S&P Global
Ratings

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Islandsbanki hf

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Islandsbanki hf

SACP	bbb+

Anchor	bbb-	
Business Position	Adequate	0
Capital and Earnings	Very Strong	+2
Risk Position	Adequate	0
Funding	Average	0
Liquidity	Strong	

+

Support	0
ALAC Support	0
GRE Support	0
Group Support	0
Sovereign Support	0

+

Additional Factors	-1

Issuer Credit Rating
BBB/Positive/A-2

Major Rating Factors

Strengths:

- High leverage ratios and strong capital.
- Stable franchise and market position
- Ample liquidity buffers despite recent deposit outflows.

Weaknesses:

- Domestic economy limits diversification opportunities.
- Uncertainty related to eventual sale or IPO and change of ownership.

Outlook

The positive outlook on Islandsbanki hf reflects S&P Global Ratings' expectation that the bank's risk-adjusted capital (RAC) ratio will remain sustainably above 15%, even while the bank prepares for an eventual sale or IPO over the next two years. However, we note that this scenario is only our base case, and uncertainty around the sales process, ownership, and capitalization remains.

We could upgrade the bank if we see strong continued economic development in Iceland, if future capital levels exceed our current expectations, or if we become more certain about future capitalization, allowing us to remove the negative adjustment notch. Despite continued positive economic and industry trends for the Icelandic banking sector, we consider unlikely a two-notch upgrade over the next two-year rating horizon given the relatively concentrated and volatile nature of the Icelandic economy.

We could revise the outlook to stable if we see signs that Iceland's strong economic development was weakening or due to an increased risk of economic imbalances in the economy. We could also revise the outlook to stable if Islandsbanki's capital levels fell below our expectations, due to a larger-than-anticipated reduction in equity capital.

Rationale

Our rating on Islandsbanki reflects our 'bbb-' anchor for banks operating in Iceland, and our view of the bank's adequate business position, very strong capital and earnings, adequate risk position, average funding, and strong liquidity. Our assessment of the bank's stand-alone credit profile (SACP) is 'bbb+'. We apply a negative notch to the rating due to the uncertainty associated with its future ownership and capital policy.

Anchor: 'bbb-' for banks operating primarily in Iceland

We 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 'bbb-', based on an economic risk score of '5 and an industry risk score of '5'.

Economic risk for Icelandic banks has, in our view, declined gradually, and we believe the 2008 financial crisis has largely worked its way through the banking system, as reflected by the banks' loan loss ratio at 15 basis points (bps) systemwide and private sector credit below 150% of GDP in 2015. In addition, we believe that economic resilience in Iceland is strengthening, as reflected by the trends of rising housing prices, strong economic growth, and low unemployment. With the recent auctions of Icelandic krona, we think the risk for a shock to the banking industry related to the currency overhang and removal of capital controls has decreased meaningfully. Although progress has been made, the last steps in removing the capital controls still create some uncertainty in the Icelandic economy in the near term.

We think industry risk has subsided following a move to a stronger regulatory system and an improved funding model based on domestic deposits and covered bonds, and significant equity levels, as well as improved access to foreign wholesale funding for the Icelandic banks. We expect returns will be based on what we believe to be sound commercial practices. Substantial one-off items have inflated the banks' profits over the past few years, but we expect future impact will be contained.

Table 1

Islandsbanki hf Key Figures

		--Year-ended Dec. 31--			
(Mil. ISK)	**2016***	**2015**	**2014**	**2013**	**2012**
Adjusted assets	1,066,224	1,044,438	910,709	865,710	823,114
Customer loans (gross)	698,673	681,583	654,558	582,657	604,786
Adjusted common equity	192,982	190,896	175,868	162,956	144,352
Operating revenues	34,453	44,673	42,668	42,597	47,649
Noninterest expenses	20,540	24,827	23,812	26,441	25,525
Core earnings	9,523	11,699	12,344	5,820	1,700

*Data as of Sept. 30. ISK--Icelandic krona.

