Housing Financing Fund

Financial Statements 2016

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 and CEO

The Housing Financing Fund ("the Fund") has its headquarters in Borgartún 21, Reykjavik and a branch in Sauðárkrókur. The Fund operates in accordance with the Housing Act no. 44/1998. The Act aims to promote, through the granting of loans and the organization of housing affairs, an environment of security and equal rights in housing affairs for citizens. The main activities of the Fund are therefore lending for the purchasing and construction of housing, granting of capital contributions for the purchasing and construction of rental housing for low-income families and individuals, and analysing the housing market to support the government's policy formulation in housing affairs. The Housing Financing Fund is an independent institution owned by the government.

The Fund's Financial Statements are prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU and additional disclosure requirements for companies that have their securities listed on the international securities market.

During the year, the Fund began preparations for the implementation of a new accounting standard IFRS 9 which becomes effective on 1 January 2018. The new standard involves changes to the classification and measurement of financial assets and introduces a new model of expected loss.

Results for the year 2016

In 2016, the operating surplus of the Housing Financing Fund's operations amounted to ISK 4,257 million compared to an operating surplus of ISK 1,827 million in 2015. Equity at year-end amounted to ISK 23,528 million and the Fund's equity ratio is 7.3% compared to 5.5% at the end of 2015. The Housing Financing Fund's equity ratio has not been higher since the Fund was established in the year 1999, and the Fund's long-term objective regarding the equity ratio is 5% as according to the Regulation no. 544/2004 on the finances and risk management of the Housing Financing Fund. The Fund is generating an operating surplus for the third consecutive year. The operating surplus will be allocated to strengthen equity.

Governance

The Board of Directors of the Housing Financing Fund believes that good corporate governance is the basis for responsible and honest communications of the owner, the Board, management, employees, customers and other stakeholders, that promote trust, transparency and credibility in management of the Fund. In addition to abiding by legislation on Housing, the Fund operates partly under the provisions of Act no. 161/2002 on financial undertakings, rules and recommendations of the FSA, Central Bank and various other provisions on the financial markets. The Fund operates as according to an organizational structure and emphasis is placed on simplifying and clarifying the division of labor. Job descriptions are available for all job positions and employee communication channels are effective. The entire structure of the Fund, and its procedures, are designed to ensure the avoidance of conflicts of interests in its activities and ensure transparency and accountability in the management of the Fund.

The Fund is composed of five members and an equal number of alternates under Article 7 of the Housing Act. The Board operates in accordance with rules of procedure which define its functions. The rules define its practices, qualifications, meetings and separation of duties between the Board and CEO. The rules are available on the Fund's website. There are no related interests between the Board and the Fund's major customers and board members submit information on related interests yearly. The Board has been involved in the making of a Rule Book containing all the rules that the Board is by law entrusted to set, and frames the powers and procedures of the Fund's operations. Furthermore, the Board has formulated the Fund's risk profile and investment strategy that establishes the risk appetite of the operations and control aspects of liquidity management.

The Board hires the CEO and appoints a Compliance Officer pursuant to the terms of reference. The CEO oversees the daily operations of the Fund and twice a year the Compliance Offices presents a report to the Board on the matters within the scope of his responsibilities. The Board meets regularly with the auditors of the Fund. The Board of Directors monitors that the reporting to the Financial Supervisory Authority, Central Bank and other regulatory authorities is as in accordance with laws and regulations. The Board also makes decisions regarding matters that are unusual and extraordinary.

Endorsement and Statement by the Board of Directors and CEO, contd.

Governance, contd.

The Executive Board is composed of 5 members in addition to the CEO. The Board deliberates on major decisions and makes recommendations on policy decisions to the Board of Directors. Six committees operate under the authority of the CEO: The Financial Committee addresses and ensures an overview of the reporting to regulators and monitors the activities of the Treasury, ensures the follow up of treasury management authorisation and recommends proposals to the Board regarding authorization of treasury management. The Quality and Security Committee addresses quality systems and information security. The Fund has received ISO 27001 verification four times since first implementing the standard in 2012. The Lending Committee discusses and makes decisions on lending, the Payment Difficulty Committee manages matters regarding payment difficulties. The Evaluation Committee on capital contributions evaluates capital contribution applications. The Fund has adopted policies on human resources, environmental, safety, archives, and quality assurance, a policy and program against bullying and sexual harassment as well as equal rights policies. During the year it was decided to begin preparations for equal pay certification.

Three committees operate under the mandate of the Board. The Audit Committee has the statutory monitoring role of the audit of the Fund, among other factors, such as the effectiveness of risk management. The committee consists of two external experts and a board member. The Operational Development Committee also works on behalf of the Board and it consists of two Board members and the CEO. Its aim is to simplify the operations of the Fund and the main objective of the committee is to streamline operations. Then, acting on behalf of the Board is the Risk Committee, consisting of two Board members and one external expert. The committee addresses operational risks and risk management as well as other matters referred to it by the Board. The Board receives copies of the minutes of the above mentioned committees.

The Housing Financing Fund is committed to maintaining reliable accounts and has defined responsibilities emphasising the segregation of duties, regular reporting to the Board and transparency in carrying out duties. Monthly figures are reviewed by the Board and the Executive Committee which is an important control factor in the operations of the Fund.

In 2016, the Board held 24 board meetings. The proportion of women on the Board of the Fund is 40% compared with 60% men. According to law, the Fund's Board is appointed by the Minister after each general election, for a term of four years. In appointing Board members following the general election in 2013, certain policies were not observed to insure diversity, but despite this there is Board diversity taking into consideration factors such as age, sex, educational and professional backgrounds of board members. In 2016, the Board was composed of the following members:

Ingibjörg Ólöf Vilhjálmsdóttir chairman

Ingibjörg Ólöf was born in 1970. She graduated with a master's degree (LL.M) in international and comparative law from George Washington University Law School in 2003. She completed the Bar Exam in 2000 and completed her law degree from the University of Iceland in 1998. Ingibjörg Ólöf is one of the founders and owners of Land Lögmenn International Legal Services. Ingibjörg Ólöf has been the ad-hoc board member of ESA since 2014. Ingibjörg specializes in i.a. international investment and trade agreements, free trade agreements, assistance with start-ups, litigation, and criminal law. In 2008-2010, she supervised legal advisory services for an equity investment fund in Switzerland and in 2006-2008 worked on the EFTA free trade agreement negotiations in Switzerland. Ingibjörg Ólöf was employed as a department head at the Ministry of Agriculture the years 1999-2006 and was a representative of the District Commissioner Seyðisfjördur 1998-1999. She has been a lecturer at the University of Bifröst and Reykjavík University. Ingibjörg Ólöf has served on the boards of numerous companies and a number of committees for the Government since 1999. She is a member of the Air Ground Rescue Team of Reykjavík.

Sigurbjörn Ingimundarson, Vice Chairman

Sigurbjörn was born in 1986. He earned a B.A. degree in law from the University of Reykjavík in 2010, in the years 2010 to 2013 he pursed postgraduate studies in law at the University of Reykjavík and is currently pursuing MBA studies at the University of Iceland. Since 2014, Sigurbjörn was employed as a Director of the Independent Party. He was employed at LOGOS Legal Services in 2012-2014 and Landsvirkjun in 2011.

Endorsement and Statement by the Board of Directors and CEO, contd.

Governance, contd.

Haukur Ingibergsson, board member

Haukur was born in 1947. He is a historian and completed the cand. mag. degree from the University of Iceland in 1973 and B.A. degree in history and geography from the University of Iceland in 1970. Haukur has held various managerial positions, was principal of Bifröst, Director of the Progressive Party, Operations Director of Icelandic Fish Quality Institution, manager of the Automobile Inspection Agency, director of the Icelandic Budget Bureau, office manager at the Ministry of Finance, Director of the Land Registry, CEO of the PRD and CEO of Registers Iceland. Hauker has served on numerous committees within and outside the government and served on boards of companies, among others the Automotive Inspections ltd, Stofnfiskur hf, Icelandic Alloys and the Board of the Icelandic College of Education.

