Íbúðalánasjóður

Housing Financing Fund
Condensed
Interim Financial Statements
June 30, 2013

Íbúðalánasjóður
Borgartúni 21
105 Reykjavík

Reg. no. 661198-3629

Contents

Endorsement and Statement by the Board of Directors and the CEO

The Condensed Interim Financial Statements of the Housing Financing Fund for the period 1 January to 30 June 2013 have been prepared in accordance with the International Financial Reporting Standard IAS 34, Interim Financial Reporting.

According to the income statement , the loss of the Fund amounted to ISK 2.98 billion for the six months ended 30 June 2013. Equity at the end of June amounted to ISK 11.7 billion according to the balance sheet.

The Fund´s equity ratio, calculated according to stipulations of the Rules of the Housing Financing Fund no. 544/2004 was 2.5% at the end of June 2013. The calculation of the ratio is equivalent to the calculation of the capital ratio of financial institutions. The long- term goal of the Fund is to maintain the ratio above 5% and not below 4% . The objective of communications between the Housing Financing Fund and the government is to achieve this equity ratio, however no time limits have been set.

Operating costs increased considerably compared to the same period of the year 2012. The increase is mainly due to the expenses of repossessed properties for sale, the expenses of the Debtors´ Ombudsman, the expansion of operations of the Fund related to the implementation and processing of payment provisions for over leveraged homes, and for the administration of repossessed properties for sale. The number of employees as of June 2013 were 98 compared to 96 at the same time in 2012.

On 30 June, the Fund´s loans amounted to ISK 776.9 billion and decreased by ISK 2.2 billion from the beginning of the year. Due to a high liquidity position, increased settlement of loans and fewer granted loans, there were no bonds issued during the first half of the year 2013.

New loans by the Fund have decreased to some extent during the period corresponding to early settlement of loans and a significant increase in operations in mortgage loan assumption. The Fund granted 468 general housing loans during the first 6 months of the year compared to 611 loans during the same period in the year 2012. Early prepayments of loans amounted to ISK 8.3 billion during the period compared to ISK 9.4 billion during the first six months of the year 2012. As a result, the Fund´s liquidity position has remained unchanged and there has not been a need for bond issue. Fewer new loans and increased settlements are, according to the Fund, the result of borrowers´ preference for non-indexed loans as opposed to indexed loans, and to some degree refinancing of indexed loans although there is no real estate transaction. Interest rate terms of such non-indexed loans have been especially favorable recently.

The Fund does not grant non-indexed loans, but plans to offer them in the coming months given that the government based on current statutory powers renders a positive response. The early settlement of loans along with the decrease in new loans have led to reinvestment risk. The reinvestment risk due to customers´early settlement of loans may have a negative impact on the spread but the extent of early settlement is still not such that it has a significant effect on the spread.

The allowance for impairment of loans amounted to ISK 22.8 billion at the end of June 2013 and has decreased by ISK 0.5 billion from the beginning of the year.

Endorsement and Statement by the Board of Directors and the CEO, contd.

Approximately 14.4% of the Fund´s loans are in payment suspension or in default at the end of June compared to 14.7% at the beginning of the year. The outstanding balance of the Fund´s loans in default for more than 90 days and in payment suspension amounted to ISK 116.5 billion, thereof defaults amounted to ISK 7.9 billion.

Since the beginning of the year, the Fund has repossessed 436 properties and sold 114 properties. The Fund owned 2,546 properties at the end of the period. Repossessed properties are recognised at the lower of cost on repossession or net fair value. Thereof 1,164 properties are rentals or 46% of total repossessed properties owned by the Fund.

The rental company Klettur ehf. was established on 23 January 2013 and the Board of Directors of the Fund approved the transfer of 525 repossessed properties. In the first half of the year 2013, two key employees were employed by the company and operations should commence in the last quarter of the year.

The Fund has been engaged in establishing a database of loans. This database relates to among other things a change in the approach regarding the classification, analysis and control of loans and interest income.

