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The Housing Finance Corporation Ltd.

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Major Rating Factors

Strengths:

- Strong credit counterparties comprising established housing association borrowers who benefit from strong government and regulatory support
- Prudent lending policies help maintain low credit risk
- Low levels of interest rate risk
- Loans are secured by fixed and floating charges over social housing properties, with a robust level of asset overcollateralization

Issuer Credit Rating

A+/Stable/A-1

Weaknesses:

- Low capital reserves amounting to just about 0.4% of loan book heightens liquidity risk
- Exposure to a single sector, with increasing borrower-concentration risk
- Weak competitive position and limited business growth potential
- Heightened operational risk on account of small staff numbers

Rationale

The ratings on U.K.-based not-for-profit lender The Housing Finance Corporation Ltd.--along with subsidiary undertakings (together, THFC)--reflect its strong capacity to meet its financial commitments. The ratings are further supported by THFC's prudent lending policy to regulated housing associations who benefit from strong government and regulatory support. Other supporting factors include relatively low levels of exposure to interest rate risk and strong levels of asset overcollateralization provided by borrowers. These factors are offset, however, by THFC's low capital reserves and single-sector exposure with increasing borrower concentration risk. THFC has a weak competitive position when compared with other lenders to the sector, and has limited potential for business growth unless more associations tap the capital markets through one of THFC's subsidiaries. Operational risk is also heightened due to small staff numbers.

THFC is a dedicated, not-for-profit lender to the U.K. social housing market. It plays a public-policy role and has close links to the U.K. government, the sector regulator, the Housing Corporation, and the sector's trade body, the National Housing Federation (NHF). These entities, however, provide no formal support. In recent years, THFC has expanded its agency role, managing housing debt transactions that provide some fee income and offer some limited diversification from its core lending activities.

THFC's ability to meet its financial obligations is dependent on its receiving payments from its borrowers. Therefore the credit standing of these borrowers is an important factor in the ratings on THFC. THFC's borrower base comprises generally strong housing associations with well-diversified property portfolios, both in terms of size and geographical location. Government support by way of housing benefit payments for tenants and the presence of the regulator, the Housing Corporation, provide further credit support for these borrowers. Another important factor that lends support to the rating is that in the course of aggregating funds and on-lending, THFC takes minimal interest rate risk. Finally, significant asset coverage provides further support in recovery scenarios, should they arise. The actual level of asset overcollateralization is about 260%, against a minimum covenanted level of 150%

calculated on a market value with tenant-in-place basis.

On the other hand, THFC has a small capital base of about £6.9 million providing support to a loan book worth £1.7 billion, and debt-service payments of about £112 million per year. While THFC's practice of match funding, the use of cash sinking funds, and its good underlying credit quality precludes the need to have substantial liquid capital resources, we consider this thin capitalization to be a key weakness and constraint on the rating. In addition, THFC's relatively narrow line of lending business presents single-industry risk, which is compounded by increasing borrower concentration risk. As a result of consolidation in the sector, THFC's exposure to housing association groups has been going up.

THFC's competitive position in the funding market is relatively weak, given the rather narrow product profile and more conservative lending criteria when compared with its competitors. THFC therefore faces potential challenges to its business strategy, although the company expects to address this situation through new capital market products. To date, however, THFC has had limited success with new bond issues. In 2007, it gained four new borrowers and its net lending was about £53 million.

THFC is staffed by a small but experienced team, although the low number of employees continues to leave THFC vulnerable to turnover and key personnel risk.

Outlook

The stable outlook reflects the quality and diversity of THFC's loan portfolio, its prudent lending policies, and its plans for new business development. Given the above-mentioned potential challenges to THFC's business position, however, the successful implementation of its business development strategy and achievement of short-term growth will help maintain current ratings. We expect improvement in THFC's reserves over time, which will improve capital ratios and bolster THFC's credit profile. However, failure to achieve its financial targets, including planned transfers to reserves, or increased exposure to business risks may put its credit standing at risk.

Business Profile

In 1987, THFC was set up by the Housing Corporation, the NHF, and the private sector to fund registered social landlords (RSLs). Accordingly, it continues to have close links with government, although it doesn't have any formal government support. It is a relatively small lender to the social housing sector with a loan book of about £1.7 billion. It lends to 120 traditional housing associations of varying sizes. The main associations which THFC focuses on are the larger development partners--that is, the top 76 of the 2000 or so registered housing associations.

Business Description

THFC is a financial intermediary, diversifying the risk to those investors wanting to lend to registered housing associations and allowing access to the capital markets for housing association borrowers that would ordinarily not be able to do so, typically owing to their size. This arrangement increases cost effectiveness due to economies of scale and helps to standardize loan terms across participating housing associations. THFC funds itself through borrowing from banks and issuing bonds to the capital markets.

