Housing Financing Fund

Financial Statements 2011

Housing Financing Fund
Borgartúni 21
105 Reykjavík

Reg.no. 661198-3629

Contents

Endorsement and Statement by the Board of Directors and the Managing Director

Operations in the year 2011

The Housing Financing Fund´s profit for the year amounted to ISK 986 million according to the income statement. The Fund's interest margin remained unchanged in the year 2011. Equity at year-end amounted to ISK 9,555 million according to the balance sheet. The Fund´s equity ratio, which is calculated on the basis of regulation no. 544/2004 on the Housing Financing Fund, is 2.3%. The ratio is calculated on the basis of the same method 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 2011 are mainly affected by extensive work related to processing of customers' debt difficulties, operation of repossessed properties, organisational changes and impairment. Therefore, full-time equivalent units increased to 92 at year end 2011 in order to manage the increased work load. In addition to increased salary expenses increased cost can be explained by significant new cost items, e.g. statutory participation in the expenses of the Debtors' Ombudsman and expenses due to evaluation of real estates with respect to the 110% solution.

In the first quarter of the year 2011, implementation of decisions regarding organisational changes made in October 2010 was finalized. The position of the assistant managing director was cancelled but head of department positions were increased from five to seven. As a result, the focus was placed on different segments and changed circumstances were taken into account. The Government´s solution of reducing housing debt to 110% of the market value of the assets and increased repossession of properties had the most effect on the increase in employees during the year. Other emphasis in the operation was aimed at improving loan procedures, increasing efficiency of control systems and improving information flow for decision making.

At year-end, loans to customers amounted to ISK 782,053 million and increased by ISK 30,772 million during the year. The Fund's borrowings amounted to ISK 854,168 million and increased by ISK 27,191 million during the year. Financing durign the year was successful, with an excess demand in all of the tenders offered by the Fund. The required rate of return in the market continued to decrease but due to interaction of loans and settlements the prepayment fee in statutory pricing of loans increased and loan interests remained unchanged during the entire year.

At year-end 2010, a provision for impairment on loans in the amount of ISK 22,762 million was recognised due to the write-down of individuals' loans down to 110% of the rateable value of assets. The Fund received fewer applications for this solution than expected and final write-down due to this solution is estimated at ISK 7,800 million. Still, many customers have apparent payment difficulties without having applied for the 110% solution or other official resources, which has been taken into account in a provision for impairment on loans. A comprehensive analysis of all of the Housing Financing Fund's customers that are legal entities revealed that there is further need for impairment. Therefore, a precautionary write-down was transferred between individuals and legal entities. As a result, contributions remain virtually unchanged from the previous year.

At the beginning of the year 2011, the Fund had approximately ISK 16,620 million in claims against Iceland’s three biggest commercial banks by the time they collapsed in early October 2008, resulting from bonds and derivative contracts entered into with the banks. At the same time, the Fund owed these banks ISK 5,342 million due to derivatives and HFF bonds. A total of ISK 1,987 million is recognised in the line item loans to banks in the balance sheet at year end 2011 (see note 9). In the financial statements it is presumed that the Fund has 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. However, rulings have been issued which support the Fund's arguments. The Fund's loss could therefore change upon final settlement.

Endorsement and Statement, contd.:

The Housing Financing Fund's portfolio of repossessed assets increased considerably during the year and at year end the Fund held 1,606 properties, thereof 642 were rented out. The Housing Financing Fund sold 154 assets in the year 2011. The Fund's rental income currently covers all direct operating expenses on repossessed assets, 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. This is due to provisions of the Competition Act, regional availability of rental properties and the condition of the properties. The establishment of an independent rental company, 100% owned by the Housing Financing Fund, is being considered but the aim with such company would be to focus on the operation of income generating assets and assets available for sale, as well as ensuring full separation between loan operation and rental operation. It is not the role of the Housing Financing Fund to carry on rental activity and if such company will be established it will at a certain point be sold out of the Fund.

The Fund´s main risk factors are credit risk, liquidity risk, interest rate- and indexation risk, duration imbalance, prepayment risk, refinancing risk and operational risk. Counterparty- and currency risk are also considered to be one of the Fund´s financial risks. The capital injection from State Treasury in the form of goverment treasury bond in the series RIKH18 1009 increased the Fund´s indexation imbalance. An agreement was reached with the State Treasury to swap the bond for indexed goverment treasury bond RIKS 30 0701 causing indexation imbalance to decrease. The swap will strenghten the Fund´s interest spread.

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 market. The Fund's financing, which is mainly in the form of HFF bonds which are not prepayale. However the Fund can buy bak its outstanding bonds in the secondary market. Under the current circumstances there is an increased demand for non-indexed interests and long-term interests are close to a historical low and therefore the effect of settlements is more extensive than usual.

On 27 March 2012, a bill of law was presented in the Parliament stipulating that the Fund shall be placed under the same surveillance as other financial undertakings by transferring selected sections of Act no. 161/2002 on Financial Undertakings under the Housing Act no. 44/1998. Thereby, emphasis would be placed on the Fund's social role and further requirements would be made with respect to its internal operation. The Housing Financing Fund has in the year 2011 provided more information to the Financial Supervisory Authority than what is stipulated by law, aimed at strengthening its internal operation.

The ESA (EFTA Surveillance Authority) has discussed and confirmed that an ISK 33,000 million state aid is legal, though with the reservation that a draft of the reorganization of the Housing Financial Fund into a social and competitive operation shall be available by the end of September 2011. Such notification was sent to the ESA in October 2011 and in January 2012 a 5 year financial plan was sent to ESA showing the Fund's long-term going concern status. The Fund awaits the ESA's response in this matter.

