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Research Update:

Icelandic Housing Financing Fund Outlook Revised To Stable; 'BB+/B' Ratings Affirmed

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Overview

- Iceland's economic conditions continue to support moderate capital build-up and an improvement in asset quality at the Icelandic Housing Financing Fund Ibudalanasjodur (HFF), though we now expect profitability to drop materially in coming years.
- We consider that the government's willingness and ability to support HFF will remain unchanged in the near term.
- We are revising the outlook on HFF to stable from positive and affirming our 'BB+/B' ratings.
- The stable outlook factors in our expectation of weaker profitability in the next 12-18 months, though we expect HFF will remain adequately capitalized, with improving asset quality trends.

Rating Action

On July 17, 2018, S&P Global Ratings revised the outlook on Icelandic lending institution Housing Financing Fund Ibudalanasjodur (HFF) to stable from positive. At the same time, we affirmed the 'BB+/B' long- and short-term issuer credit ratings.

Rationale

The outlook revision reflects our view that HFF's new public policy role is unlikely to improve profitability in the next 12 months, nor result in stronger and more stable earnings. We anticipate that HFF's profits will decline due to negative balance sheet dynamics, potentially turning into net losses over our outlook horizon. However, continued fierce competition from pension funds and commercial banks is likely to sustain high prepayment mortgage loans by existing clients, and further reduce HFF's net interest income owing to asset-liability mismatches (HFF is mainly funded with long-term non-callable bonds). Moreover, the fund's future revenue sources are uncertain as its public policy role is transitioning from that of a direct housing lender to the entity responsible for wider housing policies, constraining our assessment of the fund's business position as a going concern.

At the same time, HFF is sustaining its ongoing balance sheet reduction, which is driving our forecast of a risk-adjusted capital (RAC) ratio of about 9% in the next 18-24 months, from 8.66% in December 2017.

The benign domestic operating environment contributes to declining levels of nonperforming assets (NPAs), which dropped to 7.6% as of December 2017 from 13.2% in the previous year. We project a decline in the stock of NPAs by around 20% year on year this year and next, resulting in a NPA ratio of 6% by 2019 due to the low level of nonperforming loan inflows from legacy assets, as well as recoveries and write-offs.

Although HFF's role has diminished in recent years, we still assess the fund as important for the Icelandic government, given the role it plays for housing policies. Moreover, we do not foresee any changes in the government's willingness or ability to provide extraordinary support to HFF should the need arise, as it did through capital injections between 2010-2014.

The government still provides an ultimate, but not timely, guarantee on HFF's outstanding debt. As such, we consider that a default of HFF would have adverse consequences for the government and the domestic capital market.

Outlook

The stable outlook reflects our expectation that HFF's profitability will reduce over the next 12 months as the benefits of its new public policy role will take time to fully materialize. At the same time, we consider that HFF will maintain adequate capital levels over our outlook horizon. Despite the inherent volatility of its balance sheet, we expect HFF's RAC ratio to remain around 9% in the next 12 months. We anticipate that Iceland's economic and operating environment will stabilize in the next year, likely containing new credit losses and result in a further drop in the stock of NPAs, which we expect will almost halve in the next two years.

We could raise the ratings if we believed that HFF's new public 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 from 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 upgrade HFF if it strengthened its RAC ratio sustainably above 10%, without any deterioration in our view of its risk profile.

We could lower the ratings if we saw signs of economic trends in Iceland worsening. Specifically, we could take a negative rating action if increasing imbalances in the economy were to lead to weaker asset quality or higher market risks. Moreover, we could downgrade the bank if we concluded that the effects of a potential HFF default for the government and the capital markets had reduced, which would reduce the government's incentive to provide timely extraordinary support to HFF.

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
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- 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

- Banking Industry Country Risk Assessment Update: June 2018, June 20, 2018
- Republic of Iceland 'A/A-1' Ratings Affirmed; Outlook Stable, June 8, 2018
- Banking Industry Country Risk Assessment: Iceland, Feb. 21, 2018

Ratings List

	To	From
Housing Financing Fund Ibudalanasjodur		
Counterparty Credit Rating	BB+/Stable/B	BB+/Positive/B
Senior Unsecured	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.capitaliq.com. All ratings affected by this rating action can be found on 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)

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