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Ibudalanasjodur (Housing Financing Fund)

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Major Rating Factors

Issuer Credit Rating
Foreign Currency
A/Negative/A-1
Local Currency
A+/Negative/A-1

Strengths:

- Sovereign guarantee of ultimate payment on HFF's debt
- Ongoing sovereign support, as indicated by close oversight and tax exemptions
- Cornerstone of government's housing policy, which considers affordable housing finance important for social cohesion

Weaknesses:

- Commercial banks' presence in housing finance market reduces HFF's systemic importance
- Contemplated changes to the housing finance system may further diminish the role and indispensability of HFF's service
- Low profitability

Rationale

The ratings on Ibudalanasjodur, the Icelandic Housing Financing Fund (HFF; the Fund) continue to benefit from the support of the government of the Republic of Iceland (foreign currency A/Negative/A-1; local currency AA-/Negative/A-1+), as indicated by the sovereign's ultimate (but not timely) guarantee. HFF is 100% state owned, with the state maintaining close supervision over the Fund, as well as including its surplus in the government's consolidated accounts.

Domestic commercial banks started competing with HFF in August 2004. This has led to rapid mortgage prepayments at HFF and a swift shift in market shares, with the Fund's direct market share in local currency mortgages falling to 44% (at year-end 2007) from about 80% in 2003, a structural change that now appears irreversible. A steering group was appointed in February 2006 to formulate a proposal for reform of the Fund's mandate in Icelandic housing finance. To date, however, the group has been unable to find a proposal agreeable to all stakeholders in the Icelandic housing market. On March 17, 2006, the government publicly stated that, if HFF's mandate were eventually changed, the state would endow the Fund's liabilities at that point with a timely guarantee. After the general election in 2007, there has been no further progress regarding reform of the housing financing system in Iceland.

Outlook

The negative outlook reflects the negative ratings outlook on Iceland. We also expect that the cooling housing market in Iceland could put pressure on HFF's asset quality and profitability.

Before the final decision of the European Free Trade Association (EFTA) is published, we do not expect any changes that could lead to a further significant weakening of current government support extended to the Fund. A reduction in government support to the Fund and deterioration in its risk profile would put the local currency ratings under further downward pressure. Conversely, a significant strengthening of government support to HFF could lead to an upward revision of the local currency ratings.

If at some point HFF's mandate is changed and the government does extend a timely guarantee to the Fund's outstanding liabilities at that time, this could result in these issues being rated above the Fund's issuer credit rating, and above debt issued after the potential change in mandate.

Background And Business Description

HFF is a government agency, established by law, with the single public mandate of promoting private home ownership in Iceland. HFF started operating in 1999, pursuant to the Act on Housing Affairs of 1998. HFF replaced the State Housing Board, the State Building Fund, and the Workers' Building Fund by taking over the rights, assets, liabilities, and obligations of its predecessors.

Pursuant to the Act, HFF's role is to promote, through the granting of loans and the organization of housing affairs, the ability of Icelanders to live with security and equal rights in housing affairs, and to increase Icelanders' chances of acquiring or renting housing on manageable terms. HFF's task, therefore, is to arrange loans to individuals (for the acquisition of private homes) and to local authorities, companies, and nongovernmental organizations (for the construction or acquisition of rental housing).

HFF is not authorized to accept deposits from the public and does not provide other financial services apart from domestic housing mortgages (up to a certain ceiling). Recent clarification of regulation regarding HFF has also confirmed that the Fund can engage in loan agreements with commercial and savings banks, which represent a synthetic sale of mortgage portfolios to HFF. The Fund also advises the Minister for Social Affairs on housing issues, by monitoring housing needs in Iceland and by helping to prepare housing plans for municipalities.

Legal Status And Role Of Government

HFF is wholly owned by the state. It is a central cornerstone of the government's housing policy, which aims to provide affordable and equitable access to housing, particularly to remote regions and low-income households. Given the traditionally very high degree of private home-ownership in Iceland, affordable housing finance is regarded as important for social cohesion across the political spectrum.

HFF's position is being challenged, however, by the entry of the commercial banks into the mortgage market in August 2004, which has led to a situation where a state-supported entity now competes with private banks in an increasingly competitive market. Although some questions remain about sustainable and adequate financing of the commercial banks' mortgage lending, calls have repeatedly been made to adjust HFF's role in the housing market and to bring it into line with the changed economic realities.

