



Moody's Investors Service

## Credit Opinion: Housing Financing Fund

Global Credit Research - 23 Sep 2009

Reykjavik, Iceland

### Ratings

Category	Moody's Rating
Outlook	Negative
Issuer Rating	Baa1
Bkd Senior Unsecured -Dom Curr	Baa1

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### Key Indicators

#### Housing Financing Fund

	[1]2009	[2]2008	2007	2006	2005	[3]Avg.
Total assets (ISK billion)	767.25	726.52	605.86	542.13	494.59	[4]9.58
Total assets (EUR billion)	4.29	4.29	6.61	5.78	6.63	--
Total capital (ISK billion)	13.75	13.28	20.19	17.66	13.89	[4]2.71
Return on average assets	0.12	-1.04	0.44	0.54	0.23	0.08
Recurring earnings power [5]	0.32	0.27	0.49	0.55	0.31	0.40
Net interest margin	0.47	0.41	0.61	0.67	0.32	0.48
Cost/income ratio (%)	34.64	37.70	25.08	23.71	31.22	28.81
Problem loans % gross loans	--	0.24	0.22	0.22	0.18	0.22
Tier 1 ratio (%)	--	--	--	--	--	--

[1] As of June 30. [2] Statement period in which the bank switched to Basel II accounting framework. [3] The average calculations are based on Basel I and Basel II data where applicable. [4] Compound annual growth rate. [5] No footnote\_txt in impact\_fp\_footnotes table.

### Opinion

#### SUMMARY RATING RATIONALE

Housing Financing Fund (HFF) is a 100% government-owned Icelandic residential mortgage lender with a mission to support the government's housing policy, particularly in regard to promoting private home ownership on the most economic and equal terms available.

HFF's Baa1 issuer rating and local currency bond rating reflects the application of Moody's rating methodology for government-related issuers (GRI), under which it is based on (i) the intrinsic strength of HFF, represented by a BCA in the range of 14-16 (on a scale of 1 to 21, where 1 represents the lowest credit risk), (ii) the Baa1 government bond rating of the Republic of Iceland, and (iii) a very high probability of systemic support for HFF.

Moody's assessment that the likelihood of support is very high reflects the national government's 100% ownership of HFF as a "Treasury Part C" institution. The government of Iceland guarantees all HFF's obligations with a guarantee of collection. However, guarantees of collection do not offer bondholders the same degree of protection as a standard guarantee. There is a potential risk of non-timely repayment should the fund fail to meet its obligations, as exhaustive administrative and legal procedures must be followed before the government is obliged to pay.

However, given the vital importance of HFF to Iceland as a sole mortgage loan provider -- following the collapse of the banking system -- Moody's expects that the government would intervene in a timely fashion and provide financial or other assistance. Also, supporting this view is Moody's opinion that the fund will play an important role as a housing loan provider during the restructuring phase of the Icelandic banking system. In addition, the rating agency notes that the Icelandic pension funds hold almost half of HFF's bonds.

### **Credit Strengths**

- Status as a 100%-owned government entity, established by special law
- The government of Iceland guarantees all obligations of the HFF with a guarantee of collection

### **Credit Challenges**

- Asset quality development in light of the rapidly weakening credit environment in Iceland
- Poor capitalisation with total capital adequacy standing at 4.3% at end-June 2009
- Lack of call features in recently issued bonds could possibly lead to ALM gaps if a high level of pre-payments occurs
- High dependence on wholesale funding
- Potential further losses stemming from the fund's exposure to the failed Icelandic banks
- Weak profitability reflecting its mission to support the government's housing policy

### **Rating Outlook**

The outlook on all of HFF's ratings is negative. The issuer rating is linked closely to the rating of the Icelandic government due to a very high probability of systemic support from the latter. As such, the outlook on HFF's ratings is expected to mirror the outlook on the Icelandic sovereign ratings.

### **What Could Change the Rating - Up**

At present, we do not view the fund's issuer and bond ratings as enjoying upside pressure, as reflected by the current negative outlook.