Business position: Diverse business revenues across all domestic segments

Our assessment of Islandsbanki's business position as adequate balances the bank's broad presence in most business lines in Iceland and the concentrated nature of the economy. 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, the bank's former owner. In the first quarter of 2016, Glitnir transferred its ownership of Islandsbanki to the Icelandic government, and it is now fully owned by the government. We do not see Islandsbanki as a strategic investment for the government. As such, we view this ownership as temporary and believe that the government will put the bank up for sale in the next two years.

With total assets of ISK1.1 trillion (€8.3 billion) as at end-September 2016, Islandsbanki is almost the same size as its domestic peers Arion and Landsbankinn, and Islandsbanki maintains a comparable market position in most business lines, with a rising market share in the corporate and small and midsize enterprise (SME) segment. The bank has a strong domestic market share (30%-40%) in most business lines, due in part to two key acquisitions: Byr, previously the fourth-largest bank, in 2011; and a private pension portfolio in 2012. Islandsbanki's ability to integrate acquired entities and its focus on improving their cost efficiency supports our view of the bank's management and strategy.

Like Arion and Landsbankinn, Islandsbanki has seen a rise in retail mortgage lending, which was historically been dominated by state-owned Housing Financing Fund (HFF). Mortgage lending formed 30% of total loans at end-September 2016, and Islandsbanki has a market share of 15% in mortgages in Iceland, somewhat below its commercial banking peers. In addition, Islandsbanki is also seeing an increase in its real estate and car financing businesses, as the tourism boom in Iceland takes hold.

The bank has diverse revenues from retail banking, including asset financing and credit cards; large corporate, wealth management, and 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--			
(%)	**2016***	**2015**	**2014**	**2013**	**2012**
Loan market share in country of domicile	N/A	N/A	22.4	20.0	19.9
Deposit market share in country of domicile	N/A	N/A	32.8	31.5	31.6
Total revenues from business line (mil. ISK)	42,813.0	57,318.0	57,469.0	61,763.0	57,374.0
Commercial banking/total revenues from business line	13.5	9.3	8.6	7.1	11.8
Retail banking/total revenues from business line	39.7	39.0	37.9	39.2	42.4
Commercial & retail banking/total revenues from business line	53.3	48.3	46.4	46.2	54.3
Trading and sales income/total revenues from business line	1.5	1.7	1.1	1.4	1.5
Brokerage/total revenues from business line	3.2	3.5	3.0	3.0	3.3
Asset management/total revenues from business line	4.4	5.5	4.8	4.4	4.7
Other revenues/total revenues from business line	37.6	41.0	44.7	45.0	36.1
Investment banking/total revenues from business line	1.5	1.7	1.1	1.4	1.5
Return on equity	8.6	10.5	12.4	14.7	17.4

*Data as of Sept. 30. ISK--Icelandic krona. N/A--Not applicable.

