

# RatingsDirect®

---

## Research Update:

# Long-Term Ratings On Iceland's Housing Financing Fund (HFF) Lowered To 'BB-' On Housing System Proposals; Outlook Stable

### **Primary Credit Analyst:**

Maxim Rybnikov, London (+44) 207 176 7125; maxim.rybnikov@standardandpoors.com

### **Secondary Contact:**

Alexander Ekbohm, Stockholm (46) 8-440-5911; alexander.ekbom@standardandpoors.com

### **Analytical Group Contact:**

SovereignEurope; SovereignEurope@standardandpoors.com

## Table Of Contents

---

Overview

Rating Action

Rationale

Outlook

Related Criteria And Research

Ratings List

## Research Update:

# Long-Term Ratings On Iceland's Housing Financing Fund (HFF) Lowered To 'BB-' On Housing System Proposals; Outlook Stable

## Overview

- A government-appointed project committee on the organization of the housing system has proposed to gradually discontinue HFF's operations.
- We now consider the likelihood of the government of Iceland providing timely and sufficient extraordinary support in the event of financial distress to be high instead of extremely high.
- We are therefore lowering the long-term rating on HFF to 'BB-' from 'BB'.
- We continue to assess HFF's stand-alone credit profile at 'b-'.
- The outlook is stable, reflecting our view of balanced risks to the ratings.

## Rating Action

On July 22, 2014, Standard & Poor's Ratings Services lowered its long-term foreign and local currency issuer credit ratings on Ibudalanasjodur (Housing Financing Fund; HFF) to 'BB-' from 'BB'. At the same time, we affirmed the short-term ratings at 'B'. The outlook is stable.

## Rationale

The downgrade reflects what we see as HFF's diminishing public-policy role following the recommendations of the project committee on the organization of housing system in Iceland. We now assess HFF's role for the government as important rather than very important, under our criteria for rating government-related entities (GRES). Therefore, we believe there is a high likelihood--compared with extremely high previously--that the government of Iceland would provide timely and sufficient extraordinary support to HFF in the event of financial distress.

We currently expect HFF's operations to gradually discontinue following the housing policy proposals put forward by the project committee appointed by Iceland's Minister of Social Affairs and Housing. We understand that these proposals are to address the need for limiting persistent losses posted by the HFF in recent years, as well as promote the development of an active rental market. They also answer the requirements of the European Free Trade Association Surveillance Authority (ESA), which has on multiple occasions expressed concerns that some operations of HFF entail state aid and do not comply with the rules of the European Economic Area (EEA) agreement, demanding

changes to the scope of HFF's operations.

Under the existing system, HFF provides mortgage loans, as do commercial banks, and, to a lesser extent, pension funds. The new approach calls for the establishment of specialized mortgage companies, which will be allowed to provide mortgage loans only, and finance them through issuance of covered bonds.

The proposals specify that HFF will cease lending and its portfolio will be allowed to expire. A new state-owned housing loan company will be established. The entity will operate on the same terms as other specialized mortgage companies and, unlike HFF, will not benefit from a state guarantee.

In our view, HFF's public policy role has diminished following the proposals and we have revised the assessment of its role for the government to important from very important, as our criteria define these terms. Our view of HFF's important role is primarily based on the consequences that HFF's default could have for the government and the domestic capital market. As of end-2013, HFF's bonds amounted to about 47% of Iceland's 2013 GDP, with about two-thirds held by Icelandic pension funds. The institution's default could therefore entail losses for the pension funds, which is unlikely to be politically acceptable for the government in office. HFF's default could also undermine confidence in the companies benefiting from similar guarantees by the government.

We continue to assess HFF's link with the government as integral. The institution remains 100% state-owned and we do not expect this to change. As a state agency, HFF is not subject to bankruptcy proceedings and is exempt from taxation. The government has provided support to HFF through capital injections on three occasions during 2010-2014 totaling more than Icelandic krona (ISK) 50 billion. The government also provides an ultimate, but not timely, guarantee on HFF's outstanding debt.

The new proposals on the organization of the housing system are likely to be considered in parliament in the coming months. So far, the timeline for their implementation remains uncertain. We understand, however, that HFF is likely to continue extending some loans--especially to the residents of rural areas of Iceland--before the new specialized mortgage companies become operational.

