S&P Global Ratings

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Banking Industry Country Risk Assessment: Iceland

September 17, 2019

Banking Industry Country Risk Assessment Group				4
4 Economic Risk		**5 Industry Risk**		
Economic resilience	Low Risk	Institutional framework	Intermediate Risk	
Economic imbalances	High Risk	Competitive dynamics	Intermediate Risk	
Credit risk in the economy	Intermediate Risk	System wide funding	High Risk	

Government Support:

Support Uncertain

Major Factors

Strengths:

- Economy characterized by high per capita income levels and robust projected growth rates.
- Contained and stable credit growth while income levels increase.
- Commercial banks' conservative lending practices.

Weaknesses:

- An economy that remains volatile and sensitive to external developments, given Iceland's comparatively small size.
- Tourism-related building growth and increasing commercial real estate prices could lead to widening imbalances.
- Government ownership and nonbank involvement in the financial sector.

PRIMARY CREDIT ANALYST

Antonio Rizzo
Madrid
(34) 91-788-7205
Antonio.Rizzo@spglobal.com

SECONDARY CONTACTS

Erik Andersson
Stockholm
+ 46 84 40 5915
erik.andersson@spglobal.com

Anna Lozmann
Frankfurt
(49) 69-33-999-166
anna.lozmann@spglobal.com

See complete contact list at end of article.

Rationale

S&P Global Ratings classifies the banking sector of Iceland (A/Stable/A-1) in group '4' under its Banking Industry Country Risk Assessment (BICRA). Other countries in group '4' include Ireland, New Zealand, Poland, Kuwait, and Spain. Other peers for Iceland are Qatar and Malta (group '5').

Our bank criteria use our BICRA economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. The anchor for banks operating only in Iceland is 'bbb'.

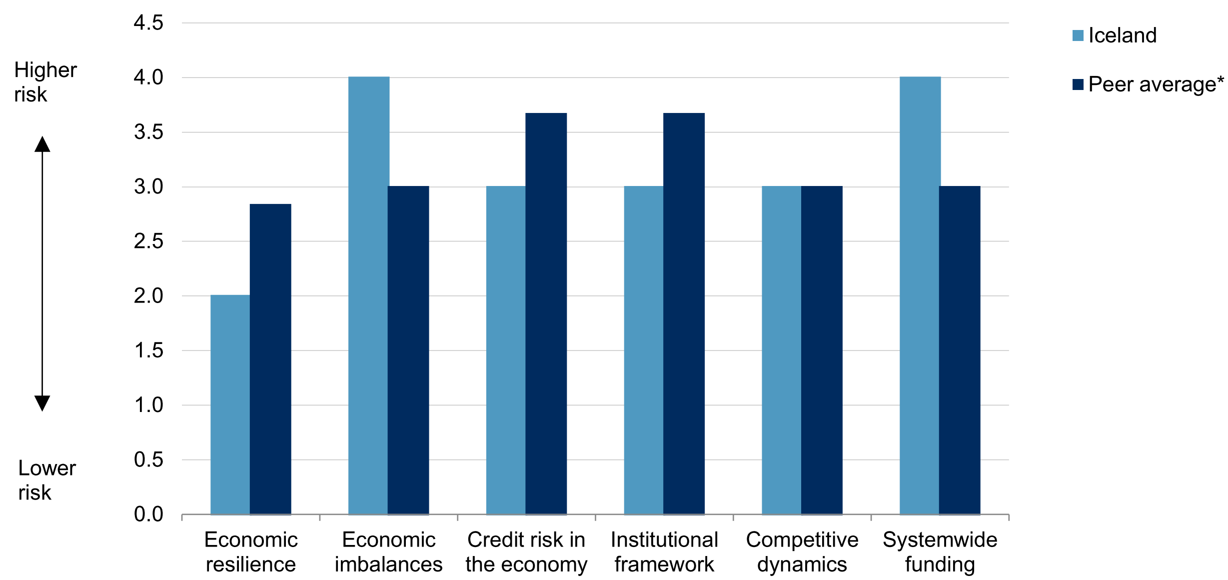
Our view of economic risks faced by Icelandic banks remain unchanged despite looming economic recession in 2019. The banks operate on a relatively solid foothold, having absorbed the shocks created by the 2008 financial crisis reflected in low nonperforming assets, contained new loan losses, stabilizing private sector debt, and the successful release of capital controls. In addition, we believe that the resilience of the Icelandic economy is sustained by improved sovereign finances and low unemployment. We anticipate that recovery of tourist arrivals and solid domestic consumption will help the country's prosperous but concentrated economy to return to annual real GDP growth of about 2% over 2020-2021. Since 2017, price growth in the housing market has cooled, following the slowdown in tourism and an increasing housing supply, and eased the risk of overheating.

Since the financial crisis, Iceland has moved to a stronger regulatory framework and an improved funding model based on domestic deposits, covered bonds, and high share of equity capital, complemented by foreign wholesale funding for the Icelandic banks. Moreover, Iceland is currently preparing to merge the central bank and the Financial Supervisory Authority with the aim of streamlining the financial supervision functions.

However, there are risks stemming from the lightly regulated pension funds' lending. Over the past few years, they have been significantly increasing their share of the mortgage market (27% as of June 2019 from 17% at year-end 2016).

Chart 1

BICRA Iceland--Peer Comparison



*Peers are Spain, Malta, Ireland, Kuwait, New Zealand, Qatar, and Poland. Source: S&P Global Ratings

Economic And Industry Risk Trends

The trend for economic risk in Iceland is stable. This reflects our expectations that house prices growth will be moderate in the next two years, because construction is gradually catching up with demand. However, the persistent shortage of housing and hotels continues to drive commercial real estate pricing, which is approaching the peak levels experienced before the financial crisis. We see continued positive development in Iceland's economic resilience, due to further strengthening of the sovereign fiscal position and improved flexibility of the monetary policy following the removal of capital controls in 2017. Nevertheless, we do not expect this to notably improve the stability of the banking sector.

