

## The Housing Finance Corp. Ltd.

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# The Housing Finance Corp. Ltd.

## Major Rating Factors

### Strengths:

- Relatively strong franchise value.
- Strong support from the U.K. government, which underpins borrower creditworthiness.
- Match-funded approach minimizes asset-liability risk.
- Robust collateralization of loan book.

### Weaknesses:

- Modest liquid financial resources that heighten liquidity risk, especially when refinancing is due.
- Potential for conflicts of interest could arise from board composition and responsibilities.
- Exposure to a single sector, with borrower-concentration risk.
- Vulnerable to operational risk stemming from small staff numbers and key personnel risk.

### Issuer Credit Rating

A+/Stable/A-1

## Rationale

The 'A+/A-1' ratings on THFC, a small nonprofit financial intermediary, reflect its long-standing franchise in the social housing sector; the strong ongoing government support for its borrowers; the robust collateralization of its loan book, and its match-funded approach, which helps to mitigate asset-liability risk. The ratings are constrained by Standard & Poor's Ratings Services' view of THFC's modest, albeit growing, liquid financial resources, driven by its low absolute level of earnings, relative lack of diversification, and the operational risk inherent to a small business operation. Our ratings do 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 equivalent to 24-months interest on outstanding debt, available to the issuer to use as required. Likewise, the 'A+' rating on the debt issued by T.H.F.C. (Funding No. 2) PLC and T.H.F.C (Funding No. 3) PLC is linked to the corporate credit rating on THFC.

In our view, THFC has a long-standing and relatively strong franchise in the social housing sector, being the main alternative to bank finance for most housing association registered providers (HARPs). We believe that there is renewed interest in THFC's products from small- and mid-size HARPs. In our view, this is caused by recent reductions in grant allocations from the central government, as well as the cost and limited availability of bank finance.

In our opinion, THFC's ability to meet its financial obligations mainly depends on receipts from its underlying HARP borrowers. Our experience of the sector leads us to believe that there is generally a "moderately high" likelihood of extraordinary support for these borrowers from the U.K. government (AAA/Stable/A-1+; unsolicited rating), and we factor this into our analysis. According to THFC, the collateralization of loans made to underlying borrowers is generally 150%, averaging about 280% across the portfolio when calculated on a market value basis, subject to tenancy. We believe that this robust collateralization could cover substantial recoveries for THFC, if

needed.

In our view, THFC's weak capitalization and its modest liquid financial resources are key weaknesses that constrain the ratings. On March 31, 2011, its capital base of £6.76 million supported loan assets of £1.59 billion (approximately 0.4%). By March 31, 2012, we expect the level of reserves to have increased to about £7.2 million, supporting loan assets of about £1.96 billion. In addition, as THFC lends solely to U.K.-based HARPs, this presents single-industry risk. Furthermore, there is quite high single-name exposure to some HARPs (up to 8% of the loan book in one case), but this risk is mitigated to a certain extent by additional dedicated debt-service reserves.

While we consider THFC's enterprise risk management framework to be adequate, we note that it is a small organization, leaving it somewhat vulnerable to staff turnover, key personnel risks, and other operational risks. Being rather small, the credit committee is a committee of the board and includes members that routinely work with borrowers. In our opinion, this requires extremely careful management to ensure that conflicts of interest are mitigated and independent oversight is preserved.

Although THFC's business model offers good operating leverage in a growing market, we consider that THFC would have limited flexibility to quickly adjust costs in the event that new business volumes were to fall materially. However, we do note that agency fees and other income received annually are sufficient to cover nearly all operational costs.

As THFC lends on substantially the same terms at which it borrows, structural interest rate risk is minimal. However, low interest rates have led to lower investment income for THFC and we expect this to continue in the short term. Although we expect reserves to marginally increase, this would not represent a material strengthening.

## Outlook

The stable outlook reflects our base-case expectation of good prospects for new lending volumes, continued support of the U.K. government to the social housing sector, the maintenance of the quality and the diversity of THFC's loan portfolio, and its prudent lending policies. We also expect that earnings, although likely to be lower in the coming financial year, will remain satisfactory.

The rating could come under pressure if THFC is unable to write much new business in the short term and if its reserves are eroded as it absorbs losses in the loan portfolio or if we find there is a significant change in government policy resulting in reduced support for the housing sector. If we believe that reduced support for the sector could ultimately lead to losses for THFC, this rating could fall by more than a notch. Conversely, we may consider raising the ratings if new business mandates rise and this leads to a material strengthening of profits and a build-up in capital, combined with an increase in ongoing and extraordinary support for this sector. Furthermore, over the rating horizon, we believe that key personnel risks and THFC's modest liquid financial resources will likely cap the ratings at their present level.

