Indexation of Consumer and Mortgage Credit in Iceland in 2014: A Critical Battle between Legality, Fairness and Legitimacy

M. Elvira Méndez Pinedo
Faculty of Law, University of Iceland

Abstract

Six years after the financial crisis that led to the collapse of the banking system in 2008, the over-indebtedness of households is one of the most important problems in Iceland. This study aims to cast light on a specific feature of the Icelandic credit system in connection with the problem of over-indebtedness. The main research question is whether the end of indexation of credit is close or not. The author argues, in the first place, that indexation of credit ex-post to the consumer price index (CPI) in negative amortization schemes is responsible for over-indebtedness. In the second place, the author describes the challenges ahead in the field of consumer and mortgage credit in Iceland in the light of European law (European Union EU and European Economic Area EEA). The incorporation of Directive 2008/48 on credit agreement for consumers to the Icelandic domestic order through the EEA Agreement allowed a preliminary legal review of the practice in light of EU/EEA consumer credit law, both at national and European level without a final conclusion. It has nevertheless led to the judicial review on the legality of some indexation alleged malpractices before national courts and to the EFTA Court for interpretation (mostly on Directives 93/13/EEC on unfair terms 87/102/EEC on consumer credit). A ruling from the Supreme Court is expected on several cases. A critical battle between the legality, the fairness and the legitimacy of indexation of credit is taking place in Iceland under the influence of European law.

Keywords: Indexation of credit – Iceland – European Economic Area – Consumer law

JEL: K0; K3 ; Z

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1. Introduction

Iceland is the only country of Europe where financial debt owed by consumers is real (indexed) and not nominal. Financial institutions, both private banks and public agencies (ie. House Financing Fund from now on HFF), calculate, disclose and claim the cost of credit ex-post, after the signature of the contract, taking into account real inflation in the economy. This applies to both secured (mortgages) and non-secured credit (consumer credit and/or

1 Indexation of credit exists also in Israel and Chile. See Eliasson (2014).
student credit). Real debt is structured by the regular indexation of credit to the consumer price index (CPI)\(^2\), a clause embedded in most credit contracts. Although indexation is not mandatory for financial institutions, it is legal on condition that it complies with the regulatory framework adopted by the national legislator (mostly Act no 38/2001) and respects European Economic Area law (in origin European Union law extended to Liechtenstein, Norway and Iceland through the EEA Agreement)\(^3\).

Indexation of financial obligations has been in place for more than 35 years (since the adoption of Act no. 13/1979 so called Ólafslög). Inflation increases the cost of living and indexed debt but does not guarantee a raise of work incomes as salaries are not indexed\(^4\). In October 2008, Iceland was the first European country to experience the consequences of the global financial crisis. The domestic banking system was rescued, the IMF was called in and a severe economic crisis ensued. Subsequent dramatic devaluation of the local currency, the Icelandic Krona (ISK), led to inflation which was passed to debtors through the specific structure and nature of credit loans\(^5\). The problem of over-indebtedness of households, already present in the boom years 2004-2008, aggravated.

Public opinion has turned against indexation in the last years and the reason is clear. A recent example in the news is descriptive: a mortgage loan was contracted on 3 July of 2008 with a principal of 18 million ISK. This was a classical consumer price indexed loan. While the consumer has already paid 96 monthly installments (starting in 83.437 ISK and most recent of 132.365 ISK and a total of 11 million ISK); the loan has been recalculated with a principal of 29 million ISK on 1 September 2014 (DV, 2014). Consumer association Hagsmunasamök heimilanna (HH) tried in vain to challenge the indexation at a political level, collected more than 38.000 signatures (in a country where population in 2014 is 327.000) requesting the end of this practice. These signatures were submitted to the President of Iceland on 20 February 2012 as an urgent call for action. As this political strategy has somehow failed so far, they have turned to the courts.

The research question addressed by this paper is whether the end of indexation of credit is close or whether Icelandic consumers are simply “waiting for Godot”. On one hand, there is some hope of a political solution since the current Government must still work on the end/cap of indexation, another key political promise due to be discussed in the legislative term 2014/2015. On the other hand, all political initiatives to end this practice have landed nowhere due to

\(^{2}\) Price indexation is a technique used to secure or link a payment with a change of an index, a product price, a exchange rate or with some other kind of reference. According to Icelandic Act No 38/2001 this practice is legal as long as the indexation is based on the consumer price index which the National Statistic of Iceland calculates every month. In Iceland savings, pensions and loans are usually indexed (not salaries). The legislation can be accessed in English at eng.idnadarraduneyti.is/laws-and-regulations/nr/1192

\(^{3}\) Agreement on the European Economic Area. O.J. No L 1, 3.1.1994, p. 3; and EFTA States’ official gazettes.

\(^{4}\) The nominal value of salaries rose more than 100% between 2000 and 2012 (from 210.000 to 474.000 ISK) but inflation reached almost 300% within the last 20 years, and almost 200% since the year 2000. See data from Statistics Iceland http://www.statice.is/Statistics/Wages,-income-and-labour-market/Wages and http://www.statice.is/Statistics/Prices-and-consumption

\(^{5}\) Devaluation of ISK Króna was more than 50% with regards to the euro from average 1€ = 85 ISK to 1€ = 180 ISK. Current exchange rate 5 September 2014 is 1 € = 155 ISK. See historical exchange rates at Central Bank of Iceland www.sedlabanki.is
the consequences on the private pension system which are anchored on indexation. So the question remains whether current judicial review of indexation can shift the balance.

The topic is explored through the lenses of the debtors subject to financial/banking practices in Iceland and grounded in the field of European consumer law which offers a conceptual framework (European Union legislation and case law from the CJEU that are later incorporated into the European Economic Area legal order). Research on the topic is almost non-existent outside Iceland and in other languages than Icelandic. This research gap needs to be filled as indexation of credit has never been assessed by specialists in the field of European consumer credit law. As no literature review can be done, the methodology chosen for the task is first descriptive and then analytical. The first task is to describe the status quo in Iceland on the cost of credit and offer a summary of the current legal framework and practical impact on over-indebted households. The second goal is to do a critical evaluation of the current challenges to indexation on the basis of the European consumer law “acquis”, which are both legal and political.

It is argued that, together with a culture of consumerism, the roots of the over-indebtedness in Iceland lie at the indexation of credit/mortgage financial obligations to the consumer price index. As it is implemented in practice, it guarantees directly the real value of debt and indirectly the purchasing power of private pension rights; but leads directly to higher debt for those indebted (especially mortgage debtors). The paper’s main highlight is to summarize the tension between legality, fairness and legitimacy that indexation of credit poses in Iceland; a tension that needs to be resolved by the executive, the legislative and the judicial powers. The findings are provisional since there are some important questions pending before the EFTA Court and national courts and political promises to be fulfilled before next legislative elections. Uncertainty on the legality and fairness of indexation will last for some time while it is clear that it lacks legitimacy. Policy implications follow since the legislator should wait for the national/European judicial review currently under way, conform to EU/EEA consumer credit law and, last but not least, start to design new public plans for access to housing, re-thinking the role of public mortgage credit and the consequences on an end of indexation for the private pension schemes (directly constructed upon this practice).

2. The status quo: the financial situation of households in Iceland

Over-indebtedness of the private sector in Iceland has been and is still a social and economic problem deeply aggravated by the financial crisis in 2008 (Ministry of Welfare, 2011). Icelandic households and companies were hit by this sort of invisible tsunami in a very harsh way.

As a report done by and for the Central Bank of Iceland notes (Ólafsson and Vignisdóttir, 2012) some macro-economic factors explain this. One reason is obvious: even before the crisis they were heavily indebted. But here is argued that another important reason tends to be forgotten. It is the nature of credit indexation embedded into private contracts, that is to say, the different lending/borrowing practices that financial institutions have offered households with very limited choice and no foreign competition from foreign banks. Lending practices in the period 2004-2008 consisted mostly in 1) mortgage/credit loans borrowed in price-indexed krónur (from now on ISK) (CPI-indexed)
and 2) mortgage/credit loans contracted in local currency ISK but indexed to foreign currencies (FX-indexed). Inflation indexed student loans are exempted from this study.

According to data from Statistics Iceland (www.hagstofa.is) and the Central Bank of Iceland (www.sedlabankin.is), the increased levels of (over-) indebtedness mean that a high percentage of households has difficulties to meet ordinary expenses. In the year 2012 there were 120.745 households indebted with some kind of credit (mortgage, car loan or overdraft, excluding students loans and credit card debt) and the share of over-indebted households (households “in distress”) peaked at 27.05% in 2009, immediately after the crisis but has declined to 20% after 1) the Icelandic state started to intervene and put into place several measures in the attempt to alleviate the debt burden and 2) FX-indexed loans were declared illegal by the Supreme Court in June 2010 and two waves of forced recalculcation of loans followed. Problems of over-indebtedness still remain, especially for debtors with inflation-indexed loans. Most distressed households are single parents, men, low-income families or those with negative equity who bought during the boom-years 2004-2008.

