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## Outlooks For Iceland's Top 3 Banks Revised To Positive On Our More Favorable View Of The Economy

**Primary Credit Analyst:**

Alexander Ekbohm, Stockholm (46) 8-440-5911; alexander.ekbohm@standardandpoors.com

**Secondary Contacts:**

Sean Cotten, Stockholm (46) 8-440-5928; sean.cotten@standardandpoors.com

Maxim Rybnikov, London (+44) 207 176 7125; maxim.rybnikov@standardandpoors.com

- We foresee solid GDP growth for Iceland for the next two years and expect economic imbalances to decline further.
- We have revised our economic risk trend for Iceland to positive from stable, and expect a continued improvement in the banking system's asset quality.
- We have therefore revised the outlooks for Arion Bank, Islandsbanki, and Landsbankinn to positive from stable, and affirmed the 'BB+/B' long- and short-term ratings.
- We have also affirmed our 'BB-/B' ratings on Housing Financing Fund; the outlook remains stable.

STOCKHOLM (Standard & Poor's) Oct. 14, 2014--Standard & Poor's Ratings Services said today it revised its outlooks on three commercial banks in Iceland--Arion Bank, Islandsbanki hf, and Landsbankinn hf.--to positive from stable. We affirmed our 'BB+/B' long- and short-term counterparty credit ratings on these banks. In addition, we affirmed the 'BB-/B' ratings on Housing Financing Fund Ibudalanasjodur (HFF); the outlook remains stable.

The outlook revisions for Iceland's three dominant commercial banks reflect our view of improving economic conditions in the country. Standard & Poor's forecasts annual real GDP growth of about 3% for the next two years. We expect imbalances to decline further over the next year as the banking system finishes restructuring its debt and as leverage in the economy continues to decline. We believe that loan losses as share of loans should decline toward

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50 basis points in 2015 (even though first-half 2014 numbers indicate a quicker drop), and that the three banks' other asset quality metrics will continue to improve. As a result, we believe that Iceland's banking system, in the near term, will have built up enough capacity to limit the impact from any residual risks from the financial crisis that broke out in 2008. For these reasons, we have revised our view of the economic risk trend in the Icelandic banking sector to positive from stable.

Our positive outlooks on the three banks largely reflect our view that the banking sector is improving and our positive outlook on Iceland. On July 18, 2014, we revised the outlook on the sovereign to positive due to strong growth and declining government debt (see "Iceland Outlook Revised To Positive On Strong Growth And Improving Public Finances; 'BBB-/A-3' Ratings Affirmed," published July 18, 2014, on RatingsDirect). The long-term rating of 'BBB-' is one notch higher than our ratings on the banks. The ratings on the sovereign, and as well our view of the banking sector, continue to be constrained by the risks associated with the government's eventual removal of capital controls. However, in our base-case scenario, we assume that the authorities would approach the removal prudently to minimize the impact on the economy and exchange rate.

The positive outlooks on the three commercial banks share a similar rationale. However, we believe that Landsbankinn and Islandsbanki, due to their larger capital bases, could benefit from greater ratings uplift if we would upgrade the sovereign and revise our assessment of risks related to economic imbalances in the banking sector to intermediate from high.

The three dominant banks are approaching the end of a long period of restructuring since their creation in 2008. The revaluations of their loan books are now largely complete, as are the large-scale write-downs and clean-up of much of their portfolios. We expect the banks to continue to maintain strong balance sheets, with very high leverage ratios and strong to very strong risk-adjusted capital (RAC) ratios, by Standard & Poor's measure, underpinned by high regulatory requirements. In addition, we do not expect a further adjustment to the structure of the domestic banking market, which is more or less divided equally among the three domestic banks, with each having a relatively similar share of the major business lines.

For HFF, we affirmed the ratings and kept the outlook at stable because we do not believe that the improvements in the domestic economy will raise its credit quality.

We see a diminished public-policy role for HFF following the recommendations of the project committee on the organization of Iceland's housing system. We assess HFF's role for the government as important and the link with the government as integral, under our criteria for rating government-related entities (GREs). Therefore, we believe there is a high likelihood that the government of Iceland would provide timely and sufficient extraordinary support to HFF in the event of financial distress (see "Long-Term Ratings On Iceland's Housing Financing Fund (HFF) Lowered To 'BB-' On Housing System

Proposals; Outlook Stable," July 22, 2014).

We currently expect HFF's operations to gradually wind down, as called for by the housing policy proposals put forward by the project committee appointed by Iceland's Minister of Social Affairs and Housing. We understand that these proposals are to address limiting losses at HFF and promoting the development of an active rental market.

#### OUTLOOK

##### Commercial banks

The positive outlooks on Arion Bank, Islandsbanki, and Landsbankinn reflect our view that their stand-alone credit profiles (SACP) will likely improve alongside improvements in the Icelandic economy. As we see a positive trend for economic risk in the Icelandic banking sector, we would expect to upgrade the banks, each with nearly one-third of the domestic market for residential and commercial lending, if our view of the sector continued to improve.

##### Arion Bank

We anticipate that Arion Bank's RAC ratio will increase toward 11%-12% as it reduces risk-weighted assets and as earnings generation remains sound. We expect the restructuring of the loan portfolio to be close to an end and further impairments to be limited. In addition, we expect the funding and liquidity profile to remain broadly in place, with the bank gradually increasing its wholesale issuance, mainly through a mix of senior unsecured and long-term covered bonds.

