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Iceland: Mortgage Debt-Relief Plan Is Credit Positive for Housing Financing Fund, Without Detriment to Sovereign Creditworthiness

RATINGS - Iceland

FC Government Bond Rating	Baa3/STA
LC Government Bond Rating	Baa3/STA
FC Bond Ceiling	Baa3
FC Bank Deposit Ceiling	Baa3
LC Bond Ceiling	Baa2

KEY INDICATORS

	2012	2013F
Real GDP (% Y/Y)	1.4	2.4
CPI (Dec, % y/y)	4.2	3.6
Fiscal Balance (% GDP)	-3.8	-2.0
Current Acct (% GDP)	2.2	3.1

Source: Moody's Investors Service, Haver Analytics, Statistics Iceland, Central Bank of Iceland

RATINGS – Housing Financing Fund

Long Term Issuer Rating	Ba1/STA
Baseline Credit Assessment	caa1

KEY INDICATORS – Housing Financing Fund

	2012	End-June 2013*
PPI / Average RWA	0.2	0.3
TCE / RWA	3.2	2.5

Source: Moody's Financial Metrics, BFM

*H1 2013 data is annualised

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Summary

On 30 November, the Government of Iceland (Baa3, stable) presented a plan to write down the high levels of household mortgage debt in the country. This was a key election promise of the government and in its view represents an important step towards achieving higher economic growth going forward. The planned debt relief amounts to ISK 150 billion (around 8% of estimated 2014 GDP) over four years from mid-2014 onwards.

This report provides our assessment of the potential impact on Iceland's sovereign credit profile and that of the government-owned Housing Financing Fund (HFF) (Ba1, stable). Our key conclusions are as follows:

» The proposed debt relief should not have a material impact on Iceland's public finances since it will largely be funded by an increase in the levy on financial institutions. However, the government will lose some tax revenue and might also have to set aside additional funds for the HFF.

» The size of the plan is relatively moderate at around 8% of estimated 2014 GDP, but should on balance have a positive impact on the economy. Households will benefit directly and immediately from the full mortgage debt relief, which will support household consumption.

» As the major provider of inflation-indexed loans, the HFF should benefit from the plan, provided that the government –as indicated – implements measures to safeguard the HFF against the cost of increasing pre-payments of mortgage loans. The impact on the banking system is negative, since the cost of financing the debt relief will be largely recovered via a tax on the banks.

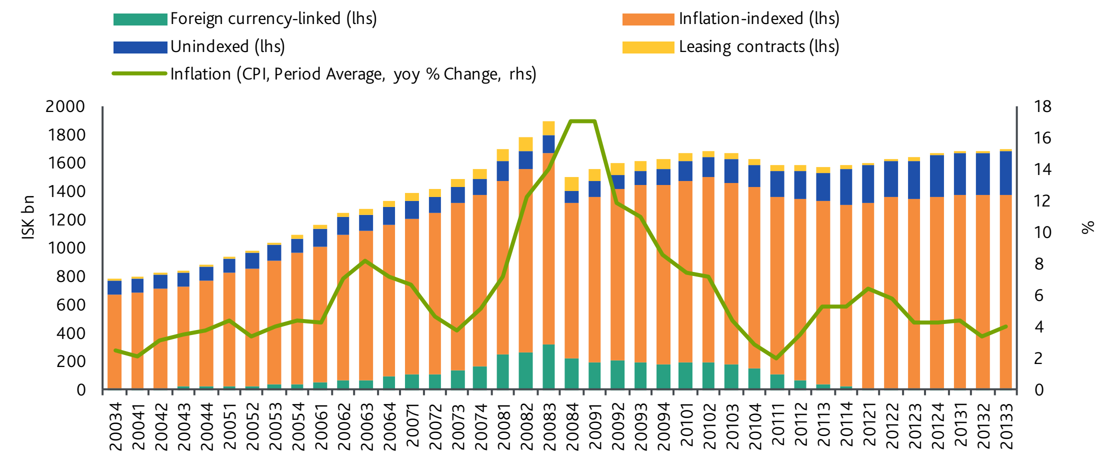
» The proposal is most negative for the estates of the three failed banks, which will bear the largest share of the banking levy without any corresponding benefit for their balance sheets. More generally, negotiations with the estates and their (predominantly foreign) creditors over the final settlement of the estates have stalled in the past several months and the imposition of the bank levy might make coming to an agreement with the creditors more difficult. This in turn could delay the lifting of the capital controls.