In the notes to the Condensed Interim Financial Statements is a discussion on matters concerning ESA´s observation regarding the Fund´s operation and State Aid (see details in note 12).

In January 2013 the Minister of Welfare appointed a committee to review the future prospects and future role of the Housing Financing Fund. The committee, according to the official task letter, was to assess future prospects and role of the Fund with the objective of securing the financial position of the Fund. The committee presented its report on 16 April 2013.

The Welfare and Housing Minister has decided, in accordance with paragraph 4 of the Action Plan on Debt Relief for Icelandic Households (Congr. Doc. 9-9) which was approved by Parliament on 28 June this year, to appoint a project panel on the future organization of housing affairs. Accordingly the Minister will appoint a cooperative committee on future organization of housing affairs that undertakes an advisory role for the project panel.

The role of the project panel will be to provide recommendations for future policies on housing affairs, explore the efficiencies of general mortgage financing and how such arrangements will be established, and identify how to improve the effectiveness of the rental market. Also the panel is to identify how the government can perform a limited role involving offering services that are in the public interest in the housing market . The aim is that proposals of the project panel be made available in early 2014.

On 2 July 2013 the Investigation Commission presented its report on the Housing Activities Fund. The Commission‘s task was based on the Congressional resolution of 17 December 2010. Parliament´s Constitutional and Supervisory Committee is expected to review the report this fall and will most likely present proposals for action based on the report. Since the current administration assumed responsibility over the Fund in 2011, the processes and procedures of lending have been transformed and risk management and internal controls of the Fund have been greatly improved. The Fund will systematically go over all the comments in the report to ensure significant improvements, if they have not already been implemented

An amendment to the Act on consumer credit from 18 March 2013, effective on 1 November 2013 will require the Fund to finance new lending with new bond classes. The objective is that a new indexed financial bond class with prepayment options will reflect prepayments of the Fund´s customers. Such a change in the financing of the Fund is created to close the prepayment risk of new loans and lay the foundation for future planning of the Fund´s risk management , where emphasis is placed on the balance of assets and liabilities.

Endorsement and Statement by the Board of Directors and the CEO, contd.

The main risk factors of the Housing Financing Fund are credit risk, liquidity risk, interest rate and inflation risk, duration imbalance, prepayment risk, refinancing risk and operational risk. Counterparty and currency risk are also considered to be among the Fund´s financial risks. The Fund is also exposed to risk due to uncertainty about the timing and final sales value of repossessed properties held for sale as well as the foreseen increase in the number of foreclosed properties owned by the Fund. The Fund's prepayment and refinancing risk is related to increased settlement of loans by the Fund's customers due to changes in the housing loans market. The Fund's financing is mainly in the form of HFF bonds which are not prepayable but the Fund could buy them back in the secondary market.

The Fund´s ability to continue as a going concern assumes that the owner of the Fund, the State Treasury, who furthermore has provided a full guarantee on all obligations of the Fund, will ensure the required equity ratio of the Fund, meet the damage caused by the economic collapse that began in the year 2008 and the insufficient yield of its´ past loan portfolio.

The Fund is currently undergoing changes in accounting policies that will affect the classification and presentation of interest income and impairment, however the net effect of these changes is not expected to have a significant impact on the Fund´s performance or equity, as noted in note 3.

Statement by the Board of Directors and the CEO

The Condensed Interim Financial Statements for the period 1 January to 30 June 2013 have been prepared in accordance with International Financial Reporting Standard, IAS 34, Interim Financial Reporting, and additional disclosure requirements for companies that have their securities listed on a regulated market. To the best of our knowledge, it is our opinion that the Condensed Interim Financial Statements give a true and fair view of the comprehensive loss of the Fund for the period 1 January to 30 June 2013, its assets, liabilities and financial position of the Fund as at 30 June 2013 and its cash flows for the period.

Further, in our opinion the Condensed Interim Financial Statements and the endorsement by the Board of Directors and the CEO give a fair view of the development and performance of the Fund´s operations and its financial position and fairly describes the principal risks and uncertainties faced by the Fund.

