

Issuer Comment: [Landsbanki Islands hf](#)

Earnings Commentary - Second Quarter 2008

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*Landsbanki's first-half 2008 results held no rating implications. Its bank financial strength rating (BFSR) remains C- and its deposit and senior debt ratings are A2. The rating outlook is stable.*

Landsbanki's pre-tax, pre-provision income rose 56% year on year in H1 2008, largely due to strong net interest income and FX gains, but fee & commission income also developed favourably. Net interest income was up 48% driven by lending growth of 64% over the past 12 months. The substantial FX gains of ISK32.3 billion (€0.26 billion) (H1 2007: ISK0.3 billion) relate to the bank's hedging strategy: in order to hedge its equity against Icelandic króna volatility, Landsbanki has built up a positive FX balance equivalent to ISK199 billion (€1.6 billion), or 79% of its Tier 1 capital. Fee & commission income was up 12% year on year and accounted for nearly 30% of total operating income. Overall, earnings before tax were up 6% to ISK31.1 billion from ISK29.5 billion in H1 2007. The bank's cost efficiency remains good. The reported cost-to-income ratio was 46% at end-H1 2008, an improvement from 52% at end-2007.

Geographically, Iceland continues to generate an increasing share of Landsbanki's earnings, at 67% of net operating income in H1 2008 vs. 53% in H1 2007. It should be noted that the increased Icelandic revenues in H1 2008 are due to the temporarily large FX gains, and when excluded Iceland account for 41% of income. The remaining share of earnings is distributed between 12% from UK/Ireland (vs. 23%), 6% from Luxembourg (vs. 7%) and 15% from other locations (vs. 22%). Furthermore, in common with its Icelandic peers, Landsbanki's business model remains to some extent dependent on investment banking, which Moody's expects to prove challenging in current market conditions. In H1 2008, investment banking accounted for 46% of total pre-tax profit (H1 2007: 53%), while retail banking accounted for 15%, and corporate banking and asset management accounted for 39% and 8%, respectively. It should be noted that FX gains are booked under investment banking.

Moody's remains concerned over the weakened credit conditions in Iceland. Indeed, in H1 2008 Landsbanki reported a significant increase of nearly 260% in loan loss provisions, which accounted for a significant 26% of pre-provision income (H1 2007: 9%). At the same time, defaults rose to 0.55% of total lending from 0.24% at end-2007. Landsbanki's loan growth has historically been rapid but is likely to be significantly slower this year. In H1, the loan book grew 27% but, considering the effect of the devaluation of the króna, in euro terms the loan book growth was close to zero. Impairment on loans to customers increased from 0.34% at end-2007 to 0.85% in H1 2008 and loan loss reserves accounted for 1.2% of gross loans at end-June 2008 (year-end 2007: 1.1%). Of the total loans, around 70% are in foreign currency. Icelandic borrowers with no currency hedge, accounted for a low 2.9% of Landsbanki's total loan portfolio.

In our published research, Moody's has highlighted concerns over Landsbanki's significant borrower concentration and related-party exposure risk, which remains higher than at the other Nordic banks, and represents a credit challenge. On a positive note, the bank's related-party exposure remained nearly unchanged as at end-H1 2008 at ISK64.2 billion or 25% of its Tier 1 capital (year-end 2007: 27%). Landsbanki has no structured credit exposure. In addition, equity exposure has remained nearly unchanged at 2.5% of balance sheet at end-June 2008 (at end-2007: 2.1%). The bank is currently pursuing a zero-growth policy with reduced balance sheet growth targets (in euro terms).

Moody's will continue to monitor closely the development of the bank's asset quality. Given the historically rapid loan growth and the weakened credit environment in Iceland, we are concerned that problem loans could increase - especially given Landsbanki's high degree of borrower concentration and concentration of large exposures to Iceland.

Landsbanki's liquidity position remains sound and the bank continues to perform comfortably in Moody's stress tests for 12 months' non-access to the capital markets. In local currency terms, the bank increased its levels of deposits by 14% in the first six months of 2008; however, in real terms deposit growth was flat or slightly negative. Landsbanki's internet-based customer deposits form a key part of the bank's funding. In May, it extended its internet savings platform to continental Europe, with the introduction of the Icesave retail deposit programme in the Netherlands. In the coming months, the bank plans to extend its savings product to other European markets.

Moody's views favourably the growth in retail deposits, which continues to support the bank's funding base. However, as we have noted previously, we have some concerns regarding the "stickiness" of these overseas internet deposits due to their relatively short history. In terms of lending, the deposit-to-loan ratio weakened to 63% at end-June 2008 from 70% at the beginning of the year. Positively, the share of term deposits with internet deposits is on the increase, strengthening to 39% at end-June 2008 from 29% at end-March 2008 and cash ISAs

now account for 12%. On the funding side, the bank benefits from a relatively light repayment schedule in the second half of this year (€151 million). Overall, debt maturing within the next 12 months amounts to €855 million or 14% of total outstanding debt. Around two thirds of the bank's 2009 funding is due in the second half of the year. At end-June 2008, Landsbanki had liquid assets of €7.8 billion. Moody's will continue to monitor closely the bank's deposit-taking and overall funding position.

The capital ratio is satisfactory at 10.3% (vs. 11.7% at year-end 2007) and the Tier 1 ratio at 8.2% (vs. 10.1% at year-end 2007)(under Basel II). The ratios were primarily down due to a 34% increase in risk-weighted assets, which in turn was a reflection of the bank's increased open FX position. Moody's notes that the Icelandic regulator permits banks to have up to 33% in hybrid capital. At end-June 2008, Landsbanki's hybrids were at the regulatory limit.

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