

Ratings On Icelandic D-SIBs Affirmed As Pandemic Recovery Risk Lingers; Outlooks Remain Stable

January 25, 2022

- In our view, economic risks facing Icelandic financial institutions remain elevated, as the tourism and some commercial real estate segments continue to recover from the pandemic hit. We believe these risks are showing early signs of receding, though there remain hurdles in the first half of 2022. Consequently, we continue to see the economic risk trend as negative.
- We are affirming our ratings on the Icelandic D-SIBs. The outlooks on these banks remain stable.
- The stable outlooks reflect the still elevated economic risks emanating from sector-wide loan underperformance in tourism and its dependent sectors following the large pandemic shock, offset by the banks' very strong capitalization and our expectation for earnings resilience.
- We have reviewed the ratings under our updated financial institutions rating methodology, which, in itself, is neutral for the ratings.

PRIMARY CREDIT ANALYST

Riley Michel
London
+44 7816 123244
riley.michel
@spglobal.com

SECONDARY CONTACT

Richard Barnes
London
+ 44 20 7176 7227
richard.barnes
@spglobal.com

LONDON (S&P Global Ratings) Jan. 25, 2022--S&P Global Ratings said today that it has affirmed the 'BBB/A-2' long and short-term ratings on Icelandic banks Arion Bank, Islandsbanki, and Landsbankinn with 'Stable' outlook.

Asset Quality Picture Clearing, Though Key Hurdles Remain

We consider that elevated economic risks persist. Sector-wide loan underperformance in tourism and its dependent sectors remains elevated, following the pandemic shock. That said, we believe risks have receded somewhat since the pre-vaccine phase of the pandemic. The recovery in tourism, though fragile, is underway. In addition, Icelandic banks have benefited from fiscal and monetary policy support--allowing time to build capital, assess exposures in detail, and provision appropriately. Nevertheless, support measures may have delayed, rather than averted, asset performance risk. Consequently, we expect to gain more clarity on the durability of some borrowers' prospects in the coming months.

At the same time, we believe economic risks are showing early signs of receding. Provision releases across the sector in the second half of 2021 reflected better than feared outcomes and plausible downside scenarios becoming less severe. As a result, we expect sector-wide full year credit losses for 2021 to be close to -10 basis points (bps) of gross loans. In addition, we consider that the banks' robust earnings provide a buffer against deteriorating conditions. Our base case sees banking sector return on equity improving to 8-9% in the coming 2 years, from closer to 6% on average over the past 5 years. We consider this strong by global standards, not least considering the D-SIBs' very strong risk-adjusted capitalization.

Proactive Policy Response Should Contain Risk From Elevated Household Debt, Property Prices

We consider that recent property price growth alongside rising household leverage could indicate a build-up of systemic risk. In 2021, inflation-adjusted property price growth was close to 10%. We believe low borrowing costs, mostly the result of monetary policy response to the pandemic, has encouraged a resilient and supported household sector to take on more debt. In turn, the property price response has been strong. That said, we believe imbalances are unlikely to rise further. We believe that the proactive monetary and macroprudential policy response is likely to limit the consequent risk of eventual sharp asset price reversal, which could be particularly painful for Iceland's highly levered private sector.

Resolution Regime Evolving

The Icelandic authorities are in the process of establishing the resolution regime and setting MREL requirements. In time, we could raise bank ratings if we see the resolution framework as effective and believe banks will build and maintain meaningful loss-absorbing buffers that lower the risk to senior preferred creditors.

Criteria Revision Neutral For Bank Ratings

These affirmations follow a revision to our criteria for rating banks and nonbank financial institutions and for determining a Banking Industry Country Risk Assessment (BICRA) (see "Financial Institutions Rating Methodology" and "Banking Industry Country Risk Assessment Methodology And Assumptions," both published on Dec. 9, 2021). The methodology change, in itself, is neutral for the ratings.

OUTLOOKS

Arion Bank

Outlook

The stable outlook reflects still elevated economic risks emanating from sector-wide loan underperformance in tourism and its dependent sectors, partly offset by still strong earnings metrics. In our base case, we anticipate risk-adjusted profitability to remain strong as margins rebound from pandemic lows and credit losses revert to about 30 bps of gross loans in the coming two years. The stable outlook also reflects our view that high capitalization will remain the bank's key credit strength, with the RAC ratio set to retain a buffer above the 15% 'very strong' threshold.

Downside scenario: We could lower the ratings on Arion if there is a large and disorderly downturn in the economy, likely due to a slower or weaker than anticipated tourism recovery. This scenario would likely be consistent with a broader and significant economic slowdown, large credit impairments, and deteriorating profitability.

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Upside scenario: We could raise the ratings if we believe the resilience and strength of the bank's earnings metrics improves significantly and sustainably. This is likely to be consistent with the ongoing decline in non-bank participation in the mortgage market. In addition, we would look for stable asset quality prospects, with loan underperformance continuing to abate.

