Two Icelandic Bank Outlooks Revised To Positive On Improving Economic Resilience; 'BBB-/A-3' Ratings Affirmed

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OVERVIEW

- The compositions of failed Icelandic banks' wind-down estates have been agreed, significantly reducing uncertainties relating to the eventual lifting of capital controls, in our view.
- That said, we observe ongoing house price growth, which could lead to widening imbalances.
- All in all, we now see a positive economic risk trend for banks in Iceland, given the more resilient economy and likely lower risk from potential large swings in the exchange rate.
- We are therefore revising our outlooks on Arion Bank and Islandsbanki to positive from stable, maintaining our positive outlook on Landsbankinn, and affirming our 'BBB-/A-3' ratings on all three banks.
- The positive outlooks indicate that we could raise the ratings if the banks' credit profiles strengthen in the improving operating environment.

STOCKHOLM (Standard & Poor's) Jan. 19, 2016--Standard & Poor's Ratings Services said today that it had revised its outlooks on Iceland-based Arion Bank and Islandsbanki hf to positive from stable. The 'BBB-/A-3' long- and short-term counterparty credit ratings on both banks were affirmed.

At the same time, we affirmed our 'BBB-/A-3' long- and short-term counterparty credit ratings on Landsbankinn hf. The outlook remains positive.

The outlook revisions result mainly from our view that economic resilience in Iceland is likely to strengthen following significant progress toward lifting capital controls. We also considered the positive rating action on Iceland on Jan. 15, 2016 (see "Iceland Ratings Raised To 'BBB+' On Further Progress Toward Capital Account Liberalization And Declining Debt Levels," published on RatingsDirect).

With the support of the failed banks' creditors, and approvals from the courts and central bank, the comprehensive proposals on the composition of all three banks' estates have been agreed and are legally binding. The agreements include payment of a stability contribution to the government. In our view, these arrangements significantly reduce risk to the banks from the removal of capital controls. As a result, we believe Iceland's economic resilience is likely to improve. We anticipate a better operating environment for banks, with borrowers' creditworthiness benefitting from robust economic growth, and access to international capital markets further improving in line with the gradual lifting of capital controls over the next few years.

We also note that the June 2015 proposals on the composition of most failed banks' wind-down estates were largely approved as drafted. A notable exception was that for Glitnir Bank, which handed over its ownership stake in Islandsbanki to the government. The agreements mean that the estates' foreign currency deposits are replaced by long-term bonds, and they take over loans from the government and central bank that were issued to the new banks when created. We expect the banks will gradually replace these funding instruments through bond issuance in international capital markets, which they all tapped during 2015.

However, we see remaining risks associated with the next phase of liberalizing capital controls. Given the resolution of the failed banks' estates, the focus will shift to the nonresident liquid krona overhang stemming from carry trade before 2008. We understand that the amount owed to nonresident investors is roughly equivalent to Icelandic krona (ISK) 300 billion (about $2.3 billion) or 14% of GDP. The government will host an auction that offers various options to investors, such as receiving a long-term treasury bond, exchanging the krona amount for foreign currency at the auction rate, or depositing the funds in a blocked account that pays no interest. We believe some investors could raise legal challenges, potentially prolonging the capital controls. There is also a possibility that a significant simultaneous withdrawal of nonresident krona holdings could weigh on Iceland's foreign currency reserves. However, we expect the government to deal with this complex issue in a prudent way. Our base case is that there will be no extraordinary pressure on the central bank's reserves, and that the lifting of capital controls will not be materially delayed.

We continue to believe that any future impact from the previous financial crisis will be limited, and we expect losses will stay small. We expect the banking system will report new loan loss provisions to outstanding loans of 15 basis points (bps) to 20bps, excluding any positive impact from revaluations of loans in 2015. Although there might be some more volatility over the coming two years, we don't anticipate the increase in loan loss provisions will exceed 50bps. Similarly, we forecast a continued decline in nonperforming loans as banks' portfolios are restructured and the economy continues to expand. We do not expect any additional significant impact from revaluations of loans taken over from the failed banks in 2008.

In addition, we expect Iceland will post robust growth rates averaging close to 3% through to 2018, with unemployment reducing toward 3.5%, which should support asset quality in the banking sector. However, we believe that Iceland remains a concentrated economy reliant on three key sectors: fishing, tourism, and hydro and geothermal energy.

In our view, therefore, the trend for economic risk in Iceland is now positive rather than stable. This reflects our view of decreasing risks related to the liberalization of capital controls and a likely improvement in economic resilience and the operating environment for Icelandic banks. In the medium term, we see the potential for a gradual reduction of household and corporate debt relative to GDP, which could also have a positive impact on our view of economic risk in Iceland. Moreover, we anticipate a well-handled auction that will reduce the nonresident krona overhang, facilitating continuation of the gradual lifting of capital controls.

However, we are mindful of the possible risk of overheating in the housing market. We observe a continued increase in real house prices, which we estimate will have risen by 7%-8% in 2015. We believe the growth is supported by increasing wages, limited new construction, and an expanding buy-to-let market, given the strong tourism inflow. Although household debt has increased by only about 1% in nominal terms since 2013, in our view this masks the effect of principal write-downs on mortgage loans under the government's debt relief program. Should house prices continue to rise at the same pace, combined with accelerated debt growth, this could heighten risks for the banking system and we could consider changing our assessment of economic imbalances. In addition, we believe that recently agreed, significant public- and private-sector wage increases could result in reduced competitiveness and a faster-than-anticipated decline in current account surpluses. In a downside scenario, these factors could weigh on growth and lead us to change our view of the economic trend to stable.