We now view the trend for industry risk in the Icelandic banking sector as negative. While we expect banks' returns to remain based on sound commercial practices, the overall profitability is stabilizing at low level (mid-single-digit return on equity), in absence of the substantial one-off items reported over the past few years and challenged by economic slowdown and pension funds competition. Moreover, although foreign investor confidence in Icelandic banks has been improving, it remains volatile and untested in a more turbulent economic environment. This increases the relevance of building up a solid deposit base, which is below peer average as a percentage of total funding, while the domestic debt capital market is inherently limited and highly concentrated by type of debt and investor. Lastly, we consider that the planned restructuring and streamlining of the financial supervision should strengthen the banking regulatory oversight.

Economic Risk

The key factors weighing on our assessment of economic risk in Iceland are the country's vulnerability to external developments, and the inherent volatility of the economy. Offsetting these factors are the relatively wealthy economy with high income levels, solid fiscal position, stabilizing house-price growth, private debt, and sound underwriting standards.

Economic resilience: Despite high per capita income, the small Icelandic economy remains volatile

Economic structure and stability. The Icelandic economy is prosperous, with per capita GDP of over $70,000 in 2018, which is strong compared with its peers in BICRA group '4'. However, given the bankruptcy of the airline WOW Air earlier this year (which had a negative impact on the key tourism sector) and a weak capelin fishing season, we expect the Icelandic economy to contract by 1.5% in 2019. Thereafter, we expect the economy to rebound, with growth averaging close to 2% annually over 2020-2022. In our view, growth rates in the tourism sector will not return to those observed over the past few years, given the sector's high prices and capacity constraints.

We also anticipate subdued private consumption growth this year, compared with recent higher levels. We expect stronger GDP dynamics from 2020 will be underpinned by investment and private consumption recovery, and supported by other airlines absorbing the capacity lost following WOW Air's bankruptcy.

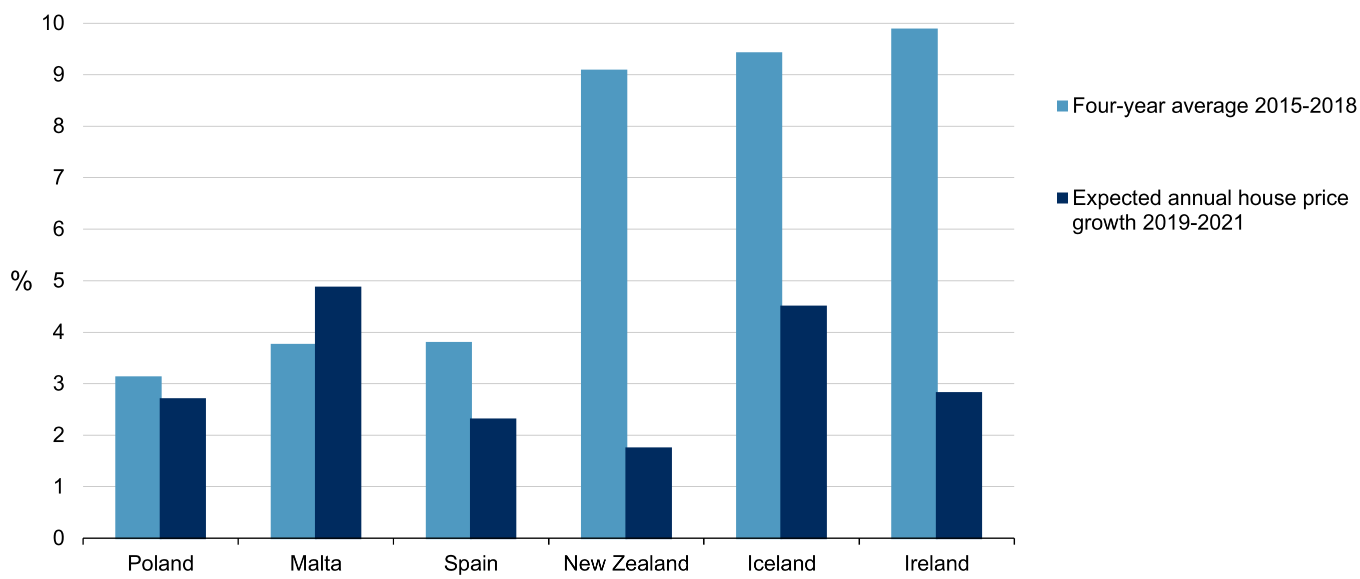
A more severe slowdown than we expect could affect bank balance sheets, given their exposure to the housing market and real estate developments.

Until 2017, Iceland saw substantial house price increases, particularly in the Reykjavik area. Since then, price growth in the housing market has cooled from double-digit levels to about 4% in the first half of 2019, in line with the slowdown in tourism and an increasing housing supply. Private sector leverage has been steadily declining as a percentage of GDP since 2008, but has recently shown signs of picking up.

We believe that the economy remains structurally volatile, partly owing to its small size, as demonstrated by boom-bust cycles in the past. Output is concentrated in the fishing, metals and, more recently, tourism sectors. As evidenced in the first half of 2019, an unexpected fall in tourism inflows or any development that hurts fish stocks or their migration patterns may have a considerable influence on the country's economic performance.

Chart 2

BICRA Iceland--Percentage Change In Inflation-Adjusted Housing Prices (Real)



Source: S&P Global Ratings.

