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Ratings

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Islandsbanki hf

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Islandsbanki hf

SACP	bbb+

Anchor	bbb	
Business Position	Adequate	0
Capital and Earnings	Very Strong	+2
Risk Position	Moderate	-1
Funding	Average	0
Liquidity	Adequate	

\+

Support	0
ALAC Support	0
GRE Support	0
Group Support	0
Sovereign Support	0

\+

Additional Factors	0

Issuer Credit Rating

BBB+/Stable/A-2

Major Rating Factors

Strengths

- High leverage ratios and very strong capital, despite planned capital optimization.
- Stable franchise and market position across all domestic business lines.

Weaknesses

- Concentrated in Iceland with limited risk diversification opportunities.
- Uncertainty related to eventual sale and change from 100% government ownership in the next few years.

Outlook: Stable

The stable outlook on Islandsbanki reflects that we expect the bank's risk-adjusted capital (RAC) ratio to remain sustainably above 15%. This is despite the bank preparing for an eventual sale or IPO over the next two years, and optimizing its capital base by distributing large dividend payouts and issuing capital instruments. We expect the bank's asset quality to improve only marginally from current levels, remaining in line with that of domestic peers. The stable outlook further balances our view of the still-supportive economic development in Iceland with the relatively concentrated and volatile nature of the economy and increasing credit risks.

We could take a negative rating action if Islandsbanki's RAC ratio declined more than we expected, or if its loan asset quality deteriorated materially, requiring significant and unexpected additional provisioning. This could follow a quicker sale than we expect to owners with a more aggressive business strategy. We could also lower our rating if we saw signs of the economic and banking industry environment in Iceland weakening.

We consider a positive rating action unlikely, as we expect the bank's regional and sector concentration to remain unchanged, while its funding and liquidity profile normalizes after the lifting of capital controls. We also reflect this in our overall banking market assessment, which incorporates the naturally rather small and concentrated Icelandic market.

Rationale

Our rating on Islandsbanki reflects our view of its capitalization and solid market position as Iceland's universal bank. At the same time, we factor in the bank's credit concentration in a small and volatile country. Despite the ongoing capital optimization, we expect the RAC ratio to remain above 15% within the next 12-24 months. In our view, the bank's high capital level more than offsets the limited diversification opportunities in Iceland and uncertainties related to its sale by the government in the next few years.

We also expect its asset quality indicators to stabilize after a prolonged balance sheet clean-up since inception, and as a result of the economic slowdown. In our view, Islandsbanki maintains a solid business position in Iceland, but remains closely comparable to the other two domestic commercial banks, with similar revenues and market share.

We consider that the bank's long-term assets are largely supported by appropriate long-term funding, while its previously high liquidity buffers are gradually declining.

Islandsbanki is wholly owned by the Icelandic government. However, we do not incorporate any support in our ratings because we consider this ownership as temporary and not a strategic investment.

Anchor: 'bbb' for banks operating primarily in Iceland

Our bank criteria use our Banking Industry Country Risk Assessment economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. The anchor for a commercial bank operating only in Iceland is 'bbb', based on an economic risk score of '4' and an industry risk score of '5'.

Our view of the economic risks that Icelandic banks face remains stable. This reflects our expectation that economic growth will continue to support the banking sector amid signs that overheating is receding. We project real GDP growth to moderate to 2%-3% in 2018-2021, from 3.6% in 2017 and 7.5% in 2016, driven by a slowdown in the expansion of the tourism sector and completion of some investment projects. The cooling of the economy will reduce the risk of imbalances, which has been evident in the recent exchange rate as well as in labor and housing market trends. Specifically, house prices will continue to increase, but at a more tempered pace than in 2017, with a growth rate of about 7% on average in 2018-2019, down from double-digit growth in the previous two years.