Our positive outlooks indicate the possibility of an upgrade if the banks' stand-alone credit profiles (SACPs) strengthen amid continued improvements in Iceland's economy and further progress on liberalization of capital controls, which should benefit economic resilience.

Details on our outlooks on each bank follow.

ARION BANK

We expect Arion Bank's capital position to strengthen, with the Standard & Poor's risk-adjusted capital (RAC) ratio increasing toward 14% within the next

18-24 months from 11.5% on June 30, 2015 (pro forma; including lower risk weights for Icelandic exposures since July 2015). We think the main contributor to this improvement will be the bank's partial execution of its plan to divest legacy assets, equity exposures that it took over as a part of debt restructurings.

We anticipate deposit outflows of approximately ISK100 billion (€700 million at ISK142 to €1) that would be partly covered by bond issues. As a result, we expect our funding and liquidity metrics for Arion Bank to deteriorate, albeit remaining consistent with our current assessment. In the longer term, we expect the bank will increase its activity in the bond market, potentially heightening the pressure on liquidity from the expiry of larger amounts of debt.

We could upgrade the bank if risks for the Icelandic banking sector continue to reduce, leading to a higher anchor, which is the starting point for our ratings on Icelandic banks. We consider improvements in Arion Bank's bank-specific factors remote.

We could revise the outlook to stable if we observed significant delays in the gradual lifting of capital controls or if economic imbalances increased, resulting in deterioration of the operating environment. We could also revise the outlook to stable if a higher anchor were likely to be offset by material weakening of Arion Bank's capitalization.

LANDSBANKINN

We could raise our long-term rating on Landsbankinn if we believe the bank's capital targets will align with a RAC ratio firmly above 15%, and we continue to view the bank's asset quality as being in line with the market average and that of domestic peers. In this respect, we anticipate that Landsbankinn will narrow the gap to its domestic peers, in terms of asset-quality metrics, over the next two years and not take excessive risks as it expands the loan book. The positive outlook also reflects our assumption that the bank will maintain strong liquidity buffers after expected deposit outflows, following the relaxation of capital controls over the coming months.

We could revise the outlook to stable if our expectation of improved economic conditions did not materialize and Landsbankinn paid an extraordinary dividend to align its leverage and capital base to domestic peers', resulting in the RAC ratio remaining below 15%. Even if Landsbankinn's capital did not reduce materially, we could still revise the outlook to stable if we consider that our current assessment of capital, earnings, and risk adequately reflected the bank's credit quality.

ISLANDBANKI

The positive outlook on Islandsbanki reflects our projection that our RAC ratio for Islandsbanki will likely be at about 12.5%-13.0% by the end of 2017. This is because we do not see the government's ownership of Islandsbanki as strategic and believe Islandsbanki will be up for sale within two years, at which time we believe that its capital will have been reduced to make the bank more attractive to a potential buyer.

The positive outlook also reflects our assumption that Islandsbanki will retain strong capital and liquidity buffers, even after expected deposit outflows over the coming months. We do not expect the uncertainty of the bank's future ownership to weaken its SACP, but it could affect the ratings over time.

We could upgrade the bank if risks for the Icelandic banking sector continue to reduce, leading to a higher anchor, which is the starting point for our ratings on Icelandic banks. We could also raise the rating if we anticipated that Islandsbanki's RAC ratio would remain sustainably above 15%, or if the bank were acquired by a higher-rated entity with expectations of strong strategic interest and integration.

We could revise the outlook to stable if we observed significant delays in the gradual lifting of capital controls or if economic imbalances increased, resulting in deterioration of the operating environment, or if a material deterioration of loan quality offset a higher anchor for Icelandic banks. Although not our base-case scenario, we could lower our rating on Islandsbanki if a potential new owner were of lower credit quality than the bank.

RELATED CRITERIA AND RESEARCH

Related Criteria

- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- 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
- Methodology For Mapping Short- And Long-Term Issuer Credit Ratings For Banks, May 4, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Commercial Paper I: Banks, March 23, 2004

Related Research

- Iceland Ratings Raised To 'BBB+' On Further Progress Toward Capital Account Liberalization And Declining Debt Levels, Jan. 15, 2016
- Landsbankinn hf, Nov. 19, 2015
- Arion Bank, Nov. 9, 2015
- Islandsbanki, Nov. 6, 2015
- Icelandic Bank Islandsbanki Affirmed At 'BBB-/A-3' After Change To Agreement With Glitnir; Outlook Still Stable, Oct. 28, 2015
- Iceland's Commercial Banks Upgraded To 'BBB-/A-3' On Receding Economic Risks; Two Outlooks Stable, One Positive, July 21, 2015

- Banking Industry Country Risk Assessment: Iceland, Dec. 10, 2014

BICRA SCORE SNAPSHOT*

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

Ratings Affirmed; Outlook Action

	To	From
Arion Bank		
Counterparty Credit Rating	BBB-/Positive/A-3	BBB-/Stable/A-3
Islandsbanki hf		
Counterparty Credit Rating	BBB-/Positive/A-3	BBB-/Stable/A-3

Ratings Affirmed

Landsbankinn hf.	
Counterparty Credit Rating	BBB-/Positive/A-3

NB: This list does not include all the ratings affected.

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