At the same time, an on-going debt-restructuring process started since 2009 by the authorities has proven essential for the economic stabilization of the country (Domurath and Mendez-Pinedo, 2014). After over-indebtedness due to indexation became the most important issue during 2013 legislative elections, the new elected Government put in place in 2014 a new plan to restructure part of indexed debt (Prime Minister’s Office, 2013 b and 2013c). The plan is to write off ISK 80 billion (USD 680 million, EUR 519 million) of the indexed mortgages in the period 2014-2017. This amount will be collected through increased taxes on financial institutions and winding-up committees of the collapsed banks. In addition, ISK 70 billion will consist of tax incentives through contributions to pension system payments. The plan allows for tax relief as well as debt cancelation of up to ISK 4 million (USD 34,000, EUR 26,000) on indexed mortgages per affected household. The plan will reportedly affect—both directly and indirectly—more than 100,000 households (Iceland Review 2014).

Indexation of credit in Iceland reflects a current paradox. Originally designed to prevent systemic inflation of a micro-currency such as the ISK, recent economic research has shown how it has the opposite effect (Mallett 2013). It

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6 Although non-indexed loans in ISK were offered by the private commercial banks, the high interest rates set by the Central Bank of Iceland in the boom years (which peaked up to 21% in 2009) made both the banks and consumers/business look to other alternatives with lower interest rates.

7 Loans denominated in foreign currency —where the principal is written in a different currency than ISK and payments are effectively done in that currency must be differentiated from FX-indexed loans where the principal is written in ISK and payments are executed in ISK. While loans in foreign currency are legal, FX-indexed loans in ISK are illegal under Icelandic Act No 38/2001 on interest and indexation. This distinction has been challenged by the EFTA Surveillance Authority, which declared on 22 May 2013 in a letter of formal notice (infringement process) that Iceland must lift a ban on mortgages linked to foreign currencies because it restricts the free movement of capital: “It can be lawful to restrict the granting of such high risk financial products to consumers,” EFTA said. “However, a total ban on granting such loans to individuals and companies goes beyond what can be considered necessary in order to protect consumers.” See ESA 2013.

8 The Icelandic State provides free compulsory public education but does not provide grants for studies at University level. Student loans offered by the public institution LÍN (www.lin.is) do not fall within the scope of our study due to the difficulties of compiling data on them- but add to the situation of over-indebtedness of households as they are indexed to CPI.
fuels further inflation leading to the growth of the debt burden and demands for pay increases. Indexation of credit leads naturally to over-indebtedness since wages are not indexed. The Central Bank has already acknowledged that monetary policy has important effects on household financial positions as exchange rate of the ISK (and resulting inflation from its historic devaluation) affect directly FX- and CPI-indexed loans and are the main determinants of their debt (Ólafsson and Vignisdóttir, 2012, 76).

Indexation of credit passed directly the financial damage of the 2008 currency crisis and banking crisis to the households. The massive depreciation of the ISK meant a dramatic increase in debt levels for all those who borrowed in foreign currencies and/or in FX-indexed loans and a slow but steady growth for those who had borrowed loans CPI-indexed loans in ISK. All households with private debt saw the nominal levels of the financial obligations increase. As a general rule it can be said that the amount of debt due by those with FX-indexed loans and CPI-indexed loans doubled either overnight or over a period of 4-5 years.

As the Report on consumer protection in the financial market stated in 2013 (Prime Minister’s Office, 2013a, 6-8), national monetary policy and lack of adequate regulation, supervision and control played a role in the current crisis of consumer and mortgage credit problems. Although over-indebtedness brings similar problems all across Europe, the reasons behind the Icelandic situation are somehow different and more difficult to resolve. As stated above, here it is argued that the over-indebtedness problem in Iceland is not only due to an excess of credit and/or to offering credit to vulnerable consumers and households already in distress ((Ólafsson and Vignisdóttir, 2012, 76) but also to the nature and cost of credit which is indexed to inflation (a fact usually set aside by international institutions reporting on Iceland such as the IMF or OCDE). Reality is nevertheless obstinate. Consumers with CPI-indexed loans constituted in 2012 the largest group of those indebted in Iceland compared to those with FX-indexed loans. Recent data from

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9 Mallett (2013) has argued that indexation of loans to the CPI of credit failed to address the economic origin and consequences of the hyperinflation and has directly contributed to increase the inflation rate through creation of secondary monetary supply. She refers to a "positive feedback loop within the banking system’s monetary regulation" in Iceland.

10 The principal borrowed on indexed loans rose either because of inflation (the relevant inflation index has increased 37.5% since 2008 according to information provided by Statistical Office of Iceland (haustofa.is) and/or because the devaluation of the local currency (ISK). See historic exchange rates at Central Bank of Iceland (sedlabanki.is/).

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Statistics Iceland (www.statice.is) confirms that the financial situation of households is slowly recovering but is still strongly dependent on the evolution of indexed debt.

Table 1 – Households in Financial Difficulties- 2004-2012

| Households in financial difficulties by household type, 2004-2012 |
|---------------------------------------------------------------|
|                                | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|-------------------------------|------|------|------|------|------|------|------|------|------|
| Total                         |      |      |      |      |      |      |      |      |      |
| Arrears on mortgage or rent payments | 9.4  | 8.0  | 5.7  | 5.8  | 5.5  | 7.1  | 10.0 | 10.1 | 10.1 |
| Housing cost is a heavy burden (older definition) | 12.4 | 11.6 | 9.9  | 9.6  | 11.8 | 15.0 | 16.4 | 19.2 |      |
| Housing cost is a heavy burden |      |      |      |      |      |      |      |      |      |
| Arrears on other loans        | 10.7 | 7.9  | 5.8  | 8.4  | 5.5  | 10.3 | 13.1 | 12.3 | 10.4 |
| Payments of other loans is a heavy burden | 9.7  | 9.7  | 7.6  | 11.5 | 10.3 | 15.5 | 19.1 | 15.1 | 13.9 |
| Unable to meet unexpected expenses | 36.1 | 39.0 | 31.9 | 29.8 | 26.2 | 29.8 | 35.6 | 39.8 | 35.9 |
| Difficult to make ends meet   | 46.2 | 36.8 | 34.8 | 28.4 | 30.1 | 39.0 | 48.7 | 51.5 | 48.2 |

Source: Central Bank of Iceland (2012) WP59 (http://www.sedlabanki.is)

According to the most recent report of the IMF on Iceland (IMF 2014), the main macro-economic risk factor still pending is the finalization of the restructuring process of the banking sector and a clarification of legal issues still pending before the courts (ie. difficult cases on FX-indexed loans declared illegal by the Supreme Court in 2010 and recalculated on two occasions ever since). The IMF does not refer to the most important issue now under judicial review: the legality of price-indexation as it has been practiced in Iceland under European law and/or the consequences of partial nullity of indexation which might derive under national/European private law if the national courts confirm that most financial institutions have consistently violated provisions of due information and consumer protection in force since 2000.

Indexation of financial obligations in Iceland is at the crossroads. In a vicious circle, indexation of credit still fuels inflation by encouraging financial institutions to increase lending (expanding secondary monetary supply, Mallett 2013, 1). Indexed credit looks attractive to consumers at the beginning since it promotes access to credit with lower initial installments than non-indexed loans. But this means postponing the cost real cost of credit. As inflation tends to rise and deflation has not been recorded in Iceland in the last 35 years, debtors tend to get over-indebted through indexation since their income does not rise as fast. While the financial industry claims CPI-indexation of credit is necessary in the monetary and economic context of the country and legal under domestic law (Act no 38/2001), consumer associations (HH, 2014) prefer to see it as a pure tool of putting the risk and damage of inflation on the weakest party and illegal under European consumer credit law incorporated to Iceland (also applicable to mortgage credit in the country).

Access to credit and indexation reflect a pure catch-22 conundrum, a paradoxical situation from which Icelanders cannot escape and which has required the intervention of the authorities and the courts since 2009 to provide debt-
relief and eventually write-offs. According to financial news based on data provided by the Central Bank of Iceland (Bloomber 2013), Iceland’s banks have already “forgiven” US$ 2.1 billion in debt since the 2008 crisis mostly due to illegal FX-indexation practices. On-going judicial review on the legality of some CPI-indexation alleged malpractices before national courts could mean additional write-downs up to ISK 400 billion (US$ 3.3 billion) which is the figure that the consumer price indexed has passed upon the private debt of households in the last five years according to the same news (Bloomberg 2013, Reply of Minister of Finance 2013). Here the plot thickens. The majority of this potential additional debt-relief would not fall upon the private financial sector but upon the state-owned HFF which is already facing bankruptcy. And this institution has sold indexed bonds based on its mortgage-portfolio to the private pension funds. At the end of the day, the end of indexation would benefit debtors but damage pension-right holders. This specific point will be analyzed later.

3. The cost of credit in Europe vs. the cost of credit in Iceland.

3.1. The cost of credit in Europe: fix or variable interest rates on the principal borrowed

Everywhere in the world the value of money decreases with inflation. The vast majority of mortgage markets – with a few exceptions such as Iceland, Chile, Turkey, and Israel – are nominal debt markets (Jónsson, Jóhannesson, Árman, Benaben and Perrucci, 2012). In general, inflation tends to benefit borrowers due to the structure of the credit system and the time factor. As the principal amount of the loan looses real value with time and inflation, borrowers see their nominal debt remain but the real debt diminishes as there is a parallel increase of salaries/purchase capacity. At the end of the day, the loss of real value of a credit is assumed by lenders. In order to compensate for this, interest is agreed between two parties, lenders and borrowers. When providing financial services such as credit or mortgage loans, banks and financial institutions try to calculate the risk in advance and predict future inflation. This is usually the cost of credit which is charged through fix rates or variable credit rates revisable regularly. Creditors, as professionals operating in the field, are supposed to be in a better position to calculate and cover their risks against inflation which they contribute to create through the expansion of credit (secondary monetary mass) while consumers, as weak parties, cannot protect themselves against inflation with similar tools or insurance. At the end, since financial institutions are exposed to risk if they expand the credit to non-responsible customers, this promotes responsible lending and borrowing.

