Housing Financing Fund

Financial Statements 2017

These Financial Statements are translated from the original statements which are in Icelandic. Should there be discrepancies between the two versions, the Icelandic version shall take precedence.

Housing Financing Fund
Borgartúni 21
105 Reykjavík

Reg.no. 661198-3629

Contents

Endorsement and Statement by the Board of Directors and CEO

The Housing Financing Fund ("the Fund") has its headquarters at Borgartún 21, Reykjavík and a branch in Sauðárkrókur. The Fund operates in accordance with the Housing Act no. 44/1998. The Act aims to promote, through the granting of loans and the organization of housing affairs, an environment of security and equal rights in housing affairs for citizens. The main activities of the Fund are providing loans for the purchase and construction of housing, granting capital contributions for the purchase and construction of rental housing for low-income families and individuals, providing housing benefits to tenants, and collecting information, researching, and performing analyses of the housing market to support the government's policy formulation in housing affairs. The Housing Financing Fund is an independent institution owned by the government.

The Fund's Financial Statements are prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU and additional disclosure requirements for companies that have their securities listed on the international securities market.

A new accounting standard IFRS 9 comes into effect as of 1 January 2018, and the Housing Financing Fund has since 2016 been involved in implementing the standard. The new standard involves significant changes in the classification and measurement of financial assets, it also introduces a new model for impairment of financial assets. The adoption of the IFRS 9 accounting standard is expected to lead to a reduction in the range of ISK 1,250-2,250 million to the beginning balance of equity. Of which, it is estimated that a decrease of ISK 1,000-2,000 million can be attributed to an increase in the provision for impairment of loans and other financial assets and approximately ISK 250 million due to changes in the classification and measurement of financial assets. The estimated impact on the Fund's equity ratio is a decrease between -0.7% to -0.4%. Further explanation may be found in Note 32u in the Financial Statements.

Results for the year 2017

The operating surplus of the Housing Financing Fund's operations amounted to ISK 1,366 million according to the income statement, compared to an operating surplus of ISK 4,257 million in 2016. Equity at year-end amounted to ISK 24,894 million and the Fund's equity ratio is 8.5% compared to 7.3% at the end of 2016. The Fund's long-term objective is to maintain an equity ratio over 5% in accordance with the Regulation no. 544/2004 on the finances and risk management of the Housing Financing Fund. The Fund is generating an operating surplus for the fourth consecutive year, the surplus will be allocated to strengthen equity.

Operations in the year 2017

Net interest income for the year amounted to ISK 1,641 million. Prepayment fees are included in interest income for the year. The substantial amounts of prepayments during the year have an effect on the development of interest income and increase the Fund's reinvestment risk, but to mitigate this effect the Fund earns a considerable amount of income in the form of prepayment fees. Operating expenses for the year amounted to ISK 1,706 million, decreasing by 1.7% between years. Salaries and related expenses decreased by 9.7%, with a decrease in full-time equivalent positions from 77 to 66, despite the fact that the Fund has taken on new projects in housing matters and assigned eight new employees to these projects. Other operating expenses increase by 10.8% due to payments to the Debtors' Ombudsman and the implementation of IFRS 9. During the year, the Housing Financing Fund made payments amounting to ISK 161 million to the operations of other government agencies or the equivalent of 20% of the other operating expenses of the Fund.

The prospects for the Fund's ability to continue as a going concern for the foreseeable future are positive, although negative returns may be expected in the coming years due to the mismatch between assets and liabilities arising from large-scale loan prepayments. However, the Fund has accumulated liquid funds in order to meet the cash flows of outstanding debt in the foreseeable future. Increased prepayments have a negative impact on the Fund's long-term interest rate margin, as the Fund is not permitted to pay its debt (funding) before maturity and has to reinvest funds received from the prepayment of loans at lower interest rates. This arrangement has meant that assets outside of the loan portfolio have increased. As the portion of funds outside of the loan portfolio increases due to prepayments of loans, the mismatch of the Fund's assets and liabilities increases which in the future will have a negative effect on the Fund's performance. The assets and liabilities of the Fund are settled gradually as according to terms but have a maturity to the year 2044 which is the final maturity date of debt. Assets outside the loan portfolio have been invested, i.a., in asset-backed indexed bonds with similar terms reducing the mismatch of the liabilities and the assets of the Fund and thus reducing the loss due to prepayments.

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

Operations in the year 2017, contd.

Regarding the principal reduction of inflation-indexed housing mortgages under Act no. 35/2014, a letter from the Ministry of Welfare dated 19 December 2014, announced that both the Minister of Social Affairs and Housing and the Minister of Finance were in agreement that the Housing Financing Fund would be compensated for the negative impact the measures have had on the Fund. Since then, the Fund has had discussions with the government on the means by which the Fund would be compensated. The Housing Financing Fund has already received compensation for its losses in the amount of ISK 1,628 million from the Treasury. Further payments have not been made, reasons being the adequate capital and liquidity positions of the Fund. The outcome of the discussions is that the government claims its previous statements stand, but at the present time further payments from the Treasury to the Housing Financing Fund are not justified given the Fund's current financial position. The Ministry of Finance has also stated that the Treasury will continue to ensure that the Housing Financing Fund maintain an adequate capital position.

Development of arrears and quality of loan portfolio

Favorable economic conditions and effective collection processes have reduced the risks of the loan portfolio. Loans in arrears have fallen sharply and the collateral position of loans improved significantly due to rising real estate prices in excess of inflation. Arrears now amount to 2.1% of total loans, but were 2.9% at the same time in 2016. The adjusted balance of all outstanding loans in arrears was ISK 10,922 million, of which the amount of arrears was ISK 1,888 million. The provision for the impairment of loans amounted to ISK 6,917 million at year end, a decrease of the provision by ISK 563 million. At the end of the year, funds invested in foreclosed properties amounted to ISK 6,631 million, decreasing by ISK 4,305 million as 297 properties were sold during the year. The book value of foreclosed properties at the end of the year was approximately 74% of the property value of the underlying asset portfolio. Since the beginning of the year, the Fund has repossessed 53 properties on foreclosed mortgages. The Fund owned 419 properties at the end of the year, of these 231 were rentals, 161 are listed for sale and 25 are vacant.

Assets and treasury management

The Housing Financing Fund's assets at the end of 2017 amounted to ISK 761,927 million. On 31 December 2017, the Fund's loans amounted to ISK 499,989 million, a reduction of ISK 77,854 million between years. Assets outside of the loan portfolio including liquid assets increased from the previous year and now amount to ISK 254,513 million compared to ISK 196,681 million at the end of 2016. The increase in assets outside of the loan portfolio between years is due to contractual payments of loans in the loan portfolio and also of increased prepayments on loans in the Fund's loan portfolio. At the end of 2015, the Fund invested in structured covered bonds with the aim of improving the Fund's return. These bonds contained a prepayment option and a portion of them were prepaid in the year. The proceeds were invested in covered bonds on the market.

At the beginning of the year, the Board adopted a new treasury management policy aimed at facilitating the Fund's ability to invest its liquid assets as efficiently as possible taking into account the risks at any given time. The objective of the policy and management of assets outside of the loan portfolio is to minimise the mismatch of assets and liabilities that arises due to increased prepayments of the Fund's loan portfolio. The main challenges for managing assets outside of the loan portfolio are interest rate and inflation risk, as well as the size of the fund. Thus, the decline in market interest rates the past year has contributed to a reduction in the Fund's interest income. The Fund's risk of inflation lies in the fact that all of the Fund's debt is indexed, but a portion of the assets are non-indexed. This entails greater challenges in the management of funds outside of the loan portfolio. The Fund's treasury management policy is risk-averse which is reflected in the Fund's investments.

Risk factors

The Housing Financing Fund is a non-profit organization and therefore has a low-risk appetite, the Fund's Board of Directors determining acceptable risks as permitted by law and regulations. The Housing Financing Fund faces various types of risks and risk management is an important and integral part of the Fund's operations. Due to improved economic conditions, the Fund's credit risk has decreased sharply as new lending and defaults on older lending decrease and collateral positions improve. At the same time however, prepayments have been significant, and a considerable portion of assets outside of the loan portfolio is invested in non-indexed assets. Inflation risk has thus increased and the main focus of the Fund's Board is reducing this risk. The Fund's Board of Directors is ultimately responsible for risk management. It reviews the Fund's risk management strategy annually, setting out the objectives, authority and framework implemented in managing the Fund's financial and operational risks.

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

Risk factors, contd.:

The Risk Committee operates under the auspices of the Board, but in addition, there is an independent risk management division operating within the Fund. Not less than four times a year, the Fund's Board of Directors receives reviews and reports on the status of the Fund's risk factors. It is ensured that all employees of the Fund are aware of risk factors inherent in their positions and that risk response is based on informed decision making.

Social responsibility and role, contd.:

The role of the Housing Financing Fund has been changing from being primarily a financing fund to being the institution responsible for the implementation of housing policies and the government's control mechanism in housing policy.These changes are due to changes in the legal environment of the Fund in 2012 and 2016 as the Fund's lending activities were limited and more emphasis was placed on the role of the Fund in public housing affairs. Subsequently, the Fund focuses more on its social role and formulated a new policy to the year 2020 which involves taking the lead in research on the housing market, thus supporting the policy formulation and implementation of the Government's housing policy. The social responsibility of the Fund is reflected, i.a. in its role which it is expected to conduct as a safety guard in promoting security and equal rights for citizens in housing affairs. The Fund performs its role in a variety of ways. The Housing Financing Fund operates a planning and analysis division that provides information based on extensive analysis of the housing market, including housing needs in the country, supply and demand for housing, housing prices and rental rates. The Fund is also working on the establishment of coordinated municipal housing plans. Housing plans as well as research and analyses of the planning and analysis division are the basis for responsible long-term housing policy and contribute to the stability of the housing market. There have been numerous open meetings on housing held on the Housing Financing Fund's premises in 2017, which have been the platform for information and exchange of views on housing. In addition, the Fund held its first housing conference in 2017 in cooperation with the Ministry of Welfare. The conference is a forum where the foundation is laid for the housing policy of the government and the status of housing is reviewed i.a. based on municipal housing plans. Also on the agenda are the latest research on housing issues as well as possible solutions for housing. Furthermore, the Housing Financing Fund provides housing support in the form of, i.a. housing benefits, lending to individuals to purchase or build their own housing regardless of location, and lending for the purchase or construction of rental apartments by municipalities, associations or non-profit organizations. The Fund is also responsible for allocating government capital contributions as according to the Public Housing Act, the objective of the contributions being to establish a new rental system with small and affordable apartments intended for low-income individuals and families. In addition, the Fund's social responsibility includes the decision to invest its liquid assets in the most cost-effective way to ensure that interest-bearing assets continue to meet the Fund's obligations and to spread the risk of investment as much as possible. The Fund also decided to revive the research fund for housing in 2017 and the first allocation will be in 2018.

