

Íbúðalánasjóður
Housing Financing Fund
Annual Accounts 2006
ISK

Íbúðalánasjóður
Housing Financing Fund
Borgartúni 21
105 Reykjavík

Reg. no. 661198-3629

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Endorsement by the Board of Directors and the Managing Director

The Annual Accounts have been prepared in accordance with the Annual Accounts Act and the Regulation on the Presentation and Contents of the Annual Accounts of Commercial Banks, Savings Banks and Other Financial Institutions. It is based on cost accounting and is prepared according to the same accounting principles as for the previous year. According to the Profit and Loss Account the net profit of the Fund amounted to ISK 2,480 million for the year, compared to ISK 1,154 for the year 2005. Net interest income amounted to ISK 3,223 million for the year, compared to ISK 1,558 million for the year 2005.

Equity, according to the Balance Sheet, amounted to ISK 16,375 million at the end of the year, or 3.0% of the Fund's total assets. The capital ratio of the Fund, calculated according to stipulations in the Rules on The Housing Financing Fund no. 544/2006, was 6.3%. The calculation of the ratio is equivalent to the calculation of the capital ratio of financial institutions. The long-term goal of the Fund is to keep the ratio above 5.0%.

Loans amounted to ISK 406,115 million at the end of the year, an increase of ISK 29,159 million during the year. Amounts due from credit institutions and market securities increased by ISK 17,990 million during the year. Borrowings amounted to ISK 525,291 million, an increase of ISK 44,907 million during the year.

The Board of Directors and the Managing Director of the Housing Financing Fund hereby confirm the Fund's Annual Accounts for the year 2006 by means of their signatures.

Reykjavik, February 22, 2007.

Board of Directors:

Hákon Hákonarson

Gunnar S. Björnsson

Elín R. Líndal

Kristján Pálsson

Jóhann Ársællsson

Managing Director:

Guðmundur Bjarnason

Independent Auditor's Report

To the Board of Directors of the Housing Financing Fund.

Report on the Financial Statements

We have audited the accompanying financial statements of the Housing Financing Fund, which comprise the balance sheet as at December 31, 2006, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with generally accepted accounting principles in Iceland. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the law and generally accepted accounting principles in Iceland. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements give a true and fair view of the financial position of the Housing Financing Fund as of December 31, 2006, and of its financial performance and its cash flows for the year then ended in accordance with the law and generally accepted accounting principles in Iceland.

Reykjavík, February 22, 2007.

KPMG hf.

Helgi F. Arnarson

Profit and Loss Account 2006

	Notes	2006	2005
Financial Income:			
Interest from credit institutions		10,397,979	5,847,034
Interest on loans		42,587,886	31,115,148
Interest on bonds		2,220,396	1,557,148
Other interest income		778,447	63,046
	3	55,984,708	38,582,376
Financial Expenses:			
Interest on borrowings	3,14	53,006,254	37,205,925
Financial income – Financial expenses		2,978,454	1,376,451
Government contribution to subsidy interests		245,009	182,000
Net interest income		3,223,463	1,558,451
Other Operating Income:			
Income from service charges	4,15	680,391	946,753
Expenses in respect of commissions and other service charges		(21,744)	(63,525)
Exchange rate difference		(18,375)	8,126
		640,272	891,354
Net operating income		3,863,735	2,449,805
Other Operating Expenses:			
Salaries and salary-related expenses	16	353,971	325,300
Other administrative expenses	20	481,230	528,299
Depreciation	25	24,836	23,513
Other operating expenses	21	25,797	24,820
		885,834	901,932
Provisions for losses on the loan portfolio	24	(497,752)	(394,159)
Net Profit for the Year	30	2,480,149	1,153,714

Balance Sheet

Assets

	Notes	2006	2005
Amounts Due From Credit Institutions:			
Deposits with the Central Bank		0	84,226
Amounts due from other credit institutions		99,029,788	94,672,388
	22	99,029,788	94,756,614
Loans:			
Loans to customers	23-24	405,721,030	376,844,198
Mortgages foreclosed		394,292	111,752
	5-7	406,115,322	376,955,950
Market Securities	8	36,411,442	22,694,738
Other Assets:			
Fixed assets	9,25	115,409	117,713
Other assets		28,579	38,725
Accrued income		86,796	23,718
		230,784	180,156
Total Assets		541,787,336	494,587,458