Debt-relief plan aims to correct damage to household balance sheets from inflation spike during the crisis

The debt burden of Icelandic households increased significantly in the financial crisis, as over 70% of all household loans in Iceland were linked to the consumer price inflation index. Inflation averaged 5.2% in 2005-07, but rose by more than 16% on average between October 2008 and April 2009, which led to a steep increase in many households' mortgage obligations and debt-service payments. Around 12% of households are still in arrears on their mortgage payments, although this has declined from above 20% reached in 2010.[1] Household debt remains very high at 108% of GDP as of Q2 2013, despite several earlier measures to provide relief to household balance sheets.[2]

EXHIBIT 1

Vast majority of household loans is indexed to inflation



Source: Haver Analytics, Central Bank of Iceland

The government's plan consists of two parts: (1) a direct write-down of inflation-indexed mortgage principal of up to 13%, amounting to a total of ISK 80 billion over a four-year period; and (2) a 6% tax exemption that can be used to pay down mortgage debt of ISK 70 billion over a three-year period. The tax exemption relates to payments that households (and their employers) would otherwise have been able to make towards their private pension funds.[3]

According to the government, the plan will lower the outstanding mortgage principal by up to 20% by 2017 and will be available for 80% of Icelandic households. The government intends to implement the relief from mid-2014 onwards. In our view, the size of the debt-relief plan is relatively moderate at around 8% of estimated 2014 GDP. We also note that earlier mortgage relief transactions will be taken into account when households apply for this plan.

[1] Source: Financial Supervisory Authority.

[2] Household debt relief between 2010 and 2013 amounted to ISK 244 billion, equivalent to around 14% of 2012 GDP. [See Central Bank of Iceland, Monetary Bulletin May 2013](#).

[3] The maximum debt relief under (1) is ISK 4million per household, while option (2) is limited to a total of ISK 1.5 million over the three-year period. Most households have mortgages of ISK 25 billion or less. Source: Prime Minister's Office website.

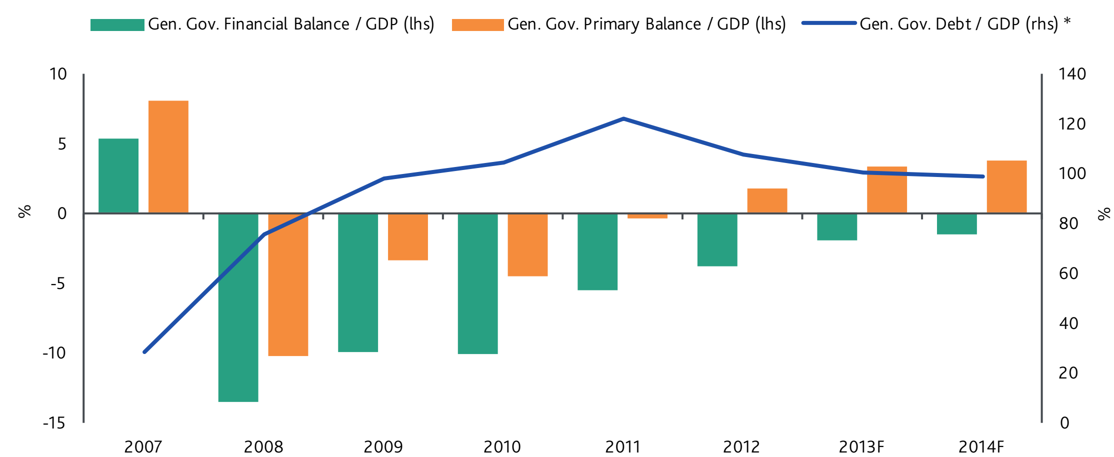
Proposed funding through bank levy should leave public finances on track

As far as the funding of the debt write-down and tax relief are concerned, the government proposes a steep increase in the levy imposed on domestic financial institutions. While the banking sector levy has been in force for some time, the government proposes to (1) extend it to the three banks in winding-up process; and (2) to increase the tax rate from 0.041% in 2013 to 0.366% of total liabilities. The government expects this to yield an additional ISK22 billion in tax revenue per annum.

On the other hand, the government will lose revenue from the tax exemption and also receive lower dividend payments from the shareholdings in the banks. The government estimates these at a combined amount of ISK 7 billion for 2014 (equivalent to 0.4% of 2014 estimated GDP). The proposal still requires parliamentary approval and legal amendments and might be adjusted so that the budgetary target of a balanced budget can still be met. We therefore believe that Iceland's public finances should not be materially affected by the implementation of the plan.

