Moody's

Rating Action: **Moody's assigns first time long-term deposit ratings of A2 and issuer rating of A3 to Islandsbanki; outlook stable**

30 Aug 2023

London, August 30, 2023 -- Moody's Investors Service ("Moody's") has assigned first time A2 long-term and Prime-1 short-term foreign and local currency bank deposit ratings and A3 long-term foreign and local currency issuer ratings t Iceland's Islandsbanki (ISB). The assigned long-term deposit and issuer ratings carry a stable outlook.

Moody's also assigned a Baseline Credit Assessment (BCA) and Adjusted BCA of baa2, an A2(cr) long-term and P-1(cr) short-term Counterparty Risk (CR) Assessment, and A2 long-term and P-1 short-term foreign and local currency Counterparty Risk Ratings (CRRs). In addition, the agency assigned a foreign and local currency senior unsecured medium-term note (MTN) program rating of (P)A3, a foreign and local currency junior senior unsecured MTN program rating of (P)Baa2 and a foreign and local currency subordinate MTN program rating of (P)Baa3.

RATINGS RATIONALE

ISB's A2 long-term deposit and A3 long-term issuer ratings result from (1) the bank's baa2 BCA and Adjusted BCA, (2) the application of Moody's Advanced Loss Failure (LGF) analysis, resulting in a three-notch uplift for deposit and two-notch uplift for issuer ratings and (3) a low probability of government support, resulting in no further uplift.

ISB's baa2 BCA reflects the bank's strong capitalization coupled with good recurring profitability, a low and falling level of problem loans and adequate liquidity balanced against elevated single name and geographical concentrations and a reliance on market funding. The BCA also reflects the limited direct impact on the bank's financial profile of the recent regulatory penalty levied on the bank and the subsequent management and board changes.

In-line with the rest of the Icelandic banking system, ISB displays strong capital ratios reflective of high capital requirements and strong internal capital generation. ISB reported a Common Equity Tier 1 (CET1) ratio of 20% against a requirement of 15.2% at end June 2023 and a strong leverage ratio of 12.8%, which is significantly better than the European average of 6%. Going forward Moody's expects capitalization to remain strong, albeit at lower levels as the bank optimizes further its capital structure.

The bank's core profitability is good and stable. Net interest income is the main driver for the bank's profitability, accounting for 75% of its operating income, while fees account for the remaining 25% reflective of the bank's strong position in the asset management segment. The bank's profitability has benefited greatly from the increasing interest rates environment and strong credit growth in the past 2 years, while the bank's limited investment banking operations have resulted in better earnings stability compared to peers. We expect the bank's profitability to moderate slightly due to increased funding costs and normalization of cost of risk but to remain strong overall.

ISB's asset quality has improved over the years reflective of Iceland's supportive economic environment, with a reported non-performing loans ratio of 1.7% at end June 2023, down from its peak of 3% in 2019. Nevertheless, the bank's Icelandic focus results in elevated sector and geographical concentrations, and ISB continues to exhibit higher single name exposures compared to peers, although its market risk and investment banking operations are more limited. Moody's expects the bank's NPL ratio asset quality to remain broadly unchanged, as a mild asset quality deterioration in the small and medium-sized enterprise (SME) will be offset by recoveries in the tourism industry relate exposures and legacy loans.

ISB also benefits from strong liquidity buffers. Liquid banking assets accounted for 19.3% of tangible banking assets at end June 2023 and the bank had a liquidity coverage ratio (LCR) ratio of 259%. ISB's liquidity pool constitutes mostly of cash and deposits with central banks and short dated government bonds. The bank also benefits from a stock of good quality stable deposits, with limited price competition from challengers, although the level of insured deposits is quite low at 45%.

The BCA also incorporates the agency's expectation that, while the bank's reliance on market funding will remain broadly unchanged going forward, it remains exposed to changes in investor sentiment as evident by its higher cost of funding in international markets, than similarly rated peers.

ISB's long-term ratings are underpinned by the bank's Adjusted BCA of baa2 and Moody's Advanced LGF analysis which takes into account the severity of loss faced by the different liability classes in the event of a failure. The LGF analysis for ISB indicates an extremely low loss-given-failure for depositors and a very low loss-given-failure for senior debt holders, leading to three notches and two notches of rating uplift from the bank's baa2 adjusted BCA respectively to A2 for the long-term deposit ratings and A3 for the long-term issuer ratings.

