

January 26, 2009

The Housing Finance Corporation Ltd.

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The Housing Finance Corporation Ltd.

Rationale

The 'A+/A-1' corporate credit ratings on The Housing Finance Corporation Ltd. (THFC Ltd.) and subsidiary undertakings (together; THFC) reflect THFC's franchise in the social housing sector, its adequate risk profile, satisfactory earnings prospects, and ongoing strong government support for the sector. These strengths counterbalance the potential challenges posed by the weakening outlook for the social housing sector, and the low interest rate environment, which will likely reduce THFC's investment income. THFC's very modest liquid financial resources also constrain the ratings.

Issuer Credit Rating

A+/Stable/A-1

The 'AA-' rating on debt issued by T.H.F.C. (Funding No. 1) PLC is credit-linked to THFC and remains unchanged.

THFC's ability to meet its financial obligations is mainly dependent on receipts from its underlying borrowers. While the social housing sector faces increased challenges with higher funding costs and reduced income from property sales, we expect THFC to continue to closely monitor the health of its borrowers. The system of government support and the regulatory framework continues to be proactive in preventing cash defaults by housing associations. In the event of a default, the robust collateralization of THFC's loans, which averages over 250% across the portfolio when calculated on a market value subject to tenancy basis, provides an indication of support in a recovery scenario. Our rating on THFC factors in no direct external support for THFC itself.

THFC's thin capitalization, and resultant modest liquid financial resources, is a key weakness that constrains the rating. As of March 31, 2008, the capital base of £7.6 million provided support to a balance sheet worth £1.8 billion. In addition, THFC's relatively narrow line of lending business presents single-industry risk, which is compounded by increasing borrower concentration risk.

In recent years, THFC's competitive position in the funding market has been relatively weak, given its rather narrow product profile and more conservative lending criteria, when compared with some of its competitors. As a result, THFC has had modest success with new bond issues and funding mandates. However, the rising costs and scarcity of bank funding may lead more associations to tap bond markets via THFC. THFC has also developed a useful relationship with the European Investment Bank which, we expect, will help to underpin lending volumes in the coming year.

THFC is a small organization, leaving it somewhat vulnerable to staff turnover and key personnel 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 and net income for THFC in the medium term. While we expect profitability to remain satisfactory, lower earnings will prevent a material strengthening of reserves.

Outlook

The stable outlook reflects the 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 will 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, diversifying the risk to those investors wanting to lend to registered housing associations and allowing cost-effective access to the capital markets for housing association borrowers that would ordinarily not be able to do so, typically owing to their size. This arrangement also helps to standardize loan terms across participating housing associations. THFC funds itself through borrowing from banks and by issuing bonds to the capital markets.

THFC is a relatively small lender to the sector, with group balance sheet assets of about £1.8 billion as at March 31, 2008. Of this, direct lending from THFC, the parent company, was about £960 million. The rest was sourced directly from the capital markets by its subsidiary companies and then on-lent to housing associations.

Ownership and Legal Status

THFC is a finance company, with the legal status of an Industrial and Provident (I&P) society. It is owned by its non-executive board members, of whom six currently hold directly (or via their employers) a fully paid £1 share in THFC. It operates under the rules registered and approved by the Registrar for Friendly Societies, which is now part of the Financial Services Authority (FSA). THFC is not formally regulated by the FSA. While the sector regulator, the Tenant Services Authority (TSA), is represented on THFC's board, THFC receives no explicit government support.

