

CREDIT OPINION

12 September 2016

Update

Rate this Research >>

RATINGS

Housing Financing Fund

Domicile	Iceland
Long Term Debt	Baa1
Type	Senior Unsecured - Dom Curr
Outlook	Stable
Long Term Deposit	Not Available
Type	Not Available
Outlook	Not Available

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.

Contacts

Dany Castiglione 44-20-7772-1070
 Vice President
 dany.castiglione@moodys.com

Aleksandar Hristov 44-20-7772-1071
 Associate Analyst
 aleksandar.hristov@moodys.com

Oscar Heemskerck 44-20-7772-5532
 Associate Managing
 Director
 oscar.heemskerck@moodys.com

Sean Marion 44-20-7772-1056
 Managing Director -
 Financial Institutions
 sean.marion@moodys.com

Housing Financing Fund

Upgrade driven by rating action on Iceland's government ratings

Summary Rating Rationale

On 9 September 2016, we upgraded the [Housing Financing Fund](#) (HFF)'s backed senior unsecured debt and issuer ratings to Baa1 from Baa3. This rating action follows the recent rating action on the [Icelandic sovereign issuer rating](#), which guarantees HFF's debt. Iceland's sovereign issuer rating was [upgraded](#) to A3 from Baa2 on 1 September 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 continue to position 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, although improving, 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
- » Weak, albeit improving, asset quality and capital adequacy
- » Household debt relief hurts profits

Rating Outlook

The outlook is stable and reflects the stable outlook on HFF's support provider, the Icelandic sovereign.

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)	5,692.4	5,345.5	5,446.9	-	-	2.2 ³
Total Assets (USD million)	6,183.6	6,468.4	7,505.5	-	-	-9.2 ³
Tangible Common Equity (ISK billion)	19.6	17.9	14.7	-	-	15.6 ³
Tangible Common Equity (EUR million)	139	116.1	92.7	-	-	22.4 ³
Tangible Common Equity (USD million)	151	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	0.2	-0.1	-	-	0.1 ⁵
Net Income / Tangible Assets (%)	0.2	0.4	-0.5	-	-	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 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 (ISK34 billion of which due to the Government Debt Relief program) and a further ISK34 billion in the first six months of 2016. 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 commercial banks in Iceland. On 26 November 2015 the

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

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.

On 12 August 2016, the Icelandic Minister of Social Affairs and Housing introduced a bill on the future arrangement of housing matters. Some of the proposed changes would impact HFF. The most significant proposed changes are: (i) increased focus on HFF's role in formulating policies and plan in housing matters; (ii) limitation of the fund's authorisation to grant loans to individuals; and (iii) introducing a booking separation between the existing loan portfolio and the tasks that HFF will undertake if the bill is approved by the parliament. The bill is subject to approval in parliament, and does not propose any change in the government guarantee for HFF.

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.

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 (825 properties at end-June 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.

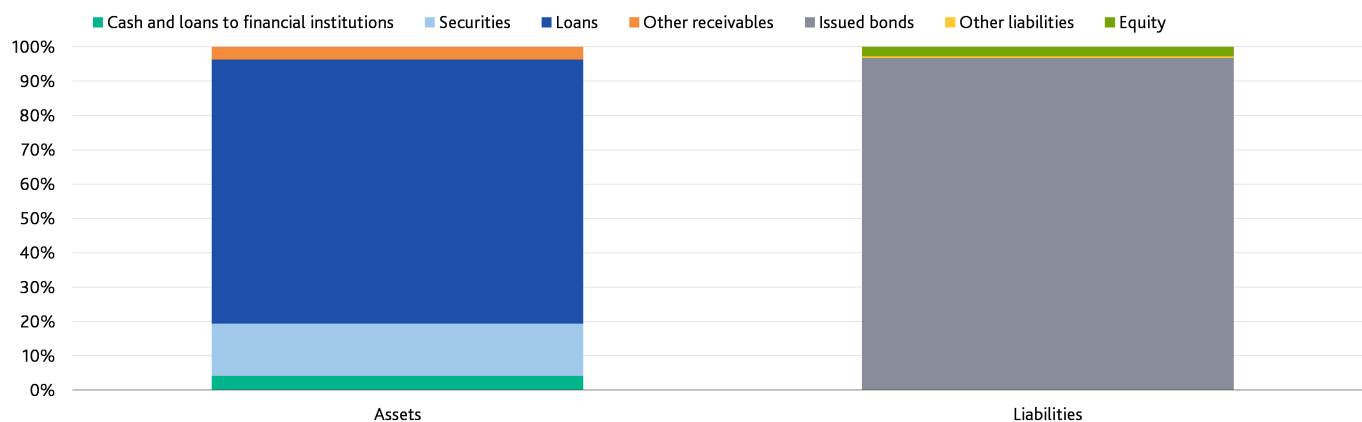
In the first six months of 2016, HFF's profitability continued its positive trend. The fund recorded a net profit of ISK2.51 billion compared to a loss of ISK379.5 million in the same period of 2015. The stronger results were driven by lower interest expenses (-10.4% year-on-year - yoy), which more than offset the decline in interest income (-7.3% yoy), leading to a net interest income of ISK525 million versus a negative ISK473.4 million in the same period of the previous year. While operating expenses remained flat at ISK909 million - although ISK87 million were attributable to one-off costs related to business streamline measures -, the fund benefitted from ISK1.37 billion in write-back of provisions, compared to just ISK370 million the previous year. Finally, the sale of Klettur generated ISK1.43 billion extraordinary income.

