

# Three Icelandic Banks Upgraded On Receding Economic Imbalances; Outlooks Stable

April 4, 2024

## Overview

- We consider that economic risks facing Icelandic banks have abated with a stabilizing housing market and significant deleveraging of the private sector.
- In our base case, we expect balanced real residential property price growth of 2%-4% per year over 2024-2025 following a marked slowdown and 3.5% contraction in 2023.
- We expect Iceland's economic growth will average 2.4% over 2024-2025 and thereby outperform most Nordic and European peers, despite the ongoing deceleration in economic activity.
- We see industry risks affecting the banking sector as broadly stable, with incumbent banks remaining profitable and well capitalized, and in a good position to absorb the impact from potential asset quality weakening and to fend off foreign bank and non-bank competition should it emerge.
- We have therefore improved our assessment of economic risk faced by Icelandic banks and revised up our anchor for banks operating in Iceland to 'bbb' from 'bbb-'.
- As a result, we raised our long-term ratings on Arion Bank, Islandsbanki hf, and Landsbankinn hf to 'BBB+', raised the resolution counterparty ratings on all three banks to 'A-', and affirmed the 'A-2' short-term issuer credit ratings on all three banks.
- The outlook is stable on all three banks.

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## Rating Action

STOCKHOLM (S&P Global Ratings) April 4, 2024--S&P Global Ratings said today that it had taken the following rating actions on Iceland-based Arion Bank, Islandsbanki hf, and Landsbankinn hf:

- Arion Bank: We raised the long-term issuer credit rating to 'BBB+' from 'BBB', affirmed the short-term issuer credit rating at 'A-2', and raised the resolution counterparty rating (RCR) to 'A-' from 'BBB+'. The outlook is stable.
- Islandsbanki hf: We raised the long-term issuer credit rating to 'BBB+' from 'BBB', affirmed the short-term issuer credit rating at 'A-2', and raised the RCR to 'A-' from 'BBB+'. The outlook is stable.

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- Landsbankinn hf.: We raised the long-term issuer credit rating to 'BBB+' from 'BBB', affirmed the short-term issuer credit rating at 'A-2', and raised the RCR to 'A-' from 'BBB+'. The outlook is stable.

See the ratings list for all the ratings affected, including the ratings on the debt instruments.

## Rationale

**We consider that economic risks facing Icelandic banks have faded with the stabilizing housing market.** Residential house price growth has slowed since the mid-2022 peak. The 12-month price inflation fell steeply over 2023 and real prices corrected by 3.5%. Still, underlying demand appears robust and transaction activity has rebounded over recent months, albeit below the pre-pandemic average, resulting in some upward pressure on housing prices. This is partly explained by government measures to support households affected by the volcanic activity on the Reykjanes peninsula and the town of Grindavik, including the government's purchase of 89 new properties for residents in the area.

In our base case we project a relatively balanced house price development with real price growth of 2%-4%, in tandem with economic growth over the next two years. This reflects our view that monetary policy will remain tight, even if we are likely to see a gradual easing in policy rates over 2024-2025, which, in conjunction with sharper borrower-based measures by the Icelandic regulator in mid-2022, should limit upward pressure on prices. At the same time, we expect underlying demand for housing will remain strong, buoyed by resilient labor markets, improving real disposable incomes, and favorable demographic trends, including work-related immigration. Although uncertain at this point, support measures extended to residents of Grindavik could have an impact on house price inflation beyond our base-case projection in 2024.

Housing prices relative to underlying fundamentals have narrowed somewhat since the 2022 peak but remain wide, both in a historical context and compared with European peers. However, this is partly explained by recent years' strong economic activity, high immigration, and lagging supply of new housing.

**Reduced private sector leverage underpins debt serviceability.** Leverage in Iceland's private sector has fallen markedly relative to GDP, along with Iceland's strongly expanding economy and slowing private sector credit growth that contracted by around 1% in real terms in 2023. With continued high interest rates and comparatively favorable economic growth projections, we expect GDP will continue to outpace loans in 2024. We project private sector debt will stabilize at around 145% of GDP over the next two years, significantly below our 152% four-year rolling average (2021-2024, forecast), which is what we typically use to inform our assessment.

Moreover, the slowdown in borrowing and high wage growth, which was above 10% in 2023, have strengthened Icelandic households' debt-servicing capacity, with household debt to disposable income falling to 145% of GDP in 2023, from 151% in 2022. Wage growth will remain relatively strong in 2024-2025, albeit lower than in recent years. This, coupled with falling inflation, will further support real disposable incomes of households.

We expect credit demand and new lending will remain muted over the next two years. But we project private sector credit will still grow by 3%-5% in nominal terms. This is in part because of the increasing share of inflation-indexed loans in the system, accounting for 52% of household mortgages (from 43% in mid-2022) and 34% of corporate debt at year-end 2023, and thereby upward indexation of consumer price index-linked debt.

