

CREDIT OPINION

10 July 2024

Update

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RATINGS

Islandsbanki	
Domicile	Iceland
Long Term CRR	A2
Type	LT Counterparty Risk Rating - Fgn Curr
Outlook	Not Assigned
Long Term Debt	A3
Type	Senior Unsecured - Fgn Curr
Outlook	Stable
Long Term Deposit	A2
Type	LT Bank Deposits - Fgn Curr
Outlook	Stable

Please see the [ratings section](#) at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Islandsbanki

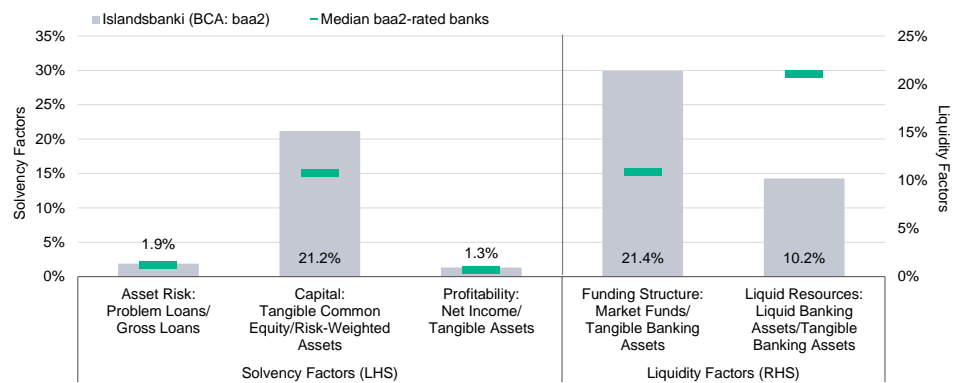
Islandsbanki: Update to credit analysis following rating action

Summary

Islandsbanki's (ISB) foreign and local currency banks deposit ratings of A2/Prime-1 and senior unsecured MTN ratings of (P)A3/(P)Prime-1 are driven by the bank's baa2 baseline credit assessment (BCA); and three notches and two notches of rating uplift, respectively, under our forward-looking Advanced Loss Given Failure (LGF) analysis, which takes into accounts the risks faced by the bank's different liabilities should Islandsbanki enter into resolution.

ISB's BCA of baa2 reflects its robust capitalisation coupled with satisfactory core profitability, a low level of problem loans and adequate liquidity, balanced against single name and high geographical concentration and reliance on market funding.

Exhibit 1
Rating Scorecard - Key Financial Factors



These represent our [Banks Methodology](#) scorecard ratios. Asset risk and profitability ratios reflect the weaker of either the latest reported or three-year average ratios. The capital ratio is the latest reported figure. Funding structure and liquid resources ratios reflect latest fiscal year-end figures.
Source: Moody's Ratings

Credit strengths

- » Low levels of non-performing loans and strong underwriting
- » Strong capitalisation supported by high capital requirements and good recurring profitability
- » Good and stable profitability supported by tight cost control
- » Adequate liquidity buffers

Credit challenges

- » Geographical and single-name concentrations result in tail risks in the loan book
- » Reliance on market funding, with a sizeable amount of FX debt, exposes the bank to changes in investor sentiment

Rating outlook

The stable outlook on ISB's long-term deposit ratings reflects the bank's resilient performance in terms of asset quality metrics and overall risk profile, and the agency's expectation that this performance will continue in the next 12-18 months.

Factors that could lead to an upgrade

- » Upward rating pressure could develop if ISB improves its risk profile by reducing single name and sector concentrations in combination with a reduction in the use of market funds while maintaining strong capitalisation and strong earnings' generation capacity across the credit cycle, without an increase in its risk profile.
- » Upward rating pressure could also develop because of a larger cushion of loss absorbing obligations protecting creditors and depositors in case of failure.

Factors that could lead to a downgrade

- » Downward pressure could emerge if ISB's (1) asset quality and risk profile was to deteriorate, for example as a result of increased exposures to more volatile sectors and/or increased single name concentrations; (2) risk profile increases more than the agency anticipates, driven by non-credit related risks such as market risk and FX risk and/or increasing CPI imbalance (3) financing conditions were to become more difficult or (4) the macroeconomic environment deteriorates significantly leading to a lower Macro Profile.
- » Furthermore, a reduction in the rating uplift as a result of our LGF analysis triggered by structural funding changes to the bank's balance sheet could lead to downward rating pressure.

