FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Iceland at 'A'; Outlook Negative

Fri 26 Mar, 2021 - 5:03 PM ET

Fitch Ratings - London - 26 Mar 2021: Fitch Ratings has affirmed Iceland's Long-Term Foreign-Currency (LTFC) Issuer Default Rating (IDR) at 'A' with a Negative Outlook.

A full list of rating actions is provided below.

KEY RATING DRIVERS

The 'A' rating is driven by Iceland's very high income per capita, strong performance on governance, and human development and doing-business indicators that are more consistent with those of 'AAA' and 'AA' rated countries. Very large pension-fund assets and sizeable deposits underpin financing flexibility. 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 impact of the coronavirus pandemic on the Icelandic economy and the resulting deterioration in the public finances. The fiscal deficit has widened materially and government debt is set to increase sharply from pre-pandemic levels over the next few years. As a small and highly open economy with a sizeable concentration in tourism and commodity exports, Iceland is heavily exposed to the pandemic shock.

The general government deficit widened to 7.3% of GDP in 2020 from 1.5% in 2019. The outturn was better relative to our expectations at the October 2020 rating review (-10.9% of GDP), owing to higher- than-expected revenues, lower-than-budgeted expenditures and a more resilient economic performance. It is also below the A-peer current median (-9.5% of GDP). General government debt rose to 80% of GDP in 2020 from 68% in 2019, well above the A-peer current median (58%).

We expect the general government deficit to widen further to 8.1% of GDP in 2021 due to additional stimulus measures outlined in the 2021 budget, but we also assume that spending will not reach the maximum set out in the budget. We estimate the direct cost of fiscal-policy measures at 3.5% of GDP in 2021. We expect the deficit to narrow to 6.5% of GDP in 2022. We believe expenditures will decline only gradually relative to GDP as we expect political pressure to maintain higher spending after the pandemic, particularly in welfare and healthcare but also with aim of boosting infrastructure investment.

Fitch forecasts gross general government debt to increase to 83.7% of GDP in 2021 and 84.7% in 2022, from 79.9% in 2020. We expect public debt to reach a peak of 85.3% in 2023 and to decline slowly thereafter. 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 record of public debt reduction of 70pp of GDP in 2011-2019 support fiscal-policy credibility over the long run.

Following data revision, general government debt levels have been revised significantly higher due to the inclusion of several state-owned entities (SOEs) into the general-government scope. At the same time, the revision implies that the size of contingent liabilities is markedly smaller. Prior to the reclassification, we had treated SOE debt as contingent liabilities for the sovereign's balance sheet.

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 194% of GDP in assets, with roughly 66% invested domestically at end-2020. The government also has strong access to the international bond market, a large cash deposit buffer (around 12% of GDP at end-2020) and is supported by robust liquidity in the banking system.

The Icelandic economy has proved more resilient to the pandemic shock relative to our initial expectations. Preliminary data from Statistics Iceland indicate that real GDP contracted 6.6% in 2020, a better outturn relative to the 8% contraction at our October 2020 rating review, mainly due to stronger domestic demand. Strong household balance sheets and government-support measures contributed to a rebound in private consumption in 2H20.

Gross fixed investment was more dynamic on the back of stronger activity in residential construction, reflecting strong demand and easing financial conditions. The impact of the pandemic on the other two major industries (fishing and aluminium products) has been less negative than initially expected.

Iceland has suffered fewer Covid-19 cases and fatalities and containment measures have been less strict relative to the rest of Europe. However, on Wednesday 24 March the government announced new domestic restrictions (expected to last for three weeks) following a spike in Covid-19 cases. The new restrictions come a few days after the announcement of the re-opening of the borders to all vaccinated foreigners arriving from outside the Schengen/European Economic Area from 6 April.

We expect the recovery to be subdued this year with real GDP growth of 2.6% as foreign tourism will take longer to gain sustained momentum. In contrast, public investment should pick up on the government's 'Investment and construction initiative' (0.9% of GDP in 2021). A stronger carryover effect from growth in 2H21 and our expectation that social-distancing rules and travel restrictions will be relaxed significantly across Iceland's trading partners underpin our view that real GDP growth will accelerate to 4.2% in 2022. For 2022 we expect a stronger rebound in tourism flows with occupancy rates 20% below their end-2019 level.

In the event of a more prolonged slowdown in the tourism sector, we see risks spilling 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 loan book. The expiration of pandemic-related loan moratoria has led to a substantial increase in loans in forbearance mostly in sectors related to tourism. We expect non-performing loans, particularly in the corporate sector related to tourism including commercial real estate, to increase over the coming months but the extent will depend on the pace of the recovery in tourism activity.

Banks are highly capitalised with an aggregated capital adequacy ratio of 24.5% in 3Q20, improved from 2019 and are in a fairly strong position to absorb shocks to asset quality. Non-performing loans were low at 3.2% of total loans in 3Q20 (2019: 2.9%) and corporate insolvencies declined 5% in 2020.

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 WBGI ranking at the 94th percentile, reflecting strong institutional capacity and effective rule of law.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to a negative rating action are:

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

- Macro: Severe and prolonged economic weakness, for example due to a delayed recovery in export-oriented sectors, sustained correction in the real-estate market and material adverse impact on the banking sector.

- External finances: Capital outflows on a scale that precipitates macroeconomic instability or erodes fiscal buffers.

Future developments that could, individually or collectively, result in a positive rating action:

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

- Macro: Greater confidence of a sustained economic recovery, for example supported by evidence that 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 LTFC 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. The SRM output has migrated to 'A-' from 'A', but in our view this is potentially a temporary worsening and the model score borders the threshold between these two indicative ratings. Consequently, the committee decided to adopt the 'A' rating as the starting point for its analysis, unchanged from the prior committee.

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 17 March 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 and Regulatory Quality and Control of Corruption as WBGI have the highest weight in the 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 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, 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(ies), either due to their nature or to the way in which they are being managed by the entity(ies). 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+

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 26 Oct 2020) (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, v1.7.1 (1)

Debt Dynamics Model, v1.2.1 (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	UK Issued, EU Endorsed

Feedback

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Sovereigns Europe Iceland