Capital and earnings: Capital at very strong levels, with stabilizing earnings

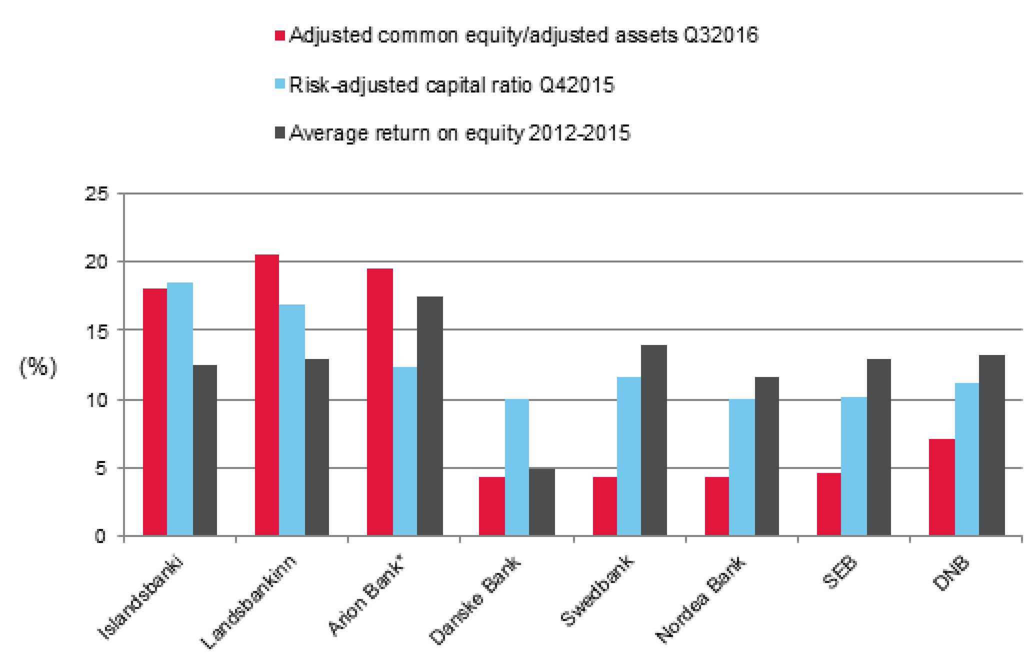
We assess the bank's capital and earnings as very strong, based on our projected RAC ratio of about 16%-17% over the next 18-24 months. Islandsbanki continues to have best-in-class capitalization among domestic peers, with a pro forma RAC ratio at 20.3% as of June 30, 2016. However, we anticipate that Islandsbanki will likely reduce capital levels in preparation for an eventual sale or IPO. In addition, we anticipate the bank will pay out normal annual dividend of 50% of net profits over the coming years.

At Sept. 30, 2016, the core tier 1 capital ratio and the total capital ratio were 27.8%, reflecting that the bank repaid the tier 2 subordinated loan of €138 million from the proceeds from the €500 million bond issuance in September 2016. The regulatory ratios can be compared with the regulatory capital requirement of approximately 19.1%, including an estimate of the pillar 2 requirement, and the bank itself targets at least 23% total capital. As such, while we expect the capital levels to decline due to an extraordinary dividend and anticipate some capital optimization--reducing equity and increasing hybrid capital--the payout will be restricted by the high capital requirements and buffers prescribed by the Icelandic regulator.

We note that the bank's leverage ratio, measured as adjusted common equity as a share of adjusted assets, was 18.1% at end-September 2016, and is considerably higher than Nordic peers' and most global commercial banks' (Chart 1). We do not anticipate the leverage ratio to fall materially below 15% given the high regulatory capital requirements and associated targets.

Chart 1

Islandsbanki Versus Domestic And Nordic Peers - Adjusted Common Equity/Adjusted Assets, Average Return On Equity, And Risk-Adjusted Capital



*Adjusted common equity/adjusted assets at Q2 2016.

We expect Islandsbanki's profits to stabilize over our two-year forecast horizon. As with its domestic peers, the bank's bottom line has been supported by revaluations of legacy assets acquired at a 47% discount. In addition, sales and revaluations of legacy private equity and real estate assets acquired during the portfolio restructuring process have boosted revenues. In addition, the bank had a gain of ISK6.2 billion from the sale of its stake in Visa Europe to Visa Inc in 2016.

We expect a lower share of extraordinary revenues from Islandsbanki going forward, with revenues stabilizing at ISK44 billion-ISK46 billion over the next two years. Improvements in fee and commission income should help offset margin pressure, as will a continued focus on cost efficiency. Islandsbanki and peers are still subject to the bank tax levy used to fund debt relief for Icelandic residential borrowers, which we expect will reduce profits by ISK2.8 billion in 2016, which amounts to about 1.5 percentage points of reduced return on equity for the bank.

Islandsbanki's earnings buffer, which measures the bank's ability to meet our normalized losses, exceeds 100 basis points (bps) in our forecast. However, this figure underestimates our expectations for actual returns given that the earnings buffer calculation assumes annual normalized losses of ISK7 billion-ISK8 billion, a level we expect the bank will outperform in 2016 and 2017 as the asset quality in Iceland improves.

