

Announcement: Moody's affirms Housing Financing Fund's Baa3 issuer rating; outlook negative

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Standalone credit strength on review for downgrade

London, 05 October 2012 -- Moody's Investors Service has today affirmed the Baa3 issuer rating of Iceland-based Housing Financing Fund (HFF), with a negative outlook. The affirmation, despite a weakening of HFF's operating performance, and specifically its reduced capital ratio, reflects that HFF's Baa3 supported rating continues to incorporate the implicit guarantee HFF receives on its funding from the Icelandic state (Baa3, negative). The negative outlook is in line with the outlook on Iceland's government bond rating.

At the same time, Moody's has placed on review for downgrade HFF's baseline credit assessment (BCA), which is in the range of 14-16 (on a scale of 1 to 21, where 1 represents the lowest credit risk). The review for downgrade of HFF's BCA reflects (1) the weakening of HFF's asset quality; (2) Moody's expectation of continued weak profitability; and (3) HFF's poor and further deteriorated capital ratio, which fell to 1.4% from 2.3% during H1 2012.

RATINGS RATIONALE

RATIONALE FOR THE ISSUER RATING

HFF's legal status -- as a Treasury C-type institution fully owned by the Icelandic government -- ensures that the government is responsible for full payment of its liabilities. However, since there is no explicit guarantee on timely payment, there is a potential risk of non-timely payment if HFF fails to meet its obligations. Moody's continues to believe that this event is unlikely to occur, given (1) the government's interest and continued involvement in HFF's operations; and (2) the substantial role HFF's bonds play in Iceland's mortgage market, where the fund reported an approximately 50% share of new lending at end-June 2012, an increase from its pre-crisis level, and bond market (40%, according to the Central Bank). Moody's Baa3 issuer rating includes the expectation that the government will recapitalize the institution in the budget process in late 2012.

The negative outlook on the issuer rating reflects (1) the negative outlook on the sovereign rating; and (2) Moody's concerns with regards to the support the government may provide to bring HFF in line with its longer-term capital target of 5%, or above. As a result, any positive change in the sovereign rating would not necessarily result in upwards pressure on HFF's rating.

RATIONALE FOR THE BCA

The review for downgrade of HFF's BCA reflects in part the weakening of HFF's operating results, and the potential for such weak profitability to continue. HFF's loans in payment suspension or in default increased to 15.1% at end-June 2012, from 14.7% at year-end 2011. The stock of repossessed properties on HFF's balance sheet increased by 28% since the beginning of the year at end-June 2012. Of these properties, 41% are rented out, and the remainder are at different stages of the sales process. However, Moody's believes there is a low probability that properties can be sold in the near future, especially outside the greater Reykjavik region on which commercial bank lending is concentrated.

HFF's net profitability reflects the large provisions the fund has taken: the fund reported an ISK3.1 billion loss in H1 2012. Looking forwards, Moody's rating review will focus on the fund's ability to improve pre-provision earnings from the current level, considering (1) its purpose of increasing people's chances of acquiring or renting housing on manageable terms; (2) low historical loan margins, combined with limited ability to re-price loans given borrowers' ability to overtake loans on historic beneficial terms; (3) increased costs of operations related to the management of non-performing loans and repossessed properties; and (4) locked-in funding, which cannot be called while loan prepayments have been higher than expected.

Following the H1 2012 loss, HFF's capital ratio fell to 1.4%. Given our concerns regarding the fund's profitability described above and the inability for HFF to quickly replenish capital through internal means, Moody's believes that there is increased pressure on the government to inject capital into HFF. HFF's full reliance on market funding

exacerbates its low capitalisation, and makes it sensitive to deterioration of investor confidence, or, over time, the removal of capital controls. Moody's review will therefore also consider the likely development of HFF's capitalisation.

PRINCIPAL METHODOLOGY

The principal methodology used in this 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 this methodology.

Headquartered in Reykjavik , Iceland, Housing Financing Fund reported total assets of ISK876.6 billion (EUR5.5 billion) at 30 June 2012.

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

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