

Credit Opinion: Housing Financing Fund

Global Credit Research - 22 Dec 2014

Reykjavik, Iceland

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Ba1
Bkd Senior Unsecured -Dom Curr	Ba1

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Key Indicators

Housing Financing Fund (Unconsolidated Financials)[1]

	[2]6-14	[2]12-13	[2]12-12	[2]12-11	[2]12-10	Avg.
Total Assets (ISK billion)	846.7	862.9	876.1	867.3	836.0	[3]0.3
Total Assets (EUR million)	5,492.5	5,446.9	5,190.6	5,462.0	5,434.2	[3]0.3
Total Assets (USD million)	7,520.1	7,505.5	6,843.2	7,090.4	7,290.2	[3]0.8
Tangible Common Equity (ISK billion)	13.4	14.7	14.6	9.4	8.4	[3]12.4
Tangible Common Equity (EUR million)	86.6	92.7	86.2	59.3	54.5	[3]12.3
Tangible Common Equity (USD million)	118.6	127.8	113.7	77.0	73.1	[3]12.9
Net Interest Margin (%)	0.0	0.3	0.3	0.3	0.3	[4]0.3
PPI / Average RWA (%)	-0.2	0.3	0.2	0.3	0.4	[5]0.2
Net Income / Average RWA (%)	-0.6	-1.0	-1.8	0.2	-9.3	[5]-2.5
(Market Funds - Liquid Assets) / Total Assets (%)	94.8	94.8	94.2	95.1	94.6	[4]94.7
Tangible Common Equity / RWA (%)	3.2	3.4	3.2	2.3	2.2	[5]2.9
Cost / Income Ratio (%)	139.8	61.9	71.0	63.4	47.7	[4]76.7
Problem Loans / Gross Loans (%)	11.2	12.6	14.7	14.6	15.6	[4]13.8
Problem Loans / (Equity + Loan Loss Reserves) (%)	247.6	267.9	310.3	374.3	306.2	[4]301.3

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] Compound Annual Growth Rate based on IFRS reporting periods [4] IFRS reporting periods have been used for average calculation [5] Basel II & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

Moody's rates the Housing Financing Fund (HFF) Ba1 with a stable outlook. The rating reflects the guarantee HFF, a fully government-owned residential mortgage lender, receives on its funding from the Icelandic state (Baa3, stable).

Rating Drivers

- Pressure on franchise, but very high likelihood of government support, however not a perfect guarantee
- Profitability will remain weak in short and medium term- Full dependence on wholesale funding
- Poor asset quality will continue to weigh on capital adequacy
- Upcoming household debt relief should benefit HFF's asset quality and capital, but increased prepayments will pressure income
- Legal and political risks

Rating Outlook

The stable outlook on the senior unsecured debt and issuer ratings reflects the strength of and links to HFF's owner, the Icelandic government, notably the guarantee following from the fund's legal status, as well as the actions - multiple capital injections - and intentions of the government to make future capital injections.

What Could Change the Rating - Up

Upwards rating pressure could develop if there is (1) a material improvement in the fund's asset quality; (2) the fund's ability to generate operating profits is restored; and (3) the fund's capitalisation improves to better match its risk profile. A positive change in the sovereign rating would place upwards pressure on HFF's rating, though a change in line with the government's rating would not be a foregone conclusion.

What Could Change the Rating - Down

A downgrade of HFF's issuer rating could result if (1) the credit strength of its owner were to deteriorate; (2) worse-than-expected loan performance exerts greater pressure on the bank's financial fundamentals; (3) capitalisation, including capital injections, deteriorates further; and (4) the likelihood of the fund to fulfil upcoming bond maturities is impaired.

DETAILED RATING CONSIDERATIONS

-PRESSURE ON FRANCHISE, BUT VERY HIGH LIKELIHOOD OF GOVERNMENT SUPPORT, HOWEVER NOT A PERFECT GUARANTEE

HFF is a residential mortgage lender and is not authorised to accept deposits. Its responsibility is to monitor housing needs in Iceland and in addition lend to municipalities, companies and associations for construction or purchase of residential housing.

