currently applicable rules. LTV ratios exceeding a specific level will require higher capital ratios in banks. If the LTV ratios deteriorate during the term of the loan this should require additional capital reserves. The probability of negative equity developments on long inflation-indexed loans should, as a rule, make them more costly for banks.

Proposal 5: Time schedule and next steps

The complete removal of inflation-indexation at one stroke could threaten financial stability and weaken the positions of both consumers and lenders. The economy therefore needs latitude to adapt to changed premises.

The premises for the full elimination of inflation indexation include establishing a foundation for a new housing system, resolving the position of the Housing Financing Fund and revising the legal framework of pension funds. Work is already underway on this under the government's auspices and it is important that it proceed smoothly. Economic stability is also of major significance in this regard, including capital controls and the programme for removal of controls. In addition, the impact of new consumer legislation on consumers' access to capital needs to be assessed, together with the effects of the debt relief programme announced in the Report of the Prime Minister's Office on Reducing the Principal of Housing Mortgages of November 2013. Last but not least, the impact of those proposals for eliminating inflation-indexation described here needs to be analysed after their implementation.

It is proposed to start with the group's above-mentioned proposals, which as a whole and in the historical context serve as a first, large step towards the elimination of inflation-indexation of consumer credit. It is suggested that these proposals be implemented no later than 1 January 2015.

Following this, it is proposed that the authorities begin an assessment no later than in 2016 of the experience gained from these actions: analyse the impact on consumers, lenders, the real estate market and the overall economy, and follow up by drafting a programme for complete eradication.

The stage proposed in this report is, in the expert group's assessment, extremely important with a view to achieving full eradication.

2.4 Mitigating measures

The above-mentioned actions to eliminate inflation-indexation will increase the debt service burden and reduce consumers' access to credit. Special consideration needs to be given to first-time buyers and low-income earners.

The following mitigating measures are proposed to reduce the negative impact. Nonetheless, the aim is to encourage a sustainable credit market, i.e. the objective is to have real estate buyers repay their loans without assistance; the assistance, in whatever form it is provided, must be aimed at helping those in need of help.

Emphasis needs to be placed on assistance at the beginning of the loan term, especially for first-time buyers and low-income earners, while cutting back the assistance as the loan term progresses or loan principals are reduced. The system may not, however, encourage indebtedness either resulting from interest subsidies or government guarantees.

1. Assistance for low-income earners and first-time buyers

- <u>Homebuyers' interest benefits:</u>Inflation-indexed 40-year annuity loans have been the most advantageous option with regard to their debt service burden at the beginning of the loan term. If this option is no longer to be available increased assistance needs to be provided for first-time buyers and low-income earners at the beginning of the loan term. This should be temporary assistance, possibly with incentives to choose a non-indexed mortgage. The interest benefit system already encourages concurrent payment of interest, since the benefits cover only interest and indexation paid and not accrued. The system thereby unavoidably supports increased capital formation. This characteristic of the interest benefit system could possibly be reinforced by limiting interest benefits to a certain part of the loan term, e.g. the first 10-15 years. By that time the debt service burden as a ratio of disposable income should have declined and equity been created, other things remaining equal. More frequent payment of interest benefits could also be encouraged, which would fit well with the monthly burden of payments on real estate mortgages.
- <u>Tax deduction:</u> It is proposed that the debt service burden for lowest-income earners be lightened with a tax deduction for reducing the principal or interest during the first years of the loan term. This action would be directed primarily at persons buying their first home.

2. General assistance for housing buyers

- Use of personal pension savings: Borrowers will be enabled to dispose of new personal pension savings to some extent to reduce the principal of new housing mortgages for a specific period while the debt service burden is greatest. Monthly contributions from personal pension savings would then serve to offset an increased debt service burden. This proposal is similar to the one made by the expert group on Debt Relief, except that that proposal applied only to loans taken out before 1 December 2013.
- Increased savings: People will be encouraged to save to accumulate equity, e.g. it will be permitted to use part of personal pension savings to save to purchase real estate, as was proposed by the expert group on Debt Relief.

3. Review of the housing system

- Despite the above-mentioned mitigating measures in response, the heavier debt service burden and more difficult access to credit will prevent the very lowest income earners from purchasing housing. It is necessary to create circumstances for a rental market which provides long-term residential security. This means developing a rental market as a future solution and a real option, in parallel to a homeowners' market, but also so that young people who wish to own rather than rent need not attempt to purchase their home at a very early stage in their lives. A mature rental market provides the opportunity to accumulate savings for a down payment on a home which tempers leveraging when the eventual purchase is made. Incentives are also needed for the building of smaller and less expensive housing, e.g. by reducing various requirements in the building regulation other than those which directly concern safety. A revision of the housing system is on the to-do list of the project management on the future structure of housing affairs, which is to deliver its proposals in February this year.