In all countries of the European Union, following harmonization on credit agreements for consumers done at European level (Consumer Credit Directives 87/102/EEC and 2008/48/EC), the general rule is that the principal of

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11 One may argue whether the financial institutions have “forgiven” credit/mortgage claims against debtors which they had no right to offer in the first place under Icelandic legislation. From this perspective, debt-relief granted for illegal FX-indexed loans should be better referred as write off or debt-recalculation following partial illegality and nullity of contracts.

12 Icelandic households owe the country’s banks ISK 1.43 trillion in loans indexed to inflation, according to the reply of the Minister of Finance to MP Margrét Tryggvadóttir (2013). Linking debt to the consumer price index has cost households ISK 275 billion from the beginning of 2008 through March 2012, according to Bloomberg (2013).

13 Council Directive 87/102/EEC of 22.12.1986 for the approximation of the laws, regulations and administrative provisions of the Member States concerning consumer credit, OJ 1987 L 42/48 and Directive 2008/48/EC of 23.04.2008 of the European Parliament.
the loan, the amount borrowed by and given to the consumer is determined and clear at the moment the contract is signed. As for the cost of credit, the risk of inflation is divided between creditors and debtors although creditors can re-evaluate their risk periodically through variable rates if the credit contract extends over a certain period. For mortgage credit, the panorama is similar except the risk is incremented by longer maturity periods which are reflected in the contractual provisions giving a certain margin of manoeuvre to financial institutions through an agreed method of variation of cost of credit (ie. variable interest rates) (Directive 2014/17/EU)\textsuperscript{14}. However, if the inflation goes out of control and the interest rates raise over predictions; debtors are somehow protected by several options: (i) the possibility to request fix interest charges for credit (which imply higher cost of credit but certainty over that cost) and (ii) the right of termination of the contract with the possibility of consumers changing supplier after having been suitably informed of changes in the cost of credit. Competition between financial credit institutions plays some benefits for consumers.

3.2. The triple cost of credit in Iceland: interest, indexation of principal and interest to consumer price index (CPI) and negative amortization

As stated above, in Iceland the situation is very different since the cost of credit is calculated and structured in a very unusual way in private contracts through a two-fold mechanism: interest (fix or variable) together the price indexation mechanism called verðtrygging. Regarding usual interest there is nothing specific to note so that it will be set aside. What is important to know is that most long term lending, and especially mortgage credit, is indexed. This means that the outstanding principal is increased by the rate of the CPI index. This is a formula used to periodically adjust loans, savings, wages and/or pensions to past inflation. Both for secured (mortgages) and non-secured credit (consumer credit and student loans) offered by private and public providers of credit we find an exception to the general panorama of financial services in Europe which is comparable –in the outcome- to the one adopted by Chile (Madariaga 2009)\textsuperscript{15}.

In a nutshell, together with the interest (fix or variable), the majority of loans are structured on the basis of on the indexation mechanism embedded and, last but not least, a negative method of amortization (where only a part of the interest and extra cost is paid and the remaining is added to the principal). Loans are endlessly recalculated in accordance with the consumer price index and must be paid out based on the index of the month of payment. The indexation does not only affect the cost of credit (payments of interest) but, above all, the principal. Through the magic of indexation (of principal and interest) and negative amortization in a never ending process, debtors see debt

\textsuperscript{14} Directive 2014/17/EU of the European Parliament and of the Council of 4.02.2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010 OJ L 60, 28.02.2014.

\textsuperscript{15} A similar system of price-indexation of loans exists in the financial sector of Chile (indexation to consumer price index is done through the Unidad de Fomento UF). As it is the case in Iceland, salaries are not automatically indexed and must be negotiated between employer and employee in a context of labor de-regulation, social “demobilisation” and anti-trade union policies. Madariaga concludes that this public policy of indexation in Chile protects the profit of certain companies such as banks, financial institutions and other sectors with important financial and damages the most vulnerable who see their income eaten up by inflation.
grow exponentially and compound interest (interest on interest) accrues. This means in practice a triple cost of credit (interest + indexation cost + negative amortization cost). When debtors or consumer associations complain, the financial sector has traditionally replied that there this indexation is not a choice but a necessity in Iceland. The argument is that there is no alternative as no private/public financial institution is ready to offer money without price-indexation or sky-high interest rates to compensate for the risk and reality of endemic inflation in Iceland (Jónsson, Jóhannesson, Árman, Benaben and Perrucci, 2012).

Here below we find the conditions offered by the public institution HFF – Íbúdalánasjóður ILS in Icelandic) in 2013 (www.ils.is). This institution provides access to mortgage credit for all, regardless of their place of residency in the country.

**Table 2**: General conditions offered by HFF in June 2013

| Condition                                             | Details                                                                 |
|-------------------------------------------------------|------------------------------------------------------------------------|
| Maximum loan amount available                         | ISK 20,000,000                                                        |
| Maximum % accepted bid price/construction cost        | 80%                                                                   |
| Interest rates                                         | A fixed rate of 4.70% without a prepayment fee or                        |
|                                                       | A fixed rate of 4.20% with a prepayment fee                            |
| Indexation                                             | Consumer price index                                                  |
| Maturity on loan                                       | 20, 30 or 40 years                                                   |
| Loan fee                                               | 1% of loan amount                                                     |
| Government tax (Stimpilgjald)                         | 1.5% of loan amount                                                   |
| Payments per year                                      | 4 or 12                                                               |
| Paper bill/electronic billing                         | ISK 75                                                                |
| Conditions                                             | Only one home with an HFF loan per individual/family                   |

**Source**: Statistics Iceland 2013 (http://www.statice.is)

Consumer associations, on the other hand, have argued that this practice does not comply with the requirements of European law as incorporated to domestic legislation as debtors must assess their financial obligations before and during the contract (HH, 2014). Notwithstanding the legal basis of price-indexation in domestic law, due information and transparency are key concepts in combination with the prohibition of abusive clauses. Before entering into arguments related to legality of indexation in Iceland under the influence of European law, it is necessary to show a case a price indexed loan with the relevant data. The example reflects the amount needed by a young family to acquire its first standard property in Reykjavik (ISK 20 million) and the maximum loan that the House Financing Fund would offer with the following general conditions.

The mortgage credit in theory: see the plan of payments as potentially disclosed to consumers during the pre-contractual stage. Price-indexed ISK 20,000,000 loan with a real total cost of 7.66% pa (expressed in annual percentage rate of charge or APRC). Consumers are duly informed that inflation could be 2.5% pa or the declared goal of the government from 2002 and this cost is duly reflected and incorporated into the calculation. This is how the payment plan could look according to the information disclosed by the HFF in June 2013:
Table 3. Credit conditions ex-ante for a typical mortgage loan from HFF in June 2013

| Indexed loan with APRC of 7.66% | House Financing Fund |
|----------------------------------|----------------------|
| Original amount borrowed         | ISK 20.000.000       |
| Period                           | 30 years             |
| Interest fees                    | ISK 17.341.922       |
| Inflation                        | 2.5%                 |
| Indexation of payments           | ISK 18.042.342       |
| Stamp fee (notarial duty)        | ISK 27.000           |
| First monthly payment            | ISK 104.016          |
| Last monthly payment             | ISK 217.651          |
| Average monthly payment - 30 years | ISK 153.920       |
| Total cost of credit             | ISK 55.411.265       |

The mortgage credit in practice: below we can see how the real payments may be affected by inflation and indexation once the contract has entered into force. Unfortunately, as reality proves, from 2002 inflation has been average of 6%. So the household could very well find paying for this loan in 2013 as it follows:

Table 4. Credit conditions ex-post for a typical mortgage loan from HFF in June 2013 if real inflation is added into the calculation

| Indexed loan with APRC of 11.33% | House Financing Fund |
|----------------------------------|----------------------|
| Original amount borrowed         | ISK 20.000.000       |
| Period                           | 30 years             |
| Interest fees                    | ISK 17.341.922       |
| Inflation                        | 6%                   |
| Indexed payments                 | ISK 64.233.963       |
| Stamp fee                        | ISK 27.000           |
| First monthly payment            | ISK 104.307          |
| Last monthly payment             | ISK 595.833          |
| Average monthly payment          | ISK 282.230          |
| Total cost of credit             | ISK 101.602.885      |

We see that there is a significant mismatch between table 3 and table 4, between the plan of payments disclosed initially and the real payments done to the bank. The final cost of credit has practically doubled from 55 million ISK to 101 million ISK. This process is a vicious circle, once the inflation affects the principal of the loan beyond the planned 2.5%, the plan of payments becomes obsolete very quickly. Consumers therefore enter into a long-term financial commitment ignoring the amount of their debt as there is always an X in the equation which is impossible to predict in advance (x= inflation). Inflation has been traditionally very high in Iceland. Even though the Central Bank

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16 The situation in Iceland is aggravated by the fact that financial institutions have mostly ignored the obligation to disclose ex-ante the total cost of credit for consumers, giving out payment plans which reflected 0% inflation (in the example above a total cost of credit of ISK 37.368.922 with average payments of ISK 103.803). See note 24.
has systematically announced a policy to fight against it since 2001, during the period 2001 -2012, inflation has amounted to 6% per year.