HFF dominated the Icelandic mortgage lending market until 2004, when the commercial and savings banks entered into direct competition. As a result, the fund's market share decreased to around 40% at end-2007. Following the collapse of the country's three major commercial banks in 2008, HFF regained market share. In addition, HFF has taken over portfolios of ISK 28.3 billion of other Icelandic banks, which accounted for 3.5% of its total loan portfolio at end-December 2012.

Moody's notes that in 2013 HFF reported a 12% year on year decline to ISK 13.3 billion in new mortgage lending. In H1 2013 mortgage lending by Iceland's commercial banks only reported a decline by 4% from H1 2012. The difference largely reflects commercial banks' issuance of non-inflation-indexed loans, which HFF is not authorised to offer. Commercial banks' non-inflation indexed loan issuance is credit negative for HFF, constraining its market share and franchise value. HFF has expressed interest obtaining authorisation to offer non-indexed loans and issuing non-inflation-indexed bonds once its investor base, substantially consisting of pension funds, shows interest in their merit, which may enable it to recapture some of the lost market share. In H1 2013, HFF accounted for 17% of new mortgage lending, down from 23% in the first half of 2012.

HFF's issuer rating benefits from six notches of systemic uplift from the Icelandic government (Baa3, Stable). Moody's assesses that the likelihood of systemic support for HFF is very high reflecting the national government's 100% ownership of HFF and its legal status as a "Treasury Part C" institution, ensuring that the government is responsible for full payment of HFF's liabilities. The guarantee does however, not satisfy all of Moody's requirements to permit full credit substitution, in particular because there is no explicit guarantee on timely payment, giving rise to a potential risk of non-timely payment if HFF were to fail to meet its obligations, which, combined with the weakening in HFF's stand-alone credit quality, supports the rating differential to the Icelandic

government .

Nevertheless, HFF's Ba1 rating - one notch below the Icelandic government - reflects the very high likelihood that the Icelandic government would honour HFF's liabilities in full and on time, given (1) the government's interest and continued involvement in HFF's operations, as demonstrated by the government's repeated recapitalisations of the institution; and (2) the substantial holdings of HFF's bonds by Icelandic pension funds, estimated at 75% end September 2014. In addition, HFF accounts for around 10% of Icelandic financial system assets.

-PROFITABILITY WILL REMAIN WEAK IN SHORT AND MEDIUM TERM

HFF's profitability is generally weak, reflecting its role as mortgage lender and lender for social housing. The fund recorded net losses of ISK4.4 billion in 2013, mainly driven by ISK5.7 billion of loan impairments. In addition to the current elevated loan loss level, the low operating profitability of the fund reflects low historical loan margins, and is deteriorating due to the fund's inability to prepay funding when borrowers prepay their loans, creating a negative spread. At the same time costs are increasing reflecting the increasing resources needed to deal with customers debt servicing problems and managing a growing portfolio of repossessed properties (2,606 properties at end-2013, up from 1,606 at end-2011). These factors have resulted in the cost-to-income ratio increasing to 70% in 2013 from 63% in 2011. We expect the fund's efficiency to be challenged going forward given the extent of loan restructurings and repossessed properties.

The first six months of 2014- mirrored the same fundamental issues seen in 2013 resulting from pressure on margins, high prepayments, and large impairments. A net loss of ISK 1.3 billion was recorded on the back of ISK0.99 billion further loan impairments and low net interest income (ISK0.46 billion lower compared to first half 2013).

Moody's recognises that HFF is working to mitigate the effect of some of these underlying causes, but does not deem a sustainable reversal of the negative trend in profitability likely in the short to medium term.

Following amendments to the Act on Consumer Credit by the Icelandic Parliament on 18 March 2013, HFF announced plans to shift prepayment risk to investors in new inflation-indexed financing from 1 November 2013, the date the law will come into force, which should over time reduce prepayment risk although the timing and potential impact is uncertain.