The banking system has largely absorbed the shocks from the 2008 financial crisis as reflected by declines in banks' nonperforming assets, low new loan losses, private sector credit below 140% of GDP in 2017, and the successful lifting of capital controls in 2017. That said, we see risks stemming from a stronger Icelandic krona (ISK) and wage inflation, which could translate into a loss of economic competitiveness. The banks' credit risk may also start increasing, due to their sizable exposure to the real estate and tourism sectors and to consumer price index (CPI)-linked mortgage loans, combined with fierce domestic competition from nonbank institutions (for example, pension funds).

We now see the trend for industry risk in Iceland as stable over our 24-month horizon. Since the financial crisis, Iceland has moved to a stronger regulatory system and adeptly managed the recent lifting of capital controls, the restructuring of legacy banks, and the implementation of measures to reduce economic volatility. Moreover, Icelandic banks have rebalanced their funding model with domestic deposits, covered bonds, high shares of equity capital, and foreign wholesale funding. However, the higher reliance on external funding, the current optimization of capital levels, and a still relatively low core deposit base (about 35% on systemwide loans) increasingly exposes banks to wholesale market volatility. Overall, we consider banks' risk appetite to be sound but some risks could arise from growth in the lending activities of pension funds, whose growing presence (about 18% of mortgage stock) is somewhat distorting the competitive landscape for mortgages.

Table 1

Islandsbanki hf Key Figures

	--Year-ended Dec. 31--				
(Mil. ISK)	**2018**	**2017**	**2016**	**2015**	**2014**
Adjusted assets	1,125,401	1,031,591	1,044,882	1,044,438	910,709
Customer loans (gross)	854,644	755,175	687,840	665,711	634,799
Adjusted common equity	165,796	163,810	166,249	190,896	175,868
Operating revenues	43,460	44,189	46,167	44,673	42,668
Noninterest expenses	28,823	27,638	28,184	24,827	23,812
Core earnings	9,254	8,909	12,294	11,699	12,344

ISK--Icelandic krona.

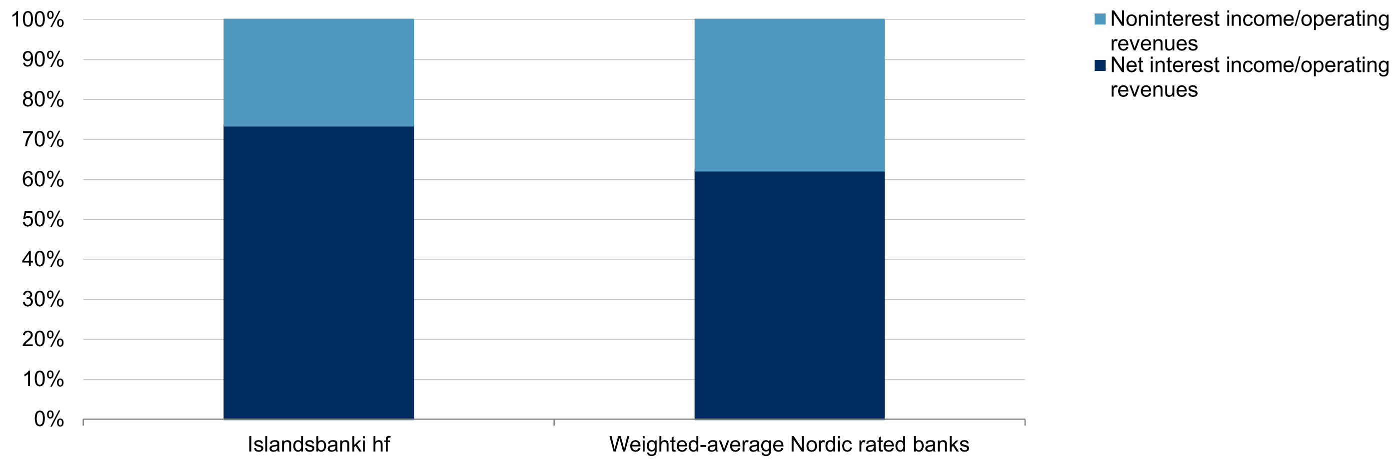
Business position: Diverse business model within the limits of the Icelandic economy

Our assessment of Islandsbanki's business position as adequate balances the bank's broad presence in most business lines in Iceland, solid domestic franchise, and the naturally concentrated economy. The bank was created in October 2008 when it acquired more than ISK900 billion (about €5.8 billion) in loans (originally valued at a 47% discount) from the estate of Glitnir, the bank's former owner. In 2016, Glitnir transferred its ownership of Islandsbanki to the Icelandic government, so the government now fully owns Islandsbanki. We do not see the bank as a strategic investment for the government. As such, we view this ownership as temporary and believe that the government will put Islandsbanki up for sale within the next few years.