Corporate Governance And Management

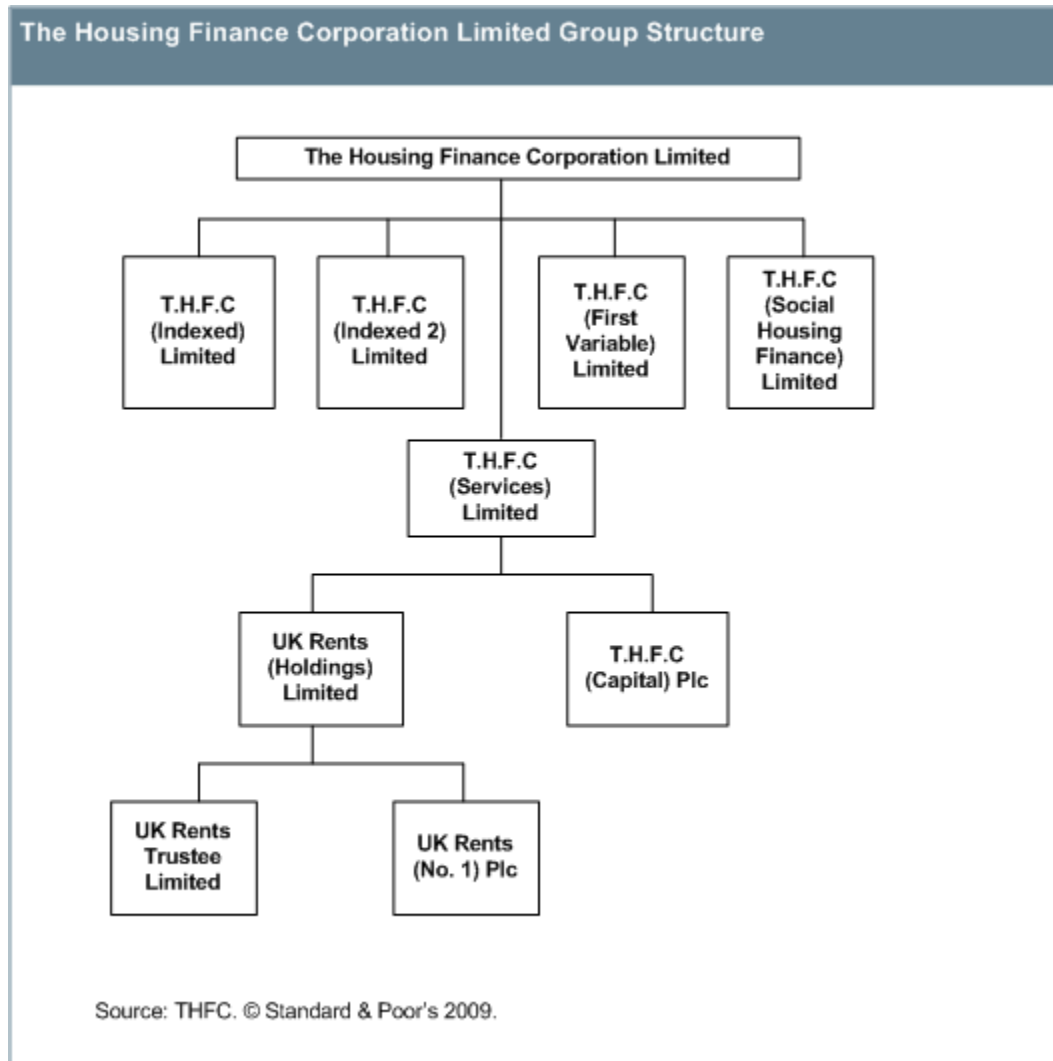
We believe the governance arrangements in place are strong given the size and relative straightforwardness of the business. A board with nine voting members governs THFC and includes a nominee from both the TSA, and the National Housing Federation (NHF), the sector's trade body. There are seven independent 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. Separate committees exist for credit, audit and risk, and personnel issues. The credit committee approves all new loans, whether to existing or new borrowers. While there is the potential for conflicts of interest to arise from outside work undertaken by some board members, 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 operations comprise seven staff who bring together a diverse range of experience in social housing, banking, accountancy, and corporate treasury functions. The small number of staff does, however, leave THFC vulnerable to turnover risk and key personnel risk.

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. THFC Ltd. is the ultimate parent and main operating company.



