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Credit Opinion: Housing Financing Fund

Global Credit Research - 22 Jan 2016

Reykjavik, Iceland

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Baa3
Bkd Senior Unsecured -Dom Curr	Baa3

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Key Indicators

Housing Financing Fund (Consolidated Financials)[1]

	[2]6-15	[2]12-14	[2]12-13	Avg.
Total Assets (ISK billion)	818.2	824.7	862.9	[3]-2.6
Total Assets (EUR million)	5,555.7	5,345.5	5,446.9	[3]1.0
Total Assets (USD million)	6,190.2	6,468.4	7,505.5	[3]-9.2
Tangible Common Equity (ISK billion)	17.1	17.9	14.7	[3]7.9
Tangible Common Equity (EUR million)	116.3	116.1	92.7	[3]12.0
Tangible Common Equity (USD million)	129.5	140.5	127.8	[3]0.7
Problem Loans / Gross Loans (%)	10.9	11.7	16.2	[4]13.0
Tangible Common Equity / Risk Weighted Assets (%)	4.8	4.5	3.4	[5]4.2
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	212.1	223.9	345.9	[4]260.7
Net Interest Margin (%)	-0.3	0.2	0.1	[4]0.0
PPI / Average RWA (%)	-0.6	0.2	-0.1	[5]-0.1
Net Income / Tangible Assets (%)	-0.2	0.4	-0.5	[4]-0.1
Cost / Income Ratio (%)	-902.3	69.4	121.8	[4]-237.0
Market Funds / Tangible Banking Assets (%)	97.7	97.3	97.2	[4]97.4
Liquid Banking Assets / Tangible Banking Assets (%)	7.7	3.4	2.5	[4]4.5

Source: Moody's

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

Opinion

SUMMARY RATING RATIONALE

In 2015 we upgraded the senior unsecured debt and issuer ratings of Housing Financing Fund (HFF) to Baa3 from Ba1 following the upgrade of the Icelandic sovereign (Baa2, stable). HFF's rating reflects the guarantee that the fund, a fully government-owned residential mortgage lender, receives on its funding from the Icelandic state. We also withdrew HFF's caa1 baseline credit assessment (BCA) and, thus, based HFF's ratings solely on its linkages with the Icelandic sovereign. The outlook on HFF is stable.

We assess HFF to be of poor intrinsic financial strength, with low profitability (net income averaged -0.12% of tangible assets in 2013 and 2014) and low capitalisation (4.8% capital ratio at end-June 2015 and 4.5% at year-end 2014). However, should HFF fail to meet its obligations, a creditor would have a senior claim against the Icelandic government.

We have positioned HFF's ratings one notch below the Icelandic sovereign's rating to reflect that, under the guarantee, creditors would first have to pursue potentially lengthy legal procedures, before the government would be obliged to pay, thus raising some uncertainty over the timeliness of the guarantee. The fund's liabilities are obligations of the government, and the government also includes regular capital contributions to the otherwise lowly capitalised HFF in its budgets. In addition, we take into account that HFF was established through specific legislation, and that its tasks are outlined in Housing Act 44/1998. Icelandic law does not permit bankruptcy proceedings against HFF.

Rating Drivers

- Uncertain future, but very high likelihood of government support

- Profitability is structurally weak driven by inability to make prepayments

- Full dependence on wholesale funding, but limited funding need

- Poor asset quality and weak capital adequacy

- Household debt relief hurts profits

Rating Outlook

The stable outlook on HFF's ratings reflects the stable outlook on its support provider, the Icelandic sovereign.

What Could Change the Rating - Up

Upward rating pressure could develop if we upgrade the Icelandic sovereign's rating.

What Could Change the Rating - Down

In line with the existing guarantee, a downgrade of the Icelandic sovereign could trigger a downgrade of HFF's ratings. In addition, a weakening of the sovereign guarantee could lead to the ratings being positioned further below the sovereign rating.

DETAILED RATING CONSIDERATIONS

UNCERTAIN FUTURE, BUT VERY HIGH LIKELIHOOD OF GOVERNMENT SUPPORT

HFF's ratings are notched off the Icelandic sovereign's rating, reflecting the guarantee the fund receives from the Icelandic government. Should HFF fail to meet its obligations, a creditor would have a senior claim against the Icelandic government.

HFF's responsibility is to monitor housing needs in Iceland and to lend to municipalities, companies and associations for construction or purchase of residential housing. The fund dominated the Icelandic mortgage lending market until 2004, when the commercial and savings banks entered into direct competition. While following the collapse of the country's three major commercial banks in 2008, HFF regained market share, as the successor commercial banks have re-entered the market place, the fund is deleveraging.

HFF's net new lending declined by nearly ISK5 billion in 2014. This largely reflects the commercial banks' issuance of non-inflation-indexed loans, which HFF was not authorised to offer, constraining its market share and franchise. However, on 26 November 2015 the Icelandic Supreme Court ruled in HFF's favour in a court case regarding indexation on home mortgages. Over time, this could enable HFF to recapture some of the lost market share as it is able to offer these loans again.

Our assessment of a very high likelihood of government support for HFF reflects the national government's full ownership, and the fund's legal status of a "Treasury Part C" institution under the Ministry of Welfare, ensuring that the government is responsible for full payment of HFF's liabilities. The government's interest and continued involvement in HFF's operations has been demonstrated by repeated recapitalisations. In addition, HFF accounts for 9% of Iceland's financial system assets, and its bonds are substantially held by domestic pension funds, (estimated at 79% end December 2015).

