FITCH AFFIRMS ISLANDSBANKI AT 'BBB-'; OUTLOOK STABLE

Fitch Ratings-London-21 April 2016: Fitch Ratings has affirmed Islandsbanki hf's Long-term Issuer Default Rating (IDR) at 'BBB-' and Viability Rating (VR) at 'bbb-'. The Outlook on the Long-term IDR is Stable. A full list of rating actions is attached at the end of this rating action commentary.

KEY RATING DRIVERS
IDRS AND VR
The ratings are underpinned by the leading Icelandic universal banking franchise of Islandsbanki, but also its exposure to a small economy susceptible to domestic and international shocks. The ratings factor in Islandsbanki's healthy capitalisation and improving asset quality. The constraints of the operating environment affect Fitch's assessment of other factors driving the ratings, such as the need to maintain strong capitalisation and the sustainability of asset quality improvements.

Capital controls were introduced in 2008 and have given rise to uncertainty for the whole banking system. Composition agreements were reached with the creditors of the failed banks in 2015, and included the transfer of ownership of Islandsbanki to the state in 1Q16. The composition agreement for Islandsbanki also entailed a partial repayment of funds "trapped" in Iceland, while ISK36bn of foreign currency deposits from Glitnir have been termed out.

A foreign currency overhang remains for the system, whereby around ISK300bn is held by non-residents who have been unable to convert these amounts to foreign currency. At the same time the Central Bank of Iceland has been building up reserves and its net foreign currency position totalled about ISK400bn at end-March 2016. An auction is expected to take place in 2Q16, allowing these investors to withdraw their investment. This should pave the way to a final lifting of controls later in 2016. We believe that Islandsbanki is well prepared for the removal of capital controls.

The bank's asset quality has been consistently improving since 2010. Gross impaired loans as a proportion of total loans have declined to around 3% at end-2015 from almost 5% at end-2014 and just under 9% at end-2013. A large portion of the loan book, which Islandsbanki acquired at a deep discount from Glitnir, has been restructured. The restructurings have reduced the borrowers' debt levels, and restructured loans have been performing well with limited impairment. Maintaining a track record of performance of these loans is an important rating factor.

Islandsbanki's capital and leverage ratios are solid and compare well with international peers (Tier 1 capital ratio of 28.3% and leverage ratio of 18.1% at end-2015). Liquidity is prudently managed, and the bank has a large liquidity buffer in place (around one-quarter of total assets at end-2015) to absorb the outflows accompanying the lifting of capital controls. However, given the legacy of the Icelandic banking system, Fitch believes that the bank will need to maintain stronger capitalisation and liquidity than similarly rated European peers in order to maintain investor confidence. The regulatory requirements, as well as the bank's own targets, have become significantly more strict in the past years, and it is important that future targets maintain an emphasis on prudence and ensure buffers are kept in the context of a potentially more volatile economy than, for example, those in more highly rated northern European countries.

SUPPORT RATING AND SUPPORT RATING FLOOR
The Icelandic sovereign's track record of imposing losses on bank creditors and public statements of burden sharing, particularly following the banking sector collapse, are the main drivers for

Islandsbanki's Support Rating of '5' and Support Rating Floor of "No Floor". While state support is possible, Fitch does not believe that support from the Icelandic authorities can be relied upon.

RATING SENSITIVITIES
IDRS AND VR
The ratings are likely to come under pressure if Islandsbanki's risk appetite increases, for example through looser underwriting standards or rapid expansion of foreign banking operations. Less conservative capital and liquidity management, or a significant shock to the economic environment leading to asset quality deterioration, would also be rating-negative.

A positive rating action would be contingent on Islandsbanki maintaining a moderate risk appetite, while sustaining the asset quality improvements and large capital buffers achieved to date. This is provided the Icelandic operating environment demonstrates resilience to external shocks in the post-capital controls era. Reduced uncertainty following the removal of the foreign currency overhang and final steps to lifting capital controls could be rating-positive.

SUPPORT RATING AND SUPPORT RATING FLOOR
The Support Rating could be upgraded and the Support Rating Floor revised upwards if Fitch changes its assessment of the Icelandic authorities' propensity to support, although this is unlikely.

The rating actions are as follows:

Long-term IDR: affirmed at 'BBB-'; Outlook Stable
Short-term IDR: affirmed at 'F3'
Viability Rating: affirmed at 'bbb-'
Support Rating; affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'

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Additional information is available on www.fitchratings.com

Applicable Criteria
Global Bank Rating Criteria (pub. 20 Mar 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=863501