The Board of Directors and the CEO of the Housing Financing Fund have today discussed the Fund's Interim Financial Statements for the six-month period ended 30 June 2013 and confirm them by means of their signatures.

Reykjavik, 30 August 2013

The Board of Directors of the Housing Financial Fund

Jóhann Ársælsson
Sjöfn Ingólfsdóttir
Lárus Blöndal
Elín R. Lindal
Henný Hinz

The CEO

Sigurður Erlingsson

Independent Auditor's Review Report

To the Board of Directors of the Housing Financing Fund.

We have reviewed the accompanying Condensed Interim Financial Statements of the Housing Financing Fund for the period of 1 January until 30 June 2013, which are comprised of the balance sheet, the income statement and statement of comprehensive income, the statement of changes in equity and statement of cash flows, and a summary of significant accounting policies and other explanatory notes. Management is responsible for the preparation and fair presentation of this interim financial information in accordance with IAS 34 "Interim Financial Reporting". Our responsibility is to express a conclusion on this Condensed Interim Financial Statement based on our review.

Scope of Review

We conducted our review in accordance with International Standard on Review Engagements 2410 *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the accompanying Condensed Interim Financial Statement give a true and fair view of the performance of the Fund for the period of 1 January to 30 June 2013 and the changes in cash flow for the period, in accordance with IAS 34 “Interim Financial Reporting”.

Emphasis of matter

We would like to draw attention to note 10, stating that the Fund's equity ratio, calculated according to provisions of the Rules on the Housing Financing Fund no. 544/2004. is 2.5% at the end of June 2013, but according to Article 7 of the Rules, the Fund shall set as a long-term goal a capital ratio over 5.0%. The Fund has been negotiating with the Ministry of Welfare regarding solutions to reach that goal. We also would like to draw attention to the discussion concerning the Fund´s ability to continue as a going concern in the Endorsement by the Board of Directors

Also we would like draw attention to note 3 Significant accounting policies and the Endorsement of the Board of Directors. As noted, the Fund is currently undergoing changes in accounting policies that will affect the classification and presentation of interest income and impairment however the net effect of these changes is not expected to have a significant impact on the Fund´s performance or equity.

Reykjavik, 30 August 2013

Grant Thornton endurskoðun ehf

Sturla Jónsson

State authorised public accountant

Davíð Arnar Einarsson

State authorised public accountant

Interim Income Statement and Statement of Comprehensive Income January 1st to June 30th 2013

	Notes	2013 1.1.-30.6.	2012 1.1.-30.6.
Interest income		39.855.176	49.470.187
Interest expense		(38.274.961)	(48.744.080)
Net interest income	6	1.580.215	726.107
Other income	7	656.340	529.565
Total operating income		2.236.555	1.255.672
Salaries and salary-related expenses		425.483	379.250
General operating expenses		1.109.175	939.416
Depreciation and amortisation		31.346	32.952
Total operating expenses		1.566.004	1.351.618
Net (operating expenses) operating income		670.551	(95.946)
Impairment of assets	9	(3.649.067)	(3.013.770)
Net (loss) profit for the period and comprehensive (loss) income		(2.978.516)	(3.109.716)

The notes on pages 12-19 are an integral part of these
Condensed Interim Financial Statements

Amounts are in ISK thousand

Interim Balance Sheet as at June 30th 2013

	Notes	30.6.2013	31.12.2012
Assets			
Cash and cash equivalents		6.278.048	10.766.771
Receivable due from State Treasury		0	13.000.000
Treasury securities		36.059.508	27.904.569
Loans to banks		15.925.771	13.946.454
Loans to customers	9	776.938.025	779.095.331
Properties held for sale	8	35.405.632	30.369.116
Operating assets		65.231	71.309
Intangible assets		145.038	147.721
Other assets		791.752	762.467
Total assets		871.609.005	876.063.738
Liabilities			
Bond issued		848.092.545	849.550.870
Other borrowings		4.788.840	4.702.013
Other liabilities		7.006.764	7.111.483
Total liabilities		859.888.149	861.364.366
Equity			
Contributed capital		53.155.408	53.155.408
Accumulated deficit		(41.434.552)	(38.456.036)
Total equity	10	11.720.856	14.699.372
Total liabilities and equity		871.609.005	876.063.738

