

Íbúðalánasjóður
Housing Financing Fund
Condensed
Interim Accounts
30 June 2012

Íbúðalánasjóður
Borgartúni 21
105 Reykjavík

Reg. no. 661198-3629

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Endorsement and Statement by the Board of Directors and the CEO

The Condensed Interim Accounts of the Housing Financing Fund for the period January 1st to June 30th 2012 have been prepared in accordance with the International Financial Reporting Standard (IFRS) for interim accounts, IAS 34.

According to the income statement and statement of comprehensive income, the loss of the Fund amounted to ISK 3.1 billion for the six months ended June 30th 2012. Equity at the end of June amounted to ISK 6.4 billion according to the balance sheet.

The Fund's equity ratio, calculated according to stipulations in the Rules on the Housing Financing Fund no. 544/2004 was 1.4% at the end of June 2012. The calculation of the ratio is equivalent to the calculation of the capital ratio of financial institutions. The long-term goal of the Fund is to keep the ratio above 5.0% and not below 4.0%. The Housing Financing Fund has been negotiating with the State regarding capital contribution from the State Treasury in order to reach this goal. It is estimated that a conclusion will be reached before year end.

Operating expenses increased considerably compared to the same period of the year 2011, which is mainly caused by expenses due to appropriated assets, share in the operating expenses of the Debtors' Ombudsman and other tasks of the Fund.

On 30 June, the Fund's loans amounted to ISK 789,4 billion and increased by ISK 7,4 billion from the beginning of the year. Due to good liquidity balance as a result of increased settlement of loans and less loans granted there was only one bond issue during the period; in January 2012 in the nominal amount of ISK 3.3 billion.

New loans by the Fund have decreased considerably during the year parallel to significant increase in early settlement of loans. The Fund granted 611 general housing loans during the first six months of the year compared to 1,119 loans during the same period in the year 2011. Early settlement of loans amounted to ISK 9.4 billion during the period compared to ISK 5.2 billion during the first six months of the year 2011. Therefore, the Fund's liquidity balance has remained unchanged and there has not been a need for bond issue since January 2012. Fewer new loans and increased settlements can according to the Fund's opinion be mainly traced to increased participation of the commercial banks and pension funds in the mortgage market with unusually favorable interest rate terms. Unlike the commercial banks the Fund does not provide non-indexed loans but aims at offering such loans in coming months. Early settlement of loans parallel to reduced new loans has led to refinancing risk for the Fund. Refinancing risk due to customers' early settlement can have negative effect on interest margin but the scope of early settlement is not so extensive and has had limited effect thereon.

The allowance for impairment on loans amounted to ISK 20.6 billion at the end of June 2012 and has decreased by ISK 1.2 billion from the beginning of the year. Fair value changes of appropriated assets held for sale in the amount of ISK 1.1 billion were recognised in the interim financial statements in addition to the ISK 1.9 billion recognised on the one hand due to impairment losses related to debt value in excess of property value upon repossession, and on the other, due to allowance for impairment on loans. This is done in order to compensate for the various conditions of properties repossessed by the Fund. On 30 June, the amount of ISK 6.2 billion had been written off due to the 110% debt mitigation method in the years 2011 and 2012.

Around 15.1% of the Fund's loans are in payment suspension or in default at the end of June compared to 14.7% at the beginning of the year. During the period, the ratio of those in payment suspension has decreased whereas loans in default have increased. Total outstanding balance of the Fund's loans in default for more than 90 days amounts to ISK 101.7 billion or 13.3% of total loans, thereof the defaulted amount is ISK 6.3 billion.

From the beginning of the year, the Fund has repossessed 501 properties and sold 58. The Fund owned 2,049 properties at 30 June 2012. The properties are recognised at the estimated market value at the end of June. Thereof, 846 properties are rented out or 41% of total properties owned by the Fund.

In the notes to the Interim Accounts is a discussion on matters concerning ESA's observation regarding the Fund's operation and State Aid (see note 10).

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

In June 2012, the Icelandic parliament, Althingi, approved Act no. 84/2012 on amendments to the Housing Act. The main changes consist in significantly increased requirements regarding the necessary qualifications of board members and the CEO, increased requirements on internal audit and risk management. Furthermore, Articles 87 -96 of Act no. 161/2002 on financial undertakings, with the exception of paragraph 2 of Art. 91 of the Act, following the amendment, apply to the operation of the Housing Financing Fund. Furthermore, a few other amendments were made regarding the Fund's authorisation to grant loans to rental companies. In addition, the Housing Financing Fund is authorised to own a rental company for properties repossessed by the Fund. The Fund intends to establish a subsidiary to handle the income generating operation of repossessed properties in the second half of the year 2012.

