

## Various Positive Rating Actions On Four Icelandic Banks On Receding Economic Risks and Improved Access To Funding

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- The gradual liberalization of capital controls in Iceland is progressing in a measured manner, which in our view implies reduced risks for the country's banking sector.
- Furthermore, economic development in Iceland appears strong and private-sector leverage continues to decrease, thereby lowering risks related to domestic credit.
- Concurrently, the banks' access to external wholesale funding has improved, as reflected by large Eurobond issuances this year.
- As a result, we are raising our ratings on Arion Bank, Islandsbanki, and Landsbankinn to 'BBB/A-2' from 'BBB-/A-3', while revising our outlook on HFF to positive from stable and affirming the 'BB/B' ratings.
- The positive outlooks on all four entities indicate that we could raise the ratings if the economic and industry environment for Icelandic banks continues to strengthen.

STOCKHOLM (S&P Global Ratings) Oct. 25, 2016--S&P Global Ratings said today that it has raised its long- and short-term counterparty credit ratings on Iceland-based Arion Bank, Islandsbanki hf, and Landsbankinn hf. to 'BBB/A-2' from 'BBB-/A-3'. The outlooks are positive.

At the same time, we revised our outlook on Housing Financing Fund Ibudalanasjodur (HFF) to positive from stable and affirmed our 'BB/B' long- and short-term counterparty credit ratings.

We will publish individual research updates on the four banks to provide more detail on the rationale behind each rating action.

The rating actions follow our review of the Icelandic banking sector and reflect improved operating conditions for banks as Iceland makes continued progress in liberalizing capital controls. The conclusion of composition agreements between the government and the estates of the three banks, signed in late 2015, has strengthened the government's finances and removed significant uncertainty with respect to the banks' balance sheets and liquidity.

In addition, the Central Bank of Iceland (CBI) held Icelandic krona auctions earlier this year, and although the outcome is not yet final, there is improved clarity on how the offshore liquid krona overhang could affect the banks' liquidity positions. Furthermore, pension funds and private investors are now able to make limited investments abroad and the CBI has demonstrated its ability to act proactively by imposing a tool to discourage short-term investment due to the carry trade (see "Iceland Ratings Affirmed At 'BBB+/A-2'; Outlook Stable," published July 15, 2016, on RatingsDirect). In addition, we consider that Icelandic banks' access to external funding has improved markedly, allowing the banks to refinance legacy debt from the central banks and the estates at lower interest rates.

Although private-sector debt continues to decrease, the Icelandic economy is expanding, with real GDP growth above 3%. We expect the economy will continue posting strong growth rates over the next two years, partly due to the continued strong performance of the tourism sector and increasing private consumption, supported by income growth. In our view, the Icelandic economy has entered an expansionary phase, since there is an underlying recovery of credit demand, even as many borrowers continue to reduce legacy debt levels. Iceland's debt capacity is supported by generally high domestic wealth, which is increasing given the economic environment and strong performance of the domestic markets. At the same time, private-sector credit has decreased in relation to GDP, aided by government-imposed debt-relief measures. Although decreasing, credit remains fairly high by global standards at 143% of GDP in 2015. We expect to see further improvements, especially on household leverage.

At the same time, we believe--partly owing to its small size and industry concentrations--that the Icelandic economy remains structurally volatile, as demonstrated by boom-bust cycles in the past, as well as recent rapid increases in wages and real estate prices. Real house prices have risen by more than 10% annually over the past two years, revealing pent-up demand for housing, strong population and wage growth, and stagnation of supply after the crisis. We expect growth will slow down somewhat as construction catches up with demand. Should house prices continue to rise at the same pace, combined with accelerated debt growth, this could heighten risks for the banking system. In addition, we believe that recently agreed significant public- and private-sector wage increases could constrain the competitiveness of the Icelandic economy and result in a faster-than-anticipated decline in current

account surpluses. The sovereign's monetary policy flexibility is restricted by the economy's high dependence on imports and the strong pass-through effect from exchange rate volatility. As such, there is an inherent risk of peaks and valleys in the Icelandic economy, which places great demands on the banks' risk control.

