FITCH AFFIRMS ISLANDSBANKI HF AT 'BBB'/STABLE

Fitch Ratings-London-15 December 2017: Fitch Ratings has affirmed Islandsbanki hf's Long-Term Issuer Default Rating (IDR) at 'BBB', Short-Term IDR at 'F3' and Viability Rating (VR) at 'bbb'. The Outlook on the Long-Term IDR is Stable.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS
IDRS, VR AND SENIOR DEBT
The ratings of Islandsbanki reflect its leading domestic universal banking franchise, with market shares of around 30% in lending and deposits, its satisfactory asset quality, stable liquidity position and high reported capital ratios. The ratings also reflect the bank's operating environment in the small Icelandic economy that is vulnerable to domestic or international economic shocks.

Management has a focussed strategy targeting organic growth in Iceland. Lending abroad is limited to below 5% of assets and currently forms around 2% of loans. The risk management framework is sound, and we expect the strong growth of the Icelandic economy to continue to support the bank's asset quality.

Islandsbanki's asset quality has consistently improved since 2010. Non-performing loans, which include 90 days past due loans that are not impaired, were a low 1.9% at end-September 2017, down from 3.4% at end-2016. A significant portion of the loan book has been restructured in the last 10 years and is now in performing status.

Islandsbanki's capital ratios are solid by international comparison. At end-September 2017 the Fitch Core Capital/ risk weighted assets (FCC) ratio was 22.6% and the common equity Tier 1 ratio was 22.5%. This reflects strict regulatory requirements (minimum 14.9% common equity Tier 1 and 19.8% total capital ratios) to offset the risks inherent to operating in a small and potentially volatile economy. Leverage is also strong, with a Basel III leverage ratio of 15.3% at end-September 2017. We expect the bank's capital ratios to fall over the medium term, but that Islandsbanki will maintain sound buffers on top of its minimum requirements. Some parts of common equity will be replaced with subordinated debt as the bank prepares for its privatisation.

Earnings are adequate, with an operating profit/ risk weighted assets ratio of around 2%-2.5% in the past four years, supported by releases of impairment reserves. We expect loan impairment charges to normalise, but to remain low in the benign environment. The fairly modest size of the bank, a consequence of the small size of its operating market, means that cost efficiency is highly sensitive to revenue-generating capacity, in particular in light of necessary IT and digital-related investments.

Islandsbanki's funding is generally stable. The bank has rebuilt its access to international wholesale funding markets, most recently issuing a SEK750 million Tier 2 bond. Liquidity is prudently managed, and the bank maintains a large liquidity buffer (over 20% of total assets at end-September 2017) to absorb potential shocks. Deposit outflows following the lifting of capital controls in March have thus far been limited. We expect deposits to remain the largest funding source. The loans-to-deposits ratio was an adequate 128% at end-September 2017.

SUPPORT RATING AND SUPPORT RATING FLOOR
Islandsbanki's '5' Support Rating (SR) and Support Rating Floor (SRF) of 'No Floor' reflect Fitch's view that senior creditors cannot rely on receiving extraordinary support from the sovereign in the

event of the bank becoming non-viable, given the track record of the sovereign in imposing losses on bank creditors. In addition, we view it likely that Iceland will eventually adopt legislation in line with the EU's Bank Recovery and Resolution Directive.

RATING SENSITIVITIES

IDRS, VR AND SENIOR DEBT

Positive rating action could arise from demonstrated resilience of the Icelandic operating environment to a slowdown or external shocks, combined with the bank maintaining its moderate risk appetite, satisfactory asset quality and conservative approach to capital and liquidity management.

The ratings could come under pressure if Islandsbanki adopts a higher risk appetite, particularly in light of its future privatisation, for example through loosening underwriting standards or expansion overseas. Aggressive capital or liquidity management, or a significant shock to the economic environment leading to asset-quality deterioration would also be rating- negative.

SUPPORT RATING AND SUPPORT RATING FLOOR

An upgrade of the SR or upward revision of the SRF would be contingent on a positive change in Iceland's propensity to support domestic banks, which Fitch views as highly unlikely.

The rating actions are as follows:

Long-Term IDR affirmed at 'BBB'; Outlook Stable
Short-Term IDR affirmed at 'F3'
Viability Rating affirmed at 'bbb'
Support Rating affirmed at '5'
Support Rating Floor affirmed at 'No Floor'
Senior unsecured debt long-term rating affirmed at 'BBB'
Senior unsecured debt short-term rating affirmed at 'F3'

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Additional information is available on www.fitchratings.com

Applicable Criteria
Global Bank Rating Criteria (pub. 25 Nov 2016)
https://www.fitchratings.com/site/re/891051