Housing affairs

Significant changes were made to the Fund's operations in 2017. The Board of the Housing Financing Fund revised the Fund's organizational chart on 3 March 2017 by establishing a new division, the housing affairs division responsible for the Fund's new projects regarding housing affairs. Today, there are eight employees in the division, the main projects being monitoring municipal housing plans, the implementation of capital contributions for the general rental system and analysis of the housing market. As the Housing Financing Fund was entrusted with the implementation of Act no. 75/2016 on housing benefits, the Fund's organizational chart was revised again on 24 November, and the new division of housing benefits was established. This revision entailed the transfer of 15 full-time equivalent positions from the Directorate of Labor to the Housing Financing Fund on 1 January 2018, and are those employees currently working in the new division of housing benefits, together with the employees of the Fund previously employed in Sauðárkrókur. The main tasks of the division are the implementation of housing benefits, management of a bond portfolio and the operation of the Fund's service center.

Capital contributions for public housing

The Housing Financing Fund is implementing the Act no. 52/2016 on public rental dwellings, thereby responsible for the establishment of a new non-profit rental system by managing the assessment process, allocation, management and follow-up of capital contribution grants for the construction of affordable rental housing. The Fund also supervises the properties, their operations and housing foundations, which operate on the basis of the Act.

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

Capital contributions for public housing, contd.:

The Housing Financing Fund has now allocated ISK 5,600 million for the development of 1,032 residential properties across the country. Of these, 82% are new residential buildings and 18% are purchased on the market. A total of 946 apartments are located in the capital area, 26 apartments in North Iceland, 31 apartments in South Iceland, 11 apartments in the Westfjords, 9 apartments in Reykjanes, 5 apartments in Southwest Iceland and 4 apartments in West Iceland. The properties are divided between user groups as follows: 40% of apartments are for individuals under income and property criteria, 34% of apartments are for students, 19% of apartments are municipality rentals, 5% of apartments are specific housing facilities for disabled people, 2% of apartments are for the disabled and 0,5% for the elderly.

Housing benefits

On 1 January 2018, the Housing Financing Fund took over the implementation of Act no. 75/2016 on housing benefits. The law came into force at the beginning of 2017, and was part of a systemic change in housing in order to equalize housing support from the government for different forms of housing. Housing subsidies were previously paid to tenants by the relevant municipality, but with the enactment of the Housing Financing Act the decision-making process and payments are centralised and in the hands of the Government. In 2017, housing benefits were paid in the amount of ISK 5,259 million to over 20 thousand applicants. The average amount of housing benefits paid was ISK 34,549 per month and the average monthly income in the calculation was ISK 209,069.

Governance

The Board of Directors of the Housing Financing Fund believes that good corporate governance is the basis for responsible and honest communications of the owner, the Board, management, employees, customers and other stakeholders, promoting trust, transparency and credibility in management of the Fund. In addition to abiding by legislation on housing, the Fund operates partly under the provisions of Act no. 161/2002 on financial undertakings, rules and recommendations of the FSA, Central Bank and various other provisions on the financial markets. The Fund operates as according to an organizational structure and emphasis is placed on simplifying and clarifying the division of labor. Job descriptions are available for all job positions and employee communication channels are effective. The entire structure of the Fund, and its procedures, are designed to ensure the avoidance of conflicts of interests in its activities and ensure transparency and accountability in the management of the Fund.

The Board of the Fund is composed of five members and an equal number of alternates as according to Article 7 of the Housing Act. The Board operates in accordance with rules of procedure which define its functions. The rules define its practices, qualifications, meetings and separation of duties between the Board and CEO. The rules are available on the Fund's website. There are no related interests between the Board and the Fund's major customers and board members submit information on related interests yearly. The Board has been involved in the making of a Rule Book containing all the rules that the Board is by law entrusted to set, and frames the powers and procedures of the Fund's operations. Furthermore, the Board has formulated the Fund's risk profile and treasury management strategy that establishes the risk appetite of the operations and control aspects of liquidity management.

The Board hires the CEO and appoints a Compliance Officer pursuant to the terms of reference. The CEO oversees the daily operations of the Fund and twice a year the Compliance Officer presents a report to the Board on the matters within the scope of his responsibilities. The Board meets regularly with the auditors of the Fund. The Board of Directors monitors that the reporting to the Financial Supervisory Authority, Central Bank and other regulatory authorities is as in accordance with laws and regulations. The Board also makes decisions regarding matters that are unusual and extraordinary.

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

Governance, contd.:

The Executive Board is composed of six members in addition to the CEO. The Board deliberates on major decisions and makes recommendations on policy decisions to the Board of Directors. Six committees operate under the authority of the CEO: The Financial Committee addresses and ensures an overview of the reporting to regulators and monitors the activities of the Treasury, ensures the follow up of treasury management authorisation and recommends proposals to the Board regarding the authorisation of treasury management. The Quality and Security Committee addresses quality systems and information security. The Fund has received ISO 27001 Information Security Standard verification four times since first implementing the standard in 2012. The Lending Committee discusses and makes decisions on lending, the Payment Difficulty Committee manages matters regarding payment difficulties. The Evaluation Committee on capital contributions evaluates capital contribution applications and the Allocation Committee makes decisions on allocation. The Fund has adopted policies on human resources, environmental, safety, archives, and quality assurance, a policy and program against bullying and sexual harassment as well as equal rights policies. In addition, the Fund has set up a policy and action plan in gender equality issues and is working to implement an equal pay certification

Three committees operate under the mandate of the Board. The Audit Committee has the statutory monitoring role of the audit of the Fund, among other factors, such as the effectiveness of risk management. The committee consists of two external experts and a board member. The Operational Development Committee also works on behalf of the Board and it consists of two Board members and the CEO. Its aim is to simplify the operations of the Fund and the main objective of the committee is to streamline operations. Then, acting on behalf of the Board is the Risk Committee, consisting of two Board members and one external expert. The committee addresses operational risks and risk management as well as other matters referred to it by the Board. The Board receives copies of the minutes of the meetings of the above mentioned committees.

The Housing Financing Fund is committed to maintaining reliable financial accounts and has defined responsibilities emphasising the segregation of duties, regular reporting to the Board and transparency in carrying out duties. Monthly figures are reviewed by the Board and the Executive Committee which is an important control factor in the operations of the Fund.

In 2017, the Board held 19 board meetings. The proportion of women on the Board of the Fund is 40% and the proportion of men is 60%. According to law, the Fund's Board is appointed by the Minister after each general election, for a term of four years. The Board of Directors and the Executive Board adhere to a certain policy on diversity with regard to factors such as age, sex and educational or professional background.

The Board of the Fund was appointed in September 2013. Ingibjörg Ólöf Vilhjálmsdóttir, Chairman of the Board, resigned in the middle of the year, and the Vice-President of the Board served as the chairman until Haukur Ingibergsson was appointed chairman at the beginning of 2018, at the same time Ásta Pálmadóttir was appointed as a board member.

In 2017, the following persons were members of the Board of the Fund:

- Ingibjörg Ólöf Vilhjálmsdóttir, from September 2013 to March 2017
- Haukur Ingibergsson, from September 2013
- Dría Snædal, from January 2014
- G. Valdimar Valdemarsson, from October 2014
- Sigurbjörn Ingimundarson, from December 2015

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

Statement by the Board of Directors and the CEO

The Financial Statements of the Housing Financing Fund for 2017 are prepared in accordance with International Financial Reporting Standards as adopted by the EU and additional disclosure requirements for companies that have securities listed on a regulated market.

According to the best of our knowledge, it is our opinion that the Financial Statements give a true and fair view of the financial performance of the Fund for the year 2017, its assets, liabilities, and financial position as at 31 December 2017 and changes in cash flows for the year 2017.

Further, in our opinion the Financial Statements and the Endorsement by the Board of Directors and the CEO include a fair view of the Fund's development and performance and its standing and describes the Fund's main risk exposures.

The Board of Directors and the CEO of the Housing Financing Fund have today discussed the Fund's Financial Statements for the year 2017 and hereby confirm them by means of their signatures.

Reykjavik, 19 March 2018.

Board of Directors:

Haukur Ingibergsson

Haukur Ingibergsson, Chairman of the Board

Drífa Snædal

Sigurbjörn Ingimundarson, Vice-President of the Board

Ásta Pálmadóttir

G. Valdimar Valdemarsson

CEO:

Hermann Jónasson

Hermann Jónasson

Independent Auditors' Report

To the Board of Directors of the Housing Financing Fund,

Opinion

We have audited the accompanying Financial Statements of the Housing Financing Fund (hereafter the Fund) for the year 2017. The Financial Statements comprise the statement by the Board of Directors and CEO, the statement of income and comprehensive income, the statement of financial position, the changes in equity, the statement of cash flows, and a summary of significant accounting policies and other explanatory information.

In our opinion, the Financial Statements present fairly, in all material respects, the results of operations of the Housing Financing Fund for the year 2017, its financial position as at December 31, 2017, and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the EU and the Financial Statements Act.

In accordance with the provisions of Article 104, paragraph 2 of the Icelandic Financial Statements Act No. 3/2006, we confirm that the statement by the Board of Directors and CEO accompanying the Financial Statements includes at least the information required by the Financial Statements Act if not disclosed elsewhere in the Financial Statements.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities section of our Report. We are independent of the Fund in accordance with the Code of Ethics for Professional Accountants in Iceland, and we have fulfilled all ethical requirements therein. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the Financial Statements for the year 2017. These matters were addressed in the context of our audit of the Financial Statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

In our opinion, the following matters are key audit matters in the audit:

a) *Credit risk and loan impairment*

We refer to the discussion in the statement by the Board and CEO, p. 2, in the coverage of the significant accounting policies in Note 32 e. (v) p. 30 and 32 l. p. 31, in the coverage of the critical accounting estimates and judgments in note 2 d. p. 14, and Note 31 b, p. 23 to 26.

We have defined loan impairment as a key factor in the audit as the assumptions used in the impairment process are based on management estimates and are partly subjective. As loans are a significant part of the Financial Statements, any change in criteria may significantly affect the operating results and financial position of the Fund. Our work covered the impairment of both loans to individuals and lending to legal entities.

As part of our audit, we performed tests of key controls relating to loan impairment. The focus of these tests included the analysis of loss events and the assumptions used in the valuation. We examined information in the systems and models used by the Fund to estimate impairment. We also examined the manner in which management evaluated the results of the valuation and responded to deviations if they occurred.

We also performed substantive procedures relating to loan impairment, including assessing the Fund's impairment methodology and whether the methodology is in compliance with International Financial Reporting Standards and the Financial Statements Act. We also selected a sample of borrowers for further examination and evaluated the assumptions applied by management.

Key Audit Matters, contd.

b) *Measurement of appropriated assets*

We refer to the discussion on significant accounting policies in Note 32 m. p.31, to the discussion on critical accounting estimates and judgments in note 2. d. p.14 and note 12, p. 17.

Appropriated assets are properties that the Fund has redeemed in the enforcement of its claims. Appropriated assets are measured in the Financial Statements at cost or fair value, whichever is lower. Furthermore, information on their net fair value is provided in the notes to the Financial Statements. The estimation of the fair value of appropriated properties is often subjective as the assumptions on which the assessment is based may be subject to management's assessment to a great extent. Each change in the assessment criteria may have a significant impact on the operating results and financial position of the Fund.

In our audit we examined the Fund's valuation methods applied in the measurement of appropriated assets and compliance with International Financial Reporting Standards and the Financial Statements Act. We examined the Fund's procedures of analysing and evaluating the underlying assumptions in the valuations as well as examining the valuation models applied. Then we compared the assumptions of the valuation models with external factors, such as property value or the average sales price of the Fund's appropriated assets.