While many uncertainties remain, our base case assumes a gradual and orderly disbanding of HFF over several years. We expect HFF's operations to be downsized so as to reduce fixed costs, while the government will only provide capital injections sufficient to ensure timely honoring of HFF's obligations. The government has also recently acknowledged that it will continue to guarantee HFF's debt.

We continue to assess HFF's stand-alone credit profile (SACP) at 'b-'.

We have revised our view of HFF's risk position and now consider it to be moderate. This reflects our expectations of a slight improvement in its asset quality, as well as the removal of uncertainty around the financing of the

government's proposal to offer debt-relief measures; these measures will take the form of write-downs of private individuals' indexed mortgages. However, we continue to believe that HFF's asset quality will likely remain pressured as a meaningful part of the portfolio is either in payment suspension or overdue past 90 days. In addition, more than half of the total private individual loan portfolio has undergone some form of restructuring, including longer amortization periods or links to a wage index rather than the initial inflation index. On the positive side, no new names have been added to the largest problem loans, and we believe the situation is starting to stabilize.

At the same time, we have also revised our view of HFF's funding profile to below average to reflect its reliance on the capital markets without any central bank access. HFF has maintained stable access to the domestic bond market since the onset of the financial crisis in 2008, despite very high impairments and an eroding capital base. This has been possible, in our view, due to the close link to the government and the outstanding guarantee, and does not signify a stand-alone strength. We assess HFF's liquidity position as adequate, taking into account the expected contractual cash flows from prepayments and amortizing loans, and the cash liquidity buffer. We expect that HFF will receive state support, if needed, to meet any liquidity needs.

We continue to assess HFF's business position as adequate despite the likely upcoming parliamentary decision to gradually wind the fund down. We believe the wind down could put pressure on revenues, especially net interest income, but expect that the state would support a gradual and orderly process. Further, we expect this will hasten the reduction in HFF's dominant market share in the mortgage market in Iceland.

Capitalization remains very weak based on our projected risk-adjusted capital ratio, which we expect to remain around 2% over the next two years. The government injected ISK13 billion in 2012 and ISK4.5 billion in 2013 to strengthen HFF's very low regulatory ratio of 3.4% but a significant portion was consumed by high provisions. We believe that HFF will likely see further losses in 2014 and 2015, although smaller than in previous years, and we expect the government will provide more capital injections.

## **Outlook**

The stable outlook reflects our expectation that HFF's current stand-alone creditworthiness remains unchanged, and that the likelihood of the government of Iceland providing timely and sufficient extraordinary support to HFF in the event of financial distress remains high (albeit revised down from extremely high).

We could lower the ratings if we revised the SACP downward, for example as a result of further significant loan losses or policy-induced write-downs without timely compensation from the state.

We could raise the rating if HFF was to significantly reinforce its currently

very weak capital adequacy, for example through a capital increase.

On July 18, 2014, we revised the outlook on the long-term sovereign ratings of Iceland to positive. However, under our criteria for rating GREs, the ratings on HFF will not change if we raise the long-term local currency sovereign credit rating on Iceland by one or more notches, all else being equal.

## **Related Criteria And Research**

### **Related Criteria**

- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012

### **Related Research**

- Banking Industry Country Risk Assessment: Iceland, Aug. 19, 2013
- Iceland Outlook Revised To Positive On Strong Growth And Improving Public Finances; 'BBB-/A-3' Ratings Affirmed, July 18, 2014

## **Ratings List**

Downgraded; Ratings Affirmed

	To	From
Housing Financing Fund Ibudalanasjodur		
Issuer Credit Rating	BB-/Stable/B	BB/Stable/B
Senior Unsecured	BB-	BB

Complete ratings information is available to subscribers of RatingsDirect at [www.globalcreditportal.com](http://www.globalcreditportal.com) and at [spcapitaliq.com](http://spcapitaliq.com). All ratings affected by this rating action can be found on Standard & Poor's public Web site at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

Copyright © 2014 Standard & Poor's Financial Services LLC, a part of McGraw Hill Financial. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES 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, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties 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 or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. 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.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgement as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective 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 nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain 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](http://www.standardandpoors.com) (free of charge), and [www.ratingsdirect.com](http://www.ratingsdirect.com) and [www.globalcreditportal.com](http://www.globalcreditportal.com) (subscription) and [www.spcapitaliq.com](http://www.spcapitaliq.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](http://www.standardandpoors.com/usratingsfees).