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CREDIT OPINION
14 June 2016

Update

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RATINGS

Housing Financing Fund

Domicile	Iceland
Long Term Rating	Baa3 , Possible Upgrade
Type	LT Issuer Rating - Fgn Curr
Outlook	Rating(s) Under Review

Please see the ratings section at the end of this report for more information.The ratings and outlook shown reflect information as of the publication date.

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Housing Financing Fund

Rating review for upgrade driven by review of Iceland's government ratings

Summary Rating Rationale

On 14 June 2016, we placed the Housing Financing Fund (HFF)'s Baa3 backed senior unsecured debt and issuer ratings on review for upgrade. The review was triggered by the recent rating action on Iceland's Baa2 sovereign issuer rating, which was placed on review for upgrade on 10 June 2016.

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 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, which creates uncertainty over the timeliness of the repayment. We also take into account that Icelandic law does not permit bankruptcy proceedings against HFF. In addition, the fund's liabilities are obligations of the government, which also provides regular capital contributions to the otherwise weakly capitalised HFF from its budget. HFF is established through specific legislation, and its mandate and role in the economy are outlined in Housing Act 44/1998.

We consider HFF's intrinsic financial strength as poor, characterised by low profitability and weak capitalisation. However, these vulnerabilities are mitigated by the state guarantee that allows for creditors to have a senior claim against the Icelandic government should HFF fail to meet its obligations.

Credit Strengths

» Very high likelihood of government support in the face of an uncertain future

Credit Challenges

» Profitability is structurally weak

» Full dependence on wholesale funding, but limited funding need

» Poor, albeit improving, asset quality and weak capital adequacy

» Household debt relief hurts profits

Rating Outlook

The review for upgrade on HFF's long-term issuer and backed debt ratings of Baa3 reflects the Icelandic government's improving credit fundamentals, as indicated by the review for upgrade on its Baa2 long-term ratings, and its capacity to support HFF through its guarantee.

The key drivers on the review for upgrade on the Icelandic government's ratings are: (1) to evaluate whether the government's new fiscal strategy and tax reform will further improve its debt sustainability in the medium term; and (2) to determine whether the upcoming auction of offshore krónur assets will be effective in reducing or containing vulnerabilities in the country's external position and thus facilitating the generalized liberalization of capital controls.

Factors that Could Lead to an Upgrade

An upgrade on the Iceland's government's rating will likely result in an upgrade of HFF.

Factors that Could Lead to a Downgrade

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.

Key Indicators

Exhibit 1

Housing Financing Fund (Consolidated Financials) [1]

	12-15[2]	12-14[2]	12-13[2]	2012	2011	Avg.
Total Assets (ISK billion)	804.3	824.7	862.9	-	-	-3.5[3]
Total Assets (EUR million)	5692.4	5345.5	5446.9	-	-	2.2[3]
Total Assets (USD million)	6183.6	6468.4	7505.5	-	-	-9.2[3]
Tangible Common Equity (ISK billion)	19.6	17.9	14.7	-	-	15.6[3]
Tangible Common Equity (EUR million)	139.0	116.1	92.7	-	-	22.4[3]
Tangible Common Equity (USD million)	151.0	140.5	127.8	-	-	8.7[3]
Problem Loans / Gross Loans (%)	13.1	14.5	17.9	-	-	15.1[4]
Tangible Common Equity / Risk Weighted Assets (%)	5.5	4.5	3.4	-	-	4.5[5]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	242.3	278.3	380.3	-	-	300.3[4]
Net Interest Margin (%)	0.2	0.2	0.1	-	-	0.2[4]
PPI / Average RWA (%)	0.0	0.2	-0.1	-	-	0.1[5]
Net Income / Tangible Assets (%)	0.2	0.4	-0.5	-	-	0.0[4]
Cost / Income Ratio (%)	94.8	69.4	121.8	-	-	95.3[4]
Market Funds / Tangible Banking Assets (%)	97.3	97.3	97.2	-	-	97.3[4]
Liquid Banking Assets / Tangible Banking Assets (%)	2.9	3.4	2.5	-	-	2.9[4]

[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

Source: Moody's Financial Metrics

Detailed Rating Considerations

The financial data in the following sections are sourced from HFF's consolidated financial statements unless otherwise stated.

Very high likelihood of government support in the face of an uncertain future

HFF's ratings are notched down from 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

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savings banks entered into direct competition with it. After the collapse of the country's three major commercial banks in 2008. HFF regained market share. However, as commercial banks have re-entered the market place in recent years, the fund's market position has been declining, leading to a deleveraging of its balance sheet.