December 31, 2006

Liabilities and Equity

	Notes	2006	2005
Borrowings:			
Securities, issue	29	515,062,428	471,107,642
Other borrowings		10,228,445	9,276,146
	28	525,290,873	480,383,788
Other Liabilities		121,899	309,256
Equity:			
Contributed capital		7,155,408	7,155,408
Retained earnings		9,219,156	6,739,006
	30,31	16,374,564	13,894,414
Total Liabilities and Equity		541,787,336	494,587,458

Not Included in the Balance Sheet:

Obligations	32
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Statement of Cash Flows 2006

	Notes	2006	2005
Cash Flows from Operating Activities:			
Net profit for the year		2,480,149	1,153,714
Difference between net profit and cash from operations:			
Indexation on amounts due from credit institutions, loans to customers and borrowings		1,058,322	404,647
Exchange rate difference		18,375 (	71,172)
Depreciation of fixed assets		24,836	23,514
Provision for losses on the loan portfolio		497,752	394,159
Changes in assets and liabilities .....	(	63,077)	350,515
Net cash provided by operating activities		4,016,357	2,255,377
Cash Flows from Investing Activities:			
Amounts due from credit institutions, changes .....	(	4,884,280)	(61,089,713)
Loans, changes .....	(	2,572,690)	73,236,282
Market securities, changes .....	(	7,126,788)	(3,599,211)
Fixed assets, changes .....	(	22,532)	(45,902)
Other assets, changes		10,146 (	30,869)
Net cash (used in) provided by investing activities	(	14,596,144)	8,470,587
Cash Flows from Financing Activities:			
Borrowings, changes		10,156,037 (	24,257,796)
Other liabilities, changes .....	(	187,356)	121,212
Net cash provided by (used in) financing activities		9,968,681 (	24,136,584)
Decrease in Cash and Cash equivalents .....	(	611,106)	(13,410,620)
Cash and Cash Equivalents at the Beginning of the Year		1,434,715	14,845,335
Cash and Cash Equivalents at the End of the Year		823,609	1,434,715

Notes to the Annual Accounts

Summary of Accounting Principles

Basis of Preparation

1. The Annual Accounts have been prepared in accordance with the Annual Accounts Act and the Regulation on the Presentation and Contents of the Annual Accounts of Commercial Banks, Savings Banks and Other Financial Institutions. It is based on cost accounting and is prepared according to the same accounting principles as for the previous year. The Annual Accounts are prepared in Icelandic currency and amounts are presented in thousands of Icelandic kronas.

Foreign Currency

2. Assets and liabilities in foreign currency are translated to Icelandic currency at the year-end 2006 exchange rate. Operational revenue and expenses in foreign currency are converted at the exchange rate of the date of transaction.

Interest Income and Expenses

3. Interest income and interest expenses are entered into the Profit and Loss Account as they accrue. Interest income is calculated on amounts due from other financial institutions, loans and market securities. Interest expenses are calculated on amounts due to issuance of securities and other borrowings.

The Fund has granted loans to rental apartments at 3.5% and 4.5% interest rate. The Government pays the interest difference between those loans and the loans taken by the Fund.

Service Income

4. Service income includes income from borrowing charges and collection charges. Service income is entered into the Fund's Profit and Loss Account when they are derived.

Loans

5. Loans are capitalised with accrued interest and indexation at year-end. Indexed loans are entered based on indices effective at the beginning of 2007.
6. A provision for losses on the loan portfolio is made to meet the risk attached to lending operations. The loss provision is based on estimation and does not represent a final write-off. In addition to the required contribution, certain risk factors are evaluated to determine the total contribution for this purpose. First, there are specific provisions to adjust for loans that have received a poor risk evaluation, and secondly, there is a general provision to meet the general risk of lending operations. The provision has been deducted from the appropriate Balance Sheet items.
7. The Fund has redeemed assets on foreclosed mortgages. Foreclosed mortgages are entered at estimated market value in the Fund's Annual Accounts.

Notes, contd.:

Market Securities

8. The Fund's market securities comprise of bonds and unit shares of mutual funds. Market securities are valued at market price at year-end.

Property and Equipment

9. Property and equipment are capitalized at cost less accumulated depreciation. Depreciation is calculated as a fixed annual percentage based on the estimated useful life of the property and equipment until a scrap value is reached. Estimated useful life is specified as follows:

Real estate	25 years
Fixtures and equipment	5-10 years
Vehicle	10 years

Cash and Cash Equivalents

10. Cash and cash equivalents in the Statement of Cash Flows consist of demand deposits with credit institutions.

Hedging

11. It is important for the Fund to maintain a balance in the composition of its borrowings and loans. The Fund's risk management policies require the Fund to minimise its exposure to risk and manage interest rate and credit risk within certain guidelines (see also separate section on risk management). The Fund uses both derivatives and other financial instruments to manage the potential earnings impact of these risks. Several types of derivatives are used for this purpose, including interest rate swaps and options. The Fund does not use hedge accounting.

