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Landsbankinn hf.

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Landsbankinn hf.

SACP	bbb+

Anchor	bbb	
Business Position	Adequate	0
Capital and Earnings	Very Strong	+2
Risk Position	Moderate	-1
Funding	Average	0
Liquidity	Adequate	

\+

Support	0
ALAC Support	0
GRE Support	0
Group Support	0
Sovereign Support	0

\+

Additional Factors	0

Issuer Credit Rating

BBB+/Stable/A-2

Major Rating Factors

Strengths:	Weaknesses:
• Very high capital and leverage ratios. • Significant liquidity buffers in relation to wholesale funding.	• Few diversification opportunities in Iceland's economy. • Uncertainty associated with future ownership of the Icelandic banking sector.

Outlook: Stable

Our stable outlook on Landsbankinn reflects our expectations that the bank's RAC ratio will remain above 15% over the next two years, despite high dividend payments and share-buyback programs. We view the bank's asset quality as in line with domestic peers' and with the risks in the Icelandic market. 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 we expected, or if its loan asset quality deteriorated materially, requiring significant and unexpected additional provisioning. This could follow a quicker sale than we expect to owners that we view as more aggressive.

We consider a positive rating action unlikely because we expect the bank's regional and sector concentration to remain unchanged while its funding and liquidity profile normalizes after the lifting of capital controls. We also reflect this in our overall banking market assessment, which includes the rather small and concentrated nature of the market.

Rationale

Our rating on Landsbankinn reflects its comfortable capitalization level and solid market position in Iceland. Despite the bank's aim to optimize its capital position, we expect its risk-adjusted capital ratio (RAC) to remain above 15% over the coming 12-24 months, which is an important factor that supports Landsbankinn's creditworthiness.

The rating also factors in the bank's geographic concentration in a small and volatile economy, material exposure to the riskier small and midsize enterprise (SME) sector, and uncertainties regarding the bank's privatization process. Due to favorable conditions in the Icelandic economy in the past couple of years, in addition to the bank's consistent risk appetite, Landsbankinn's NPLs are reducing to levels closer to domestic peers'. If the credit cycle turned, we think the high capital levels would offset the bank's inherent geographical concentration and risk profile.

Landsbankinn's funding and liquidity metrics are currently at a favorable level but remain a neutral rating factor. This is due to a relatively limited track record in times of market stress, and we consider funding to be confidence sensitive. After the capital controls were lifted in 2017, we consider it likely that the bank will become more reliant on wholesale funding in the future.

Anchor: 'bbb' for banks with an Icelandic focus

Our bank criteria use our Banking Industry Country Risk Assessment (BICRA) economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. The anchor for a commercial bank operating only in Iceland is 'bbb', based on an economic risk score of '4' and an industry risk score of '5'.

We continue to view the economic risk trend in Iceland as stable, reflecting our expectation that economic expansion will support the banking sector amid signs that overheating is receding. We expect real GDP increases will moderate to 2%-3% in 2018-2021, from 3.6% in 2017 and 7.5% in 2016, driven by a slowdown in the expansion of the tourism sector and completion of some investment projects. The cooling of the economy will reduce the risk of imbalances, which has been evident in the recent exchange rate, as well as in labor and housing market trends. Specifically, house prices will continue to increase, but at a more tempered pace than in 2017, with a growth rate of about 7% on average in 2018-2019, down from an increase of more than 10% in 2016-2017.

The banking system has largely absorbed the shocks from the 2008 financial crisis, as reflected by declines in banks' nonperforming assets (NPAs), low new loan losses, private sector credit below 140% of GDP in 2017, and the successful lifting of capital controls in 2017. That said, we see risks stemming from a volatile Icelandic krona (ISK) and wage inflation, which could translate into a loss of economic competitiveness. The banks' credit risk may also start increasing, due to their sizable exposure to the real estate and tourism sectors and to consumer price index (CPI)-linked mortgage loans, combined with fierce domestic competition from nonbank institutions (for example, pension funds).

We now see the trend for industry risk in Iceland as stable over our 24-month horizon. Since the financial crisis, Iceland has moved to a stronger regulatory system and adeptly managed the recent lifting of capital controls, the restructuring of legacy banks, and the implementation of measures to reduce economic volatility. Moreover, Icelandic banks have rebalanced their funding model with domestic deposits, covered bonds, high shares of equity capital, and foreign wholesale funding. However, the higher reliance on external funding, the current optimization of capital levels, and a still relatively low core deposit base (about 35% on systemwide loans) increasingly exposes banks to wholesale market volatility. Overall, we consider banks' risk appetite to be sound, but some risks could arise from expansion in the lending activities of pension funds, which account for about 18% of mortgage stock and somewhat distort the competitive landscape for mortgages.

