

Outlooks Revised On Three Icelandic Banks On Receding Economic Imbalances; Ratings Affirmed

November 17, 2023

- In our view, the economic risks facing Iceland's banks are receding in tandem with a stabilizing housing market and unwinding private sector leverage, leading us to see the economic risk trend as positive.
- While residential property remains overvalued by most measures, price growth has gradually abated since its mid-year 2022 peak and we now expect a mild correction in real terms in 2023 and into 2024.
- Although we expect persistent inflation and higher interest rates to result in moderately deteriorating asset quality for the banking sector, we consider unlikely the risk of credit losses materially above our base case from a sharper devaluation of property prices.
- We expect Iceland will continue to post solid growth following an already substantial recovery from the pandemic-induced recession, with GDP growth of 3.8% in 2023 and averaging 2.5% in 2024-2026.
- We see also industry risks affecting the banking sector as broadly stable, with incumbent banks remaining profitable and well-capitalized, leaving them in a good position to fend off bank and nonbank competition.
- Therefore, we revised our outlooks on three Icelandic banks and affirmed the ratings.

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STOCKHOLM (S&P Global Ratings) Nov. 17, 2023--S&P Global Ratings today took rating actions on three Iceland-based banks:

- We revised our outlooks on Islandsbanki hf and Landsbankinn hf. to positive from stable, and affirmed the 'BBB/A-2' long- and short-term issuer credit ratings.
- We revised our outlook on Arion Bank to stable from negative, and affirmed the 'BBB/A-2' long- and short-term issuer credit ratings.
- We also affirmed our 'BBB+/A-2' long- and short-term resolution counterparty ratings on all three banks and our issue ratings on their debt.

Iceland's housing market imbalances are receding, and we now expect a mild correction of real prices in 2023-2024. After rapid growth fueled by historically low interest rates in the wake of the COVID-19 pandemic, residential property price growth peaked at close to 25% in nominal terms year on year in mid-year 2022. It has gradually abated since then to 3.3% year on year in October 2023 on the back of a cumulative increase of 8.5 percentage points in policy rates to 9.25% between May 2021 and October 2023, and sharpened borrower-based measures

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implemented by the Icelandic regulator. Subsequently, most measures of housing market activity--such as number of housing purchase contracts and average time to sale--have fallen markedly in 2023. With stubborn inflation, projected to average 8.3% in 2023 and 4.8% in 2024, we now expect a mild house price correction of 5%-10% in 2023 and into 2024, in real terms. While property remains overvalued in comparison to the underlying fundamentals, the ratios of prices to wages and rents are firmly reducing, a trend we expect will continue in 2024.

Despite this ongoing cooldown, underlying demand has proven relatively resilient. This is not least due to strong wage growth, measuring 10.9% year on year in September 2023, which continues to underpin borrower debt service capacity. An expanding population driven by immigration, combined with insufficient housing supply, will also continue to support residential property valuations, in our view. We therefore deem a more pronounced price fall, with negative repercussions for the banking sector, unlikely at this stage. Similarly, a resurgence of spiraling property prices seems, in our opinion, less plausible given persistent inflation and high inflation expectations that will keep the monetary policy stance tight over the next 12-18 months.

High debt service capacity and reducing leverage balance moderately rising debt service pressures. Private sector credit growth is slowing but remained relatively high at 8% year on year in September 2023, underpinned by sustained corporate credit demand and upward adjusted principles from indexed loans. At the same time, Iceland's strong ongoing economic expansion is reducing leverage in relative terms, with private sector debt to GDP expected at slightly above 150% at year-end 2023, from 174% in 2020.

We expect higher interest rates and slowing domestic demand will translate to moderately higher nonperforming assets in the banking sector, projected at 1.6%-1.8% of total assets over 2023-2025, from 1.6% for the first three quarters of 2023. This will lead to loan loss provisions averaging 20 basis points (bps)-25 bps, a level we consider manageable given banks' solid earnings prospects. Low unemployment, which we expect will average 4% this year, should mitigate a sharper deterioration by protecting debt service capacity.