In response to the developments in the housing market, the government set up a working group on the future of HFF, comprising officials from HFF and from the Ministry of Social Affairs, which presented its findings in January 2006. The working group suggested--albeit without specific details--that the government should consider making fundamental changes to HFF's role in the housing market, and if the government were willing to do so, should consider turning HFF into a wholesale bank. A steering group was formed, which included all the stakeholders in the current system--banks and pension funds, labor unions, property owners, estate agents, consumers, and tenants--to formulate a more specific and consensual proposal for HFF's future role in the housing market. No firm decision has been made following the general elections in May 2007.

Although it is likely that HFF's current setup and legal framework will be modified to make the Fund's operations more compatible with an increasingly competitive market, it is not at present possible to say whether and to what extent this will affect the government support extended to the Fund, and, by extension, the creditworthiness of HFF. The Fund will most likely continue to serve as a cornerstone of the government's housing policy, due to the political importance assigned to equitable housing finance, particularly for remote areas and low-income households, which are not currently well served by the commercial banks. Still, a reformed arrangement with reduced support is a distinct possibility.

HFF's role was also directly challenged by a complaint launched by the domestic banks to the EFTA Surveillance Authority concerning state support for HFF. Although the EFTA Surveillance Authority decided in August 2004 that state support for HFF was compatible with European Economic Area rules, the banks appealed that decision. The EFTA court annulled the EFTA Surveillance Authority's decision on April 7, 2006, and ordered the EFTA Surveillance Authority to conduct a new investigation. A final decision is expected in the first half of 2008.

Arm's-length government administrative oversight

The government plays a dominant and supportive role in HFF's operations. The Fund's bonds and other financial obligations benefit from an ultimate guarantee of collection from the state. The guarantee is not a timely one. The payment can be claimed from the state only after HFF has defaulted on its obligations and the debt holder has exhausted all legal recourse against HFF. The rating, however, factors in an incentive for the state to act more promptly, given the importance of HFF's role.

The Fund is authorized to carry out independent operations without daily oversight from the state. Nonetheless, the state closely monitors HFF's activities, and in that respect, is well informed about the contingent liabilities represented by the Fund.

Both the Ministry of Social Affairs and the Ministry of Finance approve HFF's annual budget. The Fund's budget is fully consolidated within the state budget, which also sets out the borrowing and lending limits for the Fund, as well as establishing the ceiling on state guarantees entered into during the fiscal year. Any additional borrowing requirements for HFF have to be authorized by the government and parliament through a supplemental budget. HFF has never experienced any difficulties in obtaining the required approval to issue its bonds, however, either at the initial or at supplementary budget stage. Furthermore, HFF has never asked for and has never received budgetary support from the state, apart from a regular but minor government transfer for interest rate subsidies inherited from the past housing system, which was Icelandic krona (ISK) 245 million in 2006. There has been no further transfer since then.

The Ministry of Social Affairs appoints all five members of the board of directors--including its chairman and vice-chairman--who determine HFF's policy and monitor the Fund's activities. HFF prepares monthly reports on future and actual cash flows, outstanding bond issues, prepayments and nonperforming loans (NPLs) for the Ministry of Social Affairs, the central bank, and other institutions. Furthermore, the Ministry of Social Affairs plays an important role in determining the terms of HFF's lending business as well its refinancing.

HFF is exempt from corporate and property taxation, as well as from ordinary bankruptcy laws. The Fund is subject to supervision by the Financial Supervisory Authority, and is obliged to adhere to a reduced capital adequacy ratio of 4%. The total capital ratio was 7.0% at year-end 2007, has increased by 2.0% in 4 years. By applying Basel

II to HFF accounting, the CAD ratio is estimated to lie between 9%-10% at year-end 2007.

If HFF were ever privatized, the government would first need to change the law under which HFF operates. In that case, the government guarantee of collection on HFF obligations entered into prior to privatization would remain in place. Dissolution of the Fund would likewise require an act of law, as HFF is not subject to ordinary bankruptcy proceedings.

Operations

Mortgage loans from HFF are extended as direct cash loans to borrowers. General loans are limited to 80% of the purchase price, with the maximum loan set to ISK18 million in March 2007. The amount may not exceed 100% of the fire insurance and land evaluation. The LTV ratio of new lending in 2007 is on average 58%. Loans are extended to borrowers at a fixed real rate, which is derived from the rate at which HFF finances its lending plus a markup of at least 45bps to cover potential loan losses (20bps) and administration costs and risk management (25bps). A prepayment fee would also apply if the lending rate is lower than initial rate. An additional 50bps to cover prepayment risk is added for loans without a prepayment fee.

The Fund finances its lending with the issuance of long-term bonds (HFF bonds), which are noncallable with CPI-linked interest rates and carry the government's guarantee of collection. HFF bonds are clearable in international clearinghouses. To increase liquidity and fungibility of its bonds, HFF is currently issuing just four series of bonds, with 10 to 40 years maturity. HFF bonds are only denominated in Icelandic krona.