The subsidiaries are individual special-purpose vehicles (SPVs) set up to issue bonds and on-lend the proceeds to a pool of housing associations. This lending is secured on ring-fenced property pools to which bondholders will have direct access should they need to enforce their security. The subsidiaries are separately constituted legal entities and are entirely owned by THFC. Defaults in any of the subsidiaries, caused by default of an underlying borrower, would not cause a cross-default in THFC Ltd.'s financial obligations. However, we believe that THFC management would feel morally obliged to support a failing subsidiary, as long as it does not put THFC itself at risk of default.

All lending to THFC Ltd. by banks and other creditors is on a pari passu basis and any default of any financial

obligations of THFC Ltd. will cross-default all THFC Ltd.'s financial obligations to all its lenders. In such a situation we would expect the receiver appointed at the time to work in the best interests of all lenders. While in most cases we expect a default of THFC to be caused by default of the underlying borrowers, unforeseen cost increases and other operational risks materializing could also cause default of THFC. This risk is heightened due to its very modest levels of liquidity, which would normally provide some short-term flexibility.

Strategy

THFC's primary focus continues to be as a funding provider for regulated housing associations. In doing so, it aims to create and offer flexible and competitive refinancing opportunities for those who require it and to design and offer long-term price-competitive funding products. Owing to its size and narrow product offering, THFC has found it very difficult to compete in a sector that until now has been very heavily financed by bank debt. However, competitive dynamics have improved somewhat due to the weakening supply of bank credit.

THFC's strategy is to continue to position itself as a vehicle that housing associations can use to tap the capital market. At the same time, THFC will work at increasing its fee income with the provision of advisory services. While this may help compensate for a reduction in investment income due to the decline in interest rates, it is unlikely to offset the decline in total revenues.

THFC has also developed a very useful relationship with the EIB and acts as a conduit for funds originated from EIB and on-lent to housing associations. 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

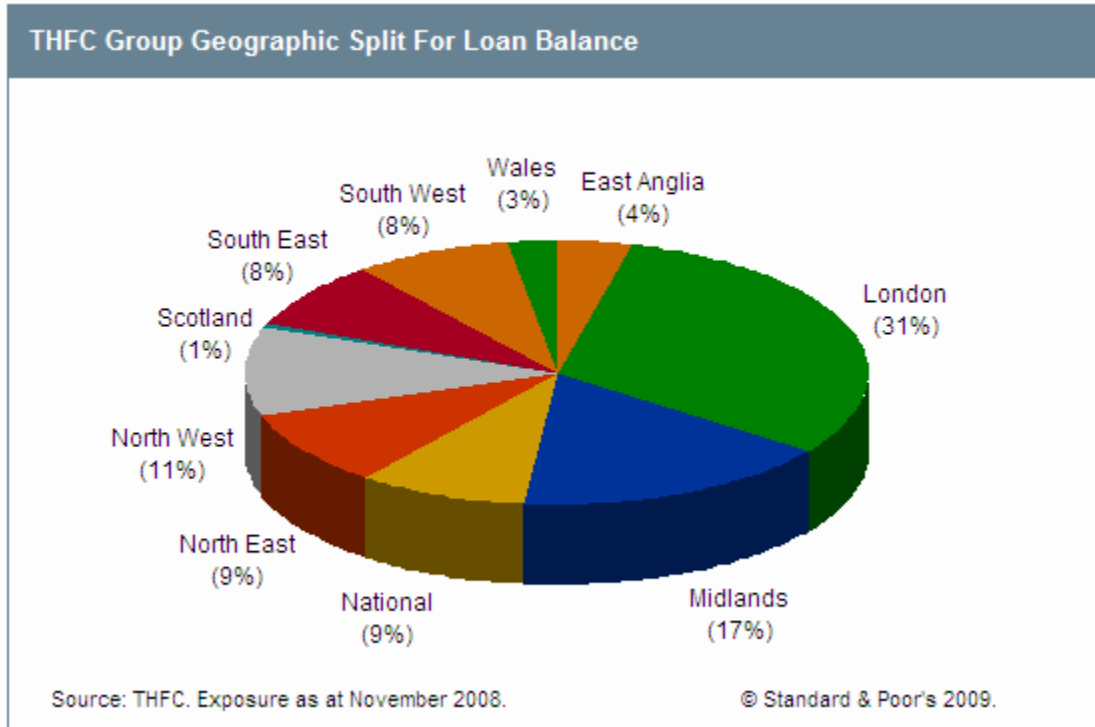
THFC's loan book is robustly collateralized. However, its ability to meet its payment obligations on time is in turn dependent on timely receipts from its housing association borrowers. The credit risk assessment of its borrowers is therefore crucial.