Despite ISB's government ownership of 42.5%, its significant deposit market share of 30% and its systemically important status, we assume a low probability of government support for its long-term 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.

The assigned ratings also incorporate ISB's environmental, social and governance (ESG) considerations, as per Moody's Investors Service's General Principles for Assessing Environmental, Social and Governance Risks Methodology. Moody's assessment of ISB's exposure to governance risks is moderate, reflected in a Governance Issuer Profile Score (IPS) of G-3. This assessment considers that, while the bank's risk management is in line with industry 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 changes in senior management. Nevertheless, the agency recognizes that the bank has taken necessary actions to address the identified weaknesses and continues to improve its compliance framework and expects management credibility to be restored in due course. ISB's Credit Impact Score (CIS) of 3 reflects the bank's moderate governance risks, as well as the limited credit impact of environmental and social factors on the rating to date

STABLE OUTLOOK

The stable outlook on ISB's long-term deposit and issuer ratings reflects the agency's expectation that the bank will continue its strong performance in the next 12-18 months, following the recent management and board related changes as it takes appropriate steps to strengthen its policies and procedures and its overall compliance framework.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

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.

For the issuer and program ratings, upward rating pressure could also develop because of a larger cushion of loss absorbing obligations protecting creditors and depositors in case of failure.

Downward pressure could emerge if ISB's (1) asset quality and risk profile was to deteriorate, for example as a result of increased concentration risk emanating from its exposures to more volatile sectors and/or increased single name concentrations within Iceland's small and interlinked operating environment; (2) risk profile increases more than the agency anticipates, driven by non-credit related risks such as market risk and foreign exchange risk (3) profitability was to deteriorate due to increased asset risk; (4) financing conditions were to become more difficult; or (5) the macroeconomic environment deteriorates significantly leading to a lower Macro Profile.

Furthermore, a reduction in the rating uplift triggered by structural funding changes to the bank's balance sheet could lead to downward rating pressure.

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Banks Methodology published in July 2021 and available at https://ratings.moodys.com/rmc-documents/71997. Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions.

For ratings issued on a program, series, category/class of debt or security this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series, category/class of debt, security or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the credit rating action on the support provider and in relation to each particular credit rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the issuer/deal page for the respective issuer on https://ratings.moodys.com.

For any affected securities or rated entities receiving direct credit support from the primary entity(ies) of this credit rating action, and whose ratings may change as a result of this credit rating action, the associated regulatory disclosures will be those of the guarantor entity. Exceptions to this approach exist for the following disclosures, if applicable to jurisdiction: Ancillary Services, Disclosure to rated entity, Disclosure from rated entity.

The ratings have been disclosed to the rated entity or its designated agent(s) and issued with no amendment resulting from that disclosure.

These ratings are solicited. Please refer to Moody's Policy for Designating and Assigning Unsolicited Credit Ratings available on its website https://ratings.moodys.com.

Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://ratings.moodys.com/documents/PBC_1288235.

At least one ESG consideration was material to the credit rating action(s) announced and described above.

The Global Scale Credit Rating on this Credit Rating Announcement was issued by one of Moody's affiliates outside the EU and is endorsed by Moody's Deutschland GmbH, An der Welle 5, Frankfurt am Main 60322, Germany, in accordance with Art.4 paragraph 3 of the Regulation (EC) No 1060/2009 on Credit Rating Agencies. Further information on the EU endorsement status and on the Moody's office that issued the credit rating is available on https://ratings.moodys.com.

Please see https://ratings.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

Please see the issuer/deal page on https://ratings.moodys.com for additional regulatory disclosures for each credit rating.

Effie Tsotsani
Vice President - Senior Analyst
Financial Institutions Group
Moody's Investors Service Ltd.
One Canada Square
Canary Wharf
London, E14 5FA
United Kingdom
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

Simon Ainsworth
Associate Managing Director
Financial Institutions Group
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

Releasing Office:
Moody's Investors Service Ltd.
One Canada Square
Canary Wharf
London, E14 5FA
United Kingdom
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454