Statement by the Board of Directors and the CEO

To the best of our knowledge the condensed interim financial accounts are in accordance with the International Financial Reporting Standard (IFRS) for interim accounts, IAS 34 and give a true and fair view of the financial performance of the Fund for the period January 1st to June 30th 2012, its assets, liabilities and financial position as at June 30th 2012 and its interim statement of cash flows for the period.

Further, in our opinion the condensed interim financial accounts and the endorsement by the Board of Directors and the CEO give a fair view of the development and performance of the Fund's operations and its financial position and fairly describes the principal risks and uncertainties faced by the Fund.

The Board of Directors and the CEO of the Housing Financing Fund have today discussed the Fund's interim financial accounts for the six-month period ended June 30th 2012 and confirm them by means of their signatures.

Reykjavik, 29 August 2012

The Board of Directors of the Housing Financial Fund

Jóhann Ársælsson
Sjöfn Ingólfssdóttir
Lárus Blöndal
Elín R. Líndal
Henný Hinz

The CEO

Sigurður Erlingsson

Independent Auditor's Review Report

To the Board of Directors of the Housing Financing Fund.

We have reviewed the accompanying condensed interim financial accounts of the Housing Financing Fund, which comprise the balance sheet as at June 30th, 2012 and the income statement and statement of comprehensive income, statement of changes in equity and statement of cash flows for the six-month period then ended, and a summary of significant accounting policies and other explanatory notes. Management is responsible for the preparation and fair presentation of this interim financial information in accordance with IAS 34 "Interim Financial Reporting". Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

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

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the accompanying condensed interim financial information is not prepared, in all material respects, in accordance with IAS 34 "Interim Financial Reporting".

Emphasis of matter

We would like to draw the attention to note no. 9, stating that the Fund's equity ratio, calculated according to provisions of the Rules on the Housing Financing Fund no. 544/2004, is 1.4% at the end of June 2012, but according to Article 7 of the Rules, the Fund shall set as a long-term goal to maintain its capital ratio over 5.0%. The Fund has been negotiating with the Minister of Welfare regarding solutions to reach that goal.

Reykjavik, 29 August 2012

KPMG ehf.

Margrét Guðjónsdóttir

Interim Income Statement and Statement of Comprehensive Income January 1st to June 30th 2012

	Notes	2012 1.1.-30.6.	2011 1.1.-30.6.
Interest income		49.470.187	46.233.313
Interest expense		(48.744.080)	(45.509.668)
Net interest income	5	726.107	723.645
Other income	6	529.565	286.341
Total operating income		1.255.672	1.009.986
Salaries and salary-related expenses		379.250	304.041
General operating expenses		939.416	617.633
Depreciation and amortisation		32.952	32.721
Total operating expenses		1.351.618	954.395
Net (operating expenses) operating income		(95.946)	55.591
Impairment of assets	8	(3.013.770)	1.506.218
Net (loss) profit for the period and comprehensive (loss) income		(3.109.716)	1.561.809

Interim Balance Sheet as at June 30th 2012

	Notes	30.6.2012	31.12.2011
Assets			
Cash and cash equivalents		4.036.121	3.962.556
Restricted cash		10.126.147	9.112.767
Treasury securities		33.582.823	33.495.031
Loans to banks		8.988.846	11.002.754
Loans to customers	8	789.415.840	782.052.561
Properties held for sale	7	29.082.229	22.486.684
Operating assets		72.204	78.390
Intangible assets		113.902	140.668
Other assets		1.144.019	1.639.875
Total assets		876.562.131	863.971.286
 Liabilities			
Bond issued		864.638.056	848.878.935
Other borrowings		5.181.413	5.288.670
Other liabilities		296.965	248.268
Total liabilities		870.116.434	854.415.873
 Equity			
Contributed capital		40.155.408	40.155.408
Accumulated deficit		(33.709.711)	(30.599.995)
Total equity	9	6.445.697	9.555.413
Total liabilities and equity		876.562.131	863.971.286