Governance

The Board of Directors of the Housing Financing Fund is nominated by the Minister of Welfare for a four year period. The Board consists of five members and five reserve members and the Minister of Welfare nominates a Chairman and Reserve Chairman amongst Board members. A new Board of Directors was appointed at the beginning of

Endorsement and Statement, contd.:

The Board of Directors of the Housing Financing Fund emphasizes on maintaining good governance. The Board of Directors of the Fund has established detailed working procedures in which its competences are defined. The Board hires a Managing Director and establishes the job description. From the year 2010 Senior Civil Servants Salary Board determines the Managing Director´s salaries but previously Managing Director´s salaries were determined by the Board of Directors. The Board of Directors also meets with the Fund's auditors on a regular basis. The Icelandic National Audit Office handled the Fund's internal audit in the year 2011. The Board of Directors supervises that all information required by law and regulations are remitted to the Icelandic Financial Supervisory Authority, the Icelandic Central Bank and other authorities at the appointed time. The Board of Directors also makes decisions regarding all unusual and substantial matters. In the year 2011, the Board of Directors held 23 Board meetings and had a half day long meeting 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 liqutity management. The Committee has meeting regularly at least monthly and it´s minutes are reviewed by 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 standard and meets monthly. A Leagal Entity Loan Committee reviews all loan applications before they are presented to the Board to be processed. The Leagal Entity Loan Committee will be granted authority in the year 2012 to approve loan applications up to a limit. The Board will process loans above the limit. In the year 2011 a Write-off Committee was established to process all write-off on loans related to the 110% measure, the Committee will complete it´s work in the year 2012.

The Fund allocates grants every year for technical innovations and other improvements in the Construction Industry according to the Housing Act and chapter 7 in reglulation no. 57/2009. The applications are valued by a special committee which the Board appoints.

The Fund and the Ministry of Wellfare interact monthly where all the Fund´s main affairs are discussed.

Statement by the Board of Directors and the Managing Director

The financial statements of the Housing Financing Fund for the year 2011 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 2011, its assets, liabilities, and financial position as at 31 December 2011 and its cash flows for the year 2011.

Further, in our opinion the financial statements and the Endorsement by the Board of Directors and the Managing Director include a fair view on the Fund's operating development and results, its standing and describes the Fund's main risk exposures.

The Board of Directors and the Managing Director of the Housing Financing Fund have today discussed the Fund's Financial Statements for the year 2010 and hereby confirm them by means of their signatures.

Reykjavik, 28 March 2012.

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 December 31, 2011, and the income statement and statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory notes.

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 misstatement, 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 relevant ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free of 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 entity'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 December 31 2011, 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 2.3% at year end 2011. However, 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 to 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, we confirm that, to the best of our knowledge, the report of the Board of Directors accompanying the financial statements includes the information required by the Financial Statement Act if not disclosed elsewhere in

Reykjavik, 28 March 2012.

KPMG ehf.

Margrét Guðjónsdóttir

Income Statement and Statement of Comprehensive Income for the year 2011

	Notes	2011	2010
Interest income		81.735.358	57.775.695
Interest expense		(78.997.610)	(55.260.696)
Net interest income	11	2.737.748	2.514.999
Other income	12	702.627	435.042
Total operating income		3.440.375	2.950.041
Salaries and salary-related expenses	13	652.518	487.624
Other operating expenses	15	1.462.496	864.478
Depreciation and amortisation	19	67.585	55.173
Total operating expenses		2.182.599	1.407.275
Net operating income		1.257.776	1.542.766
Impairment on loans and receivables	5b, 9	(271.637)	(36.056.088)
Profit (loss) for the year and comprehensive income (loss)		986.139	(34.513.322)

The notes on pages 11 to 30 are an integral part of these financial statements.

Amounts are in ISK thousand

Balance Sheet as at 31 December 2011

	Notes	2011	2010
Assets			
Cash and cash equivalents	6	3.962.556	23.379.092
Restricted cash	6	9.112.767	8.331.053
Receivable due from State Treasury	2	0	33.000.000
Treasury securities	7	33.495.031	2.049.593
Loans to banks	8	11.002.754	1.987.122
Loans to customers	5b	782.052.561	751.280.719
Properties held for sale	16	22.486.684	15.029.172
Operating assets	17	78.390	54.743
Intangible assets	18	140.668	189.022
Other assets		1.639.875	663.325
Total assets		863.971.286	835.963.841
Liabilities			
Bond issued	20	848.878.935	820.310.099
Other borrowings	21	5.288.670	6.666.266
Other liabilities		248.268	418.202
Total liabilities		854.415.873	827.394.567
Equity			
Contributed capital	2	40.155.408	40.155.408
Accumulated deficit		(30.599.995)	(31.586.134)
Total equity		9.555.413	8.569.274
Total liabilities and equity		863.971.286	835.963.841

The notes on pages 11 to 30 are an integral part of these financial statements.

Amounts are in ISK thousand

Statement of Changes in Equity for the year 2011

Year 2010	Contributed capital	(Accumulated deficit) Retained earnings	Total equity
Equity as at 1 January 2010	7.155.408	2.927.189	10.082.597
Increase in contributed capital	33.000.000		33.000.000
Loss for the year and comprehensive loss		(34.513.322)	(34.513.322)
Equity as at 31 December 2010	40.155.408	(31.586.133)	8.569.275

Year 2011			
Equity as at 1 January 2011	40.155.408	(31.586.133)	8.569.275
Profit of the year and comprehensive income		986.139	986.139
Equity as at 31 December 2011	40.155.408	(30.599.994)	9.555.414

The notes on pages 11 to 30 are an integral part of these financial statements.