The Board of Directors and CEO's Responsibilities for the Financial Statements

The Board of Directors and CEO are responsible for the preparation and fair presentation of the Financial Statements in accordance with International Financial Reporting Standards as adopted by the EU and the Financial Statements Act, and for such internal control as management determines is necessary to enable the preparation of Financial Statements that are free from material misstatement, whether due to fraud or error.

In the preparation of the Financial Statements, the Board of Directors and CEO are responsible for assessing the Fund's ability to continue as a going concern. If doubt exists as to the ability to continue as a going concern, this fact should be disclosed in the Financial Statements with relevant explanations, disclosing as applicable, the reasons for applying the going concern basis in the preparation and presentation of the Financial Statements, unless the Board of Directors and CEO either intend to liquidate the Fund or to cease operations, or have no realistic alternative but to do so.

The Board and the Audit Committee shall monitor the preparation and presentation of the Financial Statements.

Auditors' Responsibilities

Our objectives are to obtain reasonable assurance about whether the Financial Statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an Auditor's Report that includes our opinion.

Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these Financial Statements.

As part of an audit in accordance with ISAs, we exercise professional judgement and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the Financial Statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control.

Independent Auditors' Report, contd.

Auditors' Responsibilities, contd.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

- Conclude on the appropriateness of management's use of the going concern basis of accounting and based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Fund's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our Auditor's Report to the related disclosures in the Financial Statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our Auditor's Report. However, future events or conditions may cause the Fund to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the Financial Statements, including the disclosures, and whether the Financial Statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicated with the Board of Directors and the Audit Committee regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identified during our audit, if applicable.

We also provided the Board of Directors and the Audit Committee with a statement that we have complied with relevant ethical requirements regarding independence, and communicated with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated to the Board of Directors and the Audit Committee, we determined those matters that were of most significance in the audit of the Financial Statements of the current period and are therefore the key audit matters. We describe these matters in our Auditor's Report unless law or regulations preclude public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our Report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

For and on behalf of Grant Thornton endurskoðun ehf.
Reykjavik, 19 March, 2018.

Sturla Jónsson	Davíð Arnar Einarsson
State Authorized Public Accountant	State Authorized Public Accountant

Income Statement and Statement of Comprehensive Income

	Notes	2017	2016
Interest income		46.753.817	50.790.372
Interest expense		(45.112.834)	(48.933.667)
Net interest income	19	1.640.983	1.856.705
Other income	20	203.976	120.559
Total operating income		1.844.959	1.977.264
Salaries and salary-related expenses	21	825.273	914.121
Other operating expenses	22	800.192	722.391
Depreciation and amortisation	24	80.490	98.777
Total operating expenses		1.705.955	1.735.289
Net income of appropriated properties	25	157.881	104.615
Net operating income		296.885	346.590
Impairment of loans, securities and appropriated properties	26	1.068.962	2.483.550
Profit from continuing operations		1.365.847	2.830.140
Profit from discontinued operations, net of tax	3	0	1.426.613
Profit for the year and comprehensive income		1.365.847	4.256.753

The notes on pages 15 to 36 are an integral part of these Financial Statements.

Financial Statements of the Housing Financing Fund for the year 2017 11 Amounts in ISK thousand

Statement of Financial Position as at 31 December 2017

	Notes	2017	2016
Assets			
Cash and cash equivalents	6	66.608.413	53.171.360
Loans to financial institutions	7	6.891.793	61.114
Marketable securities	8	11.249.780	10.840.424
Other securities	9	163.655.406	126.607.519
Receivable from State Treasury	10	6.107.495	6.000.881
Loans	11	499.989.109	577.843.156
Appropriated properties	12	6.631.138	10.936.362
Operating assets	13	150.269	107.779
Intangible assets	14	166.005	213.904
Other assets	15	477.339	852.146
Total assets		761.926.747	786.634.645
Liabilities			
Bond issues	16	735.897.135	759.485.766
Other borrowings	17	818.745	3.153.172
Other liabilities	18	317.178	467.866
Total liabilities		737.033.058	763.106.804
Equity			
Contributed capital		57.655.408	57.655.408
Accumulated deficit		(32.761.719)	(34.127.567)
Total equity	31	24.893.689	23.527.841
Total liabilities and equity		761.926.747	786.634.645

The notes on pages 15 to 36 are an integral part of these Financial Statements.

Financial Statements of the Housing Financing Fund for the year 2017 12 Amounts in ISK thousand

Statement of Changes in Equity for the year 2017

Year 2017	**Notes**	**Contributed capital**	**Accumulated deficit**	**Equity Total**
Equity as at 1 January 2017		57.655.408	(34.127.566)	23.527.842
Profit for the year and comprehensive income		0	1.365.847	1.365.847
Equity as at 31 December 2017		57.655.408	(32.761.719)	24.893.689

Year 2016	**Contributed capital**	**Accumulated deficit**	**Equity Total**
Equity as at 1 January 2016	57.655.408	(38.384.319)	19.271.089
Profit for the year and comprehensive income	0	4.256.753	4.256.753
Equity as at 31 December 2016	57.655.408	(34.127.566)	23.527.842

The notes on pages 15 to 36 are an integral part of these Financial Statements.

Amounts in ISK thousand

Statement of Cash Flows for the year 2017

	2017	2016
Operating activities		
Profit for the year and comprehensive income	1.365.847	4.256.753
Adjusted for:		
Indexation on loans to banks and loans to customers	(12.221.927)	(15.384.196)
Indexation on borrowings	12.996.232	16.195.767
Depreciation and amortisation	80.490	98.777
Impairment reversal	(1.068.962)	(2.483.550)
Fair value changes of marketable securities	(409.356)	0
Profit from discontinued operations	0	(1.426.613)
Changes in operating assets and liabilities:		
Loans	88.612.645	83.548.228
Appropriated properties	4.161.575	10.430.657
Receivable from State Treasury	513.975	(208.811)
Other assets	205.954	44.264
Other liabilities	(393.967)	(779.941)
Cash flows from operating activities	93.842.506	94.291.335
Investing activities		
Sale of subsidiary	0	10.101.000
Loans to financial institutions, changes	(6.765.478)	4.926.493
Marketable securities, changes	0	(5.942.406)
Other securities, changes	(34.693.869)	(26.640.279)
Investment in operating assets and intangible assets	(80.490)	(120.044)
Investing activities	(41.539.837)	(17.675.236)
Financing activities		
Bond issues and other borrowings, repayments	(38.865.616)	(36.681.267)
Financing activities	(38.865.616)	(36.681.267)
Increase (decrease) in cash and cash equivalents	13.437.053	39.934.832
Cash and cash equivalents at the beginning of the year	53.171.360	13.236.528
Cash and cash equivalents at year end	66.608.413	53.171.360

The notes on pages 15 to 36 are an integral part of these Financial Statements.

Financial Statements of the Housing Financing Fund for the year 2017 14 Amounts in ISK thousand

Notes

General information

1. Reporting entity

The Housing Financing Fund ("the Fund") is headquartered in Reykjavík. The address of the Fund is Borgartún 21. The Fund operates in accordance with the Housing Act no. 44/1998. The Act aims to promote, through the granting of loans and the organization of housing affairs, an environment of security and equal rights in housing affairs for citizens. The main activities of the Fund are in accordance with the purpose of the Act. The Housing Financing Fund appertains to a special management and the Ministry of Welfare. The Housing Financing Fund is subject to supervision by the Financial Supervisory in Iceland in accordance with Act. 87/1998 on Official Supervision of Financial Activities. According to the law, the Icelandic State Treasury guaranties all of the Fund’s financial obligations.

2. Basis of preparation

a. Statement of compliance

The Financial Statements have been prepared in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union. Information as to the new IFRS accounting standards and amendments to standards can be found in note 32u.

The Financial Statements of the Housing Financing Fund were approved by the Board of Directors on 19 March 2018.

b. Basis of measurement

The Financial Statements of the Fund have been prepared on the historical cost basis except for the following: trading securities are measured at fair value, and repossessed properties are measured at the lower of cost or net fair value.

c. Functional currency

The Financial Statements are prepared and presented in Icelandic krona (ISK), which is the Fund's functional currency. All financial amounts presented have been rounded to the nearest thousand unless otherwise stated.

d. Uses of estimates and judgements

The preparation of financial statements in conformity with the IFRS requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. The estimates and underlying assumptions are based on historical experience and various other factors that are believed to be reasonable at the reporting date, 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.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised and the effect of the changes are entered in the periods that the changes are made and in subsequent periods if the change also affects those periods.

Information about significant areas of estimation uncertainty that have the most significant effect on the amounts recognised in the financial statements are described in the following notes:

- Impairment on loans, cf. note 11.
- Repossessed properties, cf. note 12.

e. Changes in presentation

Claims arising from the sale of appropriated assets are not classified as customers' loans in the financial statements as in previous statements, but among other assets. Comparative amounts have been adjusted accordingly.

3. Sale of subsidiary

On 29 June 2016 a purchase agreement was signed for the sale of 100% of the shares of the subsidiary Leigufélagið Klettur. The Competition Authority approved the sale of Klettur at year end 2016. The selling price amounted to ISK 10,101 million and covers both debt settlement with the Fund and consideration for the shares. The subsidiary was classified as assets held for sale and discontinued operations in the financial statements of the Fund at the end of 2015. The operating results of the subsidiary for the year 2016 up to the date of sale was classified as profit from discontinued operations, net of tax and amounted to ISK 1,426.6 million.

4. 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.

5. 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:

	Trading assets	Loans and receivables	Liabilities at amortised cost	Total carrying amount	Fair value
31 December 2017					
Assets:					
Cash and cash equivalents....................		66.608.413		66.608.413	66.608.413
Loans to financial institutions.................		6.891.793		6.891.793	6.891.793
Marketable securities.............................	11.249.780			11.249.780	11.249.780
Other securities......................................		163.655.406		163.655.406	181.582.453
Receivable from State Treasury.............		6.107.495		6.107.495	6.107.495
Loans..		499.989.109		499.989.109	599.951.980
Total financial assets..............................	11.249.780	743.252.216	0	754.501.996	872.391.914
Liabilities:					
Bond issues...			735.897.135	735.897.135	869.286.412
Other borrowings....................................			818.745	818.745	818.745
Other liabilities.......................................			317.178	317.178	317.178
Total financial liabilities..........................	0	0	737.033.058	737.033.058	870.422.335
31 December 2016					
Assets:					
Cash and cash equivalents....................		53.171.360		53.171.360	53.171.360
Loans to financial institutions.................		61.114		61.114	61.114
Marketable securities.............................	10.840.424			10.840.424	10.840.424
Other securities......................................		126.607.519		126.607.519	126.607.519
Receivable from State Treasury.............		6.000.881		6.000.881	6.000.881
Loans..		577.843.156		577.843.156	632.613.540
Total financial assets..............................	10.840.424	763.684.030	0	774.524.454	829.294.838
Liabilities:					
Bond issues...			759.485.766	759.485.766	835.671.985
Other borrowings....................................			3.153.172	3.153.172	3.153.172
Other liabilities.......................................			467.866	467.866	467.866
Total financial liabilities..........................	0	0	763.106.804	763.106.804	839.293.023

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. 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 year-end . 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. Fair value is based on quoted prices in active markets for identical assets. Other treasury securities are measured at their yield at acquisition.

