S&P Global
Ratings

RatingsDirect®

Research Update:

Ratings On Iceland's Housing Financing Fund (HFF) Raised To 'BB' On Stronger Projected Capitalization; Outlook Stable

Primary Credit Analyst:
Maxim Rybnikov, London (44) 20-7176 7125; maxim.rybnikov@spglobal.com

Secondary Contacts:
Alexander Ekbom, Stockholm (46) 8-440-5911; alexander.ekbom@spglobal.com
Sean Cotten, Stockholm (46) 8-440-5928; sean.cotten@spglobal.com

Table Of Contents

1679007 | 301739890

Research Update:

Ratings On Iceland's Housing Financing Fund (HFF) Raised To 'BB' On Stronger Projected Capitalization; Outlook Stable

Overview

- HFF's financial performance in 2015 has materially exceeded our previous expectations, with an operating surplus for a second year in a row. In addition, we believe HFF's recent steps to reduce its prepayment problem will underpin stronger future earnings compared to our previous forecast.
- Consequently, we have revised our assessment of HFF's stand-alone credit profile (SACP) to 'b' from 'b-'.
- We also maintain our view that the government of Iceland is highly likely to provide timely extraordinary support to HFF in a potential stress scenario.
- We are therefore raising our long-term issuer credit ratings on HFF to 'BB' from 'BB-'.
- The stable outlook reflects our view of balanced risks to the ratings over the next 12 months.

Rating Action

On July 21, 2016, S&P Global Ratings raised its long-term foreign and local currency issuer credit ratings on Iceland's Housing Financing Fund Ibudalanasjodur (HFF) to 'BB' from 'BB-'. At the same time, we affirmed our 'B' short-term ratings on HFF. The outlook is stable.

Rationale

The upgrade primarily reflects our upward revision of forecasts for HFF's earnings and capitalization, largely stemming from the improving economic conditions in Iceland having a more pronounced positive impact on HFF then we previously anticipated.

The upgrade also reflects the several steps HFF has taken to reduce its prepayment problem. In our view, this will underpin stronger earnings in the future. Consequently, we have revised up our assessment of HFF's SACP to 'b' from 'b-'. We also believe that there is a high likelihood that the government of Iceland would provide timely extraordinary support to HFF in the event of financial distress. As a result, our long-term ratings on HFF are three notches higher than its 'b' SACP.

HFF's future role and operations remain unclear. In May 2014, the project committee appointed by Iceland's Minister of Social Affairs and Housing called for a reform of the Icelandic housing system. Under the committee's proposals, HFF's operations were to be gradually discontinued over the medium term.

Under the existing system, HFF provides mortgage loans--as do commercial banks, and, to a lesser extent, pension funds. The new approach provides for the establishment of specialized mortgage companies financed through the issuance of covered bonds, which will only be allowed to provide mortgage loans. The proposals specify that HFF will cease lending and its portfolio will be allowed to expire. Meanwhile, the government would establish a new state-owned housing loan company, which would operate on the same terms as other specialized mortgage companies and, unlike HFF, will not benefit from a state guarantee.

Even though our baseline scenario continues to assume broad implementation of the proposals, we note that the government has taken no tangible steps toward enacting the proposals since they were presented in May 2014. During that time, HFF has continued to operate, although its market share in new lending has been low (below 10% of new lending in both 2014 and 2015). The institution has maintained a larger presence in certain niches--such as lending to rural areas and to lower income households--whereas other market segments have been increasingly taken over by commercial banks.

Although its role has diminished in recent years, we see HFF as still being important for the government of Iceland. We believe that until the new housing system is implemented, HFF will maintain its presence in the rural and lower income segments of the market--which are important for the authorities for social reasons--and in regions in which the banks have little presence.

We also understand there is a proposal in place under which HFF would administer government grants for the construction of social housing; the corresponding bill was passed by the Icelandic Parliament in June 2016. There are also plans to potentially explicitly entrust HFF with the social role in the future, whereby the institution would undertake lending under specified household income-based criteria rather than be completely wound-up. That said, even in that case the entity would likely be several times smaller compared to current levels as the majority of mortgage lending would be gradually taken over by commercial banks.