Table 3

Islandsbanki hf Capital And Earnings

		--Year-ended Dec. 31--			
(%)	**2016***	**2015**	**2014**	**2013**	**2012**
Tier 1 capital ratio	27.8	28.3	26.5	25.1	22.0
S&P RAC ratio before diversification	N.M.	18.4	15.0	13.7	N.M.
S&P RAC ratio after diversification	N.M.	14.1	11.7	11.0	N.M.
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	68.7	62.7	63.5	66.7	69.1
Fee income/operating revenues	28.7	29.5	26.9	24.5	19.9
Market-sensitive income/operating revenues	(0.4)	8.5	3.8	10.6	2.7
Noninterest expenses/operating revenues	59.6	55.6	55.8	62.1	53.6
Preprovision operating income/average assets	1.8	2.0	2.1	1.9	2.7
Core earnings/average managed assets	1.2	1.2	1.4	0.7	0.2

*Data as of Sept. 30. RAC--Risk-adjusted capital. N.M.--Not meaningful.

Table 4

Islandsbanki hf Risk-Adjusted Capital Framework Data

(ISK 000s)	**Exposure***	**Basel II RWA**	**Average Basel II RW (%)**	**S&P Global Ratings' RWA**	**Average S&P Global Ratings' RW (%)**
Credit risk					
Government and central banks	225,587,720	2,492,350	1	76,957,022	34
Institutions	33,480,386	7,098,296	21	7,092,447	21
Corporate	375,852,514	374,353,621	100	489,729,598	130
Retail	340,365,740	198,372,614	58	283,462,525	83
Of which mortgage	197,596,143	93,928,807	48	106,701,917	54

Table 4

Islandsbanki hf Risk-Adjusted Capital Framework Data (cont.)					
Securitization§	0	0	0	0	0
Other assets	47,239,485	45,919,411	97	76,719,657	162
Total credit risk	1,022,525,846	628,236,291	61	933,961,249	91
Market risk					
Equity in the banking book†	4,964,150	7,314,994	147	49,431,599	996
Trading book market risk	--	12,667,434	--	19,001,152	--
Total market risk	--	19,982,429	--	68,432,751	--
Insurance risk					
Total insurance risk	--	--	--	0	--
Operational risk					
Total operational risk	--	76,495,054	--	89,533,186	--
(ISK 000s)		**Basel II RWA**		**S&P Global Ratings' RWA**	**% of S&P Global Ratings' RWA**
Diversification adjustments					
RWA before diversification	--	724,713,773		1,091,927,185	100
Total Diversification/Concentration Adjustments	--	--		312,161,223	29
RWA after diversification	--	724,713,773		1,404,088,409	129
(ISK 000s)		**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global Ratings' RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments	--	196,163,532	27.1	191,948,000	17.6
Capital ratio after adjustments‡	--	196,163,532	27.1	191,948,000	13.7

*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Exposure and S&P Global Ratings' 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 June 30, 2016, S&P Global Ratings.

Risk position: Risk profile is highly correlated to systemic risks in Iceland

In our view, Islandsbanki's adequate risk position reflects our expectation that the bank's risk position will remain highly correlated to the Iceland economy. In our view, Islandsbanki has broad exposure to the retail and commercial banking market and a high share of real estate and fishing-vessel quota collateral, through its exposures to mortgages (30% of total loans), real estate (15%), and seafood (12%).

The bank continues to reduce its nonperforming assets (NPAs) alongside improvements in the Icelandic economy and the resolution of long-term legacy issues. By our measures, Islandsbanki's gross nonperforming assets (including nonaccrual loans, performing loans over 90 days past due, and repossessed assets) amount to 5.1% of customer loans and repossessed assets at end-September 2016 (versus 5.9% at end-2015). This figure is far below the 17.9% at year-end 2013, as many restructured loans are now performing. Net of loss reserves, NPAs stood at 3.2% at end-September 2016, in line with its closest peers, Arion (2.0%) and Landsbankinn (3.0%). We note that Islandsbanki has a larger share of repossessed assets (ISK8.6 billion, or 24% of gross NPLs), which explains the relatively lower share of NPL coverage at 40% compared with 46%-64% for peers. The bank's minor exposure to the offshore sector in Norway led to a slight increase in past due loans in the first nine months of 2016.

