

The Housing Finance Corporation Ltd.

Primary Credit Analyst:

Liesl Saldanha, London (44) 20-7176-3571; liesl_saldanha@standardandpoors.com

Secondary Credit Analysts:

Giles Edwards, London (44) 20-7176-7014; giles_edwards@standardandpoors.com

Richard Sugden, London (44) 20-7176-7124; richard_sugden@standardandpoors.com

Table Of Contents

Rationale

Rationale

Outlook

Business Profile: Small Financial Intermediary To The Social Housing Sector

Ownership and Legal Status

Corporate Governance And Management

Group Structure And Strategy

Risk Profile And Management

Funding

Profitability: Lower Margins Expected, High Operational Leverage

Small Capital Base Heightens Liquidity Risk

The Housing Finance Corporation Ltd.

Rationale

Strengths:

- Relatively strong franchise value.
- Strong support from the U.K. government for the underlying borrowers underpins borrower creditworthiness.
- Low levels of structural interest rate risk.
- Robust collateralization of loan book.
- Satisfactory earning prospects despite low interest rate environment.

Issuer Credit Rating

A+/Stable/A-1

Weaknesses:

- Modest liquid financial resources heighten liquidity risk.
- Exposure to a single sector, with increasing borrower-concentration risk.
- Vulnerable to operational risk stemming from small staff numbers and key personnel risk.

Rationale

The 'A+/A-1' corporate credit ratings on The Housing Finance Corporation Ltd. (THFC), a small not-for-profit financial intermediary, reflect THFC's long-standing franchise in the social housing sector, strong ongoing government support for its borrowers, robust collateralization of its loan book, and satisfactory earnings prospects. These strengths counterbalance the potential challenges posed by modest, albeit growing, liquid financial resources, and increasing borrower-concentration risk. Our rating does not factor in any uplift from potential direct extraordinary government support for THFC.

The 'AA-' rating on debt issued by T.H.F.C. (Funding No. 1) PLC reflects the corporate credit rating on THFC and the enhancement provided by a liquidity facility that is equivalent to 24-months interest on outstanding debt, which is available to the issuer to use as required. The 'A+' rating on the debt issued T.H.F.C. (Funding No. 2) PLC is linked to the corporate credit rating on T.H.F.C.

THFC's ability to meet its financial obligations is mainly dependent on receipts from its underlying borrowers—the housing associations. Our experience of the sector leads us to believe that there is a moderately high likelihood of extraordinary support for these borrowers and we factor this into our analysis. Further, should there be a default of any of the underlying borrowers, then the robust collateralization of these loans, which is at least 150% and which averages about 280% across the portfolio, when calculated on a market value subject to tenancy basis, provides comfort that substantial recoveries could be made.

THFC's thin capitalization, and resultant modest liquid financial resources, is a key weakness that constrains the rating. As of March 31, 2009, the capital base of £4.95 million provides support to loan assets of £1,029 million. As of March 2010, we expect the level of reserves to go up to £6.6 million, supporting loan assets of £1,379 million. In addition, THFC's relatively narrow line of lending business presents single-industry risk. While there is increased exposure to some associations, the risk is to a certain extent mitigated by additional, dedicated debt-service reserves.

In our view, THFC has consolidated its role as a reliable funder to this sector over the past year with the issue of

£191 million of bond debt. It also negotiated a role as a conduit for a £345 million loan from European Investment Bank (EIB), facilitating the supranational's lending to the U.K. social housing sector. This has come during a period when bank capacity to lend to the sector has been constrained. Onlending of this money has generated increased fee revenue and will also provide annuity income for several years. While we do not expect new business to continue to materialize at these levels, capital market debt issuance is expected in the short-to-medium term. Fee income and annuity and arrangement fees continue to buttress ongoing fee revenues, which is positive from a credit perspective.

THFC is a small organization, leaving it somewhat vulnerable to staff turnover, key personnel risk, and other operational risk. Although the business model is quite scalable, we consider that THFC has limited flexibility to adjust costs in the event that new business volumes fall materially.

As THFC lends on substantially the same terms at which it borrows, structural interest rate risk is minimal. However, the low interest rate environment will likely lead to lower investment income for THFC in the short to medium term and, while we expect reserves to marginally increase, this would not represent a material strengthening.

Outlook

The stable outlook reflects our expectation of continued support that the U.K. government provides to the social housing sector, the quality and the diversity of THFC's loan portfolio, and its prudent lending policies.