With total assets of ISK1.2 trillion (€8.4 billion) as of fourth-quarter 2018, Islandsbanki is a similar size as its domestic peers Arion and Landsbankinn. Islandsbanki maintains a comparable market position in most business lines, with a rising market share in the corporate and small and midsize enterprise segment. In terms of total lending from commercial banks, Islandsbanki has a strong market share at about 21% and operates out of a slimmer branch footprint than its domestic peers. The bank has diverse revenues from retail banking, including asset financing and credit cards; large corporate, wealth management, and trading activities; and corporate finance. However, the small domestic economy limits diversification prospects, in our view. The payment services company Borgun, which Islandsbanki has owned since 2016, has been formally put up for sale. Positively, this planned sale should reduce earnings volatility but will also limit business diversification and increase reliance on net interest income.

Chart 1

Islandsbanki's Net Interest Income Dependence Versus Nordic Rated Peers



Islandsbanki data as of Dec. 31, 2018, weighted average for Nordic banks is calculated based on data as of June 30, 2018 due to data availability. Source: S&P Global Ratings

Islandsbanki's strategic target is to earn about 10% return on normalized equity by 2022. This should come from improved cost efficiency despite upward wage pressures in Iceland. Moreover, the bank has recently finalized the implementation of its new IT system for payment and deposits, which should support efficiency and more advanced digital propositions to clients. Generally, in terms of digitization, we viewed Icelandic banks as lagging Scandinavian peers but they are narrowing the gap.

Table 2

Islandsbanki hf Business Position

	--Year-ended Dec. 31--				
(%)	**2018**	**2017**	**2016**	**2015**	**2014**
Loan market share in country of domicile	21.4*	21.1	19.4	20.1	20.2
Deposit market share in country of domicile	31.4*	33.8	36.5	35.9	33.9
Total revenues from business line (mil. ISK)	45,899.0	51,218.0	57,170.0	57,318.0	57,469.0
Commercial & retail banking/total revenues from business line	81.0	68.9	53.8	48.3	46.5
Brokerage/total revenues from business line	4.4	4.2	3.3	3.5	3.0
Other revenues/total revenues from business line	14.7	26.9	43.0	48.2	50.6
Return on equity	6.3	7.7	9.1	10.5	12.4

*Data as of Sept. 30, 2018. ISK--Icelandic krona.

Capital and earnings: Capitalization will likely remain robust even as the capital base is optimized

Islandsbanki's level of capital remains a rating strength, despite the ongoing optimization between equity and hybrid capital instruments. We expect the RAC ratio to decline gradually toward 16% by 2020, from 19.4% as of June 2018 and 20.5% as of December 2017. The bank is in the process of recalibrating its capital levels in preparation of an eventual sale or IPO and paid a dividend of ISK13 billion in 2018, that is, 100% of net profits. We expect further extraordinary dividends in 2019 and 2020 in addition to the 40%-50% of net profits dividend policy included in our capital forecast.

Compared with its domestic peers, Islandsbanki's RAC benefits from the smaller equity positions on its balance sheet. As of December 2018, the Common Equity Tier 1 ratio was 20.3% and the total capital ratio 22.3%. We can compare this with the regulatory total capital requirement of 18.8% and the bank's target of an additional 50-200 basis point (bp) management buffer. Therefore, although we expect capital levels to decline within 12-24 months, we consider that the bank's overall capitalization will remain solid to meet the demanding requirements set by the Icelandic regulator.