Amounts are in ISK thousand

Statement of Cash Flows for the year 2011

	Notes	2011	2010
Cash flows from operating activities			
Profit (loss) of the year and comprehensive income (loss)		986.139	(34.513.322)
Adjusted for:			
Indexation on loans to banks, loans to customers and borrowings		1.731.703	1.213.553
Depreciation and amortisation		67.585	55.173
Impairment on loans and receivables		271.637	36.056.088
Changes in operating assets and liabilities:			
Loans to customers		(5.034.646)	(10.649.475)
Properties held for sale		(7.457.512)	(12.179.368)
Other assets		(976.551)	(644.207)
Other liabilities		(169.935)	334.529
Cash flows (to) operating activities		(10.581.580)	(20.327.029)
Cash flows from investing activities			
Loans to banks		(8.676.225)	2.371.705
Treasury securities		3.345.536	0
Restricted cash		(781.714)	(548.431)
Investment in operating assets and intangible assets		(42.878)	(87.631)
Investing activities		(6.155.281)	1.735.643
Cash flows from financing activities			
Bond issues and other borrowings, repayments		(23.971.960)	(43.250.611)
Bond issues and other borrowings, issues		21.292.284	64.619.026
Financing activities		(2.679.676)	21.368.415
(Decrease) increase in cash and cash equivalents		(19.416.537)	2.777.029
Cash and cash equivalents at the beginning of the year		23.379.092	20.602.063
Cash and cash equivalents at 31 year-end..		3.962.555	23.379.092

Investing and financing activities without cash flow effect:

	2011	2010
Receivable due from State Treasury	0	33.000.000
Increase in contributed capital	0	(33.000.000)

The notes on pages 11 to 30 are an integral part of these financial statements.

Housing Financing Fund for the year 2011 10 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 development in Iceland. The Housing Financing Fund is an independent institution owned by the State and appertains to a special management and the Minister of Welfare. According to the law, the Icelandic State Treasury guaranties all of the Fund’s financial obligations.

2. Receivable due from State Treasury

With the passing of the Supplementary Budget Act for 2010, the Minister of Finance was provided the permission to enhance the capital position of the Fund by means of capital injection amount up to ISK 33,000 million. This contribution was paid in in March 2011 by means of government bonds.

3. Basis of preparation

a. *Statement of compliance*

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU.

The financial statements of the Housing Financing Fund were approved by the Board of Directors on 28 March 2012.

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 the financial statements in conformity with IFRSs requires management to make judgements, estimates and assumptions, which affect the application of accounting policies and the reported amounts of assets and liabilities, 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.

Information about significant areas of estimation uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amounts recognised in the financial statements are described in note no. 4 e (v).

e. *New standards and interpretations not yet adopted*

A few new standards, amendment to standards and interpretations have not taken effect by year-end 2011 and have not been applied in the preparation of the financial statements. It is not expected that those standards, amendments and interpretations will have a significant effect on the Fund´s financial statements when they come into force, except for IFRS 9 Financial Instruments. IFRS 9 will be applicable from the beginning of 2015 if endorsed by the EU. The potential impact of IFRS 9 on the Fund´s operations has not been evaluated.

4. Significant accounting policies

The accounting policies set out below have been applied consistently 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 income.

a. *Interest income and interest expense*

Interest income and expense are recognised in the income statement using the effective interest method. 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. Interest income is calculated on loans. Interest expense is calculated on bond issues and other borrowings. 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.

Indexation of inflation-indexed assets and liabilities are recognised in full in the income statement as they accrue and are recognised as a part of book value 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 borrowings and lending rates each year (see note no. 11). The aforementioned loans to rental apartments are 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 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 8.000 million granted in the years 2001-2009 for social benefits were compensations do not apply.

The effective interest rate is the rate that exactly discounts the estimated future cash payment and receipts through the expected life of the financial asset or liability, or where appropriate, a shorter period, to the carrying amount of the financial asset or liability. The effective interest rate is established on initial recognition of the financial asset and liability and is not revised subsequently. When calculating the effective interest rate the Fund estimates future cash flows considering all contractual terms of the instrument but not future credit losses.

Interest income and interest expense in the income statement consist of:

- Interest income on loans and interest expenses on borrowings using the effective interest method.

- Interest income on deposits and market securities using the effective interest method.

b. *Other income*

Other income consists of collection charges and rental income from repossessed apartments on mortgages foreclosed. Other income is recognised in the income statement when accrued. Borrowing fees are included in the calculation of effective interest rate and are not included in other income, but interest 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 financial liabilities

(i) Recognition and derecognition of financial assets and liabilities

The Fund initially recognises financial assets and liabilities on the date that they are originated. Those assets and liabilities are initially recognised on the date at which the Fund becomes a party to the contractual provisions of the instrument, 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 effective value creation by issue of bonds the Fund has entered into agreements with a market maker 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 collaterals are not capitalized in the Fund's books 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 presented in the balance sheet when, and only when, the Fund has a 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 at initial recognition, minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between the initial amount recognised and the maturity amount, minus any reduction for impairment.

(iv) Fair value measurement

The determination of the fair value of financial assets and financial liabilities quoted in an active market is based on quoted prices. For all other financial instruments fair value is determined by using valuation techniques. A market is considered active if quoted prices are readily and regularly available and those prices represent actual and regularly occurring market transactions on an arm's length basis.

(v) Impairment of financial assets

The carrying amount of the Fund´s financial assets is reviewed at each balance sheet 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.

Two methods are used to calculate impairment losses, one based on an assessment of individual loans and the other based on a collective assessment. Losses expected as a result of future events, no matter how likely, are not recognised.

Objective evidence of impairment include information about the following events and conditions:

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

4. Significant accounting policies, contd.:

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

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 balance sheet 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 cash flows discounted with the assets´ original effective interest rate. Impairment losses are recognised in profit or loss and reflected in an allowance account. At each balance sheet date, the fund assesses whether there is any objective evidence of impairment in individual loans.