The rating could come under pressure if THFC's reserves are eroded substantially or if in our opinion there is a significant change in government policy resulting in reduced support for this sector. In the short-to-medium term, key personnel risk and THFC's modest liquid financial resources are likely to cap the rating at its present level.

Business Profile: Small Financial Intermediary To The Social Housing Sector

THFC is a financial intermediary, borrowing from banks and the capital market to lend to registered housing associations (HAs). This allows HAs cost-effective and reliable access to the capital markets and other institutions like the EIB, who they ordinarily may not have access to.

THFC is a relatively small lender to the sector, with loan assets of £1.03 billion (£1.86 billion for the group) representing just 2% of the £58 billion private finance market (according to the "Private Finance" bulletin published by the Tenant Services Authority, November 2009; data as of December 2008).

Through a network of wholly owned subsidiaries, together forming the THFC group, the group has issued capital market debt and onlent the proceeds of about £1.9 billion to housing associations as of March 2009 (see "Group Structure And Strategy" section and group financials in the "Profitability" section).

Ownership and Legal Status

THFC is a finance company with the legal status of an Industrial and Provident (I&P) society, and is owned by seven non-executive board members. It operates under rules registered and approved by the Registrar for Friendly Societies, which is part of the Financial Services Authority (FSA). THFC is, however, not regulated by the FSA. The

Tenant Services Authority (TSA), a government agency and the social housing regulator, is represented on THFC's board, and this shareholding equates to about a 14% stake in the business. However, in view of this minor holding and the relatively minor role THFC plays as a lender in relation to the size of the sector, we do not classify THFC as a government-related entity (GRE), as defined by our GRE criteria (see "Enhanced Methodology And Assumptions For Rating Government-Related Entities," published June 29, 2009, on RatingsDirect). However, the credit quality of THFC is in part affected by the credit quality of its underlying borrowers, who we do classify as GREs, and for whom we believe there is generally a moderate-to-high likelihood of extraordinary government support. This is in addition to the significant amount of ongoing support that is also factored into our ratings of HAs.

Corporate Governance And Management

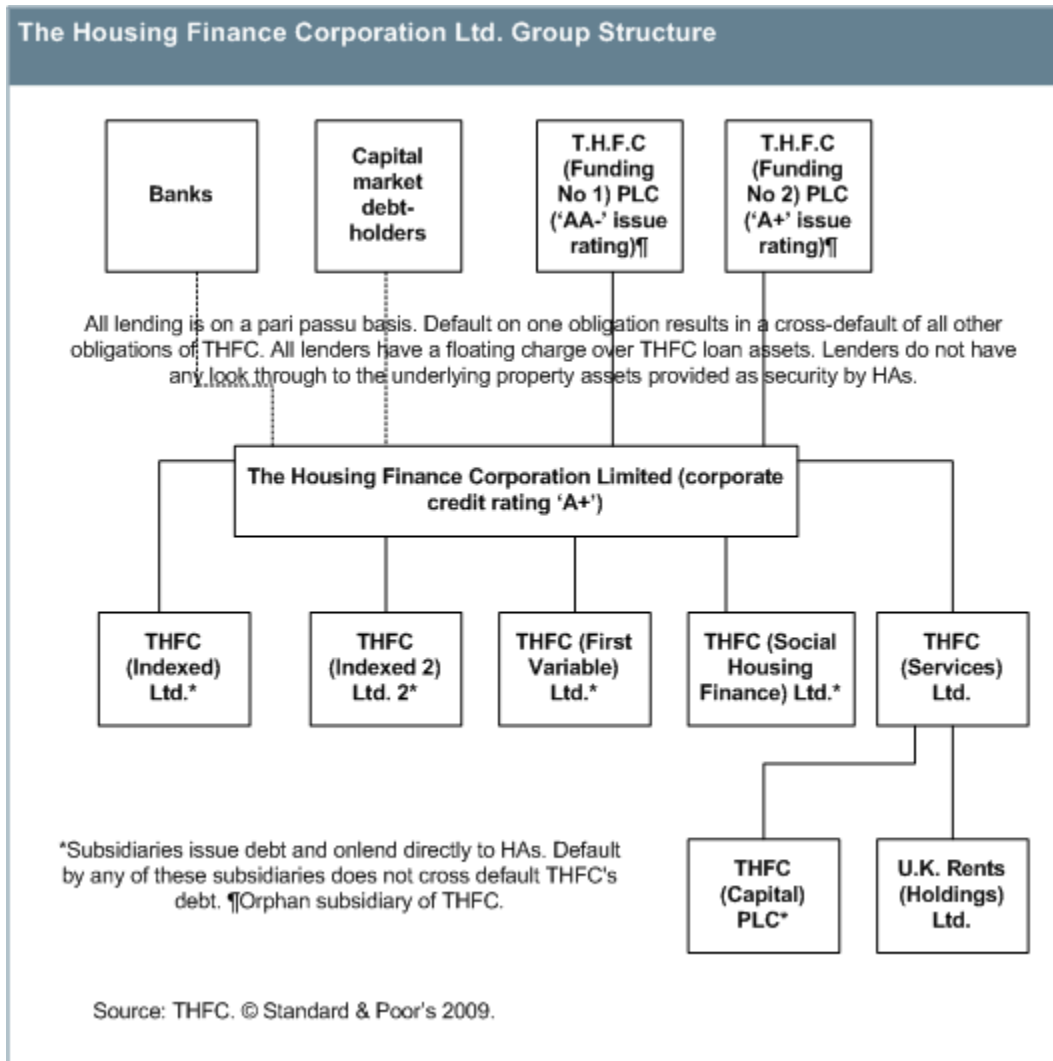
We believe the governance arrangements in place are strong. A board of nine voting members governs THFC and includes a nominee from both the TSA, and the National Housing Federation (NHF), the sector's trade body. There are seven independent board members and two executive members (THFC's Chief Executive and Group Treasurer). The board has a strong combined skill-set comprising ex-bankers, accountants, and housing association professionals. The credit committee is a committee of the board reflecting the importance placed on this function. It approves all new loans, whether to existing or new borrowers, and closely monitors all credits on the THFC "watch-list". While there is the potential for conflicts of interest to arise from external work undertaken by some board members and the executive, the board is conscious of this and manages these situations as it sees appropriate.

