Housing Financing Fund

Consolidated
Financial Statements 2014

These Financial Statements are translated from the original statements which are in Icelandic. Should there be discrepancies between the two versions, the Icelandic version shall take precedence.

Housing Financing Fund
Borgartúni 21
105 Reykjavík

Reg.no. 661198-3629

Contents

Endorsement and Statement by the Board of Directors

The Housing Financing Fund ("the Fund") has its headquarters in Borgartún 21, Reykjavik and a branch in Sauðárkróki. The Fund's objectives are to provide housing loans, loans for new constructions and property development in Iceland. The Housing Financing Fund is an independent institution owned by the State. The Fund is the owner of the subsidiary Leigufélagið Klettur ehf. and therefore the Financial Statements of the Fund are presented as Consolidated Financial Statements of the Housing Financing Fund and its subsidiary.

Performance in the year 2014

Profits from operations of the Housing Financing Fund for the year 2014 amounted to ISK 3,241 million compared to a loss of 4,353 million the previous year. The Fund's net interest margin remains unchanged between years. Equity at year-end amounted to ISK 18,087 million and the Fund´s equity ratio is 4.5% compared to 3.4% the previous year. The ratio is calculated in the same manner as for financial institutions. The Fund´s long-term objective is to maintain an equity ratio over 5.0% and communications with authorities aim at complying with the provision of the regulation thereon.

At year end, loans amounted to ISK 728,081 million and decreased by ISK 40,399 million during the year. The Fund's borrowings amounted to ISK 806,568 million and decreased by ISK 41,532 million during the year as the Fund did not seek funding from the market.

In the fall of 2008, the Fund suffered great losses due to the economic collapse. Since that time, efforts have been made to resolve disputes related to the fall of former commercial banks due to deposits, bonds and derivatives. In the year 2014, one case ended with a final settlement on the basis of an agreement reached in 2013, and an agreement was reached in the year 2014 on a final settlement of another dispute. Changes in the book value of impairment provisions due to the collapse result in a decrease in the total provisions of claims on the fallen financial institutions amounting to ISK 4,017 million. At the end of 2014, one case was not finalized. The Fund has expensed ISK 7,457 million from the year 2008 due to the fall of the commercial banks.

Development of arrears and impairment

Arrears in the loan portfolio have decreased significantly and the position of underlying collateral has improved significantly due to the rise in real estate prices in excess of inflation. Arrears peaked in July 2012 and have since been declining. Provisions of impairment arising from the risk related to the Fund´s loan portfolio increased slightly in the year 2014. In the calculation of the impairment in the year 2014, consideration was given to the suggestions and comments resulting from FME´s examination of the Fund´s loan portfolio. The impairment provision of the loan portfolio increased slightly due to the increased weight of general impairment. Annual reviews are made comparing the recognized impairment according to the Fund´s rules to the final write off due to credit losses. These reviews have revealed that previous recognized impairment provisions have been over the past two years 94-100% of the final write-offs of credit losses for personal loans and 100% for corporate loans.

Properties held for sale are recognised at the lower of cost upon repossession or fair value. The methodology leads to the total of the Fund's properties held for sale being recognised at a lower value than the estimated fair value of the same properties which according to a valuation amount to around ISK 2,213 million. The carrying amount of properties held for sale at year-end amounted to 84% of the official property value of the underlying asset portfolio.

Operations in the year 2014

Operating results for the year 2014 are mainly generated by the reversal of impairment, projects related to the solutions of debt difficulties of customers, sales of repossessed assets, the development of the Fund´s systems, the operations of the subsidiary Leigufélagið Klettur ehf., prepayments and reduced lending. Optimization efforts were undertaken by the Fund to lower operating expenses. The number of employees at the end of the year 2014 was 97, a reduction of 3 during the year. Salary expenses increased by 8,6% between years, which is mainly explained by salary increases according to collective bargain agreements and cost reduction measures due to staff reductions. The average number of positions of the parent company remained unchanged but increases within the Group, which includes Leigufélagið Klettur, as the number of positions of the subsidiary are five. Other operating expenses decrease significantly as there was a 15.6% decrease of operating expenses on a consolidated basis and a 20.8% decrease of the Fund´s operating expenses.

Endorsement and Statement by the Board of Directors contd.

The Fund´s repossessed properties decreased from 2,606 to 1,891 in the year 2014. The decrease is due among other reasons to the sale of 450 properties to the subsidiary Leigufélagið Klettur ehf. in January 2014. Also the Fund sold more of its properties than it repossessed during the year. In total the Fund repossessed 351 properties but sold 616 properties in the real estate market resulting in a reduction of properties by 262 during the year, excluding the impact of the sale of properties to the subsidiary Klettur.

Debt solutions have a significant impact on the Fund´s interest margin permanently

In November 2013, the government announced an action plan for the principal reduction of mortgages for households and in the spring of 2014 the Act. no.35/2014 on the adjustment of inflation-indexed housing mortgages was passed. Under the Act, it is expected that adjustments made by lenders will be fully compensated. On 19 December 2014, an agreement was signed between the Fund and the Ministry of Finance for the purchase of the adjusted portion of the loans due to the reduction. The effects of this agreement are twofold. On the one hand, the purchase price of the adjusted portion of the loan is somewhat lower than the carrying value of these loans. The expected loss due to the purchase of the loan portfolio is ISK 433 million and that amount is accounted for as an increase in impairment in the financial statements of 2014. It should be noted however that the discount from the sale of the adjusted portion of the loans is in part an estimated figure until definitive information is available about the final adjustment. On the other hand the provision to the loan portfolio decreases the amount of the loan portfolio by ISK 34 - 36 million. The average indexed interest rate on the adjusted loans are estimated to be 4.67%, but it is obvious that the government´s return on this portion of the loan portfolio will be much lower or near 2.2 to 3% indexed. For this reason it can be assumed that the net income of the Fund will be reduced by approximately ISK 600 to 900 million per year, without a corresponding reduction in interest payments, for the Fund´s debt is non-callable. The final impact on the interest income and the Fund´s total loss may change depending on the potential returns and inflation at any given time. As does the debt solution assume that the Fund will not benefit from contractual prepayment fees as a result of the adjustments.

Act nr. 40/2014 on personal pension savings and their use for payment of housing mortgages and for housing savings was approved on 22 May 2014. The Act was an amendment to the Act no. 44/1998 on housing, so that despite the provisions of paragraphs 2 and 3 of Article 23, additional payments or repayments of debt under the Fund´s mortgages are now allowed without payment of a fee, as is depicted in the terms of the loan. The Act acknowledges that the Fund will be compensated for its losses. In its forecast, the Fund estimates that ISK 15-17 billion will be prepaid as a result of the debt solution. The impact of these excess payments are the same as the impact of principal reductions of mortgages. For this reason, it is expected that the Fund´s net interest income will decrease on a yearly basis by ISK 300-450 million when taking into account the loss of prepayment fee income.

The aforementioned debt solutions result in a total interest loss for the Fund in the amount of ISK 900 to 1,350 million per year, or about half of the net income of the Fund. A letter from the Ministry of Welfare, dated 19 December 2014, states that it is to the understanding of both the Social and Housing Minister and the Finance Minister that the Fund be compensated for the negative impact on the performance of the Fund as a result of the principal reduction of mortgages as according to Act no. 35/2014. It also states that this position was made apparent at a meeting of the representatives of the Fund on 18 December 2014, with officials of the ministries and the Prime Minister. It is not evident however how the Fund will be compensated for its loss and authorities in consultation with the Fund have yet to implement the details. A claim on the Treasury as a result of this loss is not recognized. It should be noted that loans in arrears decreased from ISK 75.9 billion to ISK 66.5 billion from the end of the year 2014 to 1 March 2015 which in part is the cause of the government measures and this reduction will result in a decrease in the impairment of loans in the year 2015.

Endorsement and Statement by the Board of Directors contd.

The abovementioned loss due to the government´s measures will unequivocally have a major impact on the basic performance of the Fund and cause the Fund to hereinafter be driven by losses eventually to be borne by the Treasury. It is clear that such a framework for operations may cause various other risks of the Fund, such as the prepayment issues, to be amplified thereby causing doubt as to the ability of the Fund to continue as a going concern. Under these conditions, it is the objective of the Fund to minimize the Fund´s losses.

Leigufélagið Klettur ehf.

Leigufélagið Klettur ehf. was established on 23 January 2013 and the Fund´s Board approved the sale of a portion of its repossessed properties to the rental company. The finalization of the financing of Klettur has been delayed while awaiting an opinion from the ESA on the provisions of the purchase contract regarding the loan from the Fund to Klettur for the purchase. The expected leverage in the purchase agreement with Klettur is 64.4% of the purchase price of the properties. Pending the opinion from the ESA, Klettur´s liability due to the Fund, arising from the portion of the purchase price financed with a loan, is calculated on the same terms as legal entities are offered by the Fund, based on the increase in prices and 4.2% interest.

The Fund´s risk factors

The main risk factors of the Housing Financing Fund are credit risk, liquidity risk, interest rate and inflation risk, duration imbalance and financing, prepayment risk, reinvestment risk, political risk and operational risk. The Fund's prepayment and reinvestment risk is related to an increase in the settlement of loans by the Fund's customers due to changes in the housing loan market. Counterparty and currency risk are also considered to be among the Fund´s financial risks. Repossessed properties have become a major risk in the Fund´s operations due to among other factors the uncertainty of the timing of the sales of some of the properties.

Political risk is reflected in the uncertainty as to the future role and the existence of the Fund. The Social Affairs and Housing Minister appointed a project committee on the future organization of housing policy on 9 September 2013 in accordance with the resolution on the action plan for household debt relief passed by Parliament last spring. The project management submitted to the Minister proposals for the future role of the Fund on 6 May 2014, among other suggestions:

- The implementation of a new mortgage credit system in which specialized mortgage lending companies administer lending throughout the country and the framework of mortgage loans is based on the balance between lending and financing loans.

- The Fund´s operations will be separated into two functions, on the one hand a new public housing agency administering general mortgage loans for housing without government guarantees. On the other hand, many of the projects carried out by the Fund today along with additional projects proposed by the committee will be transferred to a separate institution (housing) , including projects related to public housing policy.

The committee was persistent that further government financial assistance due to the difficult financial position of the Fund be limited, as it is implicit that the Fund stops lending on existing terms.

The Ministry of Welfare has since prepared for the changes that are suggested in the report however a bill regarding the future organization of housing policy has not been submitted. Strategic decision making within the Fund has essentially been suspended, impacting the Fund´s operations in various ways, such as the risk level, prepayments, and the infrastructure of the Fund.

Governance

The Fund operates in accordance with the Housing Act no. 44/1998 and is subject to supervision of the Financial Supervisory in Iceland and abides by the rules of the stock exchange as an issuer of listed bonds.

Endorsement and Statement by the Board of Directors contd.

Board of Directors

The Board of Directors of the Housing Financing Fund places emphasis on maintaining good governance. The Board of Directors has established detailed working procedures for the Board wherein its competences are defined. The Board hires a CEO and finalizes his terms of reference. The Board of Directors meets with the Fund's auditors on a regular basis. The auditing firm Grant Thornton is the external auditor of the Fund.

The Board of Directors supervises that all information submitted to supervisory bodies, the Icelandic Financial Supervisory Authority, the Icelandic Central Bank and other authorities is at all times in accordance with law and regulations. The Board of Directors also makes decisions regarding all unusual and substantial matters. In the year 2014, the Board of Directors held 32 Board meetings.