[Figure 2: Average inflation in Iceland 1940 – 2009.]

Source Statistics Iceland

4. Indexation of credit in the light of European consumer law: a three-dimensional test.

Once the nature of indexation of credit in Iceland has been clarified, it is time to move on to the current challenges that it faces in 2014. The challenges are both political and legal and reflect the difficulties that domestic legislation has to comply with a triple test to the rule of law: 1) legitimacy (acceptance and compliance by citizens as law is what benefits the people), 2) European legality (formal validity requirements) and 3) fairness (substantial notion of justice understood as compliance with European consumer credit law and other consumer economic fundamental rights recognized by the EU/EEA Treaties)

The legitimacy will be the first aspect examined below and it is more of a political nature. A preliminary legal review of (CPI) indexation in light of European consumer credit law carried by national and European institutions early 2013 raised doubts on the legality of the practice but the legislative and executive powers chose to let the question to the judicial branch. For this very same reason, a process of judicial review both at national level and European level was requested at the initiative of a consumer association (HH) and some private parties. The courts are now assessing both legality and fairness in the light of European law. The relevance of the problem of indexation in Iceland does not end

17 High inflation has been a large problem in Iceland, ever since the country started to use its own currency one hundred years ago. It has been around 6% average in the last decade. Source Statistics Iceland (hagstofa.is/)

18 In continental Europe (France, Spain, Germany, Italy) law is subject to a triple test of legality, fairness and legitimacy whether in anglo-saxon countries and in Scandinavia (Iceland) it is common to leave aside the legitimacy pillar as a dimension related to political science. This reflects a more positivist/formal approach to law where the compliance and acceptance of legislation by the people is not relevant. In Icelandic there is no specific legal word for legitimacy as law is subject to a double test of legality (lögmaeti) and fairness (rétmaeti). See on the triple test Radbruch (1945 reprinted 2006) and Iturmendi Morales and Pattaro (1980).
in the country. The interpretation of European consumer credit and mortgage law (European Economic Agreement law) by the EFTA Court will have moral authority for the Court of Justice of the European Union and thus for all European consumers.

4.1. The legal-political review at domestic level: the legitimacy test

A legitimacy test implies asking this following question: if law is only what benefits the people, can indexation be law? Is it beneficial for consumers and households? If not, who benefits from indexation of financial obligations in Iceland?

While the problem has been known for at least a decade, indexation deploys its most destructive effect in the aftermath of the 2008 financial crisis and in a period of economic crisis. Households are confronted to a reality shock. Together with a banking crisis, there is a monetary crisis. National currency devalues around 50% against the euro and inflation goes up dramatically. The housing bubble explodes and households struggle with financial distress, negative equity and loss of employment. In October 2010 social protest due to household debt reaches its peak. While the Government 2009-2013 pursues a soft public policy of debt-mitigation and debt-relief focused on the most vulnerable, there is a general disappointment among debtors (Domurath and Mendez-Pinedo, 2014).

In this context, price-indexation of credit plays its most destructive role and provokes regular heated debates among society, frequent media discussions, articles in newspapers, debates in radio or TV, etc (Prime Minister’s Office 2013, 23). Indexation secures a massive transfer of wealth from debtors to creditors and, indirectly, to private pension funds (Arnarson 2009a).

Until 2014 it has been politically suicidal to attempt to solve end indexation without providing a solution for the private pension funds (that offer indexed pension benefits) and which own 60% of the loan portfolio of the public HFF (Arnarson 2009a and 2009b, Prime Minister’s Office 2013). The abrupt end of indexation of loans would mean the bankruptcy of the HFF and the eventual default of pension funds on their payments to retired citizens with compulsory private pension schemes.

At the end, the most fundamental questions are very difficult to answer since they refer to issues of intergenerational justice. Should some generations of Icelanders who need access to housing and credit pay with extra interest on their

19 Defenders of this system argue that indexation of credit is necessary to secure future (private) pension rights, opponents reply that no other country in Europe operates on this model based on over-indebtedness of one generation needing housing to provide for pension rights of other generations going out of the active life. For a sample of discussions in English see the blog called Economic Disaster Area economicdisasterarea.com/index.php/features/price-indexation-the-devils-economics-discussed/

20 According to Arnarson (2009), about 50-60% of the assets of pension funds are price-indexed mortgage loans, of which 5-15% are mortgage loans taken directly by fund members. By contrast, the pension funds’ liabilities consist of payments of index-linked disability benefits and old-age pensions. The Prime Minister’s Office confirmed the findings of Einarson (60% of price-indexed loans are linked to the private pension funds and/or HFF) (2013).

21 The matrix built by the price indexation of financial obligations has created a framework where the interests of private pension funds and the State House Financial Fund (HFF) are dependant to the indexation of the loans. Pension funds which handle individual pension rights have not only offered these loans directly to their affiliates but have also invested big sums in this market buying loans from the HFF. This institution has given out thousands of price-indexed loans (currently 90% of all active loans) and faces bankruptcy. A lack of opportunities for investment in Iceland provokes that these pension funds invest in this market since they are bound by their statutes to produce returns over 3.5%.
loans the retirement benefits of others? Here we find arguments about issues of (monetary) justice vs. what some others call “economics of the devil” \(^{22}\). All political initiatives die as soon as this argument is put forward. The reply to the legitimacy question seems to be this one. Indexation is detrimental to consumers interests (and 38.000 individuals have signed against it) but is beneficial for private pension right holders. If indexation has to go, a new pension system must be designed and implemented. The redistribution of wealth within a country is usually done through the public budget once a year, taking into account the resources available and the needs of citizens; not through financial institutions charging for extra cost of credit.

The legitimacy question needs to be resolved and discussed by the Parliament. Since this discussion has not yet taken place and political action and challenge to indexation by the consumer association HH does not deliver any results, the public turns to the judiciary to request a legality assessment of the practice in view of domestic and EEA legislation. As European consumer credit law has also regulated fairness, the judicial review will have to deal with that question as well.

4.2. The European/national judicial review: Legality and fairness tests

Does the practice of indexation in practice comply with national and European legal rules on ex-ante disclosure of information of consumer credit? This is a legality test. Does it comply with the minimum requirements of fairness set by the European legislator? This implies a fairness test. These are the two most important questions that the EFTA Court and the Supreme Court of Iceland must reply to on the basis of European legislation.

Regarding inflation and the indexation of financial obligations in Iceland up to 2013-2014, these are the three most important issues in European law: (i) the need to disclose ex-ante the total cost of credit to debtors (compliance with Directives 87/102 and later 2008/48 on consumer credit); (ii) the prohibition of unilateral unfair terms detrimental to consumer economic rights (compliance with Directive 93/13 on unfair terms and Directive 2005/29 on unfair commercial practices); and (iii) the partial nullity of the credit contracts for breach of due disclosure of obligatory information ex-ante to consumers unless indexation is qualified by national judges as mandatory legislation exempted from the scope of Directive 93/13\(^{23}\).

In its origin, the mechanism of price-indexation was designed to provide access to credit as previous hyper-inflation had resulted in a loss of earnings for a whole generation of savers. Indexation was first contemplated by Act No

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\(^{22}\) Recent research shows how several generations in Iceland, those born between 1970 and 1989, have no netto assets at all and are indebted up to ISK 82 billion. By contrast those born between 1915-19 and 1969, but specially those born between 1939 and 1959 have accumulated substantial assets. While it is normal that those starting in life have no patrimony and borrow from future income to finance their education and independent status, their financial situation puts them at a situation of distress. There is indeed a generational fracture there that cannot be denied by social science. Research done by Pálmason (2012) has not been published yet but can consulted at actuary.is/hagur/netto-eignir-og-skuldir-kynsloda/

\(^{23}\) According to the consumer association HH (www.heimilin.is) contrary to what legislation requires since the entry into force of European consumer credit law in Iceland, in 95% of cases financial institutions have not provided debtors with the obligatory information regarding their financial obligations ex-ante (i.e.: total cost of credit and annual percentage rate of charge through APRC). Sometimes inflation index is not even reflected in the payment plan, sometimes it is reflected as a 0% prediction. The legality of this practice is pending before the EFTA Court in case E-27/13.
71/1966 but the current indexation to the CPI (verðtrygging) was introduced by Act No 13/1979 (so called Ólafslög). Since then, it is allowed by the Act no 38/2001 on interest and price indexation and Regulation no 492 from the Central Bank of Iceland 24.