The notes on pages 12-19 are an integral part of these
Condensed Interim Financial Statements

Amounts are in ISK thousand

Interim Statement of Changes in Equity
January 1st to June 30th 2013

	Contributed capital	Accumulated deficit	Total equity
Changes in equity from January 1st to June 30th 2013:			
Equity as at January 1st 2013	53.155.408	(38.456.036)	14.699.372
Net loss for the period and comprehensive income		(2.978.516)	(2.978.516)
Equity as at June 30th 2013	53.155.408	(41.434.552)	11.720.856
Changes in equity from January 1st to June 30th 2012:			
Equity as at January 1st 2012	40.155.408	(30.599.995)	9.555.413
Net loss for the period and comprehensive income		(3.109.716)	(3.109.716)
Equity as at June 30th 2012	40.155.408	(33.709.711)	6.445.697

The notes on pages 12-19 are an integral part of these
Condensed Interim Financial Statements

Amounts are in ISK thousand

Condensed Interim Statement of Cash Flows for the Period from January 1st to June 30th 2013

	Notes	2013 1.1.-30.6.	2012 1.1.-30.6.
Net cash provided by (used in) operating activities		12.700.897	14.393.163
Net cash provided by investing activities		3.928.580	285.721
Net cash used in financing activities		(21.118.200)	(14.605.319)
Net increase (decrease) in cash and cash equivalents		(4.488.723)	73.565
Cash and cash equivalents at the beginning of the year		10.766.771	3.962.556
Cash and cash equivalents at the end of the period		6.278.048	4.036.121

The notes on pages 12-19 are an integral part of these
Condensed Interim Financial Statements

Amounts are in ISK thousand

Notes to the Condensed Interim Accounts

1. Reporting entity

The Housing Financing Fund ("the Fund") is domiciled in Iceland. The address of the Fund's registered office is Borgartún 21, Reykjavik. The Fund's objectives are to provide housing loans, loans for new constructions and property development in Iceland. The Housing Financing Fund is an independent institution owned by the State operating under the Housing Fund Act no. 44/1998, and appertains to a special management and the Ministry of Welfare. According to the law, the Icelandic State Treasury has unlimited responsibilities for all of the Fund’s financial obligations.

The Condensed Interim Financial Statements of the Housing Financing Fund were approved by the Board of Directors on 30 August 2013.

2. Statement of compliance

The Condensed Interim Financial Statements have been prepared in accordance with IAS 34 Interim Financial Reporting. They do not include all of the information required for full annual financial statements and should be read in conjunction with the Financial Statements of the Fund as at and for the year ended 31 December 2012.

3. Significant accounting policies

The accounting policies applied by the Fund in these Condensed Interim Financial Statements are the same as those applied by the Fund in its Annual Financial Statements as at and for the year ended 31 December 2012. The Financial Statements are available on the Fund´s homepage; www.ils.is as well as on the Icelandic stock exchange´s homepage; www.omxnordicexchange.com.

The Condensed Interim Financial Statements are presented in Icelandic Krona (ISK) which is the Fund´s functional currency. All amounts are rounded to the nearest thousand unless otherwise stated. They have been prepared on historical cost basis except that assets held for sale are recognised at the lower of book value or net fair value.

The Fund is currently undergoing changes in accounting policies that will affect the classification and presentation of interest income and impairment, however the net effect of these changes is not expected to have a significant impact on the Fund´s performance or equity.

New accounting policies

The company has implemented all accounting standards and amendments to standards effective for the accounting period which commenced on 1 January 2013 and have been adopted by the EU. Of these only IFRS 13 Fair value changes has affected the interim financial statement of the Fund.