Derivatives

12. The Fund has entered into cross currency and interest rate swaps and currency options. The aim with the derivatives is to reduce foreign currency risk and interest rate risk and to balance the cash flows and duration of the Fund's assets and liabilities. Derivatives that are entered into in order to hedge the currency risk and interest rate risk of market securities are recognised at fair value. Other derivatives are recognised at cost since the assets and liabilities they are hedging are also recognised at cost. The nominal amounts of derivatives are not recognised in the Balance Sheet of the Fund, but the revenue and expense of the derivatives are recognised in the Profit and Loss Account and in the Balance Sheet.

Risk management

The Fund encounters various financial risks which have to be evaluated and managed. The main risks are covered in the following section.

a. *Risk Management Structure*

The Board of Directors authorises the Fund's risk management policy after having sent it to the Financial Supervisory Authority of Iceland for review. In the policy the Board of Directors of the Fund grant the Risk Committee and the Risk and Investment Management Division to uphold the policy.

b. *Credit Risk*

All of the Fund's loans are secured by real estate mortgages. The Fund limits its risk due to these loans in two ways, by setting a maximum individual credit amount and a maximum mortgage proportion. The Risk Management Division evaluates the credit risk on an ongoing basis and prices it when deciding the interest rates on loans, which represent a markup on the interest rates on the Fund's liabilities.

Notes, contd.:

Risk management, contd.:

c. *Interest Rate Risk*

Interest rate risk arises due to duration mismatch of assets and liabilities. If not properly matched, changes in market interest rates can affect net interest income. The Fund's Investment Division is responsible for controlling this risk and for ensuring that the mismatch is within the limits set forth in the Fund's risk management policy.

d. *Prepayment Risk*

Borrowers have in general a permission to prepay their loans without having to pay any special fee. Such permission is not available on the Fund's borrowings, excluding the housing bonds. The Risk Management Division evaluates the Fund's risk involved and prices it when interest rates on the Fund's loans are decided.

e. *Liquidity Risk / Funding Risk*

The Fund's Investment Management Division is responsible for monitoring the Fund's liquidity needs and for ensuring that there is always sufficient liquidity for the Fund's operations, for granting loans and repayments of principal and interest on the Fund's liabilities.

Interest Expenses

14. Interest on borrowings is specified as follows:

	2006	2005
Bonds issued	52,226,684	36,506,232
Other borrowings	779,570	699,693
Total interest on borrowings	<u>53,006,254</u>	<u>37,205,925</u>

Income from Commissions

15. Income from commissions is specified as follows:

Borrowing charges	426,172	655,134
Collection charges	254,219	291,619
Total commission income	<u>680,391</u>	<u>946,753</u>

Personnel

16. Salaries and salary-related expenses are specified as follows:

Salaries	281,252	259,446
Salary-related expenses	59,855	54,887
Other employee related expenses	12,864	10,967
Total salaries and salary-related expenses.....	<u>353,971</u>	<u>325,300</u>

17. The Fund's total number of employees is as follows:

Average number of employees during the year measured as full-time equivalent positions	63	67
Positions at the end of the year	60	65

Notes, cont.:

18. Salaries paid to the Board of Directors and the Managing Director are specified as follows:		2006
Guðmundur Bjarnason, Managing Director		16,253
Gunnar S. Björnsson, Chairman of the Board		2,072
Other board members (4)		4,380
Total		<u>22,705</u>

Auditors' Fees

19. Remuneration to the Fund's auditors is specified as follows:		2006	2005
Audit of annual accounts		5,805	4,068
Review of interim accounts		1,960	1,472
Other services		1,198	1,528
Total		<u>8,963</u>	<u>7,068</u>

Other Administrative Expenses

20. Other administrative expenses are specified as follows:			
Collection charges		166,058	199,230
Specialist services brought in		84,547	80,019
Housing		70,893	66,845
Advertisements and promotions		36,614	49,201
Operation of IT systems		66,950	73,468
Other administrative expenses		56,168	59,536
Total		<u>481,230</u>	<u>528,299</u>
21. Other operating expenses are specified as follows:			
Grants due to technological advances		14,725	14,530
Homes' Advisory Office		5,260	4,900
Other grants		2,137	5,040
Claims in relation to the Holt Real Estate Agency		3,675	350
Total		<u>25,797</u>	<u>24,820</u>