Macroeconomic policy flexibility. In our opinion, Iceland's fiscal position is strong, giving the authorities headroom to maneuver in case of need. The fiscal position has improved considerably over the past few years, with net general government debt declining steadily from a peak of almost 80% of GDP in 2011 to a forecast 29% of GDP at the end of 2019. Given the weaker economic outlook, rising unemployment, and fiscal measures agreed around the wage negotiations, fiscal pressures will increase. Furthermore, some loosening of tax policy and infrastructure investments will likely continue, but we note that Iceland's fiscal policy framework and fiscal rules curb the potential for significant fiscal slippage. Although we expect the general government budget will turn to deficits over our forecast horizon, these will be contained averaging 1.5% of GDP annually through 2022. Consequently, net general government debt should stabilize at just under 30% of GDP.

In contrast to fiscal policy, Iceland's monetary flexibility is more constrained. The economy's small size and high dependence on imports--resulting in strong pass-through effect from exchange-rate volatility--structurally limits the ability of the Central Bank of Iceland (CBI) to independently influence domestic economic conditions. Historically, monetary policy has often not been effective at keeping inflation near the CBI's target. That said, Iceland's monetary flexibility has improved following the March 2017 lifting of capital controls and given the adherence to a broadly flexible exchange rate arrangement since then. We also believe that the accumulation of substantial extra net foreign exchange reserves has underpinned the CBI improved ability to act as a lender of last resort for the domestic banking system, both in foreign and local currencies.

Political risk. We maintain our view that Iceland benefits from a strong civil society, effective institutional checks and balances, and a highly educated and productive workforce. Despite some political volatility in 2017, we expect a broad continuation of recent government policies. Specifically, we do not foresee major fiscal risks, although a generally weaker macroeconomic environment could highlight divergent policy priorities more prominently than in the first half of the government's term.

Table 1

BICRA Iceland--Economic Resilience

	2015	2016	2017	2018	2019F	2020F
Nominal GDP (bil. $)	17.39	20.62	24.49	25.88	23.44	23.15
Per capita GDP ($)	52,838	62,005	72,390	74,278	65,650	63,887
Real GDP growth (%)	4.7	6.6	4.6	4.6	(1.5)	1.8
Inflation (CPI) rate (%)	1.6	1.7	1.8	2.7	3.2	3.5
Monetary policy steering rate (%)	5.8	5.0	4.3	4.5	4.5	4.5
One-year government borrowing rate (%)	6.3	6.6	5.2	4.9	5.0	5.0
Net general government debt as % of GDP	46.3	39.1	35.3	29.1	28.9	29.4

F--Forecast. Source: S&P Global Ratings

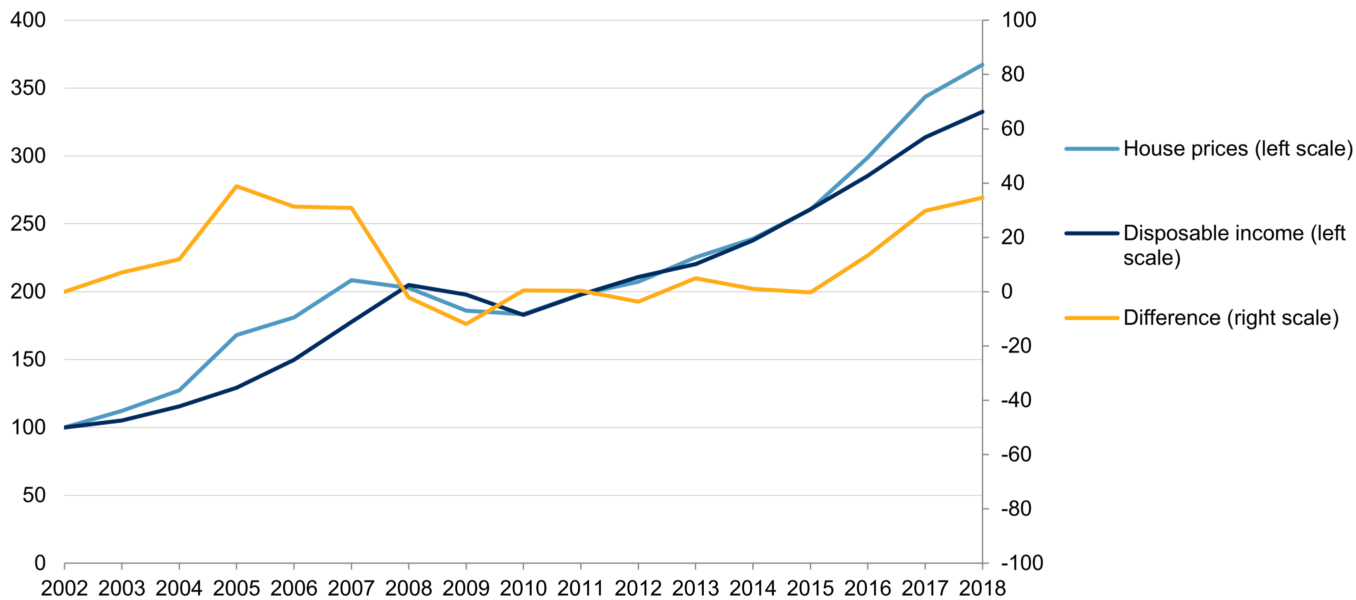
Economic imbalances: Real estate price growth is slowing, while private sector debt stabilizes after a sustained decline

Private sector credit growth. Domestic credit to the private sector in relation to GDP has declined materially since the economic crisis of 2008, but seems to have bottomed out since credit growth slightly outpaced nominal GDP increase in both 2017 and 2018. In addition to the strong economic recovery of the Icelandic economy, corporate sector deleveraging and debt-relief programs from the government--including the ability to use tax-deductible private pension savings to finance mortgages--have mainly explained the decline so far. However, for the next two years, we expect private sector credit to outpace GDP growth. This is as a result of muted economic growth and our expectation of continued demand for credit, primarily in residential real estate, supporting housing construction, albeit at more moderate levels than those seen in recent years.

