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Research Update:

Icelandic Ibudalanasjodur (Housing Financing Fund) Downgraded To 'BB+' On Deteriorating Capitalization; Outlook Negative

Primary Credit Analyst:

Kai Stukenbrock, Frankfurt (49) 69-33-999-247;kai_stukenbrock@standardandpoors.com

Secondary Credit Analyst:

Alexander Ekbohm, Stockholm (46) 8-440-59 11;alexander_ekbohm@standardandpoors.com

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Overview

- Two consecutive years of large losses have reduced HFF's capital ratio to 3.0%, while asset quality remains under pressure.
- We are lowering our long- and short-term ratings on HFF to 'BB+' and 'B', respectively.
- We assess the fund's stand-alone credit profile to be 'B-'.
- The negative outlook indicates that the ratings could be lowered should HFF's capital base erode further, or should the creditworthiness of the Republic of Iceland, its sole owner, deteriorate.

Rating Action

On June 14, 2010, Standard & Poor's Ratings Services lowered its local and foreign issuer credit ratings on Iceland-based Ibudalanasjodur (Housing Financing Fund) to 'BB+/B' from 'BBB/A-3' and 'BBB-/A-3', respectively. We removed the rating from CreditWatch, where it was placed with negative implications on Jan. 6, 2010. The outlook is negative.

Rationale

The rating action follows our review of HFF's 2009 financial position and performance, and reflects HFF's weak capital position, its second consecutive year of sizeable losses as a result of impairments on its liquidity portfolio, and our expectation that both earnings and asset quality will continue to be under substantial pressure in 2010.

The ratings on HFF reflect our opinion that there is an "extremely high" likelihood that the government of Iceland (local currency BBB/Negative/A-3; foreign currency BBB-/Negative/A-3), HFF's sole owner, would provide timely and sufficient extraordinary support to HFF in the event of financial distress.

In accordance with our criteria for rating government-related entities, this opinion is based on our assessment of HFF's "very important" role as Iceland's key residential mortgage lender--particularly following the default and restructuring of Iceland's key commercial banks--and its "integral" link with the government, as demonstrated, among other things, by the ultimate but not timely government guarantee on HFF's liabilities.

Following the breakdown of most of Iceland's commercial financial system in October 2008, HFF is now virtually the sole lender in the mortgage market. Future reform of the Icelandic residential mortgage market is possible, in order to bring the banks back into the market, particularly for lending beyond HFF's approval limits. However, we do not expect HFF's role to change significantly as a result of such reform, not least because the government considers HFF to have been pivotal in dealing with the economic crisis in Iceland.

On a stand-alone basis, HFF's operations are affected by Iceland's distressed economy, and we assess the fund's stand-alone credit profile at 'B-'. Following the second year of substantial losses, mainly caused by impairments on HFF's liquidity portfolio as a result of the default of a large part of Iceland's banking system, HFF now has a very weak capital position. The total capital ratio of 3.0% is well below regulatory limits for Iceland's financial system, from which HFF is exempt, however. A government working group is currently examining HFF's capitalization, and in its letter of intent to the IMF from April 2010, the Icelandic government has committed itself to make HFF subject to prudential rules, "with an appropriate phase in for increases in capital".

HFF incurred its second consecutive sizable loss of Icelandic krona (ISK) 3.2 billion in 2009, after a loss of ISK6.9 billion in 2008. We believe earnings and asset quality will continue to be under substantial pressure in 2010 as at the end of 2009 16% of the loan portfolio was either impaired or on various "payment holiday" solutions. Although we believe the vast majority of the provisioning effort related to the financial sector exposure is a thing of the past, we expect that new provisions to cover the high share of nonperforming loans will put substantial pressure on HFF's earnings in 2010. We expect provisioning needs and depressed net interest income to affect HFF's bottom-line such that it will barely be profitable in 2010. However, we believe there is a clear downside risk to our projections given the many uncertainties prevailing in both the house market and the broader economy.

Nonperforming loans and loans in "payment holidays" will also result in a cash flow shortfall in 2010 and 2011. We believe, however, that HFF should be able to cover this shortfall either from its cash position or through borrowing.

HFF's bonds remain the benchmark for the Icelandic inflation-indexed bond market, but the government has recently also started to issue in this segment. HFF's bonds are amortizing, with HFF aiming to closely match payment flows from mortgages to debt-service payments. As a result, HFF has limited its refinancing requirements and should predominantly need to borrow mainly for new mortgage lending. Following the recent buyback of krona-denominated external debt by the treasury, and the subsequent on-sale of ISK90 billion of HFF bonds to domestic pension funds, these now hold approximately two thirds of HFF's debt, while the share of HFF debt held by foreigners is now expected to be less than 10%. During 2009, pension funds alone are estimated to have bought the overwhelming share of HFF's issuance. Principal payments on HFF's krona-denominated debt are subject to central-bank capital controls. Interest

payments are freely convertible. We expect foreign demand for HFF's obligations to be lower in the future. Should local demand for HFF's debt issues be insufficient to fund its borrowing requirements, we would expect the government to provide funding directly to HFF.

Outlook

The negative outlook reflects that on the Republic of Iceland, indicating that if the sovereign ratings on Iceland were to be lowered, this could also lead to a lowering of the ratings on HFF. The outlook also reflects our expectation of a sustained deterioration in asset quality, which could further undermine HFF's very weak capital base, in the absence of demonstrated extraordinary support by the government.

The ratings could improve if HFF's capital base were to strengthen significantly, for example through capital injections by the government. Furthermore, an improvement in the Republic of Iceland's creditworthiness could also lead us to raise the ratings on HFF.

Related Criteria And Research

- Enhanced Methodology And Assumptions For Rating Government-Related Entities, June 29, 2009
- FI Criteria: Bank Rating Analysis Methodology Profile, March 18, 2004

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Ibudalanasjodur (Housing Financing Fund)		
Issuer Credit Rating		
Foreign Currency	BB+/Negative/B	BBB-/Watch Neg/A-3
Local Currency	BB+/Negative/B	BBB/Watch Neg/A-3
Ibudalanasjodur (Housing Financing Fund)		
Senior Unsecured (4 issues)	BB+	BBB/Watch Neg

Additional Contact:

Sovereign Ratings; SovereignLondon@standardandpoors.com

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