Loan loss provisions have been volatile, but we expect them to remain modest in the near term as we see improvement in the quality of loans. The bank recorded 14 bps of additional loss provisions during the first three quarters of 2016, markedly lower than 48 bps in 2015, and we expect losses to remain around 20 bps through 2017.

Islandsbanki's loan book is geographically focused on Iceland, primarily into retail mortgages, real estate, seafood, commerce and services, and industrials and transportation sectors. The bank has very small (3%) lending outside Iceland, which includes exposure toward the seafood industry in the North Atlantic region, and modest exposure to Norwegian offshore companies. We expect Islandsbanki to increase its retail mortgage portfolio by gaining market from the winding down HFF.

We believe that further lifting of the capital controls will have a minimal impact on the bank's asset quality. We expect the authorities will duly manage the process and that it will not result in significant volatility of the krona that could affect corporate and individual borrowers' creditworthiness. Furthermore, the bank's new lending in foreign currency is restricted to corporations with earnings abroad and well aligned with its foreign funding.

Chart 2

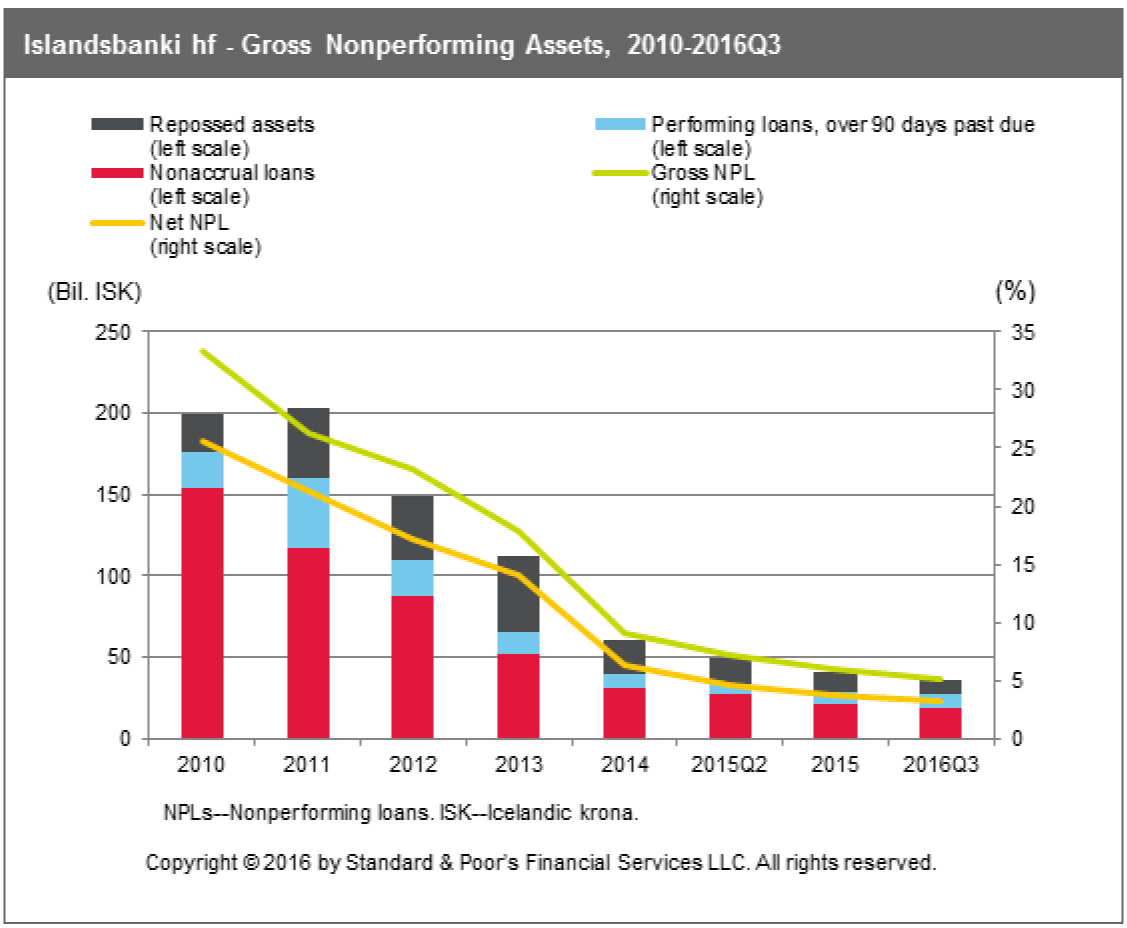


Table 5

Islandsbanki hf Risk Position					
		--Year-ended Dec. 31--			
(%)	**2016***	**2015**	**2014**	**2013**	**2012**
Growth in customer loans	3.3	4.1	12.3	(3.7)	(0.2)
Total diversification adjustment / S&P RWA before diversification	N.M.	30.7	27.9	24.3	N.M.
Total managed assets/adjusted common equity (x)	5.5	5.5	5.2	5.3	5.7
New loan loss provisions/average customer loans	0.1	0.5	0.3	1.3	3.3
Net charge-offs/average customer loans	0.4	0.9	1.4	3.0	1.7
Gross nonperforming assets/customer loans + other real estate owned	5.1	5.9	9.0	17.9	23.2
Loan loss reserves/gross nonperforming assets	39.9	38.6	32.4	24.8	31.5

*Data as of Sept. 30. RWA--Risk-weighted assets. N.M.--Not meaningful.

Funding and liquidity: Strong liquidity, despite recent deposit outflows