Real estate prices. Strong economic development, the booming tourism sector, and lagging construction have contributed to the rapid growth of real estate prices over several years until 2017. However, construction has gradually increased, and together with the weaker outlook on tourism, we expect house prices growth to slow down markedly and then stabilize over the coming two years. Nevertheless, commercial real estate (CRE) price growth remains high (about 15% on average in the last five years) and most indicators signal a deviation from the fundamentals as we have approached pre-crisis levels.

Chart 3

BICRA Iceland--Development In Disposable Income And House Prices



Note: For scale, base 100=2002. Disposable income for 2018 S&P Global Ratings' estimate.

Source: Statistics Iceland, Registers Iceland.

Equity prices. The Icelandic equity market has shown strong growth since the crisis. While the main equity index has more than doubled since 2008, it remains at less than a third of the highly inflated levels of 2007. We expect equity prices will remain a neutral factor in our assessment of economic imbalances in Iceland.

Current account and external debt position. Iceland's balance-of-payments position has improved markedly in recent years, largely on the back of strong tourism sector growth, and the country is now a net external creditor. We expect a current account deficit of 0.5% of GDP in 2019, owing to weaker tourism-sector dynamics and lower marine-product exports. This compares with a 3% of GDP surplus in 2018, and an almost 8% of GDP surplus in 2016. We forecast moderate current account deficits averaging 1.5% of GDP annually over 2020-2022. Despite the re-emergence of current account deficits, we do not at present see any immediate balance-of-payments risks. In our view, the continued external deleveraging over recent years, as well as substantially strengthened CBI net foreign exchange reserves, will allow Iceland to weather a contraction in exports in 2019 without a re-emergence of external financing pressure.

Table 2

BICRA Iceland--Economic Imbalances

	2015	2016	2017	2018	2019F	2020F
Annual change in claims of resident depository institutions in the resident nongovernment sector in % points of GDP	(15.0)	(8.8)	2.1	2.4	5.5	0.9
Annual change in key index for national residential house prices (real) (%)	7.4	12.9	13.2	4.2	5.4	3.8
Annual change in inflation-adjusted equity prices (%)	36.5	(8.4)	2.9	(8.3)	9.5	(2.1)
Current account balance/GDP	6.0	7.6	3.7	2.9	(0.5)	(1.2)
Net external debt/GDP (%)	36.3	12.0	13.3	9.7	12.3	13.4

F--Forecast. Source: S&P Global Ratings.

Credit risk in the economy: Stabilizing private sector leverage and sound underwriting standards

Private-sector debt capacity and leverage. A number of factors support Iceland's debt capacity. These are:

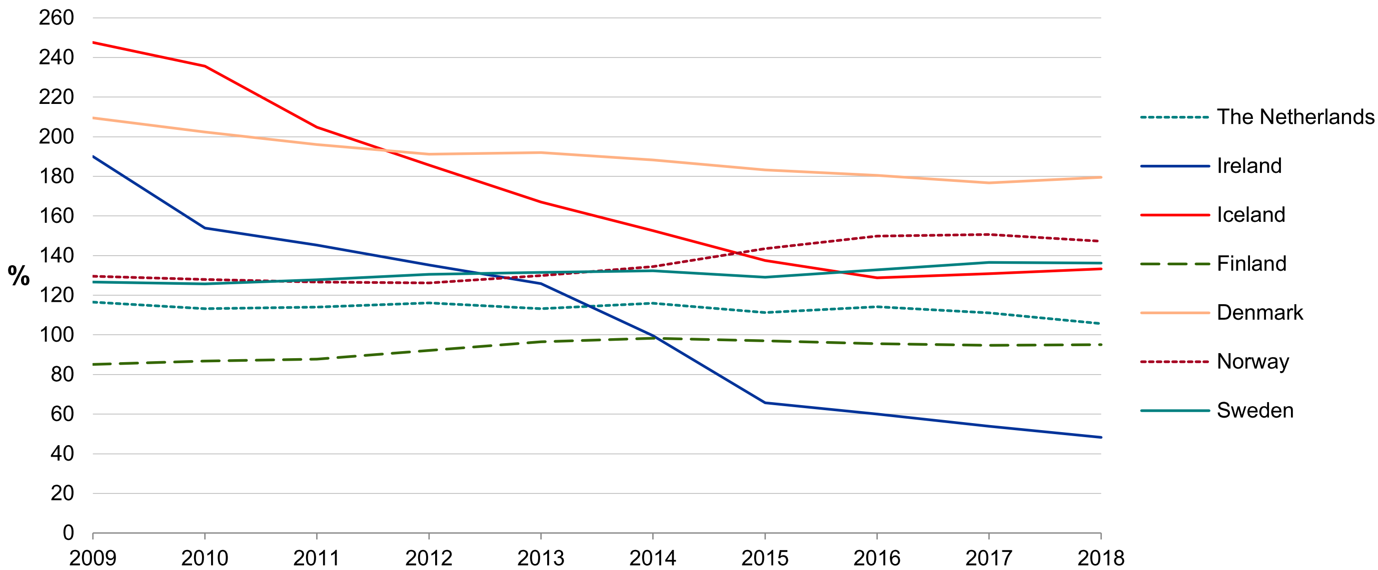
- Generally high domestic wealth;
- Marked wage increases; and
- Low unemployment

Total credit remains fairly high by global standards, at 133% of GDP in 2018, and we expect this indicator to increase slightly over our outlook horizon.

Household debt capacity has improved in the past couple of years, with a falling unemployment rate and material increases in disposable income compared with debt growth. We note also that the household debt levels compare well against other Nordic countries with high homeownership rates.

Chart 4

BICRA Iceland--Private Sector Debt To GDP



Source: S&P Global Ratings.