IFRS 13 sets out the framework for the assessment of the fair value disclosures of value when such an assessment is required or permitted under IFRS. The standard coordinates the definition of fair value as the price in traditional exchange of asssets or liabilities at the measurement date. The standard also takes over and expands the notes provisions for determining fair value in other standards, including IFRS 7 Financial Instruments: Disclosures.

Certain disclosures are required in the interim financial statements and the Fund has presented these additional explanations.

In accordance with the implementation provisions of IFRS 13 imposes a guidance on determining fair value forward and comparative amounts disclosed solely for disclosures that were previously required that existed in the accounts

Application of the standard did not lead to a change in the company's estimation of fair value.

4. Use of estimates and judgements

The preparation of the Condensed Interim Financial Statements in conformity with IFRS requires management to make judgements, estimates and assumptions, which affect the application of accounting policies and the reported amounts of assets and liabilities as well as income and expenses. The estimates and underlying assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying amounts of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period or in the period of the revision and future periods if the revision affects both current and future periods.

5. Segment information

A segment is a component of an entity that generates income and expenses that are directly attributable to the segment. Management assesses and evaluates the performance and financial results of the segment and distributes funds specifically to the segment. Financial information of the segment must be separable for operational purposes in order to be identified as a segment. The Fund identifies its operations as a single segment.

6. Net interest income

	2013 1.1.-30.6.	2012 1.1.-30.6.
Interest income		
Interest income on items not at fair value:		
Interest income on loans to customers	2.471.589	2.609.142
Interest income on other financial assets	36.981.280	46.491.691
Government contribution to subsidy interests*	299.180	289.258
	39.752.049	49.390.091
Interest income on items at fair value:		
Interest income on market securities	103.127	80.096
	103.127	80.096
Total interest income	**39.855.176**	**49.470.187**
Interest expenses		
Interest expenses on items not at fair value:		
Interest expenses and indexation on bond issue	38.074.826	48.462.642
Interest expenses on other borrowings	200.135	281.438
Total interest expenses	38.274.961	48.744.080
Net interest income	1.580.215	726.107

*Subsidy on interests on loans is due to social benefit loans to municipalities and organisations, such as student associations and organisations of disabled.

7. Other income

	2013	2012
Collection fee	81.037	79.952
Rental income on properties held for sale	575.303	449.613
Total other income	656.340	529.565

8. Income and expenses of properties held for sale

At the beginning of 2013 there were 2.224 properties owned by the Fund. During the first six months of the year 2013 the Fund repossessed 436 properties and sold 114. Thus, 2.546 properties are owned by the Fund at 30 June 2013. Thereof, 1.164 properties are rented out or 46% of total properties owned by the Fund. Income and expenses during the period in relation to properties held for sale are specified as follows:

	2013	2012
Rental income of properties held for sale	575.303	449.613
Services and other expenses (due to all properties for sale)	(454.446)	(376.229)
Net income (expenses) of properties held for sale	120.857	73.384

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Notes, contd.:

9. Loans

Impairment losses of loans during the period:

	Individuals		Legal entities		
	Specific impairment	General impairment	Specific impairment	General impairment	Total
1.1. - 30.6. 2013					
Balance at the beginning of the year	9.064.583	938.335	13.216.088	92.849	23.311.855
Impairment loss (reversal of impairment loss)	3.099.205	(20.706)	585.541	52.550	3.716.590
Write-off	(2.585.518)	0	(1.639.349)	0	(4.224.867)
Balance at 30.6.2013	9.578.270	917.629	12.162.280	145.399	22.803.578

Allowance account as percentage of loans 2,85%

Loans

	Individuals		Legal entities		
	Specific impairment	General impairment	Specific impairment	General impairment	Total
1.1. - 31.12. 2012					
Balance at the beginning of the year	5.860.102	1.411.940	14.530.379	0	21.802.421
Impairment loss (reversal of impairment loss)	6.723.919	(473.605)	1.270.630	92.849	7.613.793
Write-off	(3.519.438)	0	(2.584.921)	0	(6.104.359)
Balance at 31.12.2012	9.064.583	938.335	13.216.088	92.849	23.311.855

