MOODY'S
INVESTORS SERVICE

Credit Opinion: Housing Financing Fund

Global Credit Research - 24 Sep 2013

Reykjavik, Iceland

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Ba1
Bkd Senior Unsecured -Dom Curr	Ba1

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Key Indicators

Housing Financing Fund (Unconsolidated Financials)[1]

	[2]6-13	[2]12-12	[2]12-11	[2]12-10	[2]12-09	Avg.
Total Assets (ISK billion)	871.6	876.1	867.3	836.0	794.8	[3]2.3
Total Assets (EUR million)	5,410.0	5,190.6	5,462.0	5,434.2	4,425.8	[3]5.1
Total Assets (USD million)	7,032.2	6,843.2	7,090.4	7,290.2	6,349.9	[3]2.6
Tangible Common Equity (ISK billion)	11.6	14.6	9.4	8.4	9.9	[3]3.9
Tangible Common Equity (EUR million)	71.9	86.2	59.3	54.5	55.3	[3]6.8
Tangible Common Equity (USD million)	93.4	113.7	77.0	73.1	79.3	[3]4.2
Net Interest Margin (%)	0.4	0.3	0.3	0.3	0.4	[4]0.3
PPI / Average RWA (%)	0.3	0.2	0.3	0.4	0.6	[5]0.4
Net Income / Average RWA (%)	-1.3	-1.8	0.2	-9.3	-1.0	[5]-2.6
(Market Funds - Liquid Assets) / Total Assets (%)	95.0	94.2	95.1	94.6	94.3	[4]94.7
Tangible Common Equity / RWA (%)	2.5	3.2	2.3	2.2	3.0	[5]2.6
Cost / Income Ratio (%)	70.0	73.7	63.4	47.7	39.7	[4]58.9
Problem Loans / Gross Loans (%)	14.4	14.7	14.6	15.6	--	[4]14.8
Problem Loans / (Equity + Loan Loss Reserves) (%)	333.6	310.3	374.3	306.2	--	[4]331.1

Source: Moody's

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

Opinion

SUMMARY RATING RATIONALE

Moody's rates the Housing Financing Fund (HFF) Ba1 with a stable outlook. The rating reflects the guarantee HFF, a fully government-owned residential mortgage lender, receives on its funding from the Icelandic state (Baa3, stable).

Rating Drivers

- Pressure on franchise

- Very high likelihood of government support, but not a perfect guarantee

- Profitability will remain weak in short and medium term

- Full dependence on wholesale funding

- Poor asset quality will continue to weigh on capital adequacy

- Legal and political risks

Rating Outlook

The stable outlook on the senior unsecured debt and issuer ratings reflects the strength of and links to HFF's owner, the Icelandic government, notably the guarantee following from the fund's legal status, as well as the actions - multiple capital injections - and intentions of the government.

What Could Change the Rating - Up

Upwards rating pressure could develop if there is (1) a material improvement in the fund's asset quality; (2) the fund's ability to generate operating profits is restored; and (3) the fund's capitalisation improves to better match its risk profile. A positive change in the sovereign rating would place upwards pressure on HFF's rating, though a change in line with the government's rating would not be a foregone conclusion.

What Could Change the Rating - Down

A downgrade of HFF's issuer rating could result if (1) the credit strength of its owner were to deteriorate; (2) worse-than-expected loan performance exerts greater pressure on the bank's financial fundamentals; (3) capitalisation, including capital injections, deteriorates further; and (4) the likelihood of the fund to fulfil upcoming bond maturities is impaired.

Recent Results

Total income increased 5% in 2012 to ISK 3,614 million. The increase was driven by a 61% increase in other income more than offsetting a 9% fall in net interest income to ISK 2,484 million. The increase in other income was mainly a result of higher rental income on properties held for sale. Total operating expenses increased 22% to ISK 2,665 million driven primarily by the costs of owning and managing an increasing portfolio of appropriated assets (2,546 properties at end-June 2013, up from 2,224 properties at end-2012), as well as increased resources and costs related to the processing of customers debt problems (consulting, IT, personnel). Loan impairments increased to ISK 8,806 million from ISK 272 million in 2011. The loss for the year 2012 was ISK 7,856 million against a gain of ISK 986 million in 2011.

The group's capital ratio remained below the 5% target at 3.2% including an ISK 13,000 million contribution from the government in Q4 2012.

In the first six months of 2013, a net loss of ISK 3.0 billion was recorded on back of a further ISK3.65 billion of loan impairments and this caused the capital ratio to deteriorate to 2.5%.