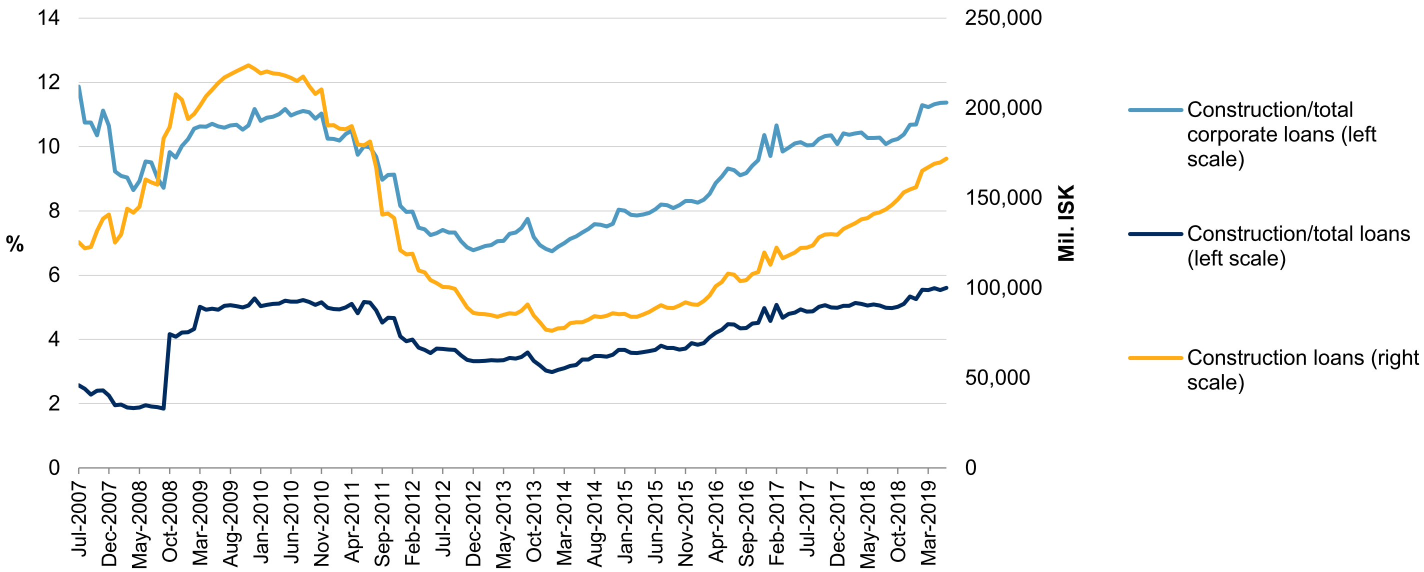
Lending and underwriting standards. Before 2008, Iceland had very aggressive lending and underwriting standards, but we believe the new banks have taken a different approach following the crisis, supported by improved risk governance and sustainable risk appetites. We consider new loan production to be of sound quality and the banks to be prudent in their balance sheet build-up.

More than two-thirds of household loans are inflation-linked, while only a negligible part is linked to foreign currencies. The inflation-linked loans are a long-standing feature of the Icelandic banking market, which eases debtors' affordability by stabilizing the monthly payments. However, this type of mortgage lending inflates the principal and tends to increase loan-to-values (LTVs) during high inflation periods. Average LTVs have been falling materially since the financial crisis--mostly supported by the steep rise in house prices--and stabilized in the past two years at about 30%.

The CRE and tourism credit-related exposures--13% and 9% of banks' total loans, respectively--represent the main source of credit risk for the Icelandic banks, in our view. Specifically, CRE prices have been increasing relative to fundamental drivers such as building costs and corporate earnings, toward levels last seen before the financial crisis. Similarly, tourism-related activities now represent an important part of the domestic economy, and the sensitivity of the banks' balance sheets to this inherently cyclical sector has increased. We believe that banks' indirect exposure to tourism is markedly higher, representing a material risk in potential future downturns.

Chart 5

BICRA Iceland--Construction Loan Development



ISK--Icelandic krona. Source: Statistics Iceland

Payment culture and rule of law. We consider payment culture and rule of law to be strong in Iceland, with a top 10% ranking in the World Bank governance indicators for rule of law and control of corruption in 2017.

Table 3

BICRA Iceland--Credit Risk In The Economy

	2015	2016	2017	2018	2019F	2020F
Claims of resident depository institutions in the resident nongovernment sector as a % of GDP	137.6	128.8	130.9	133.3	138.8	139.7
Household debt as % of GDP	80.4	75.2	75.1	75.6	77.2	76.6
Household net debt as % of GDP	(103.1)	(109.3)	(117.5)	(110.1)	(113.3)	(115.1)
Corporate debt as % of GDP	89.7	80.2	86.3	88.1	85.3	85.8
Real estate construction and development loans as a % of total loans	3.7	4.3	5.0	5.3	5.4	5.5
Foreign currency lending as a % of total domestic loans	10.3	11.4	12.9	13.2	13.9	14.1
Domestic nonperforming assets as a % of systemwide domestic loans (year-end)	8.0	5.7	3.6	2.4	2.5	2.6
Domestic loan loss reserves as a % of domestic loans	2.9	1.9	1.4	1.0	1.0	1.0

F--Forecast. Source: S&P Global Ratings.

Base-Case Credit Losses

In our base-case scenario, we assume credit losses will remain at about 30 to 40 basis points of systemwide loans over the next two years. Hence, we expect a slightly higher level of losses as we anticipate growth contraction, especially exposures in tourism, to demonstrate sensitivities in the near term. In recent years, positive revaluations have tended to match impairment losses, leaving banks in a profit-neutral or even positive position. However, we expect limited impact from such revaluations going forward.

Table 4

BICRA Iceland--Base-Case Credit Losses

	2015	2016	2017	2018	2019F	2020F
Total actual and projected credit losses (%)	0.17	-0.03	0.53	0.27	0.35	0.4

Source: S&P Global Ratings.

Industry Risk

We base our industry risk score for Iceland on our assessment of institutional framework, competitive dynamics, and systemwide funding.

