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Research Update:

Iceland-Based Islandsbanki Assigned 'BB+/B' Ratings; Outlook Stable

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Overview

- Icelandic bank, Islandsbanki hf is well positioned among the three largest commercial banks in Iceland.
- In our view, the bank is showing continued improvement in its already strong capital buffers and recovering loan book.
- We are assigning our 'BB+/B' ratings to Islandsbanki.
- The stable outlook reflects our expectation that Islandsbanki will maintain its strong capital position as Iceland's economy continues to recover.

Rating Action

On April 30, 2014, Standard & Poor's Ratings Services assigned its 'BB+' long-term and 'B' short-term counterparty credit ratings to Iceland-based bank Islandsbanki hf. The outlook is stable.

Rationale

The ratings reflect our 'bb' anchor for banks operating in Iceland and our view of Islandsbanki's "adequate" business position, "strong" capital and earnings, "adequate" risk position, "average" funding, and "strong" liquidity, as our criteria define these terms. The stand-alone credit profile (SACP) is at 'bb+'.

Islandsbanki was created in October 2008 when it acquired more than Icelandic krona (ISK) 900 billion (about €5.8 billion) in loans--originally valued at a 47% discount--from the estate of Glitnir Bank. Despite being the smallest of its domestic peers, with total assets of ISK866 billion in December 2013, Islandsbanki maintains a comparable market position. It has a strong domestic market share (30%-40%) in most business lines, due in part to two key acquisitions: that of Byr, previously the fourth largest bank, in 2011 and of a private pension portfolio in 2012. We believe these strategic acquisitions have improved the bank and support our view of the bank's management and strategy. Like its two main domestic peers, Arion Bank and Landsbankinn, Islandsbanki has seen a rise in retail mortgage lending, which has historically been dominated by state-owned Housing Financing Fund (Ibudalanasjodur).

Islandsbanki earns two-thirds of its revenues as net interest income and has diverse revenues from retail banking, including asset financing (via the ERGO brand) and credit cards; large corporate, wealth management, trading activities; and corporate finance. However, the small domestic economy limits diversification prospects, in our view.

We assess capital and earnings as "strong." Our projected risk-adjusted capital (RAC) ratio for Islandsbanki at year-end 2015 is higher than 15%, after 14.1% at year-end 2013. However, we understand the bank intends to maintain regulatory capital ratios above 18%, which aligns with a RAC ratio of 11%-12%, hence our assessment of capital and earnings as "strong." At present, the core Tier 1 capital ratio is 25.1% and we believe that the bank has a long-term objective of returning some of its excess capital to its owners. We note that the bank's leverage ratio of 19.3% (adjusted common equity to adjusted assets) is exceptional in a global comparison.

We expect Islandsbanki's profits to decrease slightly over our two-year forecast horizon. The loans it acquired when it was created in 2008 were at a 47% discount, which, together with increases in the net asset valuation, have resulted in strong earnings for the bank.

In our view, Islandsbanki's "adequate" risk position reflects its important role in Iceland's retail and commercial banking market and its high share of real estate and fishing-vessel quota collateral. We expect the bank's risk position to remain highly correlated to the economic risk we assess for the country. The bank continues to reduce its nonperforming loans (NPLs) and maintains an ambitious goal of reducing its Icelandic loan portfolio analysis ratio to 5.5% by year-end 2014 from 8.3% at year-end 2013 (versus an average of 12.5% for Iceland's top three banks at year-end 2013). Recent improvements are also reflected in the reduction of loans 90 days past due to 3.5% of loans at year-end 2013 from 12.9% at year-end 2011.

We expect that Islandsbanki's asset quality will improve because of the government's debt relief program, launched in November 2013. About one-third of the bank's loan book represents residential mortgages and the program should reduce the portfolio's overall loan-to-value by improving the equity of at-risk borrowers. We expect that the additional debt relief will improve households' finances and stimulate consumer spending, supporting further improvement of overall asset quality.

In our view, Islandsbanki is diligently preparing its balance sheet for the eventual relaxation of capital controls by building an exceptional funding and liquidity buffer. We consider Islandsbanki's funding to be "average," given its relatively strong funding metrics and lower loan-to-deposit ratio than domestic peers'. The bank's illiquid assets are more than covered by deposits, equity, and long-term debt, as shown by a stable funding ratio of 115% as of Dec. 31, 2013, up from 93% in 2010. We expect this relative strength to continue, given the small amount of debt maturing in each of the next few years, although we anticipate an increased used of long-term market funding to support lending growth over the rating horizon.

We assess the bank's liquidity as "strong," noting its considerable coverage of short-term liabilities. In December 2013, Islandsbanki's ratio of broad liquid assets to short-term wholesale funding was 3.5x. We note that the bank maintains a portion of the liquid assets to offset a potential reduction in foreign exchange deposits if the Icelandic government removes capital controls. At year-end 2013, the bank had liquid foreign exchange assets of ISK77 billion for this purpose.

We consider Islandsbanki to have "high" systemic importance in Iceland; however, we do not add any notches of uplift to the SACP because future extraordinary government support is uncertain. This reflects our view of the Icelandic government's track record of not supporting senior creditors and still limited but improved capacity to support the new smaller banking system in a severe stress scenario.

Outlook

The stable outlook reflects our view that Islandsbanki will maintain "strong" capital over the next two years, in line with its core Tier 1 targets and our forecast of capital strengthening in the near term. We also expect that the bank's asset quality metrics will continue to improve, reducing some of the equity and legacy real estate risks on its balance sheet.

We could take a positive rating action if the bank made a strategic decision to maintain capital commensurate with a RAC ratio securely above 15%, or if economic improvements in Iceland led us to reduce our risk weights for Icelandic exposures. The latter would better align the bank's internal capital targets with a higher assessment of capital and earnings. If we saw that risks for Iceland's economy and banking sector were receding, this could affect the anchor we use to rate Icelandic banks.

We could take a negative rating action if the asset quality of the bank's loan portfolio required significant additional provisioning or if unexpected valuation risks in the legacy loan book and securities portfolio arose. However, due to improvements in Iceland and conservative assumptions in our capital and earnings forecast, we view a downgrade as unlikely in the near term.

Ratings Score Snapshot

Issuer Credit Rating	BB+/Stable/B
SACP	bb+
Anchor	bb
Business Position	Adequate (0)
Capital and Earnings	Strong (+1)
Risk Position	Adequate (0)

Funding and Liquidity	Average and Strong (0)
Support	0
GRE Support	0
Group Support	0
Sovereign Support	0
Additional Factors	0

Related Criteria And Research

Related Criteria

- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

Related Research

- Banking Industry Country Risk Assessment: Iceland, Aug. 19, 2013

Ratings List

New Rating

Islandsbanki hf	
Counterparty Credit Rating	BB+/Stable/B

Additional Contact:
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Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.