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# Four Icelandic Banks Affirmed On Supportive Economic Growth, But Weakening Operating Landscape; Outlooks Stable

**Primary Credit Analyst:**
Antonio Rizzo, Madrid (34) 91-788-7205; Antonio.Rizzo@spglobal.com

**Secondary Contacts:**
Yulia Kozlova, CFA, London (44) 20-7176-3493; yulia.kozlova@spglobal.com
Salla von Steinaecker, Frankfurt (49) 69-33-999-164; salla.vonsteinaecker@spglobal.com
Markus W Schmaus, Frankfurt (49) 69-33-999-155; markus.schmaus@spglobal.com
Arianna Valezano, London + 44 20 7176 3838; arianna.valezano@spglobal.com

- Although we believe that the Icelandic banking market has stabilized, we might not see a further improvement in the competitive and funding landscape over the next few years. We have therefore revised our banking industry risk trend in Iceland to stable from positive.
- In our view, the role of pension funds in lending continues to distort Icelandic banks' competitive environment in terms of business generation and margins.
- While new external funding is gradually diversifying resources for the banks, we expect the domestic wholesale funding market to remain small and concentrated compared to that of international peers.
- Overall, economic risks in Iceland remain stable as the economy continues to grow and signs of overheating are receding.
- However, credit risk may increase, due to banks' relatively sizable exposure to the real estate and tourism sectors and to consumer price index-linked mortgage loans, combined with fierce domestic competition from bank and non-bank institutions.
- We are affirming all our ratings on Arion Bank, Islandsbanki hf, Landsbankinn hf., and Housing Financing Fund (HFF), and revising the outlook on HFF to stable from positive. The outlooks on Arion Bank, Islandsbanki, and Landsbankinn remain stable.

MADRID (S&P Global Ratings) July 17, 2018--S&P Global Ratings said today that it affirmed its long-term and short-term issuer credit ratings on Iceland-based Arion Bank, Islandsbanki hf, Landsbankinn hf., and Housing Financing Fund Ibudalanasjodur (HFF). At the same time, we revised the outlook on HFF to stable from positive. The outlooks on Arion Bank, Islandsbanki, and Landsbankinn remain stable.

The rating actions take into account our view that economic growth in Iceland continues to support the banking sector, resulting in business growth and low default rates. This is balanced by our expectation of more challenging competitive and funding dynamics.

We now see the trend for industry risk in Iceland as stable, rather than positive, over our 24-month horizon. As Icelandic banks have recently regained full access to foreign debt capital markets and seek to diversify their funding mix, they are increasing their reliance on external funding. At the same time, we expect banks' high share of stable equity to decline in the coming years. This trend, coupled with a relatively low core customer deposits base of about 35% on systemwide loans, increasingly exposes banks to wholesale market volatility, both at home and abroad. We calculate that the net external debt of the banking sector, as a percentage of domestic loans, increased to around 9% in 2017 from -2% in 2015. We consider that the domestic debt market in Iceland is relatively small and concentrated by product and type of investor, given the dominant presence of local pension funds.

We believe that risks could arise from growth in the lending activities of the pension funds. In our view, pension funds' growing presence is distorting the competitive landscape for mortgages, as pension funds are putting pressure on pricing, and arguably banks' lending underwriting, in the medium-to-long term. Pension funds enjoy a lower regulatory burden than banks and already represent about half of newly granted mortgage loans, or about 18% of the stock compared to 10% two years ago. Over the next two years, we expect that the regulators will address the negative effect of this distortion on local banks more actively.

On the other hand, we also consider that regulators have managed well the recent lifting of capital controls; the restructuring of legacy banks; and the implementation of measures to reduce economic volatility (that is, through high capital requirements and strict funding and liquidity requirements) and risky residential mortgages (for example, through a loan-to-value cap of 85%).