Specifically, we expect Islandsbanki to issue capital instruments to offset a significant reduction in common equity and change the mix of its capital base. In August 2018, Islandsbanki issued its second Tier 2 debt instrument and we expect it to tap the market for an Additional Tier 1 as soon as the market allows.

We note that the bank's leverage ratio, measured as adjusted common equity as a share of adjusted assets, was 15% at end-December 2018, and is considerably higher than Nordic peers' and most global commercial banks'. We do not anticipate the leverage ratio to fall below 12% given the bank's capital targets.

Islandsbanki's profitability should stabilize over our two-year forecast horizon. Like that of its domestic peers, the bank's bottom-line has been supported by revaluations of legacy assets acquired at a 47% discount. In addition, sales and revaluations of legacy private equity and real estate assets acquired during the portfolio restructuring process have boosted earnings (as of December 2018, the bank reported a net positive impairment on financial assets of ISK1.6 billion). However, we expect a lower share of extraordinary revenues and impairments to normalize gradually as the economy continues to slow down. Revenue growth should be supported by low-single-digit loan expansion in the next two years and broadly stable margins, which should offset the softening fee and commission income. Although the cost efficiency ratio remains higher than peers', management initiatives on this front (for example, new IT systems and headquarters) should help improve the bank's cost efficiency. Islandsbanki (and peers) are still subject to the bank tax levy, which, with the contribution to the guarantee fund, represented about 16% of the total cost base as of December 2018.

We project Islandsbanki's earnings buffer, which measures the bank's ability to generate capital given normalized loss levels (136 bps as of June 2018), to be around 150 bps in 2019 and 2020. This is broadly in line with Nordic peers.

Table 3

Islandsbanki hf Capital And Earnings

		--Year-ended Dec. 31--			
(%)	**2018**	**2017**	**2016**	**2015**	**2014**
Tier 1 capital ratio	20.3	22.6	24.9	28.3	26.5
S&P RAC ratio before diversification	N/A	20.5	19.6	18.4	15.0
S&P RAC ratio after diversification	N/A	14.2	13.5	14.1	11.7
Adjusted common equity/total adjusted capital	100	100	100	100	100
Net interest income/operating revenues	73.5	67.9	68.9	62.7	63.5
Fee income/operating revenues	28.1	31.1	29.7	29.5	26.9

Table 3

Islandsbanki hf Capital And Earnings (cont.)

	--Year-ended Dec. 31--				
(%)	2018	2017	2016	2015	2014
Market-sensitive income/operating revenues	(2.3)	(1.7)	(0.4)	8.5	3.8
Noninterest expenses/operating revenues	66.3	62.5	61.1	55.6	55.8
Preprovision operating income/average assets	1.4	1.6	1.7	2.0	2.1
Core earnings/average managed assets	0.9	0.9	1.2	1.2	1.4

N/A--Not applicable. RAC--Risk-adjusted capital.

Table 4

Islandsbanki hf Risk-Adjusted Capital Framework Data

(ISK 000s)	Exposure*	Basel III RWA	Average Basel III RW (%)	S&P Global RWA	Average S&P Global RW (%)
Credit risk					
Government and central banks	180,008,103	2,724,531	2	1,546,612	1
Institutions and CCPs	64,135,719	12,244,045	19	16,496,551	26
Corporate	464,333,088	463,200,066	100	442,802,325	95
Retail	367,143,307	202,485,579	55	181,165,531	49
Of which mortgage	232,794,411	104,786,083	45	85,039,798	37
Securitization§	0	0	0	0	0
Other assets†	25,244,376	28,811,799	114	32,998,006	131
Total credit risk	1,100,864,593	709,466,020	64	675,009,025	61
Credit valuation adjustment					
Total credit valuation adjustment	--	1,785,949	--	0	--
Market risk					
Equity in the banking book	4,515,034	6,770,867	150	48,737,886	1,079
Trading book market risk	8,213,927	15,680,586	191	52,126,456	635
Total market risk	--	25,735,697	--	67,209,122	--
Operational risk					
Total operational risk	--	83,331,388	--	99,618,272	--
(ISK 000s)		**Basel III RWA**		**S&P Global RWA**	**% of S&P Global RWA**
Diversification adjustments					
RWA before diversification	--	820,319,053	--	841,836,419	100
Total Diversification/Concentration Adjustments	--	--	--	382,961,029	45
RWA after diversification	--	820,319,053	--	1,224,797,448	145
(ISK 000s)		**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		167,763,766	20.5	163,469,000	19.4
Capital ratio after adjustments‡		167,763,766	20.5	163,469,000	13.3