### **What Could Change the Rating - Down**

HFF's BCA could come under negative pressure from the following factors: (i) a substantial further weakening of the fund's financial fundamentals, especially its capitalisation and asset quality; or (ii) a significant increase in the fund's risk profile through either a combination of risk concentrations in the loan book or a further increase in market risk.

A downgrade of HFF's issuer rating could result if (i) the government bond rating (Baa1) of the Republic of Iceland were to be downgraded, or (ii) the likelihood of systemic support were to diminish; e.g. should the government be urged to partly sell its ownership in the fund or reduce its support for it.

### **Recent Results and Company Events**

HFF recorded net profit of ISK 463 million in H1 2009, only marginally down from ISK 466 million in the equivalent period of 2008. While operating income improved by 36% year-on-year, net profit was negatively affected by 103% increase in impairments and 22% increase in operating expenses.

Also, it should be noted that net interest income increased by 38% year-on-year, mainly reflecting loan growth. HFF's loan book increased by nearly 6% during the first six months of 2009.

Reflecting the weakening operating environment HFF's asset quality weakened in H1 2009. Defaults excluding impairment (over 90 days) stood at ISK 1216 million, up from ISK 570 million in the beginning of the year. Due to the weakening economic environment, Moody's expects impaired loans to increase further.

HFF's cost-to-income ratio was 35% in H1 2009 (FY-2008: 38%). Total capital adequacy ratio was a low 4.3% at end-June 2009, down from 4.6% at end-2008.

On 25 June 2009, Moody's affirmed the Baa1 issuer rating and local currency bond ratings of HFF. The outlook on the ratings is negative in line with the sovereign rating of Iceland. Also, as part of this rating action, Moody's lowered HFF's Baseline Credit Assessment (BCA) to the range of 14-16 from 8-10. Moody's decision to lower HFF's BCA reflected the fund's weakened financial fundamentals, in particular its poor capital adequacy level.

### **DETAILED RATING CONSIDERATIONS**

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

#### **Qualitative Factors**

Factor 1: Franchise Value

Trend: Neutral

HFF is a residential mortgage lender and is not authorised to accept deposits. The fund is not permitted to engage in any commercial activity outside its core function of domestic residential mortgage lending. Its responsibility is to monitor housing needs in Iceland and assist in the preparation of municipalities' plans in relation to housing needs.

HFF dominated the Icelandic mortgage lending market until August 2004, when the commercial and savings banks entered into direct competition. As a result, the fund's market share decreased to 45% at end-2007 from a high point of 79% at end-2003. However, following the collapse of the country's three major Icelandic banks last year, HFF now dominates the mortgage lending market. Also, as a part of the emergency law that was put in place by the government in early October 2008, the fund has been given authorisation to take over mortgage loans from other Icelandic banks. So far, HFF has taken over a portfolio of ISK10 billion, which accounted for 1% of its total loan portfolio at end-2008.

Given the fund's leading market position within mortgage lending there have been discussions regarding its future role. A complaint made to the EFTA regarding HFF's competitive advantage as a recipient of state aid was rejected in July 2004. However, a successful appeal led to a formal investigation procedure being set up in June 2006. As a result of this investigation, the EFTA came to the preliminary conclusion that HFF's position is a contravention of European Economic Area (EEA) competition rules. However, given the recent events in Iceland, Moody's expects that it is likely that there will be delays with regards to a decision on the fund's future role.

#### Factor 2: Risk Positioning

Trend: Weakening

HFF is a 100% government-owned Icelandic residential mortgage lender. As such, the fund has regular meetings with the Ministry of Social Affairs and reports on its activities to the ministries as well as to the board. The Minister of Social Affairs actively supervises the fund and appoints HFF's board. Although most board members are politicians, they have been involved in social housing, construction or finance. The Icelandic Financial Supervisory Authority (FSA) now supervises all aspects of HFF in line with other financial institutions. The government controls HFF's lending policies.

HFF mortgage lending is broadly spread, but it does have a substantial proportion of larger exposures to municipalities, tenants' associations and students' association. HFF does not take currency risks; all loans and borrowings are denominated in Icelandic krona. Interest rate risk is, as far as possible, matched out.