Drífa Snædal, board member

Drífa was born in 1973. She graduated as a draftsperson from the Technical College in 1998, completed business administration from the University of Iceland in 2003 and has a master's degree in labor market theory, focusing on labor law from the University of Lund in Sweden 2012. Since 2012 Drífa has been managing director of SGS in Iceland. In 2006 she took over as Director of the Left - Green Movement and served in that position until 2010. In 2003-2004 she was training and promotional manager for the Association for Women's Shelter and later Director of the Association until 2006. Drífa has been i.a. the chairman of Vocational Students Association of Iceland, served on the board of the Left - Green Movement and served on committees amending legislation on political party finances. Drífa has served on the Board of the Duty Free Store Ltd. and been Chairman of the Board of Hlaðvarpinn - the Cultural Women's Fund.

G. Valdimar Valdemarsson, board member

Valdimar was born in 1961 and studied information technology and economics at Högskulen in Telemark in Norway from 1985 to 1988 and has since 1991 been with his own company specialising in software and consulting with a focus on accounting and project accounting. Valdimar was vice president of Regional Cooperation on central highlands from 2007-2011. He has also served on committees of the government, i.a. a committee on preparation of a bill on payment mitigation for individuals and a committee on the review of legislation regarding pensions. Valdimar has been a board member and executive board member of Bright Future since the organization of the party and always as secretary of the Board and the Executive Board. He was chairman of the Progressive Party affairs committee 2003-2009 and international coordinator of the party from 2009 to 2010. He also served as the leader of the Progressive Party Associate in Kópavogur from 2010-2011. Valdimar was President of NCF (Nordisk Ungdom Center Forbund) from 1993 to 1995 and Vice President of the same organization 1990-1993.

Risk factors

The Housing Financing Fund faces various risks and risk management is an important and integral part of other activities of the Fund. Ultimately, the Fund’s Board is responsible for risk management. The Fund is non-profit and has a low risk appetite and the Board shall determine acceptable risk as according to the laws and regulations. The Fund reviews yearly the risk profile which defines objectives, authorization and implementation of a framework for managing the financial and operational risk. The Risk Committee operates under the auspices of the Board and in addition there is an effective risk management. At least four times a year the Board reviews and reports on the Fund's risk and implementation of risk management. It is important that all employees know the Fund's risk factors related to their work and the responses to risks be based on informed decision making.

Funding

As of 31 December 2016, the Fund's loans amounted to ISK 578,471 million decreasing by ISK 69,498 million between years. The reduction in the loan portfolio is due to limited lending, the allocation of private pension savings, writes offs, and prepayments. Prepayments amounted to 47,644 million during the year. The Fund did not need to issue bonds to raise capital. Interest bearing assets excluding the loan portfolio but including liquid assets increased between years and amount to ISK 196,895 million. The increase is primarily due to positive results from sales of appropriated assets and prepayments of loans. The real return on interest bearing assets outside the loan portfolio for the period was 3.51%.

Endorsement and Statement by the Board of Directors and CEO, contd.

Development of arrears and quality of the loan portfolio

Loans in arrears are currently 2.9% of total loans compared to 6.9% in the year 2015. Improved economic conditions and effective collective procedures have reduced the risk of the loan portfolio. Arrears have decreased considerably and collateral status improved significantly due to rising housing prices in excess of inflation. Simplification of the billing processes including among other things, the Fund implementing a second phase in the process has had a positive impact on the development of arrears. The adjusted balance of the total of the Fund's loans in arrears amounted to ISK 17,500 million of which arrears amounted to ISK 3,412 million. The provision for impairment of loans amounted to ISK 7,480 million at the end of the period, a decrease of the provision by ISK 8,669 million since the beginning of the year. Approximately 10,000 households have taken advantage of the option to prepay their loans by allocating private pension savings towards their loans held by the Fund.

Properties and other assets for sale

Funds invested in appropriated properties at year end amount to ISK 10,936 million and decreased by ISK 9,085 million during the year as 888 properties were sold in 2016. The book value of appropriated properties at year end was on average 80% of the property value of the underlying portfolio. The subsidiary Leigufélagið Klettur ehf. was sold to the highest bidder in a transparent sales process. The Competition Authority approved the sale of the rental company at the end of November 2016. The Housing Financing Fund's profit from the sale of the company is ISK 1,427 million, incurred during the period. Year-to-date the Fund has repossessed 203 properties on foreclosed mortgages. Profits from sales of appropriated properties exceeded the book value of the assets by ISK 799 million. The Fund owned 663 properties at the end of the year, of which 372 are rentals, 226 are for sale and 46 vacant. Sales of appropriated properties will have a positive impact on the Fund's net interest income in the future as cash tied up in real estate is transferred into interest-bearing assets.

Operations in the year 2016

Net interest income amounted to ISK 1,857 million including interest income contributions from the Treasury, compensating for the interest loss due to government debt measures. The interest income contribution is the difference between the interest on the loan portfolio and the yield on liquid funds during the period. Operating expenses were ISK 1,735 million, and of that amount about ISK 100 million were one-time expenses due to restructuring activities and the Fund's preparations due to a new Act no. 52/2016 on public housing. Excluding the one-time expenses, operating expenses of the Fund decreased during the year by 12.8% despite substantial increases in wages as a result of collective bargaining agreements. The plans of the Fund assume that the streamlining measures will be fully implemented in 2017. Staff levels decreased by 19% from the previous year and were an average of 77 in 2016 compared to 95 in 2015. 71 employees were on the payroll of the Fund on 31 December 2016.

On 25 May, the Board approved a new organizational structure for the Fund following policy formulation which focused on simplifying and customizing its operations to the changing position of the Fund in the credit market. Emphasis was placed on simplifying procedures, shortening routes of communication and the introduction of a new credit system, with the aim of achieving the highest efficiency in the operations of the Fund. Concurrent to the implementation of the new organizational chart, the Fund's 5 year operating budget was revised. The Board approved the operating budget of the Fund for the years 2016 - 2020 which assumes that the simplification of operations and streamlining measures undertaken in the years 2015-2016 will be fully implemented. The operating budget projects positive results in all years and therefore capital injections from the Treasury are not expected, and it is expected that the equity ratio will be about 8% at the end of the period. Reduction in operating expenses during the period is expected to be 22% in real terms.

Endorsement and Statement by the Board of Directors and CEO, contd.

Operational outlook

The Fund's ability to continue as a going concern in the foreseeable future is positive. The 5-year plan assumes positive results and an equity ratio of 7%, cf. the discussion above. Furthermore the liquidity position is strong and above the Central Bank's liquidity criteria Prepayments on loans and a low rate of growth in lending, however, have a negative effect on the Fund's interest rate margin in the long term as the Fund is not permitted to prepay its debts (financing) bonds before the maturity date. As the percentage of funds outside of the loan portfolio increases due to the prepayment of loans, the duration of the Fund's assets and liabilities becomes imbalanced which may in the future affect the performance of the Fund. The assets and liabilities of the Fund are paid gradually as according to terms but have a lifetime to the year 2044 which is the maturity date of debt. Assets outside of the loan portfolio have been invested in asset-backed indexed bonds with similar payment history to enhance the balance between liabilities and assets.

Social responsibility

The social responsibility of the Fund is reflected in its role of promoting, through lending and the organization of housing, security and equal rights for citizens in housing affairs. The Fund performs its role through a variety of ways including lending to individuals to purchase or build own housing, regardless of location, and lending to municipalities, associations or non-profit companies to purchase or build rental apartments. The Fund oversees the allocation of capital contributions as according to legislation on public housing, and the contributions are intended to develop a new rental system of small and efficient apartments intended for low-income individuals and families. The Housing Financing Fund has also cultivated its social responsibility by setting up a planning and analysis division that provides information on the housing market on the basis of comprehensive analysis, including the housing needs in the country, the supply and demand for housing, housing prices and rental rates. It is the goal of the Fund's management to avoid any contributions from collective funds of the population beyond what has already been agreed. The Fund's investment policy states that the Treasury shall preserve and earn the community funds referring to the liquid funds of the Housing Financing Fund, for the benefit of society in a responsible and prudent manner. The Housing Financing Fund is wholly publicly owned and operates in the public interest. Care should be taken in all of the Fund's investment decisions and consideration should be given to its social responsibility. The Board has decided to set a policy on social responsibility, developing the policy in the near term, that emphasises the importance of management and employees to consider social responsibility in the performance of their duties.

