

RESEARCH

The Housing Finance Corporation Ltd.

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Major Rating Factors**Strengths:**

- Strong credit counterparties in the form of established housing association borrowers, with no history of defaults
- Loans secured by fixed and floating charges over social housing properties, with a robust level of asset overcollateralization
- Not-for-profit status, with links to the U.K. government and sector regulator
- Rising values of secured assets, and borrowers' surpluses increasing
- Prudent lending policy

Issuer Credit Rating

A+/Stable/A-1

Weaknesses:

- Low capital reserves relative to comparator banks and building societies
- Exposure to a single sector, with some borrower-concentration risk
- Limited business growth in recent years, due in part to a conservative lending policy
- Weak competitive position due to the continued aggressive lending activity of large banks and building societies
- Small staffing numbers, which heightens operational risk

Rationale

The ratings on U.K.-based not-for-profit lender The Housing Finance Corporation Ltd.--together 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 creditworthy counterparties in the social housing sector, strong overcollateralization, and good management. These factors are offset by THFC's low capital reserves, single-sector exposure, and weak competitive position.

THFC is a dedicated, not-for-profit lender to the U.K. social housing market. It has a high-quality loan portfolio, secured by a broad diversification of properties in terms of size and location. THFC has a relatively narrow line of lending business, however, which focuses entirely on the U.K. social housing sector and presents single-industry risk. There are also significant obligor concentrations, which have been increasing recently, as the top 10 borrowers account for about 32% of THFC's total loan book. The borrowers, however, are all concentrated in the U.K. social housing sector, where there has been no history of default to date. THFC's loan book is characterized by low turnover and reflects a microcosm of the U.K. social housing market, with no experience of cash default or economic loss to date.

THFC 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). No formal support is provided by these entities, however. THFC's not-for-profit status also provides it with a degree of financial flexibility (in that it has no shareholder dividend payment requirements) and financial conservatism. In recent years, THFC has expanded its agency role, managing housing debt transactions that provide some fee income and offer limited diversification from its core lending activities.

THFC provides well-structured loans, which are principally secured by a fixed charge over about 100,000

U.K. social housing properties. It uses conservative lending covenants (relative to the market), with a minority of loans secured by a floating charge and £6.5 million of dedicated reserves. All lending and onlending is performed via back-to-back arrangements with borrowers, and therefore THFC is not exposed to any timing risk or rate movement mismatches.

Negative pledges on all debt restrict THFC and its subsidiaries from borrowing or creating any charge that might rank above its existing debt. All creditors of THFC and its subsidiaries are secured on floating charges that rank *pari passu*. 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, for example, THFC, through a new special-purpose vehicle, T.H.F.C. (Funding No. 1) PLC, issued a 'AA-' rated bond, which benefited from a 24-month dedicated liquidity facility provided by ABN AMRO Bank N.V. (AA-/Stable/A-1+). If the facility were withdrawn or the liquidity provider downgraded, the rating on this bond could be lowered.

THFC's capital base of £6.5 million is low in comparison with the reserves of comparator banks. Overall, liquidity and financial flexibility, although adequate relative to the current asset profile, are relatively limited.

THFC's competitive position in the funding market is relatively weak due to the continued activity of banks and building societies, which provide aggressive funding to the social housing sector. This makes THFC's business strategy potentially challenging, 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 2006, it gained four new borrowers and lost one.

THFC's strategy is to seek to offer innovative products and price benefits for existing and potential new customers. THFC may come under competitive pressure to relax certain lending standards at the margin, however. Its conservative lending policy is key to the rating, but if over time financial performance improves and reserves are increased, there may be scope for some adjustment.

THFC is staffed by an experienced team. The low number of employees, however, leaves 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 its business positioning, however, the successful implementation of THFC's business development strategy and achievement of short-term growth will be crucial to maintain current ratings. Material slippage against financial targets, increased exposure to business risks, or a declining market position may put its credit standing at risk. Standard & Poor's Ratings Services expects some improvement in THFC's reserves over time, which will improve capital ratios and bolster THFC's credit profile.

