

Research Update:

Ratings On Iceland's Ibudalanasjodur (Housing Financing Fund) Lowered To 'BB' On Iceland L-C Downgrade: Outlook Negative

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Overview

- On May 17, 2011, Standard & Poor's lowered Iceland's long-term local currency ratings to 'BBB-' from 'BBB' because of Iceland's high external and fiscal debt burdens. Iceland's foreign currency ratings are affirmed at 'BBB-/A-3'.
- We view the likelihood of extraordinary government support for Iceland's Housing Finance Fund (HFF) as "extremely high". We believe HFF has an integral link with, and plays a very important role in, the government.
- We are therefore lowering HFF's long-term issuer credit ratings to 'BB' and removing them from CreditWatch Negative.
- At the same time, we are affirming the 'B' short-term ratings on HFF.
- Its stand-alone credit profile (SACP) is 'b-'.
- The outlook is negative, which means we may revise the SACP downward if we consider that the government has departed from its commitment to inject further capital into HFF by end-2011 to ensure HFF reaches adequate capital levels.

Rating Action

On May 18, 2011, Standard & Poor's Ratings Services lowered the long-term issuer credit ratings on Iceland's Ibudalanasjodur (Housing Financing Fund) to 'BB' from 'BB+' after the long-term local currency sovereign ratings on Iceland were lowered to 'BBB-' from 'BBB'. We are also removing HFF's long-term issuer credit ratings from CreditWatch Negative, where they were placed on April 14, 2011. We are affirming the 'B' short-term ratings on HFF. The outlook on HFF is negative, reflecting the possibility that we may revise its 'b-' stand-alone credit profile (SACP).

Rationale

The rating action reflects our assessment of the Icelandic government's weakened capacity to support HFF after the sovereign's long-term local currency ratings were lowered to 'BBB-' from 'BBB' on Iceland's high external and fiscal debt burdens.

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

According to 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 recent injection of capital of Icelandic krona (ISK) 33 billion at the end of 2010, and 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 new lender in the mortgage market. We view further market reform as likely, to bring the banks back into the market and fulfill the condition of government support under the European Free Trade Association Surveillance Authority (ESA) ruling. The ESA did not consider that HFF's general loan scheme complied with all the conditions of the European Economic Area Agreement, and the government has committed to present a restructuring plan for HFF by end-September 2011. We anticipate an adjustment period of more than two years.

On a stand-alone basis, HFF's operations are affected by Iceland's distressed economy, and we currently assess the fund's SACP at 'b-'. The fund posted a very substantial loss of ISK34.5 billion in fiscal-2010 mainly following the partial write-down of all private household mortgage loans that had a loan-to-value ratio greater than 110% (60% of total impairment costs). However, other nonperforming- and write-off-related impairments added to the negative result. The government's capital injection of ISK33 billion was therefore consumed in full and HFF's capital ratio remained very weak at 2.2%. In our view, the general and significant uncertainty about Iceland's economic recovery, plus the potential need for additional measures to ease the pressure on private individuals' balance sheets, will make HFF vulnerable to new substantial losses and highly likely to need another capital injection. On the funding side, we consider HFF to be second-most exposed, after the sovereign, to risks related to the capital account liberalization process in Iceland.

Outlook

The negative outlook mainly reflects the possible downward revision of HFF's SACP from 'b-' if we believe the government is going to depart from its commitment to inject HFF with more capital by end-2011 to achieve adequate capitalization. We view HFF's current capital position as very weak and believe there could be further negative pressure relating to continued provisioning needs. We believe this may come from Iceland's ongoing retail and corporate restructuring. We are also concerned about risks related to HFF's funding needs during the capital liberalization process. In addition, if HFF's role and link to the government were revised and the local currency ratings on the sovereign were lowered, we may also further lower HFF's rating.

On the other hand, additional capital support from the government and clearer financial situation could support the ratings. A firm proposal from government on restructuring HFF would also provide more certainty regarding HFF's role

in, and link to, the government.

Related Criteria And Research

- Republic of Iceland FC Ratings Affirmed On Nordic Support; LC Ratings Lowered To 'BBB-/A-3'; Outlook Negative, May 17, 2011
- Ibudalanasjodur (Housing Financing Fund) Ratings Placed On CreditWatch Negative In Line With Republic of Iceland, April 14, 2011
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Sovereign Credit Ratings: A Primer, May 29, 2008

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Ibudalanasjodur (Housing Financing Fund) Senior Unsecured (4 issues)	BB	BB+/Watch Neg

Downgraded; CreditWatch/Outlook Action; Ratings Affirmed

	To	From
Ibudalanasjodur (Housing Financing Fund) Sovereign Credit Rating	BB/Negative/B	BB+/Watch Neg/B

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Complete ratings information is available to subscribers of RatingsDirect on the Global Credit Portal at www.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at 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.

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