STANDARD & POOR'S RATINGS SERVICES
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Islandsbanki hf

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Islandsbanki hf

SACP	bb+

Anchor	bb	
Business Position	Adequate	0
Capital and Earnings	Strong	+1
Risk Position	Adequate	0
Funding	Average	0
Liquidity	Strong	

\+

Support	0
GRE Support	0
Group Support	0
Sovereign Support	0

\+

Additional Factors	0

Issuer Credit Rating

BB+/Positive/B

Major Rating Factors

Strengths:	Weaknesses:
• Relatively high leverage ratios and strong capital. • Ample liquidity buffers.	• Domestic economy offers few diversification opportunities. • Uncertainty associated with capital controls in Iceland.

Outlook: Positive

The positive outlook on Icelandic commercial bank Islandsbanki hf. reflects Standard & Poor's Ratings Services' view that the bank's stand-alone credit profile (SACP) is likely to develop alongside improvements in the Icelandic economy. We see a positive trend on the economic risk in the Icelandic banking sector and would expect to raise the ratings on Islandsbanki if we improved our view on the sector. We also anticipate that the bank 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 that are 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 return the outlook to stable 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, improvements in Iceland and conservative assumptions in our capital and earnings forecast lead us to view a downgrade as unlikely in the near term.

Rationale

Standard & Poor's rating on Islandsbanki reflect our 'bb' anchor for banks operating in Iceland, plus our view of the bank'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+'.

Anchor:'bb' for banks with Icelandic focus, though the trend is positive

Our bank criteria use our Banking Industry Country Risk Assessment's economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. The anchor for a commercial bank operating only in Iceland is 'bb', based on an economic risk score of '7' and an industry risk score of '6'.

Economic risk for Icelandic banks has, in our view, continued to decline. Imbalances have further reduced and we expect the country's prosperous but concentrated economy to achieve annual real GDP growth of about 3% for the next two years. The banks have all undergone significant restructuring efforts and the Icelandic economy is steadily reducing its debt burden and the banks their stock of nonperforming loans. Our view of economic risks, continue to be constrained by the perils associated with the eventual removal of the capital controls. However, our base-case scenario entails that the authorities would approach the lifting in a prudent way to minimize the impact of the economy and the exchange rate.

We think industry risk has subsided following a move to a more robust regulatory system and a funding model based on mainly resident domestic deposits, in contrast to the very high external wholesale dependence prior to the 2008 banking crisis. We expect returns to be in line with those in the corporate sector and based on what we believe to be sound commercial practices.

Table 1

Islandsbanki hf Key Figures

		--Year-ended Dec. 31--			
(Mil. ISK)	**2014***	**2013**	**2012**	**2011**	**2010**
Adjusted assets	907,174	865,710	823,114	795,371	683,035
Customer loans (gross)	627,204	582,657	604,786	605,997	576,876
Adjusted common equity	175,365	162,956	144,352	122,842	121,204
Operating revenues	21,199	42,597	47,649	41,710	41,567
Noninterest expenses	11,777	26,441	25,525	20,759	18,435
Core earnings	6,794	5,820	1,700	4,731	2,457

*Data as of June 30.

Business position: Acquisitions have aligned the bank's market position with its primary peers

We view Islandsbanki as having a broad presence in most business lines in Iceland. The bank 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 ISK908 billion (€6 billion at June 2014), Islandsbanki maintains a comparable market position in most business lines. It has a strong domestic market share of 30%-40% in most business lines, in part reflecting two key acquisitions: that of Byr, previously the fourth-largest bank, in 2011, and 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).

We expect Islandsbanki to continue to earn two-thirds of its revenues from net interest income, and 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.