In our opinion, the management team is experienced and knowledgeable. The Chief Executive and the Treasurer have been in the post from 2003 and have extremely strong links with other sector participants. While this helps with credit control, monitoring, and new business, it also leaves THFC vulnerable to key personnel risk. The operations staff comprises seven/eight individuals who bring together a diverse range of experience in social housing, banking, accountancy, law, and treasury functions. The small number of staff does, however, leave THFC vulnerable to turnover risk. This risk is partially mitigated by well-documented practice manuals and a good system of sharing information across the team.

Group Structure And Strategy

Structure

THFC is the parent company with several wholly owned subsidiaries. THFC (Services) Ltd. provides all administrative and management services to THFC and its main subsidiaries.



The subsidiaries are separately constituted legal entities. Most of the subsidiaries were set up to issue bonds and onlend the proceeds to selected HAs. Lending is secured on ring-fenced property pools to which bondholders will have direct access should they need to enforce their security. Importantly, for THFC, a default by any of these subsidiaries to service its respective debt will not result in a cross-default of THFC's financial obligations. However, we believe that THFC's management would feel obliged to support a failing subsidiary, as long as it does not put THFC itself at risk of default. The debt issued by these subsidiaries is not rated by Standard and Poor's.

THFC also has two orphan funding subsidiaries; T.H.F.C funding (No 1) and T.H.F.C funding (No 2). Debt issued by these two subsidiaries is rated by Standard & Poor's and the proceeds are onlent to THFC (see section on "Funding").

All lending to THFC by these funding subsidiaries, banks, and debtholders is on a pari passu basis and defaults on any of these financial obligations will cross-default all THFC's other financial obligations. In such a situation we would expect the receiver appointed at the time to work in the best interests of all lenders.

All lenders to THFC are secured by floating charges on the loan assets of THFC and have no direct access to the

property collateral provided to THFC for loans that it makes to HAs. Therefore, in the event of a THFC default, lenders have access to its loan assets alone and recovery will likely depend on the market value of those loans at that time.

Strategy

THFC's primary focus continues to be a competitive funding provider for registered HAs. Concurrently, THFC expects to increase its fee-generating advisory services and grow its annuity income. Although asset growth has been relatively significant in the last 12 months when compared to the previous five years, this growth has been opportunistic and while we do expect some growth, we do not expect this pace to continue in the short term. Further, we expect THFC to face competition from banks that can provide a more "all-round" service and other competing financial intermediaries who also have established links with the sector.