Key Indicators

Exhibit 2

Islandsbanki (Consolidated Financials) [1]

	03-24 ²	12-23 ²	12-22 ²	12-21 ²	12-20 ²	CAGR/Avg. ³
Total Assets (ISK Billion)	1,643.7	1,582.7	1,566.2	1,428.8	1,344.2	6.4 ⁴
Total Assets (USD Million)	11,810.8	11,648.6	11,033.3	10,967.7	10,536.5	3.6 ⁴
Tangible Common Equity (ISK Billion)	215.0	223.6	213.8	201.4	180.9	5.5 ⁴
Tangible Common Equity (USD Million)	1,545.1	1,645.6	1,506.2	1,546.1	1,418.0	2.7 ⁴
Problem Loans / Gross Loans (%)	1.9	1.8	1.8	2.0	2.9	2.1 ⁵
Tangible Common Equity / Risk Weighted Assets (%)	21.2	22.9	21.4	22.3	19.4	21.4 ⁶
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	10.6	9.5	9.4	10.0	14.7	10.8 ⁵
Net Interest Margin (%)	3.0	3.1	2.9	2.4	2.6	2.8 ⁵

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the issuer/deal page on <https://ratings.moody's.com> for the most updated credit rating action information and rating history.

PPI / Average RWA (%)	3.4	3.5	3.2	2.6	2.0	2.9 ⁶
Net Income / Tangible Assets (%)	1.3	1.6	1.6	1.7	0.5	1.3 ⁵
Cost / Income Ratio (%)	47.8	45.8	45.4	51.0	57.9	49.6 ⁵
Market Funds / Tangible Banking Assets (%)	21.9	21.4	23.8	23.2	26.0	23.2 ⁵
Liquid Banking Assets / Tangible Banking Assets (%)	15.7	10.2	13.1	11.1	12.6	12.5 ⁵
Gross Loans / Due to Customers (%)	143.3	145.2	151.6	147.8	150.7	147.7 ⁵

[1] All figures and ratios are adjusted using Moody's standard adjustments. [2] Basel III - fully loaded or transitional phase-in; IFRS. [3] May include rounding differences because of the scale of reported amounts. [4] Compound annual growth rate (%) based on the periods for the latest accounting regime. [5] Simple average of periods for the latest accounting regime. [6] Simple average of Basel III periods.

Sources: Moody's Ratings and company filings

Profile

Islandsbanki is an Icelandic bank founded in 1875, and offers retail, private banking, asset management, corporate and investment banking services. The bank, then under the name Glitnir, defaulted in 2008, following which the bank was reorganized as Islandsbanki with the Icelandic government assuming a position as the largest owner. The government's ownership stake was 42.5% as of Q1 2024.

The bank had around 30% market share in Iceland as March 2024, and operates through 12 branches, as well as a full-service digital and mobile app offering.

Detailed credit considerations

ISB's operations are supported by its "Strong-" weighted macro profile

ISB operates mostly in Iceland, with a small legacy international exposure in the Arctic region amounting to less than 1% of the group's assets. This is reflected in ISB's assigned Weighted Macro Profile of 'Strong -'. Iceland's 'Strong -' Macro Profile balances the country's small size and associated history of economic boom and bust episodes with relatively high wealth levels, competitiveness and favorable demographics. Iceland further benefits from high institutional and government strength, combined with a low susceptibility to political event risk.

Iceland's growth is volatile, reflecting the economy's limited diversification and relative openness, which increases its vulnerability to sector-specific and external shocks. The economy has weathered the twin shocks of the pandemic and the war in Ukraine, helped by a strong policy response and Iceland's energy independence. Diversification efforts are showing the first signs of success in some sectors, which should strengthen the economy's resilience to shocks.

We expect real GDP growth to remain relatively robust in 2024 at 1.9%, supported by strong export and tourism demand. Real GDP grew at a very strong annual rate of 4.1% in 2023. Domestic payment card turnover suggests that domestic demand has started to soften as high inflation weighs on household purchasing power. However, elevated nominal wage growth and a strong labor market will support consumption.