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. This loss covers loans that are impaired at the balance sheet date but which will not be individually identified as such until at some time in the future.

The collective impairment loss is determined by taking into account:

- historical loss experience in portfolios of similar risk characteristics,
- the estimated period between a loss occurring and that loss being identified and recognised by the establishment of an allowance against the loss on an individual loan,
- 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.

Estimates of changes in future cash flows for groups of assets 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 future cash flows 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 recognised as revenue in the income statement.

e. *Cash and cash equivalents*

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

f. *Treasury bonds and loans to banks*

Loans to banks consist of government treasury bonds 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 to customers*

Loans are financial assets with fixed or determinable payments that are not quoted in an active market. Loans and receivables include loans to customers, loans provided by the Fund in cooperation with other credit institutions 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. Then, the loans ara 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 classified as properties held for sale and recognised at the lower of cost or net fair value. The fair value is determined as the market value of the property, if available, or the rateable value. Assets that have been repossessed by the Fund are all available for sale. The Fund has entered into short term rental agreements on 642 properties available for sale at year end 2011 (2010: 346).

If the fair value of a property available for sale decreases after its initial recognition the fair value decrease is expensed as impairment on loans and receivables.

i. *Operating assets*

Operating assets are recognised at cost less accumulated depreciation.

Depreciation

Depreciation is recognised inthe income statement on a straight-line basis over the estimated useful life until residual value is reached. Estimated useful lives are 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 and its web site. Intangible assets are amortised on a straight-line basis over the estimated useful life, which is 5 years.

k. *Issued bonds and other borrowings*

Issued bonds and other borrowings are initially recognised at fair value, which is the amount borrowed including 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. *Other assets and liabilities*

Other assets and liabilities are measured at cost.

m. *Equity*

The Fund´s equity consists of contributed capital and retained earnings (accumulated deficit). The accumulated earnings or loss of the Fund from its establishment is recognized in retained earnings.

5. Financial Risk Management

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

It is important for the Fund to maintain a balance in the composition of its borrowings and loans. Following are the risks that the Fund is exposed to which are of importance:

- Credit risk
- Liquidity risk
- Interest rate risk - Prepayment risk
- Operational risk

The following include general information on the Fund's financial risk management, in addition to information about 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. Financial 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. The Fund aims at limiting financial risk and cost in accordance with its operating goals.

Risk management

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. Risk management experts shall operate within these limits. The Fund appoints a Financial Committee consisting of the Managing Director, Financial Director in addition to 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 organization.
- Nominates a financial committee.
- Remits reports to the Minister of Welfare.

Managing Director

- Responsible for 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 on loan interests.

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 policy.
- 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.

b. *Credit risk*

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

5. Financial Risk Management, contd.:

Solutions for the Fund’s clients’ payment difficulties

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

Debt mitigation is a solution bound by law for individuals, who have serious difficulties in meeting their financial obligations and do not expect to be able to do so in the immediate future. Specific debt mitigation is intended for those who have the ability to pay on their mortgage claims corresponding to the value of the property but have negative equity balance. Both of these solutions assume, in main respect, that during the agreement term, which is 1-3 years, the debtor pays on the claims corresponding to the value of the property and if he honors the agreement, claims in excess of the property value will be cancelled or written off, based on the circumstances. These solutions can create some deviation in the Fund's payment flow. Also,virtually all specific debt mitigation solutions for individuals assume a write off of mortgage claims in excess of the market value of assets, should the applicant fulfill all the requirements of the agreement. The Fund has had to hire more employees to handle these matters. On the Fund's website there is a discussion about solutions for financial difficulties.

Credit risk management

All of the Fund´s loans 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 Risk Management Division evaluates the credit risk on an ongoing basis and prices it when deciding the interest rates on loans, which represent a markup on the interest rates on the Fund´s liabilities.

As insurance for securities loans 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 110% in these transactions.

Credit risk exposure

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

	Loans to individuals		Loans to leagal entities		Total	
	2011	**2010**	**2011**	**2010**	**2011**	**2010**
Loans past due:						
1-30 days..................	776.658	361.867	122.984	21.547	899.642	383.414
31-60 days................	455.973	355.263	278.639	195.841	734.612	551.104
61-90 days................	345.988	270.690	101.726	78.631	447.714	349.321
Past due over 90 days	3.940.377	2.366.181	2.298.411	1.500.198	6.238.788	3.866.379
Total........................	5.518.996	3.354.001	2.801.760	1.796.217	8.320.756	5.150.218
Remainder of loans:						
Past due....................	113.716.430	99.780.004	46.332.864	36.271.847	160.049.294	136.051.851
Not past due............	514.551.138	527.767.191	120.933.793	113.611.820	635.484.931	641.379.011
	628.267.568	627.547.195	167.266.657	149.883.667	795.534.225	777.430.862
Loans total..............	633.786.564	630.901.196	170.068.417	151.679.884	803.854.981	782.581.080
Impairment:						
Specific impairment	(5.857.480)	(22.857.101)	(14.439.958)	(6.791.457)	(20.297.438)	(29.648.558)
General impairment	(1.504.983)	(1.355.489)	0	(296.314)	(1.504.983)	(1.651.803)
Impairment total	(7.362.463)	(24.212.590)	(14.439.958)	(7.087.771)	(21.802.421)	(31.300.361)
Book value	626.424.101	606.688.606	155.628.460	144.592.113	782.052.560	751.280.719

Financial Statements of the Housing Financing Fund for the year 2011 17 Amounts are in ISK thousand

5. Financial Risk Management, contd.:

b. *Credit risk, contd.:*

	Loans to individuals		Loans to leagal entities		Total	
	2011	2010	2011	2010	2011	2010
Lost collaterals*	6.285.605	4.763.122	3.785.740	2.739.910	10.071.345	7.503.032

* Total value of loans fully written off as pledges have been lost.