## Peer Analysis: Specialist Public Sector Lender, But With Weaker Government Links Than Its Nearest Peers

In our view, THFC has no close peers across the European finance companies rated by Standard & Poor's, although we do see similarities with Motability Operations Group PLC (Motability; A+/Stable/A-1) and, to some extent, two

Dutch public sector banks, Bank Nederlandse Gemeenten N.V. (BNG, AAA/Watch Neg/A-1+) and Nederlandse Waterschapsbank N.V. (NWB, AAA/Watch Neg/A-1+). We also compare THFC to KBN Kommunalbanken Norway (AAA/Stable/A-1+), the funding vehicle for Norwegian municipalities.

Motability is the nonprofit, privately-owned operator of the Motability Scheme, which gives disabled people in the UK access to a means of transport (generally a car) either through contract hire or hire-purchase at an affordable price. Exposure to credit risk is minimal, since all receipts are eventually received from the Department of Works and Pensions in the U.K.

**Table 1**

Peer Comparison					
	The Housing Finance Corporation Ltd.*	KBN Kommunalbanken Norway	Bank Nederlandse Gemeenten NV	Nederlandse Waterschapsbank NV	Motability Operations Group
Issuer credit rating	A+/Stable/A-1	AAA/Stable/A-1+	AAA/WatchNeg/A-1+	AAA/WatchNeg/A-1+	A+/Stable/A-1
Country	U.K.	Norway	The Netherlands	The Netherlands	U.K.
Sovereign credit rating	AAA/Stable/A-1§	AAA/Stable/A-1+	AAA/WatchNeg/A-1§	AAA/WatchNeg/A-1§	AAA/Stable/A-1§
Establishment date	1987	1926	1914	1954	1978
Guarantee structure	12.5% owned by a government agency. No guarantee.	100% owned by the Norwegian government. Letter of support from owner.	Owned 50% by central government, 50% by Dutch municipalities and provinces. No guarantee.	Owned 17% by central government, 81% by water boards and 2% by Dutch provinces. No guarantee.	Not-for-profit, privately-owned entity. Long-standing and close relationship with a government body of the central government. No guarantee.
Competition	Moderate	Limited	Limited	Limited	Limited
Total adjusted assets (bil. £)	2.5	33	101.8	51.8	4.6
Adjusted total equity/adjusted assets (%)	0.4	1.3	1.8	1.7	21.2
Government-related entity	No	Yes	Yes	Yes	Yes

Financial data as of Dec. 31, 2010, except March 31, 2011, for THFC and June 30, 2010, for Bank Nederlandse Gemeenten NV and for Nederlandse Waterschapsbank NV. \*Based on group numbers. §Unsolicited rating.

All of these entities are wholesale-funded and have very strong credit profiles with similarly high asset quality. We believe THFC faces less asset-liability risk because it is entirely match-funded. However, we consider its financial profile to be weaker than these peers due to:

- Higher credit risk: its peers lend wholly or almost exclusively to entities benefiting from government guarantees, or at least to entities like Motability, whose revenue receipts are ultimately backed by the central government via benefit payments. THFC's borrowers are not guaranteed, although we view the borrowers as government-related entities (GREs). To help mitigate this higher risk of loss, THFC only lends on a highly secured basis.
- Weaker capitalization: all these entities are quite highly leveraged, but THFC has a notably small capital base compared with its adjusted assets; and
- Higher liquidity risk: this results mainly from THFC's low capitalization and consequent financial resources. Also, unlike Kommunalbanken and the Dutch banks, THFC does not have central bank access to repurchase agreement transactions. On the other hand, Motability has significant amounts of liquid resources available for

use.

With regards to the business profile, all these entities are specialist lenders to some degree. However, while Kommunalbanken and the Dutch public sector banks lend to a variety of public sector entities, THFC lends solely to the U.K. social housing sector and Motability lends solely to individuals based in the U.K. classed as severely disabled. In our view, while we consider THFC to be highly visible as a lender to the social housing sector, it is also notable for its low market share in comparison with these peers and the greater competition that it faces from other lenders. It is also a much smaller institution, measured by adjusted assets.

Importantly, unlike its peers, we do not regard THFC as a GRE. This distinction partly reflects THFC's more modest market position, but is mainly driven by its rather different ownership and support structure. Unlike these peers, THFC is neither majority-owned by, nor does it benefit from guarantees from, central or local government.

## **Business Profile: Small Financial Intermediary To The Social Housing Sector**

THFC is a financial intermediary for the social housing sector, borrowing from banks and the capital markets to lend to HARPs. This provides HARPs with cost-effective and reliable access to the capital markets and other lending institutions, like the European Investment Bank (EIB), which they ordinarily may not have access to. It also allows investors to lend to the sector while diversifying their risk across underlying HARPs.