A new Board of Directors was appointed in September 2013, but since then there have been several changes as to its members. The Directors are:

-Ingibjörg Ólöf Vilhjálmsdóttir, from September 2013
-Haukur Ingibergsson, from September 2013
-Drífa Snædal, from January 2014
-Þorsteinn Arnalds, from September 2014
-G.Valdimar Valdemarsson, varamaður from October 2014
-Stefán Ólafsson, from September 2013 til January 2014
-Haukur Fossberg Leósson, from November 2013 to June 2014
-Steinunn Valdís Óskarsdóttir, from December 2013 to September 2014

Executive Board

The CEO receives orders directly from the Housing Financing Fund´s board and his performance in all matters and in regards to the operations of the Fund is as according to the guidelines of the board and as provided by law. The Director shall make decisions about all the affairs of the Fund that are not entrusted others by legislation, the Fund´s statutes or the Board's decision, but the overseeing of daily operations does not include measures that are unusual or extraordinary. The Director is responsible for personnel matters but the implementation of these matters is the responsibility of the Human Resource Manager and Division Managers. The CEO shall initiate the Fund´s strategic policy and make recommendations thereon to the Board. The CEO attends board meetings and has the right to discuss and make motions and is responsible for implementing the decisions of the Board.

The Executive Board is composed of, in addition to the CEO, six directors who make decisions regarding daily operations. The Executive Board focuses on major decisions and makes recommendations regarding strategic policy decisions to the Board. The financial and operational forecasts prepared by the Executive Committee are based on polices established and approved by the Board.

Endorsement and Statement by the Board of Directors contd.

Committees and policies

The Fund´s Board has established an audit committee to carry out certain assignments which fall within the Board´s scope of responsibilities. A compliance officer is employed by the Fund and submits annually a report on the duties of the compliance position.

The Fund´s Financial Committee monitors risk management and liquidity management, and makes recommendations to the Board on issues regarding the Fund´s financing. The members of the Committee are the CEO, the CFO, the director of risk management and a board member. The Committee meets at least on a monthly basis.

The Security Committee meets on a monthly basis to discuss information security. The Committee has three times received verification for ISO27001, a standard adopted by the Fund which was implemented and certified in the year 2012.

Two loan committees authorized by the CEO operate within the Fund, on the one hand for loans to individuals and on the other for loans to legal entities. All decisions regarding the granting of loans to legal entities are administered by the loan committee, other than those pertaining to the Fund´s largest loans which are also approved by the Board. The Financial Difficulties Committee consists of three members who make all decisions regarding the granting of payment solutions. The purpose of the committee is to coordinate procedures and decision making on the granting of payment solutions to insure equal treatment of applicants for solutions.

The Fund has established a personnel policy, a policy and plan against bullying and sexual harassment, and an equality opportunities plan.

Communications between the Fund´s management and the Housing and Welfare Ministry are formalized by regular consultations held to review all the major issues concerning the Fund.

Statement by the Board of Directors and the CEO

The Consolidated Financial Statements of the Housing Financing Fund for the year 2014 are prepared in accordance with International Financial Reporting Standards as adopted by the EU and additional Icelandic disclosure requirements for financial statements of companies with listed securities.

According to our best knowledge, it is our opinion that the Consolidated Financial Statements give a true and fair view of the financial performance of the Fund for the year 2014, its assets, liabilities, and financial position as at 31 December 2014 and changes in cash flows for the year 2014.

Further, in our opinion the financial statements and the Endorsement by the Board of Directors and the CEO include a fair view of the Fund's development and performance and its standing and describes the Fund's main risk exposures.

Endorsement and Statement by the Board of Directors contd.

The Board of Directors and the CEO of the Housing Financing Fund have today discussed the Fund's Consolidated Financial Statements for the year 2014 and hereby confirm them by means of their signatures.

Reykjavik, 26 March 2015.

Board of Directors:

Ingibjörg Ólöf Vilhjálmsdóttir, Chairman of the Board

Drífa Snædal

Þorsteinn Arnalds, Vice-President of the Board

Haukur Ingibergsson

G. Valdimar Valdimarsson

CEO

Sigurður Erlingsson

Independent Auditors' Report

To the Board of Directors of the Housing Financing Fund,

We have audited the accompanying Consolidated Financial Statements of the Housing Financing Fund for the year 2014. The Consolidated Financial Statements comprise the consolidated statement of income and comprehensive income, the consolidated statement of financial position, the consolidated changes in equity, cash flow, and a summary of significant accounting policies and other explanatory information.

Management´s Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these Consolidated Financial Statements in accordance with International Financial Reporting Standards as adopted by the EU. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of Financial Statements that are free from material misstatements, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditors' Responsibility

Our responsibility is to express an opinion on these Consolidated Financial Statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with relevant ethical requirements and plan and perform the audit to obtain reasonable assurance whether the Consolidated Financial Statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the Consolidated Financial Statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the Consoldiated 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 ConsolidatedFinancial 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 Company's internal control. An audit also includes evaluating the appropriateness of accounting principles used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the Consolidated 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 Consolidated Financial Statements give a true and fair view of the financial position of the Company as of 31 December 2014, of its financial performance and its cash flows for the year then ended in accordance with the law and generally accepted accounting principles of Iceland.

Emphasis of Matter

Without qualifying our opinion we draw attention to the Fund´s equity ratio which is calculated on the basis of regulation no. 544/2004 on the financial and risk management of the Housing Financing Fund and is 3.4% at year end 2014, cf. Note 32.f. According to article 7 of the regulation mentioned above the Fund´s long terms goal is to maintain an equity ratio of 5.0%. The Board of Directors in accordance with the provisions of the said Regulations notified the Minister of Social Affairs and Housing thereon.

Finally, we draw attention to the discussion in the Endorsement and Statement by the Board of Directors and CEO, as discussed in Note 2.b., on the Fund´s ability to continue as a going concern.

Verification of Directors´ Report

In accordance with the provisions of paragraph 2, Article 104 of the Icelandic Financial Statements Act No. 3/2006, we confirm that, to the best of our knowledge, the report of the Board of Directors accompanying the Consolidated Financial Statements includes the information required by the Financial Statements Act if not disclosed elsewhere in the Consolidated Financial Statements.

Reykjavik, 26 March 2015.
Grant Thornton endurskoðun ehf.

J. Sturla Jónsson
Sturla Jónsson
State Authorized Public Accountant

Davíð Arnar Einarsson
Davíð Arnar Einarsson
State Authorized Public Accountant

Consolidated Income Statement and Statement of Comprehensive Income

	Notes	2014	2013
Interest income		45.547.186	68.143.480
Interest expense		(43.995.677)	(66.917.987)
Net interest income	20	1.551.509	1.225.493
Other income	21	159.252	160.893
Total operating income		1.710.761	1.386.386
Salaries and salary-related expenses	22	986.420	908.402
Other operating expenses	23	1.009.680	1.195.956
Depreciation and amortisation	25	54.086	58.957
Total operating expenses		2.050.186	2.163.315
Net income of investment properties	26	1.049.834	0
Net income of properties held for sale	27	194.901	389.459
Net operating income		905.310	(387.470)
Impairment of loans and properties held for sale	28	(1.544.107)	(3.372.513)
Impairment of securities	19	4.017.000	(594.000)
Profit(loss) before tax		3.378.203	(4.353.983)
Income tax	18	(136.488)	0
Profit (loss) for the year and comprehensive income (loss)		3.241.715	(4.353.983)

The notes on pages 13 to 37 are an integral part of these Consolidated Financial Statements.

Amounts in ISK thousand

Consolidated Statement of Financial Position as at 31 December 2014

	Notes	2014	2013
Assets			
Cash and cash equivalents	6	17.524.392	7.916.388
Loans to financial institutions	7	7.621.776	11.478.270
Treasury securities	8	30.343.375	32.294.209
Receivable due from State Treasury	9	4.546.964	4.500.000
Loans	10	728.081.166	768.480.860
Properties held for sale	11	27.870.768	37.663.230
Investment properties	12	8.063.973	0
Investment in subsidiary	13	0	10.000
Operating assets	14	105.964	69.505
Claims on related parties	30	0	73.180
Intangible assets	15	171.002	151.428
Other assets		326.696	309.953
Total assets		824.656.076	862.947.023
Liabilities			
Bond issues	16	798.547.938	834.463.465
Other borrowings	17	3.871.068	4.273.495
Other liabilities	18	4.149.967	9.364.674
Total liabilities		806.568.972	848.101.634
Equity			
Contributed capital		57.655.408	57.655.408
Accumulated deficit		(39.568.304)	(42.810.019)
Total equity		18.087.104	14.845.389
Total liabilities and equity		824.656.076	862.947.023

The notes on pages 13 to 37 are an integral part of these Consolidated Financial Statements.

Amounts in ISK thousand

Consolidated Statement of Changes in Equity for the year 2014

Year 2014	Contributed **capital**	**Accumulated deficit**	**Equity Total**
Equity as at 1 January 2014	57.655.408	(42.810.019)	14.845.389
Profit (loss) for the year and comprehensive income (loss)	0	3.241.715	3.241.715
Equity as at 31 December 2014	57.655.408	(39.568.304)	18.087.104

Year 2013			
Equity as at 1 January 2013	53.155.408	(38.456.036)	14.699.372
Increase in contributed capital	4.500.000	0	4.500.000
Loss for the year and comprehensive loss	0	(4.353.983)	(4.353.983)
Equity as at 31 December 2013	57.655.408	(42.810.019)	14.845.389

The notes on pages 13 to 37 are an integral part of these Consolidated Financial Statements.

Amounts in ISK thousand

Consolidated Statement of Cash Flows for the year 2014

	2014	2013
Cash flows from operating activities		
Profit (loss) for the year and comprehensive income (loss)	3.241.715	(4.353.983)
Adjusted for:		
Indexation on loans to banks and loans to customers	(8.171.909)	(29.725.948)
Indexation on borrowings	8.467.687	30.982.990
Depreciation and amortisation	54.086	58.957
Impairment	(2.472.893)	3.966.513
Valuation adjustment of investment properties	(654.694)	0
Deferred tax liability	136.488	0
Changes in operating assets and liabilities:		
Loans	47.809.997	34.665.066
Properties held for sale	1.240.868	(6.341.763)
Other assets	(22.202)	(51.073)
Other liabilities	(5.317.026)	2.253.193
Cash flows from (to) operating activities	44.312.117	31.453.952
Cash flows from investing activities		
Claims on related parties	0	(73.180)
Investment in subsidiaries	0	(10.000)
Loans to (from) banks	7.953.612	2.627.610
Treasury securities	2.274.018	9.711.009
Restricted cash	(50.062)	0
Investment in operating assets and intangible assets	(96.040)	(60.860)
Cash flows from (to) investing activities	10.081.528	12.194.579
Cash flows from financing activities		
Bond issues and other borrowings, repayments	(44.785.641)	(46.498.913)
Cash flows to financing activities	(44.785.641)	(46.498.913)
Net increase (decrease) in cash and cash equivalents	9.608.004	(2.850.382)
Cash and cash equivalents at the beginning of the year	7.916.388	10.766.771
Cash and cash equivalents at year end	17.524.392	7.916.388
Investing and financing activities without cash flow effect		
Receivable from State Treasury due to increase in capital 2013 ..		(4.500.000)
Increase in contributed capital		4.500.000

The notes on pages 13 to 37 are an integral part of these Consolidated Financial Statements.

Amounts in ISK thousand

Notes

General information

1. Reporting entity

The Housing Financing Fund ("the Fund") is domiciled in Iceland. The address of the Fund's registered office is Borgartún 21, Reykjavik. The Fund's objectives are to provide housing loans, loans for new constructions and property renovations in Iceland. The Housing Financing Fund is an independent institution owned by the State. The Fund operates in accordance with the Housing Act no. 44/1998 and appertains to a special management and the Minister of Welfare. The Housing Financing Fund is subject to supervision of the Financial Supervisory in Iceland in accordance with Act. 87/1998 on Official Supervision of Financial Activities. According to the law, the Icelandic State Treasury guaranties all of the Fund’s financial obligations. The Consolidated Financial Statements of the Fund are comprised of the Financial Statements of the Housing Financing Fund and its subsidiary Leigufélagið Klettur ehf., together referred to as the "Fund" or the "Housing Financing Fund."