Moreover, Iceland's public finances have improved significantly over the past several years (see Exhibit 2 below). Fiscal consolidation has continued in 2013, and we expect the budget deficit at the general government level to be around 2% of GDP, compared to our earlier expectation of a deficit of closer to 3% of GDP.[4] The budget proposal for 2014 – the first presented by the new government elected in April 2013 – also indicates the new government's commitment to continue to reduce the budgetary shortfall and accumulate increasing primary surpluses. The 2014 budget proposal targets a balanced overall budget and a primary surplus of 3% of GDP (compared to an estimated surplus of 1.4% of GDP in 2013). The improving fiscal and debt position was a key driver for our decision in early 2013 to return the outlook on Iceland's Baa3 rating to stable from negative.[5]

EXHIBIT 2
Iceland's public finances and debt are on an improving debt



* General Government debt includes loans from the IMF and Norway, extended directly to the central bank
Source: Haver Analytics, Moody's

4 The 2013 budget deficit will be significantly higher than the original plan of a broadly balanced budget though.

5 Moody's changes outlook on Iceland's Baa3 rating to stable from negative

Impact on economy should be positive, although higher inflation could erode part of the benefit

Households will receive a significant boost to their disposable income as their debt service will be reduced on the full amount of the debt write-down as of mid-2014. This will most likely lead to stronger private consumption growth next year, although higher inflation and/or higher interest rates could erode part of the gain in purchasing power. In the first three quarters of 2013, private consumption has increased in real terms by a relatively moderate 1.4% over the pre-year period, following a much stronger increase in 2012 (+2.4%).

GDP growth so far this year has exceeded expectations, with Q3 growth in particular much stronger than expected at +3.9% year-over-year, mainly driven by exports. We consequently have revised our 2013 real GDP growth forecast to 2.4% (from 1.8% previously). We expect real GDP growth to accelerate somewhat further in 2014 to around 2.7%, driven by stronger private consumption than expected so far. The key uncertainty for Iceland's growth outlook relates to business investment, which has contracted by 13% year-over-year so far this year.

The Housing Financing Fund will benefit from asset-quality improvements

The impact on the Housing Financing Fund (HFF) should be positive as (i) it does not contribute to the bank levy and (ii) it has been the major provider of inflation-indexed mortgages, holding over half of outstanding inflation-indexed mortgages. It continues to struggle with high levels of problem loans amounting to close to 15% of gross loans at year end 2012. Overall, HFF will see an improvement in reported loan book arrears, total risk weighting of the loan book and a reduction in future impairments of the loan portfolio compared to the current expectation, which will positively impact reported equity capital ratios. However, on the negative side, the proposal will expose the HFF to increasing pre-payments and hence increasing cost of carry, which according to the government could amount to additional costs for the HFF of ISK 5-10 billion over four years. We note, however, that safeguards are under discussion which will compensate the HFF for increasing costs relating to pre-payment and that any impact of the plan on HFF's capital position either directly via changes in risk-weighted assets or through future results, will likely be offset by future government capital injections into HFF to keep the capital ratio stable around the end-June 2013 level of 2.5%.

Impact on the banking sector likely to be negative

Financial institutions will have to fund the debt write-down via an increase in the bank levy. While the debt write-off proposal includes unpaid interest and arrears - leading to improvements in the banks' asset quality and equity ratios – the overall impact will most likely still be negative for the banks. Over time, the banks would benefit from the improving economy, however, we believe that this is too uncertain to quantify at this point in time.

The negative impact will be greatest on the estates of the three failed banks, which according to government estimates will contribute approximately 80% of the total bank levy, without any corresponding benefit for their balance sheets.

Continued uncertainty over lifting of capital controls

There is no direct link between the mortgage debt-relief plan and the speed with which the capital controls will be lifted. However, completing the winding-up of the failed banks is an important prerequisite for relaxing the controls. Two of the three estates have applied for so-called "composition" rather than bankruptcy as the way to resolve the failed banks. According to calculations by the Icelandic central bank, the ISK-denominated assets of the estates that are owed to foreign creditors amount to ISK 871 billion or around 50% of GDP (June 2013), which would exert significant pressure on the exchange rate as and when converted into foreign currency.

Negotiations with the creditors on the final settlement of the failed banks seem to have stalled in recent months. The bank levy reduces the value of the assets that will ultimately accrue to the creditors of the estates. It remains to be seen whether and how this will impact the negotiations over the final settlement of the estates and the speed of capital control relaxation.