Table 2

Islandsbanki hf Business Position

		--Year-ended Dec. 31--			
(%)	**2014***	**2013**	**2012**	**2011**	**2010**
Loan market share in country of domicile	21.1	20.0	19.9	20.0	18.4
Deposit market share in country of domicile	32.8	31.5	31.6	30.1	23.1
Total revenues from business line (mil. ISK)	30,844	61,763	57,374	42,551	56,074
Commercial banking/total revenues from business line	8.2	7.1	11.8	25.2	19.8
Retail banking/total revenues from business line	34.6	39.2	42.4	49.4	41.0
Commercial & retail banking/total revenues from business line	42.9	46.2	54.3	74.6	60.8
Trading and sales income/total revenues from business line	0.8	1.4	1.5	(0.2)	(0.1)
Corporate finance/total revenues from business line	N/A	N/A	N/A	0.7	1.0
Brokerage/total revenues from business line	3.3	3.0	3.3	2.4	2.9
Asset management/total revenues from business line	4.0	4.4	4.7	6.0	5.2
Other revenues/total revenues from business line	49.0	45.0	36.1	16.5	30.3

Table 2

Islandsbanki hf Business Position (cont.)					
Investment banking/total revenues from business line	0.8	1.4	1.5	0.4	0.9

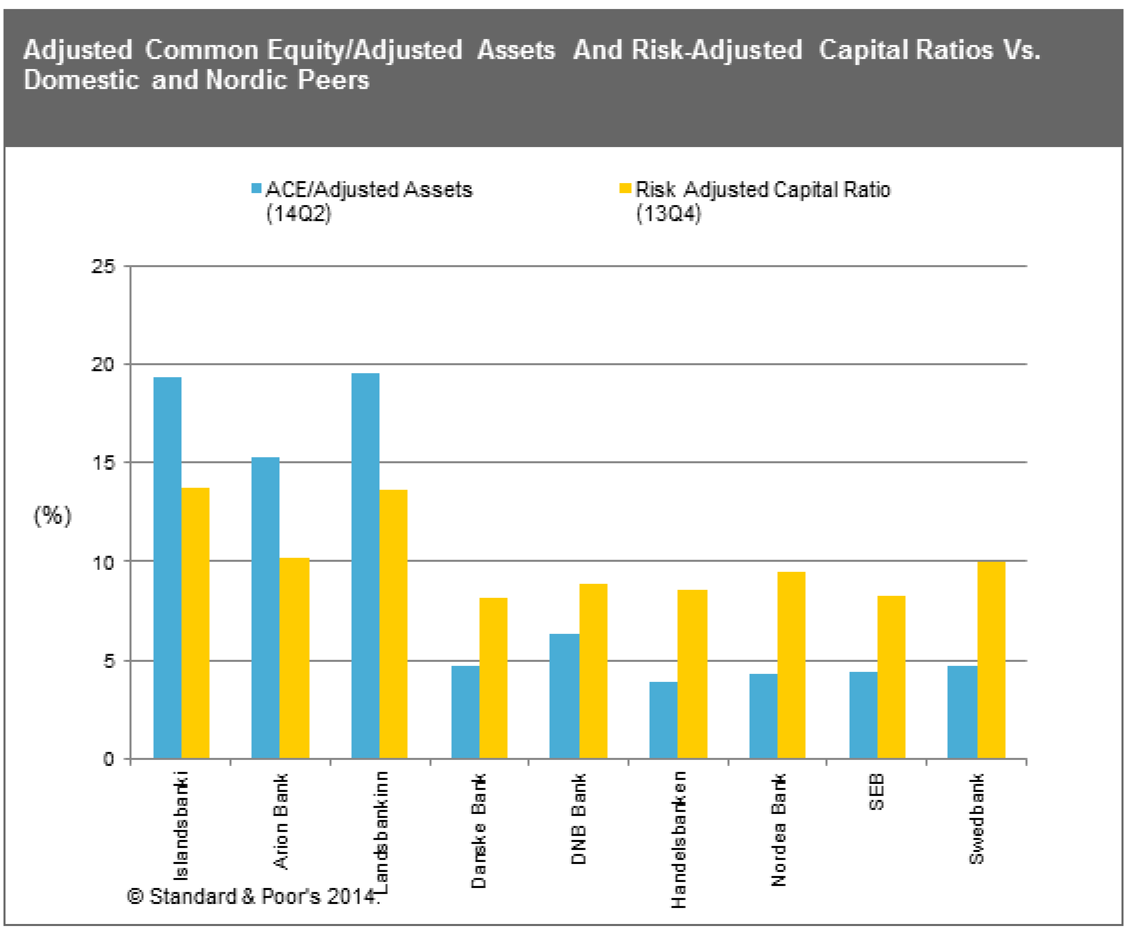
Data as of June 30. N/A--Not applicable.