Table 1

Landsbankinn hf. -- Key Figures					
	--Year ended Dec. 31--				
Mil. ISK	**2018**	**2017**	**2016**	**2015**	**2014**
Adjusted assets	1,323,419	1,189,826	1,108,523	1,116,646	1,097,145
Customer loans (gross)	1,067,667	941,826	874,368	845,206	759,802
Adjusted common equity	227,066	230,011	235,591	234,019	225,891
Operating revenues	50,037	51,605	47,879	54,395	43,486
Noninterest expenses	23,453	23,850	23,514	23,732	24,088
Core earnings	17,399	18,813	19,163	26,788	14,683

ISK--Icelandic krona.

Business position: Largest universal bank in Iceland

Our view of Landsbankinn's business position reflects its leading market share of 30%-40% in primary business lines: corporate and retail banking, asset management, and corporate finance. Landsbankinn has traditionally been the leading corporate bank in Iceland, but over the past few years it has expanded into the domestic retail mortgage space, mainly by taking shares from the state-owned Housing Financing Fund. As such, we calculate that Landsbankinn has reached a share of about 19% of the Icelandic retail market, the highest in the country alongside its competitor Arion Bank. However, the bank is relatively small in an international context, with total assets of ISK1.3 trillion--about €9.5 billion--at end-December 2018, and a domestic focus that limits its diversification prospects given the nature of the Icelandic market.

In our view, Landsbankinn has been prudently managed since its creation in 2008, when it took on the domestic operations of the now defunct Landsbanki Islands hf. The bank's medium- to long-term targets include return on equity above 10%, close to the reported level of 8.2% in 2018 (or 9.8% excluding the current special tax on financial institutions). The target cost-to-income is below 45%, which we think is achievable in the next two to three years. This is despite Landsbankinn having a slightly larger footprint than domestic competitors. The bank has diverse revenues from retail banking, including consumer finance, midsize and large corporate activities, wealth management, and trading activities. However, the small domestic economy limits diversification prospects, in our view.

The bank has no public policy role and the government is not involved in its management and strategy, despite the 98.2% ownership share held by the Icelandic government. The government plans to reduce its stake in the bank to 34%-40% over time but, although no official timeline has been disclosed, we do not expect any material divestments over our two-year outlook horizon. We think the government will withdraw its ownership from Landsbankinn in stages, and we assume that the government does not intend to hold a majority stake in the bank over the longer term.

Table 2

Landsbankinn hf. -- Business Position					
	--Year ended Dec. 31--				
%	2018	2017	2016	2015	2014
Loan market share in country of domicile	26.60	25.90	25.60	24.40	22.90
Deposit market share in country of domicile	38.40	36.10	34.50	31.10	31.70
Total revenues from business line (mil. ISK)	53,687	52,947	49,018	68,171	63,496
Commercial banking/total revenues from business line	36.44	33.20	31.17	21.16	25.33
Retail banking/total revenues from business line	34.07	35.84	38.23	27.42	28.42
Commercial and retail banking/total revenues from business line	70.51	69.04	69.40	48.57	53.75
Trading and sales income/total revenues from business line	15.93	15.81	17.50	8.12	6.60
Other revenues/total revenues from business line	13.56	15.15	13.10	43.31	39.65
Investment banking/total revenues from business line	15.93	15.81	17.50	8.12	6.60
Return on average common equity	7.93	7.95	6.45	14.15	12.08

ISK--Icelandic krona.

Capital and earnings: High capital ratio while earnings stabilize at lower levels

Although capitalization should gradually reduce, we think it will remain relatively high and, as such, a positive rating factor. The RAC ratio as of Q2 2018 stood at 17.9%, compared to 19.4% at year-end 2017, as a result of an increasing loan book and high dividend payments. We anticipate a reduction of capital to about 16%-17% over 2019, on the back of sustained regular and extraordinary dividend payments and the replacement of part of the equity base with hybrid debt instruments. Specifically, we expect Landsbankinn to issue capital instruments to offset the reduction in common equity and change the mix of its capital base. In August 2018, Landsbankinn issued its second Tier 2 debt instrument and we expect it to tap the market for an Additional Tier 1 instrument, possibly in the next two years.

