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Research Update:

Republic Of Iceland Outlook Revised To Negative On Fiscal Risk; 'BBB-/A-3' Ratings Affirmed

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Overview

- We believe that the contemplated household debt forgiveness could pose a significant fiscal risk to Iceland.
- Depending on the scope of the write-down and the mode of financing, general government debt could rise substantially.
- We have therefore revised the outlook on Iceland to negative, reflecting our view that there is at least a one-in-three chance that we could lower the ratings within the next two years.
- We are affirming our 'BBB-/A-3' long- and short-term sovereign credit ratings on Iceland.

Rating Action

On July 26, 2013, Standard & Poor's Ratings Services revised the outlook on the Republic of Iceland's long-term ratings to negative from stable. At the same time, we affirmed our 'BBB-/A-3' long- and short-term foreign and local currency sovereign credit ratings on Iceland.

Rationale

The outlook revision reflects our view that we could lower the ratings if household debt forgiveness--as promised by the new government in its coalition agreement--substantially worsens Iceland's fiscal ratios or weakens our assessment of the effectiveness and predictability of policymaking. The contemplated debt write-offs, if funded through a haircut imposed on existing creditors to the defaulted Icelandic banks (the old banks), could also damage foreign investors' confidence in Iceland and further delay the lifting of capital controls. The scope, overall cost, and financing of the write-down remain unclear, but we consider the risk of bringing additional debt from the private sector onto the public sector balance sheet to be significant. The parliament has agreed on a 10-point working plan to examine this particular issue and expects to announce a proposal in November 2013.

The new government, a majority coalition of the Progressive Party and the Independent Party, was formed after the April 2013 election. Both parties had made strong election pledges to write-down household debt. In particular, the parties focused on the inflation-linked loans, the principle of which had increased by about 38% between 2007 and 2012. This increase was due to high inflation rates in Iceland caused by the krona depreciating.

Back in 2010, a round of household debt relief was implemented to write-down all private household mortgages with a loan-to-value ratio greater than 110%. Moreover, households with foreign-exchange-linked loans received significant debt relief due to court rulings. In contrast, there have been no additional debt relief measures that specifically address inflation-indexed household loans. Households with these loans are exerting strong pressure for a further write-down.

We estimate that the proposed write-down could exceed 10% of 2013 GDP, possibly much more. HFF, the state-owned housing financing fund, would likely bear a significant part of the cost related to debt forgiveness as all of its private mortgages are inflation-linked. HFF has not defaulted on its obligations and has already been running significant losses since 2008 due to asset quality problems, previous write-downs, and realized prepayment risk. Over the last three years, the government has injected Icelandic krona (ISK) 46 billion (3% of GDP) into HFF to boost its capital. In contrast, foreign-exchange-linked loans have been mostly on the new commercial banks' balance sheets, received at a deep discount after the old banks defaulted, and write-off costs were therefore borne by foreign creditors to whom the banks had defaulted.

The ratings on Iceland are supported by our opinion of its prosperous and flexible economy, and its institutional capacity to address financial sector problems and build an environment more conducive to job creation and sustainable economic growth. The rapid post-crisis adjustment, on both the fiscal and external accounts, has allowed Iceland to complete its IMF program and regain market access, with its foreign currency debt maturity extended up to 10 years.

The ratings are constrained by high external and public-sector debt. We believe debt could have been higher still if capital controls were not present to limit residents' rights to invest overseas and nonresidents' ability to exchange krona holdings for foreign currencies. The banking sector has undergone significant restructuring, but private sector nonperforming loans (NPLs) remain high. As published in the central bank's Financial Stability Report, for the three largest commercial banks, 6% of their total loans (book value) were in default over 90 days at end-2012, down from 12% a year before.

Since the onset of the 2008 financial and economic crisis, the Icelandic economy has shown resilience by reigning in its fiscal and external deficits. After contracting by more than 10% during 2009-2010, Iceland's GDP began to recover. The 36% depreciation in its real effective exchange rate since mid-2007 has helped its economic rebalancing, but has also resulted in high inflation due to pass-through (that is, the effect of exchange rate changes on domestic inflation).

We expect the Icelandic economy to continue growing on average by nearly 2% annually in 2013-2016. The export sector is growing due to strong tourism and an increased fishing quota after years of conservation. This offsets subdued investment, which remains well below pre-crisis levels. We expect the current

account, adjusted to remove the accrued interest of the defaulted old banks, will remain in surplus from 2012 to 2016. Medium-to-long-term growth will depend largely on business investment, which is facing several uncertainties related to fishery fees; the price of energy; financing conditions; and the lifting of capital controls.

In our view, while exceptionally lax financial sector oversight contributed to the boom-bust cycle in Iceland, other established economic policies have served it well. These include measures to ensure high labor-market participation; at 85%, Iceland's is the highest in Europe and one of the highest in the world. We also expect that efforts to attract net FDI (which totaled 5.3% of GDP in 2012) will bear fruit, enhancing already-high capital intensity and productivity levels in the small and increasingly open economy.