We consider Islandsbanki's funding to be average despite its strong liquidity position. The balance sheet has been well prepared for the relaxation of capital controls given an exceptional funding and liquidity buffer in Icelandic krona and foreign currencies. Although Islandsbanki and its peers have strong liquidity positions and demonstrate relatively strong funding metrics, we expect this will remain a neutral factor for the ratings given the small balance of maturing debt due to the relatively short history of wholesale funding for the new bank.

We consider the bank's funding to be average, given its relatively strong funding metrics and lower loan-to-deposit ratio than domestic peers'. By our measures, the stable funding ratio was at 126.8% at end-September 2016, and the ratio of broad liquid assets to short-term wholesale funding was 6.9x, which is substantially above European peers. Customer deposits formed 70% of the funding base and the rest is wholesale funding, primarily consisting of senior unsecured bonds in foreign currencies and covered bonds in ISK.

On Oct. 11, 2016, private investors were authorized to invest up to ISK30 million (approximately €0.25 million) abroad, but we believe that movements have been muted for Icelandic banks' deposits. While we could see a larger impact when the limit is lifted to ISK100 million (€0.82 million) in January 2017, available yields are much higher in Iceland than abroad.

Islandsbanki's recent funding issuances demonstrate its ability to find investors in Scandinavia and abroad. The bank raised NOK500 million (ISK7.7 billion) in October 2015 and €500 million in September 2016, in addition to funding in the first half of 2016 through covered bonds and senior unsecured issuances of USD35 million (ISK4.3 billion) and €125 million (ISK 17.6 billion), respectively. We note the bank's recent €500 million senior debt issuance was used in part for early repayment of a Glitnir-owned €138 million tier 2 instrument, which further reduced ties with its former owner.