Our capital forecast is based on the current state-ownership of the bank and regulatory capital requirements. Specifically, we expect that the government will remain Landsbankinn's majority shareholder and keep a cautious stance on capital. Moreover, the regulatory capital requirements in Iceland are high relative to other European countries, mostly due to the concentrated and volatile nature of the Icelandic economy. We note that Landsbankinn's 24.9% total capital ratio as of December 2018 (Common Equity Tier 1 ratio of 23.6%), remains well above the requirement of 20.5%. Furthermore, the bank has an outstanding leverage ratio (at about 16% as of December 2018) compared with its European peers (6%-7%).

Like other Icelandic banks, Landsbankinn's profits have been volatile in the past due to loan loss reversals, litigation, and revaluations of financial assets and legacy loans acquired at deep discounts. We consider that the bank's profitability has now stabilized, with return on equity of about 8%-9% in the next two years. We expect net interest income--by far the main revenue source--to increase at about 3% in the next two years, mainly driven by both volumes of 1%-3% and slightly increasing margins. Costs were flatter in 2018 than in 2017, despite wage inflation and IT investments, and we expect the bank to remain at the same level of efficiency in 2019 and 2020.

We expect Landsbankinn's earnings buffer, which measures the capacity for a bank's earnings to cover normalized losses, will remain strong, between 180-190 basis points (bps).

We consider that Landsbankinn will continue to pay out most of its net profits as dividends, combined with extraordinary dividends in order to reduce its total capital base. In the past two years, Landsbankinn's dividend payments exceeded net profits by 1.5x on average.

Table 3

Landsbankinn hf. -- Capital And Earnings					
	--Year ended Dec. 31--				
%	**2018**	**2017**	**2016**	**2015**	**2014**
Tier 1 capital ratio	23.60	26.30	29.70	30.30	29.50
S&P Global Ratings’ RAC ratio before diversification	N/A	19.39	19.30	16.80	14.10
S&P Global Ratings’ RAC ratio after diversification	N/A	13.88	13.30	13.30	11.10
Adjusted common equity/total adjusted capital	100.00	100.00	100.00	100.00	100.00
Net interest income/operating revenues	81.57	70.29	72.37	59.42	64.56
Fee income/operating revenues	16.30	16.34	16.31	12.58	13.42
Market-sensitive income/operating revenues	0.31	8.58	3.29	21.05	12.61
Noninterest expenses/operating revenues	46.87	46.22	49.11	43.63	55.39
Preprovision operating income/average assets	2.11	2.41	2.19	2.77	1.72
Core earnings/average managed assets	1.38	1.63	1.72	2.42	1.31

N/A--Not applicable. RAC--Risk-adjusted capital.

Table 4

Landsbankinn hf. -- Risk-Adjusted Capital Framework					
Mil. ISK	**Exposure***	**Basel III RWA**	**Average Basel III RW (%)**	**S&P Global Ratings' RWA**	**Average S&P Global Ratings' RW (%)**
Credit risk					
Government and central banks	154,676	4,063	3	6,368	4
Institutions and CCPs	47,700	9,788	21	9,722	20
Corporate	578,332	533,425	92	561,925	97
Retail	406,479	204,475	50	218,879	54
Of which mortgage	276,691	114,188	41	100,698	36
Securitization§	0	0	0	0	0
Other assets†	37,685	39,050	104	49,092	130
Total credit risk	1,224,872	790,800	65	845,986	69
Credit valuation adjustment					
Total credit valuation adjustment	--	563	--	0	--
Market risk					
Equity in the banking book	18,682	18,682	100	206,844	1,107
Trading book market risk	--	17,100	--	25,650	--
Total market risk	--	35,782	--	232,494	--
Operational risk					
Total operational risk	--	96962.5	--	107673.5093	--

Table 4

Landsbankinn hf. -- Risk-Adjusted Capital Framework (cont.)

		Basel III RWA		S&P Global RWA	% of S&P Global RWA
Diversification adjustments					
RWA before diversification	--	924,107	--	1,186,153	100
Total diversification/concentration adjustments	--	--	--	471,300	40
RWA after diversification	--	924,107	--	1,657,453	140
		Tier 1 capital	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global Ratings' RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		243,013	26.3	230,011	19.4
Capital ratio after adjustments‡		243,013	26.3	230,011	13.9

*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Other assets includes deferred tax assets (DTAs) not deducted from ACE. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). CCP--Central counterparty. ISK--Iceland krona. RAC--Risk-adjusted capital. RW--Risk weight. RWA--Risk-weighted assets. Sources: Company data as of Dec. 31, 2017, S&P Global Ratings.