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**Slowing momentum but sound growth prospect ahead.** We expect Iceland's economy will continue to benefit from a favorable demographic profile and expanding emerging economic sectors. We forecast an average of 2.4% GDP growth over 2024-2025, stronger than most Nordic and European peers.

That said, GDP growth has slowed over recent quarters, with high interest rates suppressing household demand and corporate performance. After growing strongly in 2023 with tourist departures up 30% year on year, medium-term prospects for the tourism sector, accounting for around 30% of Iceland's exports, have become more uncertain, with some indicators pointing toward a slowdown in the sector.

We expect corporate loan portfolios to correlate with the tourism sector, directly and indirectly, and estimate the direct exposure to the sector at around 8% of total loans, including related commercial real estate. Domestic systemically important banks' (D-SIBs') lending to domestic businesses, accounting for 50% of customer loans, are overall well-diversified with some concentration toward real estate and construction, accounting for 17% of D-SIB's total loans, and fisheries, accounting for 9% of D-SIB's loans.

We expect tight financial conditions for borrowers and muted domestic demand will translate into upward pressure on nonperforming assets for incumbent banks, projected at 1.8%-2.0% over 2024-2025, from 1.7% as of Dec. 31, 2023. This will translate into loan-loss provisioning averaging 20-25 basis points (bps), a level we consider manageable considering banks' benign earnings prospects. Moreover, despite the ongoing deceleration of economic activity, the labor market is expected to remain robust with unemployment still close to a cyclical low, standing at 3.5% (seasonally adjusted) as of February 2024.

We anticipate the volcanic events in and near the town of Grindavik will have a limited impact on the banking sector's asset quality. Government measures to protect homeowners in the area and prudent measures to secure adequate loan loss provisioning taken by some of the banks both support our view. D-SIB exposures to affected customers amount to an aggregate 1.5% of loans, the majority of which to businesses where we expect a sizable share to be secured by transferable collateral.

**We expect banking sector profitability will continue outperform European peers.** While we expect net interest margins to have peaked, we forecast banks will continue to generate robust net interest income sufficient to offset lingering inflationary cost pressures and rising cost of risk. Consequently, we forecast the country's three incumbent banks will post net earnings of Icelandic krona (ISK)77 billion-ISK80 billion (€508 million-€527 million) over the next two years, from ISK84 billion in 2023. This translates into a robust return on average equity of 10%-12% over 2024-2025, compared with 11.9% in 2023, and a solid cost-to-income ratio around 40% (38%).

As a result of our revised view on economic risks facing Iceland's banks, we have lowered our risk weights on domestic household and corporate exposures. As such we project the three incumbent banks' risk-adjusted capital (RAC) ratios will be in 17%-18% in 2024-2026, from an estimated 17% as of year-end 2023. Although we expect Icelandic banks will remain committed to maintaining their RAC ratios above 15%, we do not exclude the potential for excess capital distribution beyond our base case, given that D-SIBs hold capital significantly above their regulatory requirements, with aggregate excess common equity tier 1 capital of nearly 600bps.

We expect broadly stable competitive dynamics, with the three incumbent banks maintaining their dominant position in the market despite rising competition from domestic pension funds in mortgage lending. After withdrawing from the market amid historically low interest rates and compressed mortgage margins, pension funds have regained market share since 2022, standing

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at around 26% at year-end 2023 compared with 23% in 2022.

### Arion Bank

Primary analyst: Niklas Dahlstrom

#### Outlook

The stable outlook reflects our expectation that Arion will maintain a sound financial position in the next 24 months with high income generation, sufficiently offsetting upward pressure on operating expenses and cost of risk, as well as robust capitalization, notwithstanding the potential for distribution of excess capital.

**Downside scenario:** As one of the three incumbent banks in Iceland, Arion's performance will be closely tied to the overall development of the Icelandic economy and banking sector. The most likely downside scenario would be an economic slowdown, pressure on household debt-servicing capacity, and falling asset prices. This is likely to be consistent with bank credit losses significantly above the long-term average amid deteriorating earning capacity.

We could also take a negative rating action if we saw a weakening of Arion's RAC ratio below the threshold for our very strong capital and earnings assessment.

**Upside scenario:** We could take a positive rating action if Arion were to build significant additional buffers of gone-concern loss-absorbing capital above our adjusted threshold of 4% of S&P Global Ratings' risk-weighted assets (RWAs).

### Islandsbanki hf

Primary analyst: Salla von Steinaecker

#### Outlook

The stable outlook reflects our expectation that Islandsbanki will maintain a sound financial position in the next 24 months, underpinned by strong profitability and operating efficiency in line with its financial targets and a robust risk-adjusted capitalization, notwithstanding the bank's ongoing privatization and the potential for distribution of excess capital.

**Downside scenario:** As one of the three incumbent banks in Iceland, Islandsbanki's performance will be closely tied to the overall development of the Icelandic economy and banking sector. The most likely downside scenario would be an economic slowdown, pressure on household debt-servicing capacity, and falling asset prices. This is likely to be consistent with bank credit losses significantly above the long-term average amid deteriorating earning capacity.