Financial Statements of the Housing Financing Fund for the year 2017 16 Amounts in ISK thousand

5. Financial assets and liabilities, contd.

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. The valuation methods are divided into 3 levels which reflect the importance of the assumptions that are the basis for the assessment of the fair value of the financial instruments.

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.

31 December 2017	Level 1	Level 2	Level 3	Total
Assets:				
Marketable securities	11.249.780	0	0	11.249.780

31 December 2016	Level 1	Level 2	Level 3	Total
Assets:				
Marketable securities	10.840.424	0	0	10.840.424

6. Cash and cash equivalents and restricted cash

Cash and cash equivalents and restricted cash are specified as follows:	2017	2016
Unrestricted cash in Central Bank	58.743.186	45.524.349
Restricted cash in financial institutions	7.865.227	7.647.011
Cash and cash equivalents total	66.608.413	53.171.360

7. Loans to financial institutions

Loans to financial institutions are specified as follows:	2017	2016
Inter-bank loans	3.053.801	0
Other claims	691	61.114
Bank bills	3.837.300	0
Loans to financial institutions total	6.891.792	61.114

8. Marketable securities

Marketable securities are specified as follows:	2017	2016
Listed treasury bonds at fair value	11.249.780	10.840.424
Marketable securities total	11.249.780	10.840.424

9. Other securities

Other securities are specified as follows:	2017	2016
Covered bonds measured at yield at acquisition	115.290.704	98.376.123
Municipal bonds	1.465.641	0
Treasury bonds measured at yield at acquisition	46.899.061	28.231.396
Treasury bonds total	163.655.406	126.607.519

10. Receivable from State Treasury

The receivable due from the State Treasury comprises two bonds, a bond amounting to ISK 4,500 million that is payable in one lump sum in the year 2018, and a bond in the amount of ISK 1,240 million that is payable in one lump sum on 1 January 2021. The bonds have a permanent prepayment privilege favourable to the Treasury, in part or in full. Only interest payments on the bonds are collected during the loan period. The bonds are not transferable by the Housing Financing Fund.

Regarding the principal reduction of inflation-indexed housing mortgages under Act no. 35/2014, a letter from the Ministry of Welfare dated 19 December 2014, announced that both the Minister of Social Affairs and Housing and the Minister of Finance were in agreement that the Housing Financing Fund would be compensated for the negative impact the measures have had on the Fund. The accumulated negative impact amount to ISK 558 million, of that amount ISK 138 million for the year 2017 (2016: ISK 420 million).

Financial Statements of the Housing Financing Fund for the year 2017 17 Amounts in ISK thousand

Notes, contd.:

11. Loans:

Loans are specified as follows:

	2017	2016
Loans to individuals	365.061.806	443.092.827
Loans to legal entities	134.927.303	134.750.329
Loans total	499.989.109	577.843.156

Impairment on loans is specified as follows:

	2017	2016
Balance at the beginning of the year	7.480.198	16.148.682
Impairment loss	(209.134)	(1.197.024)
Collected previously written off	429.407	0
Write-offs	(783.204)	(7.471.460)
Balance at year end	6.917.267	7.480.198

12. Appropriated properties

At year-end 2017 there were 419 appropriated properties held by the Fund (2016: 663) that it had repossessed for satisfaction of claims. The total number of appropriated properties managed by the Fund is specified as follows:

	2017	2016
Number of properties at the beginning of the year	663	1.348
Appropriated properties during the year	53	203
Properties sold during the year	(297)	(888)
Number of properties at year end	419	663

Properties owned by the Fund are divided as follows by geographical area:

	2017	2016
South and South West	110	147
Great Reykjavík area	71	112
South Iceland	76	119
West Iceland	45	98
East Iceland	55	82
North Iceland	38	61
Westfjords	24	44
Number of properties at year end	419	663

Appropriated properties at year end are measured at the lower of the cost or net fair value and are specified as follows:

Year-end 2017	Number of properties	Official property value	Fair value	Book value
Rentals	231	5.175.440	4.569.214	4.074.698
In sales process	161	3.205.030	2.436.398	2.253.555
Empty	25	479.015	394.195	266.279
Other properties*	2	55.100	45.851	36.606
Total	419	8.914.585	7.445.658	6.631.138

* Abandoned, rent arrears or properties that have recently entered the portfolio and are being processed

Year-end 2016				
Rentals	372	8.444.141	7.962.506	7.056.053
In sales process	226	3.882.738	3.088.287	2.800.543
Empty	46	943.250	790.329	752.208
Other properties*	19	383.390	387.166	327.558
Total	663	13.653.519	12.228.288	10.936.362

* Abandoned, rent arrears or properties that have recently entered the portfolio and are being processed

Financial Statements of the Housing Financing Fund for the year 2017 18 Amounts in ISK thousand

13. Operating assets:

Operating assets are specified as follows:

	Fixtures and equipment	Real estate	Total
Cost			
Balance at 1.1.2016	178.443	30.727	209.170
Additions during the year	51.551	0	51.551
Balance at 31.12.2016	229.994	30.727	260.721
Additions during the year	62.155	0	62.155
Balance at 31.12.2017	292.149	30.727	322.876
Depreciation			
Balance at 1.1.2016	101.899	7.693	109.592
Depreciation during the year	42.323	1.027	43.350
Balance at 31.12.2016	144.222	8.720	152.942
Depreciation during the year	18.638	1.027	19.665
Balance at 31.12.2017	162.860	9.747	172.607
Carrying amount			
Balance at 1.1.2016	76.544	23.034	99.578
Balance at 31.12.2016	85.772	22.007	107.779
Balance at 31.12.2017	129.289	20.980	150.269

Property value of real estate at year end 2017 amounted to ISK 22.9 million (2016: ISK 9.5 million) and insurance value amounted to ISK 24.3 million (2016: ISK 22.3 million).

14. Intangible assets

Intangible assets are specified as follows:

	Software
Cost	
Balance at 1.1.2016	590.131
Additions during the year	68.492
Balance at 31.12.2016	658.623
Additions during the year	12.927
Balance at 31.12.2017	671.550
Amortisation	
Balance at 1.1.2016	389.293
Amortisation during the year	55.427
Balance at 31.12.2016	444.720
Amortisation during the year	60.825
Balance at 31.12.2017	505.545

Intangible assets are specified as follows:

Carrying amounts	
Balance at 1.1.2016	200.838
Balance at 31.12.2016	213.903
Balance at 31.12.2017	166.005

15. Other assets

	2017	2016
Eir bonds	94.321	94.091
Purchase contracts	269.215	598.262
Accounts receivable	71.721	99.252
Value added tax claim	42.082	60.543
Other assets total	477.339	852.148

Financial Statements of the Housing Financing Fund for the year 2017 19 Amounts in ISK thousand

16. Bond issues

The Fund issues housing bonds in three HFF series. The name of each series indicates the maturity year of the series. The bond issues are all inflation-indexed annuity bonds with semi-annual payments. All HFF series carry 3.75% nominal interests. Housing bonds are inflation-indexed annuity bonds with four annual instalments and carry 4.75% - 6.00% nominal interests. Housing bonds are callable. Housing authority bonds are inflation-indexed annuity bonds with semi-annual payments and carry 2.70% - 6.25% nominal interests. The effective interest rate of the issued bonds is 4.31%.

Bond issues are specified as follows:	2017	2016
HFF24 bond	119.112.184	132.367.155
HFF34 bond	204.086.901	208.672.805
HFF44 bond	383.840.760	384.947.757
Housing bonds (final maturity 2040)	10.836.443	14.401.929
Housing Authority bonds (final maturity 2038)	18.020.846	19.096.120
Total bond issues	735.897.134	759.485.766

17. Other borrowings

Other borrowings are specified as follows:	2017	2016
Pension funds	77.319	376.887
Insurance fund	191.225	189.376
Callable bonds	143.469	126.607
Unpaid due to purchase of loan portfolios	406.732	2.460.302
Total other borrowings	818.745	3.153.172

18. Other liabilities

Other borrowings are specified as follows:	2017	2016
Treasury due to subsidized interest	0	243.286
Employee vacation obligation	62.979	70.954
Other liabilities	254.199	396.906
Total other liabilities	317.178	711.146

19. Net interest income

Interest income

Interest income on items not at fair value:	2017	2016
Interest income from loans to customers	34.653.773	40.967.535
Interest income from covered bonds	5.119.656	5.052.454
Interest income from corporate bonds	294.840	0
Interest income from other financial assets	4.997.721	3.570.355
Gov't contribution due to reduced interest margin related to debt solutions*	857.886	840.513
	45.923.876	50.430.857
Interest income on items at fair value:		
Interest income on market securities	829.941	359.515
	829.941	359.515
Total interest income	46.753.817	50.790.372

*The government contribution due to social benefit loans to municipalities and organisations, such as student associations and organisations of disabled.

Financial Statements of the Housing Financing Fund for the year 2017 20 Amounts in ISK thousand

19. Net interest income, contd.:

Interest expense

Interest expense on items not at fair value:

	2017	2016
Interest and indexation expense on bonds issued	44.948.837	48.871.951
Interest expense on other borrowings	163.997	61.716
Total interest expense	45.112.834	48.933.667
Net interest income	1.640.983	1.856.705

20. Other income

Other income is specified as follows:

	2017	2016
Collection and service income	203.342	111.843
Other income	633	8.716
	203.975	120.559

21. Salaries and salary-related expenses

Salaries and salary related expenses are specified as follows:

	2017	2016
Salaries	615.756	676.784
Pension fund contributions	80.179	95.125
Tax on financial activity	34.548	42.612
Employee vacation obligation	(7.975)	(4.922)
Other salary related expenses	66.821	67.099
Other personnel expenses	35.944	37.423
Total salaries and salary related expenses	825.273	914.121

A portion of salaries was recognised as a receivable from the Treasury at the end of the year and is not included in the income statement of the Fund. The total amount of salaries that is due to the procedures related to capital contributions in the year 2017 amount to ISK 50,995 thousand compared to ISK 20,052 thousand in 2016.

	2017	2016
Average number of employees during the year in full-time equivalent units	66	77

22. Other operating expenses

Other operating expenses are specified as follows:

	2017	2016
Collection fees	125.105	149.076
Operating expenses of housing	124.092	122.943
Operating cost of IT systems	147.261	193.258
Audit and review of financial statements (cf. note 23)	25.332	26.639
Professional services	72.986	85.785
Implementation of IFRS expenses	34.607	0
Real estate evaluations	6.615	11.528
Advertising, promotional material and grants	27.278	26.128
Debtors' Ombudsman	92.836	(25.212)
Financial Supervisory Authority	69.115	54.941
Credit rating	2.009	14.605
Service fees	27.726	30.163
Other operating expenses	45.230	32.537
Total other operating expenses	800.192	722.391

23. Auditors' fee

Remuneration to the auditors' is specified as follows:

	2017	2016
Audit of financial statements	13.766	11.681
Review of interim financial statements	3.242	3.049
Internal audit	5.850	9.827
Other auditor-related services	2.474	2.082
Audit and review of financial statements total	25.332	26.639
Implementation of IFRS expenses	5.564	0
Total auditors' fee	30.896	26.639

Financial Statements of the Housing Financing Fund for the year 2017 21 Amounts in ISK thousand

24. Depreciation and amortisation of the year:

Depreciation and amortisation is specified as follows:

	2017	2016
Depreciation of operating assets (cf. note 13)	19.665	43.350
Amortisation of intangible assets (cf. note 14)	60.825	55.427
Total depreciation and amortisation	80.490	98.777

25. Net income of appropriated properties

Net income of appropriated properties is specified as follows:

	2017	2016
Rental income from rented properties	525.082	726.138
Expenses due to appropriated properties	(367.201)	(621.523)
Net income of appropriated properties	157.881	104.615

The expenses due to appropriated properties in the table above include only the direct incurred costs of the properties e.g. property taxes, insurance, maintenance, energy costs and commissions of administrators. If all expenses were included such as the operating expenses incurred by the Fund due to its management of the properties, the expenses would be significantly higher than stated in the breakdown above.

