



Fitch Affirms Iceland at 'A'; Outlook Stable

Fitch Ratings - London - 22 November 2019:

Fitch Ratings has affirmed Iceland's Long-Term Foreign-Currency (LTFC) Issuer Default Rating (IDR) at 'A' with a Stable Outlook.

Key Rating Drivers

Iceland's 'A' rating is driven by the island economy's very high income per capita, solid performance on governance, human development and doing business metrics that are more in line with that of 'AAA' and 'AA' rated countries, and healthy public finances. Broad political consensus among political parties on macroeconomic and fiscal policy has underpinned the rebuilding of fiscal and external buffers. The rating is somewhat constrained by the small size of the economy and limited export diversification that result in vulnerability to external shocks and macroeconomic and financial volatility.

Iceland's near-term growth outlook has worsened since the closure of the budget airline WowAir and the grounding of IcelandAir's Boeing 737 Max jets affected the country's tourism and aviation sectors. We now forecast real GDP to contract 0.2% in 2019 (May 2019 review: 0%), bouncing back to just 1.6% in 2020 (May 2019 review: 2.5%), and 2.5% in 2021. The revision is mainly due to a sharper-than-expected slowdown in domestic demand, while external demand in 1H19 partially offset this as imports contracted faster than expected relative to exports. Domestic demand is affected by dampened economic sentiment, households increasing savings and by a cooling labour market. In the medium-term, Fitch forecasts real GDP growth to recover to a trend of 2%.

Tourism, the biggest driver of above-trend economic growth through 2018, faces more muted growth prospects. Tourism capacity has contracted since the WowAir and 737 Max jets shocks. Total passengers arriving at Keflavik airport in the year-to-October 2019 fell 11.5% yoy, with October 2019 recording the sharpest year-on-year fall in passenger arrivals of 17.2%. Airline operators have shifted capacity towards tourists visiting Iceland and away from transit passengers, which partially explains robust growth in tourist expenditure in 2Q19-3Q19. A changing composition of tourists away from budget and private accommodation towards hotel-stay tourists, as well as a weaker krona, have also supported tourist spending. Despite announcements of some new airline operators, there is significant uncertainty surrounding when air passenger capacity will recover.

The growth slowdown has affected labour market dynamics, with employment contracting 1%yoy in September 2019, and for five of the last seven months. Layoffs were concentrated in the transportation and tourism sectors. The unemployment rate also ticked up to 3.2% in September 2019, from 1.5% in the previous year. Wage growth slowed to 4.2% yoy in September 2019, and Fitch expects wage growth at about 4% in 2019-2020 as ongoing public sector wage negotiations are likely to adopt similar outcomes to the Spring private sector agreements.

HICP inflation subsided to 1.9% in October 2019, as petrol prices and airfares fell, and as pass-through from the krona depreciation in 2018 faded. Fitch forecasts inflation to be broadly stable, averaging 2% in 2020, before accelerating to 3%. Between May and November 2019, the Central Bank of Iceland has lowered its key

policy rate five times, for a total of 1.5pp to a historical low of 3%, narrowing the interest rate differential with central banks of Iceland's key trading partners. Rate cuts have led to lower bank deposit and lending rates, but credit growth has slowed over the period.

Icelandic pension funds hold 164% of GDP in assets, with 28% of assets invested abroad (end-2018: 22%). The narrowing differential with international interest rates could accelerate pension funds' portfolio rebalancing to diversify assets overseas following years of capital controls, potentially leading to strong capital outflows. The sector is made up of 21 funds with considerable heterogeneity and a strong preference for krona assets to match krona-denominated liabilities.

Fitch forecasts the current account surplus to widen slightly to 3.3% of GDP in 2019 (2018: 2.9%) as imports have contracted much faster than exports, with imports of fuel and consumer durables and WowAir aircraft lease payments falling as the economy adjusts to the slowdown. Favourable marine product prices have also supported Iceland's terms-of-trade, limiting the impact of the slowdown on external finances. Fitch forecasts foreign exchange reserves to improve slightly to a robust 6.4 months of current external payments at end-2019. Notwithstanding six years of large current account surpluses averaging 4.8% of GDP, Iceland lacks diversification in its export base, which makes the economy vulnerable to terms-of-trade shocks and the krona sensitive to capital flows.

Public finances are a strength for Iceland's rating. Fitch forecasts the general government balance surplus to narrow to 0.2% of GDP in 2019 (current 'A' median: -1.2%), as automatic stabilisers work through the near-term slowdown. The government is bringing forward planned reductions in personal income taxes by a year to 2021 and increasing investments in transport and healthcare, marginally offset by higher carbon taxes. Fitch forecasts the general government balance to fall to -0.1% of GDP in 2020, before recovering to 0.3% in 2021. Gross general government debt at 35.3% of GDP, is lower than the 'A' (48%) and 'AA' (39%) medians and should fall further to 30% by 2023 according to our projections.