Allowance account as percentage of loans 2,91%

Total impairment in the Income Statement is as follows:	2013 1.1.-30.6.	2012 1.1.-30.6.
Specific impairment loss of loans (reversal of impairment loss)	3.684.746	1.951.554
General impairment of loans	31.844	(3.458)
Impairment loss of loans (reversal of impairment loss)	3.716.590	1.948.096
Impairment of properties held for sale...	(111.294)	1.071.978
Impairment of other receivables	43.771	(6.304)
Total (impairment) impairment reversal during the period	3.649.067	3.013.770

10. Equity

The Fund's long term objective is to maintain a capital ratio over 5.0%.The calculation of the capital ratio is in accordance with international rules (Basel II). If the Fund's capital ratio falls below 4.0% the Fund's Board of Directors shall notify the Minister of Welfare thereof. Furthermore, the Fund's Board of Directors shall make proposals of ways to reach the long term capital ratio goal.

Capital ratio is specified as follows:	30.6.2013	31.12.2012
Capital according to the Interim Financial Statements	11.720.856	14.699.372
Intangible assets	(145.038)	(147.721)
Capital base	11.575.818	14.551.651
Total capital ratio is as follows:		
Credit risk	36.348.408	35.293.987
Market risk	97.473	147.388
Operational risk	500.228	500.228
Total capital requirements	36.946.109	35.941.603
Capital ratio	2,5%	3,2%

Amounts are in ISK thousand

Notes, contd.:

11. Financial assets and liabilities

According to the International Financial Reporting Standard IAS 39 Financial instruments: recognition and measurement, financial assets and liabilities are divided into specific categories. The classification affects how the relevant financial instrument is measured. Those categories to which the Fund's financial assets and liabilities pertain and their basis of measurement are specified as follows:

-Trading assets and liabilities - are recognised at fair value.
-Loans and receivables - are recognised at amortised cost.
-Other financial liabilities - are recognised at amortised cost.

The following table shows to which group financial assets and liabilities of the Fund pertain and their fair value:

30. June 2013	Fair value	Loans and receivables	Liabilities at amortised cost	Total carrying amount	Fair value 1)
Assets:					
Cash and cash equivalents............................	0	6.278.048	0	6.278.048	6.278.048
Due from State Treasury................................	0	0	0	0	0
Treasury securities...	2.599.273	33.460.235	0	36.059.508	37.908.282
Loans to banks...	0	15.925.771	0	15.925.771	15.925.771
Loans	0	776.938.025	0	776.938.025	885.177.500
Total financial assets......................................	2.599.273	832.602.079	0	835.201.352	945.289.601
Liabilities:					
Bond issues..	0	0	848.092.545	848.092.545	1.002.479.565
Other borrowings..	0	0	4.788.840	4.788.840	4.788.840
Other liabilities..	0	0	7.006.764	7.006.764	7.006.764
Total financial liabilities...................................	0	0	859.888.149	859.888.149	1.014.275.169

1) The fair value of loans is estimated by discounting the cash flows of the loan portfolio by using the yield of HFF bonds plus 1.0% spread in terms of expected prepayments. The spread reflects the cost of operating the loan portfolio and the credit risk and prepayment risk in the case of loans which do not contain prepayment options.

The fair value of HFF bonds is based on their market price at 30 June 2013. The fair value of Housing bonds is measured by discounting the cash flows by using the HFF interest plus 0.5% spread due to lesser liquidity compared to HFF bonds. The fair value of Housing Authority bonds is measured by discounting at the interest of HFF bonds plus 1.0% spread due to liquidity and prepayment risk of those bonds.

Treasury securities that are classified as trading assets are measured at fair value. Other treasury securities are measured at their yield at acquisition.

