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## Iceland's Commercial Banks Upgraded To 'BBB-/A-3' On Receding Economic Risks; Two Outlooks Stable, One Positive

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OVERVIEW

- The Icelandic authorities and the winding-up estates of failed banks have presented comprehensive proposals toward the eventual removal of capital controls.
- We believe these measures will likely facilitate a smooth transition from capital controls, reduce external risk supporting domestic credit quality, boost government revenues, and improve Icelandic banks' access to international financing.
- As a result, we consider that economic risk for the Icelandic banking system has reduced.
- We are therefore raising our ratings on Arion Bank, Islandsbanki, and Landsbankinn to 'BBB-/A-3' from 'BB+/B'.
- The outlooks for Arion and Islandsbanki are stable. We maintain our positive outlook on Landsbankinn given the potential for a further upgrade if the bank retains its relative capital advantage.

STOCKHOLM (Standard & Poor's) July 21, 2015--Standard & Poor's Ratings Services said today that it had raised its long- and short-term counterparty credit ratings on Iceland-based Arion Bank, Islandsbanki hf, and Landsbankinn hf. to 'BBB-/A-3' from 'BB+/B'.

The outlooks on Arion and Islandsbanki are stable, while the outlook on Landsbankinn remains positive.

Our upgrades of the three banks reflect our view of the improving operating conditions for Iceland's commercial banks.

The rating actions follow our review of the banking system, which incorporates our opinion that economic risks have reduced, given our expectation of lower credit losses and greater stability in the future. As a result, under our banking industry country risk methodology, we have reassigned Iceland to group 6 from group 7 (on a scale of 1 to 10, with group 1 indicating the lowest-risk banking systems). Moreover, we now anticipate a limited future impact on banks' credit profiles from the financial crisis that started in 2008. We also considered the upgrade of Iceland on July 17, 2015, as a sign of improvement and normalization in the banking sector (see "Iceland Ratings Raised To 'BBB/A-2' On Proposals Toward Lifting Capital Controls; Outlook Stable," published on RatingsDirect).

We expect new loan loss provisions in the banking system to total 15 basis points (bps) to 20 bps of outstanding loans, excluding loan revaluations, over the coming two years. This represents an improvement from 22 bps for 2014. Similarly, we expect a continued decline in nonperforming loans as restructured loans reduce and legacy loans are written off. That said, credit risk metrics will likely remain volatile as legacy cases make their way through the legal system and restructured loans are reclassified as performing loans. We do not expect any significant additional impact on the banks from revaluations of loans taken over from the defunct banks in 2008, although the first quarter saw some positive adjustments to corporate loan balances.

In our view, the proposals of the failed banks' winding-up estates and the government, presented in June, would likely address the country's sizable balance of payments overhang without materially hampering the value of the Icelandic krona or the country's financial stability. If the current proposals are implemented, which is our base case, we believe this would reduce external risks associated with the lifting of capital controls, which in our view is positive for banks, households, and companies. We also expect that nonsovereign Icelandic entities will be able to tap foreign credit markets more readily, thereby relieving potential future pressure from servicing the nonsovereign external debt.

In addition, we consider that parts of the proposals--if implemented--will have a direct and positive impact on banks. These include defined measures to replace the winding-up estates' deposit funding with longer-term funding, and agreements to refinance existing capital instruments. One exception is that Islandsbanki is expected to pay an extraordinary dividend to Glitnir Bank's estate. We still view Islandsbanki's capital as strong, however. Even though we do not expect this to happen, there are some risks that the implementation of the proposals is delayed. For instance, some creditors of the failed banks or nonresident holders of offshore krona accounts could mount a legal challenge, potentially prolonging the capital controls.

We expect Iceland to post robust growth rates averaging close to 3% through to

year-end 2018, with unemployment reducing toward 3.5%, which should support banks' asset quality. However, we are mindful that Iceland remains a concentrated economy exposed to three key sectors (fishing, tourism, and aluminum production). Iceland's monetary policy has also historically not been effective at keeping inflation near the central bank target. In our view, this somewhat limits the opportunities for risk diversification in the banking sector.

That said, nominal house prices in Iceland have increased by an average of 7.5% over the past three years. We expect to see similar growth in 2015, underpinned by the expanding economy, competition among banks to acquire mortgage loans from the state-owned housing finance company, and, more recently, record high wage increases. Rising house prices should also reduce banks' losses if they need to foreclose on mortgaged property.