The trend for economic risk in Iceland remains stable. This reflects our expectation that house prices will continue to grow, but at a more tempered pace than in 2017. We expect the growth rate to slow to about 7% on average in 2018-2019, from a double-digit level in the past two years, because construction is gradually catching up with demand.

However, we consider that the banking sector is facing structurally higher credit risks than peer countries. Specifically, a large share of loans is linked to the consumer price index. Although this is a longstanding feature of the Icelandic market, in our view, it poses risks for the banking sector if not properly managed in the medium-to-long term, given that it could inflate borrowers' principal debt. This is another area where we expect all market participants to step up their preparations for potentially more negative or volatile markets.

Moreover, commercial real estate prices--and banks' exposure to this segment--have been increasing relative to fundamental drivers such as building costs and corporate earnings, toward levels before the financial crisis. Similarly, tourism-related activities now represent an important part of the domestic economy, and with around 10% of banks' loan books directly exposed, the sensitivity of their balance sheets to this inherently cyclical sector has also increased. We believe that banks' indirect exposure to tourism is markedly higher, representing an exceptional risk in potential future downturns.

We consider that the three commercial banks--Arion Bank, Islandsbanki, and Landsbankinn--now have similar liquidity profiles, with a liquidity buffer falling from high levels as they extend their funding and optimize their capital. Although this does not result in a rating change, we now consider that the liquidity of Landsbankinn and Islandsbanki is adequate, rather than strong, as we no longer consider them outliers compared to our overall market assessment.

The revision of our outlook on HFF to stable from positive reflects our view that HFF's new public policy role is unlikely to lead to stronger and more stable earnings. We have published an individual research update on HFF to provide more details regarding the rationale behind our rating action.

OUTLOOKS

ARION BANK
Our stable outlook on Arion Bank balances our view of the bank's sustained capital generation and progress in reducing its equity position. We believe that the bank will materially reduce its capital over the next two-to-three years as it recalibrates its capital base, but that it is unlikely to reduce its risk-adjusted capital (RAC) ratio below 15%.

We could lower the rating if capital reduced beyond our expectations (that is, an RAC ratio below 15%). This could also be the case if we saw signs of a material deterioration of asset quality as a result of more aggressive underwriting or economic headwinds in Iceland. Such a development could result in us no longer viewing the combined capital and risk assessment as a relative strength for the rating.

We consider a positive rating action unlikely, as we expect the bank's regional and sector concentration to remain unchanged, while its funding and liquidity profile normalizes after the lifting of capital controls. We also reflect this in our overall banking market assessment, which includes the rather small and concentrated nature of the market.

ISLANDSBANKI

The stable outlook on Islandsbanki reflects our expectation that the bank's RAC ratio will remain sustainably above 15%, even while the bank prepares for an eventual sale or IPO over the next two years, and it optimizes its capital base by paying extraordinary dividends and issuing capital instruments. We expect the bank's asset quality to improve only marginally from current levels, remaining in line with that of domestic peers. The stable outlook further balances our view of the still-supportive economic development in Iceland with the relatively concentrated and volatile nature of the economy and increasing credit risks.

We could take a negative rating action if Islandsbanki's RAC ratio declined more than we expected, or if its loan asset quality deteriorated materially, requiring significant and unexpected additional provisioning. This could follow a quicker sale than we expect to owners we view as more aggressive. In addition, we could lower our rating if we saw signs of the economic and banking industry environment in Iceland weakening.

We consider a positive rating action unlikely, as we expect the bank's regional and sector concentration to remain unchanged, while its funding and liquidity profile normalizes after the lifting of capital controls. We also reflect this in our overall banking market assessment, which includes the rather small and concentrated nature of the market.

LANDSBANKINN

Our stable outlook on Landsbankinn reflects our expectations that the bank's RAC ratio will remain above 15% over the next two years, despite high dividend payments and share-buyback programs. We view the bank's asset quality as in line with the risks in the Icelandic market and with that of domestic peers. The stable outlook further balances our view of strong economic development in Iceland against the relatively concentrated and volatile nature of the Icelandic economy and increasing economic imbalances.