At March 31, 2011, THFC and subsidiaries together had loan assets of £2.46 billion, representing about 3% of private lending to the sector. Despite this seemingly modest position, we still consider THFC's franchise to be strong, taking into account the important niche role that it plays, its long track record, and its strong relationships with borrowers.

## **Ownership And Legal Status: Independent Not-For-Profit Society**

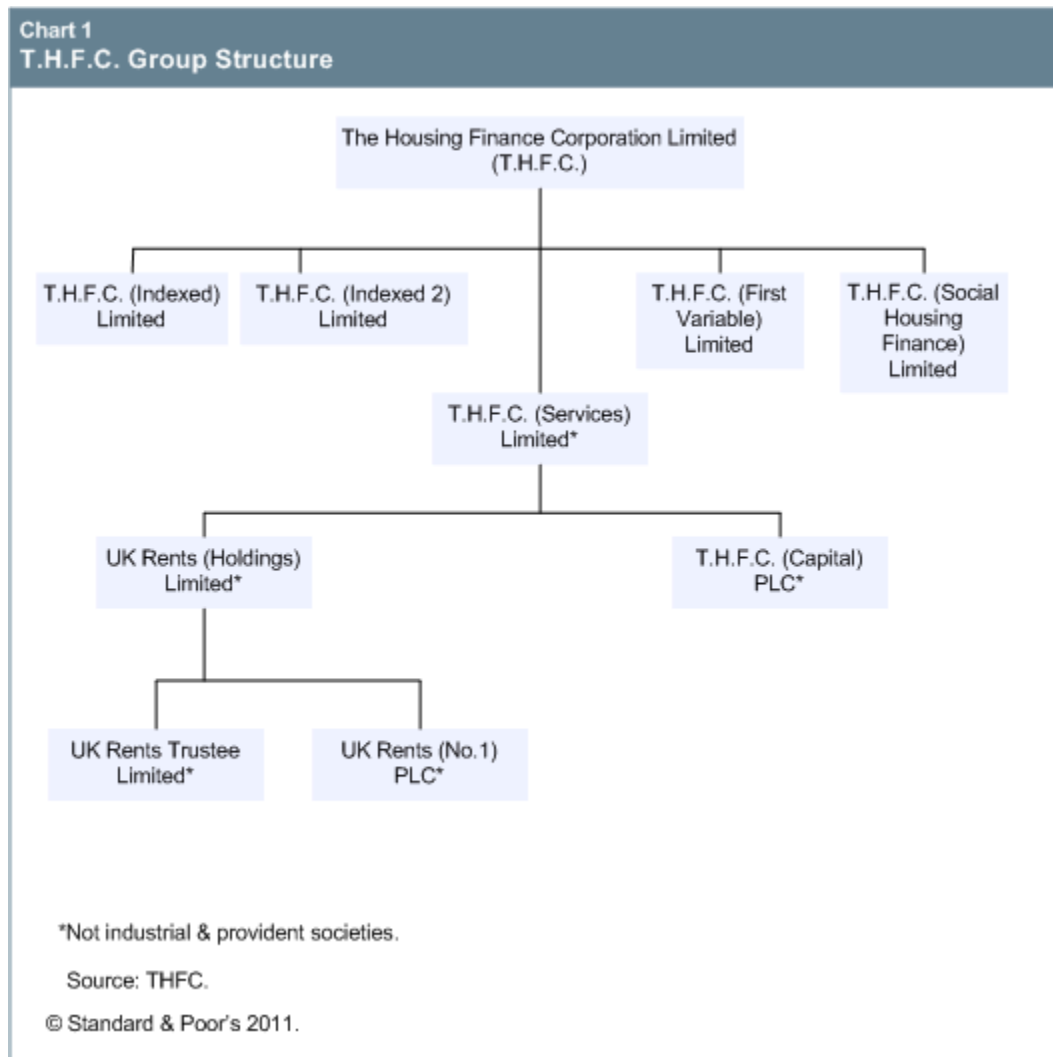
THFC is a finance company with the legal status of an Industrial and Provident (I&P) society. It operates under rules registered and approved by the Registrar for Friendly Societies, which is part of the Financial Services Authority (FSA). However, THFC is not regulated by the FSA.