Business Profile

THFC is a niche lender dedicated to the social housing sector, and is different from any previously rated lender for the following reasons:

- It is a not-for-profit entity, incorporated under the Industrial and Provident Societies Act with limited liability. This means that on a winding up the reserves must be returned to THFC's borrowers.
- It was set up in 1987 by the Housing Corporation (the industry regulator), the NHF, and the private sector to encourage funding to registered social landlords (RSLs).
- It has a public-policy role that helps differentiate it from other traditional lenders to the sector.
- It has close links with government (through the Department of Communities and Local Government and the Treasury), the Housing Corporation, and NHF, although there is no formal support from any of them. THFC is not analyzed as a government-related entity.
- It acts as an aggregating financial intermediary, which diversifies the risk to those that lend to THFC and allows access to the capital markets for RSL borrowers that would ordinarily not be able to do so owing to their size. (It improves cost effectiveness for borrowers through economies of scale.)
- It funds itself through borrowing from banks and issuing bonds to the capital markets.
- It requires borrowers to pay interest payments and some principal repayments one month in advance of the due date for THFC's own financial obligations, which enhances internal liquidity.

Business Description

THFC's book of social-housing loans totals about £1.6 billion. It lends to 126 RSLs of varying sizes (the total number of housing associations in the sector is about 5,000, although about 90% of these are extremely small and have no future debt requirements and no development activity). Many of THFC's loans date from the late 1980s and early 1990s, when it had just been established and its competitive position was much stronger than it is now. THFC was one of the first private lenders to the U.K. social housing market and was an early innovator, with the first full securitization and the largest-ever index-linked bond issue in social housing. More recently, THFC issued a new, albeit relatively small, Eurobond in December 2004, and plans further bond issues in the future. It also introduced the European Investment Bank (EIB; foreign currency AAA/Stable/A-1+) to the sector. In addition, THFC manages several structured social housing transactions, including Haven Funding PLC, Haven Funding (32) PLC, Sunderland (SHG) Finance PLC, and Harbour Funding PLC bonds, all of which are rated by Standard & Poor's.

Owing to the expansion of conventional lending sources, which have competed principally on price and relaxation of covenants, THFC has failed to keep pace with the bank market. As a result, THFC's market share has been steadily eroded since the early to mid 1990s.

THFC actively manages its portfolio, particularly for existing borrowers with relatively high-interest debt burdens that are seeking refinancing solutions. In such instances, THFC can arrange for the redemption of old debt. Where possible, THFC will seek to provide the refinancing, but at the very least will ensure that the redemption fee charged is greater than the net present value of future management fees.

Management

THFC has a very small operational team of nine experienced professionals. The chief executive arrived four years ago as part of a concerted effort to reposition THFC through a drive to increase its revenues and develop a positive business strategy. The team is experienced 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, although the small number of staff leaves THFC vulnerable to turnover risk, even though knowledge is generally well shared across the team.

Ownership And Legal Status

THFC is a not-for-profit Industrial and Provident (I&P) society. It is owned by its nonexecutive board members, six of whom hold directly (or via their employers) a fully paid £1 share in THFC.

This represents THFC's total share capital (not including reserves). 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.

Regulation

THFC is not formally regulated by the Financial Services Authority (FSA), but the I&P societies within the group (including THFC itself) are subject to its oversight as the Registrar for Friendly Societies. This oversight is not viewed by Standard & Poor's as equivalent to the market regulation for a financial services organization such as a bank or building society. THFC's day-to-day close working relationship with the Housing Corporation and its board representation, although not a formal regulatory relationship, do, however, provide some comfort.

Corporate Governance

THFC is governed by a board with nine voting members, which includes a nominee from both the Housing Corporation and the NHF. There are five independent board members, and two executive members (THFC's Chief Executive and Group Treasurer). All members have equal votes, and all are required to act in the best interests of THFC. In Standard & Poor's opinion, the board members exhibit an appropriate, relevant, and mixed skill set. Nonexecutives may only serve a maximum of three consecutive three-year terms of office. Nominated board directors can serve an unlimited tenure, up to age 70, unless reconfirmed annually. The chairman must be reelected annually for a five-year maximum term. The term of the current chairman comes to an end in June 2007. The current chairman will be succeeded by Mr. Roger Mountford who was formerly a merchant banker and has a strong financial background. Mr. Mountford joined the Board as "Chair Elect" in October 2006. In the same year, Mrs. Gill Rowley was appointed to the board as the Housing Corporation nominee. Mrs. Rowley is Head of Private Finance at the Housing Corporation.