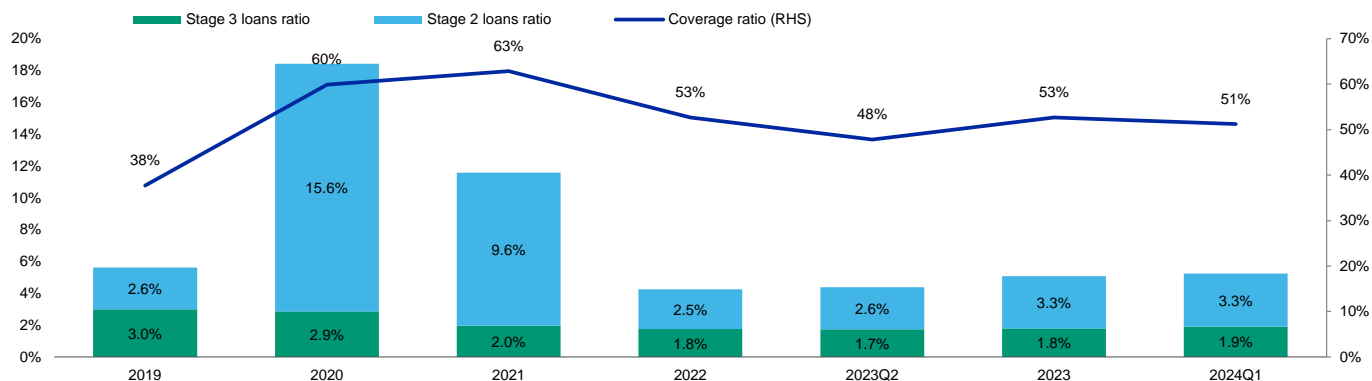
The main risks to the banking sector stem from the country's small size and limited economic diversification, which could create a risk of contagion in the event of sector specific shocks. Icelandic banks also make extensive use of market funding.

Strong underwriting supports high asset quality but geographical and single name concentrations weigh on risk profile

ISB's asset quality has remained strong, despite the high policy rates, as well as seismic activity in the Grindavik region. The bank reported non-performing loans (NPL) ratio, measured as stage 3 loans to gross loans, of 1.91% at end-March 2024, increased only slightly from 1.80% at the end of 2023 while stage 2 loans also remained stable at 3.3% of gross loans as of March 2024, reflective of the bank's strong underwriting. We expect the bank's asset quality metrics to deteriorate only marginally from current levels, as more small and medium enterprises (SMEs) experience payment difficulties at current levels of interest rates in combination with lower economic activity.

Exhibit 3

Islandsbanki's asset quality has normalised in recent years



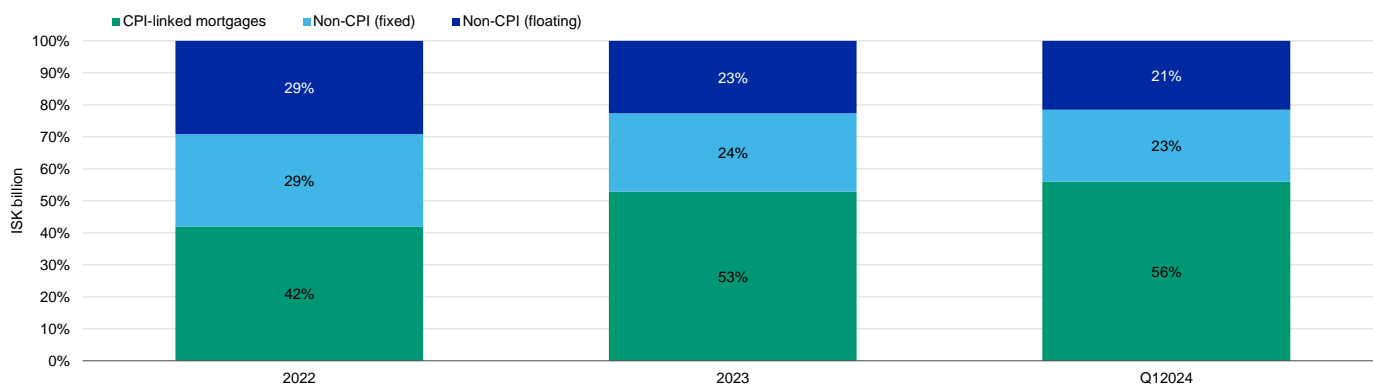
Note: coverage ratio measured as loan loss reserves / non-performing loans.
 Source: Company report

ISB's loan portfolio is evenly split between corporate and retail exposures, with the former accounting for 52% of the loan book as of end-March 2024. The retail portfolio consists mostly of retail mortgages, of which 56% was in the form of CPI-linked loans during the period. During the first three months of 2024, Islandsbanki's stock of CPI-linked mortgages grew by 7.5%, while the stock of non-indexed mortgages decreased by 4.8% (see Exhibit 5). However, the overall share of non-CPI linked loans continues to represent the majority of the loan book at 65% of gross loans, although it has decreased from 81% in 2022. The bank has taken active steps to limit the growth in CPI-linked products, by reducing the tenor and adjusting the pricing, as it manages its inflation imbalance that reached 74% of total capital at end March 2024.