As THFC has found it more difficult to compete with other wholesale-funded lenders to the social housing sector, it

has been diversifying its product profile by increasing administration services to the sector and acting as a conduit for the placement of European Investment Bank (EIB) funds with housing associations. THFC also helps to complete initial and subsequent surveillance, which will help supplement fee income.

Ownership And Legal Status

THFC is a not-for-profit Industrial and Provident (I&P) society. It is owned by its non-executive board members, six of whom hold directly (or via their employers) a fully paid £1 share in THFC. It operates under the rules registered and approved by the Registrar for Friendly Societies, which is now part of the Financial Services Authority (FSA). However, unlike a commercial bank, it is not formally regulated by the FSA. THFC has no explicit government support, other than the nomination of a board member from the sector regulator, the Housing Corporation, which is a nongovernmental departmental body.

Corporate Governance And Management

We believe the governance arrangements in place are appropriate. A board with eight voting members governs THFC and includes a nominee from both the Housing Corporation and the NHF. There are six independent board members and two executive members (THFC's Chief Executive and Group Treasurer) and all members have equal votes. The current chairman, Mr. Roger Mountford, was formerly a merchant banker. Mrs. Gill Rowley, Head of Private Finance at the Housing Corporation, is that entity's nominee, and Mr. David Orr, Chief Executive of the NHF, also sits on the board. Separate committees exist for credit, audit, and risk. The credit committee approves all new loans, whether to existing or new borrowers.

THFC has a very small operational team of nine experienced professionals, which brings together a diverse range of experience in social housing, banking, accountancy, and corporate treasury functions, with associated professional qualifications. We believe that the management team is appropriately qualified for the size and nature of the business and, although the small number of staff leaves THFC vulnerable to turnover risk, knowledge is generally well shared across the team.

Group Structure And Strategy

Structure

THFC operates through a group structure, with a service company, THFC (Services) Ltd., providing all administrative and management services to THFC and its main subsidiaries. These subsidiaries are individual special-purpose vehicles (SPVs) set up for the specific purpose of individual capital market bond issuance. The subsidiaries are separately constituted legal entities and are entirely owned by THFC. In practice, there is very little difference in the credit quality of the loans held by each subsidiary, and a number of obligors have separate loans granted by different subsidiaries. Consequently, there is considerable overlap in the obligor pools.

Strategy

THFC's strategy remains substantially unchanged. While it ultimately wants to enhance its position complementary to other lenders, Standard & Poor's considers this to be challenging in the current competitive lending environment.

THFC's primary focus continues to be as a funding provider for regulated housing associations. In doing so, it aims

to create and offer flexible and competitive refinancing opportunities for those who require it, design and offer both long-term and short-term, price-competitive funding products, and provide an excellent level of customer service. It also continues to develop ancillary services in order to diversify its income stream.

In practical terms, its main strategic initiatives are developing business in partnership with the EIB, new bond issuance and the restructuring of existing bonds, and the provision of management services to various SPVs like Harbour Funding PLC and Haven Funding PLC. In addition, THFC has flagged plans to set up a commercial paper program, whose purpose would be to finance the growing working capital needs of the larger associations. While this program has been put on hold in the near term due to adverse market conditions, it remains on the back burner.

Risk Profile And Management

Underlying credit profile

THFC's ability to meet its payment obligations on time is dependent on receipts from its borrowers. The credit risk assessment of these housing association borrowers is therefore crucial.

In general, the individual borrowers' level of credit risk is fairly low and reflects THFC's conservative lending policy of only lending to mature registered housing associations. In spite of fairly thin cash flows, access to a relatively large amount of security that is continuously being replenished, and in most cases a healthy surplus of committed bank funding lines, have helped keep default rates very low in this sector. However, the fact remains that all THFC's lending is to a single sector and borrower concentration has been increasing in recent years largely due to the recent consolidation in the sector. On the positive side, however, these borrowers have different product profiles and operate in different geographic areas.

THFC conducts independent credit assessments of all borrowers at the start of the relationship and undertakes continuous surveillance of all lending relationships. Borrowers are subject to dynamic internal credit scoring based on a blend of qualitative and quantitative factors.

All THFC's loans are secured and covenants are conservatively structured, which further mitigates credit risk. THFC's borrowers can choose to secure their lending by either a fixed charge over specified properties, or by a floating charge, subject to asset coverage tests. The majority of the company's lending is carried out via a fixed charge over properties. Security may also be pledged via a security trust structure, or by other members of their group. The security pledged to THFC will remain restricted to regulated social housing assets and therefore there will be no exposure to commercial risks.

Funding

THFC's funding is sourced either from banks or directly from the capital markets, and is all secured on the property of or security from downstream borrowers.