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 (see Exhibit 2). 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.

Exhibit 2

Balance sheet breakdown of HFF As of end-June 2016



Source: HFF reports, Moody's Investors Service

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% of gross loans at end-June 2016, from 13.1% at year-end 2015. 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.

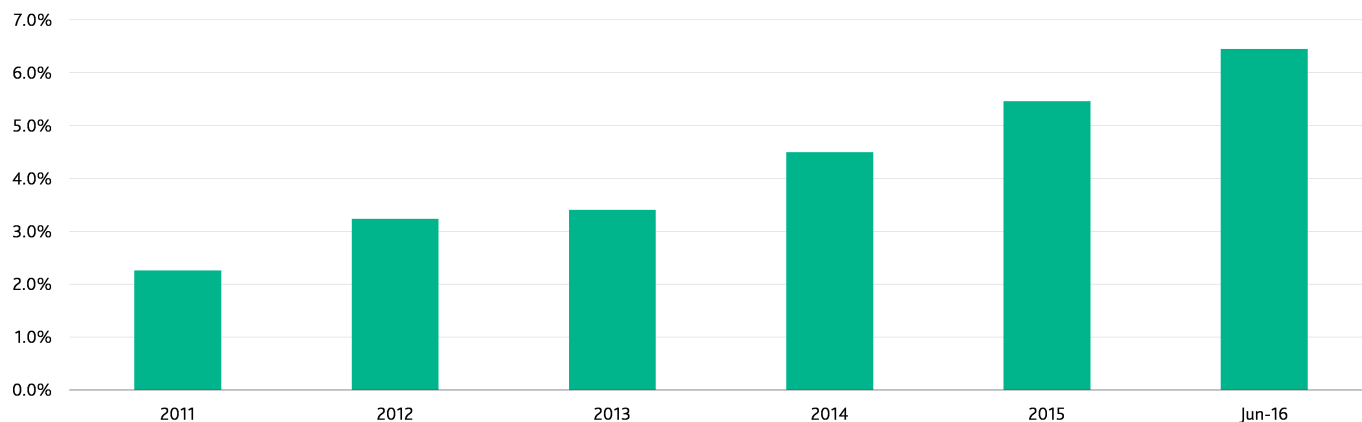
Since 2008, HFF has been permitted to make more concessions for borrowers experiencing payment difficulties. Although these measures are aimed at supporting the borrowers' debt service ability, this could eventually result in a rapid deterioration of the fund's asset quality metrics. Because of these 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 June 2016 the capital ratio remained low, although it increased to 6.45% from 5.5% at year-end 2015 (2014: 4.5%), above the 5% set as minimum for the fund by the regulator (see Exhibit 3). 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 if needed.

Exhibit 3

HFF's capital ratio has strengthened

Tangible Common Equity to Risk Weighted Assets



Source: HFF reports, Moody's Investors Service

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.

