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Research Update:

Iceland-Based Landsbankinn Rating Raised To 'BBB+' On Improved Economic Risks And Capital; Outlook Stable

Primary Credit Analyst:
Helena Cederloef, Stockholm (46) 8-440-5920; helena.cederloef@spglobal.com

Secondary Contact:
Sean Cotten, Stockholm (46) 8-440-5928; sean.cotten@spglobal.com

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Overview

- Strong economic growth in Iceland continues, with improving economic resilience and falling private sector leverage, partly offset by concerns for increasing economic imbalances.
- The positive economic development underpins Landsbankinn's very strong capital assessment. We do not expect our view to change, even as the bank optimizes its capital base in preparation for an eventual partial sale in the coming years.
- As a result, we are raising our long-term rating on Landsbankinn to 'BBB+' and affirming the 'A-2' short-term rating on the bank.
- The stable outlook reflects our expectation that economic development in Iceland will remain supportive and that Landsbankinn will maintain very strong risk-adjusted capitalization.

Rating Action

On Oct. 25, 2017, S&P Global Ratings raised its long-term rating on Iceland-based bank Landsbankinn hf. to 'BBB+' from 'BBB' and affirmed its 'A-2' short-term rating. The outlook is stable.

Rationale

The upgrade reflects our view that Landsbankinn is likely to maintain stronger risk-adjusted capital (RAC) ratios than previously expected, on the back of continued strong economic developments in Iceland. In our view, economic risks in Iceland are receding and we expect that the domestic operating environment will remain favorable over the next two years, following the release of capital controls earlier in 2017 (for more details, see "Positive Rating Actions Taken On Four Icelandic Lenders On Improving Economic Conditions," published on Oct. 25, 2017, on RatingsDirect). We have therefore raised the anchor for banks operating in Iceland to 'bbb' from 'bbb-'.

We see continued strong development in the Icelandic economy, with GDP growth expected at 4% for 2017 and a flourishing tourism sector. The sovereign's financial position continues to improve due to a strong economic performance and current account surpluses. At the same time, private sector leverage continues to decrease. However, these developments are partly offset by increasing risks associated with the overheating housing market. House prices have increased by more than household income in the past year, raising concerns regarding affordability and economic imbalances.

Our assessment of reduced risks in Iceland leads to a lower capital charge for Landsbankinn's domestic exposures, boosting the bank's RAC ratio, which we estimate at 19.9% as of June 2017, pro forma based on economic risk group 4. We expect the RAC ratio to remain above 16.5% through 2019, despite Landsbankinn's plans to replace a significant amount of its equity with debt. Our higher capital forecasts are also supported by our expectation that the government will remain Landsbankinn's majority shareholder for several years. In our view, the extraordinary elections in 2016 and 2017 have delayed any decision to proceed with the sale process. We expect the government to sell shares in Landsbankinn in stages, over a prolonged period of time, and that this process will only start after Landsbankinn's main domestic peers have successfully completed their sales processes. Our higher long-term capital expectations improve our view of Landsbankinn's ability to absorb potential future losses.

We expect that Landsbankinn will continue to pay out most of its net profits as dividends, combined with extraordinary dividends to decrease the total capital base. We anticipate that, to some extent, share capital will be replaced by capital instruments, including the Additional Tier 1 debt issuances that are part of our capital forecast for 2019. Based on the high regulatory capital requirements in Iceland and the generous management buffers Landsbankinn targets, we do not expect it to have a RAC ratio below 15% in the longer term. Landsbankinn has publicly stated that it aims to remain within the highest RAC ratio category, as determined and measured by the relevant credit rating agencies.

Because of Landsbankinn's geographic concentration, the recent positive developments only lead to a one-notch upgrade. We consider that Landsbankinn's capital and risk positions are well reflected at the 'BBB+' level, especially based on our current projections of capital reductions. Icelandic customers and institutions comprise over 90% of Landsbankinn's credit exposures, aligning the bank's credit risk profile with the Icelandic economy. We note that about 8% of Landsbankinn's loan book at mid-2017 comprises loans to construction companies, somewhat higher than peers, and a potential source of additional concentration.

Outlook

The stable outlook on Landsbankinn reflects our expectations that its RAC ratio will remain above 15% over the next two years, despite high dividend payments and share buy-back programs. We view the bank's asset quality as in line with the risks in the Icelandic market and with domestic peers'. The stable outlook further balances our view of strong economic development in Iceland against the relatively concentrated and volatile nature of the Icelandic economy and increasing economic imbalances.

We could lower the rating if Landsbankinn's RAC ratio declined more than expected, or if loan asset quality deteriorated materially, requiring significant unexpected additional provisioning. This could follow from a quicker-than-expected sale to owners we view as more aggressive, for instance, private equity companies.

We do not currently expect to raise the rating as we see limited room for an improved view of the Icelandic banking market. In addition, we expect the bank's outstanding capital strength and leverage ratios to reduce materially in the coming years.

Ratings Score Snapshot

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

Related Criteria

- 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
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011

- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Positive Rating Actions Taken On Four Icelandic Lenders On Improving Economic Conditions, Oct. 25, 2017
- Republic of Iceland Ratings Affirmed At 'A/A-1'; Outlook Stable, June 30, 2017
- Banking Industry Country Risk Assessment: Iceland, March 10, 2017

Ratings List

Upgraded; Outlook Action; Rating Affirmed

	To	From
Landsbankinn hf.		
Counterparty Credit Rating	BBB+/Stable/A-2	BBB/Positive/A-2

Upgraded

	To	From
Landsbankinn hf.		
Senior Unsecured	BBB+	BBB

Additional Contact:
Financial Institutions Ratings Europe; FIG_Europe@spglobal.com

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.capitaliq.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.