FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Iceland at 'A'; Outlook Negative

Fri 24 Sep, 2021 - 5:02 PM ET

Fitch Ratings - London - 24 Sep 2021: Fitch Ratings has affirmed Iceland's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'A' with a Negative Outlook.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

Iceland's 'A' rating is driven by its very high income per capita, very strong governance, human development and doing business indicators that are more consistent with those of 'AAA' and 'AA' rated countries. The rating is constrained by the small size of the economy and limited export diversification that result in vulnerability to external shocks and capital account risks.

The Negative Outlook reflects the uncertainty around the path of the public finances following the Covid-19 shock, which has left the public debt ratio substantially higher than pre-pandemic, and at risk of rising further over the medium term. Following the parliamentary elections due on 25 September, we expect more clarity about the pace at which fiscal support will be unwound in the short term and about the future direction of fiscal policy. Given Iceland's sizeable concentration in tourism and commodity exports, the corporate sector is vulnerable to a weaker recovery in tourism flows than Fitch assumes and potential spill-over effects on banking sector asset quality.

Our fiscal projections have worsened relative to the previous rating review. Statistics Iceland has revised upwards the 2020 general government deficit to 8.6% from 7.3% of GDP. We expect the general government deficit to widen further to 10% of GDP in 2021 (8.1% of GDP in the previous review). Our forecast revision reflects the revised starting point (a higher 2020 deficit) but also additional stimulus measures introduced earlier this year. We expect the deficit to narrow to 8% of GDP in 2022 as the economic recovery strengthens and the majority of pandemic-related fiscal support unwinds.

Following the September elections, the new government will present the new five-year fiscal plan and the 2022 budget, but we do not expect a substantial change to fiscal policy settings. In our view, the suspension of the fiscal rules until 2026 and the target to stabilise the debt ratio by 2025 will be confirmed. We expect government spending to decline only very gradually relative to GDP as there is political pressure to maintain a higher level of spending, particularly in welfare and healthcare spending but also with aim of boosting infrastructure investment.

Fitch forecasts general government debt to increase to 81% of GDP this year and 84% in 2022, from 77% in 2020. Debt levels have been revised markedly higher (in December 2020) due to the inclusion of several state-owned entities (SOEs) into the general government scope. We expect debt to peak at 85% in 2023 and to decline slowly thereafter. There is uncertainty around fiscal policy settings post-elections, but we think that broad political support for rebuilding fiscal buffers and strong record of public debt reduction of 70pp of GDP in 2011-18 supports fiscal-policy credibility over the long term.

The sovereign has high financing flexibility due to the extremely large pool of private pension funds' assets (194% of GDP at end-1Q21), 65% of which was invested domestically at end-2020. The government also has strong access to the international bond market, a large cash deposit buffer and is supported by robust liquidity in the banking system. Moreover, government assets are large at 84% of GDP. In June 2021, the Treasury sold 35% of its stake in Islandsbanki, raising ISK55 billion (1.7% of 2021 projected GDP) which will be earmarked for debt reduction. Further sales of government equity stakes could accelerate debt reduction over the coming years.

The economy grew strongly in 2Q21, helped by the re-opening of the border to foreign tourists in March and underpinned by sizeable policy support. We have revised upwards our 2021 real GDP growth forecast to 4.0% from 2.6% at the previous review, reflecting a swifter rebound in tourism flows and a stronger improvement in the labour market. The unemployment rate declined sharply to 5.5% in August 2021 from a peak of 11.6% in January, partly helped by the wage subsidy scheme. Private consumption is supported by a rapidly improving labour market, strong real wage growth and cuts to personal income taxes for lower income households. Investment is growing strongly (27% qoq in 2Q21) partly on the back of the government's "Investment and Construction" initiative.

Foreign tourist arrivals have swiftly recovered but remain far short of pre-pandemic levels. A pick up in arrivals from the US (18% of Iceland's tourists in 2019) was the key driver. In July 2021, foreign tourist arrivals rose to about 50% of July 2019 levels, a much stronger performance relative to July 2020 (19% of July 2019 levels). The re-introduction of some restrictions following a sharp rise in Covid-19 cases in August is likely to have partly hampered the recovery in tourist arrivals. We expect a stronger rebound in tourism flows in 2022. We project the rate of real GDP growth to accelerate to 4.6% in 2022. The other two key export sectors of the economy, aluminium and fishing, have been resilient throughout the pandemic period.