In 2006, THFC also updated its Rules (the equivalent of Memorandum and Articles of Association for an I&P Society) to ensure they reflect best practice.

Separate committees exist for credit, audit and risk, and personnel issues. The credit committee approves all new loans, whether to existing or new borrowers, which should help ensure that lending is impartial and without bias. Under its rules, a board meeting can be quorate with only two nonexecutive board members in attendance, although in practice the majority of board members are actively involved in all internal decision-making.

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 set up for the specific purpose of individual capital markets 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. In future, THFC may set up separate subsidiaries for lending to nontraditional businesses such as key-worker accommodation schemes in order to ring-fence these high-risk loans or investments in unregulated businesses, such as RSLs do.

Strategy

In recent years, THFC has lost market share to other funders, namely banks and building societies, where they have competed more aggressively on price and covenant packages. It has consciously adopted a niche strategy of offering funding products and restructuring that do not compete head to head with bank funding. Its main strategic business areas are: new bond issuance using the THFC credit rating; the restructuring of existing bonds; and the provision of administrative support to social housing bonds. With the growing need for working-capital facilities among larger RSLs, THFC is finalizing the structure of an aggregated CP program to address this requirement.

To date, THFC has issued £99.4 million of rated bonds via T.H.F.C. (Funding No. 1). The first issue was £67.4 million in December 2004 and the second was for £32.0 million in December 2006. Further issuance is expected in 2007. T.H.F.C. (Funding No. 1) onlends to THFC Ltd., which in turn onlends to housing association borrowers. Much of the underlying activity has been due to RSLs refinancing historically high coupon debentures and investors being given the opportunity to switch to longer duration, rated Eurobonds. In 2006, THFC also completed the onlending of a new £100 million 20-year facility made available to it by the EIB.

In 2006, bank and building society lending to the RSL sector continued to mature, with a higher proportion of transactions representing a refinancing of existing facilities. Margins continued to fall, and consequently the social housing lending market continued to be dominated by banks and building societies. This competitive climate is in part due to pressure on banks and building societies to grow their corporate lending portfolios to make up for a tightening in retail lending. Banks and building societies are also factoring in potentially lower regulatory capital requirements for lending to social housing associations under Basel II.

The objective for THFC is to further enhance its position complementary to other lenders, although Standard & Poor's considers this to be challenging in the current competitive lending environment. THFC is also considering widening its lending remit to include lending to regeneration and key-worker schemes, and general-needs core business. Although regeneration and key-worker projects are priorities for government housing policy in the U.K., and lending to these projects will heighten THFC's public-policy role, this type of project does carry greater inherent risk. We believe that if THFC develops in this direction it may risk diluting the credit quality of its existing loan portfolio. We would expect reserves or liquidity to grow appropriately to reflect these higher risks.

THFC's lending portfolio covers the full spectrum of traditional RSLs. Much recent lending has focused on the traditional small and midsize housing associations, which are likely to have less experienced management teams and boards than larger RSL organizations. They are also likely to have less sophisticated information systems and financial management. On the positive side, such associations tend to be involved in less diversification and development activity, helping to balance out some of the operational risk. Standard & Poor's reviews THFC's lending book to ensure that there have been no material changes to its risk profile year on year.

THFC plans to remain focused on the U.K. social housing market, in line with its rules. THFC's aim is to achieve an annual surplus of about £250,000. (In the financial year ended March 31, 2006--financial 2006-

-THFC achieved an annual pretax surplus of £629,000 (£453,000 after tax) due to higher interest rates and fees related to increased prepayment activity).

THFC has a good reputation as an administrator and security trustee of structured social housing transactions, and it aims to increase its activity in this area of operation.

