

Two Icelandic Bank Outlooks Revised To Positive On Potential ALAC Uplift

November 12, 2024

Overview

- The updated resolution plans for Iceland's domestic systemically important banks have increased clarity on the size of subordinated liabilities that Islandsbanki and Landsbankinn will be required to hold.
- Given the subordination requirement of 23.4% of the total risk exposure amount (including the combined buffer requirement), we expect both banks to issue a substantial amount of senior nonpreferred (SNP) instruments during the phase-in period until October 2027.
- On Sept. 4, 2024, Landsbankinn successfully entered the SNP market, demonstrating Icelandic banks' sound market access and supporting our view of their future ability to build additional loss-absorbing debt buffers.
- We revised our outlooks on Islandsbanki and Landsbankinn to positive from stable and affirmed our 'BBB+/A-2' long- and short-term issuer credit ratings and the 'A-/A-2' resolution counterparty ratings on the banks.
- The positive outlooks reflect potential uplift for additional loss-absorbing capacity (ALAC) in the issuer credit rating if the banks issue sufficient ALAC-eligible subordinated debt instruments beyond our threshold of 4% of S&P Global Ratings' risk-weighted assets.

STOCKHOLM (S&P Global Ratings) Nov. 12, 2024--S&P Global Ratings said today that it has revised its rating outlooks on Iceland-based Islandsbanki hf and Landsbankinn hf and affirmed its ratings (see the ratings list at the end of this article)

We revised our rating outlooks to positive because we anticipate that SNP debt issuance over 2024-2027 could bolster the banks' ALAC buffers, improving protection for more senior bondholders. Recently approved resolution plans, including a minimum requirement for own funds and eligible liabilities (MREL) with a binding subordination requirement, for Iceland's domestic systemically important banks (D-SIBs) have increased clarity on the size of subordinated liabilities, including own funds, that Islandsbanki and Landsbankinn will be required to hold. Therefore, we see an increased likelihood that the banks could build up ALAC-eligible debt buffers exceeding our adjusted 4% threshold over the next two years. These instruments provide protection to senior debtholders because they can absorb losses in a resolution without triggering a default of the bank.

Moreover, on Sept. 4, 2024, Landsbankinn was the first Icelandic bank to enter the SNP debt market by issuing callable floating-rate SNP notes with a four-year tenor. The issuance, which

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was made in two tranches, Swedish krona (SEK) 1 billion, equivalent to Icelandic krone (ISK) 13.3 billion or €88.4 million; and Norwegian krone (NOK) 250 million (ISK3.2 billion or €21.3 million), was oversubscribed twofold. This demonstrates investor appetite and supports our view of Icelandic banks' access to the SNP debt market.

The EU's Bank Recovery and Resolution Directive (BRRD) 2 is now fully implemented into

Icelandic law. Subsequently, in September 2024, the Resolution Authority of the Central Bank of Iceland published an update of its policy on the MREL. At the same time, it approved the resolution plans, and thereby MREL, for the country's three D-SIBs: Arion Bank (not rated), Islandsbanki, and Landsbankinn. As part of the updated MREL, a portion of the D-SIB's eligible liabilities must be subordinated, that is rank lower in the hierarchy of claims, than senior preferred instruments and liabilities excluded from bail-in. The updated MREL stipulates that subordinated eligible liabilities must total at least 13.5% of the total risk-exposure amount (TREA), which must be met alongside a combined buffer requirement of 9.9%. This translates into a subordination requirement of 23.4% of the TREA for Islandsbanki and Landsbankinn as of Sept. 30, 2024. The deadline for meeting the minimum subordination requirement is three years after the minimum requirement decision was made.

We are cautious on volumes of future subordinated issuances. In our view, future subordinated MREL issuance could increase the banks' ALAC buffers substantially and sustainably above the adjusted threshold of 4.0% of our calculated risk-weighted assets (RWAs). This is 100 basis points higher than the standard threshold, reflecting the presumed concentration of ALAC in a small number of instruments, as is the case for other midsize Nordic banks, which implies higher refinancing risks.

As of Sept. 30, 2024, Landsbankinn holds tier 2 and SNP instruments totaling ISK53.7 billion (€357 million), equivalent to 2.9% of S&P Global Ratings' projected RWAs at year-end 2024. On the same date, Islandsbanki held ISK22.2 billion (€147 million) worth of tier 2 securities, representing 1.7% of our projected RWAs at year-end 2024.

However, both banks fulfill a large part of their subordinated MREL requirement with tier 1 capital and the phase-in period for the subordination requirement is three years. Consequently, the size and timing of additional subordinated issuances remain, to a degree, uncertain and could in part be replaced by preferred instruments that would not be ALAC eligible.

Our view of the banks' underlying creditworthiness, as reflected in their stand-alone credit profiles (SACPs), remains unchanged.