4. Interest rate caps

- More varied types of loans should preferably be offered, including the option for borrowers of non-indexed loans with highly variable interest rates to purchase a cap on their interest rates and thereby hedge themselves against fluctuations in debt service. This would not mean that interest rate increases exceeding the cap would be added automatically to the principal – this has even been called an inflation-indexed annuity loan in fancy dress and should be avoided, at least in the case of loans with a long maturity. What could be done, for instance, is to offer a capped rate at a price, on interest on the first ISK 10 million borrowed for the first 10-15 years. The cost of such a cap would be freely negotiated between the contracting parties. See the more detailed discussion of capping interest rates in an Annex.

5. The Treasury increases the share of its inflation-indexed bond issuance

- Less emphasis on inflation-indexed investment options will change the investment landscape for pension funds. According to legislation, they must provide indexed pension rights and as a result pension funds have focused on inflation-indexed investment options. Floating-rate bonds are actually one form of indexation and could suit pension funds well. Pension funds may be reluctant to invest a major portion of their assets in long-term, non-indexed fixed rate investments. The Treasury can respond to this by issuing indexed bonds to a greater extent instead of the non-indexed notes which currently comprise the vast majority of Treasury paper issued. Such an arrangement would in fact contribute to price level stability, as the state itself would have major interests at stake in restraining inflation.

6. *Review of the pension system*

- Due to the relative size of pension funds on the Icelandic financial market the elimination of indexation must go hand-in-hand with a revision of the pension system. Since the private sector pension system lacks the capacity to meet its indexed obligations without earning a comparable return on its portfolio, it is practically impossible for the funds to ensure indexed pension benefits in the face of an inflation spike and macroeconomic setback. It is therefore necessary to review the pension funds' legal framework with the aim of reducing the minimum rate of return required of pension funds or linking this to current market interest rates. Furthermore, placing a cap on the indexation of pension rights could be considered, at least partially as is done in the UK. The review of the pension system is referred to those committees which are concerned with these issues within the public administration.

7. *Improved credit framework and consumer protection*

- Legislation on granting of housing mortgages: Framework legislation on credit activities, or at least legislation on the granting of consumer housing mortgages, would be conducive to improving consumer protection and working practices in the credit market. The first steps in this direction can be taken by transposing promptly the main chapters of the new EU Directive on credit agreements for consumers relating to residential immovable property, the so-called Mortgage Credit Directive, approved by the European Parliament on 10 December last year. The Directive provides, among other things, for the prime focus in lending to be on the borrower's payment capacity and not the underlying collateral when loans are granted for housing purchases. The new legislation should cover various aspects of granting credit, e.g. rights of mortgagors and authorisations of mortgagees.
- Increased transparency of rate changes by lenders: In light of the fact that loans with highly variable interest rates can be expected to become the dominant loan form following the elimination of inflation-indexation, the price development of the floating interest rates is of key significance for borrowers. The provision of Paragraph 1 of Art. 17 b in the EU Mortgage Credit Directive deals specifically with this aspect and requires Member States to ensure that the basis used for calculating variable interest rates is transparent, accessible, objective and verifiable for borrowers and regulators. This means that if a lender intends to change the interest rate due to its higher financing costs, it must be able to demonstrate that the financing cost used as a basis when granting the loan has actually changed. A provision to this effect should be included in new legislation on granting of housing mortgages or added to the current Consumer Credit Act.
- Improved information disclosure concerning interest payment capping: Loans with capped interest payments are similar to amortised indexed loans insofar as the principal can increase without the borrower being aware of it, because payment of interest exceeding the agreed interest cap is postponed and added to the principal. A provision should be added to the first paragraph of Art. 25 of the Consumer Credit Act dealing specifically with such loans. Furthermore, when lenders send notification to consumers of changes in lending rates, as

referred to in the first paragraph of Art. 13 of the Act, it would be desirable to notify the consumer specifically thereof when the interest payment cap has been reached. The consumer would be concurrently provided with a new payment schedule which would then be based on the expected development of the loan principal, in addition to which the possibility of making payment to reduce the loan without charge would be pointed out specifically to the consumer, cf. subparagraph c of the fifth paragraph of Art. 18 of the Act; by doing so, the consumer could prevent an increase to the principal.

8. Increased financial education

- Financial literacy needs to be strengthened to improve consumers' knowledge when investing in residential housing, or making other investments and borrowing. The new Consumer Credit Act, which entered into force in November last year, ensures that borrowers receive better information than before when taking out a loan. In order to increase understanding of information of a financial nature in general financial education needs to be strengthened in both compulsory and secondary schools.