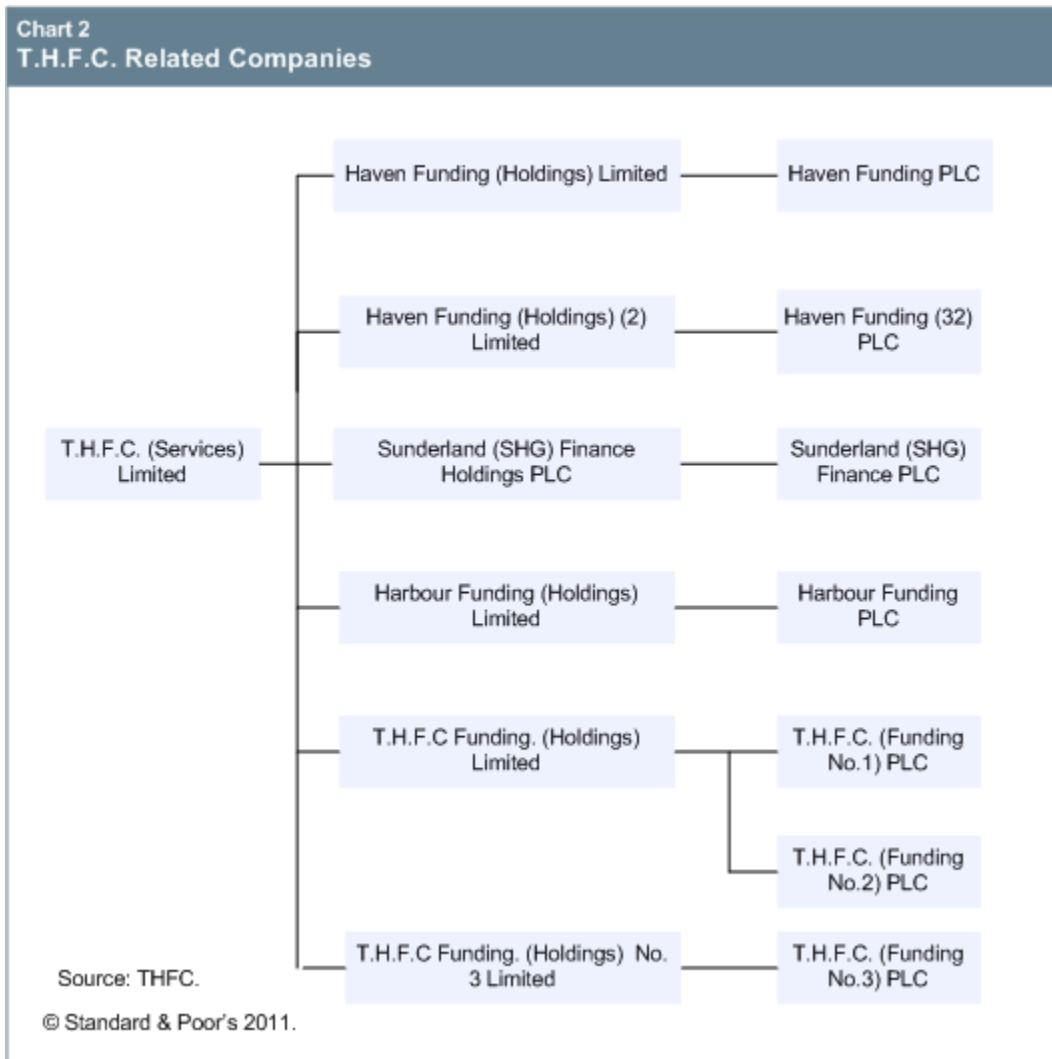
THFC is owned by seven non-executive board members, each of which holds one share. Notably, one of the shares is held on behalf of the Tenant Services Authority (TSA), which is a government agency and the current social housing regulator. However, in view of this minor holding, TSA's inability to inject capital, 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 GRE, as defined by our GRE criteria (see "Enhanced Methodology And Assumptions For Rating Government-Related Entities," published on June 29, 2009, on RatingsDirect). Although the TSA will be abolished in 2012, a new committee is being established to assume the role of economic regulator to the sector. We understand that a representative of this committee will remain on THFC's board.

While we do not view THFC itself as a GRE, in our view, the credit quality of THFC is largely affected by the credit quality of its underlying borrowers, who we do classify as GREs, and for whom we believe there is generally a "moderately high" likelihood of extraordinary government support. This is in addition to the significant amount of ongoing support that is also factored into our ratings on HARPs.

## Group Structure : A Network Of I&P Societies

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 I&P societies that were set up to issue bonds and onlend the proceeds to selected HARP's (see chart 1). Importantly for THFC, a failure by any of these subsidiaries to service its respective debt would not result in a contractual 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 doing so would not compromise the financial viability of THFC. We do not rate the debt issued by these subsidiaries.

THFC also has three orphan funding subsidiaries-- T.H.F.C. (Funding No. 1) PLC, T.H.F.C. (Funding No. 2 ) PLC and T.H.F.C (Funding No. 3) PLC. We rate the debt issued by these subsidiaries, which onlend the proceeds of any issue to THFC (see "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 would result in a cross-default of 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--they have no direct access to the property collateral provided to THFC for loans that it makes to HARP's. Therefore, in the event of a default by

THFC, lenders would have access to its loan assets alone and recovery will likely depend on the market value of those loans at that time.