26. Impairment

Total impairment recognised in the income statement is specified as follows:

	2017	2016
Specific impairment loss of loans (reversal of impairment loss)	(576.238)	(1.016.592)
General impairment on loans (reversal of impairment loss)	367.104	(180.432)
Impairment loss of loans (reversal of impairment loss)	(209.134)	(1.197.024)
Recoveries from appropriated assets	(900.450)	(798.633)
Impairment on other receivables (reversal of impairment loss)	40.623	58.995
(Impairment recognised as income) expensed impairment	(1.068.962)	(2.483.550)

27. Rental agreements

The Fund has entered into operating lease agreements on properties used in its operations. Minimum lease payments are specified as follows at year end:

	2017	2016
Payable within 1 year	112.094	115.193
Payable after 1 to 5 years	172.344	244.304
Total	284.438	359.497

28. Liabilities arising from financing activities

	Bond issues	Other borrowings	Total
Balance at 1.1.2017	759.485.766	3.153.172	762.638.938
Cash-flows			
Repayments	(36.496.761)	(2.422.529)	(38.919.290)
Non-cash			
Indexation	12.908.130	88.102	12.996.232
Balance at 31.12.2017	735.897.135	818.745	736.715.880

Financial Statements of the Housing Financing Fund for the year 2017 22 Amounts in ISK thousand

29. Related parties and salaries of management

Related parties consist of the owner of the Fund, board members, executive officers and its subsidiary. The Housing Financing Fund is publically owned and administratively falls under the Ministry and Minister of Welfare. Government institutions and self-governing corporate entities that are financially dependent on the authorities are related parties of the Fund. Loans to related parties are granted on arms-length basis. At year end 2017 there were no mortgage loans to related parties (2016: 0).

Salaries of the Board, Managing Director and key personnel is specified as follows:

	2017		2016	
	Salaries	Pension fund contributions	Salaries	Pension fund contributions
Hermann Jónasson, CEO	17.822	2.406	17.332	2.184
Sigurður Erlingsson, former CEO	0	0	5.822	611
Sigurbjörn Ingimundarson, former Board Chairman	2.502	200	0	0
Ingibjörg Ólöf Vilhjálmsdóttir, former Board Chairman, ...	586	59	3.270	412
Other Board Directors	5.486	465	6.680	842
Key personnel, (6)	103.744	14.005	96.493	11.520

Former senior management received severance pay in 2016 and 2017. The number of key personnel increased during the year 2017.

30. Other matters

Future organization of housing policy

The new Government's Political Agreement of 1 December 2017 places a strong emphasis on housing, which states that housing security, independent of financial standing and residency, is one of the fundamental preconditions of a well-functioning society. Housing reforms are being planned to promote the strengthening and improvement of the housing market, among others things by ensuring that at any given time, analyses and statistics on housing supply and demand are available based on demographic development and organizational requirements. Public access to secure housing must be strengthened by enhancing support systems and adopting coherent policies on the development of social housing, as well as increasing transparency in the rental market and increasing the disclosure of information on housing. In accordance with these objectives, the Minister for Social Affairs and Equal Opportunities has called for a bill to be proposed to amend the Housing Act, which provides for the enhanced role of the Housing Financing Fund in the fields of housing policy and planning including increased sources for data collection.

Other matters

The Fund is a party to several disputes currently before the courts. These disputes are mainly related to damages due to forced sales and sales of appropriated assets and disputes regarding payments for construction work. It is the Fund's opinion however, that these cases, neither individually nor combined are likely to have a significant financial impact on the Fund.

31. Risk management

a. *Overview of financial risks and the risk management structure*

A key issue in the Fund's daily management is to reduce its risk exposure related to financial assets and liabilities. Following are the risks that the Fund is exposed to and which are of importance:

- Credit risk
- Liquidity risk
- Interest rate risk, prepayment risk and indexation risk
- Operational risk

The following include information on the organisation of the Fund's financial and risk management, in addition to information on each of the aforementioned risks, including objectives, policies and evaluation process along with management of each risk. Furthermore, information on the Fund's capital management is disclosed.

Risk management structure

The Housing Financing Fund is a non-profit organisation. Its financial and risk management takes note thereof. Its main objective is to continuously seek to keep a low risk level in its financial operations. Furthermore, the Fund aims at limiting financial risk and cost in accordance with its operating goals.

Financial Statements of the Housing Financing Fund for the year 2017 23 Amounts in ISK thousand

31. Risk management, contd.:

a. *Overview of financial risks and the risk management structure,contd.:*

Risk management structure, contd.:

The Fund's Board of Directors

- Responsible for formulating and approving risk management strategy.
- Ensures that an effective risk management strategy is in place within the Fund, and its contents include effective processes and procedures.
- Recognises the risks involved in the operations of the Fund and sets acceptable risk limits.
- Receives statements and reports on the Fund's risk and implementation of risk management.
- Monitors risk management and assesses the effectiveness of current risk management strategy.
- Appoints the Board's Risk Committee.

The Board's Risk Committee

- Deliberates and makes decisions on the Board's proposals regarding important issues in lending practices and the Fund's financial and risk management.
- Recognizes the risks involved in the Fund's operations and sets acceptable risk limits.
- Formulates proposals for risk appetite and risk profile to the Board and decides on further implementation.
- Monitors risk management.
- Directs the internal evaluation assessment of capital requirement.

CEO

- Recruits the risk manager and informs him of employment terms.

Risk manager

- Manages and is responsible for the risk management division.
- Has unprecedented access to the Board.
- Responsible for the implementation of risk management including analysis, measurement, assessment, stress tests and the disclosure of information to the Board.
- Takes an active part in formulating risk management policies and addresses all important decisions related to risk management.

Financial committee

- The CEO, CFO, COO, and Risk manager are members of the Financial committee.
  Submits proposals to the Board on debt issuance and interest rate premiums and makes decisions on treasury
- Ensures that the disclosure of information to the Board is satisfactory and the policy of treasury and risk management is followed.
- Discusses key issues concerning the Fund's financial and risk management.

Hedges

It is important to maintain a certain balance in the Fund's combination of borrowings and loans. The Fund's financial and risk management rules stipulate that the Fund must limit its risks and manage interest rate and credit risk within a certain threshold.

The Fund's financial and risk management operates in accordance with the Fund's financial and risk management rules. The rules define the risks and their margin of tolerance in the Fund's operation.

b. *Credit risk*

Credit risk is the risk of financial loss if a customer or a counterparty to a financial instrument fails to meet its contractual obligations. The Fund's credit risk arises from loans to customers, investments in market securities and loans to financial institutions. As stated before it is the Fund’s main objective to maintain low risk level in its operations.

31. Risk management, contd.:

b. *Credit risk, contd.*

Maximum credit risk exposure as according to geographical areas

The following table shows the maximum credit risk exposure as according to geographical areas.

Year-end 2017	**Capital region**	**South and Southwest**	**West and Westfjords**	**North Iceland**	**East Iceland**	**Total**
Loans to individuals.....	224.144.239	71.210.441	21.433.567	34.686.941	13.586.619	365.061.806
Loans to entities...........	79.873.603	24.340.163	7.678.196	20.169.363	2.865.978	134.927.303
Total loans..................	304.017.842	95.550.604	29.111.763	54.856.304	16.452.597	499.989.109
Year-end 2016						
Loans to individuals.....	276.984.440	83.447.871	24.798.932	42.679.502	15.182.082	443.092.827
Loans to entities...........	78.294.806	24.318.077	8.657.546	20.500.681	2.979.219	134.750.329
Total loans..................	355.279.246	107.765.948	33.456.478	63.180.183	18.161.301	577.843.156

Quality of loans

The following table shows the carrying amount of loans that are neither past due nor impaired, the carrying amount of loans that are past due and not impaired and the carrying amount of loans that are impaired.

	Loans to individuals		**Loans to legal entities**		**Total**	
	2017	**2016**	**2017**	**2016**	**2017**	**2016**
Neither past due nor impaired						
Total............................	346.084.775	411.404.555	111.702.818	90.197.538	457.787.593	501.602.093
General impairment....	(926.694)	(702.795)	(190.664)	(117.964)	(1.117.358)	(820.759)
Carrying amount.........	345.158.081	410.701.760	111.512.154	90.079.574	456.670.235	500.781.334
Past due and not impaired						
31-60 days...................	8.721.751	11.220.242	5.545.549	315.901	14.267.300	11.536.143
61-90 days...................	2.605.619	4.287.216	0	0	2.605.619	4.287.216
Past due over 90 days	4.450.950	7.144.200	55.979	24.224	4.506.929	7.168.424
General impairment....	(171.607)	(228.876)	(106.582)	(4.489)	(278.189)	(233.365)
Carrying amount.........	15.606.713	22.422.782	5.494.946	335.636	21.101.659	22.758.418
Impaired						
Total............................	5.369.872	12.314.182	22.369.063	48.532.673	27.738.935	60.846.855
Specific impairment.....	(1.072.859)	(2.345.897)	(4.448.860)	(4.197.554)	(5.521.719)	(6.543.450)
Carrying amount.........	4.297.013	9.968.285	17.920.203	44.335.119	22.217.216	54.303.405
Loans total.................	365.061.807	443.092.827	134.927.303	134.750.329	499.989.110	577.843.156
Impairment as proportion of loans.......	0,59%	0,73%	3,40%	3,11%	1,36%	1,30%

The following table shows an age analysis of total arrears on loans.

	Loans to individuals		**Loans to legal entities**		**Total**	
	2017	**2016**	**2017**	**2016**	**2017**	**2016**
Loans past due:						
31-60 days...................	111.410	133.393	54.027	9.539	165.437	142.932
61-90 days...................	52.953	75.432	0	9.355	52.953	84.787
Past due over 90 days.	1.040.630	1.819.368	628.594	1.365.474	1.669.224	3.184.842
Total past due.............	1.204.993	2.028.193	682.621	1.384.368	1.887.614	3.412.561

Obligations not recognised in the balance sheet:	**2017**	**2016**
Binding loan commitments at year-end..	4.406.080	8.654.000

Financial Statements of the Housing Financing Fund for the year 2017 25 Amounts in ISK thousand

31. Risk management, contd.:

b. *Credit risk, contd.*

Quality of loans, contd.:

The Fund regularly reviews its loan portfolio to assess impairment. Prior to determining whether an impairment loss should be recognised in the income statement, the Fund makes judgements as to whether there is any objective evidence indicating that there is a measurable decrease in the estimated future cash flows from individual loans or from a portfolio of loans. This evidence may include observable data indicating that there have been changes in the payment status of borrowers in a group or economic conditions. Management uses estimates based on historical loss experience for assets with similar credit risk characteristics and objective evidence of impairment when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

A specific provision for impairment of loans to legal entities has been calculated on the basis of the professional judgement of employees and management of the Fund and recognised in the financial statements. The specific provision is based on official information, solvency of the legal entity, condition of underlying assets, information on the standing of the debtors, marketability of the assets and value of pledges.