We note that the banks have not materially increased the overall share of foreign wholesale funding and are increasingly tapping the domestic covered bond market to finance growth in residential mortgages. The oversubscription of two €500 million benchmark Eurobonds issued in consecutive weeks in September 2016 by Landsbankinn and Islandsbanki is a testament to the banking system's improved access to foreign debt capital markets and stronger foreign demand.

We expect banks' future returns will be based on what we believe are sound commercial practices. Substantial one-time items have inflated Icelandic banks' profits over the past few years, but we expect the future impact will be contained. The Icelandic banking system benefits from higher interest rates than in most European economies, and we see improvements in regulation and supervision. However, we also see some distortions in the market, given the high share of government ownership in the banking sector and competition by nonbanks, mainly the pension funds.

#### ECONOMIC AND INDUSTRY RISK TRENDS IN ICELAND

The trend for economic risk in Iceland remains positive, in our opinion. This reflects our view of decreasing risks related to domestic credit as Icelandic households deleverage, such that we expect debt levels will be in line with that of other wealthy European economies over the next two years. In addition, we foresee positive effects from the gradual liberalization of capital controls and a likely improvement in economic resilience and the operating environment for Icelandic banks. Furthermore, Iceland's external position has strengthened notably in recent years, and we anticipate that this will continue, particularly if the government's fiscal position remains prudent and the CBI's reserves show favorable dynamics on the back of significant foreign exchange inflows from the rapidly expanding tourism sector.

We view the trend for industry risk as positive, based on material improvements in banking regulation and supervision. There is a marked difference in the banking sector and associated restrictions compared with 2007, and we believe the recent restructuring of the legacy banks has been well managed. Despite its short track record, the forward-looking restrictions on short-term foreign investors, to reduce the appeal of the carry trade, indicate more proactive regulation and supervision, in our view. In addition, the regulators have increased capital, funding, and liquidity requirements that restrict mismatches in the banking sector's aggregate balance sheet and foreign currency positions. We expect the authorities will continue to closely monitor the banking system, which could lead us to take a more positive view on the risk related to the institutional framework. We note that, although regulatory limits are in place, banks' improved access to foreign funding markets could increase the system's reliance on external debt and offset some

of the positive impact from tighter regulation.

#### IMPACT ON BANK RATINGS

The reduction of economic and industry risk for banks in Iceland has led us to revise upward our anchor for rating Icelandic banks to 'bbb-' from 'bb+'. This change has also had a positive impact on our assessment of the banks' capital and earnings. However, due to the uncertainties regarding the banks' ownership, we have reservations about the sustainability of the high capital ratios. The commercial banks are all owned by the government to different extents, but we expect they will be sold or publicly listed over the next few years.

#### OUTLOOKS

The positive outlooks on all four banks stem mainly from the positive economic and industry risk trends we see in Iceland.

#### ARION BANK

The positive outlook on Arion Bank reflects our expectations of extraordinary dividends and capital optimization as the bank prepares for an eventual sale or IPO over the next two years.

We could raise the rating if we see strong continued economic development in Iceland or if future capital levels exceed our current expectations. We would not expect a two-notch upgrade over the next two years, given the relatively concentrated and volatile nature of Iceland's 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. An outlook revision to stable could also follow a deterioration in Arion Bank's asset quality or negative revaluation of its material equity holdings.

#### ISLANDSBANKI

The positive outlook on Islandsbanki reflects our expectation that the bank's risk-adjusted capital (RAC) ratio will remain sustainably above 15%, even while the bank prepares for an eventual sale or IPO over the next two years.

However, we note that this scenario is only a base case and uncertainty around the sales process, ownership, and capitalization remains.

We could upgrade the bank if we see strong continued economic development in Iceland, if future capital levels exceed our current expectations, or if we become more certain about future capitalization, allowing us to remove the negative adjustment notch. Despite continued positive economic and industry trends for the Icelandic banking sector, we consider unlikely a two-notch upgrade over the next two-year rating horizon, given the relatively concentrated and volatile nature of the Icelandic economy.