## **Governance And Management : Skilled Board And Capable Management**

A board of nine members governs THFC, including two executive members. The board members bring long experience and a strong combined skill-set, with nominees from the TSA and the National Housing Federation (NHF; the sector's trade body), former bankers, accountants, and housing association professionals.

Unusually, the credit committee is a committee of the board, and includes members that routinely represent or work with borrowers. Further, the committee is made up of seven (including two executives) of a total of nine board members. Taking note of both these factors, there is a potential for conflicts of interest to arise or for the independence of the board to be questioned.

We consider the management team to be experienced and capable. The chief executive and the treasurer have been in their respective posts since 2002 and have 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 11 individuals (including three part time members), leaving THFC vulnerable to a degree of turnover risk. This risk is partially mitigated by well-documented practice manuals and, we understand, a system of sharing information across the team.

## **Strategy: Competitive Lender Of Choice For Small And Medium HARPs**

THFC's primary focus is to see some modest growth in the loan book and to continue to be a competitive funder for HARPs. At the same time, THFC continues to seek avenues to increase its fee-generating advisory and administration services. We consider that these provide some modest diversification and, due to their annuity-like nature, a degree of repeatability of revenues, irrespective of transaction volumes.

At present, the U.K. government favors an increase in revenue flexibilities (permitting to raise affordable rents to up to 80% of market rents) as opposed to supply side subsidies, with a decline in development grants. We expect, at least in the short term, that this decline in grant funding will be partially replaced by debt funding for HARPs that continue to develop new units.

We also expect more bond issuance in the short term as HARPs crystallize business plans and increase private finance to fund development or refurbishment programs. We believe this could be supportive of transaction volumes for THFC through 2012-2013.

Bank competition has eased somewhat because of liquidity pressures and higher levels of capital that will be required going forward. However, we still believe THFC will face continued competition from the banks, who can often provide a more "all round" service to HARPs, as well as from other competing financial intermediaries who have established links with the sector.

## Risk Profile And Management : Risk Comes Mainly From Limited Liquid Resources And Personnel Risk

### Credit risk

In our view, the highly collateralized nature of THFC's loans to HARPs means that it faces a rather modest risk of loss in the event of borrower default, although it could take many months to fully realize the collateral. However, THFC's low liquid resources mean that its ability to meet its payment obligations on time is largely dependent on timely receipts from its HARP borrowers. As a result, aside from structural protections, such as debt-service reserve accounts, the credit risk assessment and proactive monitoring by THFC of its borrowers is paramount.

Across THFC, there are about 112 borrowers (121 borrowers for the group as a whole). Lending to the top 20 associations accounts for about 55% of the THFC loan book (see table 2) and, in our view, most of these borrowers are likely to be of high creditworthiness.

We have seen exposure to individual associations rise in the last three years. The highest exposure is to Southern Housing Group (just under 8% of the loan book) and A2 Dominion Group (5% of the loan book).

**Table 2**

<b>Top 20 Borrowers By Current Outstanding Balance At Sept. 30, 2011</b>			
<b>Borrower</b>	<b>Current balance</b>	<b>Annual cashflow all loans</b>	<b>Current balance as a percentage of total loan book (%)</b>
Southern Housing Group	160,439	10,090	7.72
A2Dominion Group	84,443	5,439	4.06
Midland Heart Limited	72,697	5,623	3.50
Network Housing Group	70,017	3,638	3.37
Metropolitan Housing Trust	63,426	3,210	3.05
Paradigm Housing	60,000	3,675	2.89
Westcountry Housing Association	47,000	2,531	2.26
Family Mosaic	44,923	3,393	2.16
One HG	44,406	2,886	2.14
Radian Housing	43,500	3,441	2.09
Home Group Limited	42,488	3,708	2.05
AmicusHorizon Group Limited	41,790	4,706	2.01
Genesis Housing Association	40,500	2,986	1.95
Yorkshire Housing Limited	40,500	2,064	1.95
East Midlands Housing Association	39,658	2,662	1.91
LHA-ASRA Housing Association	38,928	3,899	1.87
Manningham Housing Association	36,523	2,583	1.76
Mosscaire Housing Limited	34,893	2,487	1.68
Arcadia Housing	33,413	2,975	1.61
Places for People Group	33,076	3,361	1.59