Institutional framework: Improving oversight while challenges remain

Banking regulation and supervision. We consider that the regulatory setup has improved materially since 2008, on the back of higher budget, increased staff, and new legal means to actively manage a buildup of risk. As a result, the Icelandic regulator should be in a better position to curb future excesses in the domestic market.

The recent government decision to move ahead with a merger between the Financial Supervisory Authority (FME) and the CBI should benefit and streamline macro-prudential policy and financial supervision, in our view. At the same time, we would expect this move to reduce political influence, 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.

Progress on introducing a resolution regime for failing banks is moving slowly. The parliament only partially approved the European Banking Recovery and Resolution directive (BRRD) and we expect the full implementation--which includes the resolution and bail-in mechanisms--over the next 12 months.

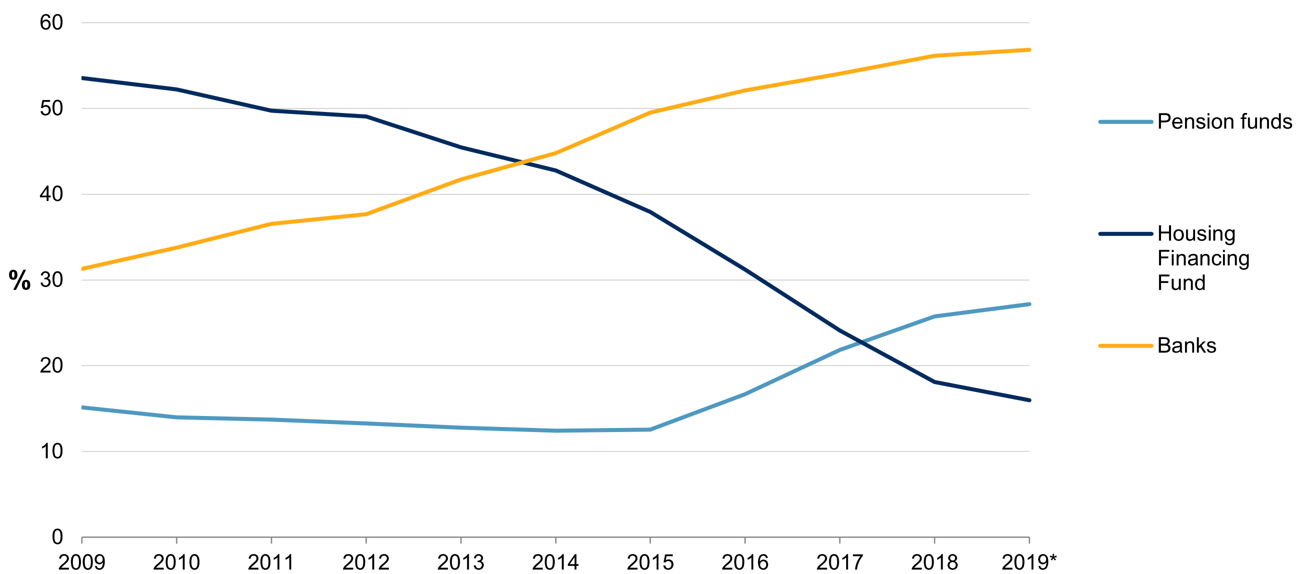
Regulatory track record. We believe that there were many signs that the Icelandic government did not properly address the banks' excessive risk-taking, and that the banks were allowed to engage in behavior that was detrimental to domestic financial stability. However, over the decade following the banking crisis, we have seen improvements, including management of capital control liberalization and the implementation of special reserve requirements for new foreign currency inflows to discourage carry trade investors, which have been recently lifted. Looking ahead, Iceland's regulatory track record will likely be determined by how well the authorities avoid cyclical overheating and volatile flows into and out of the banking system.

The FME, following a recommendation by the Financial Stability Council, decided to increase over the past year the countercyclical buffer by 0.75% to a total of 2%, which will come into force as of February 2020. This aims to enhance the resilience of the banking sector against systemic risk and excessive debt accumulation. Overall, regulatory total capital requirements remain high in an international comparison, at about 20%-21%.

We see risks in the growing role that pension funds are playing in providing domestic credit. Over the past few years, pension funds have been increasing their share of the mortgage market at the expense of the banking sector. We see risks stemming from this development, as the pension funds' supervision and their capacity to monitor credit risks is untested. In our view, it will be important for the regulator to prevent systemic risks from non-bank players and, specifically, the pension funds.

Chart 6

BICRA Iceland--Pension Funds Have Gained Material Mortgage Market Shares Recently



Note: * Datapoint as of June 30, 2019. Source: Statistics Iceland.

Governance and transparency. We consider governance and transparency to be neutral in Iceland. Banks appear to employ transparent and timely reporting standards and sound compensation practices.

Competitive dynamics: Sound commercial practices but large nonbank involvement

Risk appetite. We consider risk appetite to be sound. The main banks have a clear strategic focus on traditional lending activities rather than innovative and complex products. The returns have declined markedly over the past two years to mid-single digit level (we calculate 6% as of December 2018 for the three commercial banks), weaker than most international peers even if we adjust for a normalised equity base. Since inception, the Icelandic banks benefited from a relatively high-interest environment, but also substantially inflated by nonrecurring items, such as sales and revaluations of legacy equity positions and loans, which are now considerably lower.

Persistent wage inflation in a highly unionised country, plus bank levies (0.376% on total liabilities above Icelandic krona [ISK] 50 billion) and special taxes, weigh on the Icelandic banks' bottom line, making the banks the highest taxpayers in the country.

At this stage, the search for higher profitability has not undermined the underwriting standards, which we consider adequate in the context of the concentrated Icelandic economy.

Industry stability. The Icelandic banking market has undergone significant changes in recent years, and we believe the current structure is likely to prove broadly stable. Still, we expect ownership of the new banks will change in the next two years, as the government intends to reduce its stake in the banking sector. We think there is a low probability that new players will try to enter, given the size and concentration of the market, and we do not expect significant movements in market share between the major banks. That said, the gradual winding down and restructuring of the Housing Financing Fund (HFF) will increase commercial banks' and pension funds' market shares in the mortgage sector.

