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Research Update:

Iceland-Based Islandsbanki Upgraded To 'BBB+' On Improved Economy And Capital; Outlook Stable

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Overview

- Strong economic growth in Iceland continues, with improving economic resilience and falling private sector leverage, partly offset by concerns for increasing economic imbalances.
- As such, our view of the Icelandic banking sector has improved, as has our expectation for Icelandic bank Islandsbanki's long-term risk-adjusted capital position.
- As a result, we are raising the long-term rating on Islandsbanki to 'BBB+' from 'BBB' and affirming the 'A-2' short-term rating.
- The stable outlook reflects our expectation that the Icelandic economy will remain resilient and that Islandsbanki will maintain very strong capital levels even while it prepares for an eventual sale in the next few years.

Rating Action

On Oct. 25, 2017, S&P Global Ratings raised its long-term rating on Iceland's Islandsbanki hf to 'BBB+' from 'BBB' and affirmed its 'A-2' short-term rating. The outlook is stable.

Rationale

The upgrade reflects our improved view of the economic risks in the Icelandic banking sector, as the economic environment remains supportive following the release of capital controls earlier this year, while private sector credit to GDP remains on a negative trend (for more details, see "Positive Rating Actions Taken On Four Icelandic Lenders On Improving Economic Conditions," published on Oct. 25, 2017, on RatingsDirect). This translates into a lower capital charge for domestic exposures as well as an improvement in the bank's anchor to 'bbb' from 'bbb-'.

We see continued strong development in the Icelandic economy, with GDP growth expected at 4% for 2017 and a flourishing tourism sector. The sovereign's financial position continues to improve due to a strong economic performance and current account surpluses. At the same time, private sector leverage continues to decrease. However, the positive impact on the banking sector is limited, because we also see increasing risks for overheating and rapidly growing house prices. House prices have outgrown household income in the last year, creating concerns for affordability and economic imbalances.

The rating action also reflects our view that the eventual sale of Islandsbanki will not result in a reduction in capital beyond our current expectations. While Islandsbanki is fully government owned, we anticipate that the bank is preparing for an eventual sale. However, given our view that the extraordinary elections this autumn will postpone the eventual sale of Arion Bank to the spring of 2018, the sale of Islandsbanki is also likely to be delayed further until late 2018 or 2019. As such, we expect the bank to make gradual steps to reduce equity and issue capital instruments, a process that is unlikely to materially affect our view of the bank's ability to absorb losses given the improved domestic economy.

We expect Islandsbanki to pay further extraordinary dividends in order to reduce its currently very high capital base. We anticipate that the bank will begin to issue capital instruments in 2018 to offset some of the reduction in common equity and to optimize its capital base. As such, we anticipate that share capital will, to some extent, be replaced by capital instrument issuances, which we include in our capital forecast through 2019, allowing the pro forma mid-year risk-adjusted capital (RAC) ratio of 22.5% to stay above 16%. This view is supported by our expectation that Islandsbanki could reduce regulatory Common Equity Tier 1 (CET1) ratios to as low as 16%-17% (from 23.3% at June 2017), which we include in our projections through 2019.

Given Islandsbanki's domestic concentration to a market with limited diversification when compared globally, we think that the bank's capital and risk positions are well reflected at the 'BBB+' level, especially based on our current projections of reduced equity capital.

Outlook

The stable outlook on Islandsbanki reflects our expectation that the bank's RAC ratio will remain sustainably above 16%, even while the bank prepares for an eventual sale over the next two years, and optimizes its capital base by paying extraordinary dividends and issuing capital instruments. We view the bank's asset quality as in line with the risks in the Icelandic market and commensurate with domestic peers'. The stable outlook further balances our view of strong economic development in Iceland with the relatively concentrated and volatile nature of the Icelandic economy and increasing economic imbalances.

We could take a negative rating action if Islandsbanki's RAC ratio declined more than expected, if there are unforeseen developments in connection with an eventual change in ownership, or if loan asset quality deteriorated materially, requiring significant, unexpected additional provisioning. In addition, we could lower our ratings if we saw signs of weakening economic and regulatory stability in Iceland.

We currently consider a positive rating action as unlikely because we see limited room for improvements in the Icelandic banking market and expect the outstanding capital strength of the bank to reduce materially in the next few years.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	BBB+/Stable/A-2	BBB/Positive/A-2
SACP	bbb+	bbb+
Anchor	bbb	bbb-
Business Position	Adequate (0)	Adequate (0)
Capital and Earnings	Very Strong (+2)	Very Strong (+2)
Risk Position	Moderate (-1)	Adequate (0)
Funding and Liquidity	Average and Strong (0)	Average and Strong (0)
Support	(0)	(0)
ALAC Support	(0)	(0)
GRE Support	(0)	(0)
Group Support	(0)	(0)
Sovereign Support	(0)	(0)
Additional Factors	(0)	(-1)

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
- 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

- Positive Rating Actions Taken On Four Icelandic Lenders On Improving Economic Conditions, Oct. 25, 2017

Ratings List

Upgraded; Outlook Action; Rating Affirmed

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

Upgraded

	To	From
Islandsbanki hf		
Senior Unsecured	BBB+	BBB

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