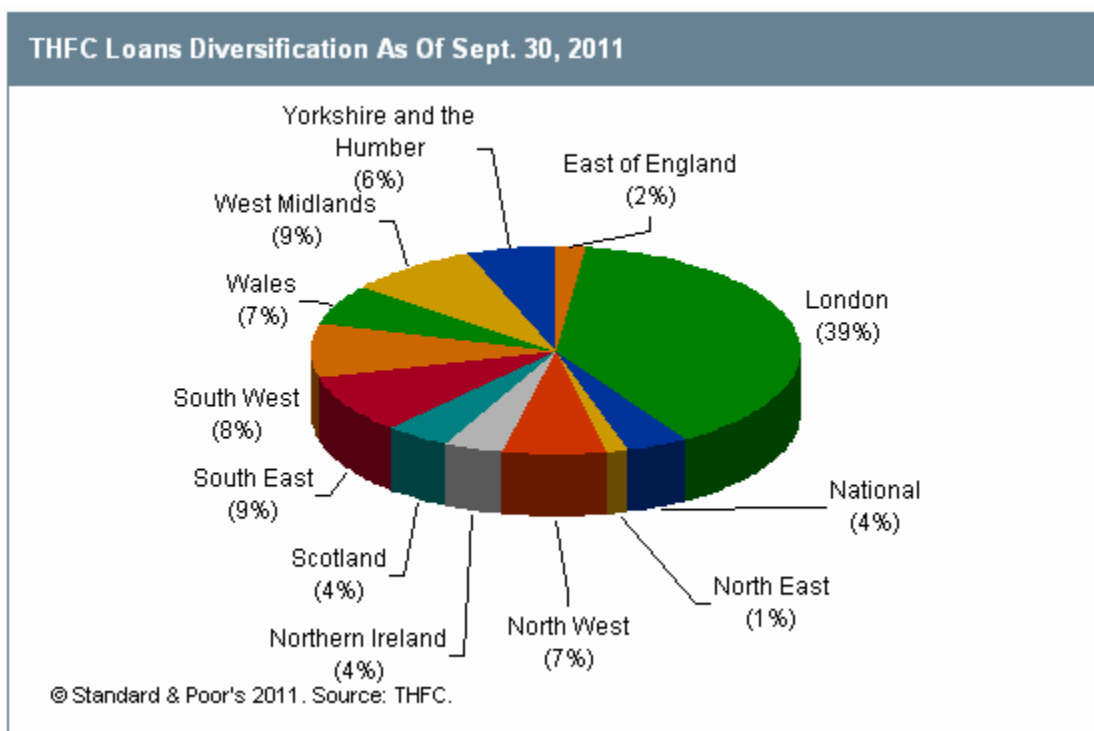
While exposure to some individual associations is large, safeguards that we have mentioned before are likely to remain in place. For example, exposure to Southern Housing Group remained at about £147 million as of September 2011. As Southern Group is one of the associations that borrowed via the THFC (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 in 2039.

While there are no fixed maximum exposure limits for individual HARP 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 £4.4 million for Midland Heart Housing Association. However, a series of defaults by its weakest borrowers (that may not happen to be the largest) has the potential to cause considerable stress to its modest liquidity reserves. We consider, however, the prospect of such a series of defaults to be unlikely over the rating horizon.

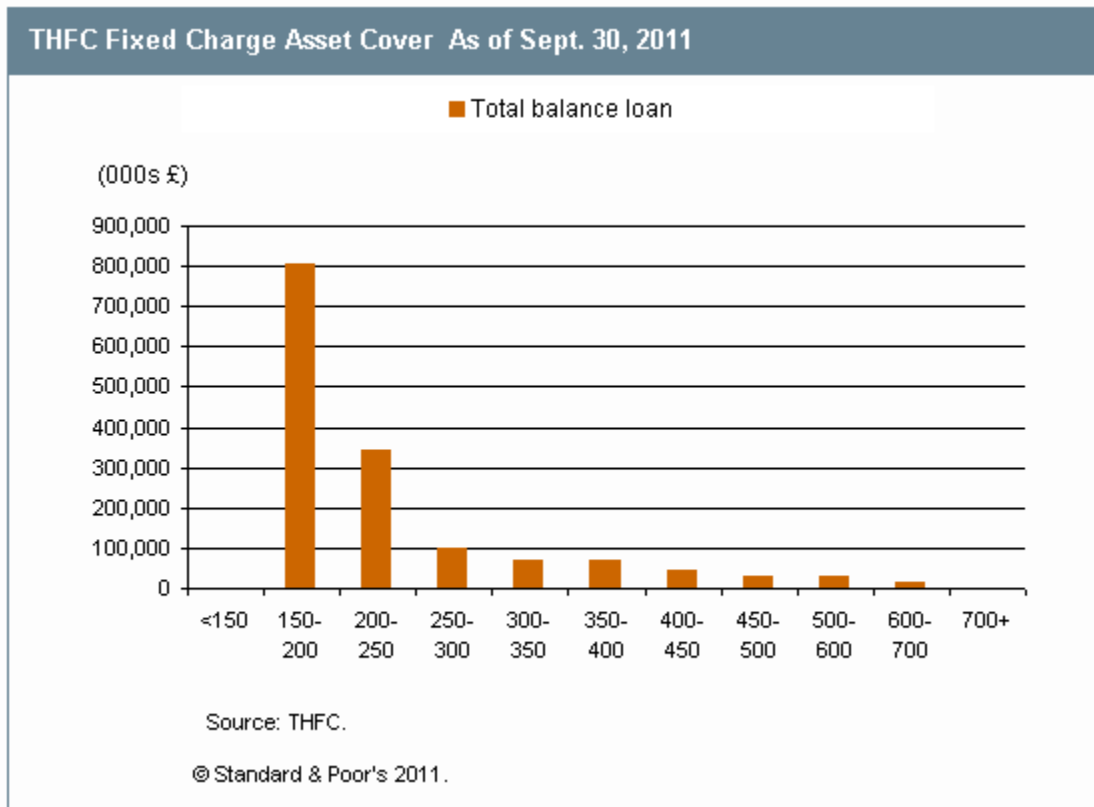
Geographically, the portfolio is generally well diversified, except for London, where 39% of the portfolio is located (see chart 3).