We could revise the outlook to stable if we saw signs that Iceland's strong

economic development was weakening or an increased risk of economic imbalances in the economy. We could also revise the outlook to stable if capital levels fell below our expectations, due to a larger-than-anticipated reduction in equity capital.

#### LANDSBANKINN

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 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 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.

#### HOUSING FINANCING FUND IBUDALANASJODUR

The positive outlook indicates that we could raise our ratings on HFF within one year if the economic conditions in Iceland improve further, reducing the risks inherent in unwinding HFF's mortgage portfolio. HFF has a strict public policy role and is unlikely to grow with the market. However, the entity may benefit from strong economic development based on decreased loan losses and an improved capital position, which could follow faster-than-anticipated earnings generation or the accelerated decrease in risk-weighted assets.

We could revise the outlook to stable if we saw signs that Iceland's strong economic development was weakening. Moreover, we could lower the ratings if we concluded that the effects of a potential HFF default for the government and the capital markets had reduced, which would reduce the incentive for the government to provide timely extraordinary support to the institution.

As per our criteria for government-related entities, the ratings on HFF would not be affected by a positive rating action on the sovereign.

#### RELATED CRITERIA AND RESEARCH

##### Related Criteria

- 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
- Commercial Paper I: Banks, March 23, 2004
- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Group Rating Methodology, Nov. 19, 2013
- Analytical Linkages Between Sovereign And Bank Ratings, Dec. 6, 2011
- Sovereign Government Rating Methodology And Assumptions, June 30, 2013

Related Research

- Iceland Ratings Affirmed At 'BBB+/A-2'; Outlook Stable, July 15, 2016
- Nordic Banks' Capital Growth Tapers Off, June 14, 2016
- The Future Of Banking: Nordic Banks Looking Svelte In The Fintech Race, June 14, 2016
- Two Icelandic Bank Outlooks Revised To Positive On Improving Economic Resilience; 'BBB-/A-3' Ratings Affirmed, Jan. 19, 2016

BICRA SCORE SNAPSHOT\*

| Iceland                    | To                | From              |
|----------------------------|-------------------|-------------------|
| BICRA Group                | 5                 | 6                 |
| Economic risk              | 5                 | 6                 |
| Economic resilience        | High risk         | High risk         |
| Economic imbalances        | Intermediate risk | Intermediate risk |
| Credit risk in the economy | Intermediate risk | High risk         |
| Industry risk              | 5                 | 6                 |
| Institutional framework    | High risk         | High risk         |
| Competitive dynamics       | Intermediate risk | Intermediate risk |
| Systemwide funding         | Intermediate risk | High risk         |
| Trends                     |                   |                   |
| Economic risk trend        | Positive          | Positive          |
| Industry risk trend        | Positive          | Stable            |

\*Banking Industry Country Risk Assessment (BICRA) economic risk and industry risk scores are on a scale from 1 (lowest risk) to 10 (highest risk). For more details on our BICRA scores on banking industries across the globe, please see "Banking Industry Country Risk Assessment Update," published monthly on RatingsDirect.

RATINGS LIST

Upgraded; Ratings Affirmed

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|  | To               | From              |
|--|------------------|-------------------|
| Arion Bank                             |                  |                   |
| Counterparty Credit Rating             | BBB/Positive/A-2 | BBB-/Positive/A-3 |
| Islandsbanki hf                        |                  |                   |
| Counterparty Credit Rating             | BBB/Positive/A-2 | BBB-/Positive/A-3 |
| Landsbankinn hf.                       |                  |                   |
| Counterparty Credit Rating             | BBB/Positive/A-2 | BBB-/Positive/A-3 |
| Outlook Action; Ratings Affirmed       |                  |                   |
|  | To               | From              |
| Housing Financing Fund Ibudalanasjodur |                  |                   |
| Counterparty Credit Rating             | BB/Positive/B    | BB/Stable/B       |

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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](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.globalcreditportal.com](http://www.globalcreditportal.com) and at [spcapitaliq.com](http://spcapitaliq.com). All ratings affected by this rating action can be found on the S&P Global Ratings' public website at [www.standardandpoors.com](http://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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