2. Basis of preparation

a. *Statement of compliance*

The Consolidated Financial Statements have been prepared in accordance with the International Financial Reporting Standards (IFRS) as adopted by the EU. Information as to the new IFRS accounting standards and amendments to standards can be found in note 2.f.

The Consolidated Financial Statements of the Housing Financing Fund were approved by the Board of Directors on 26 March 2015.

b. Uncertainty in the operations of the Housing Financing Fund and its ability to continue as a going concern

It has been obvious for quite some time that the Fund´s interest rate margin has been insubstantial or only 0.28% which is insufficient to cover the impairment comparable to the impairment resulting from the economic collapse. Therefore, the Fund has needed support from its owner.

Serious doubt exists as to the Fund's future role and the possibility of its existence and this volatile state has existed since the Social Affairs and Housing Minister appointed a project committee on the future organization of housing policy on 9 September 2013 in accordance with the resolution on the action plan for household debt relief passed by Parliament in the spring of 2013. The Project Committee on the Future Organization of housing policy has submitted to the Minister its proposals and the Ministry of Welfare is taking steps to devise a framework of laws and regulations which hopefully will be completed as soon as possible. As a result, strategic decision-making in the immediate environment of the fund has been suspended, affecting the operations of the Fund in various ways.

The government announced plans at the end of November 2013 for principal reductions of mortgages. Indexed mortgage loans will be reduced and deductions will be made of earlier measures of reductions benefited by borrowers. It is clear that the laws on the adjustment of mortgage loans to individuals and the allocation of private pension savings to reduce loan principals will cause an increase of pre- and excess payments of the Fund´s loan portfolio which will have a negative impact on the Fund´s balance of assets and liabilities and thereby on the Fund´s net interest income. The Fund´s managers expect full compensation for the loans that are written down, however implementation of the compensation plan has not been finalized, cf. note 31.

c. *Basis of measurement*

The Consolidated Financial Statements have been prepared on the historical cost basis except for the following: trading securities are measured at fair value, properties held for sale are measured at the lower of cost or net fair value, and investment properties are measured at fair value.

d. *Functional currency*

The Consolidated Financial Statements are prepared and presented in Icelandic krona (ISK), which is the Fund's functional currency. All financial amounts presented have been rounded to the nearest thousand unless otherwise stated.

e. *Uses of estimates and judgements*

The preparation of financial statements in conformity with the IFRS requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. The estimates and underlying assumptions are based on historical experience and various other factors that are believed to be reasonable at the reporting date, the results of which form the basis of making the judgements about carrying amounts of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised and the effect of the changes are entered in the periods that the changes are made and in subsequent periods if the change also affects those periods.

2. Basis of preparation, contd.

e. Uses of estimates and judgements, contd.

Information about significant areas of estimation uncertainty that have the most significant effect on the amounts recognised in the financial statements are described in the following notes:

- Impairment on loans, cf. note 10.
- Receivables and payables to fallen credit institutions, cf. note 19.
- Properties held for sale, cf. note 11.
- Investment properties, cf. note 12.

f. New standards and interpretations adopted

The Fund has adopted all International Financial Reporting Standards and interpretations applicable to the Fund's operation and which have been adopted by the EU and have entered into force at year end 2014.

IFRS 10 supersedes IAS 27 Consolidated and Separate Financial Statements and SIC-12 Consolidation of Special purpose entities. IFRS 10 describes the requirements for the preparation and presentation of consolidated financial statements and defines the concept of control as control is a fundamental concept in determining which companies are considered part of the group. Three elements of control are (a) power over the investee, (b) exposure or rights to variable returns from its involvement in the investment; and (c) the ability to use its power over the investee to affect the amount of return on investment. The Fund shall comply with IFRS 10 in its financial statements as from 1 January 2014 and the implementation of the standard has no significant impact on the financial statements of the Fund.

IFRS 12 Disclosure of interests in other companies requires a wide range of disclosures that must be included in the financial statements that enable users of financial statements to evaluate the nature and risks associated with interests in other companies and the impact of the interests on the financial position, performance and cash flows of the Fund. The Fund shall comply with IFRS 12 in its financial statements as from 1 January 2014 and the implementation of the standard has no significant impact on the financial statements of the Fund.

New standards and interpretations not yet adopted

IFRS 9 Financial Instruments, which was published in July 2014 supersedes the current guidance on financial instruments in accordance with IAS 39. IFRS 9 includes revised guidance on the classification and measurement of financial instruments, defines a new model for the calculation of the impairment of assets and new general requirements for hedge accounting. IFRS 9 becomes effective for accounting periods beginning on January 1, 2018 or later, with early adoption permitted.

If adopted by the European Union IFRS will apply to the Fund from 1 January 2018. Work is underway to assess the potential impact on the financial statements of the Fund as a result of the implementation of IFRS 9. In view of the nature of the Fund's operations, the standard will have a broad impact on financial statements of the Fund during the period in which it is implemented. In particular, it is expected that the calculation of impairment losses on the basis of expectations of potential future losses may lead to an increase in provisions for loan impairment.

IFRS 15 Revenue provides a comprehensive framework for the accounting treatment of income. The standard replaces the existing guidelines on revenue, IAS 18 Revenue and IAS 11 work contracts and the related interpretations on revenue recognition. IFRS is effective for accounting periods beginning on January 1, 2017 or after, but early adoption is permitted. Work is underway to assess the potential impact on the financial statements of the Fund as a result of the introduction of IFRS 15.

3. Significant accounting policies

The accounting policies set out below have been consistently applied to all periods presented in these Consolidated Financial Statements. Revenues and expenses of the Fund are not recognised directly in other comprehensive income and the result for the year is therefore equal to comprehensive (loss) income.

a. Basis of consolidation

(i) Subsidiaries

Subsidiaries are entities controlled by the Company. Control exists when the Company has the power, directly or indirectly, to govern the financial and operating policies of an entity so as to obtain benefits from its activities. The financial statements of subsidiaries are included in the Consolidated Financial Statements from the date that control commences until the date that control ceases. The financial statements of the subsidiary are included in the Consolidated Financial Statements, combining together the same kind of assets, liabilities, equity, income and expenses, and applied the methods of consolidation.

(ii) Intra-group transactions

All intra-group transactions, balances, income and expense are eliminated on consolidation. Unrealized losses are eliminated in the same way as unrealized gains, but only to the extent that there is no evidence of impairment.

3. *Basis of consolidation, contd.*

b. *Interest income and interest expense*

Interest income and expense are recognised in the income statement using the effective interest method and consist of interest income on loans to customers, cash and cash equivalents, restricted cash, treasury securities and loans to banks, and interest expenses on borrowings. Interest income and expense includes the amortisation of discounts and premiums and other differences between initial book value of the financial instrument and amounts due on maturity, based on the effective interest method. Borrowing fees arising from loans granted as well as the Fund´s financing is recognised in the income statement in the same manner as interest income and expense and those items are taken into account in the calculation of effective interests.

Effective interest is the imputed rate of interest used in determining the present value of estimated cash flow over the estimated useful life of a financial instrument or a shorter period if applicable, so that it equals the book value of the financial asset or liability in the balance sheet. When calculating the effective interest rate the Fund estimates future cash flows considering all contractual terms of the instrument but not future credit losses.

Indexation of inflation-indexed assets and liabilities are recognised in the income statement among interest income and expenses as they accrue and in the balance sheet as part of the carrying amount of assets and liabilities.

The requirements of the standard IAS 39.63 have been implemented as consideration is now given to the impairment of loans in the calculation of interest income (net), however in the Fund´s previous financial statements interest income was calculated without accounting for the impairment of loans (gross). In the presentation of the financial statements for the year 2014 interest income of the previous year has been adjusted to conform with the requirements of the standard.

The Fund has provided loans for rental apartments at a 3.5% and 4.5% interest rate. The State Treasury compensates the Fund the interest difference between those loans and loans taken by the Fund. The State Treasury's contribution is based on the difference between borrowing and lending rates each year (see note no. 20). The aforementioned loans to rental apartments are inflation-indexed on floating interests. No long term agreement has been made between the Fund and the State on subsidy of interests on these loans but the subsidy is determined on annual basis by the State and approved in the national budget. If the State's subsidy for the payment of the interests would no longer be granted interests on the loans should be increased in order to secure the Fund's financial return and interest margin There are loan issues in the amount of approximately ISK 8,000 million granted in the years 2001-2009 for social benefits where State compensations do not apply.

c. *Other income*

Other income consists of collection charges. Other income is recognised in the income statement when accrued. Borrowing fees are included in the calculation of effective interest rate. They are included in interest income and not other income.

d. *Other operating expenses*

Other operating expenses consist of housing costs, operation of IT systems, collection expenses, purchased expert services, contribution to the operation of the Debtors' Ombudsman and other general operating expenses, cf. note 23. Operating expenses are recognised as they are incurred.

e. *Net operating income of properties held for sale*

Net operating income of properties held for sale consist of rental income and expenses of properties held for sale, cf. note 27.

f. *Net income of investment property*

Net income of investment property consist of rental income, operating expenses and valuation adjustments, cf. note 26.

g. *Financial assets and liabilities*

(i) Recognition and derecognition of financial assets and liabilities

Purchase and sale of financial assets is recognised at the date of transaction. Those assets and liabilities are recognised on the date on which the Fund commits to purchasing or selling the asset, except for loans that are recognised when funds are transferred to borrowers. Financial assets are derecognised when the contractual rights to the cash flows from the asset expire, or when the Fund transfers the rights to receive the cash flows on the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial assets are transferred.

Financial liabilities are recognised when the Fund becomes a party to the contractual provisions of the instrument. The Fund derecognises a financial liability when its contractual obligations are discharged, cancelled or expire.

3. Significant accounting policies, contd.:

g. *Financial assets and liabilities, contd.*

(i) Recognition and derecognition of financial assets and liabilities, contd.:

To ensure efficient price determination of its issued bonds the Fund has entered into agreements with market makers on a short term securities loans, where the Fund lends to the market maker its own bonds against collateral security for a maximum of 28 days. The bonds lent are not recognised in the balance sheet. The collaterals are not capitalised in the balance sheet as the risks and rewards remain with the Fund's counterparty. At the end of the agreement term, the Fund receives the bonds lent and returns the collaterals to the market maker.

(ii) Offsetting

Financial assets and liabilities are set off and the net amount is recognised in the balance sheet when, and only when, the Fund has the legal right to set off the amounts and intends either to settle on a net basis or realise the asset and settle the liability simultaneously.

(iii) Amortised cost of financial assets and liabilities

The amortised cost of a financial asset or liability is the amount at which the financial asset or liability is measured upon initial recognition, minus principal repayments, taking into account the cumulative amortisation of premiums and discounts using the effective interest method. Discounts and premium constitute the difference between the initial book value of the financial instrument on the one hand, and its nominal value on the other. In calculating the amortised cost of financial assets impairment is also taken into account, if any.

(iv) Fair value measurement

Fair value is the price received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The best measurement of the fair value of financial instruments is based on the quoted price in an active market and is used when readily available. For other financial instruments fair value is determined by using valuation techniques. A financial asset or liability is considered to be listed on an active market if the official price can be obtained from a stock exchange or another independent party and the price reflects actual and regular market transactions between unrelated parties. The fair value of investment property is assessed on the basis of the current property valuation, cf. note 3l.

(v) Impairment of financial assets

The carrying amount of the Fund's financial assets is reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, the asset's recoverable amount is estimated.

An impairment is recognised in the income statement whenever the carrying amount of an asset exceeds its recoverable amount. An impairment loss is expensed in the income statement.

Two methods are used to calculate impairment losses on loans; one based on assessment of individual loans and the other based on collective assessment. Estimated loss as a result of future events, irrespective of the probability thereof, is not recognised.