Future role

In addition to the systematic improvements that were made to the Fund's operations during the year, the future role of the Fund has been defined following policy formulation. The Housing Financing Fund's role has changed from being primarily a financing fund to being the institution responsible for the implementation of housing affairs, cf. Article 4 Act. 44/1998, which states that the Housing Financing Fund is responsible for the administration and implementation of housing affairs as according to the Act. It is primarily changes in legislation and government priorities that call for the role change leading to new projects. The Fund will now administer the following tasks:

1. Promote research on the housing market, thereby supporting government policy formulation.
2. Grant capital contributions and establish a new rental system for tenants below specific income and asset limits.
3. Grant residential housing loans regardless of status or place of residence.
4. Implement payment of housing benefits from 1 January 2018 under further ruling by the Minister.
5. Monitor the planning of housing program policy and cooperate with municipalities on the organization of housing affairs.

In accordance with the legislation on public housing adopted in June 2016, the Housing Financing Fund was entrusted to manage the development of a new non-profit rental system by overseeing the evaluation process, distributing, administrating and monitoring the granting of capital contributions for the construction of efficient rental housing. The project was introduced by organizing meetings throughout the country and the website was opened for applications in the autumn months of 2016. The first allotment is completed, capital contributions were granted for the construction of 385 rental apartments.

Endorsement and Statement by the Board of Directors and CEO, contd.

Future role, contd.

In late 2016 a planning and analysis division was established within the Housing Financing Fund to deal with new projects and to ensure that the Fund would be even better equipped to fulfil its role as consultant to the government on strategic planning in housing policy. In addition, the Fund began to prepare for the development of housing program policies by municipalities as well as strategic planning in housing policy at the national level. The Fund will support the development of housing policies by municipalities with presentations, guidelines as well as to support coordinated data collection by municipalities. The Fund is working closely with the Icelandic Association of Local Authorities in this project. It is expected that a bill will be submitted in the spring of 2017 amending the Housing Act and bolstering the Fund's role of analysing and developing policy on the housing market.

Statement by the Board of Directors and the CEO

The Financial Statements of the Housing Financing Fund for 2016 are prepared in accordance with International Financial Reporting Standards as adopted by the EU and additional disclosure requirements for companies that have securities listed on a regulated market.

According to the best of our knowledge, it is our opinion that the Financial Statements give a true and fair view of the financial performance of the Fund for the year 2016, its assets, liabilities, and financial position as at 31 December 2016 and changes in cash flows for the year 2016.

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.

The Board of Directors and the CEO of the Housing Financing Fund have today discussed the Fund's Financial Statements for the year 2016 and hereby confirm them by means of their signatures.

Reykjavik, 3 March 2017.

Board of Directors:

Ingibjörg Ólöf Vilhjálmsdóttir, Chairman of the Board

Drífa Snædal

Sigurbjörn Ingimundarson, Vice-President of the Board

Haukur Ingibergsson

G. Valdimar Valdemarsson

CEO:

Hermann Jónasson

Independent Auditors' Report

To the Board of Directors of the Housing Financing Fund,

Opinion

We have audited the accompanying Financial Statements of the Housing Financing Fund (hereafter the Fund) for the year 2016. The Financial Statements comprise the statement by the Board of Directors and CEO, the statement of income and comprehensive income, the statement of financial position, the changes in equity, the statement of cash flows, and a summary of significant accounting policies and other explanatory information.

In our opinion, the Financial Statements present fairly, in all material respects, the results of operations of the Housing Financing Fund for the year 2016, its financial position as at December 31, 2016, and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the EU and the Financial Statements Act.

In accordance with the provisions of Article 104, paragraph 2 of the Icelandic Financial Statements Act No. 3/2006, we confirm that the statement by the Board of Directors and CEO accompanying the Financial Statements includes at least the information required by the Financial Statements Act if not disclosed elsewhere in the Financial Statements.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor’s Responsibilities section of our Report. We are independent of the Fund in accordance with the Code of Ethics for Professional Accountants in Iceland, and we have fulfilled all ethical requirements therein. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the Financial Statements for the year 2016. These matters were addressed in the context of our audit of the Financial Statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

In our opinion, the following matters are key audit matters in the audit:

a) *Credit risk and loan impairment*

We refer to the discussion in the statement by the Board and CEO, p. 4, in the coverage of the significant accounting policies in Note 30 e. (V) p. 32 and 30 l. p. 33, in the coverage of the critical accounting estimates and judgments in note 2 d. p. 13, and Note 29 b, p. 24 to 28.

We have defined loan impairment as a key factor in the audit as the assumptions used in the impairment process are based on management estimates and are partly subjective. As loans are a significant part of the Financial Statements, any change in criteria may significantly affect the operating results and financial position of the Fund. Our work covered the impairment of both loans to individuals and lending to legal entities.

As part of our audit, we performed tests of key controls relating to loan impairment. The focus of these tests included the analysis of loss events and the assumptions used in the valuation. We examined information in the systems and models used by the Fund to estimate impairment. We also examined the manner in which management evaluated the results of the valuation and responded to deviations if they occurred.

We also performed substantive procedures relating to loan impairment, including assessing the Fund’s impairment methodology and whether the methodology is in compliance with International Financial Reporting Standards and the Financial Statements Act. We also selected a sample of borrowers for further examination and evaluated the assumptions applied by management.

Key Audit Matters, contd.

b) *Measurement of appropriated assets*

We refer to the discussion on significant accounting policies in Note 30 m. p.33, to the discussion on critical accounting estimates and judgments in note 2. c. p.13 and note 12, p. 17.

Appropriated assets are properties that the Fund has redeemed in the enforcement of its claims. Appropriated assets are measured in the Financial Statements at cost or fair value, whichever is lower. Furthermore, information on their net fair value is provided in the notes to the Financial Statements. The estimation of the fair value of appropriated properties is often subjective as the assumptions on which the assessment is based may be subject to management's assessment to a great extent. Each change in the assessment criteria may have a significant impact on the operating results and financial position of the Fund.

In our audit we examined the Fund's valuation methods applied in the measurement of appropriated assets and compliance with International Financial Reporting Standards and the Financial Statements Act. We examined the Fund's procedures of analysing and evaluating the underlying assumptions in the valuations as well as examining the valuation models applied. Then we compared the assumptions of the valuation models with external factors, such as property value or the average sales price of the Fund's appropriated assets.

The Board of Directors and CEO's Responsibilities for the Financial Statements

The Board of Directors and CEO are responsible for the preparation and fair presentation of the Financial Statements in accordance with International Financial Reporting Standards as adopted by the EU and the Financial Statements Act, and for such internal control as management determines is necessary to enable the preparation of Financial Statements that are free from material misstatement, whether due to fraud or error.

In the preparation of the Financial Statements, the Board of Directors and CEO are responsible for assessing the Fund's ability to continue as a going concern. If doubt exists as to the ability to continue as a going concern, this fact should be disclosed in the Financial Statements with relevant explanations, disclosing as applicable, the reasons for applying the going concern basis in the preparation and presentation of the Financial Statements, unless the Board of Directors and CEO either intend to liquidate the Fund or to cease operations, or have no realistic alternative but to do so.

The Board and the Audit Committee shall monitor the preparation and presentation of the Financial Statements.

Auditors' Responsibilities

Our objectives are to obtain reasonable assurance about whether the Financial Statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an Auditor's Report that includes our opinion.

Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these Financial Statements.

As part of an audit in accordance with ISAs, we exercise professional judgement and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the Financial Statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the B117 but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control.

Independent Auditors' Report, contd.

Auditors' Responsibilities, contd.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

- Conclude on the appropriateness of management's use of the going concern basis of accounting and based on the audit evidence obtained, whether a material uncertainty exist related to events or conditions that may cast significant doubt on the Fund's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our Auditor's Report to the related disclosures in the Financial Statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our Auditor's Report. However, future events or conditions may cause the Fund to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the Financial Statements, including the disclosures, and whether the Financial Statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicated with the Board of Directors and the Audit Committee regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identified during our audit, if applicable.

