S&P Global
Ratings

Research

Three Icelandic Banks Downgraded On Weaker Business Prospects And Effect Of COVID-19; Outlooks Stable

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- The global recession we expect in 2020 will affect the open and concentrated Icelandic economy and its banks, despite a substantial government package to counteract the effects. It will also exacerbate some of the Icelandic banking industry's weaknesses, such as its low profitability.
- In a fiercely competitive environment, distorted by the role of pension funds in lending, with declining interest rates and increasing provisions, the Icelandic banks' business prospects and earnings in the short-to-medium term are weak compared with peers. As such, we are taking a more conservative stance on their industry risk.
- At the same time, economic risks for Icelandic banks are increasing due to growing imbalances in the corporate sector, specifically commercial real estate, combined with asset quality deterioration. That said, capitalization remains a rating strength.
- We are lowering our ratings on Arion Bank, Islandsbanki hf., and Landsbankinn hf.
- The stable outlooks indicate that we expect these banks to withstand the consequences of the looming economic recession by maintaining solid capital positions and comfortable funding and liquidity profiles.

MADRID (S&P Global Ratings) April 24, 2020--S&P Global Ratings said today that it lowered its ratings on three Iceland-based banks: Arion Bank, Islandsbanki hf., and Landsbankinn hf. The outlooks are stable.

RATIONALE

We downgraded the banks because of the sharp reduction in economic activity we anticipate for Iceland and Europe in 2020. In our view, this will exacerbate the structural weaknesses of the domestic banking industry. Meanwhile, economic risks are building up on the back of the COVID-19 pandemic.

Because we revised down our assessment of industry risk, we also revised down the anchor we use as a starting point for rating financial institutions operating primarily in Iceland to 'bbb-' from 'bbb'. This triggered the downgrade of the three banks.

The banks face an economic recession in 2020, with GDP declining by more than 7%. The longer and deeper the economic contraction, the more it could impair Icelandic banks' asset quality, increase credit losses, reduce business and revenue generation, and potentially erode its capital.

The banks' structural exposures to local small and midsize enterprises (SMEs)--including tourism, which we view as a more vulnerable sector in the current context-- and their exposure to commercial real estate and construction sector (about 20% loan book) increase the risks. We generally consider that small-to-midsized banks with loan concentrations to SMEs in regions that are strongly affected by the COVID-19 pandemic are most susceptible, in the near term, to the deteriorating environment (see "COVID-19 Countermeasures May Contain Damage To Europe's Financial Institutions For Now," March 13, 2020). Therefore, we now see a negative, rather than stable, trend for economic risk for the banks.

We have also taken a more conservative stance on the overall banking industry risks in Iceland. Icelandic banks were already facing a structural decline in their profitability levels and the current crisis will exacerbate this trend, in our view. The declining interest rates are putting net interest margins under mounting pressure. This, coupled with the stiff competition from pension fund mortgage lending in a low diversified industry, made for bleak revenue trends. In addition, it will take time for the efforts to improve efficiency to materialize and counteract the inertial cost inflation in the banking industry. At the same time, credit provisions will increase materially as the effects of the COVID-19 pandemic build. We expect the cost of risk to reach about 100 basis points (bps) on average for the three commercial banks in 2020, from 30 bps in 2019, and the total amount of nonperforming assets on average loans to exceed 5% in the next two years (from about 3% in 2019). At the same time, we expect the lower than average NPA coverage ratio to remain at around the current level, 40% on average.

As a result, we expect banks to be close to breakeven in 2020, and profitability levels to remain structurally low through 2021.

In our view, pension funds continue to distort the competitive landscape for mortgages, by increasing pressure on pricing and, potentially, by affecting banks' underwriting for lending. Pension funds enjoy lower regulatory requirements than banks and represented about half of newly granted mortgage loans (net) in 2019. As yet, regulators have made only moderate attempts to address the potential negative effects for banks of this distortion.