Accession to the EEA Agreement and the incorporation of European Union consumer law 25 changed formally the Icelandic legal landscape but it failed to ameliorate consumer’s rights in practice in spite of the incorporation of Directive on consumer credit 87/102 through Act no 121/1994 on consumer credit 26 and the incorporation of Directive 93/13 to Act no 7/36 on contracts 27. The need to incorporate the Consumer Credit Directive 2008/48/EC to the Icelandic legal order 28 opens the way for a parliamentary discussion and study on the legality of this practice which was known since 1993-1994 (Morgunblaðið, 1994). 29 A legislative review is undertaken while, at the same time, the EFTA Surveillance Authority (ESA) decides to start a case against Iceland before the EFTA Court for breach of EEA law (late implementation of the Consumer Credit Directive 2008/48/EC) where a condemning judgment follows. 30

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24 Central Bank of Iceland, Regulation No 492 of 21.06.2001. This regulation allows domestic price indexation of savings and loans provided it is based on the CPI as announced monthly by Statistics Iceland, according to provisions of Act No 38/2001 on interest and price indexation (Art 13 and 14) (see fn 1).

Art 14 reads: “Savings and loans may be price indexed in accordance with Article 13 if the basis of the price indexation is the consumer price index as calculated by Statistics Iceland in accordance with the laws applicable to the index and published monthly in the Legal Gazette. An index which is calculated and published in a specific month shall apply to the indexation of savings and loans for the following month. A loan agreement may, however, be based on a share price index, domestic or foreign, or a collection of such indices which do not measure changes to general price levels.”.

25 Art 72 European Economic Area (EEA) Agreement, Annex XIX deals with provisions on consumer protection, OJ 1994 L 1/3.

26 Art 12 Act No 121/1994 on consumer credit allows the indexation of the principal of the loan ex-post on condition that it is done following the disclosure and calculation rules of the Annual Percentage Rate of Charge (APRC) set by the Consumer Credit Directive 87/102/EEC, Act No 121/1994 available at eng.atvinnuvegaraduneyti.is/laws-and-regulations/commerce-and-trade-law/

Art 12 reads: “In the case of credit agreements containing clauses allowing indexation or variations in the rate of interest and the amount or level of other charges contained in the annual percentage rate of charge but unquantifiable at the time when it is calculated, the annual percentage rate of charge shall be calculated on the assumption that the price level, interest rate and other charges will remain unchanged until the end of the credit agreement.”.

27 Act 7/1996 on contracts, agency and void legal instruments available at http://eng.atvinnuvegaraduneyti.is/laws-and-regulations/nr/nr/7429

28 Consumer Credit Directive 2008/48/EC repealing Consumer Credit Directive 87/102/EEC was partially transposed by Icelandic Act No 121/1994 and recently amended by Act No 33/2013 of 27.03.2013. See Decision of the EEA Joint Committee No 16/2009 of 05.02.2009 amending Annex XIX (Consumer protection) to the EEA Agreement which incorporates Directive 2008/48/EC to the EEA legal order. See also Icelandic negotiating position on Chapter 28 of the EU accession screening process (consumer and health protection) at eu.mfa.is/negotiations/chapters/28/

29 In this regard it is worth noting that news from 6 October 1993 and 26 July 1994 published in the national newspaper Morgunblaðið reflect that Icelandic banks (public at that time) knew that house mortgages offered to consumers violated the provisions of European/national consumer credit legislation adopted in Iceland through the EEA Agreement. Breach of EEA law was suspected for reasons relating of lack of transparency in the calculation and disclosure of financial obligations. See Morgunblaðið (1993) (1994).

30 On 28 November 2012 the College of the EFTA Surveillance Authority (ESA) adopted a decision to bring the matter before the EFTA Court against Iceland in accordance with Art 31 of the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice (OJ L 344, 31.1.1994, p. 3; and EFTA States’ official gazettes) for failure to implement the Act referred to in Art 7 of the Agreement on the European Economic Area and Art 27 of the Act referred to at point 7h of Annex XIX to the Agreement on the European Economic Area (Directive on credit agreement for consumers 2008/48/EC) into its national law in due time and its failure to notify the Authority forthwith thereof. The EFTA Court condemned Iceland
For the purpose of assisting the Parliament with a legality assessment, the services of the European Commission and the EFTA Surveillance Authority (ESA) are requested for a legal opinion regarding the compliance of indexation with the new Consumer Credit Directive 2008/48/EC. These institutions diverge on whether or not price-indexation (which increases de facto the cost of money) falls into the scope of harmonization as “cost of credit” or not. The Commission thinks that, no matter its denomination or construction, Article 3 of Directive 2008/48 applies. Consumers must pay the amount of credit given (principal) and the total cost of credit announced (interest and other cost). In this construction, indexation would be cost of credit so it has to be calculated under the formula of annual effective rate of charge (APRC) and disclosed ex-ante. It also states very clearly that - when it is non-transparent - it does not escape control of abuse under Unfair Terms Directive 93/13/EEC applicable to mortgage contracts. The ESA, on the contrary, holds the opinion that price-indexation reflects domestic mandatory legislation and that indexation cost is some additional charge for money currently falling outside the scope of European harmonization. At any case, both institutions agree that transparency, disclosure and clarity of language for consumers are key factors. European obligations concerning disclosure ex-ante on the indexation effects on the contract cannot be set aside as consumers need to assess beforehand their capacity to take on financial obligations in order to give valid consent (main obligation under Directives 87/102 and 2008/48). Following these opinions, the Icelandic legislator as well as the Committee on Consumer Protection on Financial Markets (Prime Minister’s Office 2013, 7, 61) expressed their concerns about the potential illegality of the indexation practice (as it has been traditionally constructed) under European law. However, the legislative and executive powers concluded that the competence to clarify the legality of the practice falls upon the national courts (and eventually on the EFTA Court through the advisory opinion procedure). A process of judicial review on consumer debt and mortgage credit practices in Iceland on their compatibility with European law followed – after private cases were brought before the courts and is now under way.

The judicial challenges to the indexation of credit are not a surprise. The consumer association (HH) complains to the Ombudsman that Regulation No 492/2001 from the Central Bank of Iceland go beyond the scope of Art 13.1 of Act No 38/2001 as the law only allows indexation of principal and not of interest. The Central Bank disagrees. Following the action for infringement initiated by the ESA in a judgment of 15 May 2013, case E-12/12 (EFTA Surveillance Authority v. Iceland).

31 Council Directive 93/13/EEC of 05.04.1993 on unfair terms in consumer contracts, OJ 1993 L 95/29.
32 Act no 33/2013 on consumer credit entered into force on 1 November 2013. It is available at http://www.althingi.is/lagas/143a/2013033.html
33 This is similar to the judicial collaboration set by the Court of Justice of the European Union through the preliminary rulings procedure. See the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice (Surveillance and Court Agreement) (main part) at http://www.eftacourt.int/the-court/jurisdiction-organisation/surveillance-and-court-agreement/ and Statute of the EFTA Court and guidance for national courts at http://www.eftacourt.int/the-court/procedure/advisory-opinion-requests/
34 Formal letter from consumer association HH to the Ombudsman of the Parliament on 23 May 2011 requesting a clarification of the legal basis to index the principal of the loans to the CPI (case 6460/2011). According to the consumer association the Icelandic legislation would allow the indexation of the payments but not the indexation of the principal. The Act no. 38/2001 on Interest and Price Indexation in its Articles 13-15 only covers obligations where it is agreed or stipulated that the payments should be indexed. In their view, nowhere in the Act is stated or assumed that the principal, the total outstanding debt or total cost of borrowing would
Ombudsman concludes in June 2013 that the indexation of principal has a proper legal basis and that the interpretation of the rules of the Central Bank do not violate the legislative framework. Together with a clarification of the legal basis for price-indexation of the principal of loans, some pilot-test cases are brought to the courts. The first one is a claim by the consumer association HH against the public House Financing Fund HFF (Íbúðalínasjóður) presented before the District Court of Reykjavik on the 18 October 2012 regarding the indexation on a mortgage loan. The claim is based primarily on the Act on consumer credit (Act No 121/1994), which incorporates Directive 87/102 on consumer credit and expressly requires that comprehensive information on the total cost of the credit shall be available at the signing of loan agreements, according to conditions at the time the contract is signed. The complainants also refer to Unfair Terms Directive 93/13/EC prohibiting unfair terms in consumer contracts connecting it with requirements of transparency and disclosure of financial obligations. Act No 121/94 on consumer credit is applicable to mortgage credit since 2000 which has been replaced by Act 33/2013 on consumer credit entered into force on 1 November 2013. Directive 93/13 on the other hand has been implemented through Icelandic contract law (Act No 7/1936 on contracts as amended).

be linked to the consumer price index as the legal basis for indexation is only explicit for the indexation of payments. The Central Bank, however, claims that its regulation has a long tradition due to historic reasons and an indirect legal basis, since both methods give the same end result.

35 Reply Central Bank of Iceland of 30 August 2011 to the request of information by the Ombudsman of the Parliament of 14 July 2011 in case 6460/2011. See explanations given by Central Bank at sedlabanki.is/lisalib/getfile.aspx?itemid=8964 and Regulation No 492 of Central Bank of Iceland on Price Indexation of Savings and loans adopted on 21 June 2001 at cb.is/uploads/files/13.%20Price%20Indexation%20of%20Savings%20and%20Loans.pdf

36 See reply from the Ombudsman (case 6460/2011) at umbodsmadur.is/ViewCase.aspx?Key=2294&skoda=reifun

37 The legal basis of the case brought before the Court of Reykjavik on 18 October 2012 is Act No 121/1994 on consumer credit as reformed with Act No 179/2000 which extended protection for consumers originating in Consumer Credit Directive 87/102/EC to all credit, with no limitations of scope (thus covering mortgages).

