Housing Financing Fund

Financial Statements 2012

These financial statements are translated from the original which is in Icelandic. Should there be discrepancies between the two versions, the Icelandic version will take priority over the translated version.

Housing Financing Fund
Borgartúni 21
105 Reykjavík

Reg. no. 661198-3629

Contents

Endorsement and Statement by the Board of Directors and the CEO

The Housing Financing Fund ("the Fund") has its headquarters in Borgartún 21, Reykjavik. The Fund's objectives are to provide housing loans, loans for new constructions and property development in Iceland. The Housing Financing Fund is an independent institution owned by the State.

Operations in the year 2012

According to the income statement, loss on the operation of Housing Financing Fund during the year 2012 amounted to ISK 7,856 million. The Fund's interest margin remained unchanged in the year 2012. Equity at year-end amounted to ISK 14,699 million according to the balance sheet, including an increase in contributed capital during the year by ISK 13,000 million (see Note 2). The Fund´s equity ratio, which is calculated on the basis of Regulation no. 544/2004 on the Housing Financing Fund, is 3.2%. The ratio is calculated in the same way as for financial institutions. The Fund´s long-term goal is to maintain an equity ratio over 5.0% and discussions with the authorities aim at complying with the provision of the regulation thereon.

Operating results for the year 2012 are mainly affected by extensive work related to processing of customers' debt difficulties, operation of properties held for sale, prepayment risk and the effects of impairment. To meet the increased work load, the number of employees were increased by 10 during the year 2012. The number of employees during the year 2012 was 98. Salary expenses increased by 17% between years, which is mainly explained by the increase in the number of employees, by the new tax on financial activity of 5.45% levied on the salaries of financial and credit institutions, in addition to the effects of wage increases according to union contracts. Other operating expenses remained mostly the same despite the increase in the number of employees, except for operating cost of properties held for sale, which increased parallel to the increase in the number of properties. Operating expenses for the year were somewhat lower than budgeted.

On 13 September 2012, the Minister of Finance and Economic Affairs, by the proposal of the Government, appointed a Working Group to review the Housing Financing Fund's financial position and prospects. The aim with the group was among others to assess whether, and then how, to secure the financial position of the Fund. The group concluded its work on 23 November 2012 and presented among others a report prepared by the company IFS Ráðgjöf ehf. on the Fund's standing. In January 2013, the Minister of Welfare appointed a Working Group on the Housing Financing Fund's future prospects and role. According to the official duty letter, the aim with this group was to review the Housing Financing Fund's future prospects and role which could sustain the operation of the Fund. Furthermore, the group shall monitor the progress of the actions taken to improve the HFF's equity position and ensure its operations in the long run. Due to the Housing Financing Fund's difficult financial standing, these Working Groups have, together with a Committee on Financial Stability and supervisory bodies, to some degree overstepped the authority of the Board of Directors of the Housing Financing Fund. An example of such decision are statements regarding granting of loans which are not indexed to the consumer price index (CPI), where these parties recommended that the Housing Financing Fund should not grant such loans while there is uncertainty about the Fund's standing and prospects.

During the second half of the year 2012 public debate on the Housing Financing Fund has been characterised by serious doubt regarding the Fund's ability to continue as a going concern. The Housing Financing Fund's main problem is first of all the fact that the Fund's funding is not prepayable and therefore the Fund has no realistic retaliatory actions to react to prepayments of loans without incurring losses. This is one of the Fund's main problems and is among others one of the main causes for the small interest margin on the loan portfolio. The Fund's current interest margin only suffices to cover ordinary operating expenses and liquidity demand but not to meet the need for impairment of loans. Furthermore, the Fund's equity ratio is so low that further capital contribution from the Fund's owner will be necessary if there will be further losses in its operation. The owner of the Fund, i.e. the State Treasury, carries single responsibility for the Fund's liabilities as stated in the prospectus of the HFF bonds. Furthermore, the national budget law for each year establishes the Fund's borrowing authorisation. The Housing Financing Fund is fully owned by the State and is therefore guaranteed by the State, i.e. indirect guarantee by the State as the owner, on the Fund's entire operation. Bankruptcy or default by the Housing Financing Fund will therefore be considered as unrealistic option as such non-compliance would eventually fall on the State.

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

During the year 2012, the Fund's Board of Directors and its management have reviewed the Fund's standing and options and developed ways to react to its difficulties. The Fund places emphasis on seeking solutions on the problem of prepayments as it will have negative and unforeseeable effect on the Icelandic housing loan market if the problem will not be solved. The Fund also places emphasis on attaining normal interest margin, which would fairly reflect the

A part of the tasks of the Fund's management is to draw up the future vision of the Housing Financing Fund and define its role on the housing loan market.

During the last months, there has been much discussion about CPI-indexed and non-indexed loans, terms of consumer credits and housing loan systems. It is the view of the Fund's management that its role will not be fulfilled unless it offers both CPI-indexed and non-indexed loans to all residents in the country. Management is also looking at the possibility of having the terms of the Fund's loans more in line with the terms in our neighbouring countries. With amendments to the Act on Consumer Credit approved by the Icelandic Parliament on 18 March 2013 it is clear that the Housing Financing Fund will have to finance new CPI-indexed loans with a new type of borrowing from 1 September 2013 when the law will enter into force. It is planned that the new type of CPI-indexed financing will have a prepayment option corresponding to prepayments of the Fund's customers. By making such changes to the Fund's financing arrangements the prepayment risk of new loans will be closed out and thus the basis of the future risk management of the Fund will be laid where emphasis will be placed on establishing the balance between the Fund's assets and liabilities. The prepayment fee charged to borrowers will be moderate with the new type of financing.

At the beginning of October 2012, a lawsuit was filed against the Housing Financing Fund before the District Court of Reykjavík due to alleged breach of the Act on Consumer Credit. The main cause of the action pertains to that the Fund had not been authorised to collect the cost entailed by the CPI-indexation of the loan as the entire borrowing cost was not specified in Icelandic krona in the loan agreement. The case will challenge the Housing Financing Fund's authorisation to collect CPI-indexation on the Fund's CPI-indexed loans. By the request of the Housing Financing Fund's Board of Directors the attorney of the State has been requested to take defence on behalf of the Housing Financing Fund.

At year end, loans amounted to ISK 779,095 million and decreased by ISK 2,957 million during the year. The Fund's borrowings amounted to ISK 861,364 million and increased by ISK 3,584 million during the year. Due to strong cash position there was only one bond offer during the year 2012 leading to the decrease of lending interest by 0.2%.

Contributions to the provision for risk related to the Fund's loan portfolio were increased in the year 2012 and the effect of the impairment on the Fund's results amounted to ISK 8,805 million during the reporting year. Increased provisioning is among others due to the fact that the Fund has been incurring more loss relating to the collection of loans as the properties repossessed by the Fund are in worse state than usually. A great part of the Fund's repossessed properties have been evaluated and the majority of those assessments were carried out in the year 2012. The Fund has also recognised increased provisioning for loss related to payment solutions offered by the Fund, both due to increased risk assessment and increased number of customers applying for those solutions (see Note 5b). In general, the impairment methodology has been developed in line with management's evaluation of circumstances at each time.

The repossessed properties are recognised at the lower of cost upon repossession or fair value. The methodology leads to the total of the Fund's properties held for sale being recognised at a lower value than the estimated fair value of the same properties according to a price evaluation amounting to around ISK 2,259 million. The carrying amount of properties held for sale at year-end 2012 amounted to 86% of the official property value of the underlying asset portfolio, which is a more cautious evaluation than in previous financial statements.

The quality of the loan portfolio at year end is similar to that at the beginning of the year in terms of the extent of default in the overall portfolio but worse in terms of the age of defaults. Increased provision is recognised for loss due to the rights of borrowers with payments difficulties, such as specific debt and payment adjustments. The increase in real estate prices between years has on the other hand strenghtened to some extent the position of underlying collaterals of the loan portfolio. Defaults in the loan portfolio peaked in July 2012 but have been decreasing since then.