Across the group, there are about 103 borrowers, with 91 of these borrowing from THFC Ltd. Lending to the top 10 associations accounts for about 33% of the group loan book. In general, individual borrower's level of credit risk is fairly low and reflects THFC's conservative lending policy of only lending to mature registered housing associations. THFC generally assesses credit risk of each borrower at the outset and on a continuing basis. Further, all new lending requires board approval and the board also receives regular reports on credit risk performance.

While there are no fixed maximum exposure limits for individual housing association groups, THFC's policy is that, at a minimum, the annual payment due from its largest borrower should be no greater than THFC's reserves. THFC also calculates the expected loss given the default of each of its underlying borrowers and ensures that its reserves can cover the most significant loss. Currently the highest annual cash flow from any single borrower is about £5.0 million and the largest estimated loss given the default of a single underlying borrower is £4.1 million. However, a series of defaults by its weakest borrowers (who may not happen to be the largest) could cause considerable stress to its modest liquidity reserves. This analysis excludes monies lent to Gentoo via THFC (Capital), where there is no recourse to THFC and lenders to Gentoo have direct access to the property collateral. Gentoo does not borrow through any other THFC subsidiary or from THFC itself. If this exposure was included, the exposure to the top ten borrowers is over 50%.

Geographical diversification

The portfolio of loans to housing associations is well diversified by size and geography. Ignoring the exposure to Gentoo in the North East for reasons mentioned above, the largest geographical exposure is to London, followed by the Midlands (see chart).



THFC credit assesses all borrowers at the start of the relationship and then undertakes continuous surveillance. Using both qualitative and quantitative analysis, first the stand alone quality is assessed and then the assessment is adjusted for government support. Most credits at the end of this process are assessed to be in the safest category as defined by THFC.

All THFC's loans are secured and borrowers can choose to secure their lending by either a fixed charge over specified properties, or by a floating charge. The majority of the company's lending is carried out 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. On average, across the whole group portfolio, the actual level of asset cover is about 250%, against a minimum covenanted level of 150%. There are some cases where the minimum asset cover level is 135%, but these form a very small proportion of the total pool.

Liquidity risk

The most significant weakness in THFC's financial structure is the size of its reserves, which stand at about £7.6 million, of which about £5.6 million is freely available to THFC Ltd., the rest being generated and maintained by the subsidiary companies. The reserves, held in cash, are THFC's only liquid resources.

While match-funding reduces some structural interest rate and liquidity risk, a further mitigant is the receipt of

payments from borrowers one month before they are due to be paid to THFC's bankers or bond holders. This prevents a delayed payment or 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 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 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 the respective interest payments. Unless THFC was able to organize an additional liquidity facility, committed and available to call, this situation could bring about the default of THFC itself. 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.

With regards to refinancing risk, no bank loans fall due in 2009. In fact, refinancing needs until 2016 are very marginal. In general, most of the debt requires bullet repayments from the associations and as such leaves THFC exposed if the associations cannot refinance their debt on time. To mitigate this 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. While not an immediate problem, as exposure to "single" borrowers increases, THFC will be more exposed to refinancing risk.

