Four Icelandic Banks Outlooks Revised To Negative On Weaker Business Prospects And Earnings; Ratings Affirmed

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- In a fiercely competitive environment, no longer supported by a strong economy, Icelandic banks' business prospects and earnings have become weaker.
- Banks compensated for low operating profits with extraordinary gains in recent years, but this has largely come to an end.
- In our view, the role of pension funds in lending distorts Icelandic banks' competitive environment in terms of business generation and margins. We therefore now see a negative trend for industry risk.
- Overall, economic risks for Icelandic banks remain stable for now. We expect the economy to contract in 2019 but rebound in 2020.
- We are revising to negative from stable our outlooks on Arion Bank, Islandsbanki hf, Landsbankinn hf., and Housing Financing Fund (HFF). We are affirming the ratings on all four banks.
- The negative outlooks reflect the likelihood of downgrades if current conditions persist, to the further detriment of the banks' earnings. The negative outlook on HFF also reflects the potential negative impact on the bank's business and financial profiles following its announced restructuring.

MADRID (S&P Global Ratings) July 23, 2019--S&P Global Ratings said today that it revised to negative from stable its outlooks on four Iceland-based banks: Arion Bank, Islandsbanki hf, Landsbankinn hf., and Housing Financing Fund Ibudalanasjodur (HFF). At the same time, we affirmed the 'BBB+/A-2' long- and short-term issuer credit ratings on Arion Bank, Islandsbanki, and Landsbankinn, and the 'BB+/B' ratings on HFF.

The rating actions reflect that we now see a negative trend for the banks' operating environment over our 24-month horizon. The banks face an economic recession in 2019, declining interest rates, still-high taxation, and stiff competition from pension fund lending in an industry that is concentrated, given the size of the economy and bankable population. The declining profitability of many banks illustrates these challenges. While the part of this is attributable to the additional cost of the ongoing investments aimed at increasing efficiency, we expect banks' profitability levels to remain structurally low at least over the next two years, with return on equity (ROE) in the low- to mid-single digits. In our view, the ongoing capital optimization will only marginally improve banks' nominal ROE as they will continue issuing relatively expensive hybrid instruments to meet their capital targets.

Moreover, we believe that risks could arise also from growth in the retail mortgage lending of the pension funds. In our view, pension funds' growing presence is distorting the competitive landscape for mortgages, as pension funds are putting pressure on pricing, and arguably banks' lending underwriting, in the medium-to-long term. Pension funds enjoy lower regulatory requirements than banks and represented about half of newly granted mortgage loans (net) in 2018. This increased their total share in the outstanding stock household mortgages to 26% in 2018 from 13% three years ago. As of today, we have seen only moderate attempts from regulators to address the potential negative effects on banks of this distortion.

The recent government decision to merge the market authority (FME) and the central bank (CBI) should benefit and streamline macro-prudential policy and financial supervision, in our view. At the same time, we would expect this move to strengthen the ability of the regulator to issue binding rules to support supervision of the entire financial sector and allocate appropriate resources to tackle increasingly demanding tasks, such as financial crime and cyber risk.

Although Icelandic banks have regained full access to foreign debt capital markets in the last two years and, in turn, diversified their funding mix, foreign investor confidence remains untested in a more turbulent economic environment. We calculate that the net external debt of the banking sector, as a percentage of domestic loans, increased to around 7.5% in 2018 from -2% in 2015. This requires continued efforts to keep foreign currency liquidity and funding ratios comfortable and strengthen the deposit base. The domestic debt capital market is inherently limited and highly concentrated by type of debt and investor, given the dominant presence of local pension funds.

We have not changed our view of the overall economic risks faced by Icelandic banks, and the trend for economic risk in Iceland remains stable. We expect the banks to maintain a relatively solid foothold as Iceland enters an economic recession, with GDP set to decline by 1.5% this year under our forecasts before returning to 2% growth in 2020-2021. The banks are more resilient having absorbed the shocks created by the 2008 financial crisis, with low nonperforming assets, stabilizing private sector debt, and the successful release of capital controls. Since 2017, growth in housing prices has cooled, following the slowdown in tourism and an increasing housing supply, which eased the risk of overheating. However, we consider that the banking sector might face incremental credit risks related to commercial real estate and tourism-related activities exposures, which we will closely monitor.