Interim Statement of Changes in Equity January 1st to June 30th 2012

	Contributed capital	Accumulated deficit	Total equity
Changes in equity from January 1st to June 30th 2011:			
Equity as at January 1st 2011	40.155.408	(31.586.134)	8.569.274
Net profit for the period and comprehensive income		1.561.809	1.561.809
Equity as at June 30th 2011	40.155.408	(30.024.325)	10.131.083
Changes in equity from January 1st to June 30th 2012:			
Equity as at January 1st 2012	40.155.408	(30.599.995)	9.555.413
Net loss for the period and comprehensive loss		(3.109.716)	(3.109.716)
Equity as at June 30th 2012	40.155.408	(33.709.711)	6.445.697

Condensed Interim Statement of Cash Flows for the Period from January 1st to June 30th 2012

	Notes	2012	2011
		1.1.-30.6.	1.1.-30.6.
Net cash provided by (used in) operating activities		14.393.163	(7.307.773)
Net cash provided by investing activities		285.721	483.636
Net cash used in financing activities		(14.605.319)	(10.427.659)
Net increase (decrease) in cash and cash equivalents		73.565	(17.251.796)
Cash and cash equivalents at the beginning of the year		<u>3.962.556</u>	<u>23.826.463</u>
Cash and cash equivalents at the end of the period		<u><u>4.036.121</u></u>	<u><u>6.574.667</u></u>

Notes to the Condensed Interim Accounts

1. Reporting entity

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

The condensed interim accounts of the Housing Financing Fund were approved by the Board of Directors on August 29 2012.

2. Statement of compliance

The condensed interim accounts have been prepared in accordance with IAS 34 Interim Financial Reporting. They do not include all of the information required for full annual financial statements and should be read in conjunction with the financial statements of the Fund as at and for the year ended December 31st 2011.

3. Significant accounting policies

The accounting policies applied by the Fund in these condensed interim accounts are the same as those applied by the Fund in its annual financial statements as at and for the year ended December 31st 2011. The financial statements are available on the Fund's homepage; www.ils.is as well as on the Icelandic stock exchange's homepage; www.omxnordicexchange.com.

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

4. Use of estimates and judgements

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

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

Notes, contd.:

5. Net interest income

	2012	2011
	1.1.-30.6.	1.1.-30.6.
Interest income		
Interest income and indexation on loans	46.491.691	44.470.811
Interest income on cash and cash equivalents and restricted cash	2.431.280	798.868
Government contribution to subsidy interests	289.258	279.845
Interest income on market securities	257.958	683.789
Total interest income	<u>49.470.187</u>	<u>46.233.313</u>
Interest expenses		
Interest expenses and indexation on bond issue	48.462.642	45.141.485
Interest expenses on other borrowings	281.438	368.183
Total interest expenses	<u>48.744.080</u>	<u>45.509.668</u>
Net interest income	<u>726.107</u>	<u>723.645</u>

6. Other income

Collection fee	79.952	83.405
Rental income on properties held for sale	449.613	202.936
Total other income	<u>529.565</u>	<u>286.341</u>

7. Properties held for sale

At the beginning of 2012 there were 1,606 properties owned by the Fund. During the first six months of the year 2012 the Fund repossessed 501 properties and sold 58. Thus, 2,049 properties are owned by the Fund at 30 June 2012. Thereof, 846 properties are rented out or 41% of total properties owned by the Fund. Income and expenses during the period in relation to properties held for sale are specified as follows:

Rental income on properties held for sale	449.613	202.936
Services and other expenses (due to all properties for sale)	(376.229)	(266.797)
Net income (expenses) on properties held for sale	<u>73.384</u>	<u>(63.861)</u>

8. Loans

Impairment losses on loans during the period are specified as follows:

	Specific impairment	General impairment	Total
1.1. - 30.6. 2012			
Balance at the beginning of the year.....	20.390.481	1.411.940	21.802.421
Impairment (impairment reversal) on loans.....	1.951.554 (3.458)	1.948.096
Loans write off.....	(3.197.571)	0 (3.197.571)
Balance at 30.6.2012.....	<u>19.144.464</u>	<u>1.408.482</u>	<u>20.552.946</u>
Allowance account as percentage of loans.....			2,5%
1.1. - 30.6. 2011			
Balance at the beginning of the year.....	29.648.558	1.651.803	31.300.361
Impairment reversal on loans.....	(3.479.069) (82.174)	(3.561.243)
Loans write off.....	(1.216.602)	0 (1.216.602)
Balance at 30.6.2011.....	<u>24.952.887</u>	<u>1.569.629</u>	<u>26.522.516</u>
Allowance account as percentage of loans.....			3,3%