-FULL DEPENDENCE ON WHOLESALE FUNDING

HFF's full reliance on market funding makes the fund sensitive to deterioration of investor confidence, which may be influenced by the fund's low capitalisation or, over time, the removal of the government-implemented capital controls, which have been in place since December 2008

The fund does not take deposits and has only a moderate securities portfolio but funds its mortgage loan portfolio by issuing its bonds in the domestic market, accounting for around one third of the Icelandic bond market at end-June 2012. Investors at end-September 2014 included Icelandic pension funds (around 75%), foreign investors (around 1%), and securities and investment funds (around 12%).

On one hand, the fund's status as a government-owned institution alleviates any immediate concerns about its liquidity profile and the fund has ISK30.3billion of government bonds available for liquidity operations, as well as cash inflows from mortgage pre-payments. On the other hand, while the maturity profile of HFF's funding has been balanced and termed out, the semi-annual repaying funding structure is still potentially sensitive to a change in institutional investors' perceptions of HFF, which could be vulnerable to the weakened creditworthiness of the fund. As a strong mitigating factor, domestic investors, including pension funds, can only invest domestically as a result of the capital restrictions introduced in 2008, so that investment options are few (HFF and government bonds).

-POOR ASSET QUALITY WILL CONTINUE TO WEIGH ON CAPITAL ADEQUACY

HFF's asset quality remained weak in 2013 despite some improvements over 2012 and resulting losses continue to negatively impact the capital ratio, albeit to a lesser extent than in previous years. Loans in payment suspension or in default decreased to 12.6% of gross loans at end-December 2013, from 14.7% at year-end 2012. Furthermore The year end 2013 capital ratio stood at 3.4% (year end 2012: 3.2%), including the ISK 4.5 billion capital injection which was provided by the Icelandic Government in early 2014 after the balance sheet date. Since the financial crisis, the Icelandic government has provided ISK 51 billion in capital injections to HFF, but even with this support HFF has never met its required minimum capital ratio of 5.0%.

As of October 2014 HFF's loans in payment suspension or default stood at 10.02% of gross loans showing material improvement while the funds equity ratio was 3.2% at end June 2014

HFF's increase in loan arrears was caused by the deterioration in Iceland's economic environment in the years following the collapse of the financial system in 2008. Moody's expects that the level of problem loans will remain elevated over the next few years. However trends are improving as the stock of repossessed properties on HFF's balance sheet decreased by 19.1% at year end June 2014 relative to end June 2013. as it repossessed 234 properties and sold 733. during the first half of the year Of the entire stock of properties, 44% were rented out as at end June 2014, and the remainder are at different stages of the sales process. Moody's believes there is a low probability that properties can be sold in the near future, especially outside the greater Reykjavik region in which commercial bank lending is concentrated. HFF's establishment of a rental company in January 2013, which will specialise in renting out part of the repossessed properties, is only a minor mitigation to the risk that HFF is increasingly exposed to non-performing real estate on its balance sheet. Moreover, additional concerns relate to high concentration risks to legal entities providing (social) rental housing, which have also been affected by the economic deterioration in the years following the economic collapse.

Since 2008, HFF has been permitted to make more concessions for borrowers experiencing payment difficulties and has stated its intention to soften its collection activities. Although these measures are aimed at supporting the borrowers' debt service ability, Moody's concern is that this could eventually at some point result in a rapid deterioration of the fund's asset quality indicators. In Moody's opinion, due to these concession measures the fund's asset quality indicators may not give the full picture of the fund's current asset quality.

In April 2013, a new government took power in Iceland and has proposed an across-the-board write-down of Icelandic mortgage debt which could occur as early as this year. The scale of the write-down is still unclear.

In March 2012, a law was proposed to place HFF under the same supervision by the Icelandic FSA as other financial institutions which could strengthen HFF's credit risk measures in the longer term.