DETAILED RATING CONSIDERATIONS

Detailed considerations for HFF's currently assigned ratings are as follows:

-PRESSURE ON FRANCHISE

HFF is a residential mortgage lender and is not authorised to accept deposits. Its responsibility is to monitor housing needs in Iceland and in addition lend to municipalities, companies and associations for construction or purchase of residential housing.

HFF dominated the Icelandic mortgage lending market until 2004, when the commercial and savings banks entered into direct competition. As a result, the fund's market share decreased to around 40% at end-2007. Following the collapse of the country's three major commercial banks in 2008, HFF regained market share. In addition, HFF has taken over portfolios of ISK 28.3 billion of other Icelandic banks, which accounted for 3.5% of its total loan portfolio at end-December 2012.

Moody's notes that in 2012 HFF reported a 36% year on year decline to ISK 15.2 billion in new mortgage lending. At the same time, mortgage lending by Iceland's commercial banks increased threefold year on year. The change largely reflects commercial banks' issuance of non-inflation-indexed loans, which HFF is not authorised to offer. Commercial banks' non-inflation indexed loan issuance is credit negative for HFF, constraining its market share and franchise value. HFF has expressed interest in obtaining authorisation to offer non-indexed loans and issuing non-inflation-indexed bonds once its investor base, substantially consisting of pension funds, shows interest in their merit, which may enable it to recapture some of the lost market share if authorisation is granted. At year-end 2012, HFF accounted for 22% of new mortgage lending in Iceland.

In the first six months of 2013, new mortgage lending by HFF declined 27% to ISK5.5 billion and its market share of new mortgage lending declined to 17% from 23% compared with the same period last year..

VERY HIGH LIKELIHOOD OF GOVERNMENT SUPPORT, BUT NOT A PERFECT GUARANTEE

HFF's issuer rating now benefits from six notches of systemic uplift from the Icelandic government (Baa3, Stable). Moody's assesses that the likelihood of systemic support for HFF is very high reflecting the national government's 100% ownership of HFF and its legal status a "Treasury Part C" institution, ensuring that the government is responsible for full payment of HFF's liabilities. The guarantee does not satisfy all of Moody's requirements to permit full credit substitution, in particular because there is no explicit guarantee on timely payment, giving rise to a potential risk of non-timely payment if HFF were to fail to meet its obligations, which, combined with the weakening in HFF's stand-alone credit quality, supports the rating differential to the Icelandic government .

Nevertheless, HFF's Ba1 rating - one notch below the Icelandic government - reflects the very high likelihood that the Icelandic government would honour HFF's liabilities in full and on time, given (1) the government's interest and continued involvement in HFF's operations, as demonstrated by the government's repeated recapitalisations of the institution; and (2) the substantial holdings of HFF's bonds by Icelandic pension funds, now estimated at 65% of total bond holdings. In addition, HFF accounts for around 10% of Icelandic financial system assets.

-PROFITABILITY WILL REMAIN WEAK IN SHORT AND MEDIUM TERM

HFF's profitability is generally weak, reflecting its role as mortgage lender and lender for social housing. The fund recorded net losses of ISK41.4 billion between 2010 and 2012, mainly driven by ISK45.1 billion of loan impairments. In addition to the current elevated loan loss level, the low operating profitability of the fund reflects low historical loan margins, and is deteriorating due to the fund's inability to prepay funding when borrowers prepay their loans, creating a negative spread. At the same time costs are increasing reflecting the increasing resources needed to deal with customers debt servicing problems and managing a growing portfolio of repossessed properties (2,224 properties at end-2012, up from 1,069 at end-2010). These factors have resulted in the cost-to-income ratio increasing to 74% in 2012 from 48% in 2010. We expect the fund's efficiency to be challenged going forward given the extent of loan restructurings and repossessed properties.

The first six months of 2013 mirrored the same fundamental issues seen in 2012 resulting from pressure on margins, high prepayments, and large impairments, A net loss of ISK 3.0 billion was recorded on the back of ISK3.65 billion further loan impairments. Loan impairments rose 21% relative to the same period for last year. The cost-to-income ratio for the period was 70%.

Moody's recognises that HFF is working to mitigate the effect of some of these underlying causes, but does not deem a sustainable reversal of the negative trend in profitability likely in the short to medium term.

Following amendments to the Act on Consumer Credit by the Icelandic Parliament on 18 March 2013, HFF announced plans to shift prepayment risk to investors in new inflation-indexed financing from 1 November 2013, the date the law will come into force, which should over time reduce prepayment risk.