31. December 2012	Fair value	Loans and receivables	Liabilities at amortised cost	Total carrying amount	Fair value 1)
Assets:					
Cash and cash equivalents............................	0	10.766.771	0	10.766.771	10.766.771
Due from State Treasury................................	0	13.000.000	0	13.000.000	13.000.000
Treasury securities...	3.928.200	23.976.369	0	27.904.569	27.904.569
Loans to banks...	0	13.946.454	0	13.946.454	13.946.454
Loans	0	779.095.331	0	779.095.331	908.805.003
Total financial assets......................................	3.928.200	840.784.925	0	844.713.125	974.422.797
Liabilities:					
Bond issues..	0	0	849.550.870	849.550.870	1.019.394.810
Other borrowings..	0	0	4.702.013	4.702.013	5.025.362
Other liabilities..	0	0	7.111.483	7.111.483	7.111.483
Total financial liabilities...................................	0	0	861.364.366	861.364.366	1.031.531.655

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Notes, contd.:

[1)] The fair value of loans is estimated by discounting the cash flows of the loan portfolio by using the yield of HFF bonds plus 1.0% spread in terms of expected prepayments. The spread reflects the cost of operating the loan portfolio and the credit risk and prepayment risk in the case of loans which do not contain prepayment options.

The fair value of HFF bonds is based on their market price at 31 December 2012. The fair value of Housing bonds is measured by discounting the cash flows by using the HFF interest plus 0.5% spread due to lesser liquidity compared to HFF bonds. The fair value of Housing Authority bonds is measured by discounting at the interest of HFF bonds plus 1.0% spread due to liquidity and prepayment risk of those bonds.

Treasury securities that are classified as trading assets are measured at fair value. Other treasury securities are measured at their yield at acquisition.

Fair value Hierarchy

The following table shows the level in the hierarchy into which the fair value of financial assets and liabilities, carried at fair value in the Balance Sheet, are categorised as of 30 June 2013:

The levels are as follows:

Level 1: Valuation technique is based on quoted prices in active markets for assets and liabilities.
Level 2: Valuation technique is not based on quoted prices in active markets (level 1) but on information that is observable for the asset or liability directly (quoted price) or indirectly (adjusted quoted price).
Level 3: Valuation technique is based on significant information other than market information.

30. June 2013	**Level 1**	**Level 2**	**Level 3**	**Total**
Assets:				
Cash and cash equivalents	0	0	0	0
Due from State Treasury	0	0	0	0
Treasury securities	2.599.273	0	0	2.599.273
Loans to banks	0	0	0	0
Loans	0	0	0	0
Total financial assets	2.599.273	0	0	2.599.273

31. December 2012	**Level 1**	**Level 2**	**Level 3**	**Total**
Assets:				
Cash and cash equivalents	0	0	0	0
Due from State Treasury	0	0	0	0
Treasury securities	3.928.200	0	0	3.928.200
Loans to banks	0	0	0	0
Loans	0	0	0	0
Total financial assets	3.928.200	0	0	3.928.200

Amounts are in ISK thousand

Notes, contd.:

12. Other matters

Klettur ehf.

In the aftermath of the financial crisis 2008, the number of homes and businesses facing financial difficulties increased and defaults increased significantly. The Housing Financing Fund, the largest individual mortgage home lender has therefore had to repossess a large number of properties and at the end of June, the Fund´s portfolio consisted of a total of 2,546 appropriated properties. As owning and maintaining properties is not related to the core operations of the Fund, the Fund has strived to sell these properties. Due to the significant number of properties involved, the Fund considered the establishment of a rental company with properties suitable for the rental market. This arrangement would facilitate the transfer of a large number of properties in a single transacton, thereby decreasing the number of appropriated properties in the Fund´s portfolio. This strategy is also consistent with the government´s policy to reinforce the rental market in Iceland. The rental company Klettur ehf. was established during the Fund´s Board of Directors´ Meeting as of 23 January .2013 and an agreement was made to transfer 528 properties to the company. Upon transferring the properties, consideration was given to the rate of return requirements of rental properties and the suitability of the properties as long term rental properties. The Fund is currently appraising the assets of the company and the value of the assets are not expected to be a significant departure from the book value. As the operations of the company are insignificant as of 30 June the Condensed Interim Financial Statements are not presented as consolidated statements rather the capital contribution and claim against the subsidiary Klettur ehf. are recognised as other assets.

