

### Research Update:

## Ibudalanasjodur (Housing Financing Fund) Ratings Placed On CreditWatch Negative In Line With Republic of Iceland

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## Overview

- On April 13, 2011, we placed the 'BBB-/A-3' foreign currency and 'BBB/A-3' local currency sovereign credit ratings on Iceland on CreditWatch negative.
- We see potentially higher economic risks to Iceland associated with a prolonged period of uncertainty after the Icelandic electorate rejected, in a referendum, the so-called Icesave agreement.
- Accordingly, we are placing our 'BB+/B' ratings on Iceland's Housing Financing Fund (HFF) on CreditWatch negative.
- The CreditWatch on HFF reflects the potential deterioration of Iceland's creditworthiness, which supports the ratings, as well as a possible lowering of the HFF's stand-alone credit profile in the next few weeks.

## Rating Action

On April 14, 2011, Standard & Poor's Ratings Services placed its 'BB+/B' issuer credit ratings on state-owned Ibudalanasjodur (Housing Financing Fund; HFF) on CreditWatch with negative implications in line with the CreditWatch placement for the Republic of Iceland.

## Rationale

We see potentially higher economic risks to Iceland associated with a prolonged period of uncertainty after the Icelandic electorate rejected, in a referendum, the so-called Icesave agreement. We therefore placed the 'BBB-/A-3' foreign currency and 'BBB/A-3' local currency sovereign credit ratings on Iceland on CreditWatch negative.

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. In accordance with our criteria for rating government-related entities, we based this opinion 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 (\$275 million) at the end of 2010, and the government guarantee on HFF's liabilities. The liabilities have a guarantee of ultimate payment, but not of timely payment.

Following the breakdown of most of Iceland's commercial financial system in October 2008, HFF is now almost the only lender in the mortgage market. We consider that future reforms of the Icelandic residential mortgage market are possible to bring the banks back into the market, particularly to enable lending beyond HFF's approval limits. However, we do not expect HFF's role to change significantly as a result of such reform, not least because the government considers HFF to have been pivotal in dealing with the economic crisis in Iceland.

Iceland's distressed economy affects HFF's operations, and we currently assess the fund's stand-alone credit profile at 'b-'. The fund posted a very substantial loss of ISK34.5 billion for 2010, mainly because it partially wrote down private household mortgage loans eligible for a special government debt relief program accounting for around 20% of the portfolio. The eligible loans that were considered to have a loan-to-value ratio greater than 110% were written-down to that level. The related provision charge of ISK22 billion is, however, an estimate: the final amount depends on the total number of potential applications processed by the end of the third quarter of 2011. The estimate is likely on the conservative side. This contributed to 64% of total impairment costs, but other individually assessed nonperforming and write-off-related impairments added to the negative result.

The write-downs thus consumed the whole of the government's capital injection of ISK33 billion and HFF's capital ratio remained very weak at 2.2%. Uncertainty about the economic recovery (especially now that the electorate has rejected the Icesave resolution), and the potential future need for additional provisions and further measures to ease the pressure on private individual's balance sheets, will make HFF vulnerable to new substantial losses. In our view, it is highly likely to need another capital injection.

## **CreditWatch**

We expect to resolve the CreditWatch in a few weeks, in line with the CreditWatch on the sovereign. During this time we will analyze the consequences of the referendum result on the economic, financial, and political outlook for Iceland.

If the ratings on the Republic of Iceland are removed from CreditWatch and are affirmed, we would consider affirming the ratings on HFF. On the other hand, if we lower the sovereign ratings or if we believe there is potential for further material weakening in HFF's credit quality and capitalization, we could lower the ratings on HFF. HFF could also be downgraded if we lowered our assessment of its stand-alone credit profile because of its very weak capital position and weakening asset quality. We believe asset quality is under pressure because many of HFF's retail and corporate customers are restructuring their balance sheets, which will cause HFF to require additional provisions in 2011.

## Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

- Ratings On The Republic Of Iceland Placed On Watch Negative After The Electorate Rejects Icesave Agreement A Second Time, April 13, 2011
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Sovereign Credit Ratings: A Primer, May 29, 2008

## Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

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

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