-FULL DEPENDENCE ON WHOLESALE FUNDING

HFF's full reliance on market funding makes the fund sensitive to deterioration of investor confidence, which may be influenced by the fund's low capitalisation or, over time, the removal of the government-implemented capital controls, which have been in place since December 2008

The fund does not take deposits and has only a moderate securities portfolio but funds its mortgage loan portfolio by issuing its bonds in the domestic market, accounting for around one third of the Icelandic bond market at end-

June 2012. Investors at end-July 2013 included Icelandic pension funds (around 65%), foreign investors (around 3%), and securities and investment funds (around 15 %).

On one hand, the fund's status as a government-owned institution alleviates any immediate concerns about its liquidity profile and the fund has ISK36.1 billion of government bonds available for liquidity operations, as well as cash inflows from mortgage pre-payments. On the other hand, while the maturity profile of HFF's funding has been balanced and termed out, the semi-annual repaying funding structure is still potentially sensitive to a change in institutional investors' perceptions of HFF, which could be vulnerable to the weakened creditworthiness of the fund. As a strong mitigating factor, domestic investors, including pension funds, can only invest domestically as a result of the capital restrictions introduced in 2008, so that investment options are few (HFF and government bonds).

-POOR ASSET QUALITY WILL CONTINUE TO WEIGH ON CAPITAL ADEQUACY

HFF's asset quality weakened further in 2012 and resulting losses have continued to negatively impact the capital ratio. Loans in payment suspension or in default increased to 14.7% of gross loans at end-December 2012, from 14.6% at year-end 2011, albeit that the rate of deterioration has slowed down in the last few years. The continued weak asset quality in 2012 led to a further ISK 8.8 billion in provisions and the capital ratio was as low as 1.4% at end-June 2012 before an ISK 13 billion capital injection was provided by the Icelandic Government in early 2013 to bring the capital ratio to 3.2%. In the first six months of 2013, a further ISK 3.65 billion of impairments led to the capital ratio declining to 2.5%. The Icelandic Government has not committed this year to further capital injections, but we note that last year the announcement of support was included in the Budget 2013 report released in November. Since the crisis, the Icelandic government has provided ISK 46 billion in capital injections to HFF, but even with this support HFF has never met its target minimum capital ratio of 5.0%.

In the first six months of 2013, HFF's asset quality remains poor with loans in payment suspension or default 14.4% of the loan book at end-June 2013.

HFF's high level of loan arrears was caused by the deterioration in Iceland's economic environment in the years following the collapse of the financial system in 2008. Moody's expects that the level of problem loans will remain elevated over the next few years. Concerns are evidenced by the 46% increase in the stock of repossessed properties on HFF's balance sheet at year-end 2012 relative to year-end 2011. Of the entire stock of properties, which we expect to increase further in 2013, 41% were rented out at end-December 2012, and the remainder are at different stages of the sales process. Moody's believes there is a low probability that properties can be sold in the near future, especially outside the greater Reykjavik region in which commercial bank lending is concentrated. HFF's establishment of a rental company in January 2013, which will specialise in renting out part of the repossessed properties, is only a minor mitigation to the risk that HFF is increasingly exposed to non-performing real estate on its balance sheet. Moreover, additional concerns relate to high concentration risks to legal entities providing (social) rental housing, which have also been affected by the economic deterioration in the years following the economic collapse.

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

In March 2012 a law was proposed to place HFF under the same supervision by the Icelandic FSA as other financial institutions which could strengthen HFF's credit risk measures in the longer term.

In view of (1) HFF's deteriorated asset quality, which will likely lead to substantial additional loan loss provisions, and (2) poor profitability, and hence limited ability to quickly replenish capital through internal means, Moody's deems the current capital adequacy ratio as very poor, and subject to likely renewed deterioration in 2013 and beyond due to continued weak operating profitability and additional need for write-downs. We expect, however, that the fund will continue to receive additional capital support in future, in line with the fund's long-term, non-legally binding objective of a 5% minimum total capital ratio.

-LEGAL AND POLITICAL RISKS

There are currently two main legal risks for HFF. One is a legal challenge to HFF's right to charge prepayment fees on loans. Losing such a case could, in the worst case scenario under HFF's own estimates, increase prepayment risk by ISK 10 billion. The second case challenges the legality of indexed loans. One case was dismissed in April 2013, but further lawsuits may be expected. The implications of losing such a case would be enormous losses according to HFF's first half 2013 report.

At the end of April 2013, a new government took power in Iceland and has proposed an across-the-board write-down of Icelandic mortgage debt which could occur as early as this year. The scale of the write-down is still unclear.

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

The principal methodology used in the rating was "Government-Related Issuers: Methodology Update" published in July 2010. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

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