We also assess HFF’s role for the government as important based on the consequences for the government and the domestic capital market of a default by HFF. HFF's outstanding bonds amounted to about 35% of Iceland's GDP as of end-2015 and close to 80% is held by Icelandic pension funds. A default would therefore entail losses for the pension funds; we do not expect the government to view this as politically acceptable. The government also 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 guarantees by the government.

In our view, HFF continues to maintain an integral link with the government of Iceland. Based on its 100% government ownership and the consequences of its default, 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 has provided support to HFF through capital injections three times during 2010-2014, contributing a total of more than Icelandic krona (ISK) 50 billion.

Given positive earnings, improving asset quality, and an orderly downsizing of the balance sheet, we now see the need for further injections as less likely over the next few years. We expect the government will only inject sufficient capital to ensure that HFF honors its obligations in a timely manner rather than tie up extra capital within the institution. For example, even though the government planned to capitalize the entity in both 2014 and 2015, this was cancelled once it became apparent that HFF would post net profits.

Our revision of HFF's SACP to 'b' from 'b-' reflects its better-than-expected improvements in capital and earnings, which we now think will remain above our previous forecast. HFF's capitalization has considerably improved following an almost ISK2 billion (around €15 million) capital increase from net profits in 2015. The largest difference from our previous forecast was the more-than ISK1 billion net impairment reversals, as opposed to an expected net loss. In our view, the reversals indicate a stronger-than-anticipated positive impact on HFF from improving economic conditions in Iceland. Although subject to risks, these include robust projected economic growth and an increase in real incomes.

Moreover, the entity has taken initiatives to ease its prepayment problem and bolster capitalization. These include the sale of the subsidiary Leigufélagið Klettur ehf (Klettur) in May 2016 and the active sales of repossessed properties, supported by favorable real estate market dynamics. Both have an immediate positive impact on capital. In addition, improved interest income and reduced costs have also led us to revise upward our forecast of earnings and capital. The main driver of this is the investments in asset-backed bonds (in December 2015 and in March 2016), as well as cost management initiatives, including organizational changes and a lower headcount, which has already yielded some results.

Overall, we expect positive net earnings of ISK2.75 billion and total adjusted capital of ISK19.43 billion in 2016, which is a notable improvement from our previous forecast. While our forecast is somewhat more conservative, we note that HFF's management anticipates regulatory capital ratios reaching 8% by 2020 (from 5.5% at end-2015) and positive earnings over the coming five years.

Our assessment of other factors that contribute to the SACP, such as moderate business position and moderate risk position, remain unchanged. Even though we now expect HFF to benefit from the improving economic conditions in Iceland more so than we thought previously, the impact will still be smaller than that on Iceland's commercial banks. In particular, the continuing prepayments and only marginal new lending activity undertaken by HFF preclude it from attaining a stronger market position or growth in core business.

We consider HFF's funding profile to be below average, based on its reliance on the capital markets without any 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 expected contractual cash flows from prepayments and amortizing loans, and the cash liquidity buffer, which is heavily 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.

Outlook

The stable outlook reflects our expectation that HFF's SACP will remain unchanged, and that the likelihood of the government of Iceland providing timely extraordinary support to HFF in the event of financial distress will remain high over the next 12 months. We do not expect to take a rating action on HFF if we raise or lower our long-term local currency sovereign credit rating on Iceland by one notch, all else being equal.

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 the institution.

We could raise the ratings if we believed that the risks inherent in unwinding the mortgage portfolio had reduced substantially, for instance based on materially improved asset quality and resilient pre-provision earnings generation.

Related Criteria And Research

Related Criteria

- 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: Banks: Rating Methodology And Assumptions - November 09, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions - November 09, 2011
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions - December 06, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks - March 23, 2004

Related Research

- Iceland Ratings Affirmed At 'BBB+/A-2'; Outlook Stable, July 15, 2016
- Ratings On Iceland's Ibudalanasjodur (Housing Financing Fund) Affirmed At 'BB-/B'; Outlook Stable, Jan. 22, 2016

Ratings List

	Rating	
	To	From
Housing Financing Fund Ibudalanasjodur		
Issuer Credit Rating		
Foreign and Local Currency	BB/Stable/B	BB-/Stable/B
Senior Unsecured		
Local Currency	BB	BB-

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings 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.