**Chart 3**



All THFC's loans to HARPs 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 (see chart 4).

Chart 4



### Liquidity and funding risk

In our view, the most significant weakness in THFC's financial structure is the size of its reserves, which stood at £6.76 million as of March 31, 2011, and which we expect to touch £7.2 million in March 2012 (group reserves are £10.58 million in 2011 and expected to be £11.02 million in 2012). These reserves are THFC's only liquid resources. However, providing support for the specific borrowing (£263.25 million) from THFC (Funding No. 2) PLC and £100 million from THFC (Funding No. 3) PLC is a 12-month debt-service reserve (see "THFC Funding No. 1, No. 2 and No. 3" below).

THFC's funding is sourced either from banks or from the capital markets. Funds are onlent almost immediately after they are raised, and are lent on materially the same terms as they were sourced. Bank finance forms about 50% of the current funding structure for THFC, and is mainly made up of loans from the European Investment Bank (EIB). Capital market debt issued by the funding subsidiaries is onlent to THFC, and THFC is therefore ultimately responsible for servicing and repaying this debt.

In our view, THFC's match-funding of loans and borrowings reduces potential structural interest rate, funding, and liquidity risk. An important further mitigant of liquidity risk 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 is designed to prevent a delayed payment or an operational problem of a borrower from causing a technical default by THFC. It also provides THFC with 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 hypothetical scenario where two of its largest borrowers defaulted, and THFC had no access to any debt-service reserves, we expect that THFC's reserves would cover the related interest payments for only 12 months, which coincides with THFC's estimated period for enforcement of its security. Unless THFC was able to organize an additional liquidity facility, committed and available to call, a delay in enforcing security or the default of a further borrower could bring about the default of THFC itself.

We note, however, that due to the proactive stance of the sector's regulator, to date there has never been a cash payment default in the sector. This is because in the fairly rare circumstances where HARPs have run into viability problems, the regulator has organized an acquisition or rescue by stronger HARP peers. That said, the sector has never faced a systemic default scenario, which would be harder for the regulator to manage. At this point, changes announced with regards to the abolishing of the TSA in early 2012 and the institution of a committee which will be part of the Homes and Community Agency have not led us to believe that the support that the government provides through the office of the regulator will lead to a lower level of support for this sector.

Further, we also note that once THFC enforces its security over the property assets of a defaulted HARP, we would expect it to benefit from associated rental or asset sale income, which would provide more liquidity, although this income is not expected to flow through immediately following default.

Refinancing risk for the underlying borrowers and THFC can be material at times, as most of the loans have bullet maturities, as of course does THFC's debt. THFC is entering a period of refinancing for some bond and bank loans. The next significant maturity is £43 million in 2012 (down from £93 million as reported last year due to an early redemption and refinance). A major portion of this (£31 million) will be covered via a sinking fund provided by Metropolitan Housing Association & Cheviot Housing Association. The exposure that remains is quite small, at about £11 million.

After 2012, the next significant re-financing date is 2016.

In order to mitigate refinancing risk, THFC starts discussions about refinancing plans with associations 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 does not pre-fund and states that it will therefore only raise debt when firm borrowers are in place. Further, as lending is materially on the same terms on which THFC borrows funds, it takes almost no structural interest rate risk.

Nevertheless, THFC's revenues are exposed to interest rate risk because falling interest rates reduce its investment income. Given the prevailing low interest rate environment, we expect THFC's investment income to continue to remain at the current, substantially reduced level in the medium term.

### **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 periodically by the board. Nevertheless, the effective mitigation of operational risk typically requires periodic investment, which could be difficult for an organization like THFC, which has tight cost control limits in place, and the ability to earn a return from significant investment is limited.

## **THFC Funding No. 1, No. 2, And No. 3**

Debt issued by T.H.F.C. (Funding No. 1) PLC has about 25 years to run to maturity. The expected maturity is 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 issuer credit rating on THFC. The liquidity facility, which is a 364 day facility, is currently provided by RBS (A/stable/A-1). To date, THFC has raised £249 million through issuance from this vehicle.