The experts of the Fund have estimated the need for a provision on loans to individuals. In making this estimate the balance of loans in arrears and the value of collaterals for the loans was taken into account. Specific provision for impairment due to this has been recognised in the financial statements of the Fund.

The value of pledges is based on the current real estate value at each given time.

General impairment is also recognized in the income statement. See in addition note 25 regarding the estimation of general provisions required for impairment.

Write-off on loans

Loans are written off under the following circumstances:

- Upon loss on the sale of property auctioned, when the sales value is lower than the valuation of the apartment, according to Article 57 of Act no. 90/1991 on forced sale.
- Upon the approval of the Board of the Housing Financing Fund on the discontinuance of a claim in accordance with Regulation no. 359/2010, on the treatment of the Housing Financing Fund's claims for which pledges have been lost.
- Abiding by Act no. 101/2010 as according to the Act on Housing par. 3 Art. 47 on write-offs as according to agreement on debt mitigation.
- Upon the financial restructuring of legal entities under agreement pursuant to Act no. 101/2010 as according to the Housing Act par. 6 Art. 47.
- On the basis of law

Impairment on loans is specified as follows:

	Individuals		**Legal entities**		
	Specific impairment	**General impairment**	**Specific impairment**	**General impairment**	**Total**
Year 2017					
Balance at the beginning of the year......................	2.254.204	905.990	4.197.551	122.453	7.480.198
Impairment loss (reversal					0
of impairment loss)...............................	(964.102)	192.311	387.865	174.793	(209.133)
Write-off..	(646.649)	0	(136.556)	0	(783.205)
Collected previously written off................	429.407	0	0	0	429.407
Balance at year end................................	1.072.860	1.098.301	4.448.860	297.246	6.917.267
Year 2016					
Balance at the beginning of the year......................	6.774.733	1.071.616	8.165.074	137.259	16.148.682
Impairment loss (reversal of impairment loss)...............................	(2.044.176)	(165.626)	1.027.584	(14.806)	(1.197.024)
Write-off..	(2.476.353)	0	(4.995.107)	0	(7.471.460)
Balance at year end................................	2.254.204	905.990	4.197.551	122.453	7.480.198

Financial Statements of the Housing Financing Fund for the year 2017 26 Amounts in ISK thousand

31. Risk management, contd.:

b. *Credit risk, contd.:*

Quality of pledges

The Housing Financing Fund's loans are secured by pledges in real estates. Loans are granted to the maximum of 80% of the purchase price, provided that there are no other restrictions of a maximum loan amount, which is ISK 30 million for individuals. The maximum official property value of the assets may not be over ISK 50 million. Following the granting of a loan, pledges are not assessed specifically in terms of fair value unless in relation to the evaluation of possible impairment losses. Requirements for general housing loans are that a binding purchase offer has been made, which in general may be equal to the fair value of the specific real estate on the date of purchase.

The weighted average pledging ratio of the Fund's total loans on the official property value is approx. 38.4% at year end 2017 compared to 43.8% at year end 2016. The majority of the Fund's loans have first pledge right. The pledging ratios, i.e. calculated remaining balance on loans excluding specific impairment as a proportion of the official property value, are specified as follows at year end:

	2017	**2016**
Proportion of the total loans under 50% of the official property value	80,3%	75,2%
Proportion of the total loans from 51 - 70% of the official property value..................................	12,3%	13,9%
Proportion of the total loans from 71 - 90% of the official property value	4,7%	6,8%
Proportion of the total loans from 91 - 100% of the official property value	0,8%	1,4%
Proportion of the total loans from 101 - 110% of the official property value	0,4%	0,8%
Proportion of the total loans over 110% of the official property value	1,5%	1,8%
	100%	100%

Counterparty risk related to securities transactions

The Fund's own bonds, which it has lent to market makers, and underlying pledges are specified as follows at year end:

	2017	**2016**
Loaned own bonds, market value	75.129	1.428.803
Market value of pledges provided by counterparties..	79.083	1.597.675

Other counterparty risk

Securities holdings and money market funds without government guarantee:

	2017	**2016**
Structured covered bonds	64.836.025	83.601.055
Covered bonds..	50.454.680	0
Short term financing less than 1 year...	14.757.019	7.708.125
Money market funds..	1.465.641	0
Íslandsbanki bonds secured by mortgages...	0	14.775.068

c. *Liquidity risk*

Liquid risk management

Liquidity risk is the Fund's risk of not being able to meet its contractual interest and principal payments on its borrowings. By effective control on liquidity balance the Fund endeavours to ensure that there are always sufficient funds in order to meet its obligations if a temporary imbalance arises between the payment flow on the Fund's loans and other financial assets on the one hand, and its borrowing on the other.

The Fund's treasury management includes liquidity analysis and liquidity management. The Fund's liquidity plan is organized in advance with reference to the operational and financial budget. The liquidity budget is updated on a regular basis.

Financial Statements of the Housing Financing Fund for the year 2017 27 Amounts in ISK thousand

31. Risk management, contd.:

c. *Liquidity risk, contd.*

Measurement of liquidity risk

A key issue in the Fund's liquidity management is to ensure that there is balance between payment flow on financial assets and financial liabilities. The following table shows the contractual payment flow of the Fund's financial assets and liabilities.

Remaining balance of financial assets and liabilities:

31 December 2017	**0 - 3 months**	**3 - 12 months**	**1 - 5 years**	**Over 5 years**	**Total**
Financial assets:					
Cash and cash equivalents....................	66.608.413				66.608.413
Marketable securities.............................	11.249.780				11.249.780
Other securities......................................	6.346.660	9.181.356	52.654.068	173.983.992	242.166.076
Receivable from State Treasury.............	16.882	79.055	6.252.045	0	6.347.982
Loans to customers and banks..............	8.879.775	31.948.547	131.032.481	749.581.099	921.441.902
Total financial assets..............................	93.101.510	41.208.958	189.938.594	923.565.091	1.247.814.153
Financial liabilities:					
Borrowings and other liabilities..	13.476.345	53.688.292	247.937.034	791.659.754	1.106.761.425
Binding loan commitment........................		4.406.080			4.406.080
Total financial liabilities..........................	13.476.345	58.094.372	247.937.034	791.659.754	1.111.167.505
Net balance..	79.625.165	(16.885.414)	(57.998.439)	131.905.337	136.646.649

31 December 2016	**0 - 3 months**	**3-12 months**	**1 - 5 years**	**Over 5 years**	**Total**
Financial assets:					
Cash and cash equivalents....................	53.171.360				53.171.360
Marketable securities.............................	10.840.424				10.840.424
Other securities......................................	3.072.759	9.486.098	32.664.481	115.612.078	160.835.416
Receivable from State Treasury.............		169.340	6.311.836		6.481.175
Treasury securities.................................					
Loans to customers and banks..............	10.144.461	30.070.566	156.607.520	864.082.666	1.060.905.212
Total financial assets..............................	77.229.004	39.726.004	195.583.837	979.694.744	1.292.233.587
Financial liabilities:					
Borrowings and other liabilities...............	13.095.497	53.228.019	263.949.563	816.102.765	1.146.375.844
Binding loan commitment........................		8.654.000			8.654.000
Total financial liabilities..........................	13.095.497	61.882.019	263.949.563	816.102.765	1.155.029.844
Net balance..	64.133.506	(22.156.015)	(68.365.726)	163.591.979	137.203.743

The table above shows contractual cash flow of loans and borrowings of the Fund, including both payments and contractual interests but not estimated future inflation. Cash and cash equivalents of the Fund, which can be used to meet temporary imbalance in cash flows of financial assets and liabilities, is stated in the first column of the table. If an imbalance would occur between the cash flows of financial assets and liabilities, the Fund would meet the imbalance by expending cash, selling securities or issuing HFF bonds, as necessary.

d. *Interest risk*

Interest rate risk is defined as the risk of fluctuation in fair value or future cash flow due to changes in market interests. The Fund recognises neither financial liabilities nor financial assets at fair value, except for treasury bonds which are listed on an active market (cf.note 8) and fair value risk due to interest rate changes is therefore limited. Around 89.8% of the Fund's financial assets (2016: 87.3%) and 99.8%(2016: 99.8%) of its financial liabilities have fixed interest rates and therefore the effect of interest changes is insubstantial. Decisions on changing interests on loans with floating interests is entirely in the hands of the Fund. However, the difference between the duration of assets and liabilities causes risk exposure for the Fund as if a balance is not maintained interest rate changes may affect its net interest income. The duration of the Fund's financial assets at year end 2017 is 11.91 years (2016: 11.19 years) and of financial liabilities 9.55 years (2016: 9.42 years). According to the Fund's financial and risk management policy this difference may be up to 0.9 years.

Financial Statements of the Housing Financing Fund for the year 2017 28 Amounts in ISK thousand

31. Risk management, contd.:

d. *Liquidity risk, contd.*

Measurement of liquidity risk, contd.:

Weighted average effective interest on the Fund's borrowings excluding equity was 4.31% at year-end 2017 (2016: 4.31%), but weighted average effective interest on loans at the same time was 4.61% (2016: 4.58%). The interest margin on loans and the Fund's borrowings is therefore 0.3%.

The risk committee assesses the Fund's prepayment risk and other factors related to interest rate risk and prices it when the Fund's loan interests are decided. In order to reduce even further this risk the Fund also offers loans with prepayment fees but lower interests than loans without such fee. On a monthly basis the real proportion of prepayments is measured and estimates for future prepayment ratios are calculated. On the basis of estimated prepayments the Fund regularly reviews its funding in order to limit the sensitivity of its loan portfolio with regards to interest rates.

Borrowers may in many cases prepay their loans with the Fund without paying a specific prepayment fee. However, the Fund's issued bonds do not include prepayment options, with the exception of housing bonds. Therefore, an imbalance between the duration of financial asset and liabilities can arise, which would lead to reinvestment risk for the Fund and thereby interest rate risk.

Around ISK 174 billion of the Fund's loans (2016: ISK 213 billion) is hedged with prepayment fees in part or entirely and prepayable housing bonds should the borrower choose to prepay its loan before the end of the loan term. Interest rate and reinvestment risk related to this is considered to be considerable, especially while market interests remain low. The Fund is working on limiting this risk.

CPI-indexation risk

CPI-indexation risk is the risk of fluctuations in the consumer price index (CPI) affecting the fair value and cash flow of indexed financial instruments. The majority of the Fund's loans are indexed, financed with indexed bonds. The indexation risk is largely explained by the fact that not all financial assets are indexed, but the Fund's liabilities are all indexed. Indexation risk is managed by calculating the sensitivity of the Fund's total balance in indexed assets and liabilities with respect to changes in the consumer price index.