All creditors of THFC and its subsidiaries are secured on floating charges that rank *pari passu*. In addition, negative pledges on all debt restrict THFC and its subsidiaries from borrowing or creating any charge that might rank above its existing debt. Although all creditors are secured in this way, the ratings on specific debt issues may differ from the ratings on THFC and its subsidiaries if, for example, there are reserves or liquidity facilities dedicated to particular issues. In December 2004, THFC issued a 'AA-' rated bond through a new SPV, T.H.F.C. (Funding No. 1) PLC, which benefited from a 24-month dedicated liquidity facility provided by ABN AMRO Bank N.V. (AA-/Developing/A-1+). If the facilities were withdrawn or the liquidity provider downgraded, the rating on this

bond could be lowered. To date, THFC has raised £169 million through this funding vehicle, including £33 million in November 2007.

Liquidity risk

THFC tends to be match-funded, thereby reducing both interest rate and liquidity risk. Further protection is provided by a liquidity cushion generated by borrowers paying interest one month in advance and the use of cash sinking funds to accumulate funds from borrowers ahead of THFC's own bullet repayments. Further, as in the case of the issue from T.H.F.C (Funding No. 1), there is a dedicated liquidity facility (albeit with certain drawstops), and there is also a two-year maturity mismatch between the expected and legal maturity dates providing further comfort.

Nevertheless, Standard & Poor's considers the most significant weakness in THFC's financial structure to be the size of its available liquidity, which stands at about £6.9 million of reserves. If a borrower defaulted on interest payments for a significant period and THFC could not realize the borrower's collateral, THFC's reserves could be severely depleted, depending on the extent of its exposure to the borrower in question. In a worst-case scenario, in which its two largest borrowers defaulted before THFC managed to crystallize its security (the timing of which is estimated at 12 months), THFC would have no revenue reserves with which to cover the respective interest payments. Unless THFC was able to organize an additional liquidity facility, committed and available to call, this situation could bring about the default of THFC itself. This reinforces the need for effective credit risk management and the need to minimize the probability of default of the underlying borrowers, which is low when compared to corporate entities.

THFC has minimal exposure to short-term refinancing risk as about 90% of its liabilities do not fall due before 2016. There are, however, five key principal refinancing peaks--in 2012, 2016, 2023, 2027 and 2035--that could cause some income volatility, although in practice most RSLs refinance rather than pay down debt.

A small number of loans are due to be refinanced in 2009, but all are backed by cash sinking funds. Cash sinking funds also back larger refinancing exposures in 2012. THFC is considering allowing borrowers with cash sinking funds to replace cash with alternative security or have an external liquidity facility available in place of cash. Given THFC's own very limited cash reserves, any weakening of its position regarding refinancing risk needs to be carefully considered.

Interest rate risk

THFC takes minimal interest rate risk. Its own borrowings are immediately onlent to RSLs, with a very similar interest and principal repayment profile. Nevertheless, in terms of its earnings, THFC's income stream is exposed to a certain level of interest rate risk as lower interest rates would reduce its investment income (from the cushion of interest payments received one month in advance of due date). THFC tries to mitigate the effect of this risk by periodically reviewing its hedging policies and making prudent assumptions in the budget.

Operational risk

Key operational risks for an organization like THFC stem from breaches in internal controls, systems failures, reputational risks, and personnel risk. We understand that these risks are reviewed on an ongoing basis, including by the board's risk committee. Nevertheless, the effective mitigation of operational risk typically requires periodic investment, which could be difficult for an organization like THFC with tight cost control limits in place.

Profitability

In financial 2007, THFC made a surplus before tax of £539,000, down slightly from £629,000 in 2006. Most of this income came from fees for the arrangement of new loans or from prepayments. Net lending for 2007 was £58.7 million, up from £16.0 million in 2006. This reflected prepayments and repayments of £78.1 million, and new loans and premium on new issues of £136.8 million.

THFC's net interest margin, unlike that of a commercial bank, is effectively zero, reflecting the exact balance of lending interest income to interest payable. In general, income received reflects interest income on the free one-month float and fees related to THFC's arrangement of new issues, restructuring fees, and management of third-party portfolios.

Investment income for 2007 was £877,000, up from £766,000 in the previous year. Fees receivable and other income was slightly down at about £1.3 million in financial 2007, from £1.5 million in the previous year. As can be expected there will be variations from one year to the next depending on macroeconomic conditions and the general appetite among housing associations for funding from THFC.

Capitalization

THFC's weak capitalization is reflected in a capital and reserve base made up entirely of retained earnings of £6.9 million. Additions to reserves come solely from profits made each year which, reflecting its not-for-profit ethos, are quite small. As a result, we consider THFC's financial flexibility to replenish its reserves in the event of a stress scenario to be limited. The weak nature of THFC's capital base is, however, substantially mitigated by the generally low-risk nature of the loan book.

Ratings Detail (As Of February 20, 2008)*

The Housing Finance Corporation Ltd.

Issuer Credit Rating	A+/Stable/A-1
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Issuer Credit Ratings History

24-Jun-2004	A+/Stable/A-1
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*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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