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Research Update:

Iceland's Housing Financing Fund Outlook Revised To Positive On Improved Operating Conditions; 'BB/B' Rtg's Affirmed

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Overview

- The gradual liberalization of capital controls in Iceland is progressing in a measured manner.
- At the same time, private-sector leverage continues to decrease, leading to a decreased cost of risk and improving our capital projections for Housing Financing Fund Ibudalanasjodur (HFF).
- We are therefore revising our outlook on HFF to positive from stable and affirming our 'BB/B' ratings on the entity.
- The positive outlook reflects that we could raise our ratings on HFF within one year if banking industry trends in Iceland improve further, reducing the risks inherent in unwinding HFF's mortgage portfolio.

Rating Action

On Oct. 25, 2016, S&P Global Ratings revised its outlook on Iceland's Housing Financing Fund Ibudalanasjodur (HFF) to positive from stable. At the same time, we affirmed our 'BB/B' long- and short-term counterparty credit ratings on the entity.

Rationale

The outlook revision reflects our view of the improving operating conditions for Iceland's banking sector. We expect a trend of decreasing risks related to domestic credit, as Icelandic households deleverage. We expect that debt levels will be in line with those of other wealthy European economies over the next two years. In addition, we believe the continued liberalization of capital controls will lead to further improvements in the economic resilience of the Icelandic economy and the operating environment for Icelandic banks (see "Various Positive Rating Actions On Four Icelandic Banks On Receding Economic Risks and Improved Access To Funding," published Oct. 25, 2016, on RatingsDirect).

We also view the trend for industry risk in the Icelandic banking sector as positive, based on demonstrated access to external funding; material improvements in banking regulation and supervision; and proactive measures to avoid a repeat of the excessive growth that preceded the boom in the 2000s.

Given this progress, we have revised upward our anchor for banks operating in

Iceland to 'bbb-' from 'bb+'. This anchor is the starting point in determining our rating on HFF. In addition, HFF benefits from decreased credit risk and the stabilizing operating environment in Iceland, which has translated into our improved projections for HFF's capital and earnings. Our projections of HFF's earnings were improved by net reversals in 2015 and the first half of 2016 and our view that operating conditions for banks in Iceland have improved. As such, we see lower risk for HFF's capital and have therefore revised our capital assessment upward to moderate from weak.

Despite these improvements, we note that the entity's capital and earnings are likely to be volatile, as HFF manages the asset-liability mismatch that arises when customers prepay their HFF loans. With the prepayment, HFF is forced to invest the excess liquidity into lower-yielding products, since it is not able to prepay the outstanding bonds. Also, due to regulatory capital requirement exemptions, we expect that the government may allow capital ratios to deteriorate temporarily. However, we expect that the government will provide support when needed in order to prevent default.

Generally, we expect industrywide improvements to have less impact on HFF than on the commercial banks, given the entity's narrowly defined market role. In our view, HFF is unlikely to improve its business position, enter foreign debt capital markets, or diversify its credit exposures. We have revised our assessment of HFF's risk position to weak from moderate, since HFF compares less favorably with peers at higher rating levels. HFF is also becoming increasingly concentrated in Iceland's less liquid housing markets, given its new role and the winding-down of its portfolio.

As such, we maintain our overall view of HFF's creditworthiness and have affirmed our ratings. Nevertheless, as private-sector leverage continues to decrease due to the Icelandic economy's expansion, with real GDP growth above 3%, low unemployment rates, and contained inflation, we recognize that further improvements could have a moderately positive impact on HFF, as reflected by our positive outlook.

In our view, the likelihood that the Icelandic government would provide timely extraordinary support to HFF in the event of financial distress will remain high over the next 12 months.

Outlook

The positive outlook indicates that we could raise our ratings on HFF within one year if the economic conditions in Iceland improve further, reducing the risks inherent in unwinding HFF's mortgage portfolio. HFF has a strict public policy role and is unlikely to expand with the market. However, the entity may benefit from strong economic development, based on decreased loan losses and an improved capital position, which could follow faster-than-anticipated earnings generation or the accelerated decrease in risk-weighted assets.

We could revise the outlook to stable if we saw signs that Iceland's strong

economic development was weakening. Moreover, 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 HFF.

As per our criteria for government-related entities, the ratings on HFF would not be affected by a positive rating action on the sovereign, all else being equal.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	BB/Positive/B	BB/Stable/B
SACP	b	b
Anchor	bbb-	bb+
Business Position	Moderate (-1)	Moderate (-1)
Capital and Earnings	Moderate (-1)	Weak (-1)
Risk Position	Weak (-2)	Moderate (-1)
Funding and Liquidity	Below average	Below average
	Adequate (-1)	Adequate (-1)
Support	(3)	(3)
ALAC Support	(0)	(0)
GRE Support	(3)	(3)
Group Support	(0)	(0)
Sovereign Support	(0)	(0)
Additional Factor	(0)	(0)

Related Criteria And Research

Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- General Criteria: Group Rating Methodology - November 19, 2013
- 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

- Various Positive Rating Actions On Four Icelandic Banks On Receding Economic Risks and Improved Access To Funding, Oct. 25, 2016
- Nordic Banks' Capital Growth Tapers Off, August 2, 2016
- Iceland Ratings Affirmed At 'BBB+/A-2'; Outlook Stable; July 15, 2016
- The Future Of Banking: Nordic Banks Looking Svelte In The Fintech Race, June 14, 2016

Ratings List

Outlook Action; Ratings Affirmed

	To	From
Housing Financing Fund Ibudalanasjodur		
Counterparty Credit Rating	BB/Positive/B	BB/Stable/B
Senior Unsecured	BB	BB

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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 the S&P Global Ratings' public website 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.

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