Debt issued by THFC (Funding No. 2) has a 32-year term, is due in 2039, but has a final maturity in 2041. THFC lent 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 RP borrowers are not refinanced in 2039, the two-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.

In September 2011, THFC set up a third funding subsidiary, T.H.F.C (Funding No. 3), issuing £100 million and retaining £30 million of that issue. The bonds have an expected maturity in 2043 and a final maturity in 2045. The proceeds of the bonds were lent to six housing associations, three of which were new borrowers to THFC. The structure of these bonds, mirror the structure of the bonds issued by THFC (funding No. 2). As such, risks remain very similar and the bonds are rated 'A+', in line with the corporate credit rating of THFC.

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 and No. 3, however, a debt-service reserve equivalent to only 12-months' interest payments on the relevant THFC borrower loan that remains outstanding is only available to the issuer 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: High Operating Leverage, But Low Flexibility**

THFC is a relatively profitable enterprise, generating net profits of about 30% between 2008 and 2010. Profits are mainly driven by new business fees, which can be quite volatile. A combination of higher new business fees and lower tax outflows because of deferred tax adjustments resulted in a net profit of 34% of operating revenues in 2011, but this is expected to decline to 19% of operating revenues in March 2012. The sharp decline in percentage terms between 2011 and 2012 also illustrates the effect of high operational leverage. While THFC's business model offers good returns in a growing market, it has limited flexibility to quickly adjust operating expenses in the event

that new business volumes were to fall materially and interest rates remain at low levels. For example, staff costs including independent director costs, usually equate to about 60% of total operating expenses, but we see limited room for maneuver here, given THFC's already small staff numbers.

**Table 3**

<b>THFC Profitability</b>				
	<b>--Year-ended March 31.--</b>			
<b>(%)</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>
Return on average assets	0.04	0.05	0.04	0.04
Return on average managed assets	0.04	0.05	0.04	0.04
Pre-tax profit margin	35.21	44.57	40.65	34.27
Net interest margin	0.01	0.01	0.05	0.07
Noninterest income/operating revenues	89.86	91.74	64.55	54.31

Increased agency and arrangement fees have helped raise THFC's levels of profitability in the past two years, and have moderately offset the much-reduced investment income arising from the low interest rate environment. They have also added an element of repeatability to THFC's revenues, irrespective of new transaction volumes.

While, all net profit generated boosts reserves, which have been growing at about 10% annually, we do consider the absolute levels of earnings THFC expects to generate in 2012 to be rather low, at about £0.55 million.

## Small Capital Base That Is Expected To Grow At A Declining Rate

THFC's capital base remains small at 0.4% of the loan book, and consists of share capital and reserves. Share capital is a token £7, representing the shares held by seven of the non-executive directors. As of March 31, 2011, THFC's capital base was £6.76 million, and £10.58 million for the consolidated group as a whole, including funding subsidiaries. As of March 2012, we expect the THFC reserves to increase to about £7.2 million (£11.5 million at the group level). Although, capital reserves have been growing by about 10% for the past three years, we do not expect growth to continue at the same pace over the next few years. Further, capital as a percentage of loan assets is expected to remain at about 0.4% because of slower growth of the asset base. This small capital base provides very little flexibility, should the credit quality of the sector begin to deteriorate, as housing associations adjust to new business models, and if there is corresponding increase in credit risk HARPs choose to take.

**Table 4**

<b>THFC Liquidity</b>					
	<b>--Year-ended March 31.--</b>				
<b>(x)</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>
Pre-tax interest coverage	1.01	1.01	1.01	1.01	1.00
EBITDA interest coverage	1.01	1.01	1.01	1.01	1.00
Adjusted EBITDA interest coverage	1.01	1.01	1.01	1.01	1.00
Short-term debt/funding liabilities (%)	3.02	2.50	3.57	2.09	2.26

Table 4

THFC Significant Financial Metrics					
--Year-ended March 31.--					
(%)	2011	2010	2009	2008	2007
Equity/managed assets	0.42	0.43	0.44	0.42	0.40
Adjusted total equity/adjusted assets	0.42	0.43	0.44	0.41	0.40
Debt/equity (x)	233.92	230.13	223.78	234.36	243.05
Debt/adjusted total equity	23,398.64	23,059.06	22,473.75	23,606.22	24,533.57
Average debt/EBITDA (x)	15.19	15.37	13.17	12.74	N/A
Average debt/adjusted EBITDA (x)	15.19	15.37	13.17	12.74	N/A

N/A--Not available.

## Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

- Principles Of Credit Ratings, Feb. 16, 2011.
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008.
- Rating Finance Companies, March 18, 2004

### Ratings Detail (As Of December 19, 2011)

#### The Housing Finance Corp. 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.

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