The amount of ISK 3,413 million is recognised among loans to banks in the balance sheet (see Note 9) at year-end 2012 due to receivables from the old commercial banks resulting from bonds and derivative agreements due to their collapse in October 2008. At the same time, the Fund recognises liabilities to these banks in the amount of ISK 6,600 million due to derivative contracts. In the financial statements it is presumed that the Fund has the right to off-set these balances but uncertainty prevails over the settlement of claims and derivative contracts. However, the courts of law have not yet reached a final conclusion on the Fund's right to off-set.

The Housing Financing Fund's portfolio of repossessed properties increased considerably during the year and at year end the Fund held 2,224 properties, thereof 925 were rented out. The Housing Financing Fund sold 125 assets in the year 2012. The Fund's rental income currently covers all direct operating expenses on properties held for sale, other than cost of capital invested (see Note 16). The Fund is restricted in terms of the amount of repossessed properties that can be rented out due to regional availability of rental properties and the condition of the properties.

The rental company Klettur ehf. was established on 23 January 2013 and the Board of Directors of the Fund agreed to transfer a part of the Fund's properties to the company or 528 of the Fund's 2,224 properties held for sale. The action is a part of the separation of the operation of rental properties on the market from the Fund's basic operation and to comply with the Government's policy to enhance the rental market in Iceland. Furthermore, the establishment of the rental company is expected to facilitate the Fund in reducing its properties held for sale sooner than otherwise. The Fund aims at concluding the transfer of properties to the rental company as at the beginning of the reporting year 2013. It is not the role of the Housing Financing Fund to carry on rental activity and therefore it can be expected that the rental company will eventually be sold.

The main risk factors of the Housing Financing Fund are credit risk, liquidity risk, interest rate and inflation risk, duration imbalance, prepayment risk, refinancing risk and operational risk. Counterparty and currency risk are also considered to be among the Fund´s financial risks. The Fund is also exposed to risk due to uncertainty over the final sales value of properties held for sale as the extent of the Fund's asset portfolio is such that it will take considerable amount of time to sell the properties. The Fund's prepayment and refinancing risk is related to increased settlement of loans by the Fund's customers due to changes in the housing loans market. The Fund's financing is mainly in the form of HFF bonds which are not prepayable but the Fund could buy them back in the secondary market. Increased demand for non-indexed interests causes increased prepayments and long-term interests are close to a historical low and therefore the effect of prepayments is more extensive than usual.

On 29 June 2012 the Act no. 84/2012 amending the Housing Act no. 44/1998 was approved by the Icelandic parliament. The aim with the Act is on the one hand to meet the ESA's comments regarding the Fund's role by limiting loan granting, mainly to legal entities and, and on the other hand, the Housing Financing Fund is for the most part placed under the same supervision as financial undertakings. Similar requirements of competence apply to the Fund's board members and CEO as for financial undertakings. The Government has defined the role of the Housing Financing Fund as provider of service for public interest. Emphasis is placed on the above role of the Fund at the same time as increased requirements are made on internal activities.

Corporate Governance

Following each generally election the Minister of Welfare appoints five members and five reserve members on the Board of Directors of the Fund for a four year term. The Chairman and Reserve Chairman of the Board, appointed by the Minister among board members, shall however be appointed for the same period of office as the appointing Minister. The current Board of Directors was appointed at the beginning of the year 2011. Article 18 of Act no. 84/2012 stipulates that a new Board of Directors shall be appointed upon forming of a new Government. The Board of Directors of the HFF places emphasis on maintaining good governance. The Board of Directors has established detailed working procedures for the Board wherein its competences are defined. The Board hires a CEO and concludes its letter of appointment but the salaries of the CEO are determined by the Senior Civil Servants Salary Board as of the year 2010 on the basis of Article 9 of Act no. 87/2009. The Board of Directors also meets with the Fund's auditors on a regular basis and receives copies of minutes of meeting of the audit committee. The Icelandic National Audit Office has been handling the Fund's internal audit but in the year 2012 a tender was made on the Fund's internal audit for a three year period and based on that tender an agreement has been reached with the audit firm Ernst & Young on the work engagement for the year 2013-2015.

The Board of Directors supervises that all information submitted to supervisory bodies, the Icelandic Financial Supervisory Authority, the Icelandic Central Bank and other authorities is at all time in accordance with law and regulations. The Board of Directors also makes decisions regarding all unusual and substantial matters. In the year 2012, the Board of Directors held 23 Board meetings and had two meetings with the executive management of the Housing Financing Fund.

According to law no. 80/2008 the Fund´s Board has established an audit committee to carry out certain assignments which are a part of the Board´s responsibilities. The audit committee shall oversee the process of preparation of the financial statements in order to increase credibility of financial information. A compliance officer operates within the Fund.

The Fund´s Financial Committee monitors risk management and liquidity management. The Committee meets on regular basis but no less than monthly and its minutes are presented to the Board.

In the year 2011 a Security Committee was established which is responsible for IT and information security. The Committee is part of the implementation process of ISO 27001 adopted and certified in the year 2012. The Security Committee meets on monthly basis.

In the year 2012, it was decided to establish two loan committees on the basis of the amendments in Article 3 c of Act no. 84/2012, on the one hand for loans to individuals, and on the other, to legal entities.

Both loan committees are aimed at ensuring the quality of loan granting, obtaining interdisciplinary views and elaborate discussions on loan granting, in addition to ensuring separation of tasks. The committees' role is to contribute to improved work methods in processing loan applications and propose improvements on work methods. They shall present proposals for amendments to law and regulations regarding the Fund's loan operation, if necessary. The CEO appoint members of both committee for an undetermined period.

The Legal Entity Loan Committee has been operating during the entire year 2012. Up until the amendments to the Housing Act the committee did not have decision making authority regarding lending but reviewed all loan applications before presenting them to the Board to be processed. Henceforward, the Legal Entity Loan Committee will review and decide on loan granting to legal entities, other than those pertaining to the Fund's biggest loans. Furthermore, the loan committee will discuss on financial restructuring of legal entities and present such cases to the Board to be processed. The head of the corporate division is the Chairman of the Legal Entity Loan Committee but apart from him, the committee also consists of representatives of the legal division, financial division, asset management and the CEO.

The Customer Loan Committee began operating formally in December 2012. The head of the customer division is the Chairman of the Customer Loan Committee but apart from him, the committee also consists of representatives of the legal division, financial division, asset management and the CEO. The loan committee reviews all loan granting where there is doubt on whether all requirements for loan granting are met. The loan committee also discusses processing of loans and applications for transfer of mortgage loans where the underlying loan is higher than 80% of the value of the property. Furthermore, the committee processes general loan applications by means of random selection. The loan committee manages proposals for amendments to law and regulations pertaining to loan granting and presents them to management.

The HFF's electronic quality manual is now active and implementation of electronic work procedures is mostly concluded. Internal reviews were begun in the year 2012 and at year end the procedures of four divisions had been reviewed. At year end 2011, a Working Group was established to form the Fund's quality policy, which was then approved by the executive management and the Board of Directors in fall 2012.

The Fund has established a personnel policy, a policy and plan against bullying and sexual harassment, and an equality plan. The personnel policy is reviewed and assessed on annual basis. The Fund has not established a special remuneration committee but preparation work for establishing such committee has begun.

The Fund allocates grants every year for technical innovations or other improvements in the Construction Industry according to the Housing Act and chapter 7 in regulation no. 57/2009. The applications are reviewed by a special committee of three members appointed by the Board.

