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Research Update:

Landsbankinn Upgraded To 'BBB/A-2' On Improved Operating Conditions In Iceland And Stronger Capital; Outlook Positive

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Overview

- The gradual liberalization of capital controls in Iceland is progressing in a measured manner.
- The operating environment is improving for Icelandic banks, with falling private-sector leverage and improved access to foreign debt capital markets.
- At the same time, Icelandic bank Landsbankinn's capital position has improved materially, although we see uncertainty around future capital levels, due to an expected IPO.
- As a result, we are raising our long- and short-term ratings on Landsbankinn to 'BBB/A-2'.
- The positive outlook reflects positive trends in the Icelandic banking sector, as well as our expectations that the risk-adjusted capital ratio will remain above 15% over the next two years, despite extraordinary dividend payments and share buy-back programs.

Rating Action

On Oct. 25, 2016, S&P Global Ratings raised its ratings on Iceland's Landsbankinn hf. to 'BBB/A-2' from 'BBB-/A-3'. The outlook is positive.

Rationale

We upgraded Landsbankinn to reflect the bank's improved capital position, as well as our view of the improving operating conditions for Iceland's banking sector (see "Various Positive Rating Actions On Four Icelandic Banks On Receding Economic Risks and Improved Access To Funding," published Oct. 25, 2016, on RatingsDirect). We expect a trend of decreasing risks related to domestic credit, as Icelandic households deleverage, such that debt levels will likely come in line with other wealthy European economies over the next two years. In addition, we see the continued liberalization of capital controls leading to further improvements in economic resilience of Iceland's economy and in the operating environment for Icelandic banks.

We also view the trend for industry risk in the Icelandic banking sector as positive, based on demonstrated access to external funding, material improvements in banking regulation and supervision, and proactive measures to avoid a repeat of the excessive growth that preceded the boom of the 2000s and

to manage how cross border flows affect the domestic economy. Landsbankinn benefits from the improved access to external funding, as it can diversify its funding and refinance expensive bonds with new issues made on better terms. This is demonstrated by several large foreign currency issues over the last year, mainly used to prepay legacy LBI bonds.

We have consequently revised up our anchor for banks operating in Iceland to 'bbb-' from 'bb+'. This anchor is our starting point for calculating bank ratings.

We see positive impact on Landsbankinn's credit risk from the strong economic performance in Iceland and lower private-sector debt levels. The loan losses and nonperforming loans have decreased considerably, with positive net loan loss reversals since 2014, and nonperforming assets in relation to loans cut by half between December 2014 and June 2016. Improved economic prospects have led us to revise our assessment of Landsbankinn's capital, resulting in a pro-forma risk-adjusted capital (RAC) ratio of 18.6% as of June 30, 2016 (including our improved assessment of Icelandic economic risks).

We note that the bank is planning to pay out extraordinary dividends and complete a share buy-back program in 2016 and 2017 as parts of an initiative to optimize capital. Despite the resulting equity reduction, we expect that our assessment of Landsbankinn's capital will remain very strong over the next two years. We project a year-end 2017 RAC ratio of 16%-17% in our base case, including expectations that the bank will distribute almost 100% of net earnings, as well as extraordinary dividends and share buybacks, reducing the bank's regulatory common equity tier 1 ratio by 1-2 percentage points in 2016-2017. However, we see uncertainty about its future capitalization, given our anticipation that banks will look to optimize their capital bases owing to the high leverage ratios versus international peers and efforts to have more attractive returns on equity for potential investors.

We expect that the government will decrease its ownership stake in Landsbankinn, currently 98.2%, over time. There is currently a mandate for the government to reduce its stake to 70%, a level that could be reduced further over the long term. As such, we do not consider Landsbankinn to be a strategic government-related entity for Iceland. In our view, the IPO is likely to require recalibration of current capital and leverage levels for Landsbankinn and leads to uncertainty in our base-case capital projections. As such, we apply a negative adjustment to the rating, resulting in a counterparty credit rating one notch lower than the 'bbb+' stand-alone credit profile.

Outlook

The positive outlook on Landsbankinn reflects our view of continued improvement in the operating environment for Icelandic banks. It also mirrors our expectations that the RAC ratio will remain above 15% over the next two years, despite extraordinary dividend payments and share buy-back programs. However, we note that this scenario is only the base case and uncertainty

around Landsbankinn's optimization of capitalization remains.

We could take a positive rating action if we see a further strengthening of operating conditions for banks in Iceland. We could also raise our rating on Landsbankinn if we become more certain about future capitalization, allowing us to remove the negative adjustment notch. Despite continued positive trends for the Icelandic banking sector, we would not expect a two-notch upgrade over the next two years, given the relatively concentrated and volatile nature of the Icelandic economy.

We could revise the outlook to stable if we saw signs of a weakening of the strong economic development in Iceland or an increased risk of economic imbalances in the economy. We could also revise the outlook to stable if Landsbankinn's capital levels declined more than we expected.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	BBB/Positive/A-2	BBB-/Positive/A-3
SACP	bbb+	bbb-
Anchor	bbb-	bb+
Business Position	Adequate (0)	Adequate (0)
Capital and Earnings	Very Strong (+2)	Strong (+1)
Risk Position	Adequate (0)	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	(-1)	(0)

Related Criteria And Research

Related Criteria

- General Criteria: Group Rating Methodology - November 19, 2013
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions - January 29, 2015
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions - July 17, 2013
- Criteria - Financial Institutions - Banks: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework - June 22, 2012

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- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions - November 09, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions - November 09, 2011
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions - December 06, 2010
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks - March 23, 2004
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- Various Positive Rating Actions On Four Icelandic Banks On Receding Economic Risks and Improved Access To Funding, Oct. 25, 2016
- Nordic Banks' Capital Growth Tapers Off, Aug. 2, 2016
- The Future Of Banking: Nordic Banks Looking Svelte In The Fintech Race, June 14, 2016
- Iceland Ratings Affirmed At 'BBB+/A-2'; Outlook Stable; July 15, 2016

Ratings List

Upgraded

	To	From
Landsbankinn hf.		
Counterparty Credit Rating	BBB/Positive/A-2	BBB-/Positive/A-3
Senior Unsecured	BBB	BBB-

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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