Having developed a useful relationship with the EIB, THFC is now its largest borrower in the social housing sector. While we believe that increased borrowing from this source may not be forthcoming in the short term, it is still an indicator of THFC's franchise in this sector. Provision of administrative services provides some diversification and, although relatively small at this point, does provide some stability to revenue flows.

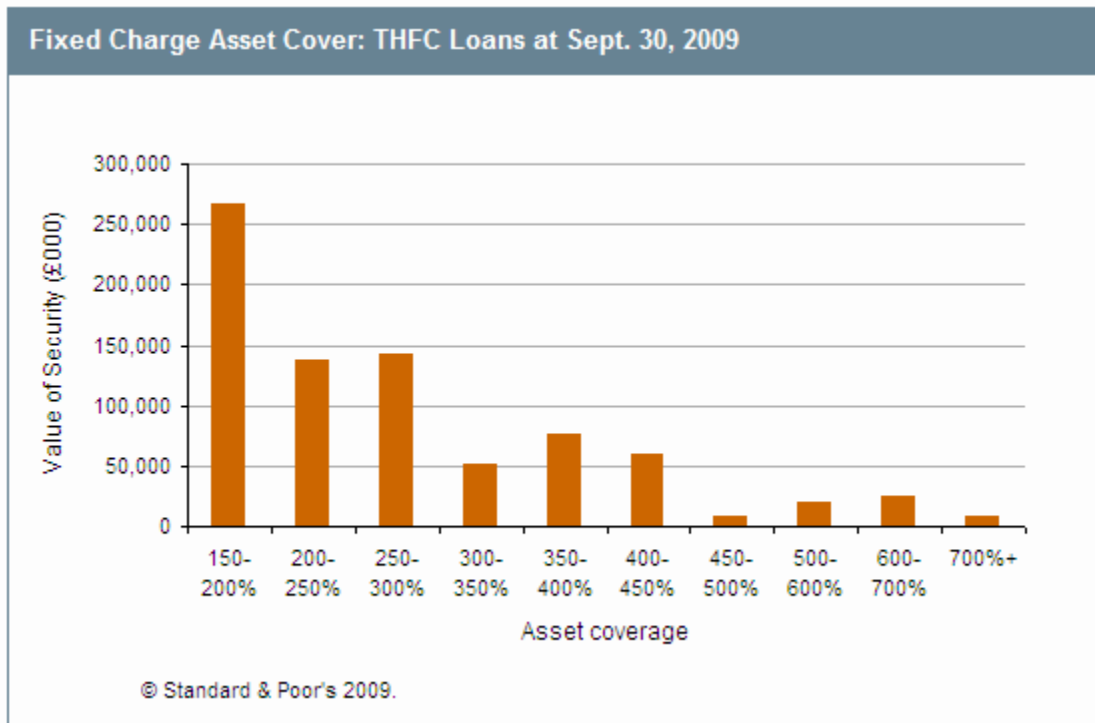
Risk Profile And Management

Credit risk

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

Across THFC, there are about 90 borrowers (103 borrowers for the group as a whole). Lending to the top 10 associations accounts for about 45% of the THFC loan book and in our view, most of these borrowers are likely to be of high credit worthiness. The portfolio of loans to housing associations is well diversified by size and geography (see chart 1).

