

### Research Update:

## Ibudalanasjodur (Housing Financing Fund) Ratings Kept On Watch Negative After Iceland LC Credit Ratings Lowered

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## Research Update:

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## Overview

- The local currency sovereign credit ratings on Ibudalanasjodur's 100% owner, the Republic of Iceland were lowered to 'BBB/A-3'.
- We are keeping our ratings on Ibudalanasjodur, Iceland's housing financing fund, on CreditWatch with negative implications, where they were placed on Jan. 6, 2010.
- We intend to resolve the CreditWatch once we have greater clarity on Ibudalanasjodur's financial position and performance in 2009.

## Rating Action

On March 30, 2010, Standard & Poor's Ratings Services said its 'BBB-/A-3' long- and short-term foreign currency issuer credit ratings and its 'BBB/A-3' long- and short-term local currency issuer credit ratings on Icelandic government-related entity Ibudalanasjodur (Housing Financing Fund; HFF) remain on CreditWatch with negative implications, where they were placed on Jan. 6, 2010, in line with a similar action on the sovereign.

## Rationale

The rating action follows the lowering of the long-term local currency sovereign credit ratings on the Republic of Iceland by one notch (foreign currency BBB-/Negative/A-3; local currency BBB/Negative/A-3). Iceland is HFF's 100% owner.

The ratings on HFF reflect our opinion that there is an "extremely high" likelihood that the government of Iceland would provide timely and sufficient extraordinary support to HFF in the event of financial distress.

In accordance with our criteria for rating government-related entities, this opinion is based on our assessment of HFF's "very important" role as Iceland's key residential mortgage lender--particularly following the default and restructuring of Iceland's key commercial banks--and its "integral" link with the government, as demonstrated, among other things, by the ultimate but not timely government guarantee on HFF's liabilities.

Following the breakdown of most of Iceland's commercial financial system in October 2008, HFF is now virtually the sole lender in the mortgage market, a role it held until 2004. The government is currently considering reform of the

residential mortgage market in order to bring the banks back into the market, particularly for lending beyond HFF's approval limits. However, we do not expect HFF's role to change significantly, not least because the government considers HFF to have been pivotal in dealing with the economic crisis in Iceland.

On a stand-alone basis, HFF is laboring under Iceland's distressed economy. Rising loan loss provisions in the mortgage and interbank portfolios may impair HFF's 2009 profitability and erode its capital, which, with a capital solvency ratio of 4.3% on June 30, 2009, we consider weak.

HFF incurred a sizable loss of Icelandic krona (ISK) 6.9 billion (about \$78.5 million) in 2008, mainly owing to large impairments in its liquidity portfolio following the collapse of the domestic financial sector. For the first half of 2009, HFF recorded a profit of ISK463 million, despite higher provisioning for impairment losses. However, we see a risk of another full-year loss, owing to further impairments of assets connected to the collapse of two additional, albeit smaller, banks in 2009.

In line with the deep recession in the economy and the correction in the housing market, at the end of 2009 about 14% of HFF's loan book was either nonperforming or on "payment holidays". A number of government-mandated anticrisis measures for the housing market, such as partial payments, payment holidays, extended maturities, and relinking of principal repayment indexation will likely result in a cash flow shortfall in 2010 and 2011. HFF should be able to cover this shortfall either from its cash position (ISK33 billion as of end-June 2009) or through borrowing.

HFF's bonds are the benchmark for the Icelandic inflation-indexed bond market. The bonds are amortizing, with HFF aiming to closely match payment flows from mortgages to debt-service payments. As a result, HFF has limited its refinancing requirements and should only need to borrow mainly for new mortgage lending. Domestic pension funds hold about 60% of HFF's bonds (about one-quarter of pension fund assets), and during 2009, pension funds alone are estimated to have bought the overwhelming share of HFF's issuance. Nonresident investors hold more than one-quarter of HFF's debt, with a large share of these holdings in public-sector hands. Principal payments on HFF's krona-denominated debt are subject to central-bank capital controls. Interest payments are freely convertible. We expect foreign demand for HFF's obligations to be lower in the future. Should local demand for HFF's debt issues be insufficient to fund its borrowing requirements, we would expect the government to provide funding directly to HFF.

## **CreditWatch**

We expect to resolve the CreditWatch on HFF by the end of April, once we have greater clarity on HFF's financial position and performance in 2009 and on potential reform efforts in the residential mortgage market. If we see a further deterioration in HFF's credit quality and capitalization, the ratings

could be lowered by up to one rating category. Conversely, a government commitment to replenish HFF's capital base, if it has weakened in 2009, could lead to an affirmation of the current ratings.

## Related Criteria And Research

- Republic of Iceland FC Ratings Affirmed On Near-Term Stability; LC Ratings Lowered To 'BBB/A-3'; Outlook Negative, March 30, 2010
- Enhanced Methodology And Assumptions For Rating Government-Related Entities, June 29, 2009
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Ratings List

CreditWatch Update

Ibudalanasjodur (Housing Financing Fund)

Issuer Credit Rating

Foreign Currency BBB-/Watch Neg/A-3

Local Currency BBB/Watch Neg/A-3

Senior Unsecured BBB-/Watch Neg

Senior Unsecured BBB/Watch Neg

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Complete ratings information is available to RatingsDirect on the Global Credit Portal subscribers at [www.globalcreditportal.com](http://www.globalcreditportal.com) and RatingsDirect subscribers at [www.ratingsdirect.com](http://www.ratingsdirect.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) 495-783-4011.

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