Objective evidence of impairment includes information on the following events and conditions:
(i) significant financial difficulty of the borrower,
(ii) deteriorating economic conditions,
(iii) a breach of contract, such as a arrears on installments or on interest or principal payments.

Individually assessed loans

Impairment losses on individually assessed loans are determined by the risk exposure on a case-by-case basis. The Fund assesses at each reporting date whether there is any objective evidence that individual loans are impaired.

Impairment losses are measured as the difference between the carrying amount of the financial assets and the present value of estimated future cash flows discounted with the assets' original effective interest rate. Impairment losses are recognised in profit or loss and reflected in an allowance account as deduction in their carrying amount.

3. Significant accounting policies, contd.:

g. Financial assets and financial liabilities, contd.:

(v) Impairment of financial assets

Collectively assessed loans

Where loans have been individually assessed and no evidence of loss has been identified, these loans are grouped in loan portfolios on the basis of similar credit risk characteristics for the purpose of calculating a collective impairment loss.

The collective impairment loss is determined by taking into account:

- historical loss experience in portfolios of similar risk characteristics,
- the estimated period from when a loss has occurred and until that loss is identified and recognised by contribution to an allowance account
- management's experienced judgement as to whether the current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience.

Changes in impairment on loan portfolios are consistent with changes in observable data from period to period, for example changes in property prices, payment status, or other factors indicative of changes in the probability of losses on the group and their magnitude. The methodology and assumptions used for estimating impairment are reviewed regularly by the Fund to minimise any differences between loss estimates and actual losses.

Reversal of impairment

If, in a later period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed in the income statement.

h. Cash and cash equivalents

Cash and cash equivalents consist of demand deposits with financial institutions.

i. Treasury securities and loans to banks

Treasury bonds and loans to banks consist of government treasury bonds, interbank loans and unsettled claims on the Icelandic banks and other financial institutions connected to the Icelandic financial crisis (see note 11). Treasury bonds are divided into securities listed on an active market and securities (RIKS30 and RIKS 33) listed on the stock exchange but without an active market, which are capitalised based on amortised cost and initial rate of return.

j. Loans

Loans are financial instruments with fixed or determinable payments that are not quoted in an active market. Loans and receivables include loans granted by the Fund to its customers and acquired loans, which are unlisted and will not be sold in the nearest future.

The loans are initially measured at fair value which represents the loan amount plus all direct transaction costs. The loans are then measured at their amortised cost using the effective interest method. The book value of loans and receivables includes accrued interest and inflation adjustments.

k. Properties held for sale

When the Fund redeems properties on foreclosed mortgages they are recognised as properties held for sale in the balance sheet. Redeemed properties are recognised at the lower of cost or net fair value. The fair value is determined as the market value of the property. The fair value is measured on the basis of a realtor's evaluation, if available, or price information from a list for real transactions with similar properties. In some cases evaluations of the asset management division of the Fund are used.

If the net fair value of a property held for sale decreases after its initial recognition the fair value decrease is expensed as impairment loss . If the net fair value increases in the future the previously recognised impairment loss is reversed but only to the extent that the carrying amount does not exceed the initial cost value. The reversal is recognised as a reduction to the previously charged impairment.

3. Significant accounting policies, contd.:

l. *Investment property*

Investment property is property held by the Fund for the purpose of generating rental income. Investment properties are initially measured at cost, including transaction costs, and are subsequently measured at fair value. The Fund relies on the official property valuation of the Icelandic Property Registry in the valuation of investment properties. The official property valuation according to the registry is defined as the fair value to be expected if the property is traded. The valuation is carried out in May of each year and is based on February prices. The valuation adjusted for the new prices is effective at the end of the year. The property valuation includes the building and land, and is divided into the valuation of the building and land. The valuation of the Fund´s investment properties is based on the official property valuation of the registry in effect at year end 2014 and is increased by the consumer price index from February 2014. Income and expenses of investment property are recognized as net income of investment property in the Fund´s income statement. Investment property is not depreciated.

m. *Operating assets*

Operating assets are recognised at cost less accumulated depreciation.

Depreciation

Depreciation is recognised in the income statement on a straight-line basis over the estimated useful lives of operating assets.

Estimated useful life is specified as follows:

Real estate	25 years
Fixtures and equipment	5-10 years

Residual value is reviewed annually unless it is immaterial.

n. *Intangible assets*

Intangible assets consist of software used in the Fund's operations. Intangible assets are amortised on a straight-line basis over the estimated useful life, which is 3 - 5 years.

o. *Issued bonds and other borrowings*

Issued bonds and other borrowings are initially recognised at fair value, which is the loan amount in addition to all costs associated with the transaction. After initial recognition they are measured at amortised cost using the effective interest rate method. Accrued interest expense and indexation are recognised as a part of the carrying amount.

p. *Equity*

The Fund's equity consists of contributed capital on the one hand and accumulated deficit on the other. The accumulated income or loss of the Fund from its establishment is recognised in accumulated deficit.

q. *Taxation*

Income tax of the taxable operations of the subsidiary, Leigufélagið Klettur ehf. is calculated and recognised in the financial statements. Calculations are based on the profit before tax, taking into account permanent differences between taxable income and income as according to the financial statements. The income tax rate is 20%. Deferred tax liabilities arises from the difference between the balance sheet items in the tax returns and financial statements. The difference stems from the fact that tax assessment is based on premises other than the financial statements.

4. *Segment information*

A segment is a component of an entity that generates income and expenses that are directly attributable to the segment. Management assesses and evaluates the performance and financial results of the segment and distributes funds specifically to the segment. Financial information of the segment must be separable for operational purposes in order to be identified as a segment. Financial information of the segment must be separable fo operational purposes in order to be identified as a segment. The Fund identifies its operations as a single segment.

5. Financial assets and liabilities

According to the International Financial Reporting Standard IAS 39 *Financial instruments: recognition and measurement,* financial assets and liabilities are divided into specific categories. The classification affects how the relevant financial instrument is measured. Those categories to which the Fund's financial assets and liabilities pertain and their basis of measurement are specified as follows:

- Trading assets and liabilities - are recognised at fair value.
- Loans and receivables - are recognised at amortised cost.
- Other financial liabilities - are recognised at amortised cost.

5. Financial assets and liabilities, contd.

The following table shows to which group financial assets and liabilities of the Fund pertain and their fair value:

	Trading assets	Loans and receivables	Liabilities at amortised cost	Total carrying amount	Fair value
31 December 2014					
Assets:					
Cash and cash equivalents		17.524.392		17.524.392	17.524.392
Due from State Treasury		4.546.964		4.546.964	4.546.964
Treasury securities	3.232.477	27.110.898		30.343.375	30.343.375
Loans to banks		7.621.776		7.621.776	7.621.776
Loans		728.081.166		728.081.166	759.072.947
Total financial assets	3.232.477	784.885.196	0	788.117.673	819.109.454
Liabilities:					
Bond issues			798.547.938	798.547.938	854.711.104
Other borrowings			3.871.068	3.871.068	3.871.068
Other liabilities			4.149.967	4.149.967	4.149.967
Total financial liabilities	0	0	806.568.972	806.568.972	862.732.139
31 December 2013					
Assets:					
Cash and cash equivalents		7.916.388		7.916.388	7.916.388
Due from State Treasury		4.500.000		4.500.000	4.500.000
Treasury securities	2.095.623	30.198.585		32.294.209	32.294.209
Loans to banks		11.478.270		11.478.270	11.478.270
Loans		768.480.860		768.480.860	853.510.424
Total financial assets	2.095.623	822.150.739	0	824.246.363	878.570.342
Liabilities:					
Bond issues			834.463.465	834.463.465	915.228.318
Other borrowings			4.273.495	4.273.495	4.397.956
Other liabilities			9.364.674	9.364.674	9.364.674
Total financial liabilities	0	0	848.101.634	848.101.634	928.990.948

The fair value of loans is estimated by discounting the cash flows of the loan portfolio by using the yield of HFF bonds plus 1.0% spread. The spread reflects the cost of operating the loan portfolio and the credit risk and prepayment risk in the case of loans which do not contain prepayment options.

The fair value of HFF bonds is based on their market price at year-end 2014. The fair value of Housing bonds is measured by discounting the cash flows by using the HFF interest plus 0.5% spread due to lesser liquidity compared to HFF bonds. The fair value of Housing Authority bonds is measured by discounting at the interest of HFF bonds plus 1.0% spread due to liquidity and prepayment risk of those bonds.

Treasury securities that are classified as trading assets are measured at fair value. They are the Fund´s only financial assets recognized at fair value. Fair value is based on quoted prices in active markets for identical assets. Other treasury securities are measured at their yield at acquisition.

Consolidated Financial Statements of the Housing Financing Fund for the year 2014 19 Amounts in ISK thousand

5. Financial assets and liabilities, contd.

Fair value hierarchy

The following table shows the level in the hierarchy into which the fair value of financial assets and liabilities, carried at fair value in the Balance Sheet, are categorised.

The levels are as follows:

Level 1: Valuation technique is based on quoted prices in active markets for assets and liabilities.
Level 2: Valuation technique is not based on quoted prices in active markets (level 1) but on information that is observable for the asset or liability directly (quoted price) or indirectly (adjusted quoted price).
Level 3: Valuation technique is based on significant information other than market information.

31 December 2014	Level 1	Level 2	Level 3	Total
Assets:				
Treasury securities	3.232.477			3.232.477
Investment properties		8.063.973	0	8.063.973
Total financial assets	3.232.477	8.063.973	0	11.296.450

31. desember 2013	Level 1	Level 2	Level 3	Total
Assets:				
Treasury securities	2.095.623	0	0	2.095.623
Investment properties	0	0	0	0
Total financial assets	2.095.623	0	0	2.095.623

The fair value of the Fund´s investment properties is based on the official property valuation of the registry in effect at year end 2014 and is increased by the consumer price index from February 2014. The fair value of trading securities is based on quoted prices in active markets.

6. Cash and cash equivalents and restricted cash

Cash and cash equivalents and restricted cash are specified as follows:	2014	2013
Unrestricted cash in Central Bank	17.387.541	7.855.259
Unrestricted cash in financial institutions	136.851	61.129
Cash and cash equivalents total	17.524.392	7.916.388

7. Loans to financial institutions

Loans to financial institutions are specified as follows:	2014	2013
Inter-bank loans	7.508.083	7.518.906
Other claims	113.693	3.959.364
Loans to banks total	7.621.776	11.478.270

8. Treasury securities

Treasury bonds are specified as follows:	2014	2013
Listed treasury bonds at fair value	3.232.477	2.095.623
Treasury bonds without active market capitalised based on amortised cost and initial rate of return	27.110.898	30.198.585
Treasury bonds total	30.343.375	32.294.209

9. Receivable due from State Treasury

The receivable due from the State Treasury is a bond amounting to ISK 4,547 million, that the Fund received during the period and that is payable in one lump sum in the year 2018. The bond has however a permanent prepayment privilege favorable to the Treasury, in part or in full. Only interest payments on the bond are collected during the loan period. The bond is not transferable by the Housing Financing Fund.

Consolidated Financial Statements of the Housing Financing Fund for the year 2014 20 Amounts in ISK thousand

10. Loans:

Loans are specified as follows:

	2014	2013
Loans to individuals	599.033.780	637.400.973
Loans to legal entities	129.047.386	131.079.887
Loans total	728.081.166	768.480.860

Impairment on loans is specified as follows:

	2014	2013
Balance at the beginning of the year	22.438.473	23.311.855
Impairment loss (reversal)	311.339	4.244.641
Write-offs	(1.622.209)	(5.118.023)
Balance at year end	21.127.603	22.438.473

11. Properties held for sale

The Fund had repossessed 1,891 properties at year end 2014 (2013: 2,206). Total number of properties held for sale managed by the Fund is specified as follows:

	2014	2013
Number of properties at the beginning of the year	2.606	2.224
Repossessed properties during the year	351	689
Properties sold during the year	(1.066)	(307)
Number of properties at year end	1.891	2.606

Properties owned by the Fund are divided as follows by geographical area:

	2014	2013
South and South West	780	881
Great Reykjavík area	340	593
South Iceland	218	369
West Iceland	201	285
East Iceland	193	232
North Iceland	109	173
Westfjords	50	73
Number of properties at year end	1.891	2.606

At year-end 2014, 913 properties of the 1,891 properties owned by the fund are in the sales process. 889 properties were rentals (2013;1,307) or 48% of the total properties owned by the Fund on 31 December 2014 (2013: 50.1%).