ESA

In June 2008, the ESA (EFTA Surveillance Authority) announced to the Icelandic authorities that the operation of The Housing Financing Fund consists of a State aid, which is not in conformity with the rules on State aids of the EEA Agreement and that the Icelandic government was obliged to adapt the operation of the Fund to those rules. The State aid to the Fund is considered to consist in unlimited state guarantee, exemption from taxation and that the state, as the Fund's owner, has not set requirements on the Fund's operating return. This conclusion is based on the fact that the Fund operates on an open market and that its loans are not limited to a specific social role. In October 2012 The Government sent proposals to ESA on HFF´s changed role in the future. The proposals emphasise minimal changes in the defined role of the Fund. Limits would however be set related to maximum property purchase price and more restrictions on loans to legal entities. The Housing Act has now been amended in order to meet these annotations. A final approval by the ESA regarding the state aid, consisting in contributions by the State to the Fund in the year 2011 was subject to conditions of the Fund's future role and financial restructuring. A financial restructuring plan was submitted to the ESA in January 2013. The Fund has communicated with the ESA during the year regarding observations made by the Icelandic Financial Services Association regarding the operation of the Fund, its market share and reconsideration by the State regarding the Fund´s lending activities, and now recently regarding the State's capital contribution to the Housing Financing Fund. Due to changes in the defined role of the Fund and as it may be expected that the Fund will need continuous aid in order to maintain its equity ratio goal, the State aid is not defined as emergency aid but rather as aid to services of general interest.

Prepayment fees

The Fund has received a significant amount of inquiries from customers regarding the prepayment fee and fee for excess payments. With amendments to the Housing Act no.120/2004 the Fund was granted the authority to offer to its customers loans on lower interest rates, provided that they would relinquish their right to prepay the loan unless they would pay the prepayment fee. It is argued that the prepayment fee has not been sufficiently explained to customers and therefore it is illegal. One of the Fund's customers requested that the fee be cancelled as he believed that it was not sufficiently specified in the bond he signed. The cancellation of the fee was denied resulting in a complaint lodged against the Fund. The Complaint Board for Social Affairs and Housing Matters investigated the matter.

The Board concluded that the Fund was found to be in compliance with the law as to the collection of the fee. This individual then summoned the Fund as he believes that the fee was inadequately specified in the bond he signed. The Fund has obtained the legal services of Friðjón Örn Friðjónsson Attorney of Law to handle the case on its behalf .

There have been complaints regarding the prepayment charge as it is significant given the current conditions. The fee is based on the provisions of the Housing Act and is noted on the bond that the loan is without rights to refinance except at special rates with reference to the provisions of law in this regard. If the fees are deemed to be illegal due to lack of information to customers, the fund is exposed to prepayments as the Fund does not have the authority to cover its own borrowing against prepayments. The Fund´s loans containing a prepayment clause amounted to ISK 140 billion at the end of June 2013. If all of these loans would be prepaid without being able to charge a prepayment fee, the Fund´s loss, based on current interest rates could amount to about ISK 10 billion.

Notes, contd.:

Legal action due to indexed loans

In the latter part of the year 2012, the Housing Financing Fund was cited for violation of the Act on Consumer Credit , challenging the legality of indexed loans. The lawsuit was filed in December 2012. The main cause of the action pertains to the Fund not having the authority to collect the costs entailed by the CPI-indexation of the loan as the entire borrowing cost was not specified in the initial loan process. A motion for dismissal was requested and granted 30 April 2012 for failure to state a valid claim. Further legal actions have not been undertaken however it may be expected that the plantiffs will pursue the matter in the fall of this year.
Discussions about the legality of indexation for consumers is prominent and the demand for adjustments on loans is widespread. Clearly, if the provisions of the Act on Consumer Credit maintain that indexed loans to individuals are illegal, the result would be enormous losses for the Fund as the majority of its obligations are indexed.