At present, a negative change in our assessment of industry risk would be sufficient for us to revise down the 'bbb' anchor we apply to financial institutions operating primarily in Iceland, which underpins our negative outlooks on Icelandic banks.

The affirmation of the banks' ratings reflects that the three commercial banks--Arion Bank, Islandsbanki, and Landsbankinn--share a solid market position in Iceland, with relatively advanced digitalized banking platforms, while their exceptional capitalization is partially balanced by its geographic and loan book concentrations. We also expect their asset quality indicators to stabilize after a prolonged balance sheet clean-up since inception and as a result of the economic slowdown. Moreover, the banks have similar funding and liquidity profiles, with liquidity buffers reducing from high levels as they extend their funding and optimize capital. We consider the banks' funding and liquidity positions to be in line with those of their international peers. We believe that the Icelandic banks materially improved their IT infrastructure and as well their ability to execute and process many fully digital products. We see the three banks as being well ahead of many other European banks in their preparation for technological disruption; however, they remain concentrated on a small market.

The revision of our outlook on HFF to negative from stable reflects mainly our view that the bank's legal structure, business set-up, and asset composition might lead to a weaker overall composition. We base this view on the government's intention to materially restructure HFF. We believe the contemplated change will not strengthen HFF's public policy role and its link to the government.

The government recently submitted a bill to the parliament to split HFF and create a new government agency, which will receive HFF's social loans portfolio (about 20% of total assets) in exchange for newly issued debt instruments. The HFF fund will maintain the ownership of the rest of the balance sheet in run-off and it will not grant new loans. The HFF fund will then be ultimately managed by the Ministry of Finance. The rating implications of the planned restructuring, expected to be approved by the Parliament by end-2019, are varied and might also incorporate considerations of HFF's potential legal status and changes to reporting requirements. Moreover, although the asset quality of the run-off portfolio might improve as result of a shrinking loan book and exclusion of social lending, the evolution of the capitalization and earnings of HFF under the new structure remains highly uncertain.

OUTLOOKS

Landsbankinn

The negative outlook reflects the possibility that we could lower the ratings on Landsbankinn over the next 24 months if the operating environment in Iceland becomes even more difficult, leading to banks having weaker business and profitability prospects than peers on a sustained basis.

At the same time, we acknowledge that Landsbankinn shows higher market shares, better efficiency and return metrics than domestic peers. During the next two years, we anticipate that the bank's risk-adjusted capital (RAC) ratio will remain above 15%, despite sustained dividend payments (ordinary or extraordinary) and other capital optimization initiatives. We also factor into our base case that Landsbankinn would not meaningfully change its strategy and underwriting standards if the bank were to be partially privatized in the next 18-24 months.

We could revise the outlook to stable should the competitive environment become more benign, leading to improved earnings prospects for banks. If this scenario does not materialize, to warrant a stable outlook we would expect to see Landsbankinn improving its returns, efficiency, and asset quality above domestic peers, with no further widening of the gap it has with foreign peers.

Arion

The negative outlook reflects the possibility that we could lower the ratings on Arion over the next 24 months if the operating environment in Iceland becomes even more difficult, leading to banks having weaker business and profitability prospects than peers on a sustained basis.

During the next two years, we anticipate that the bank's RAC ratio will remain above 15%, despite sustained dividend payments (ordinary or extraordinary) and other capital optimization initiatives. We also factor into our base case that Arion will not meaningfully change its strategy and underwriting standards over our outlook horizon. Moreover, we expect the sale of its subsidiary Valitor to be executed as planned and without a meaningful negative impact for the bank's financials, in particular its capitalization.

