FITCH: ICELAND DEBT RELIEF PROGRAMME APPEARS FISCALLY NEUTRAL

Fitch Ratings-London-06 December 2013: Iceland's proposals to relieve household debt via mortgage write-offs and tax-exempt private pension scheme savings appear consistent with the authorities' stated commitment to fiscal consolidation, Fitch Ratings says. However, another round of write-downs may dent investor perceptions of Iceland's business environment, and the prospect of foreign bank creditors in the failed banks bearing most of the cost may make it more difficult to remove capital controls.

The government aims to fully finance the plan, via as-yet-unspecified budget adjustments, and tax increases - primarily an increase in the levy on Icelandic banks' balance sheets from 0.145% of total outstanding debt to 0.366%. This bank tax is levied on Iceland's new banks as well as on its failed banks, Kaupthing Bank, Glitnir Bank, and Landsbanki Islands, through their winding up committees.

Announcing a fully financed programme that is not expected to involve additional borrowing suggests the authorities have avoided a weakening of their commitment to fiscal consolidation. When we affirmed Iceland's 'BBB' Foreign Currency IDR in October, we identified as a rating sensitivity any weakening of this commitment that caused the pace of the government debt ratio reduction to slow.

By reducing household debt, the programme may have a positive impact on the Icelandic economy, where the private sector debt overhang has weighed on consumption.

However, by increasing the financial institution tax (including on Iceland's failed banks, which remain disproportionally large) it reduces the amount of money that the failed banks' foreign creditors can ultimately collect and may further dent international investor sentiment towards Iceland. This could have a negative impact on investment, growth, and external finances, and may make it even more challenging to unwind capital controls in an orderly fashion.

Another risk is that customers of Iceland's Housing Financing Fund (HFF) may attempt to take advantage of the debt relief by refinancing their HFF mortgages and moving to other lenders. The HFF is already subject to substantial refinancing risk, as borrowers can prepay HFF loans, while HFF bonds are not callable. An increase in mortgage repayments would increase this risk, meaning recapitalisation needs could exceed the relatively modest level in our current assumptions. These assumptions see HFF recapitalisation adding around 0.2pp to the public debt to GDP ratio per year. Safeguards restricting refinancing are under discussion, and the Icelandic authorities are currently assuming that ISK5-10bn will have to be put aside as a cushion for the potential effects of higher prepayments.

Iceland's coalition government said over the weekend that inflation-linked mortgages would be written down, or borrowers incentivised to repay them, in a programme worth about ISK150bn (around 8.5% of GDP).

The scheme has two components. A direct write-down of inflation-linked mortgage principal is achieved by splitting loans into a primary loan, and a relief loan equivalent to up to 13% of the original loan. The maximum write-down per household will be ISK4m (around USD33,500). The Treasury will pay off the relief loans in four annual instalments of ISK20bn. The second component is the introduction of a three-year tax exemption on third pillar private pension savings used to repay mortgage debt.

The proposal still has to be approved by the Icelandic parliament, and so is subject to amendments. It also remains to be seen if Iceland's new banks or its legacy bank resolution committees may challenge the increase in the bank levy.

If approved, the first write-downs under the new programme could be seen in mid-2014, the government estimates that borrowers who benefit from both principal reduction and tax exemptions could reduce their mortgage principal by up to 20% by end-2017.

Contact:

Alex Muscatelli
Director
Sovereigns
+44 20 3530 1695
Fitch Ratings Ltd
30 North Colonnade
London E14 5GN

Mark Brown
Senior Director
Fitch Wire
+44 20 3530 1588

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com.

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