Total impairment in the Income Statement is as follows:

	2012	2011
	1.1.-30.6.	1.1.-30.6.
Specific (impairment), impairment reversal on loans.....	(1.951.554)	3.479.067
General impairment reversal on loans.....	3.458	82.174
Total (impairment) impairment reversal on loans.....	<u>(1.948.096)</u>	<u>3.561.241</u>
Impairment on properties held for sale.....	(1.065.674)	(2.055.023)
Total (impairment) impairment reversal during the period.....	<u>(3.013.770)</u>	<u>1.506.218</u>

Notes, contd.:

9. Equity

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

Capital ratio is specified as follows:	30.6.2012	31.12.2011
Capital according to the interim financial accounts	6.445.697	9.555.413
Intangible assets	(113.902)	(140.668)
Capital base	<u>6.331.795</u>	<u>9.414.745</u>
Total capital ratio is as follows:		
Credit risk	35.528.108	32.857.747
Market risk	204.972	54.889
Operational risk	471.299	471.299
Total capital requirements	<u>36.204.379</u>	<u>33.383.935</u>
Capital ratio	1,4%	2,3%

10. Other matters

Letter of credit for loans to contractors

In the year 2010, the District Court of Reykjavík ruled in two cases where the conclusion is that the Housing Financing Fund's Board of Directors was not authorised to insist upon a letter of credit for loans to contractors during a period when such rules had been eliminated from the Regulation. The period in question is from February 21, 2008 to April 24, 2009, during which the Board of Directors' work procedures were in effect regarding evaluation of debtor's ability to pay and mortgage eligibility, wherein a requirement was made for a letter of credit for loans to contractors. The rules were published on the website of the Fund along with other rules of procedures regarding pledgeability and credit evaluation, which the Board is to establish according to the Housing Act. In the preamble for the ruling it is specifically pointed out that the guarantees remain valid. The ruling of the District Court was confirmed by the Supreme Court on May 10 this year based on the presumptions. The Housing Financing Fund has following thereto received 10 claims from contractors who took these loans during that period and the Fund has agreed to pay the fee for bank guarantees for the aforementioned period with interests. However, the Fund has rejected payment obligation with respect to the bank guarantee fee after the provision on collection of the fee had been established in the law. Two parties have now subpoenaed the Fund for payment of the fee for periods after the provision on the bank guarantee had been enacted. The cases will be filed in September.

Investigation of Housing Financing Fund

An investigation on the Housing Financing Fund, approved by the Icelandic parliament on December 17, 2010 is being carried out. The following parties are on the investigation committee: Sigurður Hallur Stefánsson, former District Court Judge, President of the committee, Kirstín Flygenring, economist and Jón Þorvaldur Heiðarsson, lecturer at the faculty of business administration of the University of Akureyri. The aim with the investigation is to investigate the Fund's operation from when it was established at the beginning of the year 1999. The aim with the investigation is mainly to evaluate the effect of changes in housing matters, 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 Icelandic 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 ministries and during the year it was also decided to investigate the Fund's operating expenses from the beginning. Considerable work has been carried out by the Fund in providing documents and information to the committee and that work has not yet been concluded. Interviews with the Fund's employees are being carried out and according to information from members of the committee the committee intends to conclude that work before the end of the year.

Notes, contd.:

10. Other matters, contd.:

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. The Government sent proposed changes to the future role of the Fund to ESA in October last year. In the Government's proposed changes emphasis is placed on maintaining the Fund's role for the most part unchanged however establishing certain limits for loans to major assets in addition to stricter requirements regarding loans to legal entities. Amendments have now been made to the Housing Act in order to meet with these comments. Final approval by the ESA for state aid consisting mainly in equity contribution from the State to the fund in the year 2011 was subject to conditions on the Fund's future role and financial restructuring. A plan on financial restructuring was delivered to ESA in January this year. ESA has requested for further clarifications regarding that plan which the Fund is currently working on. Furthermore, the Fund is working on answers to ESA regarding the Icelandic Financial Services Association's comments on the amendment to the law.