The Fund and the Ministry of Welfare interact monthly where all the Fund´s main affairs are discussed. Furthermore, the Minister meets with the Board of Directors and the CEO two times a year where the Fund's standing is presented. The Minister of Welfare has authorised the Board of Directors and the CEO intermediately but informed on communication with a committee on financial stability, the Ministry of Finance and the Council of Ministers on financial matters due to specific aspects of the operation of the Fund.

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

Statement by the Board of Directors and the CEO

The financial statements of the Housing Financing Fund for the year 2012 are prepared in accordance with International Financial Reporting Standards as adopted by the EU and additional Icelandic disclosure requirements for financial statements of companies with listed securities.

According to our best 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 2012, its assets, liabilities, and financial position as at 31 December 2012 and changes in cash flows for the year 2012.

Further, in our opinion the financial statements and the Endorsement by the Board of Directors and the CEO include a fair view on the Fund's development and performance, 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 2012 and hereby confirm them by means of their signatures.

Reykjavik, 26 March 2013.

Board of Directors:

Jóhann Ársælsson

Sjöfn Ingólfsdóttir

Henný Hinz

Lárus L. Blöndal

Elín Rannveig Líndal

CEO:

Sigurður Erlingsson

Independent Auditor's Report

To the Board of Directors of the Housing Financing Fund.

We have audited the accompanying financial statements of the Housing Financing Fund, which comprise the balance sheet as at 31 December 2012, the statements of income and comprehensive income, changes in equity and cash flows for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information .

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards as adopted by the EU, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatements, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements 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. An audit also includes evaluating the appropriateness of accounting principles used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements give a true and fair view of the financial position of the Housing Financing Fund as at 31 December, 2012, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the EU.

Emphasis of Matter

Without qualifying our opinion we draw attention to the Fund´s equity ratio which is calculated on the basis of regulation no. 544/2004 on the finances and risk management of the Housing Financing Fund and is 3.2% at year-end 2012, after taking into account the capital contribution commitment, see note 2. According to article 7 of the regulation mentioned above the Fund´s long term goal is to maintain an equity ratio over 5.0%. The Fund has in accordance with the aforementioned regulation notified the Minister of Welfare thereon.

Report on the Board of Directors report

Pursuant to the legal requirement under Article 106, Paragraph 1, Item 5 of the Icelandic Financial Statement Act No. 3/2006 on Financial Statements, we confirm that, to the best of our knowledge, the report of the Board of Directors and the CEO accompanying the financial statements includes the information required by the Financial Statement Act if not disclosed elsewhere in the Financial Statements.

Reykjavik, 26 March 2013.

KPMG ehf.

Margrét Guðjónsdóttir

Income Statement and Statement of Comprehensive Income

	Notes	2012	2011
Interest income		77,467,433	81,735,358
Interest expenses		(74,982,586)	(78,997,610)
Net interest income	11	2,484,847	2,737,748
Other income	12	1,129,299	702,627
Total operating income		3,614,146	3,440,375
Salaries and salary-related expenses	13	768,946	652,518
Other operating expenses	15	1,827,871	1,462,496
Depreciation and amortisation	19	67,778	67,585
Total operating expenses		2,664,595	2,182,599
Net operating income		949,551	1,257,776
Impairment	5b, 9	(8,805,592)	(271,637)
(Loss) profit for the year and comprehensive (loss) income		(7,856,041)	986,139

The notes on pages 14 to 35 are an integral part of these financial statements.

Financial Statements of the Housing Financing Fund for the year 2012 10 Amounts are in ISK thousand

Balance Sheet as at 31 December 2012

	Notes	2012	2011
Assets			
Cash and cash equivalents	6	10,766,771	3,962,556
Restricted cash	6	0	9,112,767
Receivable due from State Treasury	2	13,000,000	0
Treasury securities	7	27,904,569	33,495,031
Loans to banks	8	13,946,454	14,366,754
Loans	5b	779,095,331	782,052,561
Properties held for sale	16	30,369,116	22,486,684
Operating assets	17	71,309	78,390
Intangible assets	18	147,721	140,668
Other assets		762,467	1,639,875
Total assets		876,063,738	867,335,286
Liabilities			
Bond issues	20	849,550,870	848,878,935
Other borrowings	21	4,702,013	5,288,670
Other liabilities		7,111,483	3,612,268
Total liabilities		861,364,366	857,779,873
Equity			
Contributed capital	2	53,155,408	40,155,408
Accumulated deficit		(38,456,036)	(30,599,995)
Total equity		14,699,372	9,555,413
Total liabilities and equity		876,063,738	867,335,286

The notes on pages 14 to 35 are an integral part of these financial statements.

Financial Statements of the Housing Financing Fund for the year 2012 11 Amounts are in ISK thousand

Statement of Changes in Equity for the year 2012

Year 2011	Contributed capital	Accumulated deficit	Equity Total
Equity as at 1 January 2011	40,155,408	(31,586,134)	8,569,274
Profit of the year and comprehensive income		986,139	986,139
Equity as at 31 December 2011	40,155,408	(30,599,995)	9,555,413

Year 2012			
Equity as at 1 January 2012	40,155,408	(30,599,995)	9,555,413
Increase in contributed capital	13,000,000		13,000,000
Loss for the year and comprehensive loss		(7,856,041)	(7,856,041)
Equity as at 31 December 2012	53,155,408	(38,456,036)	14,699,372

The notes on pages 14 to 35 are an integral part of these financial statements.

Amounts are in ISK thousand

Statement of Cash Flows for the year 2012

	Notes	2012	2011
Cash flows from operating activities			
(Loss) profit of the year and comprehensive (loss) income		(7,856,041)	986,139
Adjusted for:			
Indexation on loans to banks and loans to customers		(37,343,963)	(42,194,220)
Indexation on borrowings		38,646,017	43,925,924
Depreciation and amortisation		67,778	67,585
Impairment		8,805,592	271,637
Changes in operating assets and liabilities:			
Loans		29,466,215	(5,034,646)
Properties held for sale		(7,882,432)	(7,457,512)
Other assets		877,409	(976,551)
Other liabilities		3,499,213	(169,935)
Cash flows from (to) operating activities		28,279,788	(10,581,579)
Cash flows from investing activities			
Loans to banks		1,060,770	(8,676,225)
Treasury securities		6,979,377	3,345,536
Restricted cash		9,112,767	(781,714)
Investment in operating assets and intangible assets		(67,749)	(42,878)
Cash flows from (to) investing activities		17,085,165	(6,155,281)
Cash flows from financing activities			
Bond issues and other borrowings, issues		5,779,434	21,292,284
Bond issues and other borrowings, repayments		(44,340,172)	(23,971,960)
Cash flows to financing activities		(38,560,738)	(2,679,676)
Net increase (decrease) in cash and cash equivalents		6,804,215	(19,416,536)
Cash and cash equivalents at the beginning of the year		3,962,556	23,379,092
Cash and cash equivalents at year end		10,766,771	3,962,556
Investing and financing activities without cash flow effect			
Receivable from State Treasury due to increase in capital		13,000,000	0
Increase in contributed capital		(13,000,000)	0
Repossessed properties held for sale		10,827,993	9,325,737
Redeemed loans		(15,253,327)	(12,871,161)

The notes on pages 14 to 35 are an integral part of these financial statements.

Amounts are in ISK thousand

Notes

General information

1. Reporting entity

The Housing Financing Fund ("the Fund") is domiciled in Iceland. The address of the Fund's registered office is Borgartún 21, Reykjavik. The Fund's objectives are to provide housing loans, loans for new constructions and property renovations in Iceland. The Housing Financing Fund is an independent institution owned by the State. The Fund operates in accordance with the Housing Act no. 44/1998 and appertains to a special management and the Minister of Welfare. The Housing Financing Fund is subject to supervision of 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. Increase in contributed capital

In accordance with the statement of the Icelandic Government from November 2012 and the approval in December 2012 by the Parliament of the Budget Act for the year 2013, the Minister of Finance and Economic Affairs was provided the permission to increase the Fund's contributed capital by ISK 13,000 million in order to enhance the equity position of the Fund, so that the equity ratio of the Fund would not be lower than 3% at year-end 2012. The commitment was recognised as an asset in the balance sheet with a corresponding increase in equity at year-end 2012. The contribution will be paid at the end of March 2013 by means of government CPI-indexed bonds which carry interest from 1 January 2013.