The performance of retail loans has been strong, despite the 8.5% cumulative increase in the Central bank's key rate since Q2 2021 in an aim to control inflation. This is explained by the relatively small share of non-CPI linked floating rate mortgages (21% of retail loans at end March 2024) and the fact that the majority of the fixed rate non-CPI linked mortgages are due to re-price at the higher rates in the second half of 2024 and first half of 2025. In addition households have the ability to transfer their non-CPI linked mortgage to a CPI linked product where monthly payments are significantly lower, which has resulted in an increase on the share of indexed loans as a percent of total loans. Iceland benefits from strong employment and real wage growth which we expect to continue to support the performance of the retail book.

Exhibit 4

ISB's mortgages are mostly in the form of CPI linked products



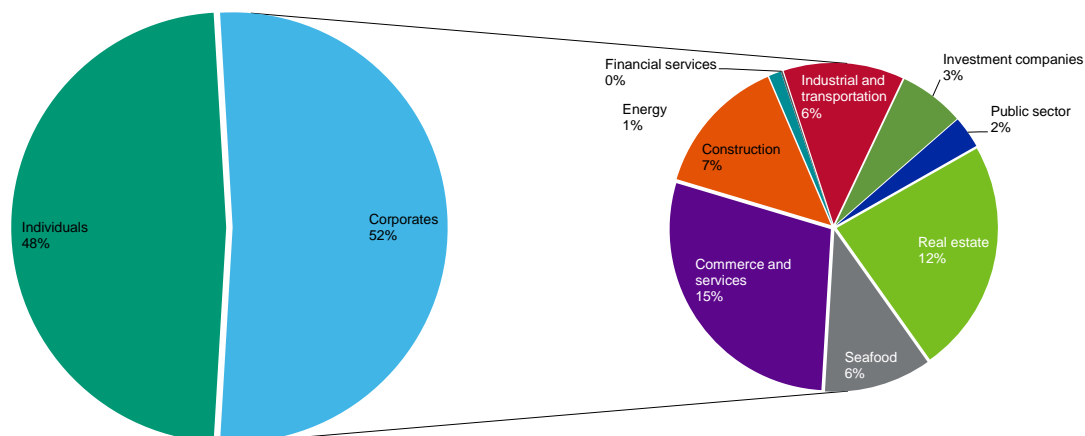
Source: Company reports

The bank's corporate book is focused on real estate and construction, commerce and services and the seafood sector. The historically volatile real estate and construction sectors accounted for 19.4% of gross loans as of March 2024. The corporate loan book also contains some client concentrations, with contagion risks between various sectors given the high degree of interconnectedness and

small size of the economy, as evidenced during the Covid-19 pandemic when severe impacts in the tourism sector resulted in issues in the broader economy. The bank's appetite for market risk is low, with small market making and proprietary trading activities, while equity in the banking book has remained stable and is comparable to peers.

Exhibit 5

ISB's corporate book benefits from a diverse mix across different sectors
At end March 2024



Source: Company reports

Our assigned score also takes into consideration ISB's track record of strong underwriting, counterbalanced by its geographical and sector concentrations and its higher share of corporate lending and client concentrations compared to peers.

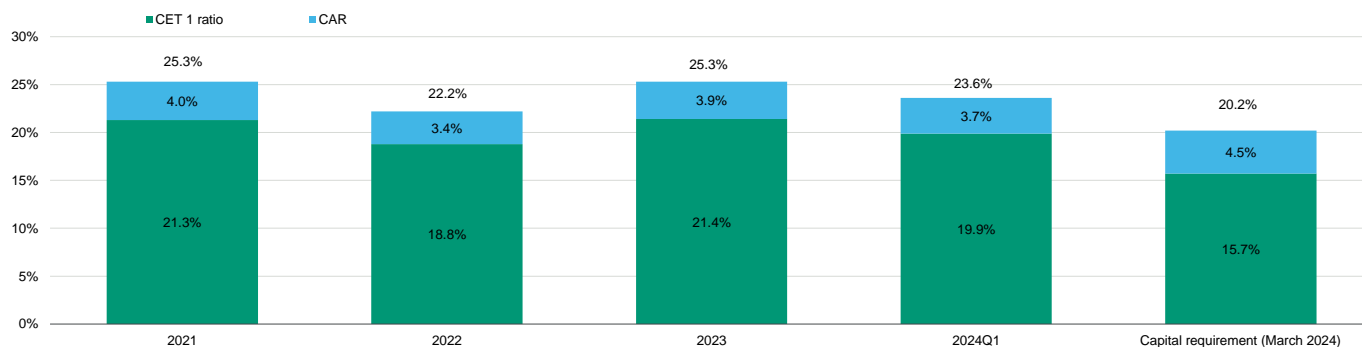
Capitalisation is expected to remain strong albeit at lower levels

ISB enjoys a strong capital position as well as a very strong leverage ratio, reflective of the use of the standardised method for calculation of capital requirements. The bank's reported common equity Tier 1 (CET1) ratio was 19.9% at end of March 2024, compared to a capital requirement of 15.7%. The bank further had a total capital adequacy ratio (CAR) of 23.6% at end-March 2024 compared to a minimum required CAR of 20.2%.