38 Based on an example of a loan which breaches these provisions, the consumer association SH constructs the legal arguments in Icelandic law. The alleged lack of due disclosure of financial obligations under Act No 121/1994 on consumer loans (also applicable to companies) sounds very familiar to experts in European consumer credit law since domestic legislation has been based on Consumer Credit Directive 87/102/EC until 1 November 2013. These are the provisions of Act No 121/94 on consumer credit which are relevant. Art 6 says that, on concluding a credit agreement the creditor shall provide the consumer with all financial information beforehand. Art 6.2 obliges to inform the borrower about price indexation (verðtrygging) and method of calculation (ie: how this item will affect financial obligations and how much it will increase overall borrowing costs). This is especially important concerning principal, rate of interest, annual percentage rate of charge and total amount which must be repaid. The annual percentage rate of charge (APRC) has to be calculated according to Art 10 to 12 of the same act. Article 11 states that the APRC shall be calculated when the credit agreement is concluded. Sanction for not providing obligatory financial information is in Art 15. Creditors can be liable for compensation as the consumer has been led to believe that the credit terms were more favorable than later turned out. Financial institutions, on the other hand, claim that their method of calculation is legal under Art 12 of the same legislation. Act No 121/94 on consumer credit eng.idnadarraduneyti.is/laws-and-regulations/nr/1137.

39 Some years ago the HFF introduced a disclaimer for all mortgage calculators used at its internet site in order to prevent future litigation on the obligation of the creditor to provide due information on the total cost of credit according to the right formula of APRC (Directive on consumer credit 87/102/EC later modified by Directive on credit agreements for consumers 48/2008/EC).

40 Art No 7/1936 on contracts, agency and void legal instruments available at eng.efnahagsraduneyti.is/laws-and-regulations/nr/7429. Art 36 establishes that a contract may be set aside, in full or in part, or amended if it would be considered unfair or contrary to good business practices to invoke the contract, [subject, however, to Art 36(c)]. The same applies to other legal obligations. Any such assessment shall take account of the substance of the contract, the position of the parties to the contract, the circumstances of the making of the contract and subsequent circumstances. Art 36 lit b further states that written
The issue of unfair commercial practices is also relevant in the light of Art 8.1. of Act No 57/2005 on Supervision of Unfair Commercial Practices and Transparency of the Market which incorporates Directive 2005/29/E)\(^{41}\). The defendant in this case is the State since the HFF is a public institution. The first judicial process advances, however, very slowly due to the opposition strategy led by the defendant HFF based on formal grounds. In September 2014 the case is still pending before the District Court of Reykjavík after a first round of formal issues has been litigated and ended up with a ruling of the Supreme Court.

Another case is started by a couple against the HFF based on a similar loan contract and for similar reasons on the basis of Consumer Credit Act No. 121/1994. In this second case, some other issues are being tested: compatibility of Icelandic legislation on interest and indexation with the MiFiD Directive\(^ {42}\) (protection of private investors in financial markets) (Prime Minister’s Office 2013, 61). This other case is pending.

But two other cases started in the autumn 2013 will be the most decisive to clarify the legality of CPI-indexation under European law and national law. They make it to the EFTA Court and are even followed by local and international news (Bloomberg 2013). The first is case E-25/13 where an advisory opinion has been issued on 28 August 2014\(^ {43}\). The questions referred ask essentially whether or not the bank *Íslandsbanki* broke European law when it sold an indexed mortgage to his client. The private party argues that the way inflation-linked loans are constructed and sold in Iceland clashes with European Economic Area laws banning unfair terms in consumer contracts (Unfair Terms Directive 93/13).

In its ruling, the EFTA Court basically refers all substantive questions on the fairness test to the national courts. The judges do not rule on the legality under Directive 87/102 which is a key question as this is the Directive which obliges to provide exact information on the cost of credit ex-ante. This issue is pending but will be clarified in case E-27/13. As for the fairness assessment under Directives 93/13/EC and 2005/29/EC on abusive clauses and commercial practices the EFTA Court provides an interpretation of the European acquis but leaves the final say to the Supreme Court of Iceland. It must determine whether indexation practices constitute or not mandatory/regulatory law falling under the scope of the Directive as a private practice BtoC (Businessstoconsumers). The Supreme Court must also determine whether indexation clauses are abusive standard terms on a case by case basis in view of all circumstances at hand. Although the EFTA Court clarifies that indexation is not directly prohibited as unfair term by the Directive, it offers some guidance. European law obliges to requirements of transparency and previous information to consumer on future financial obligations and to a explicit description of the method of calculation. The credit contract must

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\(^{41}\) Act No 57/2005 on Supervision of Unfair Commercial Practices and Transparency of the Market incorporates to the domestic legal order the European Directive 2005/29/EC of 11.05.2005 concerning unfair business-to-consumer commercial practices in the internal market, OJ 2005 L 149/22. Icelandic legislation is available in English at eng.innanrikisraduneyti.is/laws-and-regulations/english/consumers/nr/68188.

\(^{42}\) Directive 2004/39/EC of the European Parliament and of the Council of 21.04.2004 on markets in financial instruments OJ L 145 of 30.4.2004.

\(^{43}\) EFTA Court, judgment of 28 August 2014, case E-25/13 *Gunnar V. Engilbertsson v Íslandsbanki hf*, accessible at http://www.eftacourt.int/uploads/tx_nvcases/25_13_Judgment_EN.pdf. See especially para. 140-147.
explain the content of the indexation technique, that is to say how indexation will affect the principal of the loan. The plan of payment must reflect as much as possible the role of indexation. If the requirement of transparency and previous explicit information has not been complied to, it follows per se that indexation is to be considered unfair and judges have no other choice than to declare it non-binding according to Directive 93/13.

After this seminal case, the EFTA Court must also reply to the questions sent by the district court of Reykjavík on 31 October 2013 on a non-secured credit adding the Directive 87/102 to its reply. This is case E-27/2013. The main question to be clarified is whether a contract where inflation is neglected in the plan of payment (as 0%) complies with the requirements of European law. As the domestic judge puts it, the unfair terms Directive 93/13/EEC is only a piece of the European puzzle of consumer protection acquis. It is essential to connect the question to the need of clear, transparent (and comparable) information on financial obligations before the signature of the contract (Consumer Credit Directives 87/102 and 48/2008). The legality and fairness assessment still pending before the EFTA Court should be interpreted taking into account all consumer credit law deriving from the EEA Agreement (and this includes the most recent case-law from the Court of Justice of the European Union on credit).

4.3. A critical question pending: can the Icelandic financial system be ever reconciled with the (European) rule of law and democratic demands?

There is an obvious demand for justice and judicial solutions to the problem of credit indexation in Iceland. In spite of the silence that reigned until 2014 at the national courts on the application of European/domestic consumer legislation; many private parties have chosen a litigation path to invoke their rights under national consumer contract law (Art 36 and Art 36 a-d) and EEA law. Can indexation be reconciled with the European rule of law? Here is argued that its possible, provided that some important questions are clarified by the courts.

The rule of law implies compliance with the EU/EEA consumer acquis in the first place. This means legislative homogeneity but also similar application and enforcement of EU and EEA legal rules (similar outcomes through different national procedural remedies)(Méndez-Pinedo 2009). Private individuals, and consumer organizations working in this area complained to the European Commission, European Parliament and ESA in April 2011 on the deficit of consumer credit/mortgage protection in Iceland under the EEA/EU legal orders. In their opinion, governmental agencies that should protect/support consumers (Consumer Agency and Financial Supervision Authority) lack the national necessary enforcement powers and trinational courts (specially the Supreme Court with only one exception to this general rule) opt to by-pass consumer protection legislation in their rulings anchoring them to contract law (which produces effects both for private individuals and companies). Attempts by private individuals

44 EFTA Court, pending case E-27/13 Sævar Jón Gunnarsson v Landsbankinn hf. http://www.eftacourt.int/cases/detail/?tx_nvcases_pi1[case_id]=209&cHash=76c781a67c74097e647ae26edf927ce5
45 Ibid. The question is framed as it follows: “Is it compatible with the provisions of Council Directive 87/102/EEC on consumer credit, as amended by Directive 90/88/EEC and Directive 98/7/EC, that when a credit agreement is made, which is linked to the consumer price index in accordance with an authorisation in enacted legislation, and the sum loaned therefore changes in accordance with inflation, the calculation of the total cost of the credit, and of the annual percentage rate of charge, which is shown to the consumer when the agreement is made, is based on 0% inflation, and not on the known rate of inflation on the date when the loan is taken?”
to send important legal questions to the EFTA Court (by way of preliminary reference) were denied by the judges or the Supreme Court until October 2013. This judicial approach was taken despite the fact that ECJ has on numerous occasion ruled that national courts should on own initiative address consumer protection in national proceedings\textsuperscript{46}, a case-law indirectly applicable to the EEA legal order through the principle of judicial homogeneity which must guarantee similar rights for EU and EEA citizens and economic operators. They have also complained that consumer protection has not been important enough for the Icelandic legislator which has opted by either delaying the implementation of essential European Directives containing clauses on consumer protection or protecting consumers insufficiently (weak institutional supervisory system).