Our revised view of economic risks in Iceland is positive for Icelandic banks' solvency as measured by our risk-adjusted capital (RAC) ratio. This is because we measure capital relative to risks linked to where banks operate, using country-based risk weights that are lower for more stable economies. While we see the less risky operating environment in Iceland benefiting all banks, we consider that the effect will be greatest on Landsbankinn. This is partly because Landsbankinn is not initially expected to pay extraordinary dividends to its majority owner, the Icelandic government. As such, we now believe that the bank has the potential to maintain very strong capital, with the RAC ratio exceeding 15% over the next 18-24 months.

Although, in our view, the Icelandic banks we rate have strong liquidity positions and demonstrate relatively strong funding metrics, we expect this to remain neutral to the ratings as long as there is uncertainty on potential deposit outflows associated with the eventual removal of capital controls. Furthermore, banks' access to wholesale markets and international financing remains limited at this stage, although it is improving, as shown by Arion's recent €300 million issue. These factors weigh on our assessment of the banks' longer-term funding profiles, thereby constraining ratings upside based on funding and liquidity.

#### ECONOMIC RISK TREND IN ICELAND

In our view, the trend for economic risks in Iceland is stable. This is because we currently see no potential for further improvement before the suggested proposals to reduce the balance-of-payments overhang have been implemented. Furthermore, there are some risks that could delay the gradual lifting of capital controls. We expect cross-border trade and flows to increasingly underpin economic growth and reduce administrative risks that could dampen activity.

We might see the economic risk trend as positive if the proposals are implemented, therefore reducing pressure on the exchange rate, facilitating removal of the controls, and leading to external risk reducing further. This scenario could, in our view, strengthen the resilience of the Icelandic economy. The eventual reduction of household and corporate debt relative to

GDP could also have a positive impact on our view of economic risks in Iceland.

However, we believe the likely wage hikes (that could exceed 20% over next three years) could contribute to a real effective exchange rate appreciation, reduce the country's competitiveness, and contribute to higher inflation. The faster-than-anticipated decline in current account surpluses that could result could complicate the task of liberalizing cross-border financial flows. A significant deterioration of external conditions could also hamper Iceland's recovery.

#### GOVERNMENT SUPPORT AND ADDITIONAL LOSS ABSORBING CAPACITY

In our view, the likelihood of government support for Icelandic banks remains "uncertain." We base this assessment on the authorities' poor track record and, in our view, still limited albeit improved capacity to support the now smaller banking system in a severe stress scenario.

At present, we do not regard the bank resolution framework as effective and, 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 believe the current framework to be open ended but, in our view, the authorities' method of dealing with ailing banks so far indicates a tendency to safeguard depositors rather than senior unsecured creditors. 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 cause us to change our view. This is, however, contingent on whether the authorities establish measures and indicate willingness to protect senior bondholders and provide banks with the necessary funding and liquidity during a resolution, a period typically with restricted market access.

The following paragraphs provide a more detailed rationale for our rating actions on each bank.

#### ARION BANK

The ratings on Arion reflect its adequate business position, strong capital and earnings, adequate risk position, average funding, and strong liquidity, as defined in our criteria.

The contribution of Kaupthing Bank's winding-up estate, which owns 87% of Arion, has only a slightly positive effect on our assessment of Arion's funding and liquidity, due to the long-dated maturities on about Icelandic krona (ISK) 99 billion (about €672 million) of Arion's liabilities. This contribution includes:

- Extending the maturity of foreign currency denominated liabilities owed by the Kaupthing estate, amounting to ISK43.8 billion, by swapping it for a long-term Euro Medium-Term Note (EMTN) to be issued by Arion and held by the Kaupthing estate; and
- Purchasing, at par, a long-term foreign currency loan to Arion from the Central Bank of Iceland (ISK55.1 billion outstanding as of March 31,

2015), with an offer to finance the transaction via notes issued under Arion's EMTN program, on market terms with a minimum tenor of seven years. Both notes we understand would be pledged in favor of a secured note to be issued by the estate and handed over to the Icelandic government.

The stable outlook reflects our view that Arion's stand-alone credit profile (SACP) is likely to strengthen alongside improvements in Iceland's economy. We expect the bank to maintain its strong capital position, with the RAC ratio increasing to 11%-11.5% within the next 18-24 months from 10.6% at year-end 2014 (pro forma; including the lower risk weights for Icelandic credit exposures). We think the main contributor to this improvement will be the bank's partial execution of its plan to divest legacy assets (equity exposures that it took over as a part of debt restructurings). We expect that restructuring of the loan portfolio will be completed soon and further impairments will be limited.

A positive rating action would most likely follow an improvement in economic conditions in Iceland, such as illustrated by stronger resilience following clarity on the capital controls, or a sustained, material reduction in corporate and household debt. We consider any improvement in the bank-specific factors to be remote at present.