Properties held for sale at year end are measured at the lower of the cost or net fair value and are specified as follows:

Year-end 2014	Number of properties	Official property value	Fair value	Book value
Rentals	889	17.416.631	16.901.886	15.556.879
In sales process	913	14.351.411	11.946.170	11.206.199
Empty	67	964.470	828.626	778.596
Non-habitable	2	29.950	56.876	35.303
Other properties*	20	393.790	351.103	293.792
Total	1.891	33.156.252	30.084.662	27.870.768

* Abandoned, rent arrears or properties that have recently entered the portfolio and are being processed

Year-end 2013				
Rentals	1.307	23.288.027	22.738.370	21.730.526
In sales process	986	15.074.292	12.694.121	11.752.978
Empty	243	3.616.160	3.331.767	3.259.473
Non-habitable	21	288.600	268.682	237.981
Other properties*	49	893.953	893.953	682.271
Total	2.606	43.161.032	39.926.893	37.663.230

* Abandoned, rent arrears or properties that have recently entered the portfolio and are being processed

Consolidated Financial Statements of the Housing Financing Fund for the year 2014 21 Amounts in ISK thousand

12. Investment properties

Investment properties are specified as follows:

	Capital region	South and Southwest	West and Westfjords	North Iceland	East Iceland	Total
Cost						
Transferred properties	2.770.908	2.263.718	835.993	968.745	519.853	7.359.217
Additions....................	11.297	9.075	2.921	3.275	2.573	29.142
Improvements............	5.791	9.557	1.197	3.594	781	20.920
Balance 31.12.2014....	2.787.997	2.282.351	840.111	975.614	523.207	7.409.280
Valuation adjustment						
Valuation adjustment..	484.954	101.350	(37.499)	(18.878)	124.767	654.694
Balance 31.12.2014....	484.954	101.350	(37.499)	(18.878)	124.767	654.694
Carrying amount						
Balance 31.12.2014....	3.272.951	2.383.700	802.612	956.736	647.974	8.063.974

The Fund´s investment properties are residential properties owned by Leigufélagið Klettur ehf. that were previously accounted for as properties held for sale. Upon selling the assets the assets were transferred from property held for sale to investment properties in the consolidated statements. As at 31 December 2014, the total of investment properties amounted to 450 and the purchase price amounted to ISK 7.359 million.

Official property value and insurance value

The official property value of investment properties amounted to ISK 7,995 million at the end of the year. The insurance value of the Fund´s investment properties at the end of December 2014 amounted to ISK 9,810 million.

13. Investment in subsidiary

Leigufélagið Klettur ehf. was established on 23 January 2013. The Fund is the owner of 100% of the shares of the company. The operations of the subsidiary are independent and the company has been appointed a Board of Directors. There are two main objectives with establishing the company. On the one hand to release the Fund´s ownership of the properties and separate the operations of the company from the operations of the Fund. On the other hand, to accommodate the will of the government to increase the supply of housing for lease. The main purpose of Leigufélagið Klettur ehf. is to provide suitable residential accommodation for rent throughout the country, with long-term housing security in mind. The Articles of Association states that the purpose of the company 's operations is the operating and leasing of housing, building, buying and selling residential property to maintain and expand the company, as well as administrating, trading and renovating properties along with lending and other activities related to the operations of the Company. Details regarding the financing of the subsidiary are disclosed in note 30.

14. Operating assets:

Operating assets are specified as follows:

	Fixtures and equipment	Real estate	Total
Cost			
Balance at 1.1.2013	245.089	10.197	255.286
Additions during the year	10.568	0	10.568
Balance at 31.12.2013	255.657	10.197	265.854
Additions during the year	29.495	20.529	50.024
Balance at 31.12.2014	285.152	30.726	315.878
Depreciation			
Balance at 1.1.2013	178.216	5.761	183.977
Depreciation during the year	12.166	206	12.372
Balance at 31.12.2013	190.382	5.967	196.349
Depreciation during the year	12.865	700	13.565
Balance at 31.12.2014	203.247	6.667	209.914
Carrying amount			
Balance at 1.1.2013	66.873	4.436	71.309
Balance at 31.12.2013	65.275	4.230	69.505
Balance at 31.12.2014	81.905	24.059	105.964

Property value of real estate at year end 2014 amounted to ISK 8.7 million (2013: ISK 8.4 million) and insurance value amounted to ISK 21.3 million (2013: ISK 20.7 million).

Consolidated Financial Statements of the Housing Financing Fund for the year 2014 22 Amounts in ISK thousand

15. Intangible assets

Intangible assets are specified as follows:

	Software
Cost	
Balance at 1.1.2013	414.099
Additions during the year	50.292
Balance at 31.12.2013	464.391
Additions during the year	60.095
Balance at 31.12.2014	524.486
Amortisation	
Balance at 1.1.2013	266.378
Amortisation during the year	46.585
Balance at 31.12.2013	312.963
Amortisation during the year	40.521
Balance at 31.12.2014	353.484

Intangible assets are specified as follows:

Carrying amounts	
Balance at 1.1.2013	147.721
Balance at 31.12.2013	151.428
Balance at 31.12.2014	171.002

16. Bond issues

The Fund issues housing bonds in four HFF series. The name of each series indicates the maturity year of the series. The bond issues are all inflation-indexed annuity bonds with semi-annual payments. All HFF series carry 3.75% nominal interests. Housing bonds are inflation-indexed annuity bonds with four annual instalments and carry 4.75% - 6.00% nominal interests. Housing bonds are callable. Housing authority bonds are inflation-indexed annuity bonds with semi-annual payments and carry 2.70% - 6.25% nominal interests. The effective interest rate of the issued bonds is 4.31%.

Bond issues are specified as follows:

	2014	2013
HFF14 bond	0	12.587.562
HFF24 bond	154.645.941	165.839.992
HFF34 bond	214.886.971	219.404.366
HFF44 bond	383.478.068	385.983.495
Housing bonds (final maturity 2040)	25.067.248	29.090.763
Housing Authority bonds (final maturity 2038)	20.469.710	21.557.286
Total bond issues	798.547.938	834.463.465

17. Other borrowings

Other borrowings are specified as follows:

	2014	2013
Pension funds	1.332.339	1.770.830
Municipalities	442	2.580
Insurance fund	287.502	279.046
Callable bonds	95.605	179.840
Unpaid due to purchase of loan portfolios	2.155.179	2.041.199
Total other borrowings	3.871.068	4.273.496

Amounts in ISK thousand

18. Other liabilities

Other borrowings are specified as follows:

	2014	2013
Treasury due to subsidized interest	177.487	150.013
Interbank borrowings	173.315	1.590.023
Income tax liability	136.488	0
Other liabilities	3.662.677	7.624.638
Total other liabilities	4.149.967	9.364.674

The deferred tax liability of the Fund is due to the taxable activities of its subsidiary Leigufélagið Klettur ehf. The taxable income base of the subsidiary is negative in 2014, therefore there is no income tax payable in the year 2015. The deferred tax liability arises when the book value of the asset is different from its taxable base.

19. Impairment of claims on banks

The Fund had approximately ISK 16,620 million outstanding claims on Iceland's three biggest banks that collapsed in October 2008, resulting from bonds and derivative contracts entered into with the banks. At the same time, the Fund owed to these banks ISK 5,342 million due to derivatives and HFF bonds. A total of ISK 7,457 million has been written down in the Fund´s financial statements as impairment due to these claims. Uncertainty prevails regarding the settlement of claims and derivatives and the Fund's right to off-set these balances. Therefore, the Fund's loss could be different when the final settlement occurs. In the year 2014, one case was concluded based on an agreement in addition to an agreement reached finalizing another dispute. Changes during the year lead to an increase in the total write-down against claims in the amount of ISK 4,017 million.

20. Net interest income

Interest income

	2014	2013
Interest income on items not at fair value:		
Interest income on loans to customers	42.337.031	63.122.877
Interest income on other financial assets	2.603.629	4.268.000
Government contribution to subsidy interests*	606.526	618.521
	45.547.186	68.009.398
Interest income on items at fair value:		
Interest income on market securities	0	134.082
	0	134.082
Total interest income	45.547.186	68.143.480

Interest expenses

	2014	2013
Interest expenses on items not at fair value:		
Interest expenses on bonds issued	43.759.643	66.573.802
Interest expenses on other borrowings	199.434	344.185
Interest expense on items at fair value:		
Interest expense on market securities	36.600	0
Total interest expenses	43.995.677	66.917.987
Net interest income	1.551.509	1.225.493

*Subsidy on interests on loans is due to social benefit loans to municipalities and organisations, such as student associations and organisations of disabled.

21. Other income

Other income is specified as follows:

	2014	2013
Collection and service income	150.241	152.280
Other income	9.011	8.613
	159.252	160.893

Consolidated Financial Statements of the Housing Financing Fund for the year 2014 24 Amounts in ISK thousand

22. Salaries and salary-related expenses

Salaries and salary related expenses are specified as follows:

	2014	2013
Salaries	726.806	656.453
Pension fund contributions	100.002	90.968
Tax on financial activity	43.659	49.156
Other salary related expenses	80.802	70.904
Other personnel expenses	35.151	40.922
Total salaries and salary related expenses	986.420	908.402

Number of employees of the Fund are specified as follows:

Average number of employees during the year in full-time equivalent units	107	101
Number of employees at year-end	97	100

23. Other operating expenses

Other administrative expenses are specified as follows:

	2014	2013
Collection fees	201.126	210.330
Operating expenses of housing	130.463	119.132
Operating cost of IT systems	154.858	186.350
Audit and review of financial statements	16.881	22.045
Professional services	110.204	153.988
Price evaluation related to payment difficulty solutions	23.033	35.342
Advertising, promotional material and grants	14.585	33.575
Debtors' Ombudsman	165.168	268.244
Financial Supervisory Authority	53.814	60.140
Credit rating	16.614	15.843
Service fees	31.320	26.150
Other operating expenses	91.614	64.817
Total other administrative expenses	1.009.681	1.195.957

24. Auditors' fee

Remuneration to the auditors´ are specified as follows:

	2014	2013
Audit of financial statements	9.378	16.000
Review of interim financial statements	2.891	2.977
Internal audit	4.612	3.068
Total auditors' fee	16.881	22.045

25. Depreciation and amortisation of the year:

Depreciation and amortisation is specified as follows:

	2014	2013
Depreciation of operating assets (cf. note 14)	13.565	12.372
Amortisation of intangible assets (cf. note 15)	40.521	46.585
Total depreciation and amortisation	54.086	58.957

26. Net income of investment properties

Net income of investment properties is specified as follows:

	2014	2013
Rental income from investment properties	574.351	0
Expenses of investment properties	(179.211)	0
Valuation adjustment	654.694	0
Net income of investment properties	1.049.834	0

27. Net income of properties held for sale

Net income of properties held for sale is specified as follows:

	2014	2013
Rental income from rented properties	1.232.477	1.316.471
Cost of properties held for sale	(1.037.576)	(927.012)
Net income of properties held for sale	194.901	389.459

Consolidated Financial Statements of the Housing Financing Fund for the year 2014 25 Amounts in ISK thousand

27. Net income of properties held for sale, contd.

The costs of real estate for sale in the table above include only the direct incurred costs of the properties cf. property taxes, insurance, maintenance, energy costs and commissions of administrators. If all costs of the reception, operations and enforcement of property sales are to be included then consideration needs to be given to the cost of operating the Fund´s asset division in addition to the division´s share of the Fund´s administrative costs. Operating expenses of the Fund´s asset division amounted to ISK 185.6 million in 2014 compared to ISK 176 million in 2013. Revenues exceeded expenses of properties held for sale in the amount of ISK 9.3 million, if taken into account the costs of the asset division (2013: ISK 214 million).