We also provided the Board of Directors and the Audit Committee with a statement that we have complied with relevant ethical requirements regarding independence, and communicated with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated to the Board of Directors and the Audit Committee, we determined those matters that were of most significance in the audit of the Financial Statements of the current period and are therefore the key audit matters. We describe these matters in our Auditor's Report unless law or regulations precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our Report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

For and on behalf of Grant Thornton endurskoðun ehf.
Reykjavik, 3 March, 2017.

Sturla Jónsson
State Authorized Public Accountant

Davíð Arnar Einarsson
State Authorized Public Accountant

Income Statement and Statement of Comprehensive Income

	Notes	2016	2015
Interest income		50,790,372	51,706,865
Interest expense		(48,933,667)	(50,074,104)
Net interest income	18	1,856,705	1,632,761
Other income	19	120,559	182,717
Total operating income		1,977,264	1,815,478
Salaries and salary-related expenses	20	914,121	920,164
Other operating expenses	21	722,391	900,688
Depreciation and amortisation	23	98,777	53,682
Total operating expenses		1,735,289	1,874,534
Net income of appropriated properties	24	104,615	162,717
Net operating income		346,590	103,661
Impairment of loans, securities and appropriated properties	25	2,483,550	1,311,212
Profit from continuing operations		2,830,140	1,414,873
Profit from discontinued operations, net of tax	3	1,426,613	412,001
Profit for the year and comprehensive income		4,256,753	1,826,874

The notes on pages 15 to 35 are an integral part of these Financial Statements.

Financial Statements of the Housing Financing Fund for the year 2017 11 Amounts in ISK thousand

Statement of Financial Position as at 31 December 2016

	Notes	2016	2015
Assets			
Cash and cash equivalents	6	53,171,360	13,236,528
Loans to financial institutions	7	61,114	5,061,627
Marketable securities	8	10,840,424	4,898,018
Other securities	9	126,607,519	97,617,421
Receivable from State Treasury	10	6,214,997	5,877,687
Loans	11	578,470,587	647,969,024
Appropriated properties	12	10,936,362	20,021,499
Operating assets	13	107,779	99,578
Intangible assets	14	213,904	200,838
Other assets		253,885	344,543
Assets for sale	3	0	8,559,856
Total assets		786,877,931	803,886,619
Liabilities			
Bond issues	15	759,485,766	779,492,835
Other borrowings	16	3,153,172	3,631,603
Other liabilities	17	711,146	1,491,087
Total liabilities		763,350,084	784,615,525
Equity			
Contributed capital		57,655,408	57,655,408
Accumulated deficit		(34,127,561)	(38,384,314)
Total equity	29	23,527,847	19,271,094
Total liabilities and equity		786,877,931	803,886,619

The notes on pages 15 to 35 are an integral part of these Financial Statements.

Financial Statements of the Housing Financing Fund for the year 2017 12 Amounts in ISK thousand

Statement of Changes in Equity for the year 2016

Year 2016	**Notes**	**Contributed capital**	**Accumulated deficit**	**Equity Total**
Equity as at 1 January 2016		57,655,408	(38,384,314)	19,271,094
Profit for the year and comprehensive income		0	4,256,753	4,256,753
Equity as at 31 December 2016		57,655,408	(34,127,561)	23,527,847

Year 2015		**Contributed capital**	**Accumulated deficit**	**Equity Total**
Equity as at 1 January 2015		57,655,408	(39,644,432)	18,010,976
Recognition of discounts, adjustment		0	(566,756)	(566,756)
Profit for the year and comprehensive income		0	1,826,874	1,826,874
Equity as at 31 December 2015		57,655,408	(38,384,314)	19,271,094

The notes on pages 15 to 35 are an integral part of these Financial Statements.

Amounts in ISK thousand

Statement of Cash Flows for the year 2016

	2016	2015
Operating activities		
Profit for the year and comprehensive income	4,256,753	1,826,874
Adjusted for:		
Indexation on loans to banks and loans to customers	(15,384,196)	(15,188,675)
Indexation on borrowings	16,195,767	15,812,119
Depreciation and amortisation	98,777	53,682
Impairment	(2,483,550)	(1,311,212)
Valuation adjustment	(1,426,613)	(412,001)
Deferred tax liability		
Changes in operating assets and liabilities:		
Loans	83,548,228	95,114,477
Appropriated properties	10,430,657	7,677,663
Receivable from State Treasury	(208,811)	(1,240,000)
Other assets	44,264	(77,613)
Other liabilities	(779,941)	(2,522,720)
Cash flows from operating activities	94,291,335	99,732,594
Investing activities		
Related party claim, changes	(114,531)	58,708
Sale of subsidiary	10,101,000	0
Loans to financial institutions, changes	5,041,024	2,937,916
Marketable securities, changes	(5,942,406)	(1,665,541)
Other securities, changes	(26,640,279)	(69,262,202)
Investment in operating assets and intangible assets	(120,044)	(92,970)
Investing activities	(17,675,236)	(68,024,089)
Financing activities		
Bond issues and other borrowings, repayments	(36,681,267)	(35,673,443)
Financing activities	(36,681,267)	(35,673,443)
Increase (decrease) in cash and cash equivalents	39,934,832	(3,964,937)
Cash and cash equivalents at the beginning of the year	13,236,528	17,201,465
Cash and cash equivalents at year end	53,171,360	13,236,528

The notes on pages 15 to 35 are an integral part of these Financial Statements.

Amounts in ISK thousand

Notes

General information

1. Reporting entity

The Housing Financing Fund ("the Fund") is headquartered in Reykjavík. The address of the Fund is Borgartún 21. The Fund operates in accordance with the Housing Act no. 44/1998. The Act aims to promote, through the granting of loans and the organization of housing affairs, an environment of security and equal rights in housing affairs for citizens. The main activities of the Fund are in accordance with the purpose of the Act. The Housing Financing Fund appertains to a special management and the Ministry of Welfare. The Housing Financing Fund is subject to supervision by 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.

2. Basis of preparation

a. *Statement of compliance*

The Financial Statements have been prepared in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union. Information as to the new IFRS accounting standards and amendments to standards can be found in note 30u.

The Financial Statements of the Housing Financing Fund were approved by the Board of Directors on 3 March 2017.

b. *Basis of measurement*

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

c. *Functional currency*

The 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.

d. *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.

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 11.
- Repossessed properties, cf. note 12.

e. *Changes in presentation*

The methodology of the recognition of discounts on a portion of the Fund's borrowing was changed. The beginning balance of borrowings and equity has been adjusted in accordance with generally accepted accounting principles and comparative figures have been adjusted accordingly. The impact on the interest expense of the Fund are insignificant.

3. Sale of subsidiary

On June 26, 2016 a purchase agreement was signed for the sale of 100% of the shares of the subsidiary Leigufélagið Klettur. The agreement was subject to approval by the Competition Authority. The selling price amounted to ISK 10,101 million and covers both debt settlement with the Fund and consideration for the shares. The subsidiary was classified as assets held for sale and discontinued operations in the financial statements of the Fund at the end of 2015.

Profit of discontinued operations, net of tax is as follows:	2016	2015
Rental income	274,310	617,071
Operating expenses of investment properties	(100,774)	(204,462)
Operating expenses	(40,970)	(153,644)
Valuation adjustment of investment properties	741,257	561,152
Net financial expenses	(129,419)	(291,361)
Income tax	(148,881)	(116,755)
Profit net of tax of subsidiary's operations	595,523	412,001
Gains from sale of rental company	831,090	0
Profit of discontinued operations, net of tax and cost of sale	1,426,613	412,001

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. 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.