3. 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 EU.

The financial statements of the Housing Financing Fund were approved by the Board of Directors on 26 March 2013.

b. *Basis of measurement*

The financial statements have been prepared on the historical cost basis except for trading securities that are measured at fair value and properties held for sale are recognised at the lower of cost or net fair value.

c. *Presentation and 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. *Use 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, see note 5b
- Receivable and payable to fallen credit institutions, see note 9
- Properties held for sale, see note 16

3. Basis of preparation, cont.:

e. *New standards and interpretations not yet adopted*

The Fund has adopted all International Financial Reporting Standards and interpretations applicable to the Fund's operation and which have been adopted by the EU and have entered into force at year end 2012. The Fund has however not adopted standards and interpretations adopted by the EU but which will enter into force after year end 2012. These standards and interpretations are not assumed to have significant effect on the Fund's financial statements.

4. Significant accounting policies

The accounting policies set out below have been consistently applied to all periods presented in these financial statements. No revenues or expenses of the Fund are 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 banks, 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 fee 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 expenses 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 4.5% 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 (see note no. 11). The aforementioned loans to rental apartments are inflation-indexed on floating interests. No long term agreement has been made between the Fund and the State on subsidy of interests on these loans but the subsidy is determined on 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 8,000 million granted in the years 2001-2009 for social benefits where State compensations do not apply.

b. *Other income*

Other income consists of collection charges and rental income on properties held for sale. 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 the cost of operating assets available for sale, housing cost, operation of IT systems, collection expenses, purchased expert services, contribution to the operation of the Debtors' Ombudsman and other general operating expenses, cf. note 15. Operating expenses are recognised as they are incurred.

4. Significant accounting policies, contd.:

d. Financial assets and liabilities

(i) Recognition and derecognition of financial assets and liabilities

Purchase and sale of financial assets is recognised at the date of transaction. Those assets and liabilities 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 or cancelled or expire.

To ensure efficient price determination of its issued bonds the Fund has entered into agreements with market makers on a 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

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:

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

4. Significant accounting policies, contd.:

d. *Financial assets and financial liabilities, contd.:*

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 on the group 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.

e. *Cash and cash equivalents*

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

f. *Treasury securities and loans to banks*

Treasury bonds and loans to banks consist of government treasury bonds, interbank loans and unsettled claims on the Icelandic banks and other financial institutions connected to the Icelandic financial crisis (see note 9). Treasury bonds are divided into securities listed on an active market and securities (RIKS30) listed on the stock exchange but without an active market, which are capitalised based on amortised cost and initial rate of return.

g. *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.

4. Significant accounting policies, contd.:

h. *Properties held for sale*

When the Fund has redeemed properties on foreclosed mortgages they are recognised as properties held for sale in the balance sheet. Redeemed 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 a property held for sale decreases after its initial recognition the fair value decrease is expensed as impairment loss (see note 5.b.). 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.

i. *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.

j. *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.

k. *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.

l. *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.

5. 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 Fund's financial risk management, in addition to information on each of the aforementioned risks, goals, aim and evaluation process along with management of each risk. Furthermore, information on the Fund's capital management is disclosed.

5. Risk management, contd.:

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

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 low risk level in its financial operation. Furthermore, the Fund aims at limiting financial risk and cost in accordance with its operating goals.

The Fund appoints a Financial Committee consisting of the CEO, Financial Director and a finance expert. The Committee's role is to ensure sufficient disclosure of information to the Board and that finance experts in the finance department follow the financial and risk management policies. Rules on financial and risk management shall be reviewed on a regular basis, in line with changes in the financial environment and changes in the operation of the Fund.

The Fund's Board of Directors

- Establishes the Fund's financial and risk management policy and reviews on a regular basis reports on the Fund's financial risk.
- Takes note of risk factors in the Fund's administration and organisation.
- Appoints a financial committee.
- Submits reports to the Minister of Welfare.

CEO

- Reviews reports on the Fund's risks.
- Responsible for the Fund's long term financing need being met.
- Divides responsibility of financial matters in accordance with the financial and risk management policy between the financial committee and the financial department.

Financial Committee

- Brings proposals before the Board of Directors on new bond issuance.
- Brings proposals before the Board of Directors on interest levy on loan interests in accordance with the Fund's rules.

Head of financial department

- Responsible for the implementation of risk management and risk analysis and ensures that all of the Fund's payments and financial agreements are within its financial and risk management policy.
- Directs the Fund's financial and risk management departments.
- Works on proposals on revision of the financial and risk management policy.

Risk management

- Takes care of daily risk management operation.
- Shares knowledge and risk awareness within the Fund.

Financial management

- Takes care of the Fund's financing and financial operations and ensures a safe and efficient handling of securities.

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 banks. As stated before it is the Fund’s main objective to maintain low risk level in its operations.

5. Risk management, contd.:

b. *Credit risk, cont.:*

Solutions for the payment difficulties of the Fund's clients

In addition to general payment difficulty solutions, i.e. rescheduling of amounts in default and deferral of repayments due to temporary payment difficulties, the Housing Financing Fund participates in the payment difficulty solutions established on the one hand by the State and on the other hand, by joint effort of lenders in the housing market.

General solutions for payment difficulties, i.e. rescheduling of amount in default, deferral of repayments and term extentions, are mainly intended to meet temporary payment difficulties. These solutions are often used all together, i.e. amounts in default are rescheduled (changed to a new loan, a so-called reschedule loan), payment is suspended (interest suspension) and finally, the maturity of loans is extended by a period corresponding to at least the suspension period.

Specific solutions for payment difficulties, specific debt and payment adjustments for individuals have been established to meet payment difficulties of individuals.

Specific debt adjustment is based on an agreement between lenders on the housing loan market and is intended for those who have the ability to pay on their mortgage claims corresponding to the value of the property. A debtor pays on the claims, or contractual claims, for 3 years. If the debtor honours the agreement, claims in excess of the property value and contractual claims not paid during the period will be cancelled or written off. Time limit to apply for the specific debt adjustment expired at year-end 2012.

Payment adjustments is intented to allow individuals with serious payment difficulties to reorganise their finances and establish balance between their debt and ability to pay so that they will have a realistic possibility to meet their obligations in the foreseeable future. The term of a debt adjustment lasts for 1-3 years during which the debtor pays on the claims corresponding to the value of the property. The debtor can then apply for a write-off of mortgage claims in excess of the market value of the property at the end of the period provided that legal conditions are met.

These solutions decrease considerably the cash payments towards the Fund. In addition, for specific debt and payment adjustments for individuals it is always assumed that claims in excess of the market value of properties will be written-off, should the applicant fulfil the contract.

Lifting of mortgage claims in excess of the sale price was established in order to facilitate sale of over-mortgaged properties where the owners are unable to pay on the loans in the future and can sell the property on a general market. Lifting of mortgage claims in excess of sale price is also applied on the basis of the Act on payment adjustment.

Households with unpaid mortgage claim in excess of 110% of the value of the properties were offered the option of writing down the claim to 110%. The time limit to apply for this solution expired on 1 July 2011 but work on processing the applications has continued in the year 2012.

Information on possible solutions for payment difficulties can be found on the Fund's website. The following table shows the extent of these solutions based on the prepayment value of loans in the relevant solution category.