28. Impairment

Total impairment recognised in the income statement is specified as follows:

	2014	2013
Specific impairment loss of loans (reversal of impairment loss)	(434.440)	4.277.562
General impairment on loans	745.779	(32.921)
Impairment loss of loans (reversal of impairment loss)	311.339	4.244.641
Impairment on properties held for sale	1.192.377	(952.351)
Impairment on other receivables	40.391	80.223
Total expensed impairment	1.544.107	3.372.513

29. Rental agreements

The Fund has entered into a operating lease agreement on the property used in its operations. Minimum lease payments are specified as follows at year end:

	2014	2013
Payable within 1 year	119.363	109.551
Payable after 1 to 5 years	275.536	221.122
Later	9.695	85.918
Total	404.594	416.591

30. Related parties and salaries of management

The Fund has a related party relationship with its owner, board members, executive officers and its subsidiary. The Housing Financing Fund is publically owned and administratively falls under the Ministry and Minister of Welfare. Government institutions and self-governing corporate entities that are financially dependent on the authorities are related parties of the Fund. Loans to related parties are granted on arms-length basis. The balance of mortgage loans to related parties amounted to ISK 12.5 million at year end 2014 (2013: ISK 46.5 million) and are recognized as loans in the balance sheet.

Salaries of the Board, Managing Director and key personnel is specified as follows:

	2014		2013	
	Salaries	Pension fund contributions	Salaries	Pension fund contributions
Sigurður Erlingsson, CEO	14.643	1.687	16.759	1.873
Chairman of the Board, Ingibjörg Ólöf Vilhjálmsdóttir	2.369	249	518	52
Former board member, Jóhann Ársælsson	0	0	1.554	179
Other Board Directors, four	5.716	503	4.096	335
Key personnel, seven	94.157	11.505	89.008	11.521

The managing director of Leigufélagið Klettur ehf. is included as key personnel in the year 2014.

Related party transactions:

	2014		2013	
	Interest income	Claims	Interest income	Claims
Leigufélagið Klettur ehf.	244.666	7.650.628	0	73.180

Consolidated Financial Statements of the Housing Financing Fund for the year 2014 26 Amounts in ISK thousand

30. Related parties and salaries of management, contd.:

The claim in the amount of ISK 7,650 million is due to the subsidiary´s purchase of properties from the Fund in the year 2013, however the financing of the purchase under the agreement has not been finalized. The annual interest rate of the subsidiary´s liabilities under the purchase agreement is 4.2% incl. indexation. The calculation of accrued interest in the financial statements is based on these terms.

The proposed loan financing has been reported to the EFTA Surveillance Authority (ESA) and its conclusion is dependent on the response from the ESA.

Related party transactions are made on terms equivalent to those that prevail in arm´s length transactions.

31. Other matters

EFTA Surveillance Authority

On 16 July, the ESA reached its decision to close its investigation of the Fund´s activities. The ESA was investigating both the state aid received by the Fund in the form of a government guarantee on its funding and also the relief aid to the Fund in the form of a capital injection to maintain the Fund´s equity. Although the decisions of the ESA may be appealed, it is unclear as to whether this decision will be appealed. The findings of the ESA are outlined in a legal letter by Bjarnveig Eiríksdóttir in European Law, dated 14 August of this year. Recently, information has been received that SFF has appealed the decision of the Authority to conclude the matter. The Icelandic government is not a party to the case, and according to the Fund´s information it is not clear as to whether the Icelandic government will request to intervene in the case, as was done in 2004 in SFF´s complaint against ESA. If the case is lost, the ESA will resume its investigation of the Fund.

Project on future organization of housing policy: Changes to the Fund´s role

The project committee on the future organization of housing policy submitted proposals to the government in the beginning of May of this year. The committee proposes the adoption of a new mortgage credit system in which specialized mortgage lending companies administer lending throughout the country. The framework of all mortgage loans is modeled on the Danish system and is based on the balance between lending and financing loans. According to the proposal the Fund´s operations will be divided into two parts: a new public housing agency will be established and it is expected that many of the Fund´s current services will be administered by public authorities. The Fund´s current loan portfolio will be allowed to expire according to the proposal.

Some activity has occurred as to the implementation of the proposal in the year 2014. The operational foundation of a new mortgage company owned by the state has been examined, but it was decided not to start the preparations for the establishment of such a company until the changes made to the laws on financial institutions have been established. Discussions have been made to discontinue entirely the Fund´s lending activities so as not to increase the government´s guarantee, as the Fund has not raised capital through bond auctions since 2012. Presently, implementations of the proposal appear to be on standby. A bill on the amendments of the Fund´s activities still has not been submitted to the Parliament but a draft of a bill for the capital funding of rental companies has been outlined.

Principal reduction of mortgages

Laws concerning the reduction of mortgage principals and the appropriation of private savings to reduce mortgage loans were passed in the spring of 2014. A reduction of loans for the purpose of purchasing residential properties is expected. Households that paid indexed loans during the period 2008-2010 can receive a maximum reduction of their debt of ISK 4 million. Individuals are allowed to allocate up to ISK 500 thousand of contributions to private pension savings accounts yearly as a reduction on mortgage loans and couples up to ISK 750 thousand a year.

The implementation of the action plan by the Fund has been quite successful. In March 2015, approximately 90% of applicants have received notification as to the outcome of the reduction. The Fund has processed about 23,000 reductions amounting to a total of ISK 29.9 billion. It has administered 21 thousand payments from pension funds due to the allocation from private pension savings accounts, totaling about ISK 1.7 billion.

The Fund´s forecasts assume that about ISK 35 billion of the Fund´s loan portfolios will be prepaid on the basis of the solution for the reduction of principal mortgages. 75% of the prepayments due to the solution occur in early 2015 and 25% of the prepayments occur in the beginning of 2016. Accordingly, the forecasts assume that ISK 16 billion will be prepaid on the basis of the Act on the allocation of private pension savings to individuals´ mortgages and those prepayments occur evenly in the years 2015 to mid-year 2017. In the framework of the agreement on the reduction of the principals of mortgage loans it is expected that institutions will be compensated for the losses that occur due to the solution and the Fund´s managers expect full compensation, despite the fact that the implementation of the compensation has not been finalized. Nevertheless impairment amounting to ISK 433 million is recorded as an impairment loss at the end of 2014 due to the difference between the book value of prepaid portion of the loan portfolio and the expected prepayment value of that portion of the loan portfolio. Since the Fund is not permitted to pay its debts until as according to the contractual maturities, early excess and prepayments as a result of both of the solutions will have a significant effect on the criteria for net interest income of the Fund, resulting in a decrease of net interest income.

31. Other matters, contd.:

In addition to prepayments due to the principal reductions, the action plan appears to have resulted in market movements, particularly so that debtors are using the opportunity to refinance and an apparent increase of activity in the housing market.

Legal action due to indexed loans

The Fund was cited for violation of the Act on Consumer Credit, challenging the legality of indexed loans in the fall of 2013. The lawsuit was filed in November 2013. The main cause of the action pertains to the Fund not having the authority to collect the costs entailed by the CPI-indexation of the loan as total borrowing costs were not identified in the initial loan process. The judgement of the District Court was delivered on 6 February 2014. The Fund was acquitted of all the claims of the plaintiff. The Court concluded basically that the Fund was authorized and obliged to provide indexed loans. The Court concluded that the indexation charges are included in the total borrowing costs and thereby the Fund had calculated the annual percentage rate of the cost of borrowing assuming that the prices, interest rates and other fees remain unchanged until the end of the loan period. It is not specified in the judgement the target level of inflation thereby accordingly, the Court concluded that the Fund had neglected to disclose this information. The Court concludes that in assessing the level of legal negligence it should be noted that the provisions of the bond as to indexation were clear and unequivocal, and the plaintiff should have been aware that the loan was not in the form of a fixed amount.

The District Court´s ruling has not yet been appealed. It is not known when the case will be presented before the Supreme Court. As before, there is still a prominent debate about the validity of indexation, although the District Court´s decision has reduced somewhat this debate. Complaints are still being received from customers demanding reduction of their loans or even elimation on the basis of fraudulent indexation. It is clear that if indexation is revoked by the court, it will have a significant impact on the operability of the Fund and its financial position.

Other matters

Several disputes are currently before the courts mainly related to the processing of debt remedies, as according to the law it is necessary to determine such matters before the courts, as well as the sale of the Fund´s assets. There has been an increase of complaints due to forced sales and in general it appears that parties are quicker to cite complaints. It is the Fund´s opinion however, that these cases, both individually and combined are not likely to have a significant financial impact on the Fund.

32. Risk management

a. *Overview of financial risks and the risk management structure*

A key issue in the Fund's daily management is to reduce its risk exposure related to financial assets and liabilities. Following are the risks that the Fund is exposed to and which are of importance:

- Credit risk
- Liquidity risk
- Interest rate risk, prepayment risk and indexation risk
- Operational risk

The following include information on the Fund's financial risk management, in addition to information on each of the aforementioned risks, goals, aim and evaluation process along with management of each risk. Furthermore, information on the Fund's capital management is disclosed.

Risk management structure

The Housing Financing Fund is a non-profit organisation. Its financial and risk management takes note thereof. Its main objective is to continuously seek to keep a low risk level in its financial operations. Furthermore, the Fund aims at limiting financial risk and cost in accordance with its operating goals.

The Fund appoints a Financial Committee consisting of the CEO, Financial Director and a finance expert. The Committee's role is to ensure sufficient disclosure of information to the Board and that finance experts in the finance department follow the financial and risk management policies. Rules on financial and risk management shall be reviewed on a regular basis, in line with changes in the financial environment and changes in the operation of the Fund.

32. Risk management, contd.:

a. *Overview of financial risks and the risk management structure, contd.:*

The Fund's Board of Directors

- Establishes the Fund's financial and risk management policy and reviews on a regular basis reports on the Fund's financial risk.
- Takes note of risk factors in the Fund's administration and organisation.
- Appoints a financial committee.
- Submits reports to the Minister of Welfare.

CEO

- Reviews reports on the Fund's risks.
- Responsible for the Fund's long term financing need being met.
- Divides responsibility of financial matters in accordance with the financial and risk management policy between the financial committee and the financial department.

Financial Risk Committee

- Brings proposals before the Board of Directors on new bond issuance.
- Brings proposals before the Board of Directors on interest levy on loan interests in accordance with the Fund's rules.

Head of financial department

- Responsible for the implementation of risk management and risk analysis and ensures that all of the Fund's payments and financial agreements are within its financial and risk management policy.
- Directs the Fund's financial and risk management departments.
- Works on proposals on revision of the financial and risk management policy.

Risk management

- Takes care of daily risk management operations.
- Shares knowledge and risk awareness within the Fund.

Treasury

- Takes care of the Fund's financing and financial operations and ensures a safe and efficient handling of securities.

Hedges

It is important to maintain a certain balance in the Fund's combination of borrowings and loans. The Fund's financial and risk management rules stipulate that the Fund must limit its risks and manage interest rate and credit risk within a certain threshold.

The Fund's financial and risk management operates in accordance with the Fund's financial and risk management rules. The rules define the risks and their margin of tolerance in the Fund's operation.

b. *Credit risk*

Credit risk is the risk of financial loss if a customer or a counterparty to a financial instrument fails to meet its contractual obligations. The Fund's credit risk arises from loans to customers, investments in market securities and loans to banks. As stated before it is the Fund's main objective to maintain low risk level in its operations.

