FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Iceland at 'A'; Outlook Stable

Fri 16 Sep, 2022 - 5:03 PM ET

Fitch Ratings - London - 16 Sep 2022: Fitch Ratings has affirmed Iceland's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'A' with a Stable Outlook.

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

KEY RATING DRIVERS

High Income, Governance and Demographics: Iceland's 'A' rating is driven by its very high income per capita and very strong governance and human development indicators that are more consistent with those of 'AAA' and 'AA' rated countries. A favourable demographic composition (the share of people of working age was 65% in 2020) supports growth potential. The rating is constrained by the high but declining public debt burden, the small size of the economy and limited export diversification, which result in vulnerability to external shocks and balance of payments' risks.

Solid Macro Recovery: The economic recovery has strengthened over 2022. Real GDP grew by 6.1%yoy in 2Q22 (7.6% in 1Q22), underpinned by domestic demand and solid export growth. We expect the strong recovery in tourism flows (which in July were above 2019 levels) to continue. High frequency indicators (passengers thorough Keflavik Airport and foreign credit card spending) point to continuation of the strong tourism performance in the third quarter. We expect real GDP growth of 5.9% this year, an upward revision from our previous review (4.5%). We expect real GDP growth to slow sharply to 1.9% in 2023 mainly due to weaker growth in Iceland's trading partners (in particular, UK and the EU) which will be reflected in weaker tourism flows and tighter monetary policy.

Resilience to the Energy Shock: Iceland has been resilient to the global energy shock and we expect this will continue to be the case. Higher fuel and food prices represent a shock, but household purchasing power and industry profit margins are less affected by higher energy costs than the rest of Europe. The share of renewables in the energy mix, at above 80%, is the highest in Europe, and Iceland does not rely on natural gas. The main impact of the energy crisis has been via higher prices of imported oil, which affected petrol prices at the pump. As fuel and food prices decline, the squeeze on household incomes should ease. However, export demand from the UK and the EU will slow sharply and this will be the main driver of the slowdown next year.

High Inflation May Have Peaked: Headline consumer price inflation rose to 9.9% in July, its highest level in nearly a decade, but declined slightly to 9.7% in August. This follows a period of aggressive rate hikes by the Central Bank of Iceland (CBI) and adoption of macroprudential measures. It is too early to tell if inflation has peaked but there are some signs that it is moderating across the board. Recent data suggests that both house prices (which are accounted for directly in the national measure of inflation) and imported inflation, the main inflation drivers, have started to ease. The CPI excluding housing also declined, from July's 7.5% to 7.1% in August. House prices rose by 24.8% in the 12 months to August, broadly stable from a month earlier.

In our view, the combination of higher interest rates, macro-prudential measures, pick-up in housing supply and gradual withdrawal of fiscal support mean that house price growth should ease further. Moreover, oil and commodity prices should continue to decline. We expect inflation to average 8.8% in 2022 and decline more markedly to 6.4% in 2023, still well above the CBI target.

Revenue Growth Underpins Deficit Reduction: We expect the general government deficit to decline to 4.7% of GDP in 2022 from 8.9% of GDP in 2021, better than our previous review (6.5% of GDP) and lower than the 'A' peer current median (-5% of GDP). The improvement reflects the stronger than expected revenue growth and the unwinding of the majority of pandemic related support. The government has introduced some measures to protect low income households from higher inflation by bringing forward planned increases in social benefits and pensions. However, given the different nature of inflation, driven by house prices and not by energy prices, the size of the support package is small relative to other European countries.

Debt on a Gradual Downward Path: Despite a large deficit in 2021, the government debt ratio declined to 74.6% of GDP from 77.2% in 2020, underpinned by nominal GDP growth and proceeds from asset sales. We expect general government debt to decline gradually to 68.5% of GDP by 2024. The sovereign has high financing flexibility due to the extremely large pool of private pension funds' assets (194% of GDP), 65% of which is invested domestically. 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 March 2022, the Treasury sold a second stake (22.5%) in Islandsbanki raising ISK52 billion (1.4% of GDP), which is earmarked for debt reduction. Further sales of government equity stakes are likely and could accelerate debt reduction over the coming years. We do not factor in further asset sales in our debt projections.

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. These 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 will lead to a resumption of an upward trajectory of the government debt/GDP ratio over time.

- Macro: Renewed economic weakness or an adverse shock, for example due to a sharp slowdown in the tourism sector, 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:** A sharp and sustained decline in the government debt to GDP ratio, for example through implementation of a fiscal consolidation strategy or sustained GDP growth over time.

- Macro: Sustained economic recovery beyond 2022, for example supported by a diversification of the export base and without generating macroeconomic imbalances.

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.

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

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. As Iceland has a track record of 20+ years without a restructuring of public debt and captured in our SRM variable, this has a positive impact on the credit profile.

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 Stable	Affirmed	A Rating Outlook Stable
	ST IDR	F1+	Affirmed	F1+
	LC LT IDR	A Rating Outlook Stable	Affirmed	A Rating Outlook Stable
	LC ST IDR	F1+	Affirmed	F1+
	Country Ceiling	A+	Affirmed	A+

senior unsecured	LT	A	Affirmed	A

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Michele Napolitano
Senior Director
Primary Rating Analyst
+44 20 3530 1882
michele.napolitano@fitchratings.com
Fitch Ratings Ltd
30 North Colonnade, Canary Wharf London E14 5GN

Malgorzata Wegner
Director
Secondary Rating Analyst
+49 69 768076 279
malgorzata.wegner@fitchratings.com

Shelly Shetty
Managing Director
Committee Chairperson
+1 212 908 0324
shelly.shetty@fitchratings.com

MEDIA CONTACTS

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

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer’s available public disclosure.

APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 11 Jul 2022) (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, v1.3.1 (1)

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

Sovereign Rating Model, v3.13.1 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Iceland	UK Issued, EU Endorsed

DISCLAIMER & DISCLOSURES

of Conduct section of this site. Directors and shareholders' relevant interests are available at https://www.fitchratings.com/site/regulatory. Fitch may have provided another permissible or ancillary service to the rated entity or its related third parties. Details of permissible or ancillary service(s) for which the lead analyst is based in an ESMA- or FCA-registered Fitch Ratings company (or branch of such a company) can be found on the entity summary page for this issuer on the Fitch Ratings website.

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.

READ LESS

SOLICITATION STATUS

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

ENDORSEMENT POLICY

Fitch's international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch's approach to endorsement in the EU and the UK can be found on Fitch's Regulatory Affairs page on Fitch's website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

Sovereigns Europe Iceland