The bank's Pillar 2 (P2R) requirement is 1.8% (2.4% previously) as communicated by the FSA in the latest Supervisory Review and Evaluation Process (SREP) report in July 2024. ISB has historically been benefiting from the lower P2R requirement compared to its peers mainly driven by a lower add-on for market risk, reflective of the bank's limited appetite for market making activities. However, following the 2024 SREP report, the Pillar 2 requirements are comparable amongst the large Icelandic banks as although ISB's market making activities are limited, inflation imbalances have increased compared to peers.

The strong capitalisation is further supported by a strong leverage ratio of 12.6% as of end-March 2024, which is significantly above the European average ratio of around 5.8%.

Exhibit 6
ISB benefits from a strong capital position



Source: Company reports

The bank is targeting a buffer of 100bps-300bps above regulatory requirements, and considers an optimal CET1 capital at 17.1% and a total capital ratio between 20.6% and 22.6%. We expect the bank's ISK15 billion share buyback plan, combined with its 50% dividend payout ratio, to contribute to a capital optimization over the coming 12-18 months, assuming a successful divestment of the Icelandic Government which will allow ISB to proceed with planned share-buy backs.

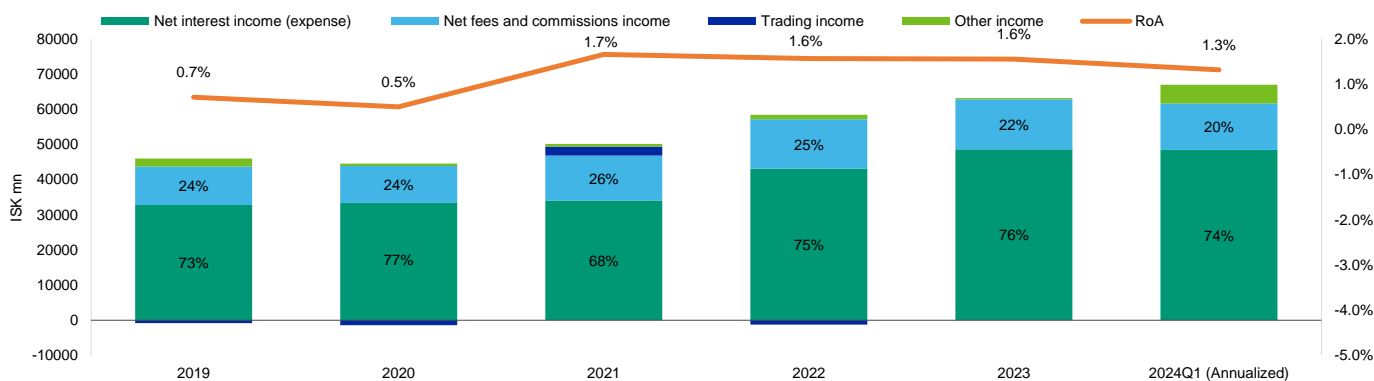
Our assigned capital score reflects ISB's strong capital position, strong leverage ratio and its access to equity capital markets as well as our expectation that the bank will continue to optimize its capital base by reducing its CET1 levels.

High reliance on net interest and fee income results in good recurring profitability supported by higher rates environment

ISB's core profitability is good and stable. The bank reported return on assets (RoA) of 1.3% at end March 2024 and 1.6% in 2023 and 2022, significantly improved from 0.9% in 2018 and 0.7% in 2019 as the bank increased its focus on pricing and cost control. The decrease in the first quarter of 2024, was mainly due to lower fee income on the back of decreased economic activity and higher taxation on to equity holdings related to forward contracts. It is worth noting that during the quarter, the bank's former headquarters were reclassified as investment property, resulting in an ISK 906 million boost to other income. Excluding the effect of this revaluation RoA is estimated at 1.1%.

Net interest income is the main source of income and accounts for almost 74% of operating income, while fees and other income account for the remaining 26% reflective of the banks strong position in the asset management segment. The bank's profitability has benefited greatly from the increasing interest rates and strong credit growth in the past two years, while limited investment banking operations have resulted lower but more stable earnings compared to peers, due to limited contribution of NFI to its core profits. We expect profitability to moderate slightly going forward due to higher cost of risk and weaker credit growth, as interest rates remain higher for longer, but to remain strong overall.