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

31 December 2016	Trading assets	Loans and receivables	Liabilities at amortised cost	Total carrying amount	Fair value
Assets:					
Cash and cash equivalents		53,171,360		53,171,360	53,171,360
Loans to financial institutions		61,114		61,114	61,114
Marketable securities	10,840,424			10,840,424	10,840,424
Other securities		126,607,519		126,607,519	126,607,519
Receivable from State Treasury		6,214,997		6,214,997	6,214,997
Loans		578,470,587		578,470,587	578,470,587
Total financial assets	10,840,424	764,525,577	0	775,366,001	775,366,001
Liabilities:					
Bond issues			759,485,766	759,485,766	835,671,985
Other borrowings			3,153,172	3,153,172	3,153,172
Other liabilities			711,146	711,146	711,146
Total financial liabilities	0	0	763,350,084	763,350,084	839,536,303

Financial Statements of the Housing Financing Fund for the year 2016 16 Amounts in ISK thousand

5. Financial assets and liabilities, contd.

31 December 2015	Trading assets	Loans and receivables	Liabilities at amortised cost	Total carrying amount	Fair value
Assets:					
Cash and cash equivalents......................		13,236,528		13,236,528	13,236,528
Loans to financial institutions...................		5,061,627		5,061,627	5,061,627
Marketable securities................................	4,898,018			4,898,018	4,898,018
Other securities...		97,617,421		97,617,421	97,617,421
Receivable from State Treasury...............		5,877,687		5,877,687	5,877,687
Loans..		647,969,024		647,969,024	653,110,598
Total financial assets................................	4,898,018	769,762,287	0	774,660,305	779,801,879
Liabilities:					
Bond issues..			779,492,835	779,492,835	892,112,593
Other borrowings......................................			3,631,603	3,631,603	3,631,603
Other liabilities..			1,491,087	1,491,087	1,491,087
Total financial liabilities.............................	0	0	784,615,525	784,615,525	897,235,283

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 . 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. Fair value is based on quoted prices in active markets for identical assets. Other treasury securities are measured at their yield at acquisition.

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 2016	Level 1	Level 2	Level 3	Total
Assets:				
Treasury securities...	10,840,424	0	0	10,840,424

31 December 2015	Level 1	Level 2	Level 3	Total
Assets:				
Treasury securities...	4,898,018	0	0	4,898,018

6. Cash and cash equivalents and restricted cash

Cash and cash equivalents and restricted cash are specified as follows:	2016	2015
Unrestricted cash in Central Bank	45,524,349	13,151,849
Unrestricted cash in financial institutions	7,647,011	84,679
Cash and cash equivalents total	53,171,360	13,236,528

Financial Statements of the Housing Financing Fund for the year 2016 17 Amounts in ISK thousand

7. Loans to financial institutions

Loans to financial institutions are specified as follows:

	2016	2015
Inter-bank loans	0	5,007,313
Other claims	61,114	54,314
Loans to banks total	61,114	5,061,627

8. Marketable securities

Marketable securities are specified as follows:

	2016	2015
Listed treasury bonds at fair value	10,840,424	4,898,018
Marketable securities total	10,840,424	4,898,018

9. Other securities

Other securities are specified as follows:

	2016	2015
Covered bonds measured at yield at acquisition	98,376,123	69,967,066
Treasury bonds measured at yield at acquisition	28,231,396	27,650,355
Treasury bonds total	126,607,519	97,617,421

10. Receivable from State Treasury

The receivable due from the State Treasury is comprised of two bonds, a bond amounting to ISK 4,500 million that is payable in one lump sum in the year 2018, and a bond in the amount of ISK 1,240 million that is payable in one lump sum on 1 January 2021. The bonds have a permanent prepayment privilege favourable to the Treasury, in part or in full. Only interest payments on the bonds are collected during the loan period. The bonds are not transferable by the Housing Financing Fund. Furthermore, a Treasury receivable is recognized for the lost interest margin on the basis of the declarations dated 19 December 2014, confirming that the Treasury will compensate for the negative effects of the debt adjustment on results, cf. Act 35/2014.

11. Loans:

Loans are specified as follows:

	2016	2015
Loans to individuals	443,574,174	518,189,581
Loans to legal entities	134,896,413	129,779,443
Loans total	578,470,587	647,969,024

Impairment on loans is specified as follows:

	2016	2015
Balance at the beginning of the year	16,148,682	21,127,603
Impairment loss	(1,197,024)	(1,274,518)
Write-offs	(7,471,460)	(3,704,403)
Balance at year end	7,480,198	16,148,682

12. Appropriated properties

At year-end 2016 there were 663 appropriated properties held by the Fund (2015: 1,348) that it had repossessed for satisfaction of claim. The total number of appropriated properties managed by the Fund is specified as follows:

	2016	2015
Number of properties at the beginning of the year	1,348	1,891
Appropriated properties during the year	203	355
Properties sold during the year	(888)	(898)
Number of properties at year end	663	1,348

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

South and South West	147	427
Great Reykjavík area	112	217
South Iceland	119	174
West Iceland	98	141
East Iceland	82	234
North Iceland	61	99
Westfjords	44	56
Number of properties at year end	663	1,348

Financial Statements of the Housing Financing Fund for the year 2016 18 Amounts in ISK thousand

Notes, contd.:

12. Appropriated properties, contd.

Year-end 2016	Number of properties	Official property value	Fair value	Book value
Rentals	372	8,444,141	7,962,506	7,056,053
In sales process	226	3,882,738	3,088,287	2,800,543
Empty	46	943,250	790,329	752,208
Other properties*	19	383,390	387,166	327,558
Total	663	13,653,519	12,228,288	10,936,362

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

Year-end 2015	Number of properties	Official property value	Fair value	Book value
Rentals	610	12,291,088	11,820,409	10,673,140
In sales process	629	10,468,087	8,388,904	7,888,135
Empty	87	1,497,664	1,314,558	1,200,935
Other properties*	22	374,780	319,964	259,289
Total	1,348	24,631,619	21,843,836	20,021,499

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

13. Operating assets:

Operating assets are specified as follows:

	Fixtures and equipment	Real estate	Total
Cost			
Balance at 1.1.2015	285,152	30,726	315,878
Additions during the year	13,220	0	13,220
Reclassified as assets for sale	(4,931)	0	(4,931)
Balance at 31.12.2015	293,441	30,726	324,167
Additions during the year	51,551	0	51,551
Balance at 31.12.2016	344,992	30,726	375,718
Depreciation			
Balance at 1.1.2015	203,247	6,667	209,914
Depreciation during the year	14,481	1,027	15,508
Reclassified assets as for sale	(833)	0	(833)
Balance at 31.12.2015	216,895	7,694	224,589
Depreciation during the year	42,323	1,027	43,350
Balance at 31.12.2016	259,218	8,721	267,939
Carrying amount			
Balance at 1.1.2015	81,905	24,059	105,964
Balance at 31.12.2015	76,546	23,032	99,578
Balance at 31.12.2016	85,774	22,005	107,779

Property value of real estate at year end 2016 amounted to ISK 9.5 million (2015: ISK 9.0 million) and insurance value amounted to ISK 22.3 million (2015: ISK 22.2 million).

Financial Statements of the Housing Financing Fund for the year 2016 19 Amounts in ISK thousand

14. Intangible assets

Intangible assets are specified as follows:

	Software
Cost	
Balance at 1.1.2015	524,486
Additions during the year	79,750
Reclassified as assets held for sale	(14,106)
Balance at 31.12.2015	590,130
Additions during the year	68,493
Balance at 31.12.2016	658,623
Amortisation	
Balance at 1.1.2015	353,484
Amortisation during the year	38,174
Reclassified as assets held for sale	(2,366)
Balance at 31.12.2015	389,292
Amortisation during the year	55,427
Balance at 31.12.2016	444,719

Intangible assets are specified as follows:

Carrying amounts	
Balance at 1.1.2015	171,002
Balance at 31.12.2015	200,838
Balance at 31.12.2016	213,904

15. Bond issues

The Fund issues housing bonds in three 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:	2016	2015
HFF24 bond	132,367,155	143,991,787
HFF34 bond	208,672,805	211,945,151
HFF44 bond	384,947,757	384,232,639
Housing bonds (final maturity 2040)	14,401,929	19,097,658
Housing Authority bonds (final maturity 2038)	19,096,120	20,225,600
Total bond issues	759,485,766	779,492,835

16. Other borrowings

Other borrowings are specified as follows:	2016	2015
Pension funds	376,887	873,090
Insurance fund	189,376	298,928
Callable bonds	126,607	157,744
Unpaid due to purchase of loan portfolios	2,460,302	2,301,841
Total other borrowings	3,153,172	3,631,603

17. Other liabilities

Other borrowings are specified as follows:	2016	2015
Treasury due to subsidized interest	243,286	207,699
Employee vacation obligation	70,954	75,875
Other liabilities	396,906	1,207,513
Total other liabilities	711,146	1,491,087

Financial Statements of the Housing Financing Fund for the year 2016 20 Amounts in ISK thousand

18. Net interest income

Interest income

Interest income on items not at fair value:	2016	2015
Interest income from loans to customers	40,967,535	45,095,900
Interest income from covered bonds*	5,052,454	(42,359)
Interest income from other financial assets	3,570,355	4,499,420
Gov't contribution due to reduced interest margin related to debt solutions**	840,513	1,870,788
	50,430,857	51,423,749
Interest income on items at fair value:		
Interest income on market securities	359,515	283,116
	359,515	283,116
Total interest income	50,790,372	51,706,865

*The Fund purchased the bonds on 1 December 2015 and the price index decrease in December exceeded the interest income accrued during the period.