Borrowers also have the ability to lower their interest rate burden by converting to an inflation-linked loan product. While supporting serviceability in the shorter term by offering a lower interest rate, indexed loans have the principle upward adjusted with inflation, which risks eroding borrower equity and weighing on collateralization levels. That said, the average Icelandic household has a comfortable equity position and sound loan-to-value following the recent house price growth cycle. We expect indexation, which accounted for 47% of mortgages and 30% of corporate debt as of July 2023, to increase over the next two years as fixed, nonindexed loans mature and borrowers seek to lower their monthly service costs.

We expect Iceland's economy will expand faster than those of most European peers, but momentum is slowing. We project GDP growth of 3.8% in 2023 and averaging 2.5% in 2024-2026. The substantial recovery from the COVID-19-induced recession has been fueled by strongly rebounding exports, estimated to have increased 30% over 2021-2023, but also robust domestic demand and upheld consumption, despite high inflation and rising interest rates. While the key tourism sector, representing roughly one-third of exports, is performing very well with most indicators surpassing 2019 levels, we expect domestic demand to take over as a key growth driver from 2024.

In tandem with Iceland's strong economic recovery, banks' corporate loan books have gradually improved with a sector nonperforming loans (NPL) ratio of 2.3% of total loans as of Sept. 30, 2023. This is unchanged from year-end 2022 and down from 8.9% in mid-year 2020. Banks' lending to domestic businesses is overall well diversified with some concentration toward real estate and

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construction, accounting for 17% of domestic systemically important banks' (D-SIBs') total loans, and key export sectors such as fisheries, accounting for 9%. We expect corporate loan portfolios to be correlated with the tourism sector, directly and indirectly, and estimate the direct exposure to tourism at slightly below 10% of total loans, including related commercial real estate.

Receding economic risks will support banks' earnings and robust risk-adjusted capitalization

(RAC). We expect broadly stable competitive dynamics, with the three incumbent banks maintaining their dominant positions in the market despite the gradual re-entry of pension funds into mortgage lending. High digital advancement, with close collaboration between incumbents and emerging technology firms, and only limited foreign competition, will continue to contain disruption risk, in our view.

We expect operating conditions to remain benign with increasing net interest income comfortably offsetting upward pressure on operating expenses, including cost of risk. We forecast the country's three incumbent banks will increase their net earnings to Icelandic krona (ISK) 81 billion-ISK87 billion (€560 million-€593 million), compared with ISK67 billion in 2022. We also expect a return on average equity of 11%-13%, from 10.3% in 2022, and cost to income of 39%-41%, from 46%. Sound earnings generation will underpin profit retention and support the build-up of capital.

Arion Bank

Outlook

The stable outlook balances our expectation that the economic risks facing Iceland's banks are receding with our view of downside risks to Arion restoring the RAC ratio sustainably above our 15% threshold for the very strong capital and earnings assessment over the next two years.

In our base case, we anticipate that Arion's profitability will remain strong, supporting the bank's capacity to build-up capital organically. This reflects our projection that Arion will maintain strong revenue generation, sufficiently offsetting upward pressure on operating expenses including cost or risk.

Downside scenario: We could revise the outlook to negative if we saw a weakening of economic risk indicators in Iceland or a lower probability of the bank restoring the RAC ratio to 15% or higher. That could materialize if the bank's asset quality or earnings came under pressure--impairing Arion's ability to build total adjusted capital (TAC)--or if S&P Global Ratings' risk-weighted assets (RWAs) increased beyond our current expectations.

Upside scenario: We could raise the rating in the next 12-24 months if we saw a sustained improvement in Iceland's economic risk indicators from receding housing market imbalances and private sector leverage. A positive rating action could also materialize if the bank were to build significant additional buffers of gone-concern loss-absorbing capital.

Islandsbanki

Outlook

The positive outlook on Islandsbanki reflects our expectation that the economic risks facing

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Icelandic banks are receding.

Upside scenario: We could raise the ratings on Islandsbanki in the next 12-24 months if we saw a sustained improvement of economic risk indicators from abating housing market imbalances and private sector leverage. This could lead us to raise the anchor on Icelandic banks to 'bbb' from 'bbb-', potentially resulting in a one-notch upgrade of Islandsbanki.