In view of (1) HFF's deteriorated asset quality, which will likely lead to substantial additional loan loss provisions, and (2) poor profitability, and hence limited ability to replenish capital through internal means, Moody's deems the current capital adequacy ratio as very poor, and it is unlikely to materially improve in the coming years due to continued weak operating profitability and additional need for write-downs. We expect, however, that the fund will continue to receive additional capital support in future, in line with the fund's long-term, non-legally binding objective of a 5% minimum total capital ratio.

-UPCOMING HOUSEHOLD DEBT RELIEF SHOULD BENEFIT HFF'S ASSET QUALITY AND CAPITAL, BUT INCREASED PREPAYMENTS WILL PRESSURE INCOME

On 30 November 2013, the Government of Iceland (Baa3, stable) presented a plan to write down parts household mortgage debt in the country to reduce especially the debt burden related to inflation-indexed mortgages. This was a key election promise of the government and in its view represents an important step towards achieving higher economic growth going forward. The planned debt relief amounts to ISK 150 billion (around 8% of estimated 2014 GDP) over four years from mid-2014 onwards and will target inflation-linked loans and households with the highest debt burden and therefore the weakest exposures. On 10 November 2014, the Government provided an updated stating that part of the debt relief programme would be accelerated. As the major provider of inflation-indexed loans, the HFF should benefit from the plan, provided that the government - as indicated - implements measures to safeguard the HFF against the cost of increasing pre-payments of mortgage loans.

The impact on the Housing Financing Fund (HFF) should be positive as (i) it does not contribute to the bank levy on financial institutions which will fund the debt relief programme and (ii) it has been the major provider of inflation-indexed mortgages, holding over half of outstanding inflation-indexed mortgages and a large share of the loan book are in payment suspension or default (12.6% at year end 2013) Overall, HFF will see an improvement in reported loan book arrears and reduced total risk weighting of the loan book, which will positively impact reported equity capital ratios. However, on the negative side, the proposal will expose the HFF to increasing pre-payments and hence increasing cost of carry, which according to the government could amount to additional costs for the HFF of ISK 5-10 billion over four years. We note, however, that safeguards are under discussion which will compensate the HFF for increasing costs relating to prepayment and that any impact of the plan on HFF's capital position either directly via changes in risk-weighted assets or through future results, will likely be offset by future government capital injections into HFF to keep the capital ratio stable around the end-June 2013 level of 2.5%.

-LEGAL AND POLITICAL RISKS

There are currently two main legal risks for HFF. One is a legal challenge to HFF's right to charge prepayment fees on loans. The Reykjavik District Court has recently given a verdict in favour of HFF relating to the right to charge prepayment fees. The case can however still be appealed to the Supreme Court. Losing such a case could, in the worst case scenario under HFF's own estimates, increase prepayment risk by ISK 10 billion. The second case challenges the legality of indexed loans. One case was dismissed in April 2013, but another lawsuit was filed in November 2013. The Fund has requested a motion for dismissal and is awaiting the outcome of the District Court. The implications of losing such a case would be enormous losses according to HFF's 2014 interim report. The EFTA Court published an advisory opinion on August on the case of an individual against Islandsbanki, which maintained the unequivocal conclusion that indexation of mortgage loans does not conflict with the rules of the European Economic Union and it's the Icelandic's courts jurisdiction to assess the validity of the financial terms.

In addition there is some uncertainty about the future role of HFF. A government committee was set up in September 2013 to review the future organization of housing policy in Iceland. The committee made its proposal to the minister of housing- and social affairs in May 2014. The proposal indicates a significant change in HFF's role as a mortgage provider in competition with the commercial banks and instead point to a clearer role as part of Icelandic housing policy. This proposal however, does not indicate a change in the government guarantees given to currently outstanding bonds.

Unless otherwise stated, all figures shown are from HFF's annual and interim reports, and monthly overviews.

The principal methodology used in the rating was "Government-Related Issuers: Methodology Update" published in July 2010. Please see the Credit Policy page on www.moody.com for a copy of these methodologies

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