A possible correction in real estate prices presents downside risks to Fitch's growth projections. House price growth last peaked at 24.2% yoy in July 2017 but has since slowed to 4.2% yoy in October 2019. Dampened tourism sentiment, declining labour market metrics, and increasing supply of building completions could result in downward pressure on house prices. A sharp correction in commercial real estate prices also presents a risk as commercial and residential property had both benefitted greatly from the tourism boom in 2010-2018. A collapse in real estate prices could further weigh on private consumption and growth, but Icelandic banks and households should be fairly resilient. Banks are well-capitalised with a tier-1 capital adequacy ratio of 21% and a low level of non-performing loans (NPLs) at 2.5% of total loans in 2Q19.

Iceland was placed on the Financial Action Task Force's grey list of jurisdictions with strategic anti money-laundering and counter-financial terrorism deficiencies in October 2019. Fitch understands that remedial actions have been implemented and expect the status could be reversed by Spring 2020. Fitch expects this to have a muted impact on Icelandic banks' correspondent banking relationships.

Sovereign Rating Model (SRM) and Qualitative Overlay (QO)

Fitch's proprietary SRM assigns Iceland a score equivalent to a rating of 'A+' on the LTFC IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LTFC IDR by applying its QO, relative to rated peers, as follows:

- External finances: -1 notch, to reflect that a lack of diversification in the export base and potential for balance-of-payments volatility leave the small economy vulnerable to external shocks, macroeconomic volatility and

challenges to macroeconomic policy management.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LTFC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES

The main factors that could individually or collectively lead to positive rating action are:

- Sustained improvement in the external balance sheet and increased resilience of the economy to external shocks.
- A marked improvement in the general government's balance sheet, supported by prudent fiscal policy.

The main factors that could individually or collectively lead to negative rating action are:

- A sustained sharper-than-expected economic downturn impacting the banking sector (e.g. through the real estate market).
- Excessive capital outflows jeopardising financial stability and weakening external buffers.

Key Assumptions

In its longer-term debt projections, Fitch assumes nominal GDP growth of 4.2% per year, government primary balance of 2.2% of GDP, and a nominal effective interest rate of 5.4% by 2028. The gradual accumulation of government assets will act as a floor on gross general government debt/GDP over the projection horizon to 2028. Under these assumptions, Fitch projects that government debt/GDP will decline and stabilise at around 30% by 2023.

ESG Considerations

Iceland has an ESG Relevance Score of 5 for Political Stability and Rights as political stability, including divisions and vested interests as reflected in the World Bank Governance Indicators are highly relevant to the rating and a key rating driver with a high weight.

Iceland has an ESG Relevance Score of 5 for Rule of law, Institutional & Regulatory Quality, and Control of Corruption as these measures of institutional and quality of policymaking as reflected in the World Bank Governance Indicators are highly relevant to the rating and a key rating driver with a high weight.

Iceland has an ESG Relevance Score of 4 for Human Rights and Political Freedoms as social stability, voice and accountability as reflected in the World Bank Governance Indicators are relevant to the rating and are rating drivers.

Iceland has an ESG Relevance Score of 4 for Creditors Rights as willingness to service and repay debt is relevant to the rating and a rating driver, as for all sovereigns.

RATING ACTIONS

ENTITY/DEBT	RATING	PRIOR
Iceland	LT IDR A ● Affirmed	A ●
	ST IDR F1+ Affirmed	F1+
	LC LT IDR A ● Affirmed	A ●
	LC ST IDR F1+ Affirmed	F1+
	Country Ceiling A+ Affirmed	A+
senior unsecured	LT A Affirmed	A
senior unsecured	ST F1+ Affirmed	F1+

Additional information is available on www.fitchratings.com

FITCH RATINGS ANALYSTS

Primary Rating Analyst

Eugene Chiam

Director

+44 20 3530 1512

Fitch Ratings Ltd

30 North Colonnade, Canary Wharf

London E14 5GN

Secondary Rating Analyst

Douglas Winslow

Director

+44 20 3530 1721

Committee Chairperson

Charles Seville

Senior Director

+1 212 908 0277

MEDIA CONTACTS

Peter Fitzpatrick
London
+44 20 3530 1103
peter.fitzpatrick@thefitchgroup.com

Applicable Criteria

Sovereign Rating Criteria (pub. 26 May 2019)
Country Ceilings Criteria (pub. 05 Jul 2019)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
Solicitation Status
Endorsement Policy

DISCLAIMER

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: [HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](https://www.fitchratings.com/understandingcreditratings). IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. DIRECTORS AND SHAREHOLDERS RELEVANT INTERESTS ARE AVAILABLE AT [HTTPS://WWW.FITCHRATINGS.COM/SITE/REGULATORY](https://www.fitchratings.com/site/regulatory). FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

COPYRIGHT

Copyright © 2019 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the

third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001

Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the "NRSRO"). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see <https://www.fitchratings.com/site/regulatory>), other credit rating subsidiaries are not listed on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the

NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

Endorsement Policy

Fitch's approach to ratings endorsement so that ratings produced outside the EU may be used by regulated entities within the EU for regulatory purposes, pursuant to the terms of the EU Regulation with respect to credit rating agencies, can be found on the EU Regulatory Disclosures page. The endorsement status of all International ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for all structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

Fitch Updates Terms of Use & Privacy Policy

We have updated our Terms of Use and Privacy Policies which cover all of Fitch Group's websites. [Learn more.](#)