**The government contribution due to social benefit loans to municipalities and organisations, such as student associations and organisations of disabled and the reduced interest margin related to government debt solutions.

Interest expenses

Interest expenses on items not at fair value:	2016	2015
Interest expenses on bonds issued	48,871,951	49,852,346
Interest expenses on other borrowings	61,716	221,758
Total interest expenses	48,933,667	50,074,104
Net interest income	1,856,705	1,632,761

19. Other income

Other income is specified as follows:	2016	2015
Collection and service income	111,843	177,295
Other income	8,716	5,422
	120,559	182,717

20. Salaries and salary-related expenses

Salaries and salary related expenses are specified as follows:	2016	2015
Salaries	676,784	663,470
Pension fund contributions	95,125	100,494
Tax on financial activity	42,612	44,108
Employee vacation obligation	(4,922)	0
Other salary related expenses	67099	75,109
Other personnel expenses	37,423	36,983
Total salaries and salary related expenses	914,121	920,164

A portion of salaries was recognised as a receivable from the Treasury at the end of the year and is not included in the income statement of the Fund. The total amount of salaries that is due to the procedures related to capital contributions in the year 2016 is ISK 20 million.

	2016	2015
Average number of employees during the year in full-time equivalent units	77	95

Financial Statements of the Housing Financing Fund for the year 2016 21 Amounts in ISK thousand

21. Other operating expenses

Other operating expenses are specified as follows:	2016	2015
Collection fees	149,076	219,421
Operating expenses of housing	122,943	125,826
Operating cost of IT systems	193,258	154,106
Audit and review of financial statements (cf. note 22)	26,639	26,086
Professional services	85,785	73,179
Real estate evaluations	11,528	14,569
Advertising, promotional material and grants	26,128	34,475
Debtors' Ombudsman	(25,212)	113,735
Financial Supervisory Authority	54,941	52,164
Credit rating	14,605	18,875
Service fees	30,163	24,858
Other operating expenses	32,537	43,394
Total other operating expenses	722,391	900,688

22. Auditors' fee

Remuneration to the auditors' is specified as follows:	2016	2015
Audit of financial statements	11,681	12,134
Review of interim financial statements	3,049	2,722
Internal audit	9,827	8,630
Other auditor-related services	2,082	2,600
Total auditors' fee	26,639	26,086

23. Depreciation and amortisation of the year:

Depreciation and amortisation is specified as follows:	2016	2015
Depreciation of operating assets (cf. note 13)	43,350	15,508
Amortisation of intangible assets (cf. note 14)	55,427	38,174
Total depreciation and amortisation	98,777	53,682

24. Net income of appropriated properties

Net income of appropriated properties is specified as follows:	2016	2015
Rental income from rented properties	726,138	1,074,225
Costs due to appropriated properties	(621,523)	(911,508)
Net income of appropriated properties	104,615	162,717

25. Impairment

Total impairment recognised in the income statement is specified as follows:	2016	2015
Specific impairment loss of loans (reversal of impairment loss)	(1,016,592)	(739,351)
General impairment on loans (reversal of impairment loss)	(180,432)	(535,167)
Impairment loss of loans (reversal of impairment loss)	(1,197,024)	(1,274,518)
Profits from sales of appropriated assets	(798,633)	(216,281)
Impairment on appropriated properties (reversal of impairment loss)	(546,888)	387,887
Impairment on other receivables (reversal of impairment loss)	58,995	(208,300)
(Impairment recognised as income) expensed impairment	(2,483,550)	(1,311,212)

Financial Statements of the Housing Financing Fund for the year 2016 22 Amounts in ISK thousand

Notes, contd.:

26. Rental agreements

The Fund has entered into operating lease agreements on properties used in its operations. Minimum lease payments are specified as follows at year end:

	2016	2015
Payable within 1 year	115,193	112,195
Payable after 1 to 5 years	244,304	235,870
Total	359,497	348,065

27. Related parties and salaries of management

Related parties consist of the owner of the Fund, 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. At year end 2016 there were no mortgage loans to related parties (2015: ISK 0.7 million).

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

	2016		2015	
	Salaries	Pension fund contributions	Salaries	Pension fund contributions
Hermann Jónasson, CEO	17,332	2,184	7,338	955
Sigurður Erlingsson, former CEO	5,822	611	15,880	1,826
Ingibjörg Ólöf Vilhjálmsdóttir, Board Chairman,	3,270	412	2,849	269
Other Board Directors	6,680	842	6,951	594
Key personnel, (6)	96,493	11,520	88,302	11,572

The former CEO and senior management received severance pay in 2016.

28. Other matters

EFTA Surveillance Authority, SFF appeals

On 16 July 2014, 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. SFF appealed the ESA decision and the Icelandic government's request to intervene in the case was approved. The case was brought before the EFTA Court on 12 November 2015. A conclusion was reached in March 2016 whereas the EFTA Court dismissed the appeal from the court and the decision from 16 July 2014 to close the investigation into the activities of the Fund prevails.

Future organization of housing policy

In the year 2016, new legislation on housing came into force. On the one hand, there are amendments to legislation on rental housing and housing co-operatives. On the other hand, there is a new Act no. 52/2016 on public housing that came into effect 1 June 2016 and new legislation on housing benefits that became effective 1 January 2017. The legislation on public housing bestows upon the Housing Financing Fund a new role which involves managing the allocation of capital contributions from the state for the construction or purchasing of rental apartments for leasing to low-income families and individuals, as well as to monitor non-profit housing institutions and public housing. In the autumn session a bill was submitted to amend the Housing Act which is expected to increase the role of the Fund in matters such as policy formulation and planning in housing affairs and restrictions on lending authorisations. The bill was not passed however the Minister of Social Affairs and Equality has declared that a bill amending the Housing Act will be resubmitted.

Financial Statements of the Housing Financing Fund for the year 2016 23 Amounts in ISK thousand

Other matters

The Fund is a party to several disputes currently before the courts. These disputes are mainly related to complaints due to the debt remedies, damages due to forced sales or sales of appropriated assets, complaints due to penalty charges, and disputes over the settlement of usufruct fees due to forced sales, among other disputes. 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.

29 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's Board of Directors

- Responsible for formulating and approving risk management strategy.
- Ensures that an effective risk management strategy is in place within the Fund, and its contents include effective processes and procedures.
- Recognises the risks involved in the operations of the Fund and sets acceptable risk limits.
- Receives statements and reports on the Fund's risk and implementation of risk management.
- Monitors risk management and assesses the effectiveness of current risk management strategy.
- Appoints the Board's Risk Committee.

The Board's Risk Committee

- Deliberates and makes decisions on the Board's proposals regarding important issues in lending practices and the Fund's financial and risk management.
- Recognizes the risks involved in the Fund's operations and sets acceptable risk limits.
- Formulates proposals for risk appetite and risk profile of the Board and decides on further implementation.
- Monitors risk management.
- Directs the internal evaluation assessment of capital requirement.

29 Risk management, contd.:

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

Risk management structure, contd.

CEO

- Responsible for the implementation of risk management, including analysis, measurement and disclosure of information to the Board.
- Delegates responsibility for the development and implementation of methods and systems to identify, measure, monitor, evaluate and manage the risks of the operations to the risk manager, who reports directly to the CEO.
- Maintains the organizational chart specifying clear responsibility, employee authorisations and the communication channels, ensures that responsibility is shared adequately, and that there is sufficient employee capacity and knowledge to meet the requirements of the risk management strategy.