HFF is responsible for granting mortgage loans as follows:

1. General loans to private persons or construction firms for the renovation, construction or purchase of residential housing:

- a. Up to a maximum loan of ISK20 million
- b. The amount may not exceed 80% of the market price, the cost of construction or the approved cost of major renewal or renovation of residential housing
- c. A limit to financing one dwelling per family, except in special circumstances

2. Loans for rental housing to municipalities, companies and associations for the construction/purchase of rental housing have all maximum of 80%. However, only loans for social renting have a maximum of 90%.

In Moody's view, the weakening credit environment in Iceland continues to have a negative impact on the fund's risk positioning. Also, HFF has an authority to take over housing-backed mortgages of Icelandic financial institutions. This regulation was approved by parliament in October 2008 in the context of the difficult financial market conditions. In Moody's opinion, potential loan portfolio transfers from the other Icelandic banks could also have a negative impact on the fund's asset quality - especially if the foreign currency-denominated mortgage loans were to be transferred to the fund. However, it should be noted that the fund has permission to reject applications for portfolio transfers. Moody's notes that mortgage loans in foreign currencies have been especially adversely affected by the depreciation of the krona. For the time being, the fund does not have any foreign currency-denominated mortgage loans in its loan portfolio.

#### Factor 3: Regulatory Environment

Refer to Moody's Banking System Outlook on Iceland, published in March 2008, and Banking System Update, published in June 2009, to obtain a detailed discussion of the country's regulatory environment.

#### Factor 4: Operating Environment

Trend: Neutral

This factor is common to all Icelandic banks. For a discussion of the operating environment, refer to Moody's Banking System Outlook, published in March 2008, and Banking System Update, published in June 2009.

#### Factor 5: Profitability

Trend: Weakening

HFF is a non-profit-maximising entity; but its mandate is to generate sufficient profits in order to sustain its lending operations. As a specialist mortgage lender, HFF is reliant on net interest income, which represents over 90% of its net operating income. The remaining income arises from collection charges.

On an annual basis, HFF first agrees its budget proposal with the Ministry of Social Affairs and then finalises the budget with the Ministry of Finance. The budget is then proposed as a bill to parliament, which decides annually on a limit for HFF's mortgage lending and the level of bond issuance required for it to fund itself, and sets the margin. The margin is set such that the fund is able to earn a satisfactory return after covering its costs and possible non-performing loans.

HFF's budget is included in the government's budget. The budget can be adjusted during the year to reflect an anticipated increase or reduction in demand for housing loans. Furthermore, the government can respond to potential financial pressure by increasing the

fund's margins. The fund is exempt from corporate tax and does not pay dividends to its owner.

HFF's financial performance weakened substantially in 2008, with the fund reporting a loss of ISK6.9 billion. Losses were primarily due to increased loan loss provisions and the fund's exposure to collapsed Icelandic banks. Overall, the fund reported impairments of ISK8.7 billion, while its operating income was only ISK 2.9 billion. As a result, the fund's solvency ratio deteriorated to a low 4.6% at end-2008 from 7% at end-2007.

HFF's total exposure to Icelandic banks was in the form of deposits, bonds and derivative agreements and amounted to around ISK43 billion in early October 2008. After the collapse of the banks the fund made an estimate that this exposure could result in a loss of ISK8 billion-ISK12 billion. The actual level of the losses should be known in more detail when the failed banks' net asset valuations have been completed.

In H1 2009, HFF recorded net profit of ISK 463 million, only marginally down from ISK 466 million in the equivalent period of 2008. While operating income improved by 36% year-on-year, net profit was negatively affected by 103% increase in impairments and 22% increase in operating expenses.

Also, it should be noted that net interest income increased by 38% year-on-year, mainly reflecting loan growth. HFF's loan book increased by nearly 6% during the first six months of 2009.

Reflecting the weakening operating environment HFF's asset quality weakened in H1 2009. Defaults excluding impairment (over 90 days) stood at ISK 1216 million, up from ISK 570 million in the beginning of the year. Due to the weakening economic environment, Moody's expects impaired loans to increase further.