The Central Bank of Iceland (CBI) has started to tighten monetary policy. It raised the policy rate by 50bp cumulatively to 1.25% (two 25bp hikes in May and August) given higher-than-expected inflation, which rose to 4.6% in April, mainly due to strong wage growth and rising commodity prices. Since then the rate has declined and was at 4.3% in August, still well above the CBI inflation target of 2.5%. We expect another 25bp hike before the end of the year as inflation expectations have also increased and house prices remain buoyant.

Mortgage lending growth has gained momentum over 2020-21. Household debt rose by 9% in 2020 on the back of falling interest rates. A high proportion of households moved their mortgages from pension funds and the Housing Finance Fund (HFF) to commercial banks to refinance at lower rates; banks' loans to households were up 31%yoy in July 2021. As a result, house prices have been dynamic, rising by 13% yoy in August 2021 vs 7.8% in August 2020. Due to the sharp rise in house prices, Fitch's Macro Prudential Risk Monitor indicates that real house prices are above their long-term trend. In June the CBI lowered the maximum loan-to-value ratio (LTV) for mortgages to 80% from 85% in response to rising real estate prices and rising household debt.

Banks are highly capitalised with an aggregated capital adequacy ratio of 24.9% in 4Q20 improved from its 2019 level, and the financial sector poses a limited contingent liability for the government in Fitch's view. Banks are in a good position to withstand a deterioration in the loan portfolio. Non-performing loans were low at 3.1% in 2Q21, but we expect them to increase.

Icelandic banks' exposures are highly concentrated. Loans to companies operating in the tourism sector accounted for 10% of the commercial banks' total lending and just over 20% of their corporate lending portfolios at end-2020. Their commercial real estate-backed mortgage lending portfolio accounted for 26% of total loans to customers. The expiration of pandemic-related loan moratoria has led to a substantial increase in loans in forbearance mostly in the sectors related to tourism. Corporate insolvencies have been limited in 2020 but have started to increase this year, rising by 18% in January-July relative to the same period of 2020. A large share of loans to tourism companies has moved from stage 1 (performing) to stage 2 (underperforming) according to IFRS-9 classification. Stage 2 loans at systemically important banks rose to 14% at end-2020 from 7% in 2019, but have come down to 12% in 2Q21.

ESG - Governance: Iceland has an ESG Relevance Score (RS) of '5[+]' for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. Theses scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Iceland has a high WBGI ranking at the 94th percentile, reflecting its long track record of stable and peaceful political transitions, well established rights for participation in the political process, strong institutional capacity, effective rule of law and a low level of corruption.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

-Public Finances: Evidence that the government's economic and fiscal strategy fails to arrest the increase in government debt/GDP ratio over time.

-Macro: Renewed economic weakness or an adverse shock, for example due to a slower-than-expected recovery in tourism, a sustained correction in the real estate market and material negative impact on the banking sector.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Public Finances: Greater confidence that the government debt to GDP ratio will decline over time once the Covid-19 crisis has subsided.

- Macro: A sustained economic recovery, for example supported by evidence that the export-oriented sectors, particularly tourism, have been resilient to the pandemic shock.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Iceland a score equivalent to a rating of 'A-' on the Long-Term Foreign-Currency (LT FC) IDR scale.

In accordance with its rating criteria, Fitch's sovereign rating committee decided not to adopt the score indicated by the SRM as the starting point for its analysis because the SRM output has migrated from 'A' to 'A-', but in our view this is potentially a temporary worsening.

Assuming an SRM output of 'A', in accordance with its rating criteria, Fitch's sovereign rating committee did not adjust the output from the SRM to arrive at the LTFC IDR.

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.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

KEY ASSUMPTIONS

The global economy performs broadly in line with Fitch's latest Global Economic Outlook published on 16 September 2021.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Iceland has an ESG Relevance Score of '5[+]' for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As Iceland has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

Iceland has an ESG Relevance Score of '5[+]' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight. As Iceland has a percentile rank above 50 for the respective Governance Indicators, this has a positive impact on the credit profile.

Iceland has an ESG Relevance Score of ''4[+]' for Human Rights and Political Freedoms as the Voice and Accountability pillar of the World Bank Governance Indicators is relevant to the rating and a rating driver. As Iceland has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

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

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Iceland	LT IDR	A Rating Outlook Negative	Affirmed	A Rating Outlook Negative
•	ST IDR	F1+	Affirmed	F1+
•	LC LT IDR	A Rating Outlook Negative	Affirmed	A Rating Outlook Negative
•	LC ST IDR	F1+	Affirmed	F1+
•	Country Ceiling	A+	Affirmed	A+
• senior	LT	A	Affirmed	A

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 26 Apr 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.2 (1)

Debt Dynamics Model, v1.2.1 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.12.2 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Iceland	UK Issued, EU Endorsed

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