Moreover, current returns--generally below cost of capital--make the market unattractive for new players, and might represent an issue for future equity investors. The privatization process formally started with the IPO of Arion Bank in June 2018, and it is expected to continue with Islandsbanki and Landsbankinn, which are still state-owned.

Banks will aim to close the profitability gap in order to ultimately ensure the sustainability of their business models. However, the declining interest rates, weaker efficiency ratios, contracting economy, and sustained competition from pension funds on mortgage lending will continue to constrain banks' ability to significantly strengthen earnings, in our view. However, Icelandic banks are proactive in lowering their operating expenses and improving efficiency, although necessary investments in information technology have weighed on these efforts in the recent past. In our view, Icelandic banks are well positioned in digitalizing processes and their overall banking offer, even compared with Iceland's Nordic peers. The level of digital innovation and the willingness of customers to embrace novel functionalities (in areas such as mortgages, consumer financing, and onboarding new clients) support this process. The digitalization process also represents an important tool for the Icelandic banks to streamline their expensive workforce and distribution network, and at the same time achieve higher revenues and reach more customers. We believe Icelandic banks are well advanced compared with other European banking markets in terms of end-to-end digital sales processes, and in their use of more cost-efficient online and mobile channels to materially increase sales activities.

Market distortions. In our view, nonbank players and government ownership in Landsbankin and Islandsbanki distort the Icelandic lending market. However, at this stage, we do not consider the government ownership a major concern, since the government has no involvement in strategy or management. As the government still plans to privatize the banking sector, we note that future changes in ownership add uncertainty, but we do not necessarily view this as a significant risk for the sector, based on the recent privatization of Arion Bank.

As of June 2019, pension funds and the HFF (which is exempt from the regulatory capital requirements as a government-owned social housing lender) together held approximately 40% of the domestic mortgage market. The market share of pension funds in residential mortgages rose to 27% in June 2019, from 13% in 2015. We also note that, despite operating outside banking regulation and with less advanced risk management practices, the pension funds have more prudent LTV requirements than the banks.

Overall, pension funds are affecting competition in the mortgage market to the extent they do not adhere to the same prudential and fiscal rules than banks. As a result, they can push the banks to compete on prices to attract new business, potentially threatening sensible pricing. Moreover, they raise competition issues since they are competitors, debt investors and shareholders in some cases.

Table 5

BICRA Iceland--Competitive Dynamics

	2015	2016	2017	2018	2019F	2020F
Return on equity (ROE) of domestic banks	16.6	9.1	7.5	6.1	7.0	7.5
Systemwide return on average assets (%)	3.4	1.9	1.5	1.1	1.1	1.2
Net operating income before loan loss provisions to systemwide loans (%)	3.26	1.92	1.98	1.79	1.93	1.91
Market share of largest three banks (%)	65.0	67.6	71.4	70.6	71.0	72.0
Market share of government-owned and not-for-profit banks (%)	62.2	60.0	61.0	60.1	62.0	65.0
Annual growth rate of domestic assets of resident FIs (%)	19.8	(4.1)	(1.7)	3.9	5.0	5.0

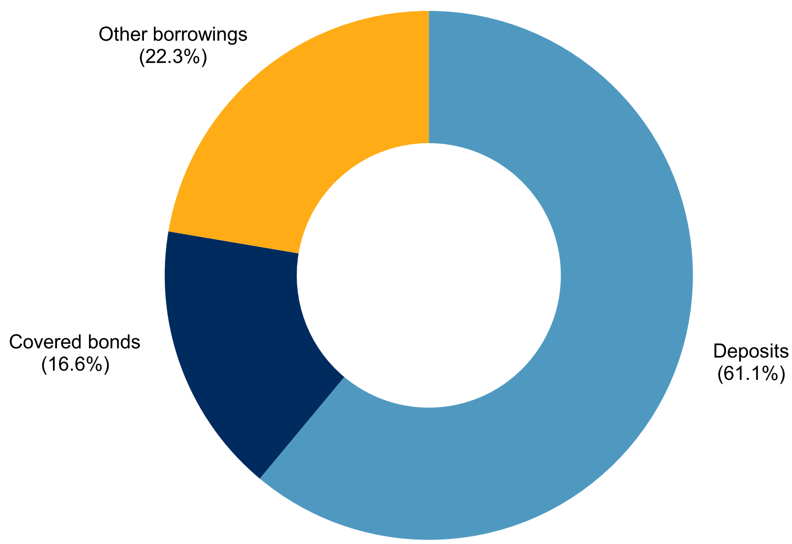
F--Forecast. FI--Financial institution. Source: S&P Global Ratings

Systemwide funding: Proved access to external debt capital markets and active--but limited--local market

Core customer deposits. The Icelandic banking system benefits from stable funding sources. Deposits are the main funding tool for the sector, with the exception of HFF, which is fully wholesale-funded. Deposits and equity constitute about two-thirds of commercial banks' assets and broadly cover their entire loan stock. Combined, households and SMEs had grown by about 9% year-on-year at the end of June 2019, which mostly drove the total deposits increase (including financial institutions and government entities) by about 7% in the same period. We expect a stable development of total deposits, despite the recent regulation update allowing private investors to invest abroad. Iceland's high interest rates and increasing wealth will likely counter deposit outflows to some extent.

Chart 7

BICRA Iceland--Total Funding Composition Of The Icelandic Commercial Banks



Source: Islandsbanki, Arion Bank, and Landsbankinn half-year 2019 reports.

