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Research Update:

Ratings On Iceland's Housing Financing Fund Affirmed At 'BB-/B'; Outlook Stable

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Overview

- In our view, Iceland's 100% state-owned mortgage lender HFF benefits from an integral link with the government.
- We continue to assess the institution's role for the government as important, primarily reflecting the consequences its default could have for the government and the domestic capital market.
- Therefore, we consider that there is a high likelihood that the government of Iceland would provide timely and extraordinary support to HFF in the event of financial distress.
- We are therefore affirming the 'BB-/B' ratings on HFF.
- The stable outlook reflects our expectation that HFF's current stand-alone creditworthiness remains unchanged, and that the likelihood of the government of Iceland providing timely and sufficient extraordinary support to HFF in the event of financial distress remains high.

Rating Action

On July 22, 2015, Standard & Poor's Ratings Services affirmed its 'BB-/B' long- and short-term foreign and local currency issuer credit ratings on Iceland's Housing Financing Fund Ibudalanasjodur (HFF). The outlook is stable.

Rationale

The ratings on HFF are supported by our view that there is a high likelihood that the government of Iceland would provide timely and extraordinary support to the institution in the event of financial distress. HFF is 100% state-owned and there is an ultimate, but not timely, government guarantee on its obligations. We continue to assess HFF's stand-alone credit profile (SACP, which reflects its credit quality without factoring in extraordinary government support) at 'b-'.

On July 17, 2015, we raised our long-term sovereign ratings on Iceland to 'BBB' from 'BBB-'. However, under our criteria for rating GREs, this has no impact on our ratings on HFF.

At present, 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 proposals the committee put forward, we expect the government to gradually discontinue HFF's operations 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 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 base case assumes that the proposals will be broadly enacted, the government has taken no tangible steps toward implementing the proposals since they were presented in May 2014. During that time, HFF has continued to operate, even though its market share in new lending has been low (just 8% in 2014).

Under the current arrangements, the government puts certain restrictions on HFF's activities. HFF can only offer indexed loans up to Icelandic krona (ISK) 24 million (about $180,000). Given the rising wages and property prices in Iceland, we consider that the institution is becoming increasingly uncompetitive compared with commercial banks, which can offer larger amounts and nonindexed loans.

Nevertheless, we see HFF as having an important role for the government of Iceland, primarily based on the consequences for the government and the domestic capital market of a default by HFF. HFF's outstanding bonds amount to about 40% of Iceland's GDP and nearly 80% are held by Icelandic pension funds. A default could therefore entail losses for the pension funds; we do not expect the government to view this as politically acceptable. HFF's default could also undermine confidence in other companies that benefit from similar guarantees by the government.

We assess HFF's link with the government as integral. We do not expect it to stop being 100% state-owned. 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 ISK50 billion. We understand that it has budgeted for an ISK5 billion capital injection in 2015, followed by a ISK3.2 billion contribution in 2016. The government also provides an ultimate, but not timely, guarantee on HFF's outstanding debt.

Although HFF's future is still unclear, we expect a gradual and orderly disbanding of the institution over several years. We anticipate that until it enacts the new housing arrangements the government is likely to try to limit HFF's operations, aiming to contain the ultimate fiscal cost of supporting the institution. We expect the government will only inject sufficient capital to ensure that HFF honors its obligations in a timely manner. For instance, even though it planned to contribute ISK3 billion in capital in 2014, the injection was cancelled once it became apparent that one-off items had enabled HFF to report a full-year profit.

We continue to assess HFF's stand-alone credit profile (SACP) at 'b-'.

In our view, the economic risk of operating in Iceland has reduced because we expect to see lower future losses. We expect new loan-loss provisions in the banking system to total 15 basis points (bps) to 20 bps of outstanding loans, excluding loan revaluations, over the coming two years. We also now anticipate that the effects of the financial crisis that started in 2008 on banks' credit profiles will be limited in future. Therefore, we have raised our anchor--the starting point for a rating--to bb+.

That said, HFF is unlikely to fully benefit from the improving conditions. Borrowers are prepaying their loans while HFF has very marginal new lending activity. The loan balance is therefore shrinking and profitability eroding because the proceeds from prepayments are being invested in liquid assets that offer a lower income. In 2014, core earnings by our measures were -ISK1.2 billion and we expect further deterioration in the next two years: we expect the pace of prepayments to stay constant or even accelerate.

Reported earnings were positive, but significantly boosted by one-off measures, such as the reversal of impairments against claims on the estates of the failed banks and significant positive revaluations of investment property. Given our view that prepayments and limited new lending are long-term problems for HFF's business operations, we have revised its business position to "moderate" from "adequate."

Our assessment of other factors that contribute to the SACP, such as capital and earnings (very weak) and risk position (moderate), remain unchanged. In our view, HFF has sustained a very low capitalization level, as measured by our risk-adjusted capital ratio. We expect this ratio to be about 2% for the next two years. We factor in losses for the coming years, offset by a reduction in HFF's balance sheet, which would have a combined neutral effect on capital.

We expect that if HFF experienced a significant deterioration in capital from the 2014 regulatory level of 4.5%, the Icelandic government would likely provide it with capital injections; this has occurred in previous years. We also anticipate that asset quality will continue to improve and HFF will report lower nonperforming loans and losses in line with our estimates for the Icelandic banking system at 20bps of loans annually. Losses could be even lower, as both wages and house prices are likely to increase. This would underpin collateral values and repayment capacity.

We consider HFF's funding profile as 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 despite very high impairments and an eroding capital base. 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. 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.

Outlook

The stable outlook reflects our expectation that HFF's current stand-alone creditworthiness remains unchanged, and that the likelihood of the government of Iceland providing timely and sufficient extraordinary support to HFF in the event of financial distress remains high. 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 on HFF if we revised the SACP downward, for example, as a result of further significant loan losses or policy-induced write-downs without timely compensation from the state. We could also lower the ratings if we concluded that the effects of a potential HFF default for the government and the capital markets have reduced, which would reduce the incentive for the government to provide timely and extraordinary support to the institution. This could occur, for instance, if the volume of HFF's outstanding bonds declined markedly.

We could raise the rating if HFF was to significantly reinforce its currently very weak capital adequacy, for example, through a capital increase.

Related Criteria And Research

Related Criteria

- Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Methodology For Mapping Short- And Long-Term Issuer Credit Ratings For Banks, May 4, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Iceland Ratings Raised To 'BBB/A-2' On Proposals Toward Lifting Capital Controls; Outlook Stable, July 17, 2015
- Outlooks For Iceland's Top 3 Banks Revised To Positive On Our More Favorable View Of The Economy, Oct. 14, 2014

Ratings List

Ratings Affirmed

Housing Financing Fund Ibudalanasjodur	
Issuer Credit Rating	BB-/Stable/B
Senior Unsecured	BB-

Additional Contact:
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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 Standard & Poor's public Web site at 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.