Chart 1

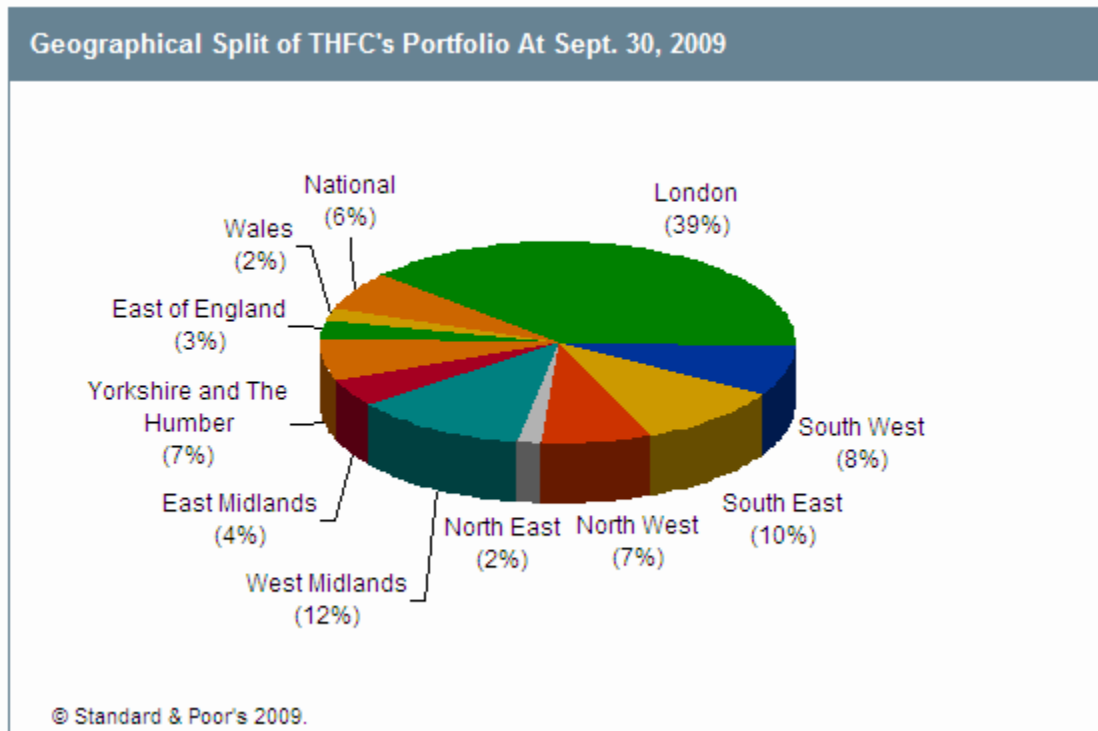


While exposure to some individual associations has increased substantially since our last report, some safeguards have also been put in place to provide added liquidity support to mitigate this increased concentration risk. For example, exposure to Southern Group has risen from about £46 million in March 2009 to about £146 million as of September 2009. As Southern Group is one of the associations who ultimately borrowed via the THFC funding No 2 vehicle, a debt-service reserve for up to 12 months interest on £100 million is available, reducing some of the ongoing debt-service risk. Refinancing risk however will remain, although the loan is due only in 2039.

While there are no fixed maximum exposure limits for individual housing association groups, THFC's policy is that, at a minimum, the annual payment (less any debt-service reserve) should be no greater than THFC's reserves. Currently the highest annual cash flow from any single borrower after adjusting for debt-service reserves is about £4.13 million for Midland Heart Housing Association. However, a series of defaults by its weakest borrowers (who may not happen to be the largest) has the potential to cause considerable stress to its modest liquidity reserves. We consider, however, the likelihood of a series of defaults quite unlikely over the rating horizon.

All THFC's loans to HAs are secured by either a fixed charge over specified properties, or by a floating charge over all assets. The majority of THFC's lending is secured via a fixed charge over properties with minimum asset cover of 150%, calculated on a market value with tenant-in-place basis (floating charges require 300% cover). The security pledged to THFC will remain restricted to regulated social housing assets. Levels of cover vary quite significantly across the group (see chart 2).

Chart 2



Liquidity risk

The most significant weakness in THFC's financial structure is the size of its reserves, which stand at about £4.95 million as at March 2009, and which are expected to touch £6.6 million in March 2010 (group reserves are £8.48 million in 2009 and £9.4 million in 2010). These reserves are THFC's only liquid resources. However, providing support for the specific borrowing (£191 million) from THFC (Funding No 2) is a 12-month debt-service reserve (see section on "Funding").

While match-funding reduces some structural interest rate and liquidity risk, an important mitigant is the receipt of payments from borrowers (in a vast majority of cases) one month before they are due to be paid to THFC's bankers or bond holders. This prevents a delayed payment or an operational problem of a borrower from causing a technical default by THFC. It also provides a source of interest income.

Nevertheless, if a borrower defaulted on interest payments for a significant period and THFC could not realize the value of 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 scenario where two of its largest borrowers who had no access to any debt-service reserves defaulted before THFC managed to enforce its security (the timing of which is estimated at 12 months), THFC would have no revenue reserves with which to cover further 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. We note, however, that due to the proactive stance of the sector's regulator there has never been a cash payment default to date, although this has not been tested in a systemic default scenario.