Risk position: Stable asset quality, while concentration risks remain

Our view of Landsbankinn's risk position mainly reflects its geographic concentration in a relatively volatile economy. Given Landsbankinn's large market shares in retail and SME lending, we think the bank's risk profile remains highly correlated to the domestic economy. For example, we note that the loan-to-value (LTV) could increase in times of high inflation, due to the high share of consumer price index-linked loans in the Icelandic market, which stood at almost 40% of customer loans at December 2018.

Landsbankinn's asset quality has improved as the Icelandic economy has recovered from the crisis, and the bank has reported material net impairment reversals since 2014. The reversals are connected to over-provisioning for legacy assets, and we expect only minor repercussions from now on. We expect loan impairments will remain low due to increased efforts to improve credit quality. As such, we anticipate normalized levels of new credit losses at about 30 bps over the coming two years, although one-off recoveries could create volatility.

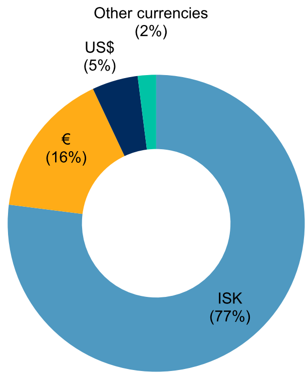
The sustained increase in customer loans over the past few years (+11.9% over the first nine months of 2018) has not resulted in increased credit losses. Gross NPAs to loans and repossessed assets have fallen to 3.0% at Q4 2018 from 3.6% in 2017, and a high 36% in 2012. Although the bank's NPAs have historically been higher than domestic peers', in part due to the higher share of SME lending, the gap is closing with domestic peers.

At the same time, we will continue monitoring the bank's share of lending to construction companies, which are generally more sensitive to swings in the economic development compared with other industries in Landsbankinn's portfolio. A young population and an increase in tourism have driven the expansion in real estate construction in the past couple of years. We note that Landsbankinn's lending to real estate and construction companies represented about 21% of total credit as of December 2018.

Foreign currency lending represents 23% of the total loan book. However, the bank mitigates this risk by granting credit to customers with income or assets in foreign currency. This mainly includes the fishing and transportation industry and modest exposure to nondomestic companies.

Chart 1

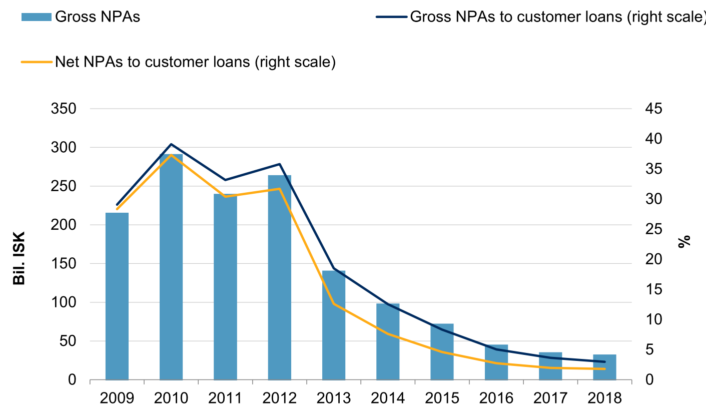
Landsbankinn hf. -- Loans By Currency



Source: Landsbankinn. Data as of Dec. 31, 2018. ISK--Icelandic krona. Figures also include loans to financial institutions, which mainly comprises balances and money market activities.

Chart 2

Landsbankinn hf. -- NPAs Stabilizing At Low Levels



Source: Landsbankinn. Data as of Dec. 31, 2018. NPA--Nonperforming asset.