Interest rate risk

THFC takes minimal structural interest rate risk because its borrowings and loans have a closely matched interest and principal repayment profile. Nevertheless, THFC's revenues are exposed to interest rate risk as lower interest rates would reduce its investment income. Given the low interest rate environment in which it is now operating, we expect THFC's investment income to fall markedly from previous 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 group's funding is sourced either from banks or directly from the capital markets. All creditors of THFC are secured on floating charges on the loan assets and rank *pari passu*. In addition, negative pledges on all debt restrict THFC and its subsidiaries from borrowing or creating any charge that might rank above its existing debt.

Although all creditors are secured, 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. This is the case for debt instruments issued by T.H.F.C. (Funding No. 1) PLC, which are rated one notch above the counterparty credit rating of THFC due to the provision of additional liquidity support. The outstanding bond(s) is due in 2035, although final maturity is in 2037. To allow for continued payment of interest according to the terms of the bond, there is a dedicated 24-month interest-only liquidity facility. The facility is also available during the two-year tail to

cover for any costs of enforcing and selling security if required. To date, THFC has raised £249 million through this funding vehicle.

Profitability: Low Margins, 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. Revenues appear to be set on a downward trend in the coming years, with significantly lower investment returns expected. Although we believe that THFC will remain profitable, cost control remains an important discipline.

Fees and investment income dominate THFC's earning streams, accounting for more than 90% of revenues (see table). However, while investment income accounted for about 40% of income in the year ended March 2008 and is expected to remain at these levels for 2009, we would expect this to fall considerably in the next few years. While fee income is expected to rise, it is not expected to be significant enough to cover the gap. THFC's therefore is expected to face reduced operating margins in the near term.

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 account for about 57% of costs in 2008 and are expected to rise to 59% of costs in 2009. Mainly as result of declining investment income, THFC is expecting retained profits to go down to about £300,000 in 2010, from about £800,000 in 2009

	THFC Financial Indicators							
	Year to March 31							
	2003	2004	2005	2006	2007	2008	2009e	
£000s								
Fees	708	877	951	1,349	1,123	1,215	1,626	
Investment income	728	656	733	766	877	1,088	964	
Other income	129	141	169	161	169	227	172	
Total revenues	1,565	1,674	1,853	2,276	2,169	2,530	2,762	
Staff costs	646	738	742	797	779	856	909	
Non-executive directors costs	161	97	98	102	99	97	121	
Legal/trustees and registrars	297	211	236	301	303	230	238	
Premises	85	75	102	104	111	107	124	
Other	316	361	306	343	338	370	353	
Total costs	1,505	1,482	1,484	1,647	1,630	1,663	1,744	
Surplus before tax	60	192	369	629	539	867	1,018	
Tax	28	54	103	176	152	107	285	
Surplus after tax	32	138	266	453	387	760	733	
Accumulated reserves	5,639	5,777	6,043	6,496	6,883	7,643	8,376	
Loans outstanding	1,449	1,452	1,585	1,607	1,672	1,790	1,899	

e--Estimate.

Capital: Capital Base Small, Heightens Liquidity Risk

THFC's capital is small, consisting only of share capital and retained earnings. The share capital is a token £6, representing the shares held by six of the non-executive directors. As of March 31, 2008, retained earnings for the group were about £7.6 million. However, some of this is tied up in subsidiaries, meaning that only about £5.6 million was readily available to support THFC itself. As of March 2009, we expect the group reserves to increase to be about £8.4 million. In view of THFC's 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 good record on financial management.

Ratings Detail (As Of January 26, 2009)*	
The Housing Finance Corporation Ltd.	
Issuer Credit Rating	A+/Stable/A-1
Issuer Credit Ratings History	
24-Jun-2004	A+/Stable/A-1
Related Entities	
T.H.F.C. (Funding No. 1) PLC	
Senior Secured (1 Issue)	AA-

*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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