Capital and earnings: Capital strong and earnings stabilizing at lower levels

Our projected risk-adjusted capital (RAC) ratio for Islandsbanki just exceeds 15% over the next 18-24 months, after 13.7% at year-end 2013, given large reductions in non-core assets in the first half of the year. At June 30, 2014, the core Tier 1 capital ratio was 26.1%, an improvement of 1% from its year-end ratio. We understand that initial proposals for regulatory capital requirements from the Icelandic regulator are quite high and could reduce the amount of potential extraordinary dividends and limit the ability of the bank to return excess capital to its owners. As such, we now expect dividends to increase only modestly from the ISK4 billion (about 25% of profits) for 2013, supporting higher capital projections.

We expect Islandsbanki's profits to decrease slightly over our two-year forecast horizon, and for long-term return on equity to be between 7%-8%, excluding one-off items and revaluations. We note that the comparability of Islandsbanki's return on equity to international peers should be considered in light of the bank's leverage ratio, which at 19.3% (adjusted common equity to adjusted assets) is exceptional on a global comparison.

Chart 1



The loans the bank acquired when it was created in 2008 were at a 47% discount. Together with increases in the net asset valuation, this has resulted in strong earnings for the bank. In addition, sales of legacy real estate assets acquired during the portfolio-restructuring process have boosted revenues in recent quarters. Going forward we expect the bank to increase mortgage lending, which should reduce the overall net interest margin somewhat. We also anticipate that Islandsbanki and domestic peers will increase fee and commission income as they search for opportunities to improve their core revenues. Following its recent acquisitions, Islandsbanki has some potential for reducing costs and improving the synergies. This is already evident in the reduction in 2014 expenses, which were nearly 10% lower than the first half of 2013. The improvements will be temporarily absorbed by the bank tax levy used to fund debt relief for Icelandic residential borrowers, which we expect to reduce profits by ISK2.5 billion per annum through 2016.

The bank's earnings buffer, which measures the ability to meet our calculation of its normalized losses, is expected to remain about 60bps in our forecast. However, we note that figure underestimates our expectations for actual returns given that the earnings buffer calculation assumes annual normalized losses of more than ISK10 billion--a level we expect the bank to outperform throughout our two-year forecast as the asset quality in Iceland improves.

Table 3

Islandsbanki hf Capital And Earnings

		--Year-ended Dec. 31--			
(%)	**2014***	**2013**	**2012**	**2011**	**2010**
Tier 1 capital ratio	26.1	25.1	22.0	19.1	22.6
S&P RAC ratio before diversification	N.M.	13.7	N.M.	N.M.	N.M.
S&P RAC ratio after diversification	N.M.	11.0	N.M.	N.M.	N.M.
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	64.0	66.7	69.1	74.9	83.9
Fee income/operating revenues	26.8	24.5	19.9	14.3	17.8
Market-sensitive income/operating revenues	4.2	10.6	2.7	8.7	(4.5)
Noninterest expenses/operating revenues	55.6	62.1	53.6	49.8	44.4
Preprovision operating income/average assets	2.1	1.9	2.7	2.8	N/A
Core earnings/average managed assets	0.4	(0.8)	(0.9)	2.7	N/A

*Data as of June 30. N/A--Not applicable. N.M.--Not meaningful.

Table 4

Islandsbanki hf Risk-Adjusted Capital Framework

(ISK 000s)	**Exposure***	**Basel II RWA**	**Average Basel II RW (%)**	**Standard & Poor's RWA**	**Average Standard & Poor's RW (%)**
Credit risk					
Government and central banks	150,543,887	1,832,398	1	70,563,499	47
Institutions	44,837,215	9,863,520	22	10,940,148	24
Corporate	256,465,734	255,748,696	100	393,778,096	154
Retail	296,167,304	182,010,941	61	296,004,676	100
Of which mortgage	165,312,673	85,433,519	52	105,800,111	64
Other assets	87,774,225	87,438,926	100	182,783,471	208
Total credit risk	835,788,365	536,894,482	64	954,069,890	114

Table 4

Islandsbanki hf Risk-Adjusted Capital Framework (cont.)