A positive rating action could also materialize if Islandsbanki were to build significant additional buffers of gone-concern loss-absorbing capital above our adjusted threshold of 4% of S&P Global Ratings' RWAs.

In our base case, we expect Islandsbanki will maintain its strong domestic retail and corporate franchise and sound financial position, underpinned by strong income generation and a robust projected RAC ratio above the 15% mark, notwithstanding the distribution of excess capital.

Downside scenario: We could revise the outlook to stable if the positive economic trajectory halted, particularly if we saw a material correction in the housing market or a weakening of key economic sectors.

An outlook revision to stable could also follow a weakening of Islandsbanki's RAC ratio below the threshold for our very strong capital and earnings assessment. That could materialize if the bank's asset quality or earnings came under pressure or if it distributed capital or increased RWAs beyond our current expectations.

Landsbankinn

Outlook

The positive outlook reflects our expectation that the economic risks facing Iceland's banks are receding.

Upside scenario: We could raise the ratings on Landsbankinn in the next 12-24 months if we saw a sustained improvement of economic risk indicators from abating housing market imbalances and private sector leverage. This could lead us to raise the anchor on Icelandic banks to 'bbb' from 'bbb-', potentially resulting in a one-notch upgrade of Landsbankinn.

A positive rating action could also materialize if the bank were to build significant additional buffers of gone-concern loss-absorbing capital above our adjusted threshold of 4% of S&P Global Ratings' RWAs.

In our base case, we expect Landsbankinn will maintain its leading domestic franchise and sound business operations, supported by strong income generation and robust RAC, notwithstanding the potential for distributions of excess capital.

Downside scenario: We could revise the outlook to stable if we saw a deterioration of economic risk indicators in Iceland. An outlook revision to stable could also follow a weakening of Landsbankinn's RAC ratio below the threshold for our very strong capital and earnings assessment. That could materialize if the bank's asset quality or earnings came under pressure or if it distributed capital or increased RWAs beyond our current expectations.

BICRA Score Snapshot

	To	From
BICRA group	5	5
Economic risk	5	5
Economic resilience	Intermediate risk	Intermediate risk
Economic imbalances	High risk	High risk
Credit risk in the economy	Intermediate risk	Intermediate risk
Trend	Positive	Stable
Industry risk	5	5
Institutional framework	Intermediate risk	Intermediate risk
Competitive dynamics	Intermediate risk	Intermediate risk
Systemwide funding	High risk	High risk
Trend	Stable	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.

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021
- 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
- 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

- Iceland Ratings Raised To 'A+' On Strong Growth and Fiscal Consolidation; Outlook Stable, Nov 10, 2023
- Banking Industry Country Risk Assessment Update: October 2023, Oct. 27, 2023
- Iceland Outlook Revised To Positive From Stable On Improving Public Finances And Strong

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Growth; 'A/A-1' Ratings Affirmed, May 12, 2023

Ratings List

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

Ratings Affirmed

Arion Bank

Resolution Counterparty Rating BBB+/-/A-2

Arion Bank

Senior Unsecured BBB

Subordinated BB+

Junior Subordinated BB-

Ratings Affirmed; Outlook Action

To From

Arion Bank

Issuer Credit Rating BBB/Stable/A-2 BBB/Negative/A-2

***** Islandsbanki hf *****

Ratings Affirmed

Islandsbanki hf

Resolution Counterparty Rating BBB+/-/A-2

Islandsbanki hf

Senior Unsecured BBB

Subordinated BB+

Junior Subordinated BB-

Ratings Affirmed; Outlook Action

To From

Islandsbanki hf

Issuer Credit Rating BBB/Positive/A-2 BBB/Stable/A-2

***** Landsbankinn hf. *****

Ratings Affirmed

Landsbankinn hf.

Resolution Counterparty Rating BBB+/-/A-2

Landsbankinn hf.

Senior Unsecured BBB

Subordinated BB+

Ratings Affirmed; Outlook Action

To From

Landsbankinn hf.

Issuer Credit Rating BBB/Positive/A-2 BBB/Stable/A-2

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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.spglobal.com/ratings for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at <https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceid/504352>. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings. Alternatively, call S&P Global Ratings' Global Client Support line (44) 20-7176-7176.

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