

## **FITCH TAKES RATING ACTIONS ON THREE ICELANDIC BANKS**

Fitch Ratings-London-09 May 2008: Fitch Ratings has today taken rating actions on three Icelandic banks, Glitnir Banki hf. (Glitnir), Kaupthing Bank hf. (Kaupthing) and Landsbanki Islands (Landsbanki), and two of their subsidiaries. The agency downgraded Glitnir's and Kaupthing's Long-term Issuer Default Ratings (IDR) to 'A-' (A minus) from 'A' and affirmed Landsbanki's at 'A'. They are removed from Rating Watch Negative. A Negative Outlook is assigned. For a full list of the rating actions, see the bottom of this Rating Action Commentary.

The Negative Outlook is predicated on the risk of a hard landing in the Icelandic economy and the weaker outlook for a number of markets the banks have expanded into, including European investment banking and capital markets activities, and the UK economy.

Fitch notes that the banks are seeing some improvements in market sentiment, reducing the risk of unanticipated calls on liquidity, but believes that they remain vulnerable to the adverse effects of a prolonged market dislocation. "All three banks have reacted rapidly to changing market conditions and have managed to maintain strong liquidity levels, materially abating immediate risks linked to still difficult wholesale funding markets," said Alexandre Birry, Director in Fitch's Financial Institutions group.

Fitch has been monitoring the sector closely since the international financial market turmoil accelerated in H207. Based on the review of the three banks, Fitch believes the banks have demonstrated resilience to adverse market developments since 2006 and have the ability to absorb a material level of stress through their profitability and capitalisation. This should be supported by the growing diversification of earnings and exposures achieved over the past three years. In addition, all three banks have started to realign costs in the face of more challenging revenue generation in a number of activities.

Nevertheless, the risks of a hard landing for the Icelandic economy have increased, in Fitch's opinion, and this would likely lead to increased loan impairments and pressure on profitability from domestic operations. Fitch also believes that profitability from those businesses most closely aligned to capital markets and investment banking will weaken over the short- to medium-term and the banks' relative reliance on those activities will impact income generation. In 2007, all three banks generated around 35% of their operating income from capital markets and investment banking activities. The banks' capital ratios - a strength in recent years - have been eroded to varying degrees by ongoing expansion, leaving less of a cushion to absorb problems and maintain confidence.

Glitnir's ratings reflect the bank's adequate underlying profitability and its sound asset quality. Its capital ratios (Tier 1 of 7.7% at end-March 2008) are weaker than its peers, having been eroded since end-2006, and contain a significant element of hybrid capital. Fitch views positively Glitnir's EUR8.7bn liquidity position at end-March 2008, which should help it meet expected refinancing needs despite the bank's reliance on wholesale funding. The rating action reflects Fitch's anticipation of further deterioration in a few of the markets the bank operates in, although the agency notes the sound outlook in Norway, Glitnir's second home market, and in its renewable energy and seafood industry niche businesses. Nevertheless, profitability is likely to come under some pressure in more challenging market conditions.

Landsbanki's funding position benefits from the rapid build-up of a large overseas retail deposit base, with customer deposits funding two-thirds of the loan book at end-March 2008. Fitch acknowledges the benefits of initiatives taken to increase the 'stickiness' of this deposit base, although it believes that an element of this will remain speculative. The Negative Outlook reflects Fitch's anticipation of deterioration in the Icelandic and UK economies, two of Landsbanki's core markets, although the bank's asset quality is still sound. Investment banking revenues are likely to

be vulnerable to a weakening of operating conditions in markets. At end-March 2008 Landsbanki's Tier 1 ratio was 8.8%.

The ratings of Kaupthing, while supported by the geographic diversification of the bank's franchise and its success in turning around and integrating foreign subsidiaries, also reflect Fitch's expectation of some deterioration in its core markets of Iceland and the UK. The large liquidity portfolio maintained by the bank and the launch of retail deposits accounts in a large number of countries should support the diversification of Kaupthing's funding sources. The agency will continue to monitor the evolution of earnings from investment banking and capital markets activities. At end-March 2008 Kaupthing's Tier 1 ratio was 9.1%.

Fitch expects to release the credit analyses on the three Icelandic banks next week.

The ratings of the three banks and two subsidiaries are as follows:

**Glitnir Banki hf.:**

Long-term IDR: downgraded to 'A-' (A minus) from 'A'; off RWN; Negative Outlook assigned

Senior debt: downgraded to 'A-' (A minus) from 'A'; off RWN

Short-term IDR: downgraded to 'F2' from 'F1'; off RWN

Support rating: affirmed at '2'

Support Rating Floor: affirmed at 'BBB'

Individual rating: affirmed at 'B/C'; off RWN

Subordinated debt: downgraded to 'BBB+' from 'A-' (A minus); off RWN

**Kaupthing Bank hf.:**

Long-term IDR: downgraded to 'A-' (A minus) from 'A'; off RWN; Negative Outlook assigned

Senior debt: downgraded to 'A-' (A minus) from 'A'; off RWN

Short-term IDR: downgraded to 'F2' from 'F1'; off RWN

Support rating: affirmed at '2'

Support Rating Floor: affirmed at 'BBB'

Individual rating: affirmed at 'B/C'; off RWN

Subordinated debt: downgraded to 'BBB+' from 'A-' (A minus); off RWN

**Kaupthing Singer & Friedlander Ltd:**

Long-term IDR: downgraded to 'A-' (A minus) from 'A'; off RWN; Negative Outlook assigned

Short-term IDR: downgraded to 'F2' from 'F1'; off RWN

Support rating: affirmed at '2'

Individual rating: affirmed at 'B/C'; off RWN

**Landsbanki Islands:**

Long-term IDR: affirmed at 'A'; off RWN; Negative Outlook assigned

Senior debt: affirmed at 'A'; off RWN;

Short-term IDR: affirmed at 'F1'; off RWN

Support rating: affirmed at '2'

Support Rating Floor: affirmed at 'BBB'

Individual rating: affirmed at 'B/C'; off RWN

Subordinated debt: affirmed at 'A-' (A minus); off RWN

**Heritable Bank Ltd:**

Long-term IDR: affirmed at 'A'; off RWN, Negative Outlook assigned

Short-term IDR affirmed at 'F1'; off RWN

Support rating: affirmed at '1'

Individual rating: affirmed at 'C'; off RWN

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