We could revise the outlook to stable should the competitive environment become more benign, leading to improved earnings prospects for banks. If this scenario does not materialize, to warrant a stable outlook we would expect to see Arion improving its returns, efficiency, and asset quality above domestic peers, with no further widening of the gap it has with foreign peers.

Islandsbanki

The negative outlook reflects the possibility that we could lower the ratings on Islandsbanki over the next 24 months if the operating environment in Iceland becomes even more difficult, leading to banks having weaker business and profitability prospects than peers on a sustained basis.

During the next two years, we anticipate that the bank's RAC ratio will remain above 15%, despite sustained dividend payments (ordinary or extraordinary) and other capital optimization initiatives. We also factor into our base case that Islandsbanki Bank will not meaningfully change its strategy and underwriting standards over our outlook horizon. Moreover, we expect the sale of the subsidiary Borgun to not have a meaningful negative impact on the bank's financials.

We could revise the outlook to stable if economic and operating conditions in Iceland improved and, at the same time, the bank's financial profile did not deteriorate.

We could also revise the outlook to stable should the competitive environment become more benign, leading to improved earnings prospects for banks. If this scenario does not materialize, to warrant a stable outlook we would expect to see Islandsbanki improving its returns, efficiency, and asset quality above domestic peers, with no further widening of the gap it has with foreign peers.

HFF

The negative outlook primarily reflects the possibility that we could lower the ratings on HFF in the next 12 months if we expect the announced changes in HFF's scope and structure to undermine its profitability further and lead us to materially change our RAC projections. This could also happen if we believe that the status of the institution and its business setup, based on the planned structural changes, would negatively affect HFF's relative creditworthiness.

We could also downgrade the bank if operating environment in Iceland became more difficult than we currently forecast and we consider that this will not be compensated for by a stronger financial profile or greater degree of government support.

We could revise the outlook to stable if we view the proposed changes as neutral for the financial profile of the rated entity, while the operating conditions in Iceland improve and the government commitment to HFF remains unchanged or improves.

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Hybrid Capital: Methodology And Assumptions, 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: Guarantee Criteria, Oct. 21, 2016
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011

- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Summary: Iceland, May 17, 2019
- Landsbankinn, Feb. 28, 2019
- Islandsbanki, Feb. 25, 2019
- Arion Bank, Feb. 8, 2019
- Icelandic Housing Financing Fund Outlook Revised To Stable; 'BB+/B' Ratings Affirmed, July 17, 2018

BICRA SCORE SNAPSHOT*

	To	From
BICRA Group	4	4
Economic risk	4	4
Economic resilience	Low risk	Low risk
Economic imbalances	High risk	High risk
Credit risk in the economy	Intermediate risk	Intermediate risk
Industry risk	5	5
Institutional framework	Intermediate risk	Intermediate risk
Competitive dynamics	Intermediate risk	Intermediate risk
Systemwide funding	High risk	High risk
Trends		
Economic risk trend	Stable	Stable
Industry risk trend	Negative	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.

RATINGS LIST

Ratings Affirmed; Outlook Action

	To	From
Arion Bank		
Issuer Credit Rating	BBB+/Negative/A-2	BBB+/Stable/A-2
Housing Financing Fund Ibudalanasjodur		
Issuer Credit Rating	BB+/Negative/B	BB+/Stable/B
Islandsbanki hf		
Issuer Credit Rating	BBB+/Negative/A-2	BBB+/Stable/A-2

Landsbankinn hf.		
Issuer Credit Rating	BBB+/Negative/A-2	BBB+/Stable/A-2
Ratings Affirmed		
Arion Bank		
Senior Unsecured	BBB+	
Subordinated	BBB-	
Housing Financing Fund Ibudalanasjodur		
Senior Unsecured	BB+	
Islandsbanki hf		
Senior Unsecured	BBB+	
Subordinated	BBB-	
Landsbankinn hf.		
Senior Unsecured	BBB+	
Subordinated	BBB-	

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