HFF bonds play a dominant role in Icelandic capital markets. They are the most liquid securities on the Icelandic Stock Exchange (ICEX) and are the de facto benchmark for long-term local currency government issuance in Iceland, as issuance from the Treasury itself is small by comparison. HFF bonds accounted for 62% of total bond turnover and 28% of bond market capitalization on ICEX in 2007.

The current lending and financing policies came into force in July 2004, representing a significant departure from the old housing financing system. The old system effectively constituted a bond swap system, under which HFF would acquire individual mortgage bonds from homebuyers, exchanging them for a housing bond (callable, CPI-linked), which homebuyers could in turn sell in the securities markets. Alongside the change in the housing financing system, around two-thirds of the traditional housing bonds were exchanged into the new HFF bonds.

The Icelandic housing market has undergone significant changes, which have reduced HFF's dominance in the market. The entrance of commercial banks into the residential mortgage market in August 2004, offering housing loans on terms comparable with, or even better than, those of HFF, has reduced the Fund's direct market share to 44% at year-end 2007, from almost 80% at year-end 2003. In particular, the option to refinance existing mortgages, which HFF is not allowed to offer, led many borrowers to refinance their mortgage loans through the commercial banks, lifting the banks to equal HFF's market share by year-end 2006. After an initial rapid shift, however, driven both by prepayments and by very rapid lending growth, particularly in upmarket lending, which had not been served by HFF, market shares are now stabilizing, as prepayments continue to slow and the Fund's lending has recovered.

HFF has dealt with the wave of prepayments in two ways, besides using the funds for new lending. First, it called outstanding housing bonds from the old housing finance system and prepayed loans to the tune of ISK84 billion, with an additional buffer of about ISK43 billion remaining. Second, it has concluded loan agreements for ISK96 billion in 2004 and 2005 with most of the commercial and savings banks. These loan agreements effectively constitute synthetic sales of part of the banks' mortgage portfolios to HFF, bringing part of their mortgage lending back on HFF's balance sheet. If these loan agreements are taken into account for market share calculations, HFF's market share is still about 54%, while that of the banks is around 33%, with pension funds accounting for the remainder.

As of May 2006, the Fund's portfolio has begun to grow again. The loan portfolio grew 15% in 2007. As general credit conditions tighten and commercial banks dramatically scale down their mortgage lending business in 2008, we expect HFF to further gain market share.

HFF is not a profit-maximizing entity. As such, the Fund doesn't pay corporate tax, property tax, or dividends. Nevertheless, HFF is by law expected to preserve its funds and to earn a return on them.

Overdue loans represent a negligible part of HFF's portfolio. After four months of nonpayment, HFF can enforce a lien on the property. Through an accelerated procedure, the court grants HFF the authority to sell the house at auction. HFF can bid on the house up to the amount owed. If HFF wins the house at auction, it will resell the house on the market. In addition, according to the law, HFF may write off mortgage claims. Currently, write-offs of loans can occur five years after a property has been auctioned.

Finances

HFF's assets, ISK605.8 billion at year-end 2007, are largely dominated by its loans to customers (77%) and the aforementioned loan agreements with banks (16%). HFF's loan book has shrunk by 9% in nominal terms from 2003 to 2006, due to prepayments, but has increased 15% in 2007.

Geographically, HFF's portfolio is concentrated in Reykjavik, the capital of Iceland, and its surroundings. These loans represent about 62% of HFF's loan portfolio and are on a declining trend. The absolute level reflects the economic and demographic concentration of the country in and around its capital, while the decline represents HFF's focus on the countryside, which is hardly served by the banks. HFF's loan portfolio remains well diversified on a borrower basis. Customer concentration is low, with the largest 20 borrowers accounting for 11.90% of the Fund's total mortgage lending in 2007. Total NPLs represented a low 0.26% of gross loans in 2007. Also, the 20 largest non-performing loans at the end of 2007 represented only 0.19% of total loans outstanding.

HFF's lending policies are not expected to change substantially, and any change in the lending portfolio is expected to be gradual and prudent. This, together with the Fund's shrewd risk management, should ensure continued strong asset quality.

The profitability of HFF is weak, reflecting the not-for-profit status of its operations. The net income-to-assets ratio was 0.42% in 2007 compared with 0.36% in 2003. Net interest income represents the bulk (93% in 2007) of HFF's total operating income. The net interest margin-to-assets ratio was 0.58% in 2007 compared with 0.55% in 2003, and has been fluctuating between 0.3% and 0.6% since HFF's creation. Operating expenditures mainly comprise salary and administrative expenditures, as the Fund does not have branches or physical representation throughout the country.