However, the government guarantee does not satisfy all of our requirements to permit full credit substitution, in particular because there is no explicit guarantee on timely payment. This lack of explicit guarantee creates the risk of non-timely payment if HFF were to fail to meet its obligations, which, combined with the weakening in HFF's stand-alone credit quality, supports the rating difference against the Icelandic government.

PROFITABILITY IS STRUCTURALLY WEAK DRIVEN BY INABILIY TO MAKE PREPAYMENTS

We assess HFF to be of poor intrinsic financial strength, with low profitability (net income was -0.20% of tangible assets over the six month to end June 2015 and averaged -0.06% in 2013 and 2014). The fund recorded a net loss of ISK0.8 billion in the first half of 2015, following a net income of ISK3.2 billion in 2014 driven mainly by negotiated settlement of claims against the failed banks in connection with bonds and derivatives and income from investment assets. We expect profitability to improve slightly in 2016 following HFF's purchase of ISK70 billion worth of bonds from ESI, the Central Bank's asset vehicle. These assets will help tighten the fund's interest rate spread as they help closing the gap between its assets and liabilities, when looking at projected cash flows, and are expected to add ISK1.1 billion of profits yearly. Although this is a move towards the right direction, the profitability outlook still remains weak as the fund's inability to prepay funding when borrowers prepay their loans increases a negative spread, a growing burden in the coming years.

At the same time, costs have risen, reflecting the increasing resources needed to deal with customers' debt servicing problems and managing the significant portfolio of repossessed properties (1,451 properties at end-November 2015, down from 1,891 at end-2014). We expect the fund's efficiency to be challenged going forward given the extent of loan restructurings and repossessed properties, as its cost-to-income ratio increased to 69% in 2014 from 63% in 2011.

FULL DEPENDENCE ON WHOLESALE FUNDING, BUT LIMITED FUNDING NEED

HFF does not take deposits and has only a moderate securities portfolio but funds its mortgage loan portfolio by issuing its bonds in the domestic market. However, the fund currently has no funding need and has not issued bonds since 2012.

POOR ASSET QUALITY AND WEAK CAPITAL ADEQUACY

HFF's asset quality remains weak, although it shows some signs of improvement as loans in payment suspension or in default decreased to 9.9% of gross loans at end June 2015, from 15% at year-end 2013. We expect that the level of problem loans will remain elevated over the next few years, and although HFF is making progress on reducing the on-balance sheet stock of properties we consider the probability of a fast paced substantial reduction as low, especially for properties outside the greater Reykjavik region in which commercial bank lending is concentrated. Moreover, additional concerns relate to high concentration risks to legal entities providing (social) rental housing, which have also been affected by the economic deterioration in the years following the economic collapse.

In November 2015, the Board of Directors decided to initiate preparations for the sale of Klettur Property Management, which specialises in renting out part of the repossessed properties. HFF aims to maximising the value of the property in accordance with the criteria underlying its establishment. The sale has not yet progressed from the terms and final sales procedure, which is ongoing.

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

In view of HFF's weak asset quality and poor profitability and thus limited ability to replenish capital through internal means, we deem the current capital adequacy ratio to be very poor. At June 2015 the capital ratio remained low, although it increased slightly to 4.8% from 4.5% at year-end 2014 (2013: 3.4%), including the ISK4.5 billion capital injection that was provided by the Icelandic government in early 2014 after the year-end 2013 balance sheet date. Since the financial crisis, the Icelandic government has provided ISK51 billion in capital injections to HFF, but even with this support the fund has not met its target capital ratio of 5%.The capital adequacy ratio is unlikely to materially improve in the coming years because of continued weak operating profitability and an additional need for write-downs. We expect, however, that the fund will continue to receive additional capital support.

HOUSEHOLD DEBT RELIEF HURTS PROFITS

In December 2014, an agreement was signed between HFF and the Ministry of Finance and Economic Affairs concerning the purchase of the restructured portion of HFF's inflation indexed loans ("adjusted loans") in connection with the government's indexed mortgage debt adjustment plan. This action follows a key election promise from the Icelandic government (in 2013), that proposed to provide ISK150 billion (around 8% of 2014 GDP) in debt relief over a 4 year period, by writing down parts of household mortgage debt. While we expect these measures to have a further negative impact on the HFF's earnings, as the fund has many borrowers that will be eligible for debt reduction, we can't estimate the full impact yet as terms are to be finalised.

In addition to this, the government approved an amendment to an existing Act on personal pension savings and their use for payment of housing mortgages in May 2014. Consequently, additional payments or repayments of debt under the Fund's mortgages are now allowed without payment of a fee. The government has agreed to compensate the Fund for its losses to a certain extent. HFF estimates that about ISK15-17 billion will be prepaid over the lifetime of the measure (June 2014 to June 2017) as a result of the debt solution, reducing net interest income by ISK300-450 million on an annualised basis, after adjusting for lost prepayment income. However, prepayments to date indicate that the total expected amount might be short of the initial estimates. The loss ultimately sustained by the fund is somewhat uncertain given, for example, the potential impacts of inflation. In our opinion, any additional loss for HFF, as a result of the debt relief program, will in practice result in increasing capital contributions from the government to HFF to keep the capital levels stable.

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

The principal methodology used in the rating was "Government-Related Issuers" published in October 2014. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies

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