Market risk					
Equity in the banking book¶	9,846,069	13,934,618	142	88,759,615	901
Trading book market risk	--	28,849,362	--	43,274,042	--
Total market risk	--	42,783,980	--	132,033,657	--
Insurance risk					
Operational risk					
Total operational risk	--	78,970,370	--	100,899,842	--
(ISK 000s)		**Basel II RWA**		**Standard & Poor's RWA**	**% of Standard & Poor's RWA**
Diversification adjustments					
RWA before diversification		658,648,832		1,187,003,389	100
Total adjustments to RWA		--		289,000,997	24
RWA after diversification		658,648,832		1,476,004,386	124
(ISK 000s)		**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**Standard & Poor's RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		165,585,103	25.1	162,956,000	13.7
Capital ratio after adjustments§		165,585,103	25.1	162,956,000	11.0

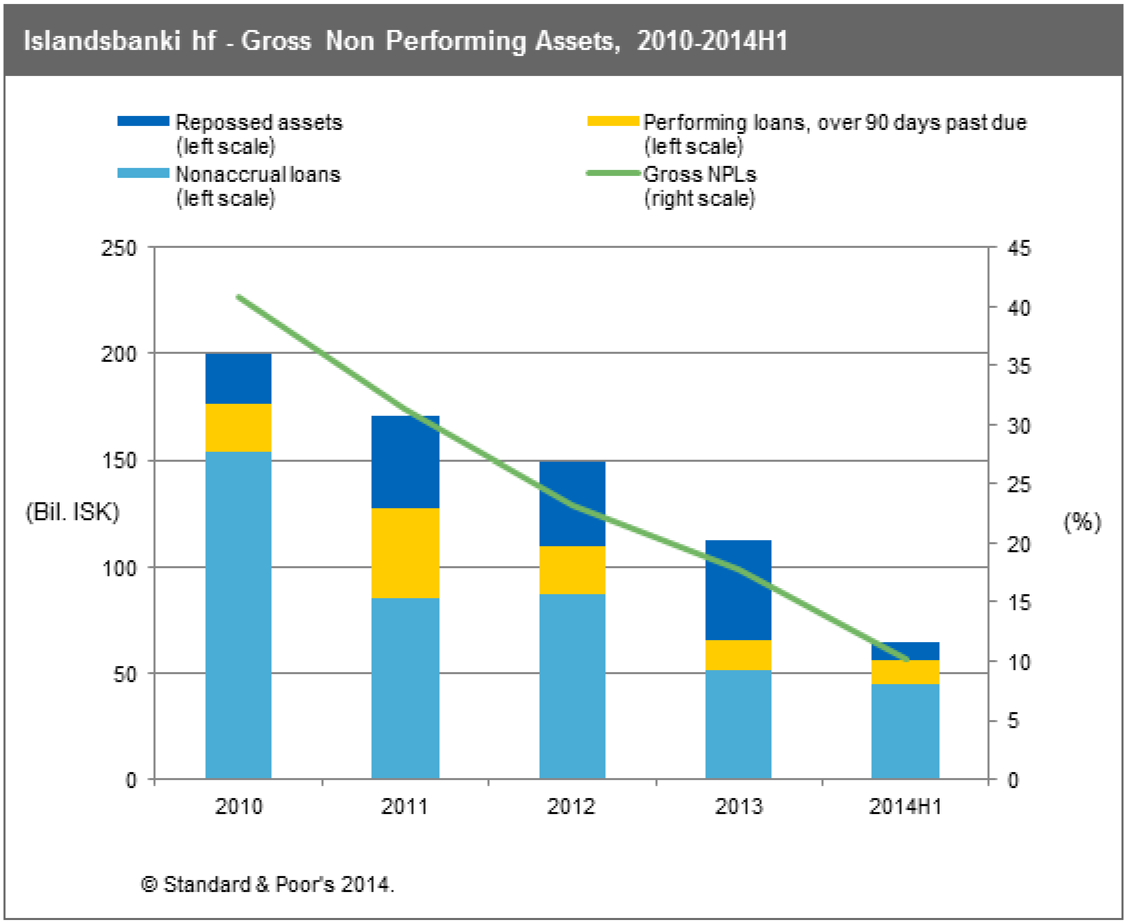
*Exposure at default. ¶Exposure and Standard & Poor's risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. §Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital.ISK--Iceland Krona. Sources: Company data as of Dec. 31, 2013, Standard & Poor's.