	2012	2011
Payment suspension	11,365,493	18,003,863
Rescheduled loans	2,293,091	2,177,929
Extending the maturity of loans	8,558,228	8,128,846
Specific solutions	14,213,084	4,960,236
Outstanding amount of loans with write-off in excess of 110% of the value of the property	56,765,188	52,330,464

More than one solution in the table here above may have been applied to the same loan.

Financial Statements of the Housing Financing Fund for the year 2012 20 Amounts are in ISK thousand

5. Risk management, contd.:

b. Credit risk, contd.:

Credit risk management

All of the Fund´s loans to customers are secured by real estate mortgages. The Fund limits its risk due to these loans in two ways: by setting a maximum individual loan amount and a maximum pledge ratio. In addition, borrowers need to undergo a credit evaluation. The finance committee evaluates the Fund's credit risk on an ongoing basis and determines the price thereof as part of the spread on the Fund's borrowing rates on loans when lending interest rates are determined.

As insurance for securities loaned to market makers with the Fund's bonds, the Fund holds pledge in the form of cash or securities. Pledgeable securities are issued securities with market makers, issued by the Government Debt Management and also the Fund's own bonds. The Fund's pledge is invariably well over 100% in these transactions.

Credit risk exposure

The following table shows total default on loans, the outstanding amount of loans in default and not in default, impairment on loans and book value of loans less impairment:

	Loans to individuals		Loans to legal entities		Total	
	2012	**2011**	**2012**	**2011**	**2012**	**2011**
Loans past due:						
31-60 days................	527,899	488,858	210,089	278,639	737,988	767,497
61-90 days................	407,243	371,496	99,577	101,726	506,820	473,222
Past due over 90 days	5,023,724	3,722,653	2,598,823	2,007,875	7,622,547	5,730,528
Total past due...........	5,958,866	4,583,007	2,908,489	2,388,240	8,867,355	6,971,247
Outstanding amount which is not past due and 1-30 days past due	124,924,122	117,684,256	25,316,742	31,106,833	150,240,863	148,791,089
Total.........................	130,882,988	122,267,263	28,225,231	33,495,073	159,108,219	155,762,336
Loans not past due:						
Loans not past due ...	531,534,316	539,517,662	111,764,652	108,574,983	643,298,968	648,092,645
Total loans...............	662,417,303	661,784,926	139,989,883	142,070,056	802,407,186	803,854,981
Impairment:						
Specific impairment	(9,064,584)	(5,860,102)	(13,216,088)	(14,530,379)	(22,280,671)	(20,390,481)
General impairment	(938,335)	(1,411,940)	(92,849)	0	(1,031,184)	(1,411,940)
Total impairment......	(10,002,919)	(7,272,042)	(13,308,937)	(14,530,379)	(23,311,855)	(21,802,421)
Carrying amount	652,414,385	654,512,883	126,680,946	127,539,677	779,095,331	782,052,560
Impairment as proportion of loans....	1.51%	1.10%	9.51%	10.23%	2.91%	2.71%

Comparative figures for the year 2011 have been changed in the table as division between individuals and legal entities was incorrect in the previous year.

Obligations not recognised in the balance sheet:	**2012**	**2011**
Binding loan commitments at year-end...	7,391,600	4,413,708

Financial Statements of the Housing Financing Fund for the year 2012 21 Amounts are in ISK thousand

5. Risk management, contd.:

b. *Credit risk, contd.:*

Credit risk exposure

The Fund regularly reviews its loan portfolios 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 before the decrease can be identified with an individual loan in that portfolio. 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 similar to those in the portfolio 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 default 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.

Furthermore, a provision for general impairment has been recognised in the income statement. See further note 4.d on evaluation of general write down need due to impairment.

Value of pledges is based current rateable value at each time.

Write-off on loans

Loans are written off under the following two circumstances:

i) Upon loss on the sale of apartments 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

ii) Upon the approval of the Housing Financing Fund of the discontinuance of a claim of "lost pledge" in accordance with Regulation no. 359/2010, on the treatment of the Housing Financing Fund's claims for which pledges have been lost

Impairment on loans is specified as follows:

	Individuals		Legal entities		
	Specific impairment	General impairment	Specific impairment	General impairment	Total 2012
Year 2012					
Balance at the beginning of the year................	5,860,102	1,411,940	14,530,379	0	21,802,421
Impairment loss (reversal of impairment loss).........................	6,723,919	(473,605)	1,270,630	92,849	7,613,793
Write-off..	(3,519,438)		(2,584,921)	0	(6,104,359)
Balance at year end..........................	9,064,583	938,335	13,216,088	92,849	23,311,855

Financial Statements of the Housing Financing Fund for the year 2012 22 Amounts are in ISK thousand

5. Risk management, contd.:

b. Credit risk, contd.:

Write-off on loans, contd.:

	Individuals Specific impairment	Individuals General impairment	Legal entities Specific impairment	Legal entities General impairment	Total 2011
Year 2011					
Balance at the beginning of the year	22,764,344	1,355,488	6,884,214	296,315	31,300,361
Impairment loss (reversal of impairment loss)	(9,535,046)	56,452	8,622,278	(296,315)	(1,152,631)
Write-off	(7,369,196)		(976,113)		(8,345,309)
Balance at year end	5,860,102	1,411,940	14,530,379	0	21,802,421

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

	2012	2011
Specific impairment loss of loans (reversal of impairment loss)	7,994,549	(912,768)
General impairment on loans	(380,756)	(239,863)
Impairment loss of loans (reversal of impairment loss)	7,613,793	(1,152,631)
Impairment on properties held for sale	1,545,562	1,361,389
Impairment on other receivables	64,002	62,879
Impairment on loans to banks (see note 9)	(417,765)	0
Total expensed impairment	8,805,592	271,637

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 20 million for individuals. 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 equalled 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 rateable value is approx. 59% at year end 2012 compared to 62% at year end 2011. The majority of the Fund's loans have first pledge right. The pledging ratios, i.e. calculated remaining balance on loans without specific impairment as proportion of the rateable value, are specified as follows at year end:

	2012	2011
Proportion of the total loans under 50% of the rateable value	64%	62%
Proportion of the total loans from 51 - 70% of the rateable value	16%	15%
Proportion of the total loans from 71 - 90% of the rateable value	11%	11%
Proportion of the total loans from 91 - 100% of the rateable value	3%	4%
Proportion of the total loans from 101 - 110% of the rateable value	2%	3%
Proportion of the total loans over 110% of the rateable value	4%	5%
	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:

	2012	2011
Loaned own bonds, market value	3,236,626	8,035,380
Market value of pledges provided by counterparties	3,811,201	8,928,200

Housing Financing Fund for the year 2012 23 Amounts are in ISK thousand

5. Risk management, contd.:

c. *Liquidity risk*

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.

Liquidity risk management

The Fund's liquidity risk management includes liquidity analysis, access to secured loan lines from banks and liquidity plan. The Fund's liquidity plan is determined one year a head in terms of operating and financial budget. The liquidity plan is updated on a regular basis. A short-term plan is concluded daily for liquidity, including the estimation of the Fund's cash flow for the next 20 working days.