Risk of loss on financial assets not recognised in the financial statements:	2011	2010
Loan obligations at year-end	4.413.708	1.132.517

Impairment losses on loans

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 and is based on the professional judgement of staff and managers of the Fund and has been 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. If the settlement value of a loan is higher than one of the following three items: rateable value, estimated market value of pledges or the solvency of a legal entity, a specific provision for impairment is recognised.

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 calculated in accordance with loss experience.

Write off on loans

Loans are written off under the following circumstances:

i) Upon loss on the sale of apartments auctioned, which the sales value is lower than the valuation off the apartment, according to Article 57 of law 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 receivables that have lost their pledges.

Impairment on loans is specified as follows:	Specific impairment	General impairment	Total 2011
2011			
Balance at the beginning of the year	29.648.558	1.651.803	31.300.361
Provision for impairment losses	(912.768)	(239.863)	(1.152.631)
Write offs	(8.345.309)	0	(8.345.309)
Balance at year-end	20.390.481	1.411.940	21.802.421
Impairment on loans as a percentage of loans			2,75%

Financial Statements of the Housing Financing Fund for the year 2011 18 Amounts are in ISK thousand

5. Financial Risk Management, contd.:

b. *Credit risk, contd.:*

	Specific impairment	General impairment	Total 2010
2010			
Balance at the beginning of the year	500.000	768.591	1.268.591
Provision for impairment losses	34.791.210	883.212	35.674.422
Write offs	(5.642.652)	0	(5.642.652)
Balance at year-end	29.648.558	1.651.803	31.300.361
Impairment on loans as a percentage of loans			4,16%

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

	2011	2010
(Decreased contribution) contribution due to specific provision for impairment on loans to individuals	(16.904.238)	20.707.631
Provision for impairment losses of loans to legal entities	7.646.161	8.440.927
(Decreased contribution) contribution due to general impairment	(239.863)	883.212
Write down due to the 110% solution and loans written off	8.345.309	5.642.652
Total (decreased contribution) contribution to provision for impairment	(1.152.631)	35.674.422
Fair value of properties available for sale	1.361.389	0
Write down of other receivables	62.879	16.666
Write down of loans to banks (see note 9)	0	365.000
Total impairment	271.637	36.056.088

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 valuation of a possible impairment loss. Requirements for general housing loans are that a binding purchase offer has been made, which in general may be equaled 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. 62% at year end 2011 compared to 64% at year end 2010. 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:

	2011	2010
Proportion of the total loans under 50% of the rateable value	62%	60%
Proportion of the total loans from 51% - 70% of the rateable value	15%	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	4%	4%
Proportion of the total loans from 100% - 110% of the rateable value	3%	3%
Proportion of the total loans over 110% of the rateable value	5%	7%
	100%	100%

Counterparty risk related to securities transations

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

	2011	2010
Lent own bonds, market value	8.035.380	2.293.320
Market value of pledges provided by counterparties	8.928.200	2.545.209

Financial Statements of the Housing Financing Fund for the year 2011 19 Amounts are in ISK thousand

5. Financial 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 endeavors 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 strategy. The Fund's liquidity strategy is determined one year a head in terms of operating and financial budget. The liquidity strategy is updated on a regular basis. A short term strategy 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
December 31, 2011					
Financial assets:					
Cash and cash equivalents	3.962.556				3.962.556
Restricted cash...........................	9.112.767				9.112.767
Treasury securities......................	1.797.824	10.924.017	22.684.024		35.405.865
Loans to customers and loans to 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	1.471.921.006
Binding loan commitment...........	903.708		3.510.000		
Total financial liabilities.................	20.501.743	60.369.305	293.449.227	1.102.014.440	1.471.921.006
Nettó staða.................................	19.692.294	(857.185)	(28.286.636)	192.244.380	187.206.561
December 31, 2010					
Financial assets:					
Cash and cash equivalents	23.379.092				23.379.092
Restricted cash...........................			8.705.950		8.705.950
Treasury securities......................	2.049.593				2.049.593
Loans to customers and loans to banks	10.366.847	37.695.226	297.891.420	1.210.520.562	1.556.474.055
Total financial assets....................	35.795.532	37.695.226	306.597.370	1.210.520.562	1.590.608.690
Financial liabilities:					
Borrowings and other liabilities....	18.937.947	55.753.323	324.148.823	930.980.568	1.329.820.661
Binding loan commitment...........	1.132.517				
Total financial liabilities.................	20.070.464	55.753.323	324.148.823	930.980.568	1.329.820.661
Net balance................................	15.725.068	(18.058.097)	(17.551.453)	279.539.994	259.655.512

Financial Statements of the Housing Financing Fund for the year 2011 20 Amounts are in ISK thousand

5. Financial Risk Management, contd.:

c. *Liquidity risk, contd.:*

The table above shows the agreed upon cash flow of loans and borrowings of the Fund, including both payments and agreed upon interests but not budgeted future inflation. Cash and cash equivalents of the Fund that can be used to meet temporary imbalance in cash flows of financial assets and liabilities, are in the first time 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 sell 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 interbank loans and treasury bonds which are listed on an active market (see notes 7 and 8). Additionally, both the loans and borrowings of the Fund carry a fixed interest rate. If a balance is not ensured interest rate changes affect the Fund's net interest income. The Fund's financial and risk management is responsible for managing this risk and ensuring that the difference stays within set limits according to the Fund's financial and risk management policies. The average duration of financial assets at year end 2011 is 11.3 years (2010: 10.5 years) and financial liabilities 10.5 years (2010: 10.3 years). According to the Fund's financial and risk management policy the difference may be up to 0.9 years.