Rating History

	Government Bonds		Outlook	Foreign Currency Ceilings				Date
	Foreign Currency	Local Currency		Bonds & Notes		Bank Deposit		
Iceland								
Outlook changed	Baa3	Baa3	Stable	--	--	--	--	February-13
Rating Lowered	--	--	--	Baa3	--	--	--	November-12
Outlook changed	Baa3	Baa3	Negative	--	--	--	--	July-10
Outlook changed	Baa3	Baa3	Stable	--	--	--	--	April-10
Outlook changed	Baa3	Baa3	Negative	--	--	--	--	April-10
Outlook changed	Baa3	Baa3	Stable	--	--	--	--	November-09
Rating Lowered	Baa3	Baa3	--	Baa2	P-3	Baa3	P-3	November-09
Rating Lowered	Baa1	Baa1	Negative	A2	P-2	Baa1	P-2	December-08
Rating Lowered & Review for Downgrade	A1	A1	RUR-	Aa1	--	A1	--	October-08
Review for Downgrade	Aa1	Aa1	RUR-	--	--	--	--	September-08
Rating Lowered	Aa1	Aa1	Stable	--	--	Aa1	--	May-08
Outlook Changed	Aaa	Aaa	Negative	--	--	--	--	March-08
Rating Raised	Aaa	--	Stable	Aaa	--	Aaa	--	October-02
Rating Assigned	--	Aaa	--	--	--	--	--	July-97
Rating Raised	Aa3	--	Stable	Aa3	--	Aa3	--	July-97
Review for Upgrade	A1	--	RUR+	--	--	--	--	June-97
Outlook Assigned	--	--	Positive	--	--	--	--	March-97
Rating Raised	A1	--	--	A1	--	A1	--	June-96
Review for Upgrade	A2	--	RUR+	--	--	--	--	April-96
Rating Assigned	--	--	--	--	--	A2	P-1	October-95
Rating Assigned	--	--	--	--	P-1	--	--	October-90
Rating Assigned	A2	--	--	A2	--	--	--	May-89

Rating History – Housing Financing Fund

	LT Issuer Rating		Outlook		Date
	Foreign Currency	Local Currency		BACKED Senior Unsecured (Domestic)	
Housing Financing Fund					
Rating Lowered & Outlook changed	Ba1	Ba1	Stable	Ba1	February-13
Outlook changed	Baa3	Baa3	Negative	Baa3	July-10
Outlook changed	Baa3	Baa3	Stable	Baa3	April-10
Outlook changed	Baa3	Baa3	Negative	Baa3	April-10
Rating Lowered & Outlook changed	Baa3	Baa3	Stable	Baa3	November-09
Rating Lowered & Outlook changed	Baa1	Baa1	Negative	Baa1	December-08
Rating Lowered	A1	A1	RUR-	A1	October-08
Review for Downgrade	Aa1	Aa1	RUR-	A1	September-08
Rating Lowered & Outlook changed	Aa1	Aa1	Stable	Aa1	May-08
Outlook changed	Aaa	Aaa	Negative	Aaa	March-08
Rating Assigned	--	--	--	Aaa	July-04
Rating Assigned	Aaa	Aaa	Stable	--	June-04

Moody's Related Research

Issuer Comments:

- Iceland's Budget Includes Housing Financing Fund Capital Injection, October 2013 (159163)
- Iceland's Working Group Proposals may have negative credit implications for new borrowing by HFF, April 2013 (153244)
- Court Decision Frees Iceland from Failed Landsbanki Liabilities, a Credit Positive, January 2013 (149659)
- Iceland's Prepayments on IMF and Nordic Government Loans Are Credit Positive, June 2012 (143316)
- Iceland: Early repayment of part of IMF and Nordic loans is positive, March 2012 (140810)

Credit Focus:

- Landsvirkjun and the Housing Financing Fund: A comparison of Icelandic government-guaranteed entities, April 2013 (151292)

Special Comments:

- Cyprus: Lessons on Capital Controls from Iceland, May 2013 (153572)

Rating Action:

- Moody's changes outlook on Iceland's Baa3 rating to stable from negative

Credit Opinion:

- Iceland, Government of

Rating Methodologies:

- Sovereign Bond Ratings, September 2013 (157547)
- Sovereign Default and Recovery Rates, 1983-2012, June 2013 (154805)

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