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## Research Update:

# Iceland's Housing Financing Fund Ratings Affirmed At 'BB/B'; Outlook Positive

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## Research Update:

# Iceland's Housing Financing Fund Ratings Affirmed At 'BB/B'; Outlook Positive

## Overview

- In our view, Iceland's favorable economic conditions continue to support capital buildup and improvement in asset quality at the Housing Financing Fund *Ibudalanasjodur* (HFF), but we expect the fund's core earnings will remain under pressure over the next year.
- Following amended legislation in 2016, the fund is gradually shifting its focus to implementation of housing policies from direct lending, but we do not anticipate any immediate impact on HFF's credit profile.
- We are therefore affirming our 'BB/B' ratings on HFF.
- The positive outlook indicates that we could raise our ratings on HFF within one year if economic conditions in Iceland improve further, reducing the risks inherent in unwinding HFF's mortgage loan portfolio and supporting a stronger capital position.

## Rating Action

On July 10, 2017, S&P Global Ratings affirmed its 'BB/B' long- and short-term counterparty credit ratings on Icelandic lending institution Housing Financing Fund *Ibudalanasjodur* (HFF). The outlook remains positive.

## Rationale

The affirmation reflects our expectation that Iceland's government remains highly likely to provide support to HFF, if needed, thereby allowing HFF to meet its financial obligations in a timely manner. It also reflects our view that the evolution of the fund's public role does not at this point change its stand-alone creditworthiness.

We note that HFF's role is gradually changing from that of a direct housing lender. The institution is responsible for the administration and implementation of housing affairs on behalf of the government, through policy formulation, promoting research on the housing market, as well as administering capital contributions, and from January 2018, housing benefits. As such, we understand that the government's previous plan to ultimately dismantle the institution is now off the table. In the future, the fund is expected to earn fee income from the government, based on its implementation of the aforementioned tasks.

Nevertheless, the exact scale and scope of the new tasks are currently

uncertain, as are the details of the compensation that HFF would receive from the government. In addition, we understand that the government still intends to downsize HFF substantially, since lending is no longer the fund's main task. We believe that HFF will maintain its presence in the rural and lower-income segments of the market--which are important to the authorities for social reasons--and in regions where banks have little presence. Other than that, new lending will likely remain very limited.

Although the institution's role has diminished in recent years, we still assess it as important for the Icelandic government. This is because HFF will likely continue lending in the rural and lower-income segments of the market. Moreover, a default of HFF would have adverse consequences for the government and the domestic capital market, in particular for the pension funds that own about 80% of HFF's bonds. The government provides an ultimate, but not timely, guarantee on HFF's outstanding debt. In our view, HFF's default could undermine confidence in other companies that benefit from similar government guarantees.

In our view, HFF also has an integral link with the government of Iceland. Based on the government's 100% ownership of HFF and the consequences of a potential default of HFF, the authorities are highly likely to provide timely extraordinary support should the need arise. As a state agency, HFF is not subject to bankruptcy proceedings and is exempt from taxation. The government provided support to HFF through capital injections three times during 2010-2014, contributing a total of more than Icelandic krona (ISK) 50 billion (about €0.4 billion).

Our view of HFF's stand-alone creditworthiness is unchanged. We expect that HFF will continue posting positive, albeit very low, net earnings over the next two years, aided by Iceland's economic growth and high property prices, leading to extraordinary income from loan loss reversals and realized gains from sales of appropriated assets. However, HFF's long-term profitability remains fragile, in our view. We expect only a modest slowdown of prepayments because continued fierce competition for new lending from pension funds and commercial banks continues to put pressure on HFF's net interest income. Therefore, we continue to assess HFF's business position as moderate.

HFF's capital and earnings remain moderate in our view. We expect one-time gains from the sale of appropriated assets to boost earnings somewhat over the next two years, aiding capital buildup. However, in our base case, we do not expect our risk-adjusted capital (RAC) ratio for HFF will exceed 7% within the next 18-24 months. As of year-end 2016, our RAC ratio stood at 5.9%.

We still assess HFF's risk position as weak. While we see a positive development in asset quality, nonperforming assets remain high compared with peers', and there is a high level of single-name concentration. We expect loan losses will be close to zero in 2017, after two years of net provision reversals. The strong economic development in Iceland, with over 7% GDP growth and low unemployment rates, has had a positive impact on HFF, and we expect the benign operating environment will persist over the next year. However,

HFF's focus on financially weaker customers and illiquid regions is increasing, since customers that qualify for pension funds' stricter lending requirements tend to leave HFF. In addition, interest rate risk is increasing because the fund is struggling to find attractive investment opportunities for its excess liquidity.

