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Research Update:

Iceland-Based Islandsbanki Upgraded To 'BBB/A-2' On Improved Operating Conditions For Icelandic Banks; Outlook Positive

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Overview

- Operating conditions for Icelandic banks are improving, in our view, with falling private-sector leverage and improved access to foreign debt capital markets.
- Islandsbanki's capital levels are the highest among Icelandic peers, however, we see uncertainty as to future levels due to preparation for a possible sale or IPO.
- As a result, we are upgrading Islandsbanki to 'BBB/A-2' from 'BBB-/A-3'.
- The positive outlook reflects positive trends in the Icelandic banking sector and the potential that improved clarity of future capital and ownership could lead to an upgrade in the coming two years.

Rating Action

On Oct. 25, 2016, S&P Global Ratings raised its long- and short-term counterparty credit ratings on Iceland-based Islandsbanki hf to 'BBB/A-2' from 'BBB-/A-3'. The outlook is positive.

Rationale

The upgrade primarily reflects improving operating conditions for Iceland's banking sector (see "Various Positive Rating Actions On Four Icelandic Banks On Receding Economic Risks and Improved Access To Funding," published Oct. 25, 2016, on RatingsDirect).

We expect the trend of improving domestic asset quality will reduce risks related to domestic credit, following the deleveraging of Icelandic households and corporates in recent years. In addition, we believe the continued liberalization of capital controls will lead to further improvements in economic resilience of the Icelandic economy and reduce the downside risks in the operating environment for Icelandic banks.

Industry risk in the Icelandic banking sector has also improved, in our view, based on demonstrated access to external funding; material improvements in banking regulation and supervision; and proactive measures to avoid a repeat of the excessive growth that preceded the boom in the 2000s and to manage the impact of cross-border flows impacting the domestic economy. Along with its

commercial banking peers, Islandsbanki benefits from the improved access to foreign debt capital markets, in our view, allowing it to diversify its funding and refinance expensive bonds with new issues made on better terms.

Accordingly, we have revised upward our anchor for banks operating in Iceland to 'bbb-' from 'bb+'. This anchor is the starting point in determining our rating on Islandsbanki.

Islandsbanki continues to have best-in-class capitalization among domestic peers, with a pro forma risk-adjusted capital (RAC) ratio at 20.3% as of June 30, 2016. However, we anticipate that Islandsbanki will likely reduce capital levels in preparation for an eventual sale or IPO. We estimate a potential reduction equivalent to a 5%-6% reduction in the regulatory common equity tier 1 capital ratio over the next two years, as part of the sales process. In addition, we anticipate the bank will pay out normal dividends of 50% of net profits over the coming years. As such, we project Islandsbanki's longer-term RAC ratio will be at 16%-17%. However, we see uncertainty as to the future capitalization level, given our expectation that banks might look to optimize their capital bases, given their very high leverage ratios versus international peers', and to have more attractive returns on equity for potential investors. As such, we apply a one-notch negative adjustment to Islandsbanki's 'bbb+' stand-alone credit profile (SACP), resulting in our 'BBB' long-term credit rating.

The improved anchor for the Icelandic banking sector and the bank's capital metrics result in a two-notch improvement in our assessment of Islandsbanki's SACP to 'bbb+' from 'bbb-'. However, we see uncertainty around our base-case capital expectations, due to the potential for higher-than-projected extraordinary dividends or capital optimization as the bank prepares for sale. Accompanying this, the bank's medium-term ownership situation remains unsettled, and we expect the government will initiate a sale or IPO process during our outlook horizon. A change in ownership could have a material impact on the bank's strategy and risk management.

We expect Islandsbanki will maintain its adequate business position, underpinned by its top-3 market position in most business lines in Iceland. We project a return on equity from core earnings of almost 6%, based on current equity levels, but could see an increase if leverage ratios are reduced by extraordinary dividends.

We expect to see a continued stabilization of Islandsbanki's credit risk from the strong economic performance in Iceland and lower private-sector debt. As such, we continue to assess the risk position as adequate and well captured within the 'bbb-' anchor and our very strong capital and earnings assessment. Finally, we continue to view the bank's funding as average for Icelandic banks and its liquidity position as strong. We note the bank's recent €500 million senior debt issuance was used in part for early repayment of a Glitnir-owned €138 million tier 2 instrument, reducing further ties with its former owner.

Outlook

The positive outlook reflects our expectation that the bank's RAC ratio will remain sustainably above 15%, even while the bank prepares for an eventual sale or IPO over the next two years. However, we note that this scenario is only a base case and uncertainty around the sales process, ownership, and capitalization remains.

We could upgrade the bank if we see strong continued economic development in Iceland, if future capital levels exceed our current expectations, or if we become more certain about future capitalization, allowing us to remove the negative adjustment notch. Despite continued positive economic and industry trends for the Icelandic banking sector, we consider unlikely a two-notch upgrade over the next two-year rating horizon given the relatively concentrated and volatile nature of the Icelandic economy.

We could revise the outlook to stable if we saw signs that Iceland's strong economic development was weakening or an increased risk of economic imbalances in the economy. We could also revise the outlook to stable if the bank's capital levels fell below our expectations, due to a larger-than-anticipated reduction in equity capital.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	BBB/Positive/A-2	BBB-/Positive/A-3
SACP	bbb+	bbb-
Anchor	bbb-	bb+
Business Position	Adequate (0)	Adequate (0)
Capital and Earnings	Very strong (+2)	Strong (+1)
Risk Position	Adequate (0)	Adequate (0)
Funding and Liquidity	Average and Strong (0)	Average and Strong (0)
Support	(0)	(0)
ALAC Support	(0)	(0)
GRE Support	(0)	(0)
Group Support	(0)	(0)
Sovereign Support	(0)	(0)
Additional Factors	(-1)	(0)

Related Criteria And Research

Related Criteria

- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions - January 29, 2015
- General Criteria: Group Rating Methodology - November 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions - July 17, 2013
- Criteria - Financial Institutions - Banks: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework - June 22, 2012
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions - November 09, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions - November 09, 2011
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions - December 06, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks - March 23, 2004

Related Research

- Various Positive Rating Actions On Four Icelandic Banks On Receding Economic Risks and Improved Access To Funding, Oct. 25, 2016
- Nordic Banks' Capital Growth Tapers Off, June 14, 2016
- The Future Of Banking: Nordic Banks Looking Svelte In The Fintech Race, June 14, 2016
- Two Icelandic Bank Outlooks Revised To Positive On Improving Economic Resilience; 'BBB-/A-3' Ratings Affirmed, January 19, 2016

Ratings List

Upgraded

	To	From
Islandsbanki hf		
Counterparty Credit Rating	BBB/Positive/A-2	BBB-/Positive/A-3
Senior Unsecured	BBB	BBB-

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