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:

	0 - 3 months	3 - 12 months	1 - 5 years	Over 5 years	Total
31 December 2012					
Financial assets:					
Cash and cash equivalents................	10,766,771				10,766,771
Receivable due from State Treasury.	13,000,000				13,000,000
Treasury securities............................	12,124,652	16,597,552			28,722,204
Loans to customers and banks..	24,378,934	41,115,988	225,759,312	1,251,807,498	1,543,061,732
Total financial assets..........................	60,270,357	57,713,540	225,759,312	1,251,807,498	1,595,550,707
Financial liabilities:					
Borrowings and other liabilities.........	19,958,589	57,384,979	275,226,233	1,036,832,213	1,389,402,014
Binding loan commitment.................	671,600	5,010,000	1,710,000	0	7,391,600
Total financial liabilities......................	20,630,189	62,394,979	276,936,233	1,036,832,213	1,396,793,614
Net balance..	39,640,168	(4,681,439)	(51,176,921)	214,975,285	198,757,093
31 December 2011					
Financial assets:					
Cash and cash equivalents................	3,962,556				3,962,556
Restricted deposits...........................	9,112,767				9,112,767
Treasury securities............................	1,797,824	10,924,017	22,684,024		35,405,865
Loans to customers and banks..	25,320,890	48,588,103	242,478,566	1,294,258,820	1,610,646,379
Total financial assets..........................	40,194,037	59,512,120	265,162,590	1,294,258,820	1,659,127,567
Financial liabilities:					
Borrowings and other liabilities.........	19,598,035	60,369,305	289,939,227	1,102,014,440	1,471,921,007
Binding loan commitment.................	903,708	0	3,510,000	0	4,413,708
Total financial liabilities......................	20,501,743	60,369,305	293,449,227	1,102,014,440	1,476,334,715
Net balance..	19,692,294	(857,185)	(28,286,637)	192,244,380	182,792,852

Financial Statements of the Housing Financing Fund for the year 2012 24 Amounts are in ISK thousand

5. Risk management, contd.:

c. Liquidity risk, contd.:

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 response by issuing HFF bonds or selling short term securities.

d. Interest rate 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 (see note 7) and fair value risk due to interest rate changes is therefore limited. Around 90.0% of the Fund's financial assets (2011: 89.6%) and 99.7% (2011: 99.7%) 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 hand of the Fund. However, the difference between the duration of assets and liabilities causes risk exposure for the Fund as interest rate changes can affect its net interest income. The Fund's financial division manages this risk and shall ensure that the difference is within limits established by the Fund's financial and risk managements policy. The duration of the Fund's financial assets at year end 2012 is 10.9 years (2011: 11.0 years) and of financial liabilities 10.2 years (2011: 10.4 years). According to the Fund's financial and risk management policy this difference may be up to 0.9 years.

Weighted average effective interest on the Fund's borrowings was 4.30% at year-end 2012, but weighted average effective interest on loans was 4.59%. The difference between interest on the Fund's loans and borrowings decreases by 0.004% during the year 2012, which can be explained mainly by the increase in the extent of prepayments of loans in comparison to previous years and less share in new loans in the market.

Prepayment risk

The financial 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 fee but lower interests than loans without such fee. On monthly basis the real proportion of prepayments is measured and estimates for future prepayment proportions are made. On the basis of estimated prepayments the Fund regularly reviews its financing 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 house 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 310 billion of the Fund's loans (2011: ISK 312 billion) is hedged with prepayment fee in part of entirely and prepayable house bonds would 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 mainly due to necessary liquidity according to the Fund's financial and risk management policy. 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.

5. Risk management, contd.:

	2012	2011
CPI-indexed financial assets:		
Loans	776,249,859	780,188,180
Treasury securities and other assets	46,102,990	42,725,693
Total financial assets	822,352,849	822,913,873
CPI-indexed financial liabilities:		
Bond issue	849,550,870	848,878,935
Other borrowings	4,605,010	5,179,418
Total financial liabilities	854,155,880	854,058,353
Total CPI-indexation balance	(31,803,031)	(31,144,480)

Indexed liabilities were around ISK 31.8 billion in excess of indexed assets at year end 2012 (2011: ISK 31.1 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 318 million (2011: ISK 311 million).

Interest-free assets

When the Fund redeems appropriated assets the loan becomes interest-free. At year end 2012, the Fund held 2,224 properties for sale (2011: 1,606 properties) recognised at the value of ISK 30,369 million. (2011: ISK 22,487 million). At year end 2012, the Fund held claims against credit institutions related to the financial collapse in the amount of ISK 3,413 million. (2011: 5,351 million) Interest-free assets amount thus to ISK 33,782 million at year end 2012 (2011: ISK 27,838 million).

e. *Operational risk*

Operational risk is the risk of loss as a result of insufficient internal processes, people 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. Head of departments are responsible for management of operational risk in their departments and monitor the operational risk as well as their employees.

f. *Equity and capital management*

The Fund's long-term objective is to maintain a 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 Welfare 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:	2012	2011
Total equity according to the financial statements	14,699,372	9,555,413
Intangible assets	(147,721)	(140,668)
Equity base	14,551,651	9,414,745
Total equity requirement is specified as follows:		
Credit risk	35,293,987	32,857,747
Market risk	147,388	54,889
Operational risk	500,228	471,299
Total capital requirements	35,941,603	33,383,935
Equity ratio	3.2%	2.3%

Financial Statements of the Housing Financing Fund for the year 2012 26 Amounts are in ISK thousand

6. Cash and cash equivalents and restricted cash

	2012	2011
Unrestricted cash in Central Bank	5,376,201	3,343,476
Unrestricted cash in financial institutions	5,390,570	619,080
Cash and cash equivalents total	10,766,771	3,962,556
Restricted cash in Íslandsbanki hf.	0	9,112,767
Restricted cash total	0	9,112,767

7. Treasury securities

Treasury bonds are specified as follows:

	2012	2011
Listed treasury bonds at fair value	3,928,200	1,797,824
Treasury bonds without active market capitalised based on amortised cost and initial rate of return	23,976,369	31,697,207
Treasury bonds total	27,904,569	33,495,031

8. Loans to banks

Loans to banks are specified as follows:

	2012	2011*
Inter-bank loans	10,533,454	9,015,632
Claims on collapsed banks (see note 9)	3,413,000	5,351,122
Loans to banks total	13,946,454	14,366,754

*In the financial statements for the year 2011 claims on collapsed banks amounting to ISK 2.0 billion were presented on a net basis. In these financial statements those comparative amounts are presented gross.

9. Impairment of claims on banks

The Fund had approximately ISK 16,620 million outstanding claims on Iceland's three biggest banks that collapsed in October 2008, resulting from bonds and derivative contracts entered into with the banks. At the same time, the Fund owed to these banks ISK 5,342 million due to derivatives and HFF bonds. A total of ISK 10,738 million has been written down as impairment due to these claims. In the financial statements it is presumed that the Fund has among others the right to off-set these balances. Uncertainty prevails regarding the settlement of claims and derivatives and the Fund's right to off-set these balances. Therefore, the Fund's loss could be different when the final settlement occurs. In the year 2012, one case was concluded based on set-off but other ruling have been issued on cases to which the Housing Financing Fund is not a party regarding related matters. Therefore the Fund has increased its provision for remaining issues. Changes during the year lead to a decrease in the total write-down against claims in the amount of ISK 418 million. The Fund has unsolved matters with ALMC hf., LBI hf. and Glitnir hf. At year-end 2012, carrying amount of claims due to matters related to the financial collapse amounted to ISK 3,413 million and is recognised among loans to banks in the balance sheet and recognised debt in the amount of ISK 6,600 million among other liabilities.