Solutions for the payment difficulties of the Fund's clients

In addition to general payment difficulty solutions, i.e. rescheduling of amounts in arrears and deferral of repayments due to temporary payment difficulties, the Housing Financing Fund participates in the payment difficulty solutions established on the one hand by the State and on the other hand, by joint effort of lenders in the housing market.

General solutions for payment difficulties, i.e. rescheduling of amount in arrears, deferral of repayments and term extensions, are mainly intended to meet temporary payment difficulties. These solutions are often used all together, i.e. amounts in arrears are rescheduled (changed to a new loan, a so-called reschedule loan), payment is suspended (interest suspension) and finally, the maturity of loans is extended by a period corresponding to at least the suspension period.

Specific solutions for payment difficulties, specific debt and payment adjustments for individuals have been established to meet payment difficulties of individuals.

32. Risk management, contd.:

b. *Credit risk, contd.:*

Solutions for the payment difficulties of the Fund’s clients, contd.:

Specific debt adjustment is based on an agreement between lenders on the housing loan market and is intended for those who have the ability to pay on their mortgage claims corresponding to the value of the property. A debtor pays on the claims, or contractual claims, for 3 years. If the debtor honors the agreement, claims in excess of the property value and contractual claims not paid during the period will be cancelled or written off. Time limit to apply for the specific debt adjustment expired at year-end 2012.

The Fund has also entered into agreements with customers to avoid the enforcement process, which includes restructuring and payment distribution of arrears for up to 18 months. A total of 666 homes had active contracts with the Fund for the payment of arrears for up to 18 months at the end of 2014.

Payment adjustments are intended to allow individuals with serious payment difficulties to reorganise their finances and establish balance between their debt and ability to pay so that they will have a realistic possibility to meet their obligations in the foreseeable future. The term of a debt adjustment lasts for 1-3 years during which the debtor pays on the claims corresponding to the value of the property. The debtor can then apply for a write-off of mortgage claims in excess of the market value of the property at the end of the period provided that legal conditions are met.

These solutions decrease considerably the cash payments towards the Fund. In addition, for specific debt and payment adjustments for individuals it is always assumed that claims in excess of the market value of properties will be written-off, should the applicant fulfil the contract.

Lifting of mortgage claims in excess of the sale price was established in order to facilitate sale of over-mortgaged properties where the owners are unable to pay on the loans in the future and can sell the property on a general market. Lifting of mortgage claims in excess of sale price is also applied on the basis of the Act on payment adjustment.

Households with unpaid mortgage claim in excess of 110% of the value of the properties were offered the option of writing down the loan to 110%. The time limit to apply for this solution expired on 1 July 2011.

Payment detainment is a solution available to temporarily relieve the payment burden of loans by linking the loans to a so called Payment Detainment Index instead of the CPI. Approximately 49.7% of the value of the loans to individuals utilized this option at the end of 2014 (2013:50.6%).

The balance of the payment detainment account was ISK 11.349 million at the end of the year 2014. Payment detainment involves accounting for the proportion of indexation consistent with the change in payment detainment index and the consumer price index in the payment detainment account. At the end of the year 2014 approximately 1.6% of the indexation factor was recorded in the payment detainment account, the highest ratio being 19.6% in 2010. It may be expected that with continued development the Fund´s borrowers will begin payments of payment detainment balances in early 2015.

Information on possible solutions for payment difficulties can be found on the Fund's website. The following table shows the extent of these solutions based on the prepayment value of loans in the relevant solution category.

	2014	**2013**
Payment suspension	1.866.221	4.944.343
Rescheduled loans	2.549.316	2.289.755
Extending the maturity of loans	8.475.917	8.672.691
Specific solutions		
- Specific debt adjustments	7.764.872	10.262.905
- Payment adjustments	7.869.245	9.583.006
- Lifting of mortgage claims in excess of sale price- outstanding amount of loans	4.736.807	4.597.556

Credit risk management

Outstanding amount of loans with write-off in excess of 110% of loan-to-value	52.722.134	54.741.901

More than one solution in the table here above may have been applied to the same loan.

Consolidated Financial Statements of the Housing Financing Fund for the year 2014 30 Amounts in ISK thousand

32. Risk management, contd.:

b. *Credit risk, cont.:*

Credit risk management, contd.:

All of the Fund´s loans to customers are secured by real estate mortgages. The Fund limits its risk due to these loans in two ways: by setting a maximum individual loan amount and a maximum pledge ratio. In addition, borrowers need to undergo a credit evaluation. The finance committee evaluates the Fund's credit risk on an ongoing basis and determines the price thereof as part of the spread on the Fund's borrowing rates on loans when lending interest rates are determined.

As insurance for securities loaned to market makers with the Fund's bonds, the Fund holds pledge in the form of cash or securities. Pledgeable securities are issued securities with market makers, issued by the Government Debt Management and also the Fund's own bonds. The Fund's pledge is invariably well over 100% in these transactions.

Maximum credit risk exposure as according to geographical areas

The following table shows the maximum credit risk exposure as according to geographical areas.

Year-end 2014	Capital region	South and Southwest	West and Westfjords	North Iceland	East Iceland	Total
Loans to individuals.....	403.835.921	93.736.929	29.508.424	54.665.427	17.283.791	599.030.493
Loans to entities...........	79.404.188	20.417.662	7.943.763	18.902.211	2.382.850	129.050.673
Total loans.................	483.240.109	114.154.592	37.452.186	73.567.638	19.666.641	728.081.166

Year-end 2013	Capital region	South and Southwest	West and Westfjords	North Iceland	East Iceland	Total
Loans to individuals.....	430.673.197	99.068.134	31.341.051	57.941.141	18.377.448	637.400.972
Loans to entities...........	79.339.338	21.163.791	9.310.766	18.739.715	2.526.279	131.079.888
Total loans.................	510.012.535	120.231.925	40.651.817	76.680.856	20.903.726	768.480.860

Quality of loans

The following table shows the carrying amount of loans that are neither past due nor impaired, the carrying amount of loans that are past due and not impaired and the carrying amount of loans that are impaired.

	Loans to individuals		Loans to legal entities		Total	
	2014	2013	2014	2013	2014	2013
Neither past due nor impaired						
Total...........................	521.216.159	541.066.469	91.796.523	80.556.629	613.012.682	621.623.098
General impairment....	(625.972)	(533.317)	(151.200)	(82.275)	(777.172)	(615.592)
Carrying amount.........	520.590.187	540.533.153	91.645.323	80.474.354	612.235.510	621.007.507
Past due and not impaired						
31-60 days..................	19.508.784	16.211.140	896.243	144.671	20.405.028	16.355.811
61-90 days..................	6.582.464	11.581.469	552.880	145.336	7.135.344	11.726.805
Past due over 90 days	21.765.945	19.907.389	7.205.498	1.698.531	28.971.443	21.605.920
General impairment....	(812.243)	(361.642)	(154.628)	(21.029)	(966.870)	(382.671)
Carrying amount.........	47.044.951	47.338.355	8.499.993	1.967.510	55.544.944	49.305.865
Impaired						
Total............................	39.747.137	58.471.402	39.937.137	61.136.296	79.684.274	119.607.698
Specific impairment.....	(8.348.495)	(8.941.937)	(11.035.066)	(12.498.273)	(19.383.561)	(21.440.210)
Carrying amount.........	31.398.642	49.529.465	28.902.070	48.638.023	60.300.713	98.167.488
Loans total................	599.033.780	637.400.973	129.047.386	131.079.887	728.081.166	768.480.860
Impairment as proportion of loans.......	1.61%	1,52%	8.08%	8.77%	2.82%	2,84%

Consolidated Financial Statements of the Housing Financing Fund for the year 2014 31 Amounts in ISK thousand

32. Risk management, contd.:

b. *Credit risk, cont.:*

Quality of loans, contd.:

The following table shows an age analysis of total arrears on loans.

	Loans to individuals		Loans to legal entities		Total	
	2014	2013	2014	2013	2014	2013
Loans past due:						
31-60 days..................	386.358	467.095	190.458	214.321	576.816	681.416
61-90 days..................	266.251	336.555	85.701	98.704	351.952	435.259
Past due over 90 days.	3.949.753	4.293.635	3.783.456	4.546.940	7.733.209	8.840.575
Total past due.............	4.602.362	5.097.285	4.059.615	4.859.965	8.661.977	9.957.250

Obligations not recognised in the balance sheet:	2014	2013
Binding loan commitments at year-end..	2.051.900	2.093.000

The Fund regularly reviews its loan portfolio to assess impairment. Prior to determining whether an impairment loss should be recognised in the income statement, the Fund makes judgements as to whether there is any objective evidence indicating that there is a measurable decrease in the estimated future cash flows from individual loans or from a portfolio of loans before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there have been changes in the payment status of borrowers in a group or economic conditions. Management uses estimates based on historical loss experience for assets with similar credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

A specific provision for impairment of loans to legal entities has been calculated on the basis of the professional judgement of employees and management of the Fund and recognised in the financial statements. The specific provision is based on official information, solvency of the legal entity, condition of underlying assets, information on the standing of the debtors, marketability of the assets and value of pledges.

The experts of the Fund have estimated the need for a provision on loans to individuals. In making this estimate the balance of loans in arrears and the value of collaterals for the loans was taken into account. Specific provision for impairment due to this has been recognised in the financial statements of the Fund.

The value of pledges is based on the current real estate value at each given time.

General impairment is also recognized in the income statement. See in addition note 3.g.v. regarding the estimation of general provisions required for impairment.

Write-off on loans

Loans are written off under the following two circumstances:

- Upon loss on the sale of apartments auctioned, when the sales value is lower than the valuation of the apartment, according to Article 57 of Act no. 90/1991 on forced sale

- Upon the approval of the Housing Financing Fund of the discontinuance of a claim of "lost pledge" in accordance with Regulation no. 359/2010, on the treatment of the Housing Financing Fund's claims for which pledges have been lost

Consolidated Financial Statements of the Housing Financing Fund for the year 2014 32 Amounts in ISK thousand

32. Risk management, contd.:

b. *Credit risk, cont.:*

Write-off on loans, contd.:

Impairment on loans is specified as follows:

	Individuals		Legal entities		
	Specific impairment	General impairment	Specific impairment	General impairment	Total 2014
Year 2014					
Balance at the beginning of the year	8.941.937	894.959	12.498.273	103.304	22.438.473
Impairment loss (reversal of impairment loss)	2.293.521	543.255	(2.727.961)	202.524	311.339
Write-off	(2.886.963)	0	1.264.754	0	(1.622.209)
Balance at year end	8.348.495	1.438.214	11.035.066	305.828	21.127.603

	Individuals		Legal entities		
	Specific impairment	General impairment	Specific impairment	General impairment	Total 2013
Year 2013					
Balance at the beginning of the year	9.064.583	938.335	13.216.088	92.850	23.311.855
Impairment loss (reversal of impairment loss)	4.091.807	(43.376)	185.755	10.455	4.244.641
Write-off	(4.214.453)	0	(903.570)	0	(5.118.023)
Balance at year end	8.941.937	894.959	12.498.273	103.304	22.438.473

Quality of pledges

The Housing Financing Fund's loans are secured by pledges in real estates. Loans are granted to the maximum of 80% of the purchase price, provided that there are no other restrictions of a maximum loan amount, which is ISK 24 million for individuals. Following the granting of a loan, pledges are not assessed specifically in terms of fair value unless in relation to the evaluation of possible impairment losses. Requirements for general housing loans are that a binding purchase offer has been made, which in general may be equal to the fair value of the specific real estate on the date of purchase.