Table 6

Islandsbanki hf Funding And Liquidity					
		--Year-ended Dec. 31--			
(%)	**2016***	**2015**	**2014**	**2013**	**2012**
Core deposits/funding base	70.0	74.8	78.5	76.5	77.1

Table 6

Islandsbanki hf Funding And Liquidity (cont.)					
		--Year-ended Dec. 31--			
(%)	2016*	2015	2014	2013	2012
Customer loans (net)/customer deposits	123.7	112.2	119.9	113.4	118.4
Long term funding ratio	95.3	93.2	94.1	92.2	92.0
Stable funding ratio	126.8	128.5	116.6	114.7	110.4
Short-term wholesale funding/funding base	5.9	8.5	7.5	9.8	9.9
Broad liquid assets/short-term wholesale funding (x)	7.0	4.8	4.4	3.5	3.2
Net broad liquid assets/short-term customer deposits	54.0	49.6	34.4	35.4	31.4
Short-term wholesale funding/total wholesale funding	19.8	33.9	34.9	41.8	43.3
Narrow liquid assets/3-month wholesale funding (x)	10.2	9.4	7.3	4.8	3.7

*Data as of Sept. 30.

External support: Government support for Icelandic banks is uncertain

We do not consider Islandsbanki to be a strategic government-related entity for Iceland and see the 'government's ownership as temporary. Nevertheless, we consider Islandsbanki to have high systemic importance in Iceland. We do not add any notches of uplift to the SACP, however, because future extraordinary government support is uncertain. This reflects our view of the Icelandic government's track record of not supporting senior creditors and its still-limited--but improved--capacity to support the country's new, smaller banking system in the event of severe financial stress.

At present, we do not regard the bank resolution framework as effective. As such, for our ratings on Icelandic banks, we do not consider additional loss-absorbing capacity (see "Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity," published April 27, 2015). We regard the current framework as open ended but, in our view, the authorities' method of dealing with failing banks so far indicates a tendency to safeguard depositors rather than senior unsecured creditors. Over the next two to three years, we expect Iceland to implement a framework similar to the EU's Banking Recovery And Resolution Directive and, with it, bail-in powers that could lead us to change our view.

Additional rating factors: A one-notch deduction for uncertainty regarding ownership change

Islandsbanki's acquisition by the Icelandic government is the result of an ownership transfer from Glitnir as part of the composition agreements. We believe that the bank will be under pressure to optimize its capital base, given its very high leverage ratio versus that of its international peers, and to have more attractive returns on equity for potential investors. Given this uncertainty, we apply one-notch negative adjustment to Islandsbanki's 'bbb+' SACP, resulting in our 'BBB' long-term credit rating.

Related Criteria And Research

Related Criteria

- General Criteria: Group Rating Methodology - November 19, 2013
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions - January 29, 2015
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And

Assumptions - July 17, 2013

- Criteria - Financial Institutions - Banks: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework - June 22, 2012
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions - November 09, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions - November 09, 2011
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions - December 06, 2010
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks - March 23, 2004
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- Iceland-Based Islandsbanki Upgraded To 'BBB/A-2' On Improved Operating Conditions For Icelandic Banks; Outlook Positive – October 25, 2016
- Various Positive Rating Actions On Four Icelandic Banks On Receding Economic Risks and Improved Access To Funding - October 25, 2016
- Nordic Banks' Capital Growth Tapers Off - August 02, 2016
- The Future Of Banking: Nordic Banks Looking Svelte In The Fintech Race - June 14, 2016
- Iceland Ratings Affirmed At 'BBB+/A-2'; Outlook Stable - July 15, 2016

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 30, 2016)

Islandsbanki hf	
Counterparty Credit Rating	BBB/Positive/A-2
Senior Unsecured	BBB
Short-Term Debt	A-2
Counterparty Credit Ratings History	
25-Oct-2016	BBB/Positive/A-2
19-Jan-2016	BBB-/Positive/A-3
21-Jul-2015	BBB-/Stable/A-3
14-Oct-2014	BB+/Positive/B
30-Apr-2014	BB+/Stable/B

Ratings Detail (As Of November 30, 2016) (cont.)	
Sovereign Rating	
Iceland (Republic of)	BBB+/Stable/A-2

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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