Risk position: Highly correlated to systemic risks in Iceland

In our view, Islandsbanki's risk position reflects the bank's important role in the retail and commercial banking markets 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 (LPA) 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). By our measures, Islandsbanki's gross non-performing assets amount to 10.2% of customer loans and repossessed assets at June 2014 (including non-accrual loans, performing loans over 90-days past due, and repossessed assets). This figure is far below the 17.9% at end-2013, and is a signal of the pace of restructuring of the portfolio. Net of loss reserves, the NPLs were 6.7% at June 2014, indicating loss reserve coverage of 36%. New loan loss provisions continue to fall as well, with only 14bps of additional loss provisions recorded during the first half of 2014, as opposed to 1.3% of customer loans in 2013. We note that there are some counterparties' restructurings or defaults in the Icelandic court systems, and we expect provisions to be somewhat volatile over the next two years but to continue to reduce from end-2013 levels on average. Likewise, we believe any remaining positive revaluations of the loan book are more limited, with the potential exception of a few larger counterparties.

Chart 2



We expect that Islandsbanki's asset quality will continue to improve as the economy improves and the impacts of the government's debt-relief program, launched in November 2013, filter through the economy. About one-third of the bank's loan book represents residential mortgages, and the debt relief 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 other sectors of the economy.

Table 5

Islandsbanki hf Risk Position					
		--Year-ended Dec. 31--			
(%)	2014*	2013	2012	2011	2010
Growth in customer loans	15.3	(3.7)	(0.2)	5.0	N.M.
Total diversification adjustment / S&P RWA before diversification	N.M.	24.3	N.M.	N.M.	N.M.
Total managed assets/adjusted common equity (x)	5.2	5.3	5.7	6.5	5.6
New loan loss provisions/average customer loans	0.1	1.3	3.3	(0.0)	N/A
Net charge-offs/average customer loans	1.3	3.0	1.7	5.2	N/A

Table 5

Islandsbanki hf Risk Position (cont.)					
Gross nonperforming assets/customer loans + other real estate owned	10.2	17.9	23.2	26.3	33.3
Loan loss reserves/gross nonperforming assets	36.3	24.8	31.5	24.4	30.9

*Data as of June 30. N/A--Not applicable. N.M.--Not meaningful.

Funding and liquidity: Strong liquidity, even considering potential outflows of FX deposits

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 Dec. 31, 2013 (estimated to be 119.7% at June 2014), 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 note the bank's considerable coverage of short-term liabilities. In December 2013, Islandsbanki's ratio of broad liquid assets to short-term wholesale funding was 3.5x (estimated to be 5x at June 2014). We note that the bank maintains a portion of the liquid assets to offset the potential reduction in foreign exchange deposits if the Icelandic government removes the capital controls. At June 2014, the bank had liquid foreign exchange assets of ISK73 billion for this purpose, compared to ISK86 billion in foreign exchange deposits.