	2017	2016
CPI-indexed financial assets:		
Loans	499.989.109	577.843.156
Treasury securities and other assets	166.977.131	142.781.411
Total financial assets	666.966.240	720.624.567
CPI-indexed financial liabilities:		
Bond issue	735.897.134	759.485.766
Other borrowings	818.745	3.106.224
Total financial liabilities	736.715.879	762.591.990
Total CPI-indexation balance	(69.749.639)	(41.967.423)

Indexed liabilities amounted to approx. ISK 69.8 billion in excess of indexed assets at year end 2017 (2016: ISK 42.1 billion). Based on year-end position and assuming that all other variables remain constant a 1% inflation calculated over a period of one year would have adverse impact on the Fund's results amounting to ISK 698 million (2016: ISK 421 million).

Interest-free assets

When the Fund redeems appropriated assets the loan becomes interest-free. At year end 2017, the Fund held 419 properties for sale (2016: 663 properties) recognised at the value of ISK 6,631 million. (2016: ISK 10,936 million).

e. *Operational risk*

Operational risk is the risk of loss as a result of insufficient internal processes, employees and systems, or because of external events, including legal risk. The Fund uses both preventive and supervisory methods to minimise its operational risk. The preventive methods include clear and documented procedures regarding all the Fund's major factors of operations, training of employees, data back-up, access control and other procedures. The Fund is ISO 27001 certified for information security, a written security policy as well as having a Risk Committee and Security manager who administer various aspects of operational risk. Head of divisions are responsible for management of operational risk in their divisions and monitor the operational risk as well as their employees.

Financial Statements of the Housing Financing Fund for the year 2017 29 Amounts in ISK thousand

31. Risk management, contd.:

f. *Equity and capital management*

The Fund's long-term objective is to maintain an equity ratio over 5.0%. The calculation of the equity ratio is in accordance with international standards (Basel II). If the Fund's equity ratio falls below 4.0% the Fund's Board of Directors shall notify the Minister of Social Affairs and Equality thereof. Furthermore, the Fund's Board of Directors shall propose solutions to reach the long term equity ratio goal.

Equity ratio is specified as follows:	2017	2016
Total equity according to the financial statements	24.893.689	23.527.841
Intangible assets	(166.005)	(213.904)
Equity base	24.727.684	23.313.937

Total equity requirement (eg 8% of the risk base) is specified as follows:

Credit risk	20.805.595	25.159.555
Market risk	2.238.629	243.910
Operational risk	281.885	295.474
Total capital requirements	23.326.109	25.698.939
Equity ratio	8,48%	7,26%

32. Significant accounting policies

The accounting policies set out below have been consistently applied to all periods presented in these Financial Statements. Revenues and expenses of the Fund are not recognised directly in other comprehensive income and the result for the year is therefore equal to comprehensive (loss) income.

a. *Interest income and interest expense*

Interest income and expense are recognised in the income statement using the effective interest method and consist of interest income on loans to customers, cash and cash equivalents, restricted cash, treasury securities and loans to financial institutions, and interest expenses on borrowings. Interest income and expense includes the amortisation of discounts and premiums and other differences between initial book value of the financial instrument and amounts due on maturity, based on the effective interest method. Borrowing fees arising from loans granted as well as the Fund's financing is recognised in the income statement in the same manner as interest income and expense and those items are taken into account in the calculation of effective interests.

Effective interest is the imputed rate of interest used in determining the present value of estimated cash flow over the estimated useful life of a financial instrument or a shorter period if applicable, so that it equals the book value of the financial asset or liability in the balance sheet. When calculating the effective interest rate the Fund estimates future cash flows considering all contractual terms of the instrument but not future credit losses.

Indexation of inflation-indexed assets and liabilities are recognised in the income statement among interest income and expense as they accrue and in the balance sheet as part of the carrying amount of assets and liabilities.

The Fund has provided loans for rental apartments at a 3.5% and 4.2% interest rate. The State Treasury compensates the Fund the interest difference between those loans and loans taken by the Fund. The State Treasury's contribution is based on the difference between borrowing and lending rates each year (cf. note 18). The aforementioned loans for rental apartments are inflation-indexed at fixed interest rates. A long term agreement has not been made between the Fund and the State on subsidy of interests on these loans but the subsidy is determined on an annual basis by the State and approved in the national budget. If the State's subsidy for the payment of the interests would no longer be granted interests on the loans should be increased in order to secure the Fund's financial return and interest margin There are loan issues in the amount of approximately ISK 8 billion granted in the years 2001-2009 for social benefits where State compensations do not apply.

b. *Other income*

Other income consists of collection charges. Other income is recognised in the income statement when accrued. Borrowing fees are included in the calculation of effective interest rate. They are included in interest income and not other income.

c. *Other operating expenses*

Other operating expenses consist of housing costs, operation of IT systems, collection expenses, purchased expert services, contribution to the operation of the Debtors' Ombudsman and other general operating expenses, cf. note 22. Operating expenses are recognised as they are incurred.

Financial Statements of the Housing Financing Fund for the year 2017 30 Amounts in ISK thousand

32. Significant accounting policies, contd.

d. *Net operating income of appropriated properties*

Net operating income of appropriated properties consist of rental income and expenses of appropriated properties, cf. note 25.

e. *Financial assets and liabilities*

(i) Recognition and derecognition of financial assets and liabilities

Purchases and sales of financial assets are recognised at the date of transaction. The transactions are recognised on the date on which the Fund commits to purchasing or selling the asset, except for loans that are recognised when funds are transferred to borrowers. Financial assets are derecognised when the contractual rights to the cash flows from the asset expire, or when the Fund transfers the rights to receive the cash flows on the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial assets are transferred.

Financial liabilities are recognised when the Fund becomes a party to the contractual provisions of the instrument. The Fund derecognises a financial liability when its contractual obligations are discharged, cancelled or expire.

To ensure efficient price determination of its issued bonds the Fund has entered into agreements with market makers on short term securities loans, where the Fund lends to the market maker its own bonds against collateral security for a maximum of 28 days. The bonds lent are not recognised in the balance sheet. The collaterals are not capitalised in the balance sheet as the risks and rewards remain with the Fund's counterparty. At the end of the agreement term, the Fund receives the bonds lent and returns the collaterals to the market maker.

(ii) Offsetting

Financial assets and liabilities are set off and the net amount is recognised in the balance sheet when, and only when, the Fund has the legal right to set off the amounts and intends either to settle on a net basis or realise the asset and settle the liability simultaneously.

(iii) Amortised cost of financial assets and liabilities

The amortised cost of a financial asset or liability is the amount at which the financial asset or liability is measured upon initial recognition, minus principal repayments, taking into account the cumulative amortisation of premiums and discounts using the effective interest method. Discounts and premium constitute the difference between the initial book value of the financial instrument on the one hand, and its nominal value on the other. In calculating the amortised cost of financial assets impairment is also taken into account, if any.

(iv) Fair value measurement

Fair value is the price received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The best measurement of the fair value of financial instruments is based on the quoted price in an active market and is used when readily available. For other financial instruments fair value is determined by using valuation techniques. A financial asset or liability is considered to be listed on an active market if the official price can be obtained from a stock exchange or another independent party and the price reflects actual and regular market transactions between unrelated parties.

(v) Impairment of financial assets

The carrying amount of the Fund's financial assets is reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, the asset's recoverable amount is estimated.

An impairment is recognised in the income statement whenever the carrying amount of an asset exceeds its recoverable amount. An impairment loss is expensed in the income statement.

Two methods are used to calculate impairment losses on loans; one based on assessment of individual loans and the other based on collective assessment. Estimated loss as a result of future events, irrespective of the probability thereof, is not recognised.

Objective evidence of impairment includes information on the following events and conditions:

32. Significant accounting policies, contd.:

e. Financial assets and financial liabilities, contd.:

(v) Impairment of financial assets, contd.

(i) significant financial difficulty of the borrower,
(ii) deteriorating economic conditions,
(iii) a breach of contract, such as arrears on installments or on interest or principal payments.

Individually assessed loans

Impairment losses on individually assessed loans are determined by the risk exposure on a case-by-case basis. The Fund assesses at each reporting date whether there is any objective evidence that individual loans are impaired.

Impairment losses are measured as the difference between the carrying amount of the financial assets and the present value of estimated future cash flows discounted with the assets' original effective interest rate. Impairment losses are recognised in profit or loss and reflected in an allowance account as deduction in their carrying amount.

Collectively assessed loans

Where loans have been individually assessed and no evidence of loss has been identified, these loans are grouped in loan portfolios on the basis of similar credit risk characteristics for the purpose of calculating a collective impairment loss.

The collective impairment loss is determined by taking into account:

- historical loss experience in portfolios of similar risk characteristics,
- the estimated period from when a loss has occurred and until that loss is identified and recognised by contribution to an allowance account
- management's experienced judgement as to whether the current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience.

Changes in impairment on loan portfolios are consistent with changes in observable data from period to period, for example changes in property prices, payment status, or other factors indicative of changes in the probability of losses in the loan portfolio and their magnitude. The methodology and assumptions used for estimating impairment are reviewed regularly by the Fund to minimise any differences between loss estimates and actual losses.

Reversal of impairment

If, in a later period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed in the income statement.

f. Impairment loss of assets other than financial assets

At each balance sheet date, the carrying amount of assets is reviewed to determine whether there is any indication that there has been an impairment loss. If evidence of impairment exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss, if any. The recoverable amount is the higher of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the estimates of future cash flows have not been adjusted. If it is not possible to estimate the recoverable amount of an individual asset, the Fund estimates the recoverable amount of the cash-generating unit to which the asset belongs. If the recoverable amount of an asset or cash-generating units is estimated to be less than its carrying amount, the carrying amount of the asset is reduced to its recoverable amount. Impairment of cash-generating units are deducted from the carrying amount of the assets of the unit. Impairment losses are recognized in the income statement.

g. Discontinued operations

A discontinued operation is an entity or component of an entity that either has been disposed of or classified as held for sale and either (1) represents a major line of business, (2) is part of a single co-ordinated plan to dispose of a separate major line of business, or (3) is a subsidiary acquired exclusively with a view to resell.

Profit of loss from discontinued operations is presented as a single amount in the income statement or statement of comprehensive income and consists of (1) the profit or loss after tax from the operations of the discontinued operation, (2) the profit or loss after tax arising from the fair value assessment less sales costs, (3) gains or losses from the sale or disposal of the discontinued operations.

32. Significant accounting policies, contd.:

h. *Cash and cash equivalents*

Cash and cash equivalents consist of demand deposits with financial institutions.

i. *Loans to banks*

Loans to banks consist of interbank loans and unsettled claims on the Icelandic banks.

j. *Marketable securities*

Marketable securities are securities listed on an active market and are stated at fair value.

k. *Other securities and Receivable from Treasury*

Other securities consist of government treasury bonds, structured covered bonds issued by Arion Bank secured by the bank's mortgages and covered bonds issued by Landsbankinn, Arion bank and Islandsbanki, secured by mortgages. Initially, the covered bonds are recognized at fair value in the Fund's financial statements including direct transaction costs and subsequently measured at amortized cost using the effective interest method. The interest revenue and impairment is recognized in the income statement. Treasury bonds are securities (RIKS30 and RIKS33) listed on the stock exchange but not on an active market and are capitalised based on amortised cost and initial rate of return (cf. note 9). In addition, investments in 2017 in RIKS21 are recognised at their yield on acquisition.

l. *Loans*

Loans are financial instruments with fixed or determinable payments that are not quoted in an active market. Loans and receivables include loans granted by the Fund to its customers and acquired loans, which are unlisted and will not be sold in the nearest future.