Islandsbanki

Outlook

The stable outlook reflects still elevated economic risks emanating from sector-wide loan underperformance in tourism and its dependent sectors, partly offset by continuing earnings strength. In our base case we anticipate risk-adjusted profitability to remain strong as margins rebound from pandemic lows and credit losses revert to about 30 bps of gross loans in the coming two years. The stable outlook also reflects our view that high capitalization will remain the bank's key credit strength, and gradual privatization will not significantly change the bank's risk profile, capitalization, or strategy.

Downside scenario: We could lower the ratings on Islandsbanki if there is a large and disorderly adjustment in the economy, likely due to a slower or weaker than anticipated tourism recovery. This scenario would likely be consistent with a broader and significant economic slowdown, large credit impairments, and deteriorating profitability.

Upside scenario: We could raise the ratings if we believe the strength and resilience of the bank's earning capacity has improved significantly and sustainably. This is likely to be consistent with the ongoing decline in non-bank participation in the mortgage market. In addition, we would look for stable asset quality prospects, with loan underperformance continuing to abate.

Landsbankinn

Outlook

The stable outlook reflects still elevated economic risks emanating from sector-wide loan underperformance in tourism and its dependent sectors, partly offset by still strong underlying earnings resilience. In our base case we anticipate risk-adjusted profitability to remain strong as margins rebound from pandemic lows and credit losses revert to about 30 bps of gross loans in the coming two years. The stable outlook also reflects our view that high capitalization will remain the bank's key credit strength, with the RAC ratio likely to retain a solid buffer ahead of the 15% 'very strong' threshold.

Downside scenario: We could lower the ratings on Landsbankinn if there is a large and disorderly adjustment in the economy, likely due to a slower or weaker than anticipated tourism recovery. This scenario would likely be consistent with a broader and significant economic slowdown, large credit impairments, and deteriorating profitability.

Upside scenario: We could raise the ratings if we believe the bank's earnings strength and resilience has improved significantly and sustainably. This is likely to be consistent with the ongoing decline in non-bank participation in the mortgage market. In addition, we would look for

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stable asset quality prospects, with loan underperformance continuing to abate.

BICRA Score Snapshot

BICRA Score Snapshot -- Iceland

BICRA group	5
Economic risk	4
Economic resilience	Intermediate risk
Economic imbalances	Intermediate risk
Credit risk in the economy	Intermediate risk
Trend	Negative
Industry risk	6
Institutional framework	Intermediate risk
Competitive dynamics	High risk
Systemwide funding	High risk
Trend	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 Score Snapshot

Rating Component Score Summary: Icelandic Financial Institutions

Institution	Anchor	Business position	Capital and earnings position	Risk position	Funding and liquidity	CRA adj.	Group SACP	Type of external support	No. of notches of support	Long-term ICR/outlook
Arion Banki hf.	bbb-	Adequate (0)	Very Strong (+2)	Moderate (-1)	Adequate/Adequate (0)	0	bbb	None	0	BBB/Stable
Íslandsbanki hf.	bbb-	Adequate (0)	Very Strong (+2)	Moderate (-1)	Adequate/Adequate (0)	0	bbb	None	0	BBB/Stable
Landsbankinn hf.	bbb-	Adequate (0)	Very Strong (+2)	Moderate (-1)	Adequate/Adequate (0)	0	bbb	None	0	BBB/Stable

Adj--Adjustment. CRA--Comparable ratings analysis. ICR--Issuer credit rating. SACP--Stand-alone credit profile. Data as of Jan. 25, 2022.

Related Criteria

- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021

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- Criteria | Financial Institutions | General: Financial Institutions Rating Methodology, Dec. 9, 2021
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Banking Industry Country Risk Assessment Update: December 2021, Dec. 17, 2021
- Certain Financial Institution Issuer And Issue Ratings Placed Under Criteria Observation Following Criteria Update, Dec. 9, 2021
- RFC Process Summary: Financial Institutions Rating Methodology, Dec. 9, 2021
- RFC Process Summary: Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021
- Financial Institutions And BICRA Criteria Published, Dec. 9, 2021

Ratings List

***** Arion Bank *****

Ratings Affirmed

Arion Bank

Issuer Credit Rating	BBB/Stable/A-2
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Arion Bank

Senior Unsecured	BBB
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Subordinated	BB+
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Junior Subordinated	BB-
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***** Islandsbanki hf *****

Ratings Affirmed

Islandsbanki hf

Issuer Credit Rating	BBB/Stable/A-2
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Islandsbanki hf

Senior Unsecured	BBB
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Subordinated	BB+
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Junior Subordinated	BB-
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***** Landsbankinn hf. *****

Ratings Affirmed

Landsbankinn hf.

Issuer Credit Rating	BBB/Stable/A-2
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Landsbankinn hf.

Senior Unsecured	BBB
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Subordinated	BB+
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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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceld/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on 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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