In our view, HFF's funding and liquidity remain a weakness. We consider HFF's funding profile to be below average, based on its reliance on the capital markets and lack of central bank access. Although HFF has not issued bonds since 2012, due to high prepayments and low new lending, we consider that its ability to access the domestic bond market remains stable. In our view, this is mainly due to HFF's close link with the government and the outstanding government guarantee, and does not signify a stand-alone strength. We assess HFF's liquidity position as adequate, taking into account the fund's expected contractual cash flows from prepayments and amortizing loans, and its cash liquidity buffer, which is partly invested in long-dated covered bonds issued by Arion Bank to reduce the maturity mismatch. We expect that HFF would receive state support to meet any liquidity needs, although we do not currently anticipate that it will need such support in the next few years.

Given our assessment of a high likelihood of extraordinary government support in case of need, our ratings on HFF remain three notches higher than our 'b' assessment of HFF's stand-alone credit profile.

## **Outlook**

The positive outlook indicates that we could raise our ratings on HFF within one year if economic conditions in Iceland improve further, reducing the risks inherent in unwinding HFF's mortgage loan portfolio. HFF has a strict public policy role and is unlikely to expand lending in the market. However, its outstanding loan book may benefit from positive economic developments, resulting in decreased loan losses and an improved capital position. Capital metrics could also benefit from faster-than-anticipated earnings generation or the accelerated decrease in risk-weighted assets.

We could revise the outlook to stable if we saw signs that Iceland's strong economic development was weakening. Moreover, we could lower the ratings if we concluded that the effects of a potential HFF default for the government and the capital markets had reduced, which would reduce the incentive for the government to provide timely extraordinary support to HFF.

## **Ratings Score Snapshot**

Issuer Credit Rating	BB/Positive/B
SACP	b

Anchor	bbb-
Business Position	Moderate (-1)
Capital and Earnings	Moderate (-1)
Risk Position	Weak (-2)
Funding and Liquidity	Below Average (-1)
	Adequate
Support	3
ALAC Support	0
GRE Support	3
Group Support	0
Sovereign Support	0
Additional Factors	0

## Key Metrics

Housing Financing Fund Ibudalanasjodur					
	--Year ended Dec. 31--				
(Mil. ISK)	2016	2015	2014	2013	2012
<b>Key Figures</b>					
Adjusted assets	786,664	804,073	824,485	862,796	875,916
Customer loans (gross)	585,951	664,118	749,209	790,919	802,407
Adjusted common equity	23,314	19,637	17,916	14,694	14,552
Operating revenues	2,082	1,978	2,301	4,424	3,614
Noninterest expenses	1,680	1,875	2,050	3,090	2,665
Core earnings	2,018	1,093	(1,241)	(4,354)	(7,856)
<b>Business Position (%)</b>					
Loan market share in country of domicile	19.82	21.59	24.90	27.01	28.08
Total revenues from business line (mil. ISK)	4,456	2,759	6,973	4,424	3,614
Commercial & retail banking/total revenues from business line	46.72	71.69	42.39	100.00	100.00
Other revenues/total revenues from business line	53.28	28.31	57.61	N/A	N/A
Return on equity	19.63	9.63	19.69	(29.47)	(64.78)
<b>Capital And Earnings (%)</b>					
Tier 1 capital ratio	7.26	5.46	4.50	3.40	3.20
Net interest income/operating revenues	89.18	82.54	67.43	66.61	68.75
Noninterest expenses/operating revenues	80.69	94.76	89.11	69.85	73.73
Provision operating income/average assets	0.05	0.01	0.03	0.15	0.11
Core earnings/average managed assets	0.25	0.13	(0.15)	(0.50)	(0.90)
<b>Risk Position (%)</b>					
Growth in customer loans	(11.77)	(11.36)	(5.27)	(1.43)	(0.18)
Total managed assets/adjusted common equity (x)	33.75	40.96	46.03	58.73	60.20
New loan loss provisions/average customer loans	(0.27)	(0.15)	0.20	0.64	1.15

## Housing Financing Fund Ibudalanasjodur (cont.)

(Mil. ISK)	--Year ended Dec. 31--				
	2016	2015	2014	2013	2012
Net charge-offs/average customer loans	1.20	0.52	0.21	0.86	0.76
Gross nonperforming assets/customer loans + other real estate owned	13.22	15.60	17.56	21.59	22.20
Loan loss reserves/gross nonperforming assets	9.48	15.13	15.48	12.54	12.61
<b>Funding And Liquidity (%)</b>					
Long term funding ratio	91.56	91.38	91.92	90.64	91.10
Stable funding ratio	120.66	107.25	98.04	94.89	95.79
Short-term wholesale funding/funding base	8.70	8.84	8.26	9.53	9.05
Broad liquid assets/short-term wholesale funding (x)	2.88	1.75	0.84	0.60	0.65
Short-term wholesale funding/total wholesale funding	8.70	8.84	8.26	9.53	9.05

ISK--Icelandic krona. N/A--Not applicable.

## Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions, Dec. 6, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Ratings List

Ratings Affirmed

Housing Financing Fund Ibudalanasjodur

Counterparty Credit Rating	BB/Positive/B
Senior Unsecured	BB

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Certain terms used in this report, particularly certain adjectives used to

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