A negative rating action could be triggered by a substantial increase in provisions or the securities portfolio, either of which could result in the RAC ratio falling below 10%.

#### ISLANDSBANKI

The ratings on Islandsbanki reflect its "adequate" business position, "strong" capital and earnings, "adequate" risk position, "average" funding, and "strong" liquidity.

We assume that the agreement between Glitnir and the Icelandic government for Islandsbanki to pay extraordinary dividends to its majority shareholder, the estate of Glitnir, will more than offset the impact of lower risk weights on Icelandic exposures resulting from our view of reduced economic risk in Iceland. However, we expect Islandsbanki to maintain strong capital.

The stable outlook reflects our projection that the RAC ratio will be at about 13% within the next 18-24 months compared with the pro forma 2014 level of 17.2%.

The extraordinary dividend of ISK38 billion and an additional ISK17 billion in dividends paid in foreign currency reduces our RAC ratio forecast by about four percentage points. The agreement requires Glitnir's estate to reinvest its share of the ISK17 billion into capital instruments issued by Islandsbanki, but we are not yet certain about these instruments' capacity to absorb losses while the bank is a going concern. Furthermore, the agreement stipulates that Glitnir's estate must make "commercially reasonable efforts" to monetize its 95% share of Islandsbanki by the end of 2016. We do not expect

the uncertainty of the bank's future ownership to weaken its SACP, but it could affect the ratings over time.

We could take a positive rating action if Islandsbanki's RAC ratio were to strengthen beyond 15%, trends in the Icelandic banking sector improve further, or if the bank were acquired by a higher-rated entity that regarded it as strategic or core to its operations.

We could take a negative rating action if loan asset quality deteriorated, requiring significant additional provisioning; or if valuation risk unexpectedly arose in the legacy loan book. In addition, we could lower our rating on Islandsbanki if the potential new owner is of lower credit quality than the bank.

#### LANDSBANKINN

The ratings on Landsbankinn reflect its adequate business position, strong capital and earnings, adequate risk position, and average funding profile. We consider that the bank's liquidity position has improved to strong from adequate, given its ample buffers in both local and foreign currency.

We expect that Landsbankinn will maintain its strong balance sheet. Given the bank's 98% government ownership, we do not expect it to make any extraordinary dividend payments as part of the agreements with the winding-up estate. However, we note that following Islandsbanki's extraordinary dividend payout, Landsbankinn's capital and leverage position will be considerably higher than peers. We believe that Landsbankinn could consider an extraordinary dividend to better align its capital levels to peers as the government contemplates options to reduce up to 28% of its 98% stake. Consequently, we expect the bank to maintain a RAC ratio somewhat lower than the pro forma 15.6% at year-end 2014, with relatively stable nominal equity levels and credit growth offsetting further reductions in the large equity positions in the banking book.

The positive outlook reflects that we could raise our long-term rating on Landsbankinn if its capital metrics improve more than we anticipate and the RAC ratio stays firmly above 15%. In addition, we continue to see improvements in the Icelandic banking sector and anticipate that Landsbankinn will keep narrowing the distance to its peers with respect to asset quality metrics over the next two years.

We could revise the outlook to stable or take a negative rating action if asset quality worsened, requiring significant additional provisions; or if valuation risk arose unexpectedly in the legacy loan book and securities portfolio. We could also change our view of the bank's capital and earnings if Landsbankinn were to pay out an extraordinary dividend, although such a large reduction is unlikely given regulatory capital constraints.

#### RELATED CRITERIA AND RESEARCH

Related Criteria

- Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- 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
- Methodology For Mapping Short- And Long-Term Issuer Credit Ratings For Banks, May 4, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Iceland Ratings Raised To 'BBB/A-2' On Proposals Toward Lifting Capital Controls; Outlook Stable, July 17, 2015
- Banking Industry Country Risk Assessment Update: June 2015, June 12, 2015
- Banking Industry Country Risk Assessment: Iceland, Dec. 10, 2014

BICRA SCORE SNAPSHOT\*

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

RATINGS LIST

Upgraded

*Iceland's Commercial Banks Upgraded To 'BBB-/A-3' On Receding Economic Risks; Two Outlooks Stable, One Positive*

	To	From
Arion Bank		
Counterparty Credit Rating	BBB-/Stable/A-3	BB+/Positive/B
Islandsbanki hf		
Counterparty Credit Rating	BBB-/Stable/A-3	BB+/Positive/B
Landsbankinn hf.		
Counterparty Credit Rating	BBB-/Positive/A-3	BB+/Positive/B

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

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