Exhibit 7
ISB has maintained strong recurring profitability supported by higher rates



Source: Company reports

ISB's net interest income increased by 12.7% in 2023, supported by higher rates and strong credit growth. The key interest rate increased to 9.25% on 23 August 2023, following thirteen consecutive rate hikes since the ultralow rate level of 0.75% seen in the first half of 2021. The net interest slightly declined to 3.0% in the first three months of 2024, compared to 3.1% in 2023 and 2.9% in 2022, driven by decreasing deposit margins. We expect net interest margins to remain broadly stable as the benefits from the high interest rate will be offset by increased funding costs and lower credit growth.

ISB's net fee and commission income (NFCI) benefits from a good degree of diversification. Payment and processing fees remain the dominate income driver followed by personal and corporate investment banking and asset management fees. Although ISB does not have an in-house insurance operation, but owns 100% of the share capital of Allianz Iceland which is in a strategic partnership with Allianz Global, and has positively impacted the bank's NFCI.

In the first three months of 2024, NFCI decreased by 5.0% YoY, mainly driven by a 13.9% decrease in card and payment processing as the economic recovery and increasing tourism positively impacted transaction levels. Also, investment banking and brokerage income fell by 4.7% for the same period, while asset management decreased by 4.3%, as capital markets continued to exhibit signs of increasing stress.

ISB benefits from good cost control which compares favorably to domestic peers. The bank targets a cost-to-income (C/I) of 45% and is already within target in March 2024 with a reported 44.9%. However, total operating expenses increased to ISK7.8 billion in the first three months of 2024, compared to ISK7.5 billion for the same period in 2023, largely due to wage increases in response to the high level of inflation, as well as investments in IT and strategic projects. We expect the bank's C/I ratio remain within target going forward, despite elevated wage growth, as investment in the business are expected to result in increased revenues and long-term efficiency gains.

Our assigned score reflects our expectation that the bank's profitability will remain strong but moderate slightly from current levels, due to increased funding costs and normalization of cost of risk.

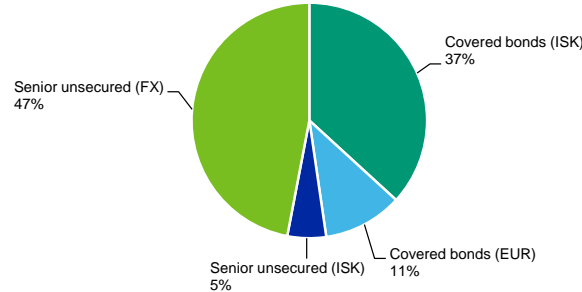
Reliance on market funding balanced against adequate liquidity

ISB's liability structure consisted of 61.7% deposits as of end of March 2024, slightly above when compared to the average level of 60.3% for the period 2019-2023, showcasing both a resilient core deposit base, as well as the ability for the bank to grow its deposits in line with asset growth. Almost 46% of deposits are being covered by the deposit guarantee scheme but only 11% of deposits being term deposits with 3 months or more until maturity. Nevertheless, we consider ISB's deposit base as stable due to the closed nature of the Icelandic banking sector, with no international banks offering banking services in ISK.

The bank's market funding consists of covered bonds as well as senior unsecured debt, both issued in both domestic and foreign currencies (see Exhibit 9). Senior debt accounts for 52% of debt outstanding, and is mostly issued in foreign currency which provides access to a wider investor base. Although, high reliance on foreign investors exposes the bank to changes in investor sentiment in times of market stress, this is somewhat offset by improved market access, for senior debt issuances, in the domestic markets in the past 18 months.

Covered bonds account for around 60% of market funding, which we consider a more stable source of funding, and is primarily issued in local currency. In 2022, the bank started also issuing in the international markets, which although it provides diversification in its investor base it also increases somewhat the FX risk due to the absence of international counterparties to provide currency swaps for these issuances. FX debt issuances broadly match FX lending needs as well as the bank's FX assets held in the liquidity portfolio, and the net position is closely monitored and managed to zero.

Exhibit. 8
Islandsbanki has a diverse mix of market funding
 Breakdown of market funding as of March 2024



Source: Company reports

Our assigned market funding score reflects our view that the bank's use of market funds will remain broadly unchanged in the coming years implying a market funds to TBAs ratio of approximately 22%. The score also incorporates our view that ISB's stable and sticky deposit base, combined with the bank's refinancing strategy and good market access in the vast domestic market somewhat offsets risks related to changes in investor sentiments particularly in the international capital markets.

ISB benefits from adequate liquidity, with highly liquid assets accounting for 15% of tangible banking assets in March 2024. The bank benefits from a very strong Basel III LCR ratio of 190% in March 2024, consisting of LCR for EUR of 404% and LCR for ISK of 101%, well above the regulator's minimum requirements of a total LCR of 100%, a EUR LCR of 80%, and a minimum ISK LCR of 50%. The liquidity pool of assets consists mostly of cash and deposits with the central bank and government bonds.