In light of the more difficult operating environment, Moody's expects the fund's profitability to remain weak. As a result, we view the overall trend in profitability as weakening. Furthermore, Moody's is concerned that the fund's profitability could be impaired by further losses stemming from the fund's exposure to the failed Icelandic banks. The actual level of the losses should be known in more detail when the failed banks' net asset valuations have been completed.

#### Factor 6: Liquidity

Trend: Weakening

The fund does not take deposits and does not have a securities portfolio but funds its mortgage loan portfolio by issuing its bonds in the domestic market, where it accounted for around 34% of the total Icelandic bond market at end-April 2009. Investors that hold HFF's bonds include Icelandic pension funds (around 45%), foreign investors (around 25%), fixed income funds (10%-15%) and banks (including old banks and the central bank, 10%-15%).

On one hand, the fund's status as a government-owned institution alleviates any immediate concerns about its liquidity profile. On the other hand, while the maturity profile of HFF's funding has been balanced and termed out, the funding structure is still potentially sensitive to a change in institutional investors' perceptions of HFF, which could deteriorate in response to the weakening credit environment in Iceland.

Therefore, we see a weakening trend in the fund's liquidity.

#### Factor 7: Capital Adequacy

Trend: Weakening

In light of the large losses that the fund reported in 2008, the total capital adequacy ratio deteriorated to a low 4.6% at the end of the year from 7% at end-2007. In H1 2009, capital adequacy deteriorated further and stood at 4.3% at end-June 2009. While not legally binding, the fund's long-term objective is to maintain a minimum total capital ratio of 5%. HFF's exemption from corporate tax and dividend payments allows it to retain its earnings, which can be subsequently transferred to its capital base.

In Moody's view, HFF's capitalisation is poor, especially in light of the rapidly weakening credit environment in Iceland. The fund's weak operating profitability and the possible emergence of rising credit expenses continues to indicate its need for higher capital levels. However, there are no plans for a capital injection.

#### Factor 8: Efficiency

Trend: Weakening

HFF does not have a branch network, which partly explains its good cost efficiency. In H1 2009, HFF's cost-income ratio was 35% (FY 2008: 38%). Efficiency by another measure, operating costs as a percentage of total assets, remained relatively stable at 0.17% in H1 2009 compared with 2008 (0.16%). By this second measure, HFF's efficiency is in line with other specialised lenders in the Nordic countries.

Moody's believes that cost efficiency could weaken further. It is likely that the fund's current dominant market position and potential loan portfolio transfers from other banks will increase its need for additional employees and as a result increase operating expenses further.

#### Factor 9: Asset Quality

Trend: Weakening

In Moody's view, the weakening credit environment in Iceland is likely to lead to future asset quality problems. Although there has not yet been any significant weakening in HFF's loan quality indicators so far, it is likely that this will become more visible in its year end 2009 accounts.

Moreover, additional concerns relate to high concentration risks. Following the collapse of the country's three largest banks last year, HFF is currently the only active mortgage lender. Also, increasing unemployment levels are likely to negatively affect households' debt service ability.

We also note that due to the weakening Icelandic economy, 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 do not give the correct picture of the fund's current asset quality.

Historically, HFF's asset quality has been very good as reflected by the low level of problem loans. The fund's problem loans (i.e. individually impaired and over 90 days past due but not impaired loans) accounted for a low 0.24% of gross loans at end-2008, which compares with 0.22% at year-end 2007. Loan loss reserves provided a high 101% coverage of problem loans at end-2008 (end-2007: 115%).

Reflecting the weakening operating environment HFF's asset quality weakened in H1 2009. Defaults excluding impairment (over 90 days) stood at ISK 1216 million, up from ISK 570 million in the beginning of the year. Due to the weakening economic environment, Moody's expects impaired loans to increase further.

We expect the fund's asset quality to deteriorate in H2 2009, in line with the deterioration of the general macroeconomic environment in Iceland, and hence we see a weakening trend in this factor.



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