Rating Action: Moody's downgrades Iceland's Housing Financing Fund to Ba1; outlook stable

Global Credit Research - 20 Feb 2013

Standalone credit assessment lowered to caa1 from b2

London, 20 February 2013 -- -- Moody's Investors Service has today downgraded to Ba1 stable from Baa3 negative the senior unsecured debt and issuer ratings of Iceland-based Housing Financing Fund (HFF). Moody's rating action was triggered by the lowering of HFF's baseline credit assessment (BCA) to caa1 from b2, and follows the change in outlook for the government of Iceland (Baa3 senior) to stable from negative on 7 February.

The change in HFF's BCA concludes Moody's review that was initiated on 5 October 2012, reflecting (1) the weakening of HFF's asset quality; (2) Moody's expectation of continued weak profitability; and (3) HFF's poor and further deteriorated capital ratio, which fell to 1.4% from 2.3% during H1 2012. The downgrade of HFF's senior debt to Ba1, stable, from Baa3 negative reflects these stand-alone pressures offset by the continued high level of support from the Icelandic government.

The stable outlook on the senior unsecured debt and issuer ratings reflects the strength of and links to HFF's owner, the Icelandic government, notably the guarantee following from the fund's legal status, as well as the actions and intentions of the government.

RATINGS RATIONALE

RATIONALE FOR THE BCA

The lowering of HFF's BCA reflects the strong likelihood of further systemic support being required to maintain HFF as a going concern given Moody's expectation that (1) HFF's deteriorated asset quality will continue to weigh on its credit strength; (2) both pre-provision and net profitability will remain weak; and (3) notwithstanding the ISK 13 billion government capital injection announced late 2012, HFF's capitalisation remains low at approximately 3% at year-end 2012, and will likely deteriorate again in 2013, due to operating losses and additional need for write downs. HFF's full reliance on market funding makes the fund sensitive to deterioration of investor confidence, which may be influenced by the fund's low capitalisation or, over time, the removal of the government-implemented capital controls, which have been in place since December 2008.

HFF's weakened asset quality is demonstrated by loans in payment suspension or in default increasing to 14.7% of gross loans at end-December 2012, from 14.6% at year-end 2011, albeit that the rate of deterioration has slowed down. The stock of repossessed properties on HFF's balance sheet increased by 46% at year-end 2012 relative to year-end 2011, and is expected to increase further in 2013. Of the entire stock of properties 41% were rented out at end-December 2012, and the remainder are at different stages of the sales process. However, Moody's believes there is a low probability that properties can be sold in the near future, especially outside the greater Reykjavik region in which commercial bank lending is concentrated. HFF's establishment of a rental company in January 2013, which will specialise in renting out part of the repossessed properties, is only a minor mitigation to the risk that HFF is increasingly exposed to non-performing real estate on its balance sheet.

Moody's says that HFF's recent net losses reflect the increased costs related to the management of problem loans and repossessed real estate, the low operating profitability of the loan book taking into account funding costs, and large loan loss provisions. In H1 2012, general operating expenses increased by 52% year-on-year to ISK939.4 million, reflecting increased costs of properties available for sale and counselling for households. The low operating profitability of the fund further reflects low historical loan margins, and is deteriorating due to the fund's inability to prepay funding when borrowers prepay their loans, creating a negative spread. We recognise that HFF is working to mitigate the effect of some of these underlying causes, but do not deem a sustainable reversal of the negative trend in profitability likely in the short to medium term. The fund reported an ISK3.1 billion loss in H1 2012, including ISK3 billion in loan-loss impairments.

Following the H1 2012 loss, HFF's capital ratio fell to 1.4%. The Icelandic government announced late 2012 its intention to recapitalise the fund with ISK13 billion, to report an approximately 3% capital adequacy ratio at year-end

2012. We expect this recapitalisation to be implemented and reflected in HFF's annual statements, which are generally published by the end of March. In view of (1) HFF's deteriorated asset quality, which will likely lead to substantial additional loan loss provisions, and (2) poor profitability, and hence limited ability to quickly replenish capital through internal means, Moody's deems the 3% capital adequacy ratio as very poor, and subject to likely renewed deterioration in 2013 and beyond. We expect, however, that the fund will continue to receive additional capital support in future, in line with the fund's long-term objective of a 5% minimum total capital ratio.

RATIONALE FOR THE ISSUER RATING

The downgrade of HFF's senior unsecured and issuer ratings mainly reflects HFF's weakened standalone creditworthiness, as highlighted above. Following the downgrade, HFF's ratings benefit from six notches of uplift, taking into account the existence of a form of guarantee of HFF's liabilities and the credit strength of its owner/guarantor, the government of Iceland. However, HFF's rating now deviates from that on the Icelandic government.

HFF's legal status -- as a Treasury C-type institution fully owned by the Icelandic government -- ensures that the government is responsible for full payment of its liabilities. The guarantee does not satisfy all of Moody's requirements to permit full credit substitution, in particular because there is no explicit guarantee on timely payment, giving rise to a potential risk of non-timely payment if HFF were to fail to meet its obligations, which, combined with the weakening in HFF's stand-alone credit quality, supports the rating differential to the Icelandic government.

Nevertheless, HFF's Ba1 rating -- one notch below the Icelandic government -- reflects the very high likelihood that the Icelandic government would honour HFF's liabilities in full and on time, given (1) the government's interest and continued involvement in HFF's operations, as demonstrated by the government's repeated recapitalisations of the institution; and (2) the substantial role HFF's bonds play in Iceland's mortgage market, where the fund reported an approximately 50% share of new lending at end-June 2012, an increase from its pre-crisis level, and bond market (40%, according to the Central Bank).

WHAT COULD MOVE THE RATINGS UP/DOWN

An upgrade of HFF's ratings in the short term is unlikely, given the stable outlook. Longer term, upwards pressure could develop if there is (1) a material improvement in the fund's asset quality; (2) the fund's ability to generate operating profits is restored; and (3) the fund's capitalisation improves to better match its risk profile. A positive change in the sovereign rating would place upwards pressure on HFF's rating, though a change in line with the government's rating would not be a foregone conclusion.

The fund's ratings could come under further downwards pressure if (1) the credit strength of its owner were to deteriorate; (2) worse-than-expected loan performance exerts greater pressure on the bank's financial fundamentals; (3) capitalisation, including capital injections, deteriorates further; and (4) the likelihood of the fund to fulfil upcoming bond maturities is impaired.

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was Government-Related Issuers: Methodology Update published in July 2010. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

Headquartered in Reykjavik , Iceland, Housing Financing Fund reported total assets of ISK876.6 billion (EUR5.5 billion) at 30 June 2012.

Unless otherwise stated, all figures shown are from HFF's annual and interim reports, as well as monthly overviews.

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