In our base case, we expect Islandsbanki and Landsbankinn will maintain sound operating performance over the next two years. Profitability remained strong in the first nine months of 2024, aided by increasing loan volumes and resilient net interest margins. Although we expect net interest margins may decline slightly as policy rates fall over 2025-2026, we project credit growth of 5%-6% alongside strong operating efficiency will support returns on equity of 9%-11% (compared with 10.9% for Islandsbanki and 11.7% for Landsbankinn in the first nine months 2024). This will continue to underpin very strong risk-adjusted capital (RAC) ratios exceeding 15%. Moreover, although the slowdown in Iceland's economy could weigh on asset quality metrics, we expect the banks' loan books will remain resilient, with nonperforming assets contained below 2% of total loans and the cost of risk at about 25 basis points.

Islandsbanki hf

Primary credit analyst: Salla von Steinaecker

Outlook

The positive outlook reflects our expectation that Islandsbanki will build up significant buffers of ALAC to meet the subordinated MREL requirement by 2027.

Upside scenario: We could take a positive rating action if Islandsbanki's subordinated buffer exceeded our adjusted threshold of 4% of S&P Global Ratings' RWAs in the next 24 months. This would reduce the default risk for senior preferred debt holders.

Furthermore, we expect the bank to maintain a sound financial position over the next two years, underpinned by strong profitability and operating efficiency in line with its financial targets and a robust risk-adjusted capitalization, notwithstanding the bank's ongoing privatization and the potential for distribution of excess capital.

Downside scenario: We could revise the outlook to stable if Islandsbanki failed to reach our adjusted ALAC threshold. We could also take a negative rating action if its RAC ratio were to fall below 15%, the level we consider to be very strong (for example, due to significant shareholder distributions) or if we observed a material deterioration of Iceland's macroeconomic indicators, to which Islandsbanki would not be immune.

Ratings Score Snapshot

Issuer Credit Rating	BBB+/Positive/A-2
SACP	
Anchor	bbb
Business position	Adequate (0)
Capital and earnings	Very strong (+2)
Risk position	Moderate (-1)
Funding and liquidity	Adequate and adequate (0)
Comparable ratings analysis	(0)
Support	(0)
ALAC support	(0)
GRE support	(0)
Group support	(0)
Sovereign support	(0)
Additional factors	(0)
SACP--Stand-alone credit profile.	bbb+

Landsbankinn hf

Primary credit analyst: Niklas Dahlstrom

Outlook

The positive outlook reflects our view that Landsbankinn could issue substantial amounts of ALAC-eligible instruments over the next 12-24 months to meet the subordinated MREL requirement by 2027.

Upside scenario: We could take a positive rating action if Landsbankinn's subordinated buffer exceeded our adjusted threshold of 4% of S&P Global Ratings' RWAs.

A positive rating action would also be consistent with Landsbankinn maintaining its sound financial position, supported by strong profitability and robust capitalization, notwithstanding the potential for distribution of excess capital.

Downside scenario: We could revise the outlook to stable if Landsbankinn failed to reach our adjusted ALAC threshold.

We could also take a negative rating action if Landsbankinn's RAC ratio fell below the 15% that indicates very strong capital and earnings, or if we observed a material deterioration in Iceland's macroeconomic indicators, to which Landsbankinn would not be immune.

Ratings Score Snapshot

Issuer Credit Rating	BBB+/Positive/A-2
SACP	
Anchor	bbb
Business position	Adequate (0)
Capital and earnings	Very strong (+2)
Risk position	Moderate (-1)
Funding and liquidity	Adequate and adequate (0)
Comparable ratings analysis	(0)
Support	(0)
ALAC support	(0)
GRE support	(0)
Group support	(0)
Sovereign support	(0)
Additional factors	(0)
SACP--Stand-alone credit profile.	bbb+

Related Criteria

- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, April 30, 2024
- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021
- Criteria | Financial Institutions | General: Financial Institutions Rating Methodology, Dec. 9, 2021
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- 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

- Banking Industry Country Risk Assessment Update: October 2024, Oct. 30, 2024
- Banking Industry Country Risk Assessment: Iceland, Sept. 17, 2024
- TM Acquisition Will Broaden Landsbankinn hf.'s Customer Offering And Will Have A Moderate Effect On Capital, June 5, 2024
- Three Icelandic Banks Upgraded On Receding Economic Imbalances; Outlooks Stable, April 4, 2024
- Nordic Banks In 2024: Ploughing On Through Tough Terrain, Feb. 7, 2024

Ratings List

*****|Islandsbanki hf*****

Ratings Affirmed

Islandsbanki hf

Resolution Counterparty Rating A-/--/A-2

Islandsbanki hf

Senior Unsecured	BBB+
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Subordinated	BBB-
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Junior Subordinated	BB
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Ratings Affirmed; Outlook Action

	To	From
Islandsbanki hf		
Issuer Credit Rating	BBB+/Positive/A-2	BBB+/Stable/A-2

***** Landsbankinn hf. *****

Ratings Affirmed

Landsbankinn hf.

Resolution Counterparty Rating	A/--/A-2
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Landsbankinn hf.

Senior Unsecured	BBB+
Senior Subordinated	BBB
Subordinated	BBB-

Ratings Affirmed; Outlook Action

	To	From
Landsbankinn hf.		
Issuer Credit Rating	BBB+/Positive/A-2	BBB+/Stable/A-2

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.spglobal.com/ratings for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at <https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceld/504352>. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings. Alternatively, call S&P Global Ratings' Global Client Support line (44) 20-7176-7176.

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