The recent government decision to merge the market authority (FME) and the central bank (CBI) should benefit and streamline macroprudential policy and financial supervision, in our view. At the same time, we would expect this move to strengthen the regulator's ability to issue binding rules that support supervision of the entire financial sector and allocate appropriate resources to tackle increasingly demanding tasks, such as financial crime and cyber risk. At the same time, the government initiatives should allow the country to come off the Financial Action Task Force (FATF) "grey list", to which it was added in 2019.

Overall, we expect the banks to enter this crisis on a more solid foothold than the 2008 financial crisis. The 'BBB' rating level and stable outlooks factor in the solid market position of the three commercial banks in Iceland, which have relatively advanced digitalized banking platforms. In our view, the three banks are well ahead of many other European banks in their preparation for technological disruption.

Although Icelandic banks have regained full access to foreign debt capital markets and, in turn, diversified their funding mix, foreign investor confidence remains untested in a more turbulent economic environment. We consider Icelandic banks' funding and liquidity metrics to be in line with those of their international peers and adequate for their risk profiles. The banks' funding profile is similar, with a stable funding ratio of around 110% on average, as of December 2019. Moreover, their wholesale funding needs are limited in 2020, which coupled with the additional central bank liquidity facilities announced recently, eases pressure on liquidity needs. Our calculation of liquidity ratios remain comfortable, with liquid assets covering more than 3x, on average, the short-term funding as of December 2019.

OUTLOOKS

Landsbankinn

The stable outlook indicates that we expect a sharp economic contraction in Iceland associated with COVID-19 to impair the bank's profitability, causing return on equity to remain at 2%-4% over the next two years and asset quality to deteriorate so that Landsbankinn's nonperforming assets (NPA) ratio is likely to rise above 5%, from 3% as of December 2019.

At the same time, we acknowledge that Landsbankinn has a higher market share and slightly better efficiency than domestic peers. During the next two years, we anticipate that its risk-adjusted capital (RAC) ratio will remain above 15%, on the back of moderate loan growth and contained dividend payments. We also factor in our base case that the bank will improve its local currency liquidity metrics as planned, in line with its peers.

We could lower the ratings on Landsbankinn if the economic environment in Iceland becomes even more difficult, causing profitability prospects for banks to weaken for a prolonged period, alongside declining capitalization, with RAC ratio falling below 15%, and worsening asset quality.

Although unlikely in the current environment, we could raise our ratings on Landsbankinn if it proves able to strengthen significantly the performance of its returns, efficiency, and risk profile above domestic peers, with no further widening of the gap it has with foreign peers.

Islandsbanki

The stable outlook indicates that we expect a sharp economic contraction in Iceland associated with COVID-19 to impair the bank's profitability, causing return on equity to remain at 2%-4% over the next two years and asset quality to deteriorate so that Islandsbanki's NPA ratio is likely to rise above 5%, from 3% as of December 2019.

During the next two years, we anticipate that Islandsbanki's RAC ratio will remain above 15%, on the back of moderate loan growth and contained dividend payments. Moreover, we do not expect the sale of the subsidiary Borgun to weigh on the bank's financials.

We could lower the ratings on Islandsbanki if the economic environment in Iceland becomes even more difficult, causing profitability prospects for banks to weaken for a prolonged period and the RAC ratio to decline below 15%.

Although unlikely in the current environment, we could raise our ratings on Islandsbanki if it proves able to strengthen significantly the performance of its returns, efficiency, and risk profile above domestic peers, with no further widening of the gap it has with foreign peers.

Arion

The stable outlook indicates that we expect a sharp economic contraction in Iceland associated with COVID-19 to impair the bank's profitability, causing return on equity to remain at 2%-4% over the next two years and asset quality to deteriorate so that Arion's NPA ratio is likely to rise above 5%, from 2.9% as of December 2019.

During the next two years, we anticipate that Arion's RAC ratio will remain above 15%, on the back of moderate loan growth and contained dividend payments or buy-backs. Moreover, we expect the sale of its subsidiary Valitor to be executed as planned and without a meaningful negative impact for the bank's financials, particularly its capitalization.