THFC's success in increasing its share of the social housing lending market depends on the ability of the capital markets to compete with bank financing, mainly on price. While bank margins remain aggressively low, THFC will continue to face a challenging task to significantly increase market share.

Risk Profile And Management

Credit risk

All THFC's loans are secured, and covenants are conservatively structured. 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. THFC amended its trust deed in financial 2003 to permit its borrowers more flexibility to use spare borrowing capacity in existing pledged security to raise new borrowing from THFC. This might encourage existing customers to extend their loans with THFC, rather than refinance them elsewhere.

In 2006, THFC proposed further amendments that would allow borrowers to pledge security to THFC via a security trust structure or to pledge security owned by other members of their group. These amendments are expected to be adopted early in 2007. The security pledged to THFC will remain restricted to regulated social housing assets: No new security exposed to commercial risks will be offered as a consequence of this change.

THFC and its subsidiaries pledge security to their respective investors in the form of a floating charge over the group's assets (that is, the social housing loans book) and its capital reserves of about £6.5 million. All THFC's secured creditors, including institutional investors and lenders, legally rank *pari passu*, and have the benefit of overcollateralization over secured asset values compared with the value of THFC's loans.

There have been no defaults within the sector to date (although this does not include loan restructuring). This is due in part to the early intervention and supportive framework of the sector regulator where housing associations face financial pressures.

THFC has no sector diversification. It is restricted by its own rules and regulations, which only permit it to lend to RSLs. Furthermore, THFC does not lend to "nonmature" large-scale voluntary transfer associations, which are generally more risky than traditional associations because they are 100% debt-financed on transfer and have higher maintenance requirements.

THFC has two key loan covenants based on asset coverage and asset-specific income coverage. Assets are typically valued on a "market value" basis (subject to tenancies), which is generally about two-thirds of the actual open market value. THFC requires periodic revaluations of individual security portfolios to ensure that secured assets provide coverage valued at least 150% of the outstanding loan balance. In practice, the well-seasoned nature of the lending and associated security means that there is typically a cushion over and above this 150% threshold. The ratio is currently estimated at about 288% (market value subject to tenancies). THFC covenant arrangements ensure income coverage is sufficient to meet interest repayments.

About one-third of THFC's lending continues to be to associations with housing stock based in London and southeast England, a region with high property values and high demand for affordable housing. Overall, THFC's loan portfolio is generally representative of the social housing sector as a whole.

The top 10 largest borrowers are a mixture of sizes and have differing levels of development activity and operate in different geographic areas. THFC is not, therefore, particularly exposed to any one area, and its lending policy has resulted in a relatively balanced portfolio.

Standard & Poor's believes that THFC's asset performance is in part determined by its internal credit scoring process. The scope of our review, therefore, includes a validation of THFC's credit approach, an assessment of the predictability of its internal credit scoring model to evaluate credit risk appropriately, and a review of the adequacy of its monitoring and control procedures.

THFC's credit scoring system has recently been adjusted, which has led to an overall improvement in the portfolio credit score. THFC uses the Housing Corporation Assessment indicators for financial viability and management and governance and asset values (which continued to grow in 2006). Out of 126 borrowers, six have been upgraded and two downgraded. The majority, however, have remained unchanged. The likely maximum loss in any one year can be assessed from the loss given default ratio derived from default probabilities associated with the internal ratings for borrowers. Any new borrowers are similarly credit scored.

Standard & Poor's continues to monitor THFC's internal credit scoring system, which is an important rating factor. THFC's prudent lending policy and strong borrower base, which is measured by the internal credit scoring system, helps offset its low level of capital reserves. We recognize that there may be pressure to erode some of the strong credit standing of the portfolio over time in order to compete with banks. Any increased credit exposure from a relaxation of credit policy, or a rebalancing of existing weaker borrowers, or introduction of weaker new borrowers is likely to weigh on the ratings on THFC, unless there is a corresponding increase in reserves.

Funding and liquidity risk

All THFC funding is sourced from banks or directly from the capital markets. THFC has good relationships with its own funders, including the EIB.