Table 4

Islandsbanki hf Risk-Adjusted Capital Framework Data (cont.)

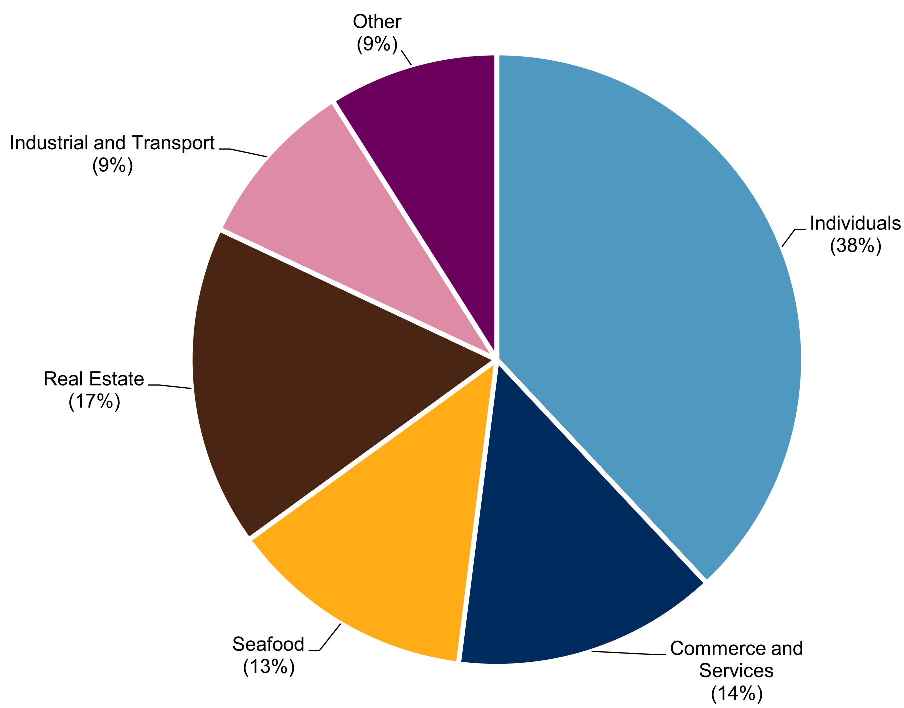
*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Other assets includes Deferred Tax Assets not deducted from adjusted common equity. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. ISK--Icelandic krona. Sources: Company data as of June 30, 2018, S&P Global Ratings.

Risk position: Highly correlated to systemic risks in Iceland

Our assessment of Islandsbanki's risk position reflects the bank's lack of geographic diversification and presence in a concentrated market. This is a weakness compared with peer banks of similar economic risk and anchor. In our view, Islandsbanki has broad exposure within Iceland to the retail and commercial banking market. Islandsbanki's loan book is primarily focused on retail loans (37% of total loans, of which 29% mortgages), real estate (17%), and fishing (13%).