10. 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:

Housing Financing Fund for the year 2012 27 Amounts are in ISK thousand

10. Financial assets and liabilities, contd.:

31 December 2012	Trading assets	Loans and receivables	Liabilities at amortised cost	Total carrying amount	Fair value
Assets:					
Cash and cash equivalents................		10,766,771		10,766,771	10,766,771
Due from State Treasury...................		13,000,000		13,000,000	13,000,000
Treasury securities............................	3,928,200	23,976,369		27,904,569	27,904,569
Loans to banks..................................		13,946,454		13,946,454	13,946,454
Loans..		779,095,331		779,095,331	908,805,003
Total financial assets..........................	3,928,200	840,784,925	0	844,713,125	974,422,797
Liabilities:					
Bond issues......................................			849,550,870	849,550,870	1,019,394,810
Other borrowings..............................			4,702,013	4,702,013	5,025,362
Other liabilities..................................			7,111,483	7,111,483	7,111,483
Total financial liabilities.....................	0	0	861,364,366	861,364,366	1,031,531,655
31 December 2011					
Assets:					
Cash and cash equivalents................		3,962,556		3,962,556	3,962,556
Restricted deposits...........................		9,112,767		9,112,767	9,112,767
Treasury securities............................	1,797,824	31,697,207		33,495,031	33,495,031
Loans to banks..................................		14,366,754		14,366,754	14,366,754
Loans to customers..........................		782,052,561		782,052,561	900,360,307
Total financial assets..........................	1,797,824	841,191,845	0	842,989,669	961,297,415
Liabilities:					
Bond issues......................................			848,878,935	848,878,935	1,025,669,409
Other borrowings..............................			5,288,670	5,288,670	5,785,544
Other liabilities..................................			3,612,268	3,612,268	3,612,268
Total financial liabilities.....................	0	0	857,779,873	857,779,873	1,035,067,221

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

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

Financial Statements of the Housing Financing Fund for the year 2012 28 Amounts are in ISK thousand

11. Net interest income

	2012	2011
Interest income		
Interest income on items not at fair value:		
Interest income on loans to customers	72,381,770	78,206,012
Interest income on other financial assets	4,196,327	2,726,566
Government contribution to subsidy interests*	585,986	580,938
	77,164,083	81,513,516
Interest income on items at fair value:		
Interest income on market securities	303,350	221,842
	303,350	221,842
Total interest income	77,467,433	81,735,358
Interest expenses		
Interest expenses on items not at fair value:		
Interest expenses on bonds issued	74,560,002	78,410,726
Interest expenses on other borrowings	422,584	586,884
Total interest expenses	74,982,586	78,997,610
Net interest income	2,484,847	2,737,748

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

12. Other income

	2012	2011
Collection fee	171,480	174,351
Rental income from properties held for sale	957,819	528,276
Total other income	1,129,299	702,627

13. Salaries and salary-related expenses

Salaries and salary related expenses are specified as follows:	2012	2011
Salaries	560,388	498,205
Pension fund contributions	78,837	68,919
Tax on financial activity	34,871	0
Other salary related expenses	60,232	56,601
Other personnel expenses	34,618	28,793
Total salaries and salary related expenses	768,946	652,518

Number of employees of the Fund are specified as follows:

	2012	2011
Average number of employees during the year in full-time equivalent units	98	88
Number of employees at year-end	94	92

Financial Statements of the Housing Financing Fund for the year 2012 29 Amounts are in ISK thousand

Notes, contd.:

14. Auditors' fee

Remuneration to the auditors´ are specified as follows:

	2012	2011
Audit of financial statements	16,390	15,750
Review of interim financial statements	5,115	4,733
Total auditors' fee	21,505	20,483

15. Other operating expenses

Other administrative expenses are specified as follows:

	2012	2011
Collection fees	174,845	178,091
Cost of properties held for sale	779,298	416,692
Operating expenses of housing	117,196	104,239
Operating cost of IT systems	191,672	183,235
Audit and review of financial statements	21,505	20,483
Professional services	77,561	57,762
Price evaluation related to payment difficulty solutions	47,803	109,276
Advertising, promotional material and grants	19,672	41,011
Debtors' Ombudsman	225,384	221,190
Financial Supervisory Authority	37,196	31,995
Credit rating	26,540	23,380
Service fees	30,980	40,687
Other operating expenses	78,219	34,455
Total other administrative expenses	1,827,871	1,462,496

16. Properties held for sale

The Fund had repossessed 2,224 properties at year end 2012 (2011: 1,606). Properties owned by the Fund have increased considerably, mainly in the last three years. Total number of properties held for sale managed by the Fund is specified as follows:

	2012	2011
Number of properties at the beginning of the year	1,606	1,069
Repossessed properties during the year	743	691
Properties sold during the year	(125)	(154)
Number of properties at year end	2,224	1,606

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

	2012	2011
Area of Suðurnes	739	401
Great Reykjavík area	493	336
South Iceland	302	263
West Iceland	267	239
East Iceland	224	223
North Iceland	141	107
Westfjords	58	37
Number of properties at year end	2,224	1,606

At year-end 2012, 1,618 properties have been evaluated but 606 properties have not. 769 properties are under sales process and at the same time the Fund had entered into short-term lease agreements on 925 properties.

Financial Statements of the Housing Financing Fund for the year 2012 30 Amounts are in ISK thousand

16. Properties held for sale, contd.:

At year end 2012, 925 properties were rented out (2011: 642) or 41.6% of the total number of properties managed by the Fund (2011: 40.2%). Income and expenses on properties held for sale is specified as follows:

Rental income from rented properties	957,819	528,276
Cost of properties held for sale	(779,298)	(416,692)
Income in excess of expenses from properties held for sale	178,521	111,584

Properties held for sale at year end 2012 are measured at the lower of the cost or net fair value and are specified as follows:

	Number	Rateable value	Fair value	Book value
Rented-out	925	15,693,847	15,036,622	14,038,498
Empty	939	14,545,008	12,772,885	11,901,454
Non-habitable	324	4,691,522	4,175,381	3,870,954
Under construction	36	642,220	643,451	558,210
Total	2,224	35,572,597	32,628,339	30,369,116

17. Operating assets

Operating assets are specified as follows:

	Fixtures and equipment	Real estate	Total
Cost			
Balance at 1.1.2011	205,844	10,197	216,041
Additions during the year	34,029	0	34,029
Balance at 31.12.2011	239,873	10,197	250,070
Additions during the year	5,216	0	5,216
Balance at 31.12.2012	245,089	10,197	255,286
Depreciation			
Balance at 1.1.2011	155,948	5,350	161,298
Depreciation during the year	10,176	206	10,382
Balance at 31.12.2011	166,124	5,556	171,680
Depreciation during the year	12,092	205	12,297
Balance at 31.12.2012	178,216	5,761	183,977
Carrying amounts			
Balance at 1.1.2011	49,896	4,847	54,743
Balance at 31.12.2011	73,749	4,641	78,390
Balance at 31.12.2012	66,873	4,436	71,310

Rateable value of real estate at year end 2012 amounted to ISK 7.7 million (2011: ISK 7.0 million) and insurance value amounted to ISK 20.8 million (2011: ISK 19.7 million).

18. Intangible assets

Intangible assets are specified as follows:

	Software
Cost	
Balance at 1.1.2011	342,717
Additions during the year	8,849
Balance at 31.12.2011	351,566
Additions during the year	62,533
Balance at 31.12.2012	414,099

Financial Statements of the Housing Financing Fund for the year 2012 31 Amounts are in ISK thousand

18. Intangible assets, contd.:

Intangible assets are specified as follows, contd.:

	Software
Amortisation	
Balance at 1.1.2011	153,695
Amortisation during the year	57,203
Balance at 31.12.2011	210,898
Amortisation during the year	55,480
Balance at 31.12.2012	266,378
Carrying amounts	
Balance at 1.1.2011	189,022
Balance at 31.12.2011	140,668
Balance at 31.12.2012	147,721

19. Depreciation and amortisation of the year is specified as follows:

	2012	2011
Depreciation of operating assets (cf. note 17)	12,297	10,382
Amortisation of intangible assets (cf. note 18)	55,480	57,203
Total depreciation and amortisation	67,777	67,585

20. Bond issues

The Fund issues housing bonds in four 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 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.