External funding. We believe Icelandic banks demonstrate good access to external markets despite widening spreads in late 2018. The three main commercial banks all managed to issue subordinated bonds under their European medium-term note programs in the international markets over the past two years, and showing positive investors' interest. The net increase in foreign exchange (FX) funding is channelled towards some additional foreign currency denominated lending and to build up stronger liquid assets portfolio and FX liquidity ratios.

Domestic debt-capital markets. We consider that the domestic debt market in Iceland is relatively small and concentrated by product and type of investor, given the dominant presence of local pension funds. However, we find it neutral to our assessment of system-wide funding. The market has been open for several years and the banks issue continuously. Total banks' domestic issuance increased by about 23% year-on-year at the end of June 2019. Banks issued especially long-term covered bonds and commercial papers, reaching about 11% of total funding as of December 2018. We expect that the banks' issuance in the local market will continue to gradually increase, especially in the covered bond category, accompanying the demand for new loans. The level of asset encumbrance remains relatively low compared with European peers, at between 11% (Landsbankinn) and 21% (Arion Bank).

Foreign investment in the domestic bond market--which declined markedly when the CBI implemented reserve requirements on new capital inflows in 2016--should resume gradually despite current economic uncertainties.

Government role. We make no adjustment to our assessment of funding risk to reflect government involvement. The Icelandic government has a poor recent track record of providing liquidity and guarantees to the banking sector. We believe this is not because of a lack of willingness, but because the banking system was too big for the government to extend meaningful support in 2008. Since then, total assets have declined significantly and the system is mostly funded with deposits.

Table 6

BICRA Iceland--Systemwide Funding

	2015	2016	2017	2018	2019F	2020F
Systemwide domestic core customer deposits by formula as a % of systemwide domestic loans	25.0	27.3	30.0	29.9	30.1	30.1
Net banking sector external debt as a % of systemwide domestic loans	(1.9)	6.8	8.8	7.5	9.2	10.0
Systemwide domestic loans as a % of systemwide domestic assets	72.7	75.4	76.5	80.6	81.4	81.4
Outstanding of bonds and CP issued domestically by the resident private sector as a % of GDP	75.7	73.1	71.6	70.7	72.2	70.6
Total consolidated assets of FIs as a % of GDP	255.0	198.3	183.9	179.0	185.5	186.6
Total domestic assets of FIs as a % of GDP	200.4	177.0	165.5	160.5	166.4	167.4

F--Forecast. FI--Financial institution. Source: S&P Global Ratings.

Peer BICRA Scores

Iceland has a wealthy and prosperous economy in line with its peers in BICRA group '4'. Iceland has a comparably high GDP per capita and low unemployment. However, its volatile nature--demonstrated by boom-bust cycles in the past and a weak track record of its institutional framework--counterbalances these positives.

Table 7

BICRA Iceland--Peer BICRA Scores

	Iceland	Estonia	Spain	Qatar	Ireland	Malta	Kuwait
BICRA group	4	4	4	5	4	5	4
Economic risk	4	4	4	5	5	4	5
Industry risk	5	5	4	5	4	6	4
Country classification of government support	Support uncertain	Support uncertain	Support uncertain	Highly supportive	Support uncertain	Support uncertain	Highly supportive

Source: S&P Global Ratings.

Government Support

In our view, the likelihood of government support for Icelandic banks remains uncertain. We base this assessment on the authorities' poor track record and what we view as a still-limited--albeit improved--capacity to support the banking system in a severe stress scenario.

At present, we do not regard the bank-resolution framework as effective and, as such, we do not include additional loss-absorbing capacity when rating Icelandic banks. In our view, the authorities' method of dealing with ailing banks so far indicates a tendency to safeguard depositors rather than senior unsecured creditors.

Over the next year, we expect Iceland to finalize the implementation of a framework aligned with the EU's BRRD and, with it, bail-in powers that could cause us to change our view. However, this is contingent on whether the authorities establish measures and indicate willingness to protect senior bondholders and provide banks with the necessary funding and liquidity during a resolution, a period when market access is usually restricted.

Table 8

BICRA Iceland--Five Largest Financial Institutions In Iceland (By Assets) As Of June 2019

Bank	Assets (bil. €)	Assets (bil. ISK)
Landsbankinn hf.	10	1,403
Íslandsbanki hf.	9	1,230
Arion banki hf.	9	1,233
Housing Financing Fund*	5	746
Kvika banki hf.*	1	88

*Data as of December 2018. ISK--Icelandic krona. Source: Company reports.

Related Criteria

- 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
- Sovereign Rating Methodology, Dec. 18, 2017

Related Research

- Four Icelandic Banks Outlooks Revised To Negative On Weaker Business Prospects And Earnings; Ratings Affirmed, July 23, 2019
- Summary: Iceland, May 17, 2019
- Nordic Banks' Strong Capital Will Cushion Them From The Challenges Ahead, March 28, 2019
- Banking Industry Country Risk Assessment Update: July, July 30, 2019

- Analytical Linkages Between Sovereign And Bank Ratings, Dec. 6, 2011
- Nordic Banks Sport Strong Capital--And It's Not Likely To Soften, Oct. 17, 2018

This report does not constitute a rating action.

Contact List

PRIMARY CREDIT ANALYST

Antonio Rizzo
Madrid
(34) 91-788-7205
Antonio.Rizzo@spglobal.com

SECONDARY CONTACT

Erik Andersson
Stockholm
+ 46 84 40 5915
erik.andersson@spglobal.com

SECONDARY CONTACT

Anna Lozmann
Frankfurt
(49) 69-33-999-166
anna.lozmann@spglobal.com

SECONDARY CONTACT

Salla von Steinaecker
Frankfurt
(49) 69-33-999-164
salla.vonsteinaecker@spglobal.com

SOVEREIGN ANALYST

Ludwig Heinz
Frankfurt
(49) 69-33-999-246
ludwig.heinz@spglobal.com

RESEARCH CONTRIBUTOR

Joshua C Joseph
Mumbai
joshua.joseph1@spglobal.com