Chart 2

Loan Breakdown By Sector: Some Concentration In Real Estate And Fishing

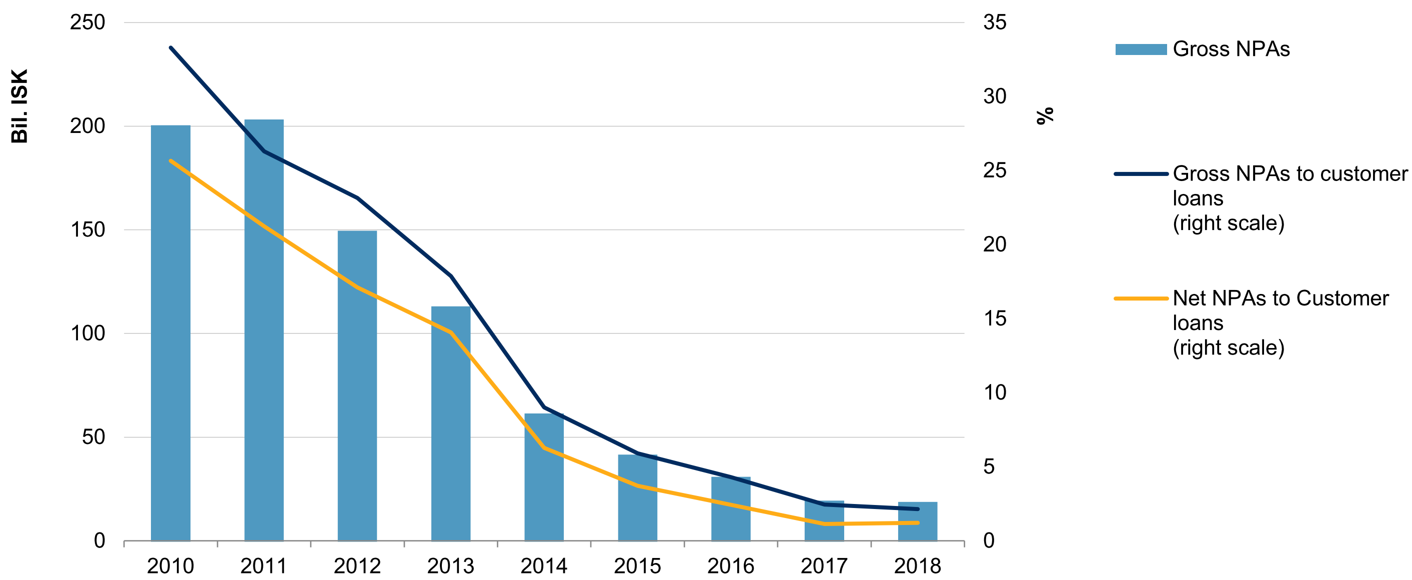


Source: Islandsbanki hf 2018 annual report.

Islandsbanki, along with the other major banks in the domestic market, has cleaned up its balance sheet materially since inception in 2008. By our measures, Islandsbanki's gross nonperforming assets had fallen to 2.1% as of Q4 2018 (from 23.2% at Q4 2012). We expect these to stabilize around this level in the next 18-24 months with coverage of 44%, which is broadly in line with domestic peers. However, we also note though that Stage 2 loans (that is, those loans that experience an increased credit risk but not impaired) represent an additional 3.4% (on total loans). Although loan loss provisions to customer loans have been volatile and underestimated due to positive recovery of legacy assets, we project levels to normalize and reach about 50 bps in the coming 24 months.

Chart 3

Nonperforming Assets Have Stabilized At A Low Level



ISK--Icelandic krona. NPAs--Nonperforming assets. Source: Company data, S&P Global Ratings.

Islandsbanki's exposure to the tourism segment has stabilized at around 13% of total loans. This sector is prone to volatility and is slowing down after years of material growth.

Foreign currency lending represents 17% of the total loan book. However, the bank mitigates this risk by granting credit to customers with income in (or correlated to) foreign currency, which includes mainly the fishing and transportation industry and modest exposure to Norwegian offshore companies.

Like other domestic peers, a substantial part (about 35%) of Islandsbanki's loan book is inflation-linked (CPI). This might add pressure on credit quality in a period of high inflation, although tools are in place to mitigate risks in the short term.