Interest rate risk management

The financial committee evaluates the risk that the Fund is exposed to due to prepayment risk and rates it when the Fund's loan interests are determined. In order to further reduce this risk the Fund also offers loans with a prepayment fee, carrying lower interests than those without such fee. The real rate of prepayment is calculated on a monthly basis along with estimates about prepayment ratios. On the basis of estimated prepayments the Fund continuously reviews its financing when necessary aiming at limiting the interest sensitivity of its asset portfolio.
Weighted average interest on the Fund´s borrowings at year-end 2011 was 4.299% (2010: 4.340%), but the weighted average interest on loans was 4.572% (2010: 4.614%) and thus the interest-rate differential on borrowings and loans is 0.273% (2010: 0.274%). Due to increase in the Fund´s loan defaults since the financial crash in autumn 2008 the Fund has raised the interest premium, i.e. the difference between interest on loans and interest on borrowings.

Borrowers have in some instances a permission to repay their loans without having to pay any special fee. Such permission is not available on the Fund's borrowings except for housing bonds. Therefore, the balance between the average duration of financial assets and financial liabilities can be disrupted. This incurs refinancing risk, and therefore interest rate risk.
Around 206.5 million of the Fund´s loans are covered totally or partly with a prepayment fee if the borrower decides to prepay it´s loan before maturity date. Interest and reinvestment risk related to prepayments must be considered substantial while interest rates remain low on the market. Some actions are being taken to limit these risks.

Non-interest bearing assets

When the Fund repossesses an apartment on a foreclosed mortgage, the loan ceases to be interest bearing from the date of claim. At year-end 2011, the Fund owned 1,606 apartments for sale (2010: 1,069) at book value ISK 22,487 million (2010: ISK 15,029 million). The Fund´s claims on the Icelandic banks and other financial institutions, related to the financial crisis, amounted to ISK 1,987 million at year-end 2011 (2010: ISK 1,987 million). Non-interest bearing assets amount to ISK 24,474 million at year end 2011 (2010 ISK 17,016 million).

Indexation risk

Indexation risk is the risk of changes in fair value and cash flows of indexed financial assets and liabilities due to fluctuations in the consumer price index (CPI). Most of the Fund´s loans are indexed and funded by issuance of indexed bonds. For the most part, indexation risk arises from cash and cash equivalent financial assets that the Fund is required to hold in accordance with its financial- and risk management policy. Indexation risk is monitored by calculating the sensitivity of indexed financial assets and liabilities to changes in CPI.

5. Financial Risk Management, contd.:

		2011	2010
Financial assets:			
Loans		780.188.180	750.639.485
Treasury bonds and other assets		42.725.693	12.459.341
Financial assets total		822.913.873	763.098.826
Financial liabilities:			
Bond issues		848.878.935	820.310.099
Other borrowings		5.179.418	6.666.266
Financial liabilities total		854.058.353	826.976.365
Total indexation balance		(31.144.480)	(63.877.539)

Non-indexed liabilities in excess of non-indexed assets at year-end 2011 amounted to ISK 31.1 billion (2010: 63.9 billion). Based on year-end position and assuming that all other variables remain constant a five percent inflation calculated over a period of one year would have adverse impact on the Fund´s results amounting to ISK 1,145 million (2010: 1,283 million). The calculation is based on the difference between non-indexed interests of underlying assets and annual inflation.

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 minimize its business risk. The preventive methods include clear and documented procedures regarding all the Fund´s major operations, training of employees, data back-up, access control, and so on. Head of departments are responsible for the management of operational risk of their department and monitor the operational risk as well as their staff.

f. *Equity and capital management*

The Fund's long term objective is to maintain an solvency ratio over 5%. The calculation of solvency ratio is in accordance to international rules (Basel II). If the Fund's solvency ratio falls below 4% 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 solvency ratio goal.

Solvency ratio is specified as follows:	2011	2010
Total equity according to the financial statements	9.555.413	8.569.274
Intangible assets	(140.668)	(189.022)
Equity base	9.414.745	8.380.252

Total equity requirement is specified as follows:

Credit risk	32.857.747	30.226.708
Market risk	54.889	77
Operational risk	471.299	446.646
Total capital requirements	33.383.935	30.673.431
Solvency ratio	2,3%	2,2%

It is assumed that the Fund will be granted an additional contribution in order to reach its long term goal of 5% equity ratio in the supplementary national budget for the year 2012.

Amounts are in ISK thousand

6. Cash and cash equivalents

	2011	2010
Unrestricted cash in Central Bank	3.343.476	20.208.121
Unrestricted cash in other financial institutions	619.080	3.170.971
Cash and cash equivalents total	3.962.556	23.379.092
Restricted cash in Íslandsbanki hf.	9.112.767	8.331.053
Restricted cash total	9.112.767	8.331.053

Restricted cash is available for payment in January 2012.

