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Research Update:

Iceland-Based Landsbankinn Assigned 'BB+/B' Ratings; Outlook Stable

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Research Update:

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Overview

- Landsbankinn hf. is a commercial bank in Iceland with a market-leading position in corporate and retail business lines.
- In our view, the bank operates with significant liquidity and capital buffers and low leverage in the difficult economic environment.
- We are assigning our 'BB+/B' ratings to Landsbankinn.
- The stable outlook reflects our expectation that Landsbankinn's capital will continue to strengthen and that it will restructure a significant amount of legacy bonds due in 2014-2018.

Rating Action

On Jan. 20, 2014, Standard & Poor's Ratings Services assigned its 'BB+' long-term and 'B' short-term counterparty credit ratings to Iceland-based Landsbankinn hf. The outlook is stable.

Rationale

The ratings reflect our 'bb' anchor for banks operating in Iceland and our view of Landsbankinn's "adequate" business position, "strong" capital and earnings, "adequate" risk position, "average" funding, and "adequate" liquidity, as our criteria define these terms. The stand-alone credit profile (SACP) is at 'bb+'.

Landsbankinn was created in October 2008 from the domestic operations of the now defunct Landsbanki Íslands hf. (LBI) group. We consider Landsbankinn's business position "adequate" because of its strong domestic market share (30%-40%) in primary business lines (corporate and retail banking, asset management, and corporate finance) and growing presence in retail mortgage lending, which is presently dominated by state-owned Housing Financing Fund Ibudalanasjodur. In our view, Landsbankinn maintains a slight advantage in Iceland's small market, despite stiff competition from Arion Bank and Islandsbanki. However, it is relatively small, with total assets of Icelandic krona (ISK) 1.2 trillion (about €7 billion) in September 2013, which limits its diversification in an international context.

However, despite its size, Landsbankinn's revenue base is rather broad. Approximately 60% of its revenues come from net interest income, split evenly between corporate and retail customers. The remainder comes from diverse fee-income streams, market-related activities (including asset management), and its treasury units.

In our view, Landsbankinn has been well managed since its creation in 2008, demonstrating superior operating efficiency and a reduction of nonperforming loans. The bank also operates with significant liquidity and capital buffers and low leverage in the difficult economic environment. We view positively management's proactive efforts to restructure two bonds, issued in 2010 and 2013 to LBI's resolution estate as part of the transfer of assets to Landsbankinn. These LBI bonds totaled about ISK240 billion at year-end 2013, following a prepayment of ISK50 billion in December.

Capital and earnings are "strong" because we project our risk-adjusted capital (RAC) ratio for Landsbankinn to remain below 15% at year-end 2015, after 13.1% at year-end 2012. Given the relatively high risk weights for Icelandic exposures, this strong RAC ratio understates the bank's leverage position. Our leverage ratio for Landsbankinn (adjusted common equity to adjusted assets) was higher than 20% in September 2013. This is one of the best leverage ratios among global commercial banks we rate, whose ratios are between 3% and 10% in most markets. We expect the bank to pay dividends to maintain its regulatory capital ratios above 20%, which supports our forecasts. The Tier 1 ratio was 26.7% on Sept. 30, 2013.

We anticipate a significant reduction of Landsbankinn's profitability over our two-year forecast horizon. The primary reason is that, since its inception, the bank's profits have been boosted by improvements in the valuations of corporate loan assets acquired at a deep discount from LBI. By contract, 85% of the cumulative value improvement of the corporate loan assets was distributed to LBI in the form of an ISK92 billion bond issued in 2013. Although all future valuation improvements will remain with Landsbankinn, we expect the additional impact of these revaluations to diminish significantly in 2014 and 2015. In addition, a bank levy associated with the government's recent debt-relief proposal could reduce Landsbankinn's net profit by about ISK3 billion per annum (about 10% of our forecast net profit for 2013). In total, we expect the bank's earnings buffer to diminish to about 15 basis points (bps) from more than 100bps in 2012, signifying a slowdown in capital generation and the lower capacity of earnings to cover normalized losses.