Table 5

Islandsbanki hf Risk Position					
	--Year-ended Dec. 31--				
(%)	**2018**	**2017**	**2016**	**2015**	**2014**
Growth in customer loans	11.6	9.2	2.9	4.1	12.3
Total diversification adjustment / S&P RWA before diversification	N/A	43.9	44.8	30.7	27.9
Total managed assets/adjusted common equity (x)	6.8	6.3	6.3	5.5	5.2
New loan loss provisions/average customer loans	(0.2)	0.4	0.1	0.5	0.3

Table 5

Islandsbanki hf Risk Position (cont.)					
	--Year-ended Dec. 31--				
(%)	**2018**	**2017**	**2016**	**2015**	**2014**
Net charge-offs/average customer loans	0.6	0.7	0.5	0.9	1.4
Gross nonperforming assets/customer loans + other real estate owned	2.1	2.5	4.3	5.9	9.0
Loan loss reserves/gross nonperforming assets	43.9	54.9	44.4	38.6	32.4

N/A--Not applicable.

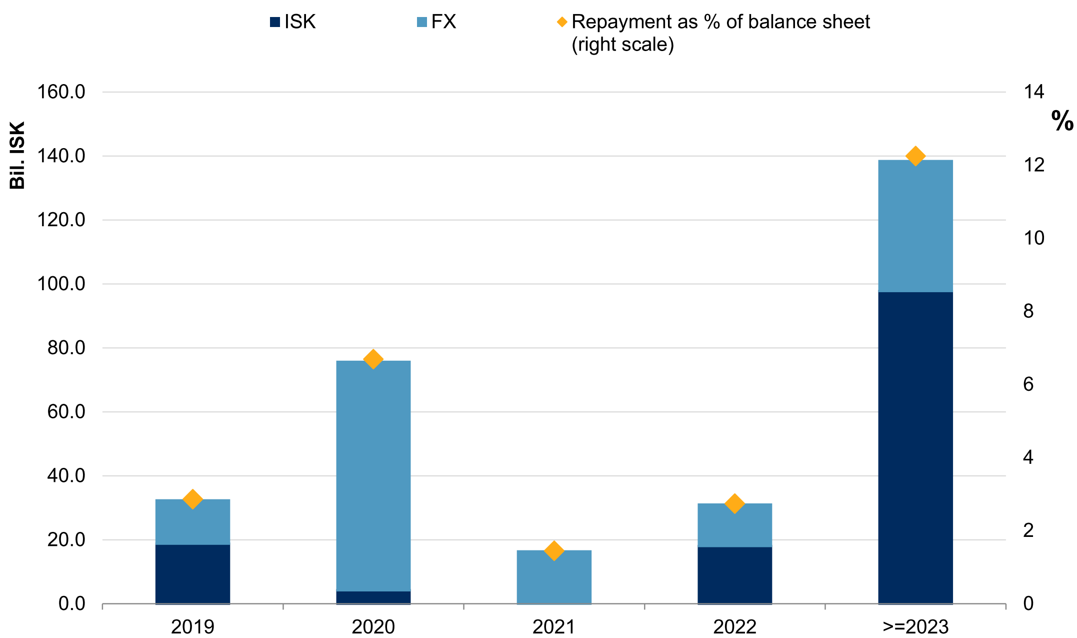
Funding and liquidity: Increasing wholesale financing reliance and normalizing liquidity position

Customer deposits still form the majority of total funding, at 65% of the funding base in December 2018, of which about a third is CPI-linked and in foreign currency. The granularity of Islandsbanki's deposit base has also reduced (the 10 largest depositors made up 16% of total deposits in 2018 compared with 24% in 2015). The remaining part of the funding consists primarily of senior unsecured bonds in foreign currencies (about 50% of total wholesale sources) and covered bonds in the domestic market (approximately 40%). We expect Islandsbanki to gradual increase the reliance on wholesale financing, while our stable funding ratio (114% at December 2018) should decrease only marginally in the next 24 months.

We anticipate that the liquidity ratios will reduce as the bank's debt profile normalizes, and could see further pressure if liquidity is reduced as part of extraordinary dividend activity. The ratio of broad liquid assets to short-term wholesale funding was 3.9x in December 2018, down from 4.5x at year-end 2017. This is slightly above international peers', but we expect the ratio to decline gradually.