Table 5

Landsbankinn hf. -- Risk Position					
	--Year ended Dec. 31--				
%	2018	2017	2016	2015	2014
Growth in customer loans	13.36	7.72	3.45	11.24	3.88
Total diversification adjustment/S&P Global Ratings' RWA before diversification	N/A	39.73	45.63	29.00	27.00
Total managed assets/adjusted common equity (x)	5.84	5.19	4.72	4.78	4.86
New loan loss provisions/average customer loans	(0.02)	(0.06)	(0.61)	(0.63)	(0.02)
Net charge-offs/average customer loans	0.38	0.49	0.87	0.68	1.56
Gross nonperforming assets/customer loans + other real estate owned	2.97	3.64	5.04	8.33	12.53
Loan loss reserves/gross nonperforming assets	40.38	47.03	47.12	47.14	42.51

N/A--Not applicable. RWA--Risk-weighted assets.

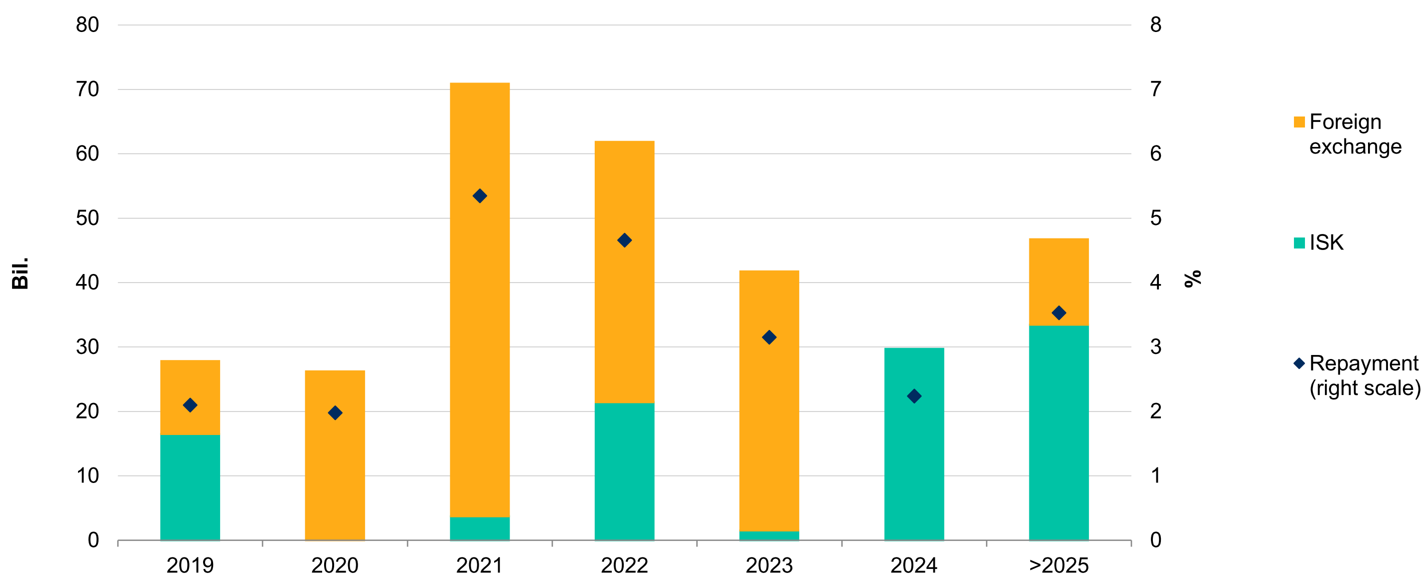
Funding and liquidity: Normalizing funding and liquidity metrics

Our assessment factors in the gradual normalization of the funding and liquidity profile from a level stronger than most international peers'. With the final release of capital controls in 2017 and the ongoing capital optimization, the reliance on wholesale funding, including short-term sources, has increased to about 31% of total financing sources at December-end 2018 from 27% two years previously. Furthermore, Icelandic banks' access to wholesale markets, domestic as well as international, has been continuous in recent months, but it still needs to prove better resilience to adverse market conditions. Although the bank remains largely deposit-funded, representing 65% of the funding base at Dec. 31, 2018, the loan-to-deposit ratio is 154%, which is high compared with international peers'. At the same time, we note that deposits increased by 15% in 2018, despite the recent release of capital control that has not led to rapid outflows of assets outside Iceland. Landsbankinn's stable funding ratio was at 103% at December 2018, a decrease from 111.2% at the end of 2017, but we think this metric should stabilize around this level in the coming years as credit expansion slows down.

Our measure of Landsbankinn's liquidity is reducing as the bank's debt profile normalizes (about ISK31 billion of debt is maturing in the next 12 months, mostly in foreign currency) and as liquidity sources reduce due to extraordinary dividend payments. Our measure of liquidity, broad liquid assets to short-term wholesale funding, dropped to 1.45x in December 2018, down from 3.7x at year-end 2017, which is a level more in line with other international peers'. We expect this indicator to stabilize around the current level in the next 12-24 months.