The loans are initially measured at fair value which represents the loan amount plus all direct transaction costs. The loans are then measured at their amortised cost using the effective interest method. The book value of loans and receivables includes accrued interest and inflation adjustments.

m. *Appropriated properties*

When the Fund redeems properties on foreclosed mortgages they are recognised as appropriated properties in the balance sheet. Appropriated properties are recognised at the lower of cost or net fair value. The fair value is determined as the market value of the property. The fair value is measured on the basis of a realtor's evaluation, if available, or price information from a list for real transactions with similar properties. In some cases, evaluations of the asset management division of the Fund are used.

If the net fair value of an appropriated property decreases after its initial recognition the fair value decrease is expensed as impairment loss. If the net fair value increases in the future the previously recognised impairment loss is reversed but only to the extent that the carrying amount does not exceed the initial cost value. The reversal is recognised as a reduction to the previously charged impairment.

n. *Operating assets*

Operating assets are recognised at cost less accumulated depreciation.

Depreciation

Depreciation is recognised in the income statement on a straight-line basis over the estimated useful lives of operating assets.

Estimated useful life is specified as follows:

Real estate	25 years
Fixtures and equipment	5-10 years

Residual value is reviewed annually unless it is immaterial.

32. Significant accounting policies, contd.:

o. *Intangible assets*

Intangible assets consist of software used in the Fund's operations. Intangible assets are amortised on a straight-line basis over the estimated useful life, which is 3 - 5 years.

p. *Assets for sale and liabilities associated with assets for sale*

Assets and disposal groups together with the related liabilities are classified as held for sale and liabilities associated with assets held for sale if their carrying amount is recovered through a sale transaction rather than through continuing use. Assets and liabilities classified as held for sale are measured at the lower of the carrying amount or fair value less costs to sell. Assets held for sale and liabilities associated with assets for sale are distinguished from other assets and liabilities in the balance sheet. Assets classified as held for sale are not depreciated.

r. *Issued bonds and other borrowings*

Issued bonds and other borrowings are initially recognised at fair value, which is the loan amount in addition to all costs associated with the transaction. After initial recognition they are measured at amortised cost using the effective interest rate method. Accrued interest expense and indexation are recognised as a part of the carrying amount.

s. *Equity*

The Fund's equity consists of contributed capital on the one hand and accumulated deficit on the other. The accumulated income or loss of the Fund from its establishment is recognised in accumulated deficit.

t. *New standards and interpretations adopted*

The Fund has adopted all International Financial Reporting Standards, interpretations and amendments to standards adopted by the EU which are applicable to the Fund's operations and which have entered into force at year end 2017.

u. *New standards and interpretations not yet adopted*

The IASB has published new standards and amendments to existing standards that have not become effective and have not been adopted early by the Fund. Information on those standards that are expected to be relevant to the Fund’s financial statements is provided below.

IFRS 9 ‘Financial Instruments’

IFRS 9 ‘Financial Instruments’ is a new accounting standard that supersedes IAS 39 ‘Financial Instruments: Recognition and Measurement’ and became effective on 1 January 2018. The new standard includes significant changes to the classification and measurement of financial assets and introduces a new model for impairment of financial assets.

The Housing Financing Fund has been preparing for the implementation of the standard since 2016. The implementation of IFRS 9 has largely been conducted by the Fund's risk management with the involvement of the Operations, Business, and Planning and Analysis Divisions. The implementation is an important task for the Fund, which requires developing and implementing new processes and governance in various areas. In order to comply with IFRS 9, improvements have also been made to the Fund's internal systems and, if necessary, they have been revised. A special steering group was established due to IFRS 9 and the group is responsible for the implementation of the standard by the Fund. The steering group consists of the Managing Director of the Operations Division, the Risk Manager and the CEO of the Housing Financing Fund. The Audit Committee and Risk Committee have also monitored the project and are responsible for the final approval of the IFRS 9 implementation within the Fund.

In general, there are three major changes resulting from the adoption of IFRS 9. First, there are changes in the classification and measurement of financial assets and financial liabilities in the financial statements, secondly, changes are made to the impairment of financial assets and thirdly changes are made in hedge accounting. Below is an account of the major changes and their expected impact.

Classification and measurement

The new standard entails significant changes in the classification and measurement of financial assets. Financial assets should be classified into the following main categories according to IFRS 9:

(1) financial assets measured at amortized cost if the objective with the asset is to hold the financial asset to maturity and collect, on specified due dates, contractual payments consisting only of principal and interest payments.

(2) financial assets measured at fair value through other comprehensive income (FVOCI) if the objective with the asset is to hold the financial asset to maturity and collect, on specified due dates, contractual payments consisting only of principal and interest payments, as well as to sell the financial assets.

(3) financial assets measured at fair value through profit or loss which includes all other financial assets.

32. Significant accounting policies, contd.:

u. New standards and interpretations not yet adopted, contd.:

The Fund has assessed the classification of financial assets due to the implementation of IFRS 9. The assessment has taken into account the current investment policy approved by the Board of Directors, independent of the manner in which the relevant financial assets were classified at initial recognition under IAS 39. The Fund expects that the implementation of IFRS 9 will result in a change in that financial assets that are currently classified as marketable securities and measured at fair value through profit or loss will be measured at amortized cost.

IFRS 9 largely complies with IAS 39 on the classification of financial liabilities. Financial liabilities shall be divided into two categories: amortised cost and fair value through profit or loss. The Fund estimates no changes to the classification and measurement of financial liabilities when implementing IFRS 9.

Impairment

The fundamental difference between the provisions of IAS 39 and IFRS 9 regarding impairment of financial assets is that impairment of financial assets according to IAS 39 is based on incurred loss while impairment of financial assets as according to IFRS 9 is based on expected loss. The latter method implies that an impairment loss is recognised on the basis of future expectations and should therefore result in an increase in provisions for impairment losses in the downturn.

During the implementation, the Fund has had to develop extensive models to assess the expected credit loss of financial assets. Furthermore, the credit risk of each individual loan had to be defined based on historical data. The standard also sets out requirements for defining various terms, selecting the approach that is considered the most appropriate for the Fund, the application of various assumptions of expected credit loss and the use of external information.

The Fund decided to develop new methodologies and calculation models to calculate expected credit losses in accordance with IFRS 9. Expected credit loss may be expressed as probability of default, loss given default and exposure at default.

The calculation of impairment under IFRS 9 is based on a three-stage impairment model, which is intended to reflect the deterioration in credit quality of financial assets. The objective of the standard is that impairment should increase when credit risk increases and credit quality has deteriorated from initial recognition.

• Stage 1 - Credit risk has not increased significantly since the initial recognition of financial assets or credit risk is considered to be insignificant. For first-stage assets, impairment losses are based on 12-month expected credit losses.

• Stage 2 - Credit risk has risen sharply since initial recognition but there is no objective evidence of a credit loss event. For assets at the second level, lifetime expected credit losses are recognised.

• Stage 3 - Objective evidence of impairment exists at the reporting date and the financial asset is considered to be in default. The third level is largely comparable to the specific and general impairment of financial assets in accordance with IAS 39. At the third level lifetime expected credit losses are recognised, as in the second stage.

Risk management is responsible for calculating impairment of loans and ensuring compliance with IFRS 9 requirements. A special financial committee composed of the CEO, the Managing Director of the Operations Division and the Treasury, and the Risk Manager are responsible for reviewing and approving the results.

Significant increase in credit risk and definition of default

According to IFRS 9, the estimate of changes in credit risk is based on the risk of default over the expected lifetime of financial assets. In assessing a significant increase in credit risk, quantitative and qualitative information are used and analyses are derived from historical data.

A significant increase in credit risk (SICR) is assessed on the basis of the following criteria:

32. Significant accounting policies, contd.:

u. New standards and interpretations not yet adopted, contd.:

• Loans in a higher risk category based on estimated assumptions from the initial date of commitment - The current risk category is calculated for each loan and compared to the expectations of the expected risk group from the initial date of commitment. If the risk has risen considerably based on the original assumptions then there is considered to be an increase in credit risk.

• Additional information on credit ratings are also used in assessing credit risk, such as warning signs and credit watch lists.

• Loans in arrears for more than 30 days.

Loans are considered to be in default if loans are more than 90 days past due, if customers show severe signs of financial difficulties, or indications exist that the loans are managed differently.

If the increase in credit risk has decreased or is no longer present then assets may be reclassified from stage two back to stage one. However, the loan remains in the second stage for at least three months. Similarly, the loan is no longer deemed to be in default if the indicators that resulted in default have not been present for the past three months, and then the loan reverts from stage three to stage two. Loans that were in stage three remain in stage two for at least nine months, i.e. in total, the loan is managed separately for at least one year from the date of default.

Economic forecasts

IFRS 9 requires that calculations of expected credit losses take into account probability forecasts of future economic conditions. The Fund also takes into account forecasts of whether credit risk has increased significantly since the initial date of the loan commitment. The Fund relies on statistical analysis based on historical data in assessing the relationships between economic variables, credit risk and expected credit losses. The Housing Financing Fund's Planning and Analysis Division will set-up scenarios, on the one hand the baseline forecast that reflects the most likely outcome, as well as setting a positive and negative scenario that reflects statistically probable deviations from the baseline forecast. All prerequisites for the calculations are presented to the Finance Committee that either approves the prerequisites or proposes remedies.

Hedge accounting

IFRS 9 introduces new rules for hedge accounting designed to harmonize hedge accounting and risk management. The standard allows entities to postpone the adoption of hedge accounting under IFRS 9 and to continue the application of the hedge accounting requirements in IAS 39. The Fund has not applied the provisions of IAS 39 on hedge accounting in its financial statements.

The effect of the changes

The estimated financial impact of the implementation of IFRS 9 on 1 January 2018 is in the range of ISK 1,250 - 2,250 million, decreasing the beginning balance of equity. Of which it is estimated that a decrease of ISK 1,000 - 2,000 million can be attributed to an increase in the provision for impairment of loans and other financial assets and approximately ISK 250 million due to changes in the classification and measurement of financial assets. The estimated impact on the Fund's equity ratio is in the range of -0.7% to -0.4%.

Other standards

IFRS 15 ‘Revenue from Contracts with Customers’ provides a comprehensive framework for the accounting treatment of income. The standard replaces IAS 18 ‘Revenue’, IAS 11 ‘Construction Contracts’, and several revenue-related Interpretations. The new standard establishes a contract-based revenue recognition model. Revenue is recognised as the amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to customers. IFRS 15 is effective for annual reporting periods beginning on or after 1 January 2018, if endorsed by the EU. Management has started to assess the impact of IFRS 15 but is not yet in a position to provide quantified information.

IFRS 16 ‘Leases’ replaces IAS 17 ‘Leases’ and other related interpretations. The standard establishes guidelines for the recognition, measurement, presentation and disclosure of leases. The standard's objective is to ensure that lessors and lessees provide information that represents the financial transactions. IFRS 16 is expected to change the balance sheet, income statement, and cash flow statement for companies with material off balance sheet leases. The requirements for lessor however are substantially unchanged. IFRS 16 is effective for annual reporting periods beginning on or after 1 January 2019. Management has started to assess the impact of IFRS 15 but is not yet in a position to provide quantified information

New standards, interpretations and amendments not either adopted or listed above are not expected to have a material impact on the Fund’s financial statements.