At year-end 2007, HFF bonds accounted for about 88% of HFF's funding, with the housing bonds (7.6%) and housing authority bonds of the old housing financing system plus other bonds accounting for the rest. About 72% of HFF's borrowing was long term (more than five years) and about 5% was short term. The investor base is predominantly made up of domestic pension funds (about 30%-40%), foreign investors (about 30%-40%), and the rest domestic banks and mutual funds. In 2008, as of April 22 HFF had finalized one auction of ISK8 billion, which was three times oversubscribed. The weighted interest rate for the auction and prepaid HFF bonds was 4.73%.

Regarding maturity mismatch and prepayment risk, HFF is exposed to the mismatch in callability between assets and liabilities. To protect itself, HFF has introduced a new risk management policy and implemented a new treasury and asset management system. Since November 2005, HFF has tried to transfer the prepayment risk to clients by adding a 25bps margin to lending without a prepayment fee. According to risk management policy the duration mismatch should be between +/- 0.9 years. As at end-2007, the effective duration gap had been reduced to 0.0 years. The interest margin could also be increased to finance the risk of prepayment. Furthermore, as discussed above, HFF has been engaging in long-term loan agreements, effectively buying derivatives on commercial banks' mortgage portfolios to compensate for the reduction in its own loan book due to prepayments.

HFF has liquidity of between ISK32.5 billion as of the end of March 2008. The amount of cash or cash equivalents required are designed to cover six month's interest and redemption payments and three months' net lending to cover liquidity and refinancing risk.

Table 1

Icelandic Housing Financing Fund (HFF) Balance Sheet

	2007 (IFRS)	2006 (IFRS)	2006	2005	2004	2003
(Mil. ISK)						
Trading assets/market securities	42,030	37,940	36,411	22,695	19,095	5,367
Claims on credit institutions	95,942	97,024	99,030	94,756	47,078	8,863
Outstanding lending	467,567	406,944	406,115	376,956	431,163	445,280
Other assets	319	226	231	180	477	322
Total assets	605,858	542,134	541,787	494,587	497,813	459,832
Trading liabilities	2	825	N.A	N.A	N.A	N.A
Bond issues/borrowed funds	578,748	513,311	515,062	471,108	463,006	411,402
Other borrowings	4,438	10,228	10,228	9,276	21,878	36,724
Other liabilities	306	109	122	309	188	81
Equity	20,189	17,661	16,375	13,894	12,741	11,625
Total liabilities and equity	605,858	542,134	541,787	494,587	497,813	459,832

ISK--Icelandic krona. N.A--Not available.

Table 2

Icelandic Housing Financing Fund (HFF) Profit and Loss Account

	2007 (IFRS)	2006 (IFRS)	2006	2005	2004	2003
(Mil. ISK)						
Net interest earnings	3,511	3,502	3,223	1,559	1,856	2,519
Other operating income	257	254	640	891	915	880
Other operating expenses	(945)	(891)	(886)	(902)	(900)	(784)
Impairment of loans and receivables/provision for loan losses	(295)	(83)	(497)	(394)	(755)	(937)
Profit for the period	2,528	2,782	248	1,154	1,116	1,678

Table 2

Icelandic Housing Financing Fund (HFF) Profit and Loss Account (cont.)

ISK--Icelandic krona.

Additional research provided by Tufan Basarir.

Ratings Detail (As Of April 25, 2008)*		
Ibudalanasjodur (Housing Financing Fund)		
Issuer Credit Rating		
Foreign Currency		A/Negative/A-1
Local Currency		A+/Negative/A-1
Senior Unsecured		
Local Currency		A
Issuer Credit Ratings History		
17-Apr-2008	*Foreign Currency*	A/Negative/A-1
01-Apr-2008		A+/Watch Neg/A-1
20-Nov-2007		A+/Negative/A-1
22-Dec-2006		A+/Stable/A-1
05-Jun-2006		AA-/Negative/A-1+
10-Feb-2005		AA-/Stable/A-1+
14-Jun-2004		A+/Positive/A-1+
17-Apr-2008	*Local Currency*	A+/Negative/A-1
01-Apr-2008		AA-/Watch Neg/A-1+
20-Nov-2007		AA-/Negative/A-1+
17-Jul-2006		AA-/Stable/A-1+
01-Mar-2006		AA+/Watch Neg/A-1+
16-Feb-2005		AA+/Negative/A-1+
10-Feb-2005		AA+/Watch Neg/A-1+
14-Jun-2004		AA+/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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