Amounts Due from Credit Institutions

22. Amounts due from credit institutions mature as follows:			
On demand		823,609	1,350,489
Up to 3 months		4,242,565	1,353,385
Over 1 year and up to 5 years		6,830,337	5,693,188
Over 5 years		87,133,277	86,359,552
Total		<u>99,029,788</u>	<u>94,756,614</u>

Notes, cont.:

Loans

23. Loan to customers specified by maturity:

	2006	2005
On demand	701,704	685,071
Up to 1 year	8,588,025	7,867,237
Over 1 year and up to 5 years	37,198,005	33,030,447
Over 5 years	359,233,296	335,261,443
Total	<u>405,721,030</u>	<u>376,844,198</u>

24. Changes in the provision for losses during the year are specified as follows:

	Specific	General	2006 Total	2005 Total
Provision at the beginning of the year	743,811	2,684,811	3,428,622	3,162,540
Provision for losses over the year	84,406	413,346	497,752	394,159
Actual losses during the year	(102,431)		(102,431)	(128,077)
Provision at the end of the year	<u>725,786</u>	<u>3,098,157</u>	<u>3,823,943</u>	<u>3,428,622</u>
Provision for losses on the loan portfolio as percentage of loans	0.2%	0.7%	0.9%	0.9%

Other assets

25. Property and equipment are specified as follows:

	Vehicle	Real estate	Fixtures and equipment	Total
Total value 1.1.2006	3,735	6,071	220,333	230,139
Additions during the year			22,532	22,532
Total value 31.12.2006	<u>3,735</u>	<u>6,071</u>	<u>242,865</u>	<u>252,671</u>
Depreciation during the year	405	4,234	107,787	112,426
Disposals during the year	374	243	24,220	24,836
Total depreciation	<u>778</u>	<u>4,477</u>	<u>132,007</u>	<u>137,262</u>
Net book value 31.12.2006	<u>2,957</u>	<u>1,594</u>	<u>110,858</u>	<u>115,409</u>
Annual depreciation ratios	10%	4%	10-20%	

The official assessment value of the real estate and land at year end 2006 amounted to ISK 7.5 million. The fire insurance value of the real estate at the same time amounted to ISK 12.7 million.

Notes, cont.:

Assets and Liabilities Index-linked or in Foreign Currencies

26. The total amount of indexed assets is ISK 517,306 million, and the total amount of indexed liabilities is ISK 525,262 million respectively, at year-end.
27. The total amount of assets in foreign currencies in the Annual Accounts is ISK 0,3 million, and the total amount of liabilities amounted to ISK 28,5 million.

Borrowings

28. Borrowings mature as follows:

	2006	2005
Up to 1 year	20,111,300	18,146,460
Over 1 year and up to 5 years	80,926,626	71,125,619
Over 5 years	424,252,947	391,111,709
Total	<u>525,290,873</u>	<u>480,383,788</u>

29. Issued bonds are specified as follows:

HFF bonds	446,825,911	393,404,439
Housing bonds.....	43,572,438	53,369,774
Housing Authority bonds	24,664,079	24,333,429
Total	<u>515,062,428</u>	<u>471,107,642</u>

Equity

30. Changes in equity are as follows:

	Contributed capital	Retained earnings	Total
Equity 1.1.2006	7,155,408	6,739,007	13,894,415
Net profit		2,480,149	2,480,149
Equity 31.12.2006	<u>7,155,408</u>	<u>9,219,156</u>	<u>16,374,564</u>

31. The capital ratio of the Fund, calculated according to stipulations in the Rules on The Housing Financing Fund no. 544/2006, was 6.3%. The calculation of the ratio is equivalent to the calculation of the capital ratio of financial institutions. The long-term goal of the Fund is to keep the ratio above 5.0%.

The ratio is calculated as follows:

Equity	16,374,564
Risk base	259,913,714
Capital ratio	6.3%

Notes, cont.:

Obligations

32. Derivatives are specified as follows at the end of the year 2006:

Derivatives with a positive position

	Book value	Fair value
Interest rate swaps, recognised at cost	1,600,471	199,256
Interest rate swaps, recognised at fair value	1,083,718	1,083,718
Total positive position	<u>2,684,189</u>	<u>1,282,974</u>

Derivatives with a negative position

Interest rate swaps, recognised at cost	0	(812,547)
Interest rate swaps, recognised at fair value	(12,586)	(12,586)
Total negative position	<u>(12,586)</u>	<u>(825,133)</u>
Net position	<u>2,671,603</u>	<u>(457,841)</u>