We could lower the rating if Landsbankinn's RAC ratio declined more than we expected, or if its loan asset quality deteriorated materially, requiring significant and unexpected additional provisioning. This could follow a quicker sale than we expect to owners we view as more aggressive.

We consider a positive rating action unlikely, as we expect the bank's regional and sector concentration to remain unchanged, while its funding and liquidity profile normalizes after the lifting of capital controls. We also reflect this in our overall banking market assessment, which includes the rather small and concentrated nature of the market.

HFF

The stable outlook reflects our expectations that HFF's profitability will decline in the next 12 months, and that the benefits stemming from HFF's newly assigned public policy role will take time to materialize. At the same time, we consider that HFF will maintain adequate capital levels over our two-year outlook horizon. Despite the inherent volatility of HFF's balance sheet, we expect that the RAC ratio will remain around 8.5%-9.0% in the next 12 months. We anticipate that Iceland's economic and operating environments will stabilize, and, in turn, support contained new credit losses and low nonperforming loans, as HFF continues to work out legacy assets and new lending is limited.

We could raise the ratings if we expected that HFF's new public role would result in stronger and more stable earnings, most likely based on significant and predictable fee income. This assessment could follow more commitment and clarity from the Icelandic government on the future role of HFF, including the scale and scope of its different functions, business model, and compensation structure.

We could also raise our ratings if HFF strengthens its RAC ratio to sustainably above 10%, while our view of its risk profile does not deteriorate.

We could lower the ratings if we saw signs of economic trends in Iceland worsening. Specifically, we could take a negative rating action if we thought that increasing imbalances in the economy would lead to weaker asset quality or higher market risks.

We could downgrade HFF if we concluded that the effects of a potential default of HFF for the Icelandic government and the capital markets had diminished, thereby reducing the government's incentive to provide timely extraordinary support to HFF.

RELATED CRITERIA

- 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: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk

Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

RELATED RESEARCH
- Banking Industry Country Risk Assessment Update: June 2018, June 20, 2018
- Republic of Iceland 'A/A-1' Ratings Affirmed; Outlook Stable, June 8, 2018
- Banking Industry Country Risk Assessment: Iceland, Feb. 21, 2018

BICRA SCORE SNAPSHOT*

| Iceland | To | From |
|---|---|---|
| BICRA Group | 4 | 4 |
| Economic risk | 4 | 4 |
| Economic resilience | Intermediate risk | Intermediate risk |
| Economic imbalances | High risk | High risk |
| Credit risk in the economy | Intermediate risk | Low risk |
| Industry risk | 5 | 5 |
| Institutional framework | Intermediate risk risk | Intermediate risk |
| Competitive dynamics | Intermediate risk | Intermediate risk |
| Systemwide funding | High risk | High risk |
| Trends | | |
| Economic risk trend | Stable | Stable |
| Industry risk trend | Stable | Positive |

*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.

Ratings List

Ratings Affirmed; Outlook Revised

| | To | From |
|---|---|---|
| Housing Financing Fund Ibudalanasjodur | | |
| Counterparty Credit Rating | BB+/Stable/B | BB+/Positive/B |

Ratings Affirmed

| | | |
|---|---|---|
| Housing Financing Fund Ibudalanasjodur | | |
| Senior Unsecured | BB+ | |

| | |
|---|---|
| Arion Bank | |
| Counterparty Credit Rating | BBB+/Stable/A-2 |
| Senior Unsecured | BBB+ |
| | |
| Islandsbanki hf | |
| Counterparty Credit Rating | BBB+/Stable/A-2 |
| Senior Unsecured | BBB+ |
| Subordinated | BBB- |
| | |
| Landsbankinn hf. | |
| Counterparty Credit Rating | BBB+/Stable/A-2 |
| Senior Unsecured | BBB+ |

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. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings 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.