This criticism expressed to the European institutions appears well grounded. The research done independently for the Government by a group of experts in 2013 confirms -sometimes implicitly sometimes very explicitly- this finding (Prime Minister’s Office 2013, 102)\textsuperscript{47}. On top of that, a proper consumer credit legal framework appears far away since Iceland still lacks a system of administrative supervision required by the Unfair Terms Directive 93/13 (Prime Minister’s Office 2013, 58, 69) and has not implemented either the Injunctions Directive 2009/22\textsuperscript{48}.

In the second place, compliance with EU/EEA law also means judicial homogeneity between the EFTA Court and the CJEU and a constructive judicial dialogue before European and national judges for the protection of similar individual rights (Méndez-Pinedo and Hannesson, 2013). No European case litigated before the EFTA or CJEU so far has had a direct impact on the national legal framework (Prime Minister’s Office 2013, 63-69)\textsuperscript{49}. Although consumer association HH has invoked publicly the need to take into account the \textit{Aziz} ruling from the CJEU, this judgment has not had a direct influence yet on national legislation\textsuperscript{50}. Other important rulings from the European court are also kept at distance while the relevance of the rulings is of outmost importance for those following the process.

\textsuperscript{46} CJEU, judgment of 14 June 2012 case C-618/10 (Banco Español de Crédito) OJ 2012 C 227/5.

\textsuperscript{47} The Committee criticizes the lack of judgments of the Icelandic courts on the basis of consumer law on the basis of a historic preference for the rule \textit{pacta sunt servanda} and the freedom and autonomy of the parties in private law. The conclusions of their report do not fare well when compared to other Scandinavian countries and the situation of consumers is aggravated by the high cost of credit in the country, both interest and CPI-indexed explained (but not justified) by a micro-currency and high inflation. To remedy this situation the Committee proposes the adoption of a general law on consumer protection as well as a public policy ad hoc in the area of consumer protection in the financial markets. The Committee, however, presents no proposals on monetary and economic policy to fight against these systemic/endemic Icelandic problems.

\textsuperscript{48} EFTA COURT (pending case E-15/13) Action brought on 9 July 2013 by the ESA against Iceland for non-implementation of Directive 2009/22/EC of the European Parliament and of the Council of 23 April 2009 on injunctions for the protection of consumers’ interests, OJ 2009 L 110/30.

\textsuperscript{49} This report states that national courts do not follow EU/EEA consumer law. For instance, in the case E-7206/2009 before the district court of Reykjavik, a consumer from Akureyri (in the North) was forced to litigate in Reykjavik (the Southwest) for a question of consumer credit. This was required without regards to the previous case \textit{Océano} from the CJEU where a similar procedural requirement was struck down in Spain as an obstacle of access to justice in connection with the assessment of unfairness required by the Unfair Terms Directive 93/13/EEC. See CJEU, judgment of 27 June 2000 joined cases C-240/98 to C-244/98 (\textit{Océano Grupo}) ECR 2000 I- 04941.

\textsuperscript{50} CJEU judgment of 14 March 2013 case C-415/11 (Aziz). OJ 2013 L 141/5 is not even mentioned on the Report on Consumer Protection in Financial Markets (Prime Minister’s Office, 2013, 63-69) when summarizing the case-law of the CJEU. This is probably due to the fact that the final judgment was adopted when the Committee had finalized drafting its report. However, there is no mention either to the Opinion Advocate General \textit{Kokott} in the case \textit{Aziz} which is given on 8 November 2012.
What are the most important issues pending before the courts? The questions of legality and fairness. Fairness is mostly regulated by Unfair Terms Directive 93/13 and Commercial Practices Directive 2005/29 and it is implicit in Directive 87/102 and Directive 2008/48 that establish conditions of legality for consumer credit (calculation and disclosure of information on cost of credit ex-ante).

It is a fact in Iceland that indexation of capital is unbalanced towards creditors who are the only parties secured against inflation. Banks and financial institutions, on the other side, are entities responsible for inflation by issuing money/debt (secondary money supply). This lack of balance detrimental to consumers raises doubts in the light of the definition of abusive clauses used by the European legislator. Taking this into account, the first fundamental issue is whether indexation (Act No 38/2001) qualifies as mandatory law since Directive 93/13 exempts mandatory law from its scope. Some questions are essential: what are the limits of legislative power under Recital 24 Unfair Terms Directive 93/13 which exonerates mandatory law from its scope on the assumption that national legislators will assure a good level of consumer protection under EU Treaties/EEA Agreement? When can this presumption “de iure” be falsified “de facto”? Can a legislator authorize the use of potential abusive clauses in detriment of consumers? Under which conditions? In which circumstances?

Financial institutions have the obligation to inform the consumer of the total cost of credit through the APCR formula required by both Consumer Credit Directives 87/102 and 48/2008 (in force in Iceland since 1 January 1994 and 1 November 2013 respectively). In this regard, we find the interplay of Directives 87/102 (48/2008) and Unfair Terms Directive 93/13/EEC and another second set of important questions: What are the limits of transparency in relation with abusive clauses? Can clear and transparent information given ex-ante justify later abusive practices escaping the control of Unfair Terms Directive 93/13 (ie. extreme cost of money or anatocism)? Can transparency alone legitimize indexation and price variation clauses after the contract has been signed?

It is important to remember here the general ethic of consumer protection since the debtor cannot assess in advance the effect of inflation upon the contract nor assess the justification of price increases after its entry into force on the basis of a clear formula. Directives 87/102 and 48/2008 are based on the “information is protection” paradigm where a fully informed consumer gives a binding consent to a contract with financial obligations and can compare offers from different potential creditors. In this framework it is essential to disclose the total cost of credit in the way prescribed (in advance, using common definition, a certain European standard form and following the methodology of Annual Percentage Change of Rate (APCR)).

The scope of European harmonization on the cost of (consumer) credit will be a fundamental key to answer some of the questions. For a legality assessment in European law, it is essential to determine under Directives 87/102 and 48/2008 whether indexation falls under the scope of the term “total cost of credit” or can escape this scope as “other charges” of credit. At any case, whether it is cost or charge, requirements on transparency are still in force.

In a legal opinion disclosed to the Icelandic Parliament (2012-2013), this author argued that position pointing to other issues that also need a reply: how to secure a proactive role of the national judges in the assessment of abusive
clauses even though the private parties have not raised the argument, the consequences of potential illegality when transparency is not respected in the contract under domestic and European law, the question whether a public institution such as the HFF falls under the scope of the Unfair Terms Directive 93/13 and the UCPD 2005/29, the influence of new EU Directive on mortgage credit\textsuperscript{51}; and, last but not least, the consequences of the interpretation of national contract law in the light of European consumer credit law when the legislator has extended the scope of Directives on consumer credit to mortgage loans as it is the case in Iceland\textsuperscript{52}.

It was argued to the Icelandic Parliament that price-indexation is cost of credit falling under the scope of European harmonization. Furthermore, the claim was put forward that indexation clauses which are not transparent and disclosed in a plain and intelligible language are potential abusive clauses in European law (on the basis of case-law from the CJEU\textsuperscript{53}). If the method to calculate price increases in a credit contract is not disclosed ex-ante and is not transparent, the fairness control applies under Directive 93/13 (both for consumer credit and mortgage credit) (Rott, 2013)\textsuperscript{54}. This is because Iceland has incorporated Directives 87/102 and 93/13 since 1 January 1994. It has extended European rules of consumer credit protection to mortgages since the year 2000. Iceland is therefore obliged by EEA law to provide similar rights to citizens. Its legal order must be consistent with the case-law of the CJEU and this means a European interpretation of the legal provisions\textsuperscript{55}.

Taking into account Directives 87/102 and 93/13 together, as the case \textit{RWE} shows, a European assessment could conclude with the following thesis\textsuperscript{56}. Even for price variations based on legal provisions (such as gas supply contracts and/or indexation) and offered by public institutions (such as the HFF) there is a European test of fairness to pass.

\textsuperscript{51} Although the EU has adopted a new Directive on mortgage credit for residential property which is based on a similar paradigm of protection, this act needs to be incorporated to the EEA legal order by a decision of the EEA Joint Committee and later adopted by the Icelandic Parliament. Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010 Text with EEA relevance OJ L 60, 28.2.2014.

\textsuperscript{52} For a summary of some other relevant cases from the CJEU and arguments still pending in Iceland for clarification see (Prime Minister’s Office, 2013, 63-69).

\textsuperscript{53} CJEU judgment of 16 November 2010 case C-76/10 (Pohotovost) para 77 ECR 2010 I-11557 OJ 2011 C 30/12 in connection with judgment of 21 March 2013 in case C-92/11 (RWE), nyr. OJ 2013 C 156/3. The Court concludes in Pohotovost that, notwithstanding Directive on unfair terms in consumer contracts 93/13/EC and national courts powers, the failure to mention the APR in a contract is a breach of Directive on consumer credit 87/102/EC that triggers sanctions under national applicable law. In the case RWE it deals with the lack of transparency of price variation clauses allowed by national legislation in the gas sector. In the case RWE the Court states: Para 47 “A standard term which allows such a unilateral adjustment of price must, however, meet the requirements of good faith, balance and transparency laid down by those Directives”. Para 49 “... the contract (must) set out in transparent fashion the reason for and method of the variation of the charges for the service to be provided, so that the consumer can foresee, on the basis of clear, intelligible criteria, the alterations that may be made to those charges ...” This task is for national courts to assess.

