

Icelandic Bank Ratings Unaffected By Sufficiently Effective Resolution Regime; 'BBB+' RCRs Assigned; Outlooks Stable

May 17, 2022

- We now assess the Icelandic resolution framework as sufficiently effective.
- While the banks have until January 2024 to meet regulatory loss-absorbing capacity requirements, their existing capital and liability stacks meet those requirements today. We do not expect the banks to build additional loss-absorbing capacity buffers sufficient to meaningfully lower default risk on senior preferred debt, at least in the near term.
- Consequently, our long-term issuer credit ratings on the Icelandic banks are unchanged at 'BBB', and the outlooks remain stable.
- We are assigning our 'BBB+/A-2' resolution counterparty ratings to the three rated Icelandic banks classified as domestic systemically important institutions.

LONDON (S&P Global Ratings) May 17, 2022--S&P Global Ratings said today that it assigned its 'BBB+/A-2' long- and short-term resolution counterparty ratings (RCRs) to Arion Bank, Islandsbanki hf, and Landsbankinn hf.

Resolution Regime Sufficiently Effective

The rating action follows our assessment of the Icelandic resolution regime as sufficiently effective after the country's progress in adopting legislation and developing its policy framework.

As a member of the European Economic Area, Iceland is implementing EU resolution laws and enacted the first Banking Recovery and Resolution Directive (BRRD1) in September 2020. We understand BRRD2 will follow later this year or in early 2023. The resolution authority recently released its policy on the minimum requirement for own funds and eligible liabilities (MREL) and set institution-specific MREL requirements, binding from January 2024, on three domestic systemically important banks (D-SIBs): Arion Bank (BBB/Stable/A-2), Islandsbanki (BBB/Stable/A-2), and Landsbankinn (BBB/Stable/A-2). In addition, in November 2021, the financial stability committee of the Central Bank of Iceland announced that it considers the three D-SIBs to be resolvable. Taken together, these support our view of the regime's effectiveness.

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Bank Ratings Unaffected, For Now

Our revised view of Iceland's resolution regime means that the three D-SIBs are now eligible for rating uplift in respect of their additional loss-absorbing capacity (ALAC) buffers. However, the ratings on the banks are unaffected because they each currently hold insufficient buffers of ALAC-eligible, gone-concern, loss-absorbing instruments to meaningfully reduce default risk for senior preferred debt holders, and we expect this will remain the case for at least the coming two years.

Under our published methodology, instruments are ALAC-eligible if they are both junior to senior preferred instruments and not included in our measure of core capitalization, the latter incorporating common equity and additional Tier 1 hybrid instruments. Consequently, in practice, Tier 2 capital securities and potential senior non-preferred debt issues are ALAC-eligible instruments for the Icelandic banks.

The three Icelandic D-SIBs have not yet issued senior non-preferred debt and have a relatively small amount of Tier 2 instruments in their capital stacks, close to 2% of S&P Global Ratings' risk-weighted assets (S&P RWAs), on average. Between the banks, there is little variation around this 2%. This is below our typical 3% threshold for one notch of ALAC rating uplift. That said, consistent with our methodology, we are likely to adjust the standard 3% threshold by up to 100 basis points to reflect factors such as maturity concentrations. This is one typical adjustment we make and can reflect concentration risk facing banks with relatively few ALAC-eligible debt issues or weak weighted-average maturities.

Iceland's banks each have few ALAC-eligible instruments outstanding, all with effective (first-call date) residual maturities that fall within five years of Dec. 31, 2021. Consequently, each of the banks has a weighted maturity of close to two years, which we view as a short horizon. This would be consistent with our treatment of other European banks exhibiting at least one concentrated feature in their ALAC instrument profiles. Combined, these factors support our stance that we are likely to apply an adjustment.

In Iceland's statutory creditor hierarchy, senior preferred debt ranks below all deposits. This is similar to EU countries such as Greece, Italy, and Portugal. As a result, the resolution authority could use senior preferred debt to recapitalize a resolved bank, without affecting confidence-sensitive and systemically important liabilities like any deposit classes. Accordingly, the resolution authority has stated that senior preferred debt qualifies as MREL until at least 2024, and most likely beyond that date, in our view.

Since banks already have sufficient regulatory capital and senior preferred debt to meet their MREL requirements, we see little need for the banks to significantly raise their ALAC buffers. The BRRD2 subordination requirement may see some banks issue senior non-preferred debt, but we expect this to be small. Consequently, we expect the banks' ALAC buffers to remain close to 2% of S&P RWAs over our two-year rating outlook horizon. That said, and while outside our base case in the immediate term, the banks may choose to issue ALAC-eligible instruments independent of their need to meet MREL requirements. We will monitor the banks' issuance plans and take a forward-looking approach in our assessment of ALAC buffers alongside the likelihood of a bail-in resolution without a default on senior preferred debt.

Resolution Counterparty Ratings Assigned

We have assigned our 'BBB+/A-2' long- and short-term RCRs to Arion, Islandsbanki, and Landsbankinn. The long-term RCRs are one notch above our issuer credit ratings on the banks because we consider that Iceland's resolution regime establishes a subset of liabilities that are protected from default in an effective resolution process through their statutory exclusion from bail-in.

These include guaranteed deposits and collateralized liabilities, including covered bonds (for more details and a list of the liabilities excluded from bail-in, see "Resolution Counterparty Ratings Jurisdiction Assessment For Iceland Completed," published on May 17, 2022). We expect these liabilities would be more likely to continue performing on a complete and timely basis in a resolution scenario relative to other senior liabilities, whose default risk is addressed by the issuer credit rating.

Related Criteria

- Criteria | Financial Institutions | General: Financial Institutions Rating Methodology, Dec. 9, 2021
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019
- 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
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Resolution Counterparty Ratings Jurisdiction Assessment For Iceland Completed, May 17, 2022
- Banking Industry Country Risk Assessment: Iceland, Feb. 21, 2022
- Ratings On Icelandic D-SIBs Affirmed As Pandemic Recovery Risk Lingers; Outlooks Remain Stable, Jan. 25, 2022
- Icelandic Bank Resolution Act Completes The European Map, But Implementation And Effectiveness Remain Unclear, Sept. 1, 2020

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceld/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating

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