Bond issues are specified as follows:	2012	2011
HFF14 bond	23,818,334	33,893,818
HFF24 bond	171,795,356	175,409,280
HFF34 bond	217,859,984	215,513,826
HFF44 bond	378,312,359	363,794,510
Housing bonds (final maturity 2040)	35,392,219	36,731,999
Housing Authority bonds (final maturity 2038)	22,372,618	23,535,502
Total bond issues	849,550,870	848,878,935

21. Other borrowings

Other borrowings are specified as follows:	2012	2011
Pension funds	2,127,166	2,493,558
Municipalities	25,163	58,815
Insurance fund	263,858	247,360
Callable bonds	97,002	109,253
Unpaid due to purchase of loan portfolios	2,188,823	2,379,684
Total other borrowings	4,702,013	5,288,670

Financial Statements of the Housing Financing Fund for the year 2012 32 Amounts are in ISK thousand

22. Rental agreements

The Fund has entered into a operating lease agreement on the property used in its operations. Minimum lease payments are specified as follows at year end:

	2012	2011
Payable within 1 year	106,725	97,059
Payable after 1 to 5 years	214,956	200,039
Later	119,726	149,788
Total	441,407	446,886

23. Related parties and salaries of management

The Fund has a related party relationship with its owner, board members and executive officers. The Housing Financing Fund is publically owned and administratively falls under the Ministry of Welfare. Government institutions and self-governing corporate entities that are financially dependant on the authorities are related parties of the Fund. Loans to related parties are granted on arms-length basis. They amount to ISK 171 million at year end 2012 (2011: ISK 168 million).

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

	2012		2011	
	Salaries	Pension fund contributions	Salaries	Pension fund contributions
Sigurður Erlingsson, CEO	14,598	1,701	12,313	1,411
Chairman of the Board of Directors	1,727	199	2,072	238
Former Chairman of the Board of Directors	345	40	0	0
Other Board Directors, four	3,799	316	4,145	370
Key personnel, seven	80,357	10,566	71,866	10,134

Housing Financing Fund for the year 2012 33 Amounts are in ISK thousand

Other matters

24. Althingi´s investigation of the Parliament on Housing Financing Fund

An investigation is ongoing on the Housing Financing Fund approved on December 17, 2010 by the Icelandic parliament. The investigation committee consists of Sigurður Hallur Stefánsson, former District Court Judge, Chairman of the committee, Kristín Flygenring, economist, and Jón Þorvaldur Heiðarsson, lecturer at the Department of Business Administration of the University of Akureyri. The investigation will concern the operations of the Fund from the beginning of the year 1999, when the Fund began its operation. The aim with the investigation will first of all be to evaluate the effect of these changes, policy of the Fund and individual decisions during this period on the financial position of the Fund and real-estate market in whole; secondly to evaluate the effect of the operations of the Housing Financing Fund on economic management; and thirdly to evaluate how well the Fund has managed to attend its statutory role during this time. Following the investigation, there will be a comprehensive revision of the policy and operations of the Fund as well as the financing of the housing credit system in Iceland. The investigation committee has requested for documents regarding the Fund´s loans and communication with the Ministries and in the year 2012 it was decided to investigate also the Fund's operating expenses from the beginning of its operations. Considerable amount of work has been carried out by the Fund in gathering documents and explanations for the committee and that work is now reaching conclusion. The committee has interviewed some of the Fund's employees. The Housing Financing Fund has requested to make remarks on the subject of the report when it will be available but before its publication.

25. Communication with ESA

In June 2008, the ESA (EFTA Surveillance Authority) announced to the Icelandic authorities that the operation of The Housing Financing Fund consists in a State aid, which is not in conformity with the rules on State aids of the EEA Agreement and that the Icelandic government was obliged to adapt the operation of the Fund to those rules. The State aid to the Fund is considered to consist in unlimited state guarantee, exemption from taxation and that the state, as the Fund's owner, has not set requirements on the Fund's operating return. This conclusion is based on the fact that the Fund operates on an open market and that its loans are not limited to a specific social role. In October 2012 The Government sent proposals to ESA on HFF´s changed role in the future. The proposals emphasise minimal changes in the defined role of the Fund. Limits would however be set related to maximum property purchase price and more restrictions on loans to legal entities. The Housing Act has now been amended in order to meet these annotations. A final approval by the ESA regarding the state aid, consisting in contributions by the State to the Fund in the year 2011 was subject to conditions of the Fund's future role and financial restructuring. A financial restructuring plan was submitted to the ESA in January 2013. The Fund has communicated with the ESA during the year regarding observations made by the Icelandic Financial Services Association regarding the operation of the Fund, its market share and reconsideration by the State regarding the Fund´s lending activities, and now recently regarding the State's capital contribution to the Housing Financing Fund. Due to changes in the defined role of the Fund and as it may be expected that the Fund will need continuous aid in order to maintain its equity ratio goal, the State aid is not defined as emergency aid but rather as aid to services of general interest. Therefore it is no longer considered necessary to demonstrate that State aid is sufficient to enable the Fund to sustain its operations without further assistance. It is presumed that ESA will agree on the definition of contribution to the Fund. If so, the the issue regarding equity contribution would be concluded. On the other hand it is expected that communication with ESA will continue regarding the authorities´ implementation of the extent of the Fund´s lending activities and its operations.

26. Prepayment fee

The Fund has received significant amount of inquiries from customers regarding the prepayment fee and fee for excess payments. With amendments to the Housing Act no.120/2004 the Fund was granted the authority to offer to its customers loans on lower interest rates, provided that they would relinquish their right to prepay the loan unless they would pay the prepayment fee. It is argued that the prepayment fee has not been sufficiently explained to customers and therefore it is illegal. One of the Fund's customers requested that the fee be cancelled as he believed that it was not sufficiently specified in the bond he signed. The Complaint Board for Social Affairs and Housing Matters is now investigating the matter. If the fee will be deemed unlawful due to lack of information to customers the Fund will be exposed to prepayments because it does not have the authority to prepay its borrowings against the prepayments. The Fund's loans including the prepayment provision amounted to ISK 141 billion at year-end 2012. If these loans would all be prepaid the Fund´s loss, based on current interest rate, could amount to ISK 10 billion.

27. Lawsuit regarding indexation

Last fall, a lawsuit was filed against the Fund due to alleged breach of the Act on Consumer Credit by granting indexed loans. The court case was filed in December 2012. The lawsuit is based on the assumption that the Fund was not authorised to collect indexation and interests as the total borrowing cost on the loan was unknown when the loan was taken. At the request of the Minister of Welfare the attorney of the State has been requested to take defence of behalf of the Fund and its office works on the case along with the Fund´s head of legal division. A plea of inadmissibility has been filed and is estimated to be examined in April 2013. Material conclusion in the case is not expected until year end. Furthermore, the Fund's CEO has been subpoenaed personally on the basis of provisions of law on financial undertakings regarding personal liability of employees of financial undertakings. A plea of inadmissibility will be filed due to lack of involvement and procedural error. The illegality of indexation against consumers has been discussed and it has been demanded that those loans be corrected. It is evident that if provisions of the law on consumer credit will lead to indexation of loans to individuals to be deemed illegal such ruling would have massive effect on the Fund as its obligation are all indexed. Recently, an opinion was issued by ESA, which monitors EU Directives into Icelandic law. The opinion states that the indexation of mortgage loans is not in breach with provisions of European law as long as the consumers are sufficiently informed regarding the indexation upon taking the loan.

28. Subsequent events

The rental company Klettur ehf. was established in January 2013 and the Board of Directors of the Fund agreed to transfer a part of the Fund's properties to the company or 528 of the Fund's 2,224 properties held for sale. The action is a part of a procedure to separate the operation of rental properties on market from the Fund's basic operation and to comply with the Government's policy to reinforce the rental market in Iceland. Furthermore, the establishment of the rental company is expected to facilitate the Fund in reducing the number of its properties held for sale. Upon transferring of the properties to the company special consideration was made for that they would meet with requirements for rental properties with regards to required rate of return. Furthermore, consideration was made for the suitability of the properties for long term rent.