Risk manager

- Performs daily risk monitoring, measurement and mandatory reporting to regulators.
- Is a member of the Financial Committee.
- Attends meetings of the Risk Committee.

Financial committee

- The CEO, CFO, and Risk manager are members of the Financial committee.
- Ensures that information to the Board is satisfactory and Treasury policy and risk management are followed.
- Discusses key issues concerning the Fund's financial and risk management.

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.

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 2016	**Capital region**	**South and Southwest**	**West and Westfjords**	**North Iceland**	**East Iceland**	**Total**
Loans to individuals......	277,285,423	83,538,480	24,825,860	42,725,844	15,198,567	443,574,174
Loans to entities...........	78,379,590	24,344,481	8,666,947	20,522,941	2,982,454	134,896,413
Total loans...................	355,665,013	107,882,961	33,492,807	63,248,785	18,181,021	578,470,587
Year-end 2015						
Loans to individuals......	332,448,951	90,470,702	28,511,698	49,792,196	16,966,034	518,189,581
Loans to entities...........	77,833,745	22,348,036	8,758,338	19,140,664	1,698,659	129,779,443
Total loans...................	410,282,696	112,818,738	37,270,036	68,932,860	18,664,693	647,969,024

Financial Statements of the Housing Financing Fund for the year 2016 25 Amounts in ISK thousand

29. Risk management, contd.:

b. *Credit risk, contd.*

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	
	2016	2015	2016	2015	2016	2015
Neither past due nor impaired						
Total............................	411,832,428	451,922,023	90,295,115	101,722,474	502,127,543	553,644,497
General impairment.....	(684,721)	(726,347)	(117,964)	(126,347)	(802,685)	(852,694)
Carrying amount..........	411,147,707	451,195,676	90,177,151	101,596,127	501,324,858	552,791,803
Past due and not impaired						
31-60 days...................	11,227,280	15,423,452	316,239	917,852	11,543,519	16,341,304
61-90 days...................	4,289,716	7,390,499	0	18,480	4,289,716	7,408,979
Past due over 90 days	7,151,402	13,192,854	24,250	156,511	7,175,652	13,349,365
General impairment.....	(221,269)	(345,269)	(4,489)	(10,912)	(225,758)	(356,181)
Carrying amount..........	22,447,129	35,661,536	336,000	1,081,931	22,783,129	36,743,467
Impaired						
Total............................	12,233,542	38,107,102	48,580,813	35,266,459	60,814,355	73,373,561
Specific impairment.....	(2,254,204)	(6,774,733)	(4,197,551)	(8,165,074)	(6,451,755)	(14,939,807)
Carrying amount..........	9,979,338	31,332,369	44,383,262	27,101,385	54,362,600	58,433,754
Loans total.................	443,574,174	518,189,581	134,896,413	129,779,443	578,470,587	647,969,024
Impairment as proportion of loans........	0.71%	1.49%	3.10%	6.01%	1.28%	2.82%

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

	Loans to individuals		Loans to legal entities		Total	
	2016	2015	2016	2015	2016	2015
Loans past due:						
31-60 days...................	133,393	308,253	9,539	120,177	142,932	428,430
61-90 days...................	75,432	182,686	9,355	35,243	84,787	217,929
Past due over 90 days..	1,819,368	2,762,694	1,365,474	3,017,233	3,184,842	5,779,927
Total past due..............	2,028,193	3,253,633	1,384,368	3,172,653	3,412,561	6,426,286

Obligations not recognised in the balance sheet:	2016	2015
Binding loan commitments at year-end...	8,654,000	4,589,200

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.

Financial Statements of the Housing Financing Fund for the year 2016 26 Amounts in ISK thousand

29. Risk management, contd.:

b. Credit risk, contd.

Quality of loans, contd.

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 25 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
- Abiding by Act no. 101/2010 as according to the Act on Housing par. 3 Art. 47 on write-offs as according to agreement on debt mitigation
- Upon the financial restructuring of legal entities under agreement pursuant to Act no. 101/2010 as according to the Housing Act par. 2 Art. 47.

Impairment on loans is specified as follows:

	Individuals		Legal entities		
	Specific impairment	General impairment	Specific impairment	General impairment	Total
Year 2016					
Balance at					
the beginning of the year......................	6,774,733	1,071,616	8,165,074	137,259	16,148,682
Impairment loss (reversal					
of impairment loss)...............................	(2,044,176)	(165,626)	1,027,584	(14,806)	(1,197,024)
Write-off..	(2,476,353)	0	(4,995,107)	0	(7,471,460)
Balance at year end.................................	2,254,204	905,990	4,197,551	122,453	7,480,198
Year 2015					
Balance at					
the beginning of the year......................	8,348,495	1,438,214	11,035,066	305,828	21,127,603
Impairment loss (reversal					
of impairment loss)...............................	367,726	(366,598)	(1,107,077)	(168,569)	(1,274,518)
Write-off..	(1,941,488)	0	(1,762,915)	0	(3,704,403)
Balance at year end.................................	6,774,733	1,071,616	8,165,074	137,259	16,148,682

Financial Statements of the Housing Financing Fund for the year 2016 27 Amounts in ISK thousand

29. Risk management, contd.:

b. *Credit risk, contd.:*

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 30 million for individuals. The maximum official property value of the assets may not be over ISK 50 million. 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. 43.8% at year end 2016 compared to 45,8% at year end 2015. 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:

	2016	2015
Proportion of the total loans under 50% of the official property value	75.2%	71.3%
Proportion of the total loans from 51 - 70% of the official property value.......................................	14.0%	14.7%
Proportion of the total loans from 71 - 90% of the official property value	6.8%	8.2%
Proportion of the total loans from 91 - 100% of the official property value	1.4%	2.0%
Proportion of the total loans from 101 - 110% of the official property value	0.8%	1.2%
Proportion of the total loans over 110% of the official property value	1.8%	2.6%
	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:

	2016	2015
Loaned own bonds, market value	1,428,803	2,891,160
Market value of pledges provided by counterparties..	1,597,675	3,245,499

Other counterparty risk

Securities holdings and money market funds without government guarantee:

	2016	2015
Structured covered bonds Arion Bank..	83,601,055	69,967,066
Íslandsbanki bonds secured by mortgages...	14,775,068	0
Money market funds...	0	5,007,313

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 ahead 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.

Financial Statements of the Housing Financing Fund for the year 2016 28 Amounts in ISK thousand

29. Risk management, contd.:

c. *Liquidity risk, contd.*

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:

31 December 2016	0 - 3 months	3 - 12 months	1 - 5 years	Over 5 years	Total
Financial assets:					
Cash and cash equivalents	53,171,360				53,171,360
Marketable securities	10,840,424				10,840,424
Other securities	3,072,759	9,486,098	32,664,481	115,612,078	160,835,416
Receivable from State Treasury		169,340	6,311,836		6,481,175
Loans to customers and banks	10,144,461	30,070,566	156,607,520	864,082,666	1,060,905,212
Total financial assets	77,229,003	39,726,003	195,583,836	979,694,745	1,292,233,587
Financial liabilities:					
Borrowings and other liabilities	13,095,497	53,228,019	263,949,563	816,102,765	1,146,375,844
Binding loan commitment		8,654,000			8,654,000
Total financial liabilities	13,095,497	61,882,019	263,949,563	816,102,765	1,155,029,844
Net balance	64,133,506	(22,156,016)	(68,365,726)	163,591,980	137,203,743
31 December 2015					
Financial assets:					
Cash and cash equivalents	13,236,528				13,236,528
Marketable securities	4,898,018				4,898,018
Other securities	1,071,045	6,437,150	13,851,371	170,682,010	192,041,576
Receivable from State Treasury		152,820	6,183,327		6,336,147
Loans to customers and banks	11,593,954	37,754,195	169,303,324	969,566,020	1,188,217,493
Total financial assets	30,799,545	44,344,165	189,338,022	1,140,248,030	1,404,729,762
Financial liabilities:					
Borrowings and other liabilities	14,291,552	54,890,950	267,088,345	893,789,329	1,230,060,175
Binding loan commitment	11,473	4,577,727			4,589,200
Total financial liabilities	14,303,025	59,468,677	267,088,345	893,789,329	1,234,649,375
Net balance	16,496,521	(15,124,512)	(77,750,323)	246,458,701	170,080,387

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.