Standard & Poor's considers the biggest weakness in THFC's financial structure to be the size of its available liquidity, which stands at about £6.5 million of reserves, with an additional liquidity cushion provided by borrowers who pay interest one month in advance. 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 but available at call, this situation could bring about the default of THFC itself. THFC and its subsidiaries have no general standby liquidity facilities for their obligations, other than the specific and dedicated facility for the recent bond issue by T.H.F.C. (Funding No. 1). Standard & Poor's notes, however, that THFC has had no liquidity issues throughout its existence. Virtually all interest payments are made by direct debit and the one-month liquidity buffer has proved sufficient.

In effect, THFC takes no interest-rate risk. Its own borrowings are immediately onlent to RSLs, with a substantially identical interest and principal repayment profile. Nevertheless, THFC's income stream is exposed to a certain level of interest-rate risk in terms of its earnings as its investment income (that is, interest payments received one month in advance of due date) is adversely affected by lower interest rates. THFC tries to mitigate the effect of this risk through periodically reviewing its hedging policies and making prudent assumptions in the budget. It does not, however, make use of derivative funding, other than interest rate swaps, forward rate agreements, and purchased interest-rate options. Most of its interest income is fixed at short-term (less than 12 months) rates.

In addition, about 90% of THFC's liabilities do not fall due before 2016. There are three key principal refinancing peaks--in 2016, 2023, and 2025--that could cause some income volatility, although in practice most RSLs refinance rather than pay down debt. Although the current refinancing profile is manageable, further borrowing will seek to avoid maturities coinciding with these peaks. Absolutely no currency risk is taken. All borrowing and lending is conducted in British pounds sterling. Any decision regarding nonsterling CP issues to appeal to a wider investor market will need to be backed by currency rate swaps.

We consider the new management team to have made good progress in ascertaining the potential operational risks that a small organization might face. These risks are regularly reviewed by the board.

Profitability

THFC is a not-for-profit organization. Under its rules, it cannot trade for profit, but any annual surpluses are accumulated as reserves. THFC's aim is to make a steady surplus each year in order to increase reserves.

In financial 2006, THFC made a surplus before tax of £629,000, up from £376,000 in 2005. This continues a steady trend of profitability improvement since 2003, although it is still less than the profits achieved in 2001 and 2002.

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. Other 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.

The profit increase in financial 2006 was primarily due to an increase in interest income on the monthly float and restructuring fees. The monthly float, which is conservatively invested in cash accounts at major U.K. financial institutions, together with interest on reserves, produced interest income of £766,000 in financial 2006, compared with £733,000 in the previous year. Fees receivable and other income totaled £1.5 million in financial 2006, up by £400,000 on the previous year.

Profitability was also aided by relatively stable expense growth. Although THFC has moderately high overhead costs, this partially reflects the buildup of staff in anticipation of future growth. If THFC is unsuccessful in its transition strategy, it could wind down with relatively limited additional expense owing to the small size of its team and its maintenance of a small leasehold office (there is no branch network).

Costs are carefully controlled, reflecting the limited income sources and the fixed nature of the majority of THFC's expenses. Although it is a not-for-profit organization, virtually all THFC's surpluses are subject to taxation.

Capitalization

At March 31, 2006, THFC's reported equity-to-assets ratio was a low 0.39%, relatively unchanged from the previous year. In addition, the absolute size of THFC's capital base--£6.5 million--is small, although THFC is expecting to add an additional £300,000 million to reserves in 2007. Furthermore, Standard & Poor's considers THFC's financial flexibility to replenish its reserves in the event of a stress scenario to be limited. THFC's capitalization, therefore, does not compare favorably with that of a commercial bank. The weak nature of THFC's capital base is, however, partially mitigated by the very low-risk nature of the loan book.

All THFC's lending is secured. For the majority of its portfolio, THFC has a fixed charge over identified pledged assets. In addition, THFC's asset-coverage covenant is required to be at least 150% and any release or withdrawal of security is not permitted if coverage is less than 200%. Asset coverage is currently greater than 200%.

Ratings Detail (As Of 23-Feb-2007)*

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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