Chart 3

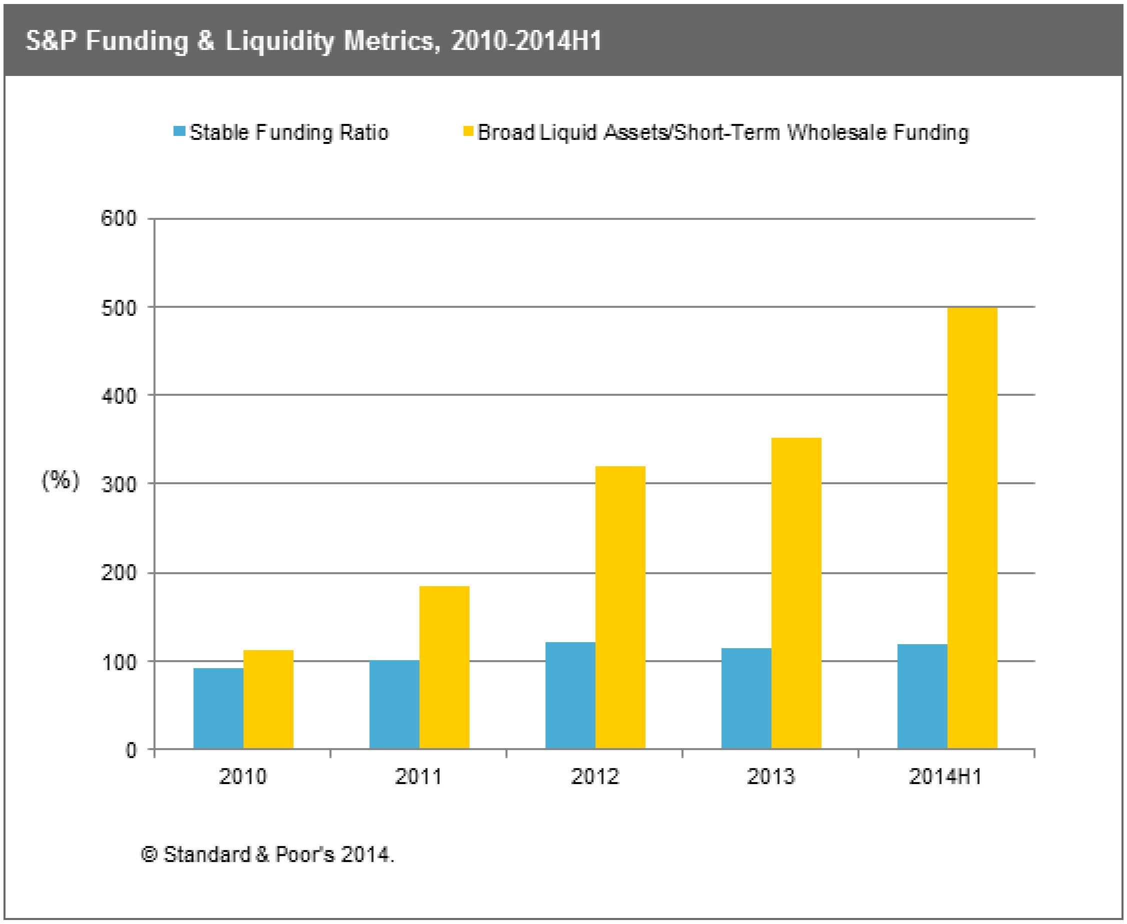


Table 6

Islandsbanki hf Funding And Liquidity					
		--Year-ended Dec. 31--			
(%)	**2014***	**2013**	**2012**	**2011**	**2010**
Core deposits/funding base	77.5	76.5	77.1	74.6	64.3
Customer loans (net)/customer deposits	116.1	113.4	118.4	121.9	157.5
Long term funding ratio	94.3	92.2	92.0	89.0	82.9
Stable funding ratio	119.7	114.7	110.4	102.2	92.6
Short-term wholesale funding/funding base	7.2	9.8	9.9	13.2	21.1
Broad liquid assets/short-term wholesale funding (x)	5.0	3.5	3.2	1.8	1.1
Net broad liquid assets/short-term customer deposits	39.9	35.4	31.4	15.9	4.7
Short-term wholesale funding/total wholesale funding	32.1	41.8	43.3	52.1	59.1
Narrow liquid assets/3-month wholesale funding (x)	6.8	4.8	3.7	2.0	1.3

*Data as of June 30.

Support: Government support for Icelandic banks is uncertain

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.

Additional rating factors:None

No additional factors affect the ratings.

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, Feb 26, 2013
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Outlooks For Iceland's Top 3 Banks Revised To Positive On Our More Positive View Of The Economy, Oct. 14, 2014
- 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 Outlook Revised To Positive On Strong Growth And Improving Public Finances; 'BBB-/A-3' Ratings Affirmed, July 18, 2014
- Banking Industry Country Risk Assessment: Iceland, Aug. 19, 2013

Anchor Matrix

Industry Risk	Economic Risk									
	1	2	3	4	5	6	**7**	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	**bb**	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of November 5, 2014)	
Islandsbanki hf	
Counterparty Credit Rating	BB+/Positive/B
Senior Unsecured	BB+
Short-Term Debt	B

Ratings Detail (As Of November 5, 2014) (cont.)	
Counterparty Credit Ratings History	
14-Oct-2014	BB+/Positive/B
30-Apr-2014	BB+/Stable/B
Sovereign Rating	
Iceland (Republic of)	BBB-/Positive/A-3

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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