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Research Update:

DRAFT: Icelandic Housing Financing Fund Long-Term Ratings Raised To 'BB+'; Outlook Positive

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Table Of Contents

DRAFT

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DRAFT: Icelandic Housing Financing Fund Long-Term Ratings Raised To 'BB+'; Outlook Positive

Vendor headline: S&PGR Raises Icelandic HFF LT Rtgs To 'BB+'; Outlook Pos

Overview

- Iceland's strong economic growth is continuing; improving economic resilience and falling private sector debt is only partly offset by concerns about increasing economic imbalances.
- This supports a stronger-than-expected capital position for Iceland's Housing Financing Fund.
- As a result, we are raising our long-term ratings on HFF to 'BB+'.
- The positive outlook reflects our expectation that HFF's new public policy role could lead to stronger and more stable earnings than we currently expect over the next 12 months.

Rating Action

On Oct. XX, 2017, S&P Global Ratings raised its long-term foreign and local-currency issuer credit ratings on Iceland's Housing Financing Fund (HFF) to 'BB+' from 'BB'. At the same time, we affirmed the short-term foreign and local-currency ratings at 'B'. The outlook is positive.

Rationale

The upgrade reflects HFF's improved capitalization on the back of continued strong economic developments in Iceland. We expect that the domestic operating environment will remain favorable over the next year. We forecast the fund's risk-adjusted capital (RAC) to approach 8.9% in the next 18-24 months, from 5.9% in December 2016, and to remain comfortably within an adequate range, by our standards.

Our assessment of receding economic risks in Iceland follows continued strong economic development, with GDP growth above 7% in 2016 and a strong performance of the tourism sector. The sovereign's financial position has strengthened over the past several years and private sector debt is decreasing as a percentage of GDP, improving Iceland's economic resilience and decreasing credit risk, in our view. However, these developments are partly offset by increasing risks associated with the overheating housing market. House prices have increased by more than household income in the past year, raising

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concerns regarding affordability and economic imbalances.

The favorable economic environment in Iceland also contributes to declining levels of nonperforming assets (NPAs) and positive net earnings for HFF, as appropriated collateral is sold above book value and the proportion of customers in financial difficulties falls. In the last two years, HFF has posted net credit loss reversals.

Our assessment of reduced risks at Iceland leads to a lower capital charge for HFF's domestic exposures, which boosts the risk-adjusted capital ratio by 180 basis points and contributes to the fund's ability to build capital. We anticipate that HFF will continue posting low but positive net earnings, pay no dividends, and see further reductions in the loan book and NPAs. However, HFF's long-term profitability remains fragile, in our view. We expect only a modest slowdown of prepayments of HFF's existing mortgage loans because of continued fierce competition for new lending from pension funds and commercial banks, which continues to put pressure on HFF's net interest income. The fund's future revenue sources are uncertain as its public policy role is transitioning from that of a direct housing lender, constraining our assessment of the fund's business position as a going concern.

Although HFF's role has diminished in recent years, we still assess the fund as important for the Icelandic government, since HFF is likely to continue lending to customers that the commercial banks do not generally service. Moreover, a default of HFF would have adverse consequences for the government and the domestic capital market, in particular for the pension funds that own about 80% of HFF's bonds. The government 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 government guarantees.

In our view, HFF also has an integral link with the government of Iceland. Based on the government's 100% ownership of HFF and the consequences of a potential default of HFF, the authorities are highly likely to provide timely extraordinary support should the need arise, as they did through capital injections when needed in 2010-2014.

Based on HFF's important role and integral link to the government, we include three notches of uplift for potential government support in HFF's ratings. We do not foresee any changes in the government's incentives or ability to support HFF in the near term.

Outlook

The positive outlook on HFF reflects S&P Global Ratings' expectations that the fund's new public policy role could lead to stronger and more stable earnings. We also expect that HFF will maintain an adequate capital level in the next year. We do not anticipate that Iceland's economic development and operating

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environment will improve significantly, but expect that HFF's new credit losses will remain low as its legacy nonperforming loans are rapidly worked through and new lending is limited.

We could raise the ratings if we expected that HFF's new role would result in stronger and more stable earnings, most likely based on significant and predictable fee income. This assessment could follow from more commitment and clarity form the government on the future role of HFF, including the scale and scope of its different functions, business model, and compensation structure. We could also consider raising the ratings if we perceived significant improvements in risk metrics and funding structure.

We could revise the outlook to stable if we saw signs of Iceland's strong economic developments weakening, or if we believed that the increasing economic imbalances would lead to larger credit losses and NPAs for HFF. Moreover, we could revise the outlook 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.

Ratings Score Snapshot

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

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Related Criteria

- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- 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: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

TBC

Ratings List

TBC

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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.capitaliq.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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