We could lower the ratings on Arion if the economic environment in Iceland becomes even more difficult, causing profitability prospects for banks to weaken for a prolonged period declining capitalization and worsening asset quality.

Although unlikely in the current environment, we could raise our ratings on Arion if it proves able to strengthen significantly the performance of its returns, efficiency, and risk profile above domestic peers, with no further widening of the gap it has with foreign peers.

Ratings Score Snapshots

	To	From
Arion Bank		
Issuer Credit Rating	BBB/Stable/A-2	BBB+/Negative/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)	Moderate (-1)
Funding and Liquidity	Average and Adequate (0)	Average and Adequate (0)
Support	0	0
ALAC Support	0	0
GRE Support	0	0
Group Support	0	0
Sovereign Support	0	0
Additional Factors	0	0
Islandsbanki hf.		
Issuer Credit Rating	BBB/Stable/A-2	BBB+/Negative/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)	Moderate (-1)
Funding and Liquidity	Average and Adequate (0)	Average and Adequate (0)
Support	0	0
ALAC Support	0	0
GRE Support	0	0
Group Support	0	0
Sovereign Support	0	0
Additional Factors	0	0
Landsbankinn hf.		
Issuer Credit Rating	BBB/Stable/A-2	BBB+/Negative/A-2
SACP	bbb	bbb+
Anchor	bbb-	bbb
Business Position	Adequate (0)	Adequate (0)
Capital and Earnings	Very Strong (+2)	Very Strong (+2)

Ratings Score Snapshots (cont.)

	To	From
Risk Position	Moderate (-1)	Moderate (-1)
Funding and Liquidity	Average and Adequate (0)	Average and Adequate (0)
Support	0	0
ALAC Support	0	0
GRE Support	0	0
Group Support	0	0
Sovereign Support	0	0
Additional Factors	0	0

BICRA Score Snapshot

Iceland		
	To	**From**
BICRA group	5	4
Economic risk	4	4
Economic resilience	Low Risk	Low Risk
Economic imbalances	High Risk	High Risk
Credit risk in the economy	Intermediate Risk	Intermediate Risk
Industry risk	6	5
Institutional framework	Intermediate Risk	Intermediate Risk
Competitive dynamics	High Risk	Intermediate Risk

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, 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
- 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

- Tech Disruption In Retail Banking: Nordic Techies Make Mobile Banking Easy, Feb. 4, 2020
- Nordic Banks' Capital And Earnings Can Weather The Weakening Credit Cycle, Nov. 14, 2019
- Bulletin: Banking Industry Country Risk Assessment For Iceland Unaffected By The Country's FATF Grey Listing, Oct. 23, 2019
- Banking Industry Country Risk Assessment: Iceland, Sept. 17, 2019

Ratings List

****************** Arion Bank ******************		
Downgraded		
	To	**From**
Arion Bank		
Senior Unsecured	BBB	BBB+
Subordinated	BB+	BBB-
Junior Subordinated	BB-	BB
Downgraded; Outlook Action;		
	To	**From**
Arion Bank		
Issuer Credit Rating	BBB/Stable/A-2	BBB+/Negative/A-2
***************** Islandsbanki hf *****************		
Downgraded		
	To	**From**
Islandsbanki hf		
Senior Unsecured	BBB	BBB+
Subordinated	BB+	BBB-
Downgraded; Outlook Action;		
	To	**From**
Islandsbanki hf		
Issuer Credit Rating	BBB/Stable/A-2	BBB+/Negative/A-2
***************** Landsbankinn hf. *****************		
Downgraded		
	To	**From**
Landsbankinn hf.		
Senior Unsecured	BBB	BBB+
Subordinated	BB+	BBB-

Downgraded; Outlook Action;

	To	From
Landsbankinn hf.		
Issuer Credit Rating	BBB/Stable/A-2	BBB+/Negative/A-2

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/sourceId/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.