Methodology

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

Ratings

Exhibit 4

Category	Moody's Rating
HOUSING FINANCING FUND	
Outlook	Stable
Issuer Rating	Baa1
Bkd Senior Unsecured -Dom Curr	Baa1

Source: Moody's Investors Service

© 2016 Moody's Corporation, Moody's Investors Service, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. AND ITS RATINGS AFFILIATES ("MIS") ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND CREDIT RATINGS AND RESEARCH PUBLICATIONS PUBLISHED BY MOODY'S ("MOODY'S PUBLICATIONS") MAY INCLUDE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS AND MOODY'S OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. MOODY'S PUBLICATIONS MAY ALSO INCLUDE QUANTITATIVE MODEL-BASED ESTIMATES OF CREDIT RISK AND RELATED OPINIONS OR COMMENTARY PUBLISHED BY MOODY'S ANALYTICS, INC. CREDIT RATINGS AND MOODY'S PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER CREDIT RATINGS NOR MOODY'S PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS AND PUBLISHES MOODY'S PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL, WITH DUE CARE, MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

MOODY'S CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT INTENDED FOR USE BY RETAIL INVESTORS AND IT WOULD BE RECKLESS AND INAPPROPRIATE FOR RETAIL INVESTORS TO USE MOODY'S CREDIT RATINGS OR MOODY'S PUBLICATIONS WHEN MAKING AN INVESTMENT DECISION. IF IN DOUBT YOU SHOULD CONTACT YOUR FINANCIAL OR OTHER PROFESSIONAL ADVISER. ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.

All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MOODY'S considers to be reliable including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process or in preparing the Moody's Publications.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability to any person or entity for any indirect, special, consequential, or incidental losses or damages whatsoever arising from or in connection with the information contained herein or the use of or inability to use any such information, even if MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers is advised in advance of the possibility of such losses or damages, including but not limited to: (a) any loss of present or prospective profits or (b) any loss or damage arising where the relevant financial instrument is not the subject of a particular credit rating assigned by MOODY'S.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability for any direct or compensatory losses or damages caused to any person or entity, including but not limited to by any negligence (but excluding fraud, willful misconduct or any other type of liability that, for the avoidance of doubt, by law cannot be excluded) on the part of, or any contingency within or beyond the control of, MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers, arising from or in connection with the information contained herein or the use of or inability to use any such information.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

Moody's Investors Service, Inc., a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by Moody's Investors Service, Inc. have, prior to assignment of any rating, agreed to pay to Moody's Investors Service, Inc. for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,500,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at www.moody's.com under the heading "Investor Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

Additional terms for Australia only: Any publication into Australia of this document is pursuant to the Australian Financial Services License of MOODY'S affiliate, Moody's Investors Service Pty Limited ABN 61 003 399 657 AFSL 336969 and/or Moody's Analytics Australia Pty Ltd ABN 94 105 136 972 AFSL 383569 (as applicable). This document is intended to be provided only to "wholesale clients" within the meaning of section 761G of the Corporations Act 2001. By continuing to access this document from within Australia, you represent to MOODY'S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" within the meaning of section 761G of the Corporations Act 2001. MOODY'S credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail investors. It would be reckless and inappropriate for retail investors to use MOODY'S credit ratings or publications when making an investment decision. If in doubt you should contact your financial or other professional adviser.

Additional terms for Japan only: Moody's Japan K.K. ("MJJK") is a wholly-owned credit rating agency subsidiary of Moody's Group Japan G.K., which is wholly-owned by Moody's Overseas Holdings Inc., a wholly-owned subsidiary of MCO. Moody's SF Japan K.K. ("MSFJ") is a wholly-owned credit rating agency subsidiary of MJJK. MSFJ is not a Nationally Recognized Statistical Rating Organization ("NRSRO"). Therefore, credit ratings assigned by MSFJ are Non-NRSRO Credit Ratings. Non-NRSRO Credit Ratings are assigned by an entity that is not a NRSRO and, consequently, the rated obligation will not qualify for certain types of treatment under U.S. laws. MJJK and MSFJ are credit rating agencies registered with the Japan Financial Services Agency and their registration numbers are FSA Commissioner (Ratings) No. 2 and 3 respectively.

MJJK or MSFJ (as applicable) hereby disclose that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MJJK or MSFJ (as applicable) have, prior to assignment of any rating, agreed to pay to MJJK or MSFJ (as applicable) for appraisal and rating services rendered by it fees ranging from JPY200,000 to approximately JPY350,000,000.

MJJK and MSFJ also maintain policies and procedures to address Japanese regulatory requirements.

REPORT NUMBER 1040870