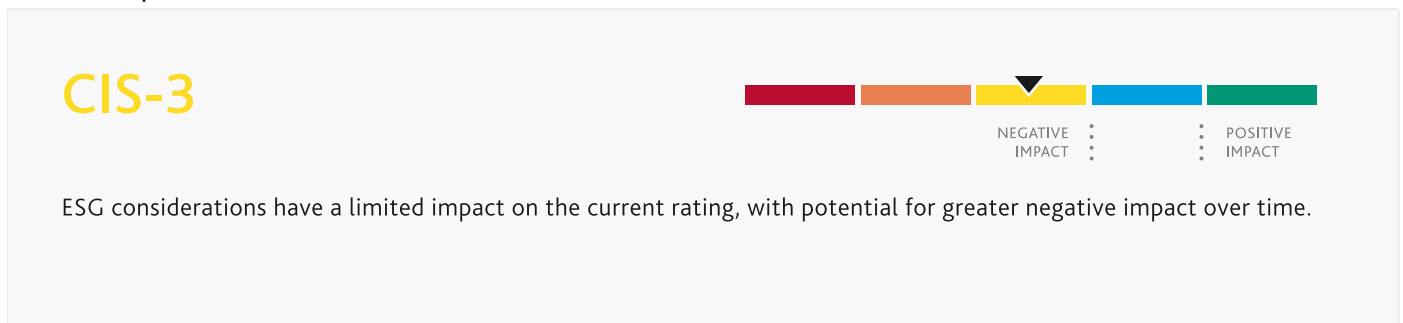
Source of facts and figures cited in this report

Unless noted otherwise, we have sourced data relating to systemwide trends and market shares from the central bank. Bank-specific figures originate from banks' reports and Moody's Banking Financial Metrics. All figures are based on our own chart of accounts and may be adjusted for analytical purposes. Please refer to the document [Financial Statement Adjustments in the Analysis of Financial Institutions](#), published on 8 April 2024.

ESG considerations

Islandsbanki's ESG credit impact score is CIS-3

Exhibit 9
ESG credit impact score

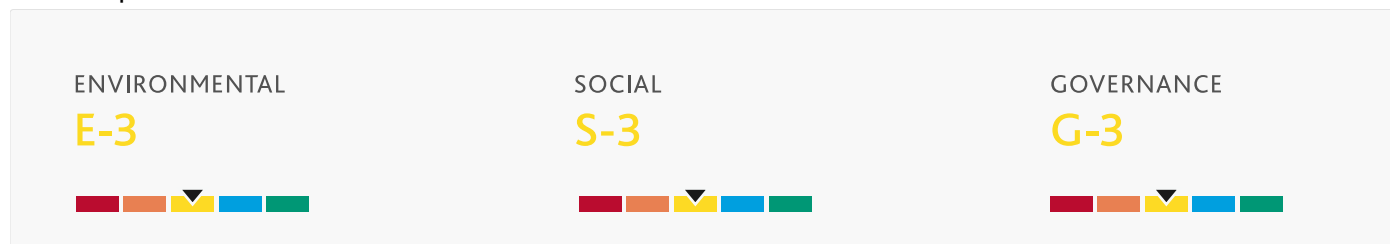


Source: Moody's Ratings

Islandsbanki's **CIS-3** indicates that ESG considerations have a limited impact on the current rating with the potential for downward rating pressure from moderate governance risks. These reflect the need to address and improve the bank's compliance and control frameworks, following shortcomings identified in relation to the partial disposal of the Icelandic government's stake in 2022.

Exhibit 10

ESG issuer profile scores



Source: Moody's Ratings

Environmental

Islandsbanki faces moderate environmental risks primarily because of its portfolio exposure to carbon transition risk as a diversified bank. In line with its peers, the bank is exposed to mounting business risks and stakeholder pressure to meet broader carbon transition goals. Consequently, ISB is actively engaging in optimizing its loan portfolio longer-term toward less carbon intensive assets.

Social

Islandsbanki faces moderate social risks mainly related to customer relations as well as to societal trends. The bank's developed policies and procedures mitigate conduct risk associated with the distribution of financial products such as regulatory and reputational risks, as well as exposure to litigation. Continued investments in technology and the bank's long track record of handling sensitive customer data, as well as appropriate culture and governance that ensure adherence to regulatory standards, help to manage high cyber and personal data risks. Islandsbanki benefits from Iceland's more favourable demographic profile, relative to many other countries, which affords business opportunities for the bank.