The recovery of domestic demand since 2011 has improved tax collections. This has narrowed the general government headline deficit to 3.4% of GDP in 2012, from around 10% in 2009 and 2010. In May 2012, the Icelandic government successfully issued a 10-year bond amounting to 7% of GDP and used the receipts to prepay some official borrowing from the IMF and Nordic countries; this transaction has lengthened the maturity of the government's external liabilities.

High public sector and external debt burdens, however, remain key ratings constraints. Foreign exchange controls, implemented in 2008 to limit capital flight and stabilize the exchange rate, remain in place. Government plans to lift the controls have been hampered by significant risks associated with potential capital flight. Iceland's relatively shallow domestic capital markets also continue to be a ratings weakness.

The financial sector has been significantly restructured since the bank defaults of 2008. New commercial banks have made notable progress in restructuring their balance sheets. Loan-loss provisions have declined steadily and we expect restructuring will continue in 2013. However, NPLs remain significant; concentration risk--given the economy's dependence on the fisheries and aluminum sectors--is still high; and further meaningful losses cannot be ruled out, especially if the banking sector has to participate in a partial write-off of household debt.

Outlook

The negative outlook reflects that we could lower the ratings over the next two years if household debt forgiveness substantially worsens Iceland's fiscal ratios or weakens our assessment of the effectiveness and predictability of policymaking. The contemplated debt forgiveness could be seen as a departure from government policy, which has so far focused on ring-fencing sovereign liabilities and limiting the cost of financial crisis to the government. We could consider lowering the rating if we reassess the strength of Iceland's policy environment and institutional framework as a result of this policy shift.

The ratings could stabilize at the current level if we see that the scope of debt relief is limited, the cost to the state is contained, and the mode of financing does not, in our view, deter investment into the Icelandic economy.

Key Statistics

Table

Republic of Iceland - Selected Indicators

	2007	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f
Nominal GDP (bil. US $)	20.4	16.8	12.1	12.6	14.1	13.7	13.6	14.0	14.4	14.9
GDP per capita (US $)	66,396	53,357	37,934	39,556	44,196	42,733	42,703	43,844	45,021	46,594
Real GDP (% change)	6.0	1.2	(6.6)	(4.1)	2.9	1.6	1.3	1.8	2.0	2.0
Real GDP per capita (% change)	3.3	(1.3)	(7.7)	(3.6)	2.6	1.3	1.3	1.8	2.0	2.0
General government balance (% of GDP)	5.4	(13.5)	(9.9)	(10.1)	(5.6)	(3.4)	(2.0)	(1.5)	(0.5)	0.5
Change in general government debt (% of GDP)	1.7	52.2	22.6	8.7	21.8	(8.7)	2.2	1.8	(2.4)	(3.3)
General government debt (% of GDP)*	28.5	77.4	99.1	105.4	121.0	106.9	104.3	101.1	93.6	85.5
Net general government debt (% of GDP)*	12.4	50.2	58.1	65.3	68.3	70.3	69.4	67.9	65.4	62.1
General government interest expenditure (% of revenues)	5.4	7.6	16.1	13.3	12.4	12.4	11.6	11.0	10.6	9.8
Bank claims on resident non-govt. sectors (% of GDP)	311.2	208.1	153.7	147.1	146.1	137.8	133.6	131.0	128.1	125.2
Consumer price index (average; % change)	5.0	12.4	12.0	5.4	4.0	5.2	4.0	3.9	4.0	4.0
Gross external financing needs** (% of CARs and usable reserves)	317.7	653.9	157.7	139.5	112.9	90.9	96.0	91.3	87.6	86.6
Current account balance¶ (% of GDP)	(15.7)	(18.0)	(0.2)	(2.1)	(0.3)	0.8	1.2	1.5	1.1	0.4
Current account balance¶ (% of CARs)	(28.0)	(35.1)	(0.4)	(3.7)	(0.5)	1.3	1.9	2.3	1.8	0.6
Narrow net external debt§ (% of CARs)	433.4	158.1	175.5	145.9	92.6	93.0	90.4	82.0	79.6	77.5
Gross external debt (% of GDP)	520.0	169.2	139.4	127.3	128.6	108.9	107.3	103.7	105.2	102.8

*General government debt includes Central Bank of Iceland's borrowings from the IMF and Norway. **Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within one year. Iceland's external accounts are adjusted to exclued the assets and liabilities of the old banks in winding up procedure. ¶Iceland's current accounts are adjusted to exclude accruded interest of the old banks in winding up procedure. §Narrow net external debt is defined as the stock of foreign and local currency public and private sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CARs--Current account receipts. e--Estimate. f--Forecast.

The data and ratios above result from S&P's own calculations, drawing on national as well as international sources, reflecting S&P's independent view on the timeliness, coverage, accuracy, credibility and usability of available information.

Related Criteria And Research

- Sovereign Government Rating Methodology And Assumptions, June 24, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009
- Sovereign Defaults And Rating Transition Data, 2012 Update, March 29, 2013

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts. The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook.

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Iceland (Republic of)		
Sovereign Credit Rating	BBB-/Negative/A-3	BBB-/Stable/A-3
Transfer & Convertibility Assessment	BBB-	
Senior Unsecured	BBB-	
Short-Term Debt	A-3	
Commercial Paper	A-3	

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