Refinancing risk for the underlying borrowers and THFC can be material at times, as most of the loans have bullet

maturities, as does THFC's debt. For example, about £93 million of THFC's deep discount bonds are due in 2012 and THFC depends on four HAs being able to refinance their loans by this date. Just over 50% of the £93 million is expected to be covered by sinking funds available at maturity. The largest exposure is to Stadium Housing Association (expected to be £31 million at maturity). After 2012, the next significant re-financing date is 2016. To mitigate refinancing risk, THFC starts discussions with associations about refinancing plans up to two years before the date of refinancing, and would expect these plans to be firm at least six months before the due date.

Interest rate risk

THFC takes minimal structural interest rate risk because its borrowings and loans are made materially on the same terms. Nevertheless, THFC's revenues are exposed to interest rate risk as lower interest rates would reduce its investment income which accounts for about 45% of revenues at present. Given the prevailing low interest rate environment, we expect THFC's investment income to continue to be fairly low for the next few years.

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 by the board. 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 and an expected drop in profitability going forward.

Funding

THFC's funding is sourced either from banks or from the capital markets. As THFC matches funds, funding risk is minimal. Funds are onlent almost immediately and are lent on materially the same terms as they were sourced.

The proceeds of the debt issued by the funding subsidiaries are onlent to THFC and THFC is therefore ultimately responsible for servicing and repaying this debt.

Debt issued by T.H.F.C. (Funding No. 1) PLC has a 37-year term bullet maturity, an expected maturity in 2035, but a legal final maturity in 2037. So, if THFC is unable to repay this debt in 2035, because the underlying borrower has been unable to refinance its loan or for any other reason, THFC has until 2037 to enforce and realize its security on the over-collateralized nonperforming loans or use its reserves to ultimately repay bondholders. Providing credit enhancement, a liquidity facility equivalent to 24-months interest on outstanding debt is available to the issuer to cover any shortfall in receipts from THFC. This credit enhancement allows us to rate the issue 'AA-', one notch higher than the corporate rating of THFC. To date, THFC has raised £249 million through issuance from this vehicle.

Similarly, debt issued by T.H.F.C (Funding No 2) has a 32-year term, is due in 2039, but has a final maturity in 2041. THFC onlent the proceeds of this issue to eight housing associations, which have each provided debt-service reserves equivalent to 12-months interest on their respective loans. These individual reserves can only be used if the respective association defaults on its obligation under the loan agreements with THFC. Further, if the loans to these HA borrowers are not refinanced in 2039, the 2-year tail is expected to allow THFC to enforce and realize its security to allow for ultimate repayment of the bonds in 2041. In our opinion, the level of credit enhancement provided by these debt-service reserves is insufficient for us to rate the issue above the rating of THFC. The debt issued by this vehicle is therefore rated 'A+', in line with the corporate rating.

The difference in size and availability of additional liquidity to the respective issuers helps differentiate the relative risk of these bonds. In THFC (Funding No 1), the size of the facility is equivalent to 24-months of interest payable on outstanding bond debt and is available to the issuer to cover any shortfall in funds irrespective of the reason for the shortfall. In THFC (Funding No 2), however, a debt-service reserve equivalent to only 12-months interest payments on the relevant THFC borrower loan that remains outstanding is available to the issuer only when that particular borrower defaults on its loan obligation to THFC. In summary, not only is the size of the reserve available vastly different, the circumstances when it can be used also differs and it is these differences that are reflected in the ratings on these issues.

Profitability: Lower Margins Expected, High Operational Leverage

High profitability is not THFC's primary aim and would be at odds with its ethos, but THFC does seek to make a sufficient return to boost its reserves. Increased agency and arrangement fees have helped raise levels of profitability in the past year and in part have made up for reduced investment income. Fees and investment income dominate THFC's earning streams, accounting for more than 90% of revenues (see table). As investment income is forecast to drop off substantially in the short term, unless THFC continues to be able to raise the volume of new business, total revenues are expected to deteriorate mainly due to decline in investment income.

Although THFC's business model is scalable, we consider that THFC has limited flexibility to adjust costs, in the event that new business volumes fall materially. For example, staff costs including independent director costs are expected to equate to 62% of total costs in 2010. As costs such as these are more difficult to scale back in view of THFC's already small staff numbers, other things being equal a 10% reduction in revenues would be expected to lead to a 24% decline in surplus before tax in 2011.

