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Research Update:

Icelandic Bank Islandsbanki Affirmed At 'BBB-/A-3' After Change To Agreement With Glitnir; Outlook Still Stable

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Table Of Contents

Overview

Rating Action

Rationale

Outlook

Ratings Score Snapshot

Related Criteria And Research

Ratings List

Research Update:

Icelandic Bank Islandsbanki Affirmed At 'BBB-/A-3' After Change To Agreement With Glitnir; Outlook Still Stable

Overview

- Islandsbanki recently announced amendments to its original agreement with Glitnir Bank.
- As part of the changes, Glitnir will relinquish to the government of Iceland all of its shares in ISB Holding, which owns 95% of shares in Islandsbanki.
- We are affirming our 'BBB-/A-3' counterparty credit ratings on Islandsbanki.
- The outlook remains stable.

Rating Action

On Oct. 28, 2015, Standard & Poor's Ratings Services affirmed its 'BBB-' long-term and 'A-3' short-term counterparty credit ratings on Iceland-based bank Islandsbanki hf. The outlook remains stable.

Rationale

Islandsbanki recently announced amendments to its original agreement with Glitnir Bank. As part of the changes, Glitnir will relinquish to the government of Iceland all of its shares in ISB Holding ehf., which owns 95% of shares in Islandsbanki. With this proposed change, Islandsbanki will no longer pay the extraordinary dividends to Glitnir as was initially planned in the original proposed agreement between Glitnir and the Icelandic Central Bank announced in June 2015. As part of the revised proposal, Glitnir will purchase a euro-denominated subordinated debt instrument (Icelandic krona [ISK] 20 billion [about €138 million] on Islandsbanki's balance sheet as of June 30, 2015) from the central bank at face value, plus payment for accrued interest.

Although Islandsbanki will not pay dividends to Glitnir under the new agreement, we see the government's ownership as accommodating Glitnir's owners' desire to simplify the agreement and allow them to extract capital from Iceland by the end of the year. As such, we do not see Islandsbanki as a strategic investment for the government and believe that the bank will be up for sale from the government of Iceland within two years. We believe that it is likely that capital levels will be reduced in preparation for an eventual sale and, as such, we project the risk-adjusted capital (RAC) ratio will fall to 12%-13% by the end of 2017, down from a pro forma midyear 2015 RAC ratio of

17.3%. The subordinated instrument acquired by Glitnir was not included in our capital assessment and does not affect our capital metrics.

The amended proposal also refers to changes to the original agreement with respect to Glitnir's estate's deposits held by Islandsbanki. As part of the original agreement with Glitnir, the estate's deposits in foreign currency were to be replaced by a minimum seven-year bond issued under the bank's euro medium-term note program. The new agreement only refers to a "special agreement" between Glitnir and Islandsbanki for a bond issue to replace the foreign currency deposits. We still expect the foreign currency deposits to be replaced by a longer-term bond.

Moreover, although not mentioned in the new agreement, we now believe that it is probable that the majority of the Glitnir estate's ISK deposits (estimated at ISK30 billion) will be withdrawn, reducing liquid assets, rather than replaced by a 10-year bond as in previous communication from the bank.

In addition to Glitnir's deposits, we anticipate that the bank could lose a large share of its ISK23 billion financial institutions deposits (as reported in June 2015) as part of the central bank's offshore ISK auction during the fall of 2015 or in early 2016. The reduction in financial institutions deposits has no impact on stable funding ratios, given that we consider this funding to be short term in nature.

The pro forma funding and liquidity metrics remain consistent with our existing assessment of "average" funding and "strong" liquidity, as our criteria define these terms. In total, the anticipated changes to deposits and reduction in the subordinated debt instrument would reduce the actual stable funding ratio to 113%, from 117% on June 15, 2015, indicating the strength of the existing funding structure. Applying the same stress on liquidity metrics, the ratio of broad liquid assets to short-term wholesale funding would improve to 5.2x (4.1x on June 30, 2015), thanks to the reduction in short-term financial institution deposits.

Outlook

The stable outlook on Islandsbanki reflects our projection that the RAC ratio will likely be at about 12.5%-13.0% by the end of 2017, given the government's likely attempts to complete a sale of the bank while extracting some of the capital currently above regulatory limits. We do not see the government's ownership as strategic and believe that Islandsbanki will be up for sale from the government of Iceland within two years, at which time we believe that capital levels will be reduced to make the bank more attractive to a potential buyer.

Our stable outlook also reflects our assumption that Islandsbanki will retain strong capital and liquidity buffers, even after expected deposit outflows owing to the relaxation of Iceland's capital controls over the coming months. We do not expect the uncertainty of the bank's future ownership to weaken its

stand-alone credit profile, but it could affect the ratings over time.

We could take a positive rating action if we anticipated that Islandsbanki's RAC ratio would remain above 15%, trends in the Icelandic banking sector improve further, or if the bank were acquired by a higher-rated entity with expectations of strong strategic interest and integration.

We could take a negative rating action if loan asset quality deteriorated materially, requiring significant unexpected additional provisioning. In addition, we could lower our rating on Islandsbanki if the potential new owner is of lower credit quality than the bank.

Ratings Score Snapshot

Issuer Credit Rating	BBB-/Stable/A-3
GCP	bbb-
Anchor	bb+
Business Position	Adequate (0)
Capital And Earnings	Strong (+1)
Risk Position	Adequate (0)
Funding	Average (0)
Liquidity	Strong (0)
Support	(0)
ALAC* Support	(0)
GRE Support	(0)
Group Support	(0)
Sovereign Support	(0)
Additional Factors	(0)

*ALAC--Additional loss-absorbing capacity.

Related Criteria And Research

Related Criteria

- 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's Commercial Banks Upgraded To 'BBB-/A-3' On Receding Economic Risks; Two Outlooks Stable, One Positive, July 21, 2015
- Banking Industry Country Risk Assessment: Iceland, Dec. 10 2014.
- Outlooks For Iceland's Top 3 Banks Revised To Positive On Our More Favorable View Of The Economy, Oct. 14, 2014
- Iceland-Based Landsbankinn Assigned 'BB+/B' Ratings; Outlook Stable, Jan. 20, 2014

Ratings List

Ratings Affirmed

Islandsbanki hf

Counterparty Credit Rating
Senior Unsecured

BBB-/Stable/A-3
BBB-

Additional Contact:

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