Financial Statements of the Housing Financing Fund for the year 2016 29 Amounts in ISK thousand

29. Risk management, contd.:

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 87.3% of the Fund's financial assets (2015: 90.7%) and 99.8%(2015: 99.7%) 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 hands 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 2016 is 11.19 years (2015: 9.52 years) and of financial liabilities 9.42 years (2015: 9.6 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 2016 (2015: 4.31%), but weighted average effective interest on loans at the same time was 4.58% (2015: 4.59%). The interest margin on loans and the Fund's borrowings is therefore 0.27%.

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 fees 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.

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 housing 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 213 billion of the Fund's loans (2015: ISK 253 billion) is hedged with prepayment fees in part or entirely and prepayable housing bonds should 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.

	2016	2015
CPI-indexed financial assets:		
Loans	577,716,249	641,646,252
Treasury securities and other assets	142,781,411	108,485,821
Total financial assets	720,497,660	750,132,073
CPI-indexed financial liabilities:		
Bond issue	759,485,766	778,926,079
Other borrowings	3,106,224	3,603,972
Total financial liabilities	762,591,990	782,530,051
Total CPI-indexation balance	(42,094,330)	(32,397,978)

Indexed liabilities were around ISK 42.1 billion in excess of indexed assets at year end 2016 (2015: ISK 32.4 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 421 million (2015: ISK 324 million).

Interest-free assets

When the Fund redeems appropriated assets the loan becomes interest-free. At year end 2016, the Fund held 663 properties for sale (2015: 1,348 properties) recognised at the value of ISK 10,936 million. (2015: ISK 20,021 million).

Financial Statements of the Housing Financing Fund for the year 2016 30 Amounts in ISK thousand

29. Risk management, contd.:

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 Social Affairs and Equality 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:	2016	2015
Total equity according to the financial statements	23,527,847	19,271,094
Intangible assets	(213,904)	(200,838)
Equity base	23,313,943	19,070,256
Total equity requirement is specified as follows:		
Credit risk	25,159,555	28,397,602
Market risk	243,910	134,695
Operational risk	295,474	257,480
Total capital requirements	25,698,939	28,789,777
Equity ratio	7.26%	5.46%

30. 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. *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 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. 18). The aforementioned loans for 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 billion granted in the years 2001-2009 for social benefits where State compensations do not apply.

Financial Statements of the Housing Financing Fund for the year 2016 31 Amounts in ISK thousand

30. Significant accounting policies, contd.

b. *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.

c. *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 21. Operating expenses are recognised as they are incurred.

d. *Net operating income of appropriated properties*

Net operating income of appropriated properties consist of rental income and expenses of appropriated properties, cf. note 24.

e. *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.

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.

(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.

30. Significant accounting policies, contd.:

e. *Financial assets and financial liabilities, contd.:*

(v) Impairment of financial assets, contd.

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 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.

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.

f. *Impairment loss of assets other than financial assets*

At each balance sheet date, the carrying amount of assets is reviewed to determine whether there is any indication that there has been an impairment loss. If evidence of impairment exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss, if any. If it is not possible to estimate the recoverable amount of an individual asset, the Fund estimates the recoverable amount of the cash-generating unit to which the asset belongs. The recoverable amount is the higher of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the estimates of future cash flows have not been adjusted. If it is not possible to estimate the recoverable amount of an individual asset, the Fund estimates the recoverable amount of the cash-generating unit to which the asset belongs. If the recoverable amount of an asset or cash-generating units is estimated to be less than its carrying amount, the carrying amount of the asset is reduced to its recoverable amount. Impairment of cash-generating units are deducted from the carrying amount of the assets of the unit. An impairment loss is recognized in the income statement.

Discontinued operations

A discontinued operation is a component of an entity that either has been disposed of or classified as held for sale and either (1) represents a major line of business, (2) is part of a single co-ordinated plan to dispose of a separate major line of business, or (3) is a subsidiary acquired exclusively with a view to resell.

30. Significant accounting policies, contd.:

g. Discontinued operations, contd.

Profit of loss from discontinued operations is presented as a single amount in the income statement or statement of comprehensive income and consists of (1) the profit or loss after tax from the operations of the discontinued operation, (2) the profit or loss after tax arising from the fair value assessment less sales costs, (3) gains or losses from the sale or disposal of the discontinued operations.

h. Cash and cash equivalents

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

i. Loans to banks

Loans to banks consist of interbank loans and unsettled claims on the Icelandic banks.

j. Marketable securities

Marketable securities are securities listed on an active market and are stated at fair value.

k. Other securities and Receivable from Treasury

Other securities consist of government treasury bonds, structured covered bonds issued by Arion Bank secured by the bank's mortgages and bonds issued by Íslandsbanki secured by mortgages. Initially, the covered bonds are recognized at fair value in the Fund's financial statements including direct transaction costs and subsequently measured at amortized cost using the effective interest method. The interest revenue and impairment is recognized in the income statement. Treasury bonds are securities (RIKS30 and RIKS 33) listed on the stock exchange but not on an active market and are capitalised based on amortised cost and initial rate of return (note no 9).

l. 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.

m. Appropriated properties

When the Fund redeems properties on foreclosed mortgages they are recognised as appropriated properties in the balance sheet. Appropriated 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 an appropriated property 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.

n. 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.

30. Significant accounting policies, contd.:

o. *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.

q. *Assets for sale and liabilities associated with assets for sale*

Assets and disposal groups together with the related liabilities are classified as held for sale and liabilities associated with assets held for sale if their carrying amount is recovered through a sale transaction rather than through continuing use. Assets and liabilities classified as held for sale are measured at the lower of the carrying amount or fair value less costs to sell. Assets held for sale and liabilities associated with assets for sale are distinguished from other assets and liabilities in the balance sheet. Assets classified as held for sale are not depreciated.

r. *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.

s. *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.

t. *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 2015.

u. *New standards and interpretations not yet adopted*

The IASB has published new standards and amendments to existing standards that have not become effective and have not been adopted early by the Fund. Information on those standards that are expected to be relevant to the Fund's financial statements is provided below.

IFRS 9 'Financial Instruments' (2014) supersedes the current guidance on financial instruments in accordance with IAS 39. The new standard introduces changes to IAS 39's guidance on the classification and measurement of financial assets and introduces a new 'expected credit loss' model for the impairment of financial assets. IFRS 9 also provides new guidance on the application of hedge accounting. Management has started to assess the impact of IFRS 9 but is not yet in a position to provide quantified information. In view of the nature of the Fund's operations, the main area of expected impact is the recognition of an expected credit loss-based impairment on the Fund's loans.

IFRS 9 will be mandatory for annual reporting periods beginning on or after 1 January 2018.

IFRS 15 'Revenue from Contracts with Customers' provides a comprehensive framework for the accounting treatment of income. The standard replaces IAS 18 'Revenue', IAS 11 'Construction Contracts', and several revenue-related Interpretations. The new standard establishes a control-based revenue recognition model. Revenue is recognised as the amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to customers. IFRS 15 is effective for annual reporting periods beginning on or after 1 January 2018, if endorsed by the EU. Management has started to assess the impact of IFRS 15 but is not yet in a position to provide quantified information.

New standards and interpretations not yet adopted, contd.:

IFRS 16 'Leases' replaces IAS 17 'Leases' and other related interpretations. The standard establishes guidelines for the recognition, measurement, presentation and disclosure of leases. The standard's objective is to ensure that lessors and lessees provide information that represents the financial transactions. IFRS 16 is expected to change the balance sheet, income statement, and cash flow statement for companies with material off balance sheet leases. The requirements for lessor however are substantially unchanged. IFRS 16 is effective for annual reporting periods beginning on or after 1 January 2019. Management has started to assess the impact of IFRS 15 but is not yet in a position to provide quantified information

New standards and interpretations not yet adopted, contd.:

New standards, interpretations and amendments not either adopted or listed above are not expected to have a material impact on the Fund's financial statements.