Governance

ISB faces moderate governance risks. While its risk management is in line with best practices, some policies and procedures in respect to the partial government share sale in March 2022 were considered not sufficient by the Central Bank's financial supervision authority, leading to unforeseen senior management turnover. Nevertheless, the bank has taken necessary actions to address the identified weaknesses and continues to improve its compliance framework, while management credibility is expected to be restored over time. ISB is partly owned by the Government of Iceland, which is considered a passive shareholder, but this does not result in incremental governance risks because of the country's developed institutional framework.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moody's.com. In order to view the latest scores, please click [here](#) to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

Support and structural considerations

Loss Given Failure (LGF) analysis

The European Union's BRRD has been transposed into Icelandic law, applicable from 1 September 2020, which confirmed our current assumptions regarding the LGF analysis. We assume a residual tangible common equity of 3% and post-failure losses of 8% of tangible banking assets, a 25% run-off in junior wholesale deposits, a 5% run-off in preferred deposits, in line with our standard assumptions.

The Icelandic legislation has established full depositor preference over senior unsecured creditors. Therefore, we assign a 100% probability to deposits being preferred to senior unsecured debt.

For Islandsbanki's short-term and long-term deposit ratings and issuer ratings we have considered the likely impact on loss given failure from the combination of their own volume and the amount of debt subordinated to them. This results:

- » for the deposit ratings in a Preliminary Rating Assessment of A2/Prime-1, three notches above the BCA, reflecting an extremely low loss given failure.
- » for the issuer ratings in a Preliminary Rating Assessment of A3, two notches above the BCA, reflecting a very low loss given failure.

Government support considerations

Despite Islandsbanki's significant deposit market share of 30%, and its systemically important status, we assume a low probability of government support for its deposit, CRA, and CRR ratings reflecting Iceland's implementation of the EU's Bank Recovery and Resolution Directive (BRRD) and the country's past track record on providing no support to the financial sector during the 2008 financial crisis.

Methodology and scorecard

About Moody's Bank Scorecard

Our scorecard is designed to capture, express and explain in summary form our Rating Committee's judgement. When read in conjunction with our research, a fulsome presentation of our judgement is expressed. As a result, the output of our scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating methodology and scorecard factors

Exhibit 11

Rating Factors

Macro Factors							
Weighted Macro Profile	Strong - 100%						
Factor	Historic Ratio	Initial Score	Expected Trend	Assigned Score	Key driver #1	Key driver #2	
Solvency							
Asset Risk							
Problem Loans / Gross Loans	1.9%	a3	↔	ba2	Single name concentration	Sector concentration	
Capital							
Tangible Common Equity / Risk Weighted Assets (Basel III - transitional phase-in)	21.2%	aa3	↔	a1	Expected trend		
Profitability							
Net Income / Tangible Assets	1.3%	a3	↔	baa1	Expected trend		
Combined Solvency Score		a2		baa1			
Liquidity							
Funding Structure							
Market Funds / Tangible Banking Assets	21.4%	baa3	↑	baa3	Expected trend	Market funding quality	
Liquid Resources							
Liquid Banking Assets / Tangible Banking Assets	10.2%	ba2	↑	ba1			
Combined Liquidity Score		ba1		baa3			
Financial Profile				baa2			
Qualitative Adjustments				Adjustment			
Business Diversification				0			
Opacity and Complexity				0			
Corporate Behavior				0			
Total Qualitative Adjustments				0			
Sovereign or Affiliate constraint				A2			
BCA Scorecard-indicated Outcome - Range				baa1 - baa3			
Assigned BCA				baa2			
Affiliate Support notching				0			
Adjusted BCA				baa2			
Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency Rating	Foreign Currency Rating	
Counterparty Risk Rating	3	0	a2	0	A2	A2	
Counterparty Risk Assessment	3	0	a2 (cr)	0	A2(cr)		
Deposits	3	0	a2	0	A2	A2	
Senior unsecured bank debt	2	0	a3	0	(P)A3	A3	
Junior senior unsecured bank debt	0	0	baa2	0	(P)Baa2	(P)Baa2	
Dated subordinated bank debt	-1	0	baa3	0	(P)Baa3	(P)Baa3	

[1] Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.

Source: Moody's Ratings

Ratings

Exhibit 12

Category	Moody's Rating
ISLANDSBANKI	
Outlook	Stable
Counterparty Risk Rating	A2/P-1
Bank Deposits	A2/P-1
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa2

Counterparty Risk Assessment	A2(cr)/P-1(cr)
Issuer Rating	A3
Senior Unsecured	A3
Junior Senior Unsecured MTN	(P)Baa2
Subordinate MTN	(P)Baa3

Source: Moody's Ratings

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