FITCH UPGRADES ISLANDSBANKI TO 'BBB'; OUTLOOK STABLE

Fitch Ratings-London-27 January 2017: Fitch Ratings has upgraded Islandsbanki hf's Long-Term Issuer Default Rating (IDR) to 'BBB' from 'BBB-' and Viability Rating (VR) to 'bbb' from '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.

The upgrade reflects the continuous strengthening of the Icelandic operating environment following extended robust economic growth and an improved external position. Fitch recently revised the Outlook on Iceland's rating to Positive (see "Fitch Revises Outlook on Iceland to Positive; Affirms at 'BBB+", dated 17 January 2017).

The upgrade also reflects the successful re-building by Islandsbanki of a solid balance sheet in the wake of Glitnir's collapse in 2008, including successfully restructuring a large share of its loan book and managing down legacy funding and trapped deposits in an orderly fashion.

KEY RATING DRIVERS
IDRs, VR AND SENIOR DEBT
Islandsbanki's ratings are underpinned by the bank's leading Icelandic universal banking franchise, with domestic market shares of about 30% in lending and deposits, continuously improving asset quality, a stable liquidity position and high reported capital ratios. We believe the bank has established a good risk management framework and view positively its mainly domestic-focused strategy, with operations abroad limited to below 5% of assets. The bank's concentration in a small market is a rating constraint, as its size makes it more vulnerable to domestic and international shocks.

Iceland has taken significant steps in reducing its external vulnerabilities and removing capital controls. Composition agreements were reached with the creditors of failed banks in 2015, and included the transfer of ownership of Islandsbanki to the state in 1Q16. "Trapped" liquid krona-denominated assets held by non-residents have been reduced over time, including through an auction in June 2016. The remaining overhang is significant (ISK191 billion at end-2016) but this is mitigated by the FX reserves the Central Bank of Iceland has been building up (ISK815 billion at end-2016) and current account surpluses. Capital controls on residents have been eased substantially since October 2016.

Islandsbanki's capital and leverage ratios are solid by international comparison (Fitch Core Capital/weighted risks ratio of 27.9% and Basel III leverage ratio of 17.7% at end-September 2016), reflecting strict regulatory requirements (minimum 14.4% common equity Tier 1, 16.5% Tier 1 and 19.3% total capital ratios including fully-loaded counter-cyclical buffer) to offset the risks inherent to operating in the small and volatile economy.

We expect the bank's capital ratios to fall in the medium term, but that Islandsbanki will maintain sound buffers on top of its minimum requirements. Some part of common equity will be replaced with subordinated debt as the bank prepares for its privatisation. Capitalisation will likely remain a rating strength for the foreseeable future.

The bank's asset quality has been consistently improving since 2010. Gross impaired loans as a proportion of total loans have declined to just 2.7% at end-September 2016. A large portion of the loan book, which Islandsbanki acquired at a deep discount from its predecessor Glitnir, has been restructured. The restructurings have reduced the borrowers' debt levels, and restructured loans have been performing well with limited impairment. We expect Iceland's strong economic growth driven by domestic demand and tourism to continue to support Islandsbanki's asset quality.

The bank's funding and liquidity profile is fairly stable and further improved in 2016. All legacy funding from Glitnir was repaid in 2016. Remaining funding from foreign entities "trapped" under capital controls (about ISK21 billion) is minimal and is fully covered by cash kept in a special account with the central bank.

Islandsbanki continued to improve its access to international capital markets, most recently with a benchmark EUR500 million senior unsecured bond issued in September 2016. Liquidity is prudently managed, and the bank maintains a large liquidity buffer in place (around one-quarter of total assets at end-September 2016) to absorb the outflows accompanying the lifting of capital controls, which have so far been limited.

Islandsbanki's 'F3' Short-Term IDR is the lower of the two options mapping to the 'BBB' Long-Term IDR as we do not consider the bank's liquidity to be exceptional for its rating level.

SUPPORT RATING AND SUPPORT RATING FLOOR
The Icelandic sovereign's track record of imposing losses on bank creditors and public statements of burden sharing, particularly following the banking sector collapse, are the main drivers for Islandsbanki's Support Rating of '5' and Support Rating Floor of "No Floor". While state support is possible, Fitch does not believe that support from the Icelandic authorities can be relied upon.

RATING SENSITIVITIES
IDRs, VR AND SENIOR DEBT
Upside for Islandsbanki's ratings is currently limited. In the longer term, demonstrated resilience of the Icelandic operating environment to external shocks would be credit-positive if Islandsbanki maintains a moderate risk appetite, sound asset quality and a conservative approach to capital and liquidity management.

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

The senior unsecured debt ratings will likely move in tandem with Islandsbanki's IDRs.

SUPPORT RATING AND SUPPORT RATING FLOOR
The Support Rating could be upgraded and the Support Rating Floor revised upwards if Fitch changes its assessment of the Icelandic authorities' propensity to support, although this is unlikely.

The rating actions are as follows:

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

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

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