Chart 3

Landsbankinn hf. -- Maturity Profile Of Long-Term Debt



Source: Landsbankinn, as of Dec. 31, 2018. ISK--Icelandic krona.

Table 6

Landsbankinn hf. -- Funding And Liquidity

	--Year ended Dec. 31--				
%	2018	2017	2016	2015	2014
Core deposits/funding base	65.36	65.81	70.65	67.48	67.46
Customer loans (net)/customer deposits	152.21	152.96	144.71	145.17	130.27
Long-term funding ratio	88.91	94.46	93.73	93.50	93.94
Stable funding ratio	102.67	111.23	110.69	115.66	121.90
Short-term wholesale funding/funding base	13.57	7.01	8.13	8.55	7.91
Broad liquid assets/short-term wholesale funding (x)	1.45	3.27	2.94	3.42	4.36
Net broad liquid assets/short-term customer deposits	9.55	24.86	23.02	32.58	40.79
Short-term wholesale funding/total wholesale funding	39.18	20.50	27.71	26.30	24.32

Table 6

Landsbankinn hf. -- Funding And Liquidity (cont.)					
	--Year ended Dec. 31--				
%	2018	2017	2016	2015	2014
Narrow liquid assets/three-month wholesale funding (x)	2.10	5.28	4.18	4.79	4.74

Support: Government support for Icelandic banks is uncertain

We expect that the government will gradually decrease its ownership stake in Landsbankinn, currently 98.2%. According to its ownership policy, the government plans to retain a minority take of 34%-40% over the long term. As such, we do not consider Landsbankinn to be a strategic government-related entity for Iceland. Although we regard the bank as having high systemic importance, we add no uplift to the SACP because future extraordinary government support is uncertain, in our view. This reflects the Icelandic government's track record of not providing support for senior creditors and its improved, but still limited, capacity to support the country's new, smaller banking system in the event of severe financial stress.

At present, we do not regard the bank resolution framework as effective. As such, our ratings on Icelandic banks do not take into consideration any additional loss-absorbing capacity. We regard the current framework as open ended, but the authorities' method of dealing with failing banks so far indicates a tendency to safeguard depositors rather than senior unsecured creditors, in our view. In June 2018, the Icelandic parliament passed a bill that incorporates into the local legislation part of the EU's Banking Recovery And Resolution Directive (BRRD) provisions, including recovery plans, early interventions, and intra-group support. Over the next 12 months, we expect Iceland to finalize the BRRD implementation and, with it, bail-in powers that could lead us to change our view.

Hybrid ratings

We rate Landsbankinn's subordinated debt 'BBB-', two notches below the bank's 'bbb+' SACP. We deduct one notch due to the instruments' subordination to senior creditors' claims, and another notch because the instruments are available to absorb losses at the point of nonviability of the bank via statutory loss absorption. Given the lack of going-concern loss absorption, we are not including the instruments in our calculation of the total adjusted capital.

Additional rating factors: None

No additional factors affect this rating.

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

Related Research

- Iceland 'A/A-1' Ratings Affirmed; Outlook Stable, Dec. 7, 2018
- Nordic Banks' Strong Capital Isn't Likely To Soften, Oct. 17, 2018
- Iceland-Based Landsbankinn's Proposed Tier 2 Subordinated Notes Rated 'BBB-', Aug. 24, 2018
- Four Icelandic Banks Affirmed On Supportive Economic Growth, But Weakening Operating Landscape; Outlooks Stable, July 17, 2018

Anchor Matrix

Industry Risk	Economic Risk									
	1	2	3	**4**	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	**bbb**	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of February 28, 2019)	
Landsbankinn hf.	
Issuer Credit Rating	BBB+/Stable/A-2
Senior Unsecured	BBB+
Short-Term Debt	A-2
Subordinated	BBB-
Issuer Credit Ratings History	
25-Oct-2017	BBB+/Stable/A-2
25-Oct-2016	BBB/Positive/A-2
21-Jul-2015	BBB-/Positive/A-3
14-Oct-2014	BB+/Positive/B

Ratings Detail (As Of February 28, 2019) (cont.)	
Sovereign Rating	
Iceland	A/Stable/A-1

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.