THFC Financial Indicators							
	Year ended March 31						
	2003	2004	2005	2006	2007	2008	2009
Fees	708	877	951	1,349	1,123	1,215	1,693
Investment income	728	656	733	766	877	1,088	979
Other income	129	141	169	161	169	227	177
Total revenues	1,565	1,674	1,853	2,276	2,169	2,530	2,849
Staff costs	646	738	742	797	779	856	900
Non-executive directors costs	161	97	98	102	99	97	109
Legal/trustees and registrars	297	211	236	301	303	230	223
Premises	85	75	102	104	111	107	125
Other	316	361	306	343	338	370	334
Total costs	1,505	1,482	1,484	1,647	1,630	1,663	1,691
Surplus before tax	60	192	369	629	539	867	1,158
Tax	28	54	103	176	152	107	317
Surplus after tax	32	138	266	453	387	760	841
Accumulated reserves	5,639	5,777	6,043	6,496	6,883	7,643	8,484
Loans outstanding	1,449	1,452	1,585	1,607	1,672	1,790	1,898

Small Capital Base Heightens Liquidity Risk

THFC's capital is small, consisting only of share capital and reserves. The share capital is a token £7, representing the shares held by seven of the non-executive directors. As of March 31, 2009, the capital base was about £4.5 million (group including funding subsidiaries of £8.48 million). As of March 2010, we expect the THFC's reserves to increase to be about £6.6 million (£10.1 million at the group level). In view of THFC's not-for-profit status, weak capital generation, and shareholder structure, we consider its financial flexibility to replenish its reserves in the event of a large loss to be rather limited. This is, however, substantially mitigated by the generally low-risk profile of the loan book and THFC's very good record on financial management.

Ratings Detail (As Of December 21, 2009)*

The Housing Finance Corporation Ltd.

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

Issuer Credit Ratings History

24-Jun-2004	A+/Stable/A-1
-------------	---------------

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

Additional Contact:

International Public Finance Ratings Europe; PublicFinanceEurope@standardandpoors.com

Additional Contact:

International Public Finance Ratings Europe; PublicFinanceEurope@standardandpoors.com

Copyright © 2009 by Standard & Poors Financial Services LLC (S&P), a subsidiary of The McGraw-Hill Companies, Inc. All rights reserved. No part of this information may be reproduced or distributed in any form or by any means, or stored in a database or retrieval system, without the prior written permission of S&P. S&P, its affiliates, and/or their thirdparty providers have exclusive proprietary rights in the information, including ratings, creditrelated analyses and data, provided herein. This information shall not be used for any unlawful or unauthorized purposes. Neither S&P, nor its affiliates, nor their third-party providers guarantee the accuracy, completeness, timeliness or availability of any information. S&P, its affiliates or their third-party providers and their directors, officers, shareholders, employees or agents are not responsible for any errors or omissions, regardless of the cause, or for the results obtained from the use of such information. S&P, ITS AFFILIATES AND THEIR THIRD-PARTY PROVIDERS DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE. In no event shall S&P, its affiliates or their third-party providers and their directors, officers, shareholders, employees or agents be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of the information contained herein even if advised of the possibility of such damages.

The ratings and credit-related analyses of S&P and its affiliates and the observations contained herein are statements of opinion as of the date they are expressed and not statements of fact or recommendations to purchase, hold, or sell any securities or make any investment decisions. S&P assumes no obligation to update any information following publication. Users of the information contained herein should not rely on any of it in making any investment decision. S&P's opinions and analyses do not address the suitability of any security. S&P does not act as a fiduciary or an investment advisor. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of each of these activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P's Ratings Services business may receive compensation for its ratings and credit-related analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge) and www.ratingsdirect.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

Any Passwords/user IDs issued by S&P to users are single user-dedicated and may ONLY be used by the individual to whom they have been assigned. No sharing of passwords/user IDs and no simultaneous access via the same password/user ID is permitted. To reprint, translate, or use the data or information other than as provided herein, contact Client Services, 55 Water Street, New York, NY 10041; (1)212.438.7280 or by e-mail to: research_request@standardandpoors.com.

Copyright © 1994-{} by Standard & Poor's Financial Services LLC, a subsidiary of The McGraw-Hill Companies, Inc. All Rights Reserved.