Chart 4

Islandsbanki hf Maturity Profile Of Long-Term Debt



ISK--Icelandic krona. FX--Foreign currency. Source: Islandsbanki as of Dec. 31, 2018.

Table 6

Islandsbanki hf Funding And Liquidity

	--Year-ended Dec. 31--				
(%)	**2018**	**2017**	**2016**	**2015**	**2014**
Core deposits/funding base	63.5	70.4	73.2	74.8	78.5
Customer loans (net)/customer deposits	146.2	133.2	115.8	112.2	119.9
Long term funding ratio	94.6	94.7	96.2	93.2	94.1
Stable funding ratio	113.8	116.1	130.1	128.5	116.7
Short-term wholesale funding/funding base	6.5	6.4	4.7	8.5	7.5
Broad liquid assets/short-term wholesale funding (x)	3.9	4.5	8.4	4.8	4.4
Net broad liquid assets/short-term customer deposits	31.4	34.4	50.0	49.6	34.5
Short-term wholesale funding/total wholesale funding	17.7	21.7	17.5	33.9	34.9
Narrow liquid assets/3-month wholesale funding (x)	7.0	15.5	27.5	9.4	7.3

External support: Government support for Icelandic banks is uncertain

We do not consider Islandsbanki to be a strategic government-related entity for Iceland and see the government's ownership as temporary. Nevertheless, we view Islandsbanki as having high systemic importance in Iceland. We do not apply any notches of uplift to the stand-alone credit profile (SACP) to arrive at the issuer credit rating, as we view future extraordinary government support as uncertain. This reflects our view of the Icelandic government's track record of not supporting senior creditors and its still-limited--but improved--capacity to support the country's new, smaller banking system in the event of severe financial stress.

At present, we do not regard the bank resolution framework as effective. As such, we do no incorporate additional loss-absorbing capacity in our ratings on Icelandic banks. We regard the current framework as open-ended but, in our view, the authorities' method of dealing with failing banks so far indicates a tendency to safeguard depositors rather than senior unsecured creditors. In June 2018, the Icelandic parliament passed a bill that incorporates into the local legislation part of the EU's Banking Recovery And Resolution Directive (BRRD) provisions, including recovery plans, early interventions, and intra-group support. Over the next 12 months, we expect Iceland to finalize the BRRD implementation and, with it, bail-in powers that could lead us to change our view.

Hybrid ratings

We rate Islandsbanki's subordinated debt at 'BBB-', two notches below the bank's 'bbb+' SACP. We deduct one notch due to the instruments' subordination to senior creditors' claims, and another notch because the instruments are available to absorb losses at the point of non-viability of the bank via statutory loss absorption. Given the lack of going-concern loss absorption, we are not including the instruments in our calculation of the total adjusted capital.

Related Criteria

- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Iceland 'A/A-1' Ratings Affirmed; Outlook Stable, Dec. 7, 2018
- Nordic Banks' Strong Capital Isn't Likely To Soften, Oct. 17, 2018
- Four Icelandic Banks Affirmed On Supportive Economic Growth, But Weakening Operating Landscape; Outlooks Stable, July 17, 2018

Anchor Matrix

Industry Risk	Economic Risk 1	2	3	4	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	**bbb**	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of February 25, 2019)

Islandsbanki hf	
Issuer Credit Rating	BBB+/Stable/A-2
Senior Unsecured	BBB+
Short-Term Debt	A-2
Subordinated	BBB-
Issuer Credit Ratings History	
25-Oct-2017	BBB+/Stable/A-2
25-Oct-2016	BBB/Positive/A-2
19-Jan-2016	BBB-/Positive/A-3
21-Jul-2015	BBB-/Stable/A-3
14-Oct-2014	BB+/Positive/B
30-Apr-2014	BB+/Stable/B
Sovereign Rating	
Iceland	A/Stable/A-1

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.