Announcement: Housing Financing Fund

Moody's affirms Baa1 rating of HFF (Iceland)

Baseline Credit Assessment lowered

London, 25 June 2009 -- Moody's Investors Service has today affirmed the Baa1 issuer rating and local currency bond ratings of Iceland's Housing Financing Fund (HFF). The outlook on the ratings remains negative in line with the sovereign rating of Iceland. However, Moody's changed HFF's Baseline Credit Assessment (BCA) to the range of 14-16 from 8-10.

Moody's notes that HFF's Baa1 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 lowering of HFF's BCA reflects the fund's weakened financial fundamentals, in particular its poor capital level, which was a low 4.6% at the end of 2008 and leads to vulnerability to prolonged stress. The fund's capital adequacy was badly affected by the net losses of ISK6.9 billion (US$58 million) that it reported for 2008. These were primarily due to increased loan loss provisions and the fund's exposure to the collapsed Icelandic banks. Overall, the fund reported impairments of ISK8.7 billion (US$73 million), while its operating income was only ISK2.9 billion (US$24 million).

The acute phase of the crisis in Iceland appears to have passed, as demonstrated by the relative stability of the Icelandic krona since the initiation of the IMF programme in November 2008. However, Moody's outlook for Iceland's economy remains negative. The krona continues to be weak against the major currencies, indicating that financial pressures have not yet abated, and economic confidence remains fragile. Businesses and households with foreign currency loans now face much higher debt service payments, asset prices have plummeted and unemployment is rising.

HFF is not exposed to foreign-exchange mortgages. However, due to the weakening Icelandic economy, the fund 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 result in a rapid deterioration of the fund's asset quality indicators. Although there has not yet been any significant weakening in HFF's loan quality indicators, it is likely that this will occur in its 2009 accounts.

Commenting on the fund's other GRI rating inputs, Moody's notes that it has refined its assessment of the ability of the Icelandic state to provide systemic support. The rating agency previously used the local currency deposit ceiling (LCDC; A1 in the case of Iceland) as the main input for its assessment of the ability of a national government to support its banks. Although anchoring the probability of support at the LCDC is appropriate in most circumstances -- regarding the provision of liquidity to a selected number of institutions over a short period of time -- it might overestimate the capacity, and even willingness, of a central bank to support financial institutions in the event of a banking crisis becoming both truly systemic and protracted.

Moody's therefore believes that the government's local currency debt rating (usually adjusted by no more than two notches of uplift due to the array of tools available to the central bank to support the banking system) should have a greater weight when considering the ability of the government to provide systemic support.

Although this refined approach allows two notches of uplift from the government bond rating as the main input for its assessment of the ability of the national government to support its banks, given the difficult economic and fiscal situation that Iceland is facing, Moody's says that no notching uplift is appropriate. Thus, the anchor used for measuring the government's ability to provide systemic support is now Iceland's government bond rating of Baa1 (negative outlook).

Despite the lowering of the BCA, HFF's issuer and local currency bond ratings were affirmed. 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.

The outlook on all HFF's ratings is negative as the issuer rating is closely linked 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.

Moody's previous rating action on HFF was on 4 December 2008, when the ratings were downgraded to Baa1 following the previous sovereign downgrade.

The principal methodologies used in rating HFF are "Revised Methodology for Government Related Non-Bank Financial Institutions" and "The Application of Joint Default Analysis to Government Related Issuers", which can be found at www.moodys.com in the Credit Policy & Methodologies directory, in the Ratings Methodologies sub-directory. Other methodologies and factors that may have been considered in the process of rating HFF can also be found in the Credit Policy & Methodologies directory.

Headquartered in Reykjavik, Iceland, HFF is a 100% government-owned Icelandic residential mortgage lender with a mission to support the government's housing policy. It had total assets of ISK726 billion (€4.3 billion) at the end of 2008.

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