7. Treasury bonds

Treasury bonds are specified as follows:

	2011	2010
Treasury bonds at fair value	1.797.824	2.049.593
Treasury bonds without active market recognised at cost	31.697.207	0
Total receivable from credit institutions	33.495.031	2.049.593

8. Loans to banks

Loans to banks are specified as follows:

	2011	2010
Inter-bank loans	9.015.632	0
Receivable from credit institutions related to the financal collapse (see note 9)	1.987.122	1.987.122
Loans to banks total	11.002.754	1.987.122

9. Impairment on claims on banks

The Fund had approximately ISK 16,620 million outstanding receivable from Iceland's three biggest banks that collapsed in early 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. During 2009, the Financial Supervisory Authority suspended the Boards of SPRON and Straumur-Burðarás Investment Bank and appointed Resolution Committees for the banks. According to the decision of the Resolution Committees, deposits of ISK 5,254 million where withheld in closed accounts. A total of ISK 11,154 million has been impaired due to these claims. In the financial statements it is presumed that the Fund has 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. There is still a dispute regarding the Fund´s deposits in Straumur-Burðarás Investment bank hf. amounting to ISK 1,293 million. According to a letter from Glitnir hf.´s Resolution Committee received by the Fund in 2010 a claim is for the payment of ISK 5,776 million, however the book value of the Fund´s position with Glitnir hf. is debt amounting to ISK 1,300 million. The Fund´s Board has entirely rejected the claim of Glitnir hf. The Fund´s actual loss may therefore differ when final settlement takes place.

10. Financial assets and liabilities

According to the IFRS, 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 the amortized cost value.
- Other financial liabilities - are recognised at the amortized cost value.

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10. Financial assets and liabilities, contd.:

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

	Trading assets and liabilities	Loans and receivables	Other at amortised cost value	Book value	Fair value [1]
31 December 2011					
Assets:					
Cash and cash equivalents..........		3.962.556		3.962.556	3.962.556
Restricted cash...........................		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	9.015.632	1.987.122		11.002.754	11.002.754
Loans to customers....................		782.052.563		782.052.563	852.810.867
Total financial assets	10.813.456	828.812.215	0	839.625.671	910.383.975
Liabilities:					
Bond issues................................			848.878.935	848.878.935	1.105.442.608
Other borrowings.......................			5.288.670	5.288.670	5.785.544
Total financial liabilities	0	0	854.167.605	854.167.605	1.111.228.152
31 December 2010					
Assets:					
Cash and cash equivalents..........		23.379.092		23.379.092	23.379.092
Restricted cash...........................		8.331.053		8.331.053	8.331.053
Due from State Treasury............		33.000.000		33.000.000	33.000.000
Treasury securities......................	2.049.593			2.049.593	2.049.593
Loans to banks		1.987.122		1.987.122	1.987.122
Loans to customers....................		751.280.719		751.280.719	799.464.447
Total financial assets	2.049.593	817.977.986	0	820.027.579	868.211.307
Liabilities:					
Bond issues................................			820.310.099	820.310.099	969.366.425
Other borrowings.......................			6.666.266	6.666.266	5.641.633
Total financial liabilities	0	0	826.976.365	826.976.365	975.008.058

1) Fair value of loans is estimated on the basis of the Fund´s current loan interests. Fair value of bond issuance and other borrowings is estimated on the basis of the yield of bond issues at year end. Treasury securities grouped as trading assets andi liabilities are at fair value other treasury securities are stated at cost.

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11. Net interest income

	2011	2010
Interest income		
Interest income on items not at fair value:		
Interest income on cash and restricted deposits	1.538.674	2.080.963
Interest income on loans to customers	78.206.012	55.175.269
Government contribution to subsidy interests*	580.938	492.142
	80.325.624	57.748.374
Interest income on items at fair value:		
Interest income on market securities	1.409.734	27.321
	1.409.734	27.321
Total interest income	81.735.358	57.775.695
Interest expenses		
Interest expenses on items not at fair value:		
Interest expenses on bonds issued	78.410.726	54.794.913
Interest expenses on other borrowings	586.884	465.783
Total interest expenses	78.997.610	55.260.696
Net interest income	2.737.748	2.514.999

*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 operating income

	2011	2010
Collection fee	174.351	215.912
Rental income from properties for sale	528.276	219.130
Total other operating income	702.627	435.042

13. Salaries and salary-related expenses

Salaries and salary-related expenses are specified as follows:

Salaries	498.205	376.956
Pension premium	68.919	54.221
Other salary-related expenses	56.601	41.946
Other personnel expenses	28.793	14.501
Total salaries and salary-related expenses	652.518	487.624

Number of employees of the Fund are specified as follows:

Average number of full-time equivalent units	88	70
Number of employees at year-end	92	70

Financial Statements of the Housing Financing Fund for the year 2011 25 Amounts are in ISK thousand

Notes, contd.:

14. Auditor's fee

Renumeration to the auditor´s are specified as follows:

	2011	2010
Audit of Financial Statements	15.750	15.012
Review of Interim Financial Statements	4.733	4.471
Other services	5.307	7.480
Total auditor's fee	25.790	26.963

15. Other administrative expenses

Other administrative expenses are specified as follows:

Collection fees	178.091	189.237
Cost of properties available for sale	416.692	202.485
Operating expenses of housing	104.239	94.029
Operating cost of IT systems	183.235	149.598
Professional services	78.245	67.010
Price evaluation due to debt mitigation programs	109.276	3.381
Advertising and promotions	41.011	41.070
Institution of counselling for households	221.190	5.153
Financial Supervisory Authority	31.995	27.555
Credit rating	23.380	23.195
Service fees	40.687	31.936
Other operating expenses	34.454	29.829
Total other administrative expenses	1.462.495	864.478

16. Properties held for sale

The Fund had repossessed 1,606 properties at year end 2011 (2010: 1,069). Properties owned by the Fund have increased considerably from the financial crisis, mainly in the last two years. Total number of properties managed by the Fund is specified as follows:

	2011	2010
Number of properties at the beginning of the year	1.069	347
Repossessed properties during the year	691	854
Properties sold during the year	(154)	(132)
Number of properties at year end	1.606	1.069

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

East Iceland	223	175
Great Reykjavík area	336	237
North Iceland	107	65
South Iceland	263	168
Area of Suðurnes	401	225
Westfjords	37	39
West Iceland	239	160
Number of properties at year end	1.606	1.069