In our view, Landsbankinn's "adequate" risk position reflects its significant market shares and loan book, given risks in the market and the time to restructure existing loans. Landsbankinn's nonperforming loan stock is decreasing, which we expect to continue as the market recovers and additional debt relief improves households' finances and stimulates consumer spending. New loss provisions during the first three quarters of 2013 represented 1.6% of customer loans. We forecast the share of new provisions to fall below 1.0% by the end of 2014, given the considerable reduction of loans past due by more than 90 days to 4.2% of the loan book as of Sept. 30, 2013, from 5.8% in December 2012, and decreasing impaired loans.

By our measure, a comparably high amount (19%) of Landsbankinn's risk-weighted assets is associated with equities in the banking book and positions on the trading book. The bank is significantly reducing these exposures, but we anticipate that the pace of the reduction will slow somewhat as market values appreciate and some repossessed collateral is converted to assets held for sale.

We consider Landsbankinn's funding to be "average," balancing its relatively strong funding metrics against its high use of wholesale funding and demanding debt-repayment schedule, given the maturity of the LBI loans in 2018. The LBI loans comprised 26% of Landsbankinn's assets in September 2013. Equity capital accounted for more than 20% of assets, while 40% of the balance sheet comprised customer deposits. The bank's loan-to-deposit ratio of 144% in September 2013 stems from its creation in 2008, reflecting the relationship between loans and deposits in Iceland at that time. We believe this relationship will continue because we expect growth of the loan book, in particular household mortgage lending, will outpace that of deposits. As of Sept. 30, 2013, we estimate the bank's stable funding ratio at 127%, demonstrating a steady improvement from 106% in 2010.

Despite solid ratios by our measures, we assess the bank's liquidity as "adequate." In September 2013, Landsbankinn's ratio of broad liquid assets to short-term wholesale funding was 2.7x. We estimate that the impact of the ISK50 billion prepayment of the LBI loans would have reduced this ratio to 2.1x and the stable funding ratio to about 120%. This transaction, in our view, can facilitate the extension of the repayment terms on the LBI loans, which would reduce the uncertainty and maturity concentration in the bank's funding and liquidity profile. Looking ahead, we anticipate an orderly resolution of the LBI loans, and the central bank has stated that such a restructuring would be necessary to allow distribution of repayments from the estate of LBI to its creditors under the existing capital controls.

We consider Landsbankinn 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.

Outlook

The stable outlook reflects our view that over the next 24 months Landsbankinn's capital will continue to strengthen and that it will restructure a significant amount of legacy bonds due in 2014-2018.

We could take a positive rating action if the bank's capital improved beyond our present forecast and it reported sustainably stronger revenues or lower credit losses than we expect. We could also take a positive rating action on Landsbankinn if risks for Iceland's economy and banking sector were to diminish. In addition, we could revise our assessment of the bank's overall funding and liquidity upward if it reduced the concentrations in its debt-maturity profile, which might lead to an upgrade.

We could take a negative rating action 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, we have used conservative loss assumptions in our capital and earnings forecast, so we view a downgrade as unlikely at present.

Ratings Score Snapshot

Issuer Credit Rating	BB+/Stable/B
SACP	bb+
Anchor	bb
Business Position	Adequate (0)
Capital and Earnings	Strong (+1)
Risk Position	Adequate (0)
Funding and Liquidity	Average and Adequate (0)
Support	0
GRE Support	0
Group Support	0
Sovereign Support	0
Additional Factors	0

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

Related Research

- Banking Industry Country Risk Assessment: Iceland, Aug. 19, 2013

Ratings List

New Rating

Landsbankinn hf.	
Counterparty Credit Rating	BB+/Stable/B

Additional Contact:
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