We could upgrade the bank if our assessment of risks for the Icelandic sovereign and the Icelandic banking sector continue to improve. We could consider revising upward our assessment of funding and liquidity if risks associated with nonresident deposits were to be resolved. This would improve the bank's financial flexibility and keep its funding metrics and ample liquidity strong.

We could revise the outlook to stable if the bank doesn't execute its plan to dispose of legacy assets as we expect, lowering our expectations for the RAC ratio. Although unlikely, an unexpected substantial increase in provisioning in the legacy loan book and securities portfolio could also lead to such a revision. A situation where the sector does not continue to improve or slides into a reversal could also lead to an outlook revision to stable.

##### Islandsbanki

We anticipate that Islandsbanki will improve its capital ratios and asset quality metrics over the next two years, and make further progress in reducing the legacy equity and 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.

We could revise the outlook to stable if the asset quality of the bank's loan portfolio required significant additional provisioning or if valuation risks unexpectedly arose in the legacy loan book and securities portfolio. 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. A situation where the sector does not continue to improve or slides into a reversal could also lead to an outlook revision to stable.

#### Landsbankinn

We anticipate that Landsbankinn will improve its capital ratios and narrow the gap with peers regarding asset quality metrics over the next two years. We also anticipate that the preliminary agreement will extend the repayment profile of legacy bonds of the defunct Landsbanki Islands hf.

We could take a positive rating action if the bank's capital improved beyond our present forecast and it reported sustainably stronger revenues or lower credit losses than we expect. We note that Landsbankinn's capital would improve significantly above our 15% threshold for very strong capital if we revised upward our economic risk assessment for Iceland.

We could revise the outlook to stable if the asset quality of the bank's loan portfolio required significant additional provisioning or if valuation risks unexpectedly arose in the legacy loan book and securities portfolio. However, we have used conservative loss assumptions in our capital and earnings forecast, so we view a downgrade as unlikely at present. A situation where the sector does not continue to improve or slides into a reversal could also lead to an outlook revision to stable.

#### Housing Financing Fund (HFF)

The stable outlook reflects our expectation that HFF's SACP remains unchanged, and that the likelihood of the government of Iceland providing timely and sufficient extraordinary support to HFF in the event of financial distress remains high (though revised downward from extremely high in July 2014; see "Long-Term Ratings On Iceland's Housing Financing Fund (HFF) Lowered To 'BB-' On Housing System Proposals; Outlook Stable," published on July 22, 2014.)

We could lower the ratings if we revised the SACP downward, for example as a result of further significant loan losses or policy-induced write-downs without timely compensation from the state.

We could raise the ratings if HFF was to significantly reinforce its currently very weak capital adequacy, for example through a capital increase.

On July 18, 2014, we revised the outlook on the long-term sovereign ratings of Iceland to positive. However, under our criteria for rating government-related entities, the ratings on HFF do not change if we raise the long-term local currency sovereign credit rating on Iceland by one or more notches, all else being equal.

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### BICRA SCORE SNAPSHOT\*

Iceland	To	From
BICRA Group	7	7
Economic risk	7	7
Economic resilience	High risk	High risk
Economic imbalances	High risk	High risk
Credit risk in the economy	High risk	High risk
Trend	Positive	Stable
Industry risk	6	6
Institutional framework	High risk	High risk
Competitive dynamics	Intermediate risk	Intermediate risk
Systemwide funding	High risk	High risk
Trend	Stable	Stable

\*Banking Industry Country Risk Assessment (BICRA) economic risk and industry risk scores are on a scale from 1 (lowest risk) to 10 (highest risk). For more details on our BICRA scores on banking industries across the globe, please see "Banking Industry Country Risk Assessment Update," published monthly on RatingsDirect.

### RELATED CRITERIA AND RESEARCH

#### Related criteria

- 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
- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

#### Related research

- Banking Industry Country Risk Assessment Update: October 2014, Oct. 8, 2014
- Iceland-Based Islandsbanki hf. Assigned 'BB+/B' Ratings; Outlook Stable, April 30, 2014
- Iceland-Based Landsbankinn Assigned 'BB+/B' Ratings; Outlook Stable, Jan. 20, 2014
- Iceland-Based Arion Bank Assigned 'BB+/B' Ratings; Outlook Stable, Jan 10, 2014
- Iceland Outlook Revised To Positive On Strong Growth And Improving Public Finances; 'BBB-/A-3' Ratings Affirmed, July 18, 2014
- Long-Term Ratings On Iceland's Housing Financing Fund (HFF) Lowered To 'BB-' On Housing System Proposals; Outlook Stable, July 22, 2014
- Banking Industry Country Risk Assessment: Iceland, Aug. 19, 2013

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RATINGS

Ratings Affirmed; Outlook Action

	To	From
Arion Bank		
Islandsbanki hf		
Landsbankinn hf.		
Counterparty Credit Rating	BB+/Positive/B	BB+/Stable/B
Housing Financing Fund Ibudalanasjodur		
Counterparty Credit Rating	BB-/Stable/B	BB-/Stable/B

NB: This list does not include all the ratings affected.

**Additional Contact:**

Financial Institutions Ratings Europe; FIG\_Europe@standardandpoors.com

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