At year end 2011, 642 properties were rented out (2010: 346) or 40.2% of the total number of properties managed by the Fund (2010: 31.8%). Income and expenses on assets available for sale is specified as follows:

Rental income (from rented properties)	528.276	219.130
Services and other expenses (due to all properties for sale)	(416.692)	(202.485)
Income in excess of expenses from properties held for sale	111.584	16.645

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17. Operating assets

Operating assets are specified as follows:

	Fixtures and equipment	Buildings	Total
Cost			
Balance at 1.1.2010	200.121	10.197	210.318
Additions during the year	5.723	0	5.723
Balance at 31.12.2010	205.844	10.197	216.041
Additions during the year	34.029		34.029
Balance at 31.12.2011	239.873	10.197	250.070
Depreciation			
Balance at 1.1.2010	147.151	5.144	152.295
Depreciation for the year	8.797	206	9.003
Balance at 31.12.2010	155.948	5.350	161.298
Depreciation for the year	10.176	206	10.382
Balance at 31.12.2011	166.124	5.556	171.680
Carrying amounts			
Balance at 1.1.2010	52.970	5.053	58.023
Balance at 31.12.2010	49.896	4.847	54.743
Balance at 31.12.2011	73.749	4.641	78.390

Official assessment value at year end 2011 amounted to ISK 7.0 million (2010: ISK 6.4 million) and insurance value amounted to ISK 19.7 million (2010: ISK 17.9 million).

18. Intangible assets

Intangible assets are specified as follows:

	Software
Cost	
Balance at 1.1.2010	260.809
Additions during the year	81.908
Balance at 31.12.2010	342.717
Additions during the year	8.849
Balance at 31.12.2011	351.566
Amortisation	
Balance at 1.1.2010	107.525
Amortisation for the year	46.170
Balance at 31.12.2010	153.695
Amortision for the year	57.203
Balance at 31.12.2011	210.898
Carrying amounts	
Balance at 1.1.2010	153.284
Balance at 31.12.2010	189.022
Balance at 31.12.2011	140.668

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

	2011	2010
Depreciation of operating assets (cf. note 17)	10.382	9.003
Amortisation of intangible assets (cf. note 18)	57.203	46.170
Total depreciation and amortisation	67.585	55.173

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:	2011	2010
HFF14 bond	33.893.818	42.133.702
HFF24 bond	175.409.280	176.563.541
HFF34 bond	215.513.826	201.681.934
HFF44 bond	363.794.510	338.237.691
Housing bonds (final maturity 2040)	36.731.999	37.144.937
Housing Authority bonds (final maturity 2038)	23.535.502	24.548.294
Total bond issues	848.878.935	820.310.099

21. Other borrowings

Other borrowings are specified as follows:	2011	2010
Pension funds	2.493.558	2.912.844
Municipalities	58.815	107.818
Insurance fund	247.360	229.736
Callable bonds	109.253	143.862
Unpaid due to purchase of loan portfolios	2.379.684	3.272.006
Total other borrowings	5.288.670	6.666.266

22. Rental agreements

The Fund has entered into a long term rental agreement on the property utilised for its operation. Minimum rental payments are specified as follows at year end:

	2011	2010
Payable within 1 year	97.059	84.327
Payble after 1 to 5 years	200.039	165.375
Later	149.788	143.380
Total	446.886	393.082

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23. Related parties

The Fund has a related party relationship with owners, 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-lenght basis. They amount to 167.9 million at year-end.

Salaries of the Board, Managing Director and key personnel is specified as follows:	2011	2010
Sigurður Erlingsson, Managing Director	12.313	2.006
Guðmundur Bjarnason, former Managing Director	0	8.821
Chairman	2.072	2.072
Other Board Directors, four	4.145	4.145
Key personnel, seven (2010: five)	71.866	59.486

Other matters

24. Housing Affairs Complaint Committee

The Housing Affairs Complaint Committee has during the year 2010 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 a clause regarding loans to contractors and letters of credit in the regulation on housing bonds and housing bond transactions had been suspended. 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 pledgeablility and credit evaluation, which the Board is to establish according to the Housing Act. The ruling however specifically states that the guarantee shall remain valid. The ruling by the District Court has been appealed to the Supreme Court and the matter will presumably be pleaded in the year 2012.

25. Investigation on Housing Financing Fund

An investigation has now been initiated 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 has recently decided to investigate also the Fund's operating expenses. It is not clear when the committee will conclude its work.

Amounts are in ISK thousand

26. 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 Funds 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 proposals to ESA on HFF´s changed role last October. The proposals emphasise minimal changes in the defined role of the Fund. Limits were set related to maximum property purchase prize and more restrictions on loans to leagal entities. These proposals are under consideration within ESA. It is not expected that these proposals will have material effect on the Fund´s role.

27. Prepayment fee

The Fund has received significant amount of inquiries from customers regarding the prepayment fee. With amendments to the Housing Act no.120/2004 the Fund was granted the authority to offer to all of its customers loans on lower interest rates, provided that they would relinquish their right to prepay the loan. It is believed 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 disallowed 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. A number of complaints have been received concerning the prepayment fee given the fact that significant amounts are involved in the current interest rate environment. The fee is based on provisions of law on housing matters and it is stated in the bond that the loan cannot be prepaid unless with the payment of a specific prepayment fee and reference is made to the applicable law thereon. If the fee will be deemed unlawful due to lack of information to customers the Fund will be exposed to prepayments in cases where it does not have the authority to prepay its own loans against the prepayments. The Fund's loans including the prepayment provision amounted to ISK 133.5 billion at year end. If these loans will all be prepaid the Fund´s damage, based on current interest rate, could amount to ISK 10 billion.