FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Iceland at 'A'; Outlook Negative

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Fitch Ratings - London - 23 Oct 2020: Fitch Ratings has affirmed Iceland's Long-Term Foreign-Currency (LTFC) Issuer Default Rating (IDR) at 'A' with a Negative Outlook.

Fitch has withdrawn the 'F1+' senior unsecured ratings on Iceland's euro and US dollar commercial paper as they have been repaid.

KEY RATING DRIVERS

The 'A' rating is driven by Iceland's very high income per capita, very strong performance on governance, human development and doing business indicators that are more consistent with that of 'AAA' and 'AA' rated countries. The coronavirus pandemic has resulted in sharp deterioration in Iceland's near-term growth and public finance outlook. As a small and highly open economy with a sizeable concentration in tourism and commodity exports, Iceland is exposed to the economic shock with a severe recession, large budget deficits and rising government debt.

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 rising government debt/GDP and downside risks of a prolonged and intensified pandemic leading to macroeconomic and financial spill-overs.

Government debt is forecast to rise by around 30pp of GDP between end-2019 and end-2025 as a result of automatic stabilisers and fiscal stimulus measures to support households and businesses. Fitch forecasts gross general government debt/GDP to jump to 52% in 2020 (2019: 37%) and continue rising to 63% by 2022, compared with the projected 'A' median of 59%. Fitch assumes 20% of the total amount earmarked as guarantees for bridge and support loans (ISK19.6 billion, or 0.7% of GDP) will crystallise on the government's balance sheet. The current coalition government projects government debt/GDP to stabilise only by 2025, which Fitch believes is plausible.

Under our medium-term projections, government debt/GDP stabilises at close to 64% in 2023. Parliamentary elections in 2021 could lead to a fiscal strategy with a slower debt reduction path, but Fitch believes that broad political support for rebuilding fiscal buffers and a strong track record of public debt reduction of 55pp of GDP in 2011-2019 support fiscal policy credibility over the long run.

Fitch forecasts the general government deficit to spike to 10.9% of GDP in 2020, easing only slightly to 9.6% in 2021 due to additional stimulus measures recently outlined in the budget and to 7.5% by 2022. This year's measures include roughly 3.4pp of GDP in discretionary measures (half of which related to partial unemployment benefits and wage subsidies) and 4.5pp of GDP in automatic stabilisers being allowed to work fully. The 2021 budget projects a similar sized automatic stabiliser effect, with investment forming the bulk of a 1.7pp of GDP discretionary stimulus package.

Iceland has high flexibility to finance large fiscal deficits arising from its response to the pandemic shock over the next few years. Icelandic private pension funds managed 168% of GDP in assets, with roughly 70% invested domestically at end-2019. The government also has strong access to the international bond market, a large cash deposit buffer (around 9% of GDP) and is supported by robust liquidity in the banking system.

Swift, decisive public health measures have hitherto averted the need for a strict national lockdown to manage the spread of the virus, while substantial fiscal and monetary policy stimulus packages have limited the decline in consumption and maintained broad macroeconomic and financial stability through the crisis.

Fitch forecasts real GDP to contract 8% in 2020 (8.5% contraction at our May 2020 review). The slight upward revision reflects greater-than-expected goods and services import compression (2Q20: -35% yoy), while private consumption was resilient relative to that in western European peer economies, contracting just 8.3% yoy in 2Q20 due to fiscal stimulus support and the ability to withdraw savings from third-pillar pensions.

Nevertheless, resurgent coronavirus infections have led to tighter testing requirements for international visitors since August 2020, choking off a brief recovery in tourist arrivals in June and July 2020. A third wave of infections since September is further dampening the nascent recovery. Fitch forecasts growth to rebound to 4% in 2021, before easing to 2% by 2024 as the output gap closes. We forecast the unemployment rate to average 7.7%, comparable to the peak during the global financial crisis, and only fall slightly to 6% by 2022.

We see downside risks that a prolonged contraction in the tourism sector could spill over to other sectors of the economy, such as real estate and banks. Commercial banks' loan exposure to construction, real estate and retail account for 25% of the total at end-2019, with the tourism sector estimated at 9% of the total loan book. A sharp contraction in real estate prices could further weigh on growth through wealth effects and depressed bank lending.

Icelandic banks are highly capitalised, with an aggregated capital adequacy ratio of 24.8% at end-2Q20, improved from its 2019 level. Non-performing loans were low at 3.3% of total loans in 2Q20 (2019: 2.9%), but we expect to see a material rise as loan payment holidays expire.

Despite goods and service exports falling 38.8% yoy in 2Q20, we have revised up our current account balance forecast to 0.6% of GDP in 2020 (May 2020 forecast: -2.3% of GDP), due to much stronger import compression owing to reduced overseas travel by residents and lower travel industry-imported services. Net capital inflows have supported FX reserves accumulation, which we project at a strong 11 months of current external payments at end-2020, significantly above the 'A' median projected five months. Although the capital account has been supported by pension funds agreeing to temporarily stop increasing investments abroad in 2Q20-3Q20, risk of capital outflows remains from pension funds diversifying overseas, especially given the reduced differential between international and domestic interest rates.

The Central Bank of Iceland has cut its key policy rate by 175bps to 1% since the onset of the pandemic. From mid-September to end- 2020, it is conducting regular foreign-currency sales to deepen the FX market and reduce intra-week volatility. Harmonised inflation rose to 1.4% yoy in September 2020, driven by depreciation pass-through from the krona but continued to be weighed down by lower oil prices. Despite announcing a large government bond buying programme in March 2020 of up to ISK150 billion (5% of GDP), Central Bank of Iceland purchases have only reached ISK927 million.

ESG

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, as is the case for all sovereigns. These scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model (SRM). 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 and effective rule of law.

RATING SENSITIVITIES

The main factors that could, individually or collectively, lead to negative rating action/downgrade:

- Public Finances: Materially higher than forecast general government debt/GDP, for example due to lack of fiscal consolidation after the initial COVID-19 related support measures, weaker growth prospects or materialisation of contingent liabilities.

- External Finances: Capital outflows at a scale that precipitates macroeconomic instability or erosion of external buffers.

- Macro: Severe and prolonged economic weakness, for example due to a larger-than-expected contraction in the export sectors or sustained correction in the real estate market and material adverse impact on bank asset quality.

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

- Public Finances: Greater confidence in general government debt/GDP stabilising in the medium term.

- Macro: Greater confidence that the economy will avoid a prolonged crisis, for example supported by diminishing downside risks in the export sectors.

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

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

Fitch's sovereign rating committee did not adjust the output from the SRM to arrive at the final 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

We assume that the global economy develops in line with our Global Economic Outlook published on 7 September, with global economic growth rebounding in 2021 from a deep but short-lived recession in 2020 due to the pandemic. In particular, we forecast world GDP to decline 4.4% in 2020, before recovering 5.2% in 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 WBGI 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.

Iceland has an ESG Relevance Score of 5 for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as WBGI 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.

Iceland has an ESG Relevance Score of 4 for Human Rights and Political Freedoms as the Voice and Accountability pillar of the WBGI is relevant to the rating and a rating driver.

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+

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

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Sovereign Rating Criteria (pub. 27 Apr 2020) (including rating assumption sensitivity)

Country Ceilings Criteria (pub. 01 Jul 2020)

APPLICABLE MODELS

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

Country Ceiling Model, v1.7.1 (1)

Debt Dynamics Model, v1.2.0 (1)

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

Sovereign Rating Model, v3.12.1 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Iceland	EU Issued

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Sovereigns Europe Iceland