We could also lower the rating if we expect risk-adjusted capitalization to fall below the level we consider to be very strong. This could occur if the bank undertakes significant excess shareholder distributions resulting in a sustainably lower RAC ratio.

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**Upside scenario:** We could take a positive rating action if Islandsbanki were to build significant buffers of additional loss-absorbing capacity above our adjusted threshold of 4% of S&P Global Ratings' RWAs. This would reduce the default risk for senior preferred debt holders.

## Landsbankinn hf

Primary analyst: Niklas Dahlstrom

### Outlook

The stable outlook reflects our expectation that Landsbankinn will maintain its leading domestic franchise and sound business operations in the next 24 months, supported by strong income generation sufficiently offsetting rising operating expenses, including cost of risk, and robust capitalization, notwithstanding the potential for distribution of excess capital.

**Downside scenario:** As one of the three incumbent banks in Iceland, Landsbankinn's performance will be closely tied to the overall development of the Icelandic economy and banking sector. The most likely downside scenario would be an economic slowdown, pressure on household debt-servicing capacity, and falling asset prices. This is likely to be consistent with bank credit losses significantly above the long-term average amid deteriorating earning capacity.

We could also take a negative rating action if we saw a weakening of Landsbankinn's RAC ratio below the threshold for our very strong capital and earnings assessment.

**Upside scenario:** We could take a positive rating if Landsbankinn were to build significant additional buffers of gone-concern loss-absorbing capital above our adjusted threshold of 4% of S&P Global Ratings' RWAs.

## BICRA Score Snapshot

### Iceland BICRA Score Snapshot

	To	From
<b>BICRA group</b>	<b>4</b>	<b>5</b>
Economic risk	4	5
Economic resilience	Intermediate risk	Intermediate risk
Economic imbalances	Intermediate risk	High risk
Credit risk in the economy	Intermediate risk	Intermediate risk
Trend	Stable	Positive
<b>Industry risk</b>	<b>5</b>	<b>5</b>
Institutional framework	Intermediate risk	Intermediate risk
Competitive dynamics	Intermediate risk	Intermediate risk
Systemwide funding	High risk	High risk
Trend	Stable	Stable

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### Iceland BICRA Score Snapshot (cont.)

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

- Banking Industry Country Risk Assessment Update: March 2024, March 26, 2024
- Nordic Banks In 2024: Ploughing Through Tough Terrain, Feb. 7, 2024
- Credit Conditions Europe Q1 2024: Adapting To New Realities, Nov. 28, 2023
- Outlooks Revised On Three Icelandic Banks On Receding Economic Imbalances; Ratings Affirmed, Nov. 17, 2023
- Iceland Ratings Raised To 'A+' On Strong Growth and Fiscal Consolidation; Outlook Stable, Nov 10, 2023
- Islandsbanki's Solid First-Quarter Earnings, Reduced Capital Distribution Provide Financial Flexibility, May 10, 2023
- Banking Industry Country Risk Assessment: Iceland, March 24, 2023

### Ratings List

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\*\*\*\*\* Arion Bank \*\*\*\*\*

Upgraded		
	To	From
<b>Arion Bank</b>		
Senior Unsecured	BBB+	BBB
Subordinated	BBB-	BB+
Junior Subordinated	BB	BB-

Upgraded; Ratings Affirmed		
	To	From
<b>Arion Bank</b>		
Issuer Credit Rating	BBB+/Stable/A-2	BBB/Stable/A-2
Resolution Counterparty Rating	A-/--/A-2	BBB+/--/A-2

\*\*\*\*\* Islandsbanki hf \*\*\*\*\*

Upgraded		
	To	From
<b>Islandsbanki hf</b>		
Senior Unsecured	BBB+	BBB
Subordinated	BBB-	BB+
Junior Subordinated	BB	BB-

Upgraded; Outlook Action; Ratings Affirmed		
	To	From
<b>Islandsbanki hf</b>		
Issuer Credit Rating	BBB+/Stable/A-2	BBB/Positive/A-2

Upgraded; Ratings Affirmed		
	To	From
<b>Islandsbanki hf</b>		
Resolution Counterparty Rating	A-/--/A-2	BBB+/--/A-2

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

Upgraded		
	To	From
<b>Landsbankinn hf.</b>		
Senior Unsecured	BBB+	BBB
Subordinated	BBB-	BB+

Upgraded; Outlook Action; Ratings Affirmed		
	To	From
<b>Landsbankinn hf.</b>		
Issuer Credit Rating	BBB+/Stable/A-2	BBB/Positive/A-2

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### Upgraded; Ratings Affirmed

	To	From
<b>Landsbankinn hf.</b>		
Resolution Counterparty Rating	A-/--/A-2	BBB+/--/A-2

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](http://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/sourceld/504352>. Complete ratings information is available to RatingsDirect subscribers at [www.capitaliq.com](http://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](http://www.spglobal.com/ratings). Alternatively, call S&P Global Ratings' Global Client Support line (44) 20-7176-7176.



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