FitchRatings

Tagging Info

Fitch Revises Iceland's Outlook to Positive; Affirms at 'BBB' Ratings Endorsement Policy

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Fitch Ratings-London-30 January 2015: Fitch Ratings has revised the Outlook on Iceland's Long-term foreign currency and local currency Issuer Default Ratings (IDR) to Positive from Stable and affirmed the IDRs at 'BBB' and 'BBB+', respectively. The issue ratings on Iceland's senior unsecured foreign and local currency bonds have also been affirmed at 'BBB' and 'BBB+'. The Country Ceiling has been affirmed at 'BBB' and the Short-term foreign currency IDR at 'F3'.

KEY RATING DRIVERS
The revision of the Outlook reflects the following key rating drivers and their relative weights:

High
The extension of the bond maturities on the loan between Landsbankinn hf. and LBI hf. (which is managing the winding-up of Landsbanki Islands hf. following its collapse in 2008) will cut Iceland's private foreign-debt service burden over the next three years, reducing the risk of balance of payment pressures, and improving external financing sustainability. According to central bank estimates, the bond renegotiation has reduced Icelandic residents' foreign debt service up to 2018 by ISK124bn (around 6.5% of 2014 GDP).

The extension agreement coincided with the approval of capital control exemptions allowing the priority creditors of LBI outside Iceland to be paid out. The estimated amount of these payments is around ISK400bn.

Fitch believes that the bond renegotiation and approval of capital control exemptions are important steps in the long process of the removal of the capital controls that have been in place since 2008. We expect to see further concrete steps in this process over the next two years.

Medium
Public finances improved significantly in 2014. Fitch estimates that the general government balance for 2014 was 0.1% of GDP, up from -1.7% in 2013 - the first budget surplus since 2007. The budgetary performance in 2014 was boosted by one-off factors. These are expected to unwind to a large extent over the next two years, leading to small deficits of 0.8% and 0.5% of GDP in 2015 and 2016. Iceland has recorded primary surpluses since 2012, averaging just over 3% of GDP.

We estimate that the government debt to GDP ratio fell back to 82% in 2014 from 86.3% in 2013. We expect the debt ratio to fall to 77.7% in 2015 and 71.3% in 2016, underpinned by large primary surpluses and strong nominal GDP growth. Our 2016 debt forecast takes into account the government's intention to pay down half of the USD1bn bond (around 3.3% of 2014 GDP) maturing that year out of its sizeable deposits, which stood at around 23% of GDP at 3Q14.

Iceland's 'BBB' ratings also reflect the following key rating drivers:
The ratings are underpinned by a very high level of income per capita compared with rating peers (USD52,000 compared with the 'BBB' median of USD10,600), and indicators of human development and governance more akin to the highest-rated sovereigns.

The legacy of the financial crisis weighs on Iceland's external position. External liabilities are much higher than those of rating peers, pending the resolution of the estates of the old banks. In 2014, net external debt (including the bank estates) was estimated to be almost four-and-a-half times GDP (in comparison, the 'BBB' median was 4.6%).

Capital controls remain in place, and weigh on Iceland's credit profile. The Icelandic authorities believe that the removal of capital controls is contingent on avoiding excessive balance of payments pressures arising from the unwinding of 'locked-in' ISK assets owned by non-residents (amounting to around EUR2bn, or 15.5% of GDP) or the mismatch of between domestic claims and assets of the failed bank estates.

Despite the improvement in 2014, public finances remain a rating weakness. The government debt to GDP ratio estimated at end-2014 was more than double the peer rating median of 40%. State guarantees are sizeable, amounting to around 62% of GDP (three-quarters of these are accounted for by the Housing Finance Fund).

Domestic demand took over from net trade as the driver of economic growth in Iceland in 2014. We believe domestic demand - especially private consumption and investment - will remain the driver of economic growth over the next two years. We estimate that full-year GDP growth in 2014 was 1.9%, and that growth will pick up to average 3.2% this year and 3.0% in 2016. Domestic demand-driven growth will push down on the current account over the next two years - we expect the current account surpluses of the past two years to turn to a small deficit of 0.4% of GDP by 2016.

RATING SENSITIVITIES
Future developments that could, individually or collectively, lead to an upgrade include:
-Further concrete steps in the process of lifting capital controls, for example with agreements with the failed bank estates.
-Continued steady falls in the public debt and external debt ratios.
-A longer track record of monetary and exchange rate stability in the context of continued economic growth.

Developments that could lead, individually or collectively, to negative rating action are:
-Failure to implement concrete steps in liberalising capital controls.
-Crystallisation of significant contingent liabilities from the financial system, especially the Housing Finance Fund (HFF), above the amounts already assumed in Fitch's debt sensitivity analysis.
-Weakening public debt dynamics, either from a weakened commitment to fiscal consolidation or a worse than expected economic performance

KEY ASSUMPTIONS
The ratings and Outlooks are sensitive to a number of assumptions.

For its debt sensitivity analysis, Fitch assumes a nominal GDP growth rate of 5%, an average primary balance of 3.4% of GDP, an average effective interest rate of 6% and an annual nominal exchange rate depreciation of 2% over 2017-2023. We assume an equity injection by the government to HFF equivalent to 0.3% of GDP in 2015, and 0.2% of GDP in the four years thereafter. Under these assumptions, gross government debt as a share of GDP would decline to 57% by 2023.

Fitch assumes that the review of the legislative framework of the Central Bank of Iceland will safeguard the independence, financial soundness and accountability of the central bank and its decision-making bodies.

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Applicable criteria, 'Sovereign Rating Criteria' dated 12 August 2014 and 'Country Ceilings' dated 28 August 2014, are available at www.fitchratings.com.

Applicable Criteria and Related Research: Iceland - Rating Action Report

Sovereign Rating Criteria
Country Ceilings

Additional Disclosure
Solicitation Status