FitchRatings

Fitch Affirms Islandsbanki at 'BBB'; Outlook Stabl

Fitch Ratings-London-26 November 2018: Fitch Ratings has affirmed Islandsbanki hf's Long-Term Issuer Default Rating (IDR) at 'BBB' 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 are underpinned by its leading Icelandic universal banking franchise, with domestic market shares of about 30% in lending and deposits, good 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 domestic-focused strategy. These factors are offset by the bank's concentration on a small market, as its size makes Islandsbanki more vulnerable to domestic and international shocks, as well as by only adequate profitability.

Iceland (A/Stable) has significantly reduced external vulnerabilities, lifting nearly all capital controls in 2017 and with general government debt falling below 40% GDP. The sovereign has experienced strong economic growth, averaging 4.4% in 2013-2017 and the central bank has built up significant FX reserves (ISK761 billion at end-October 2018). Fitch views the regulatory framework as strong, as authorities aim to ensure resilience in light of the financial crisis.

Management has a strategy of targeting organic credit growth in Iceland, in line with domestic GDP growth. Lending abroad is limited to below 5% of assets and only to industries linked to the Icelandic economy, primarily seafood. The risk management framework is sound, although loan growth has been rapid in the past two years, and Fitch would expect to see this stabilise at lower levels in the future.

Islandsbanki's asset quality has consistently improved since 2010. A significant portion of the loan book has been restructured over the past decade and is now in performing status. Stage 3 loans under IFRS9 represented 2.5% of gross lending at end-September 2018 and have improved since the implementation of IFRS9.

Islandsbanki's capital ratios are solid by international comparison. At end-September 2018 the Fitch Core Capital (FCC)/risk weighted assets (RWA) ratio was 19.8% and the common equity Tier 1 ratio was 19.9%. This reflects strict regulatory requirements (from May 2019 minimum 14.8% common equity Tier 1 and 19.3% total capital ratios) aimed at offsetting the risks inherent to operating in a small and potentially volatile economy. Leverage is also strong, with a Basel III leverage ratio of 14% at end-September 2018. 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. As the bank prepares for privatisation it may look to issue more subordinated debt to further optimise its capital structure.

Earnings are adequate, with an average operating profit/RWA ratio of around 2% in the past four years, although the ratio was supported by releases of impairment reserves, which we believe are unsustainable. We expect loan impairment charges to normalise but to remain low in the current benign environment. The fairly modest scale 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, and the bank's already lean branch structure.

Islandsbanki's funding is generally stable. The bank has rebuilt its access to international wholesale funding markets, and has issued two Tier 2 bonds, totaling SEK1.25 billion, in the past year. It is also the largest covered bond issuer in Iceland with ISK132.6 billion outstanding at end-September 2018. Liquidity is prudently managed, and the bank maintains a large liquidity buffer (over 20% of total assets at end-September 2018) to absorb potential shocks. We expect deposits to remain the largest funding source. The loans-to-deposits ratio was an acceptable 139% at end-September 2018.

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 a continued improvement in asset quality, particularly as the loan book seasons following recent rapid growth. Improved profitability and a trend towards the bank's targeted cost efficiency would also be viewed positively, combined with the bank maintaining its moderate risk appetite and conservative approach to capital and liquidity management.

The ratings could come under pressure if Islandsbanki increases its risk appetite, particularly in light of its likely 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 long-term debt rating affirmed at 'BBB'
Senior unsecured short-term debt rating affirmed at 'F3'

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Applicable Criteria

Bank Rating Criteria (pub. 12 Oct 2018) (https://www.fitchratings.com/site/re/10044408)

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