The weighted average pledging ratio of the Fund's total loans on the official property value is approx. 53.6% at year end 2014 compared to 57.6% at year end 2013. The majority of the Fund's loans have first pledge right. The pledging ratios, i.e. calculated remaining balance on loans without specific impairment as proportion of the official property value, are specified as follows at year end:

	2014	2013
Proportion of the total loans under 50% of the official property value	66,9%	64,1%
Proportion of the total loans from 51 - 70% of the official property value	15,3%	15,5%
Proportion of the total loans from 71 - 90% of the official property value	9,5%	10,3%
Proportion of the total loans from 91 - 100% of the official property value	2,9%	3,3%
Proportion of the total loans from 101 - 110% of the official property value	1,8%	2,3%
Proportion of the total loans over 110% of the official property value	3,6%	4,5%
	100%	100%

Counterparty risk related to securities transactions

The Fund's own bonds, which it has lent to market makers, and underlying pledges are specified as follows at year end:

	2014	2013
Loaned own bonds, market value	2.536.537	2.955.035
Market value of pledges provided by counterparties	2.808.760	3.195.048

Consolidated Financial Statements of the Housing Financing Fund for the year 2014 33 Amounts in ISK thousand

32. Risk management, contd.:

c. *Liquidity risk*

Liquid risk management

Liquidity risk is the Fund's risk of not being able to meet its contractual interest and principal payments on its borrowings. By effective control on liquidity balance the Fund endeavours to ensure that there are always sufficient funds in order to meet its obligations if a temporary imbalance arises between the payment flow on the Fund's loans and other financial assets on the one hand, and its borrowing on the other.

The Fund's liquidity risk management includes liquidity analysis, access to secured loan lines from banks and liquidity plan. The Fund's liquidity plan is determined one year a head in terms of operating and financial budget. The liquidity plan is updated on a regular basis. A short-term plan is concluded daily for liquidity, including the estimation of the Fund's cash flow for the next 20 working days.

Measurement of liquidity risk

A key issue in the Fund's liquidity management is to ensure that there is balance between payment flow on financial assets and financial liabilities. The following table shows the contractual payment flow of the Fund's financial assets and liabilities.

Remaining balance of financial assets and liabilities:

	0 - 3 months	3 - 12 months	1 - 5 years	Over 5 years	Total
31 December 2014					
Financial assets:					
Cash and cash equivalents....................	17.524.392				17.524.392
Receivable due from State Treasury.......	4.546.964				4.546.964
Treasury securities.................................	11.365.747	18.977.629			30.343.375
Loans to customers and banks...............	12.975.867	38.644.260	199.427.647	1.152.818.234	1.403.866.009
Total financial assets..............................	46.412.970	57.621.889	199.427.647	1.152.818.234	1.456.280.740
Financial liabilities:					
Borrowings and other liabilities...	13.320.962	52.964.969	258.265.533	924.544.567	1.249.096.031
Binding loan commitment.......................	5.130	2.046.770			2.051.900
Total financial liabilities...........................	13.326.092	55.011.739	258.265.533	924.544.567	1.251.147.931
Net balance..	33.086.878	2.610.150	(58.837.886)	228.273.667	205.132.809
31 December 2013					
Financial assets:					
Cash and cash equivalents....................	7.916.388				7.916.388
Receivable due from State Treasury.......	4.500.000				4.500.000
Treasury securities.................................	11.155.199	21.139.010			32.294.209
Loans to customers and banks...............	22.762.871	41.615.301	211.647.521	1.201.913.127	1.477.938.819
Total financial assets..............................	46.334.458	62.754.311	211.647.521	1.201.913.127	1.522.649.416
Financial liabilities:					
Borrowings and other liabilities...............	19.907.418	60.015.060	260.793.114	980.916.257	1.321.631.851
Binding loan commitment.......................	523.250	1.569.750	0		2.093.000
Total financial liabilities...........................	20.430.668	61.584.810	260.793.114	980.916.257	1.323.724.851
Net balance..	25.903.790	1.169.500	(49.145.594)	220.996.870	198.924.566

Amounts in ISK thousand

32. Risk management, contd.:

c. *Liquidity risk*

Measurement of liquidity risk, contd.:

The table above shows contractual cash flow of loans and borrowings of the Fund, including both payments and contractual interests but not estimated future inflation. Cash and cash equivalents of the Fund, which can be used to meet temporary imbalance in cash flows of financial assets and liabilities, is stated in the first column of the table. If an imbalance would occur between the cash flows of financial assets and liabilities, the Fund would response by issuing HFF bonds or selling short term securities.

d. *Interest risk*

Interest rate risk is defined as the risk of fluctuation in fair value or future cash flow due to changes in market interests. The Fund recognises neither financial liabilities nor financial assets at fair value, except for treasury bonds which are listed on an active market (see note 8) and fair value risk due to interest rate changes is therefore limited. Around 90.7% of the Fund's financial assets (2013: 90.9%) and 99.5% (2013: 99.1%) of its financial liabilities have fixed interest rates and therefore the effect of interest changes is insubstantial. Decisions on changing interests on loans with floating interests is entirely in the hand of the Fund. However, the difference between the duration of assets and liabilities causes risk exposure for the Fund as interest rate changes can affect its net interest income. The Fund's financial division manages this risk and shall ensure that the difference is within limits established by the Fund's financial and risk management's policy. The duration of the Fund's financial assets at year end 2014 is 9 years (2013: 9.7 years) and of financial liabilities 9.67 years (2013: 9.9 years). According to the Fund's financial and risk management policy this difference may be up to 0.9 years.

Weighted average effective interest on the Fund's borrowings excluding equity was 4.31% at year-end 2014 (2013: 4.31%), but weighted average effective interest on loans at the same time was 4.59% (2013: 4.61%). The difference between interest on the Fund's loans and borrowings decreases slightly by 0.02% during the year 2014. The interest margin on loans and the Fund´s borrowings is therefore 0.28%.

Prepayment risk

The financial committee assesses the Fund's prepayment risk and other factors related to interest rate risk and prices it when the Fund's loan interests are decided. In order to reduce even further this risk the Fund also offers loans with prepayment fee but lower interests than loans without such fee. On monthly basis the real proportion of prepayments is measured and estimates for future prepayment proportions are made. On the basis of estimated prepayments the Fund regularly reviews its financing in order to limit the sensitivity of its loan portfolio with regards to interest rates. As according to an amendment to the law on consumer credit in November 2013 new loans to individuals bear á 1% prepayment fee, however the borrower may pay an excess payment of up to ISK 1 million on its loan per year, without prepayment fee.

Borrowers may in many cases prepay their loans with the Fund without paying a specific prepayment fee. However, the Fund's issued bonds do not include prepayment options, with the exception of house bonds. Therefore, an imbalance between the duration of financial asset and liabilities can arise, which would lead to reinvestment risk for the Fund and thereby interest rate risk.

Around ISK 287 billion of the Fund's loans (2013: ISK 303 billion) is hedged with prepayment fee in part of entirely and prepayable house bonds would the borrower choose to prepay its loan before the end of the loan term. Interest rate and reinvestment risk related to this is considered to be considerable, especially while market interests remain low. The Fund is working on limiting this risk.

CPI-indexation risk

CPI-indexation risk is the risk of fluctuations in the consumer price index (CPI) affecting the fair value and cash flow of indexed financial instruments. The majority of the Fund's loans are indexed, financed with indexed bonds. The indexation risk is mainly due to necessary liquidity according to the Fund's financial and risk management policy. Indexation risk is managed by calculating the sensitivity of the Fund's total balance in indexed assets and liabilities with respect to changes in the consumer price index.

	2014	2013
CPI-indexed financial assets:		
Loans	724.997.783	763.267.389
Treasury securities and other assets	34.913.934	37.108.164
Total financial assets	759.911.717	800.375.553
CPI-indexed financial liabilities:		
Bond issue	798.547.938	834.463.465
Other borrowings	3.775.459	4.093.654
Total financial liabilities	802.323.397	838.557.119
Total CPI-indexation balance	(42.411.680)	(38.181.566)

Consolidated Financial Statements of the Housing Financing Fund for the year 2014 35 Amounts in ISK thousand

32. Risk management, contd.:

d. *Interest risk, contd.*

CPI-indexation risk, contd.:

Indexed liabilities were around ISK 42.4 billion in excess of indexed assets at year end 2014 (2013: ISK 38.2 billion). Based on year-end position and assuming that all other variables remain constant a 1% inflation calculated over a period of one year would have adverse impact on the Fund´s results amounting to ISK 424 million (2013: ISK 382 million).

Interest-free assets

When the Fund redeems appropriated assets the loan becomes interest-free. At year end 2014, the Fund held 1,891 properties for sale (2013: 2,606 properties) recognised at the value of ISK 27,871 million. (2013: ISK 37,663 million).

e. *Operational risk*

Operational risk is the risk of loss as a result of insufficient internal processes, people and systems, or because of external events, including legal risk. The Fund uses both preventive and supervisory methods to minimise its operational risk. The preventive methods include clear and documented procedures regarding all the Fund's major factors of operations, training of employees, data back-up, access control and other procedures. The Fund is ISO 27001 certified for information security, a written security policy as well as having a Risk Committee and Security manager who administer various aspects of operational risk. Head of departments are responsible for management of operational risk in their departments and monitor the operational risk as well as their employees.

f. *Equity and capital management*

The Fund's long-term objective is to maintain an equity ratio over 5.0%. The calculation of the equity ratio is in accordance with international standards (Basel II). If the Fund's equity ratio falls below 4.0% the Fund's Board of Directors shall notify the Minister of Welfare thereof. Furthermore, the Fund's Board of Directors shall propose solutions to reach the long term equity ratio goal.

Equity ratio is specified as follows:	**2014**	**2013**
Total equity according to the financial statements	18.087.104	14.845.388
Intangible assets	(171.002)	(151.428)
Equity base	17.916.102	14.693.960
Total equity requirement is specified as follows:		
Credit risk	31.456.893	33.927.452
Market risk	105.056	68.108
Operational risk	287.674	460.228
Total capital requirements	31.849.622	34.455.788
Equity ratio	4.50%	3.40%

Consolidated Financial Statements of the Housing Financing Fund for the year 2014 36 Amounts in ISK thousand

33. Consolidation

Income statement	HFF	Leigufélagið Klettur ehf.	Consolidated 2014	Consolidated 2013
Net interest income	1.788.482	(236.973)	1.551.509	1.225.493
Other income	159.252	0	159.252	160.893
Operating expenses	(1.925.687)	(84.942)	(2.050.186)	(2.163.315)
Net income of investment properties	0	1.049.834	1.049.834	0
Net income of properties held for sale	194.901	0	194.901	389.459
Profits of subsidiary	545.937	0	0	0
Net operating income	762.885	727.919	905.310	(387.470)
Impairment	2.478.830	(5.937)	2.472.893	(3.966.513)
Profit (loss) before tax	3.241.715	721.982	3.378.203	(4.353.983)
Income tax	0	(136.488)	(136.488)	0
Profit (loss) for the year	3.241.715	585.494	3.241.715	(4.353.983)

Statement of financial position	HFF	Leigufélagið Klettur ehf.	Consolidated 2014	Consolidated 2013
Cash and cash equivalents	59.713.580	322.927	60.036.507	56.188.867
Loans	728.081.166	0	728.081.166	768.480.860
Properties held for sale	27.870.768	0	27.870.768	37.663.230
Investment properties	0	8.063.973	8.063.973	0
Other assets	8.778.276	31.950	603.662	614.066
Total assets	824.443.790	8.418.850	824.656.076	862.947.023
Total liabilities	806.356.686	5.153.033	806.568.972	848.101.634
Total equity	18.087.105	3.265.817	18.087.104	14.845.389
Total liabilities and equity	824.443.790	8.418.850	824.656.076	862.947.023

Consolidated Financial Statements of the Housing Financing Fund for the year 2014 37 Amounts in ISK thousand