HFF's net loan book declined by nearly ISK80 billion in 2015 (ISK40 billion of which due to the Government Debt Relief program). This largely reflects increasing customers' pre-repayments – the rising property prices have provided favourable conditions for customers to refinance their HFF loans at a cheaper rate. In addition, the strict underwriting criteria that HFF follows limit its ability to compete with the commercials banks in Iceland. On 26 November 2015 the Icelandic Supreme Court ruled in HFF's favour in a court case regarding indexation on home mortgages. We believe that 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 80% end March 2016).

However, the government's guarantee does not satisfy all of our requirements to allow for 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 weak stand-alone credit quality of HFF, justifies the rating difference with the Icelandic government.

Profitability is structurally weak, driven by inability to make prepayments

We see HFF's intrinsic financial strength as poor and characterised by low profitability. However, a significantly large reversal of impairments of loans and securities helped HFF to report a net income of ISK1.8 billion in 2015, equivalent to 0.23% return on tangible banking assets. This represents a decline compared to 0.39% in 2014, but an improvement compared to a loss of -0.50% in 2013.

In November 2015, HFF's Board of Directors decided to initiate preparations for the sale of HFF's subsidiary Klettur Property Management (Klettur), which specialises in renting out part of the repossessed properties. The sale successfully concluded in May 2016 for a total consideration of ISK10.1 billion, ISK1.5 billion above book value. According to our calculations, the transaction will translate into a one-off gain of about 2.4x HFF's 2015 net operating income (earning before impairment provisions) for the fiscal year ending in 2016.

Aside from this one-off gain, we expect core 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 support the fund's margin and help to improve the maturity mismatch between its assets and liabilities. Although this will ease some pressure on profitability, the outlook on profitability remains weak as the fund's inability to prepay its funding when borrowers prepay their loans increases its negative carry trade, 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 (1287 properties at end-March 2016, down from 1,891 at end-2014). However, together with the Klettur transaction, HFF announced a new organizational structure to streamline its operations, allowing it to refocus on its social role in the Icelandic economy, namely lending for construction or purchase of residential housing when commercial banks are not fulfilling this role. The fund expects the change to result in an approximately ISK324 million reduction in operating costs by 2017, about 17% of HFF's total reported operating expenses in 2015.

Full dependance on wholesale funding, but limited funding need

HFF does not take deposits and funds its mortgage loan portfolio by issuing bonds in the domestic market. However, the fund currently has no new funding needs and has not issued new bonds since 2012. In addition, HFF has a moderate size liquid asset portfolio, part of which consists of the ESI covered bonds.

Poor, albeit improving, asset quality and weak capital

HFF's asset quality remains weak, although it shows some signs of improvement as loans in payment suspension or in default decreased to 11.1% of gross loans at end December 2015, from 15% at year-end 2013. We expect that the level of problem loans will remain elevated over the next few years. Although HFF is making progress on reducing the on-balance sheet stock of repossessed 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.

Since 2008, HFF has been permitted to make more concessions for borrowers experiencing payment difficulties. 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 metrics. Because of these concession measures, the fund's asset quality metrics may not fully reflect 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 weak. At December 2015 the capital ratio remained low, although it increased to 5.5% from 4.5% at year-end 2014 (2013: 3.4%), for the first time in a number of years above the 5% set as minimum for the fund by the regulator. 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% until recently. The capital adequacy ratio is unlikely to materially improve in the coming years because of continued weak operating profitability. We expect, however, that the fund will continue to receive additional capital support.

Household debt relief hurts profits

In 2014 the government approved an amendment to an existing Act on personal pension savings, which allows the repayment of principal on housing mortgages with private savings. This has led to a significant amount of homes taking advantage of this to date and, consequently, to a high prepayment rate on existing mortgages, which has led to a decrease in HFF’s portfolio in 2015. The government has agreed to compensate credit institutions for the losses incurred as a result of the debt solution. Although HFF expects to receive a full compensation, the final amount owed by the state has not yet been agreed, which makes the potential loss ultimately sustained by HFF somewhat uncertain at this stage. As a result, HFF has recognised a ISK1.4 billion impairment in 2015 for the possible difference between the prepaid portion of the loans and the expected compensation potentially provided by the government.

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.

Ratings

Exhibit 2

Category	Moody's Rating
HOUSING FINANCING FUND	
Outlook	Rating(s) Under Review
Issuer Rating	Baa3
Bkd Senior Unsecured -Dom Curr	Baa3

Source: Moody’s Investors Service

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