\textsuperscript{54} Commenting on the case RWE on gas supply and price variation clauses, it is important to note the meaning of transparency for Rott, “The transparency requirement shall prevent suppliers from formulating the clause in an unclear manner so as to be able to abuse their discretion stemming from the uncertainty in order to change the equivalence of performance and price. Transparency requires, according to established case law of the BGH, that the customer is able to understand the extent of forthcoming price increases from the applied formula and that he can himself control the justification of price increases on the basis of the formula in question. […] Applying this test, the courts have, for example, dismissed price variation formulas that referred to a price that is applied by the supplier’s supplier without being explained since that price cannot be controlled in any way by the end customer” (Rott, 2013).

\textsuperscript{55} CJEU, judgment of 12 July 2012 Case C-602/10 (SC Volksbank România). OJ 2012 C 287/6.

\textsuperscript{56} CJEU, judgment of 21 March 2013 in case C-92/11 (RIFE), nyr. See para 39 and 55.
Good faith, balance and transparency are essential principles for the Court of Justice of the EU and so must be for the EFTA Court. Price alterations must be based on objective criteria and their correct calculation must be comprehensible and subject of control by the consumers, both in private and public law. The consequences of the invalidity of indexation due to lack of transparency under European law are already clear for the CJEU. A judicial declaration that no price variation right existed with retroactive effects *ex tunc*\(^57\) should follow as national courts cannot revise the content of invalid clauses\(^58\).

At any case, both the answers given by the European Commission and the ESA and the first ruling from the EFTA Court confirm several points. To the question: can EU/EEA Member States introduce by law permissions for creditors to do unilateral changes to the principal borrowed and to the borrowing cost of capital (through price-indexation)? All institutions reply in the affirmative but limit the validity of the technique to the strict respect of the legal framework (obligations) set by European law. The EFTA Court will have to take a position regarding these issues in a second ruling expected before the end of 2014 but the final assessment and review of indexation seems to fall on the national courts.

If the European and national courts clarify well all legal issues, the resolution of the critical question pending: can the Icelandic financial system be reconciled democratic demands? will be easier. The rulings will pave the way for future legal/political action (ie. put an end on indexation, design a new access to housing and pension systems policies) and satisfy the demands from the debtors. However, before indexation is abolished, a plan B must be set in action so that the pension system and the HFF do not face real bankruptcy.

5. Conclusions

Indexation of credit in Iceland is no longer a secret kept away from international and European scrutiny. Following the doubts of Icelandic legislator confirmed by a preliminary assessment done by the European Commission and the ESA, different questions on indexation are now before the courts. A ruling from the EFTA Court delivered on 28 August 2014 has broken the spell and some important questions must be replied by the Supreme Court of Iceland. Other cases pending before district courts also challenge the legality of some contracts in the light of Directives 87/102 on consumer credit and 93/13 on unfair terms (and eventually Directive 2005/29 on unfair commercial practices). Last but not least, a new ruling from the EFTA Court on a second case will help to clarify difficult pending issues.

The working hypothesis exposed in this paper is proved. Traditional practices of indexation of student, consumer and mortgage credit where the cost of inflation is set aside ex-ante or is hidden behind an opaque veil of complexity seem highly problematic in the light of European consumer credit law. The incorporation of Directive 2008/48 to the domestic system (Act No 33/2013 in force since 1 November 2013) showed how difficult is to make this practice fit into the European legal framework. Compliance with clear information disclosure obligations ex-ante on total amount

\(^{57}\) In the case RIFE all past bills had to be recalculated (but statute of limitations limited this obligation to last 3 years). CJEU judgment of 21 March 2013 in case C-92/11 (RIFE), nyr. Para 64.

\(^{58}\) CJEU, judgment of 14 June 2012 case C-618/10 (Banco Español de Crédito), nyr. Para 73.
of credit given and total cost of credit is mandatory (APRC rules). In this sense, it remains to be seen whether indexation of credit – as practiced by financial institutions with a disclosure of 0% inflation/cost in the loan contract - can survive that European test. The fact that most important cases are still pending before the Supreme Court does not limit the research question but signals the need for further analysis on pending questions of European law in relation to consumer/mortgage credit.

There is a critical battle being fought at the courts between consumers/association HH and financial institutions (including public HFF). While the judicial review looks mainly to the past and focuses on concrete individual cases, consequences will arise for the present and the future. The institutional-systemic implications of a negative assessment by the judges on the compatibility of indexation of credit with EEA law are great. Lack of transparency in signed contracts might lead to the partial invalidity of thousands of credit agreements, the recalculation of loans with retroactive effects and to the eventual prohibition or cap of indexation in the future for abuse and unfairness. No matter how the Courts rule, a political decision or legal act determining the future of indexation (erga-omnes effects of the judicial rulings) will become unavoidable before the end of legislative term.

Iceland is navigating difficult waters. While the legality of thousands of credit contracts in Iceland will be tested – at least indirectly - against European law, a victory of consumer credit and mortgage law – if given retroactive effects - might prove both a victory (for debtors) and a defeat for tax-payers (as HFF is a public institution). The same applies to the new debt-relief plan for debtors with indexed loans implemented in 2014 by the authorities. The plan which must reduce the principal of indexed mortgage debt for more than 100.00 individuals now living in more than 61 countries seems like a provisional victory for the Prime Minister and his party (Framsóknaflokkur) but it can turn into a political defeat if indexation is not abolished as promised.

Structural changes to the economic, monetary, financial, credit and housing policies are needed. Icelandic new debt relief program, even if fiscally neutral, will only be temporary help as long as indexation to inflation is in force creating a vicious circle. The debt-mitigation and debt-restructuring programs carried in Iceland during 2009-2012, as well as this new plan 2013-2014, have avoided to tackle the real cause of the problem. Indexation embedded into credit contracts should end if the problem of over-indebtedness is to be ever solved in Iceland. On the other hand, it is idealistic to think that judicial review alone – even with the support of the EFTA Court – will bring new access-to-housing, credit and private pension policies based on a sound sustainable and non-inflationary monetary policy anchored by good economic governance that Iceland needs. That is a task for the legislator and for the executive as well as the Central Bank, creditors and debtors all alike. Price-indexation only reflects some important underlying problems: the failure of the fight against inflation since 35 years ago, the lack of a good policy on responsible lending/borrowing, the dependence of the private pension funds and pension rights on the indexation of mortgage; and the constraints in a global context of a micro-currency now protected with restrictions on movement of capital only temporarily allowed under EU/EEA law. All these points show the need of radical structural reforms.

The situation in Iceland on the problem of indexation reflects a classical tension between legitimacy, legality and fairness; a tension that must be solved. The task to reconcile these three dimensions will fall upon the Parliament on
the basis of the judicial review. All private interests at stake must be balanced and reoriented to secure a public common good, a better model of economic growth where the redistribution of wealth on the basis of solidarity is not structured by financial institutions on the basis of credit on one side and anchored by private pension schemes on the other. A new approach must be adopted and a new legal framework adopted where tax and budgetary issues will play a key role. This simply means that the end of indexation is both possible and impossible, we simply do not know. In this regard, let’s hope Icelanders are not waiting for Godot, a character from Samuel Beckett’s play that will never show in the now classical Theatre of the Absurd.

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Annex I: “The Incredible Loan Machine”

A Model of Icelandic Consumer Loan Repayment Structures

Provided by Hagsmunasamtök heimilanna (The Homes Association) of Iceland

Specification of the example shown:

Loan to value: 80% of ISK 25.000.000
Loan principal: ISK 20.000.000
Stamp duty: 1,5% = 300.000
Borrowing fee: 1,0% = 200.000
Paperwork cost: ISK 2.800
Cash disbursment: ISK 19.497.200
Borrowing date: 01/04/2013
First payment: 01/05/2013
Loan term: 40 years
Instalments: 480
Invoice fee: ISK 120

Fixed interest rate: 4,10%
Base CPI: 409,9 points
Prevalent 12m inflation rate: 4,83%
Historical inflation average: 5,84%

Nominal rate loans shown for comparison reflect the method of disclosure as practiced by lenders until entry into force of act 33/2013 (effectively excluding the cost of the indexation component)
### Cost of credit calculation

| Loan type: | Indexed annuitet | Indexed proportional * | Nominal annuitet ** | Nominal proportional |
|------------|------------------|------------------------|---------------------|----------------------|
| Color:     | red              | orange                 | light blue          | dark blue            |
| Total repayment | kr. 121.229.116 | 93.956.277            | 40.778.760          | 36.491.723          |
| Repayment ratio | % 606,15%    | 469,78%               | 203,89%            | 182,46%             |
| Total credit cost | kr. 101.731.916 | 74.459.077            | 21.281.560          | 16.994.523          |
| Total cost ratio | % 521,78%   | 381,90%               | 109,15%            | 87,16%              |
| Annual Percentage Rate | APRC 9,41% | 9,45%                 | 4,37%              | 4,41%               |

* Proportional = payments proportional to remaining principal, plus interest

** Nominal = nominal amounts, excluding indexation cost components (significant part of total cost)

-- Note: before act 33/2013, lenders have in most cases omitted indexation when providing loan price information