Icelandic Bank Ratings Affirmed As Risks Shift Amid High House Prices And Rising Rates; Outlooks Stable

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- The economic risks facing Iceland's banks have increased rapidly as property prices have risen materially ahead of their fundamental determinants. We now see a higher risk of a disorderly correction that could have potentially severe consequences for the banks. At the same time, the firming tourism recovery continues to underpin improving corporate-sector loan performance. Consequently, we see the economic risk trend as stable.
- We believe that the industry risks affecting Iceland's banks have eased. Icelandic banks' profitability has shown resilience to the COVID-19 pandemic and strong returns are likely to persist. We expect this to provide a buffer against the emergence of significant competition from nonbank lenders, should it occur. The industry risk trend remains stable.
- We affirmed the 'BBB/A-2' ratings on the Icelandic domestic systemically important banks (D-SIBs) Arion Bank hf., Islandsbanki hf., and Landsbankinn hf.
- The stable outlooks reflect our view that the banks' capitalization will remain very strong, alongside healthy and improving earnings capacity. We believe these factors will provide a buffer to help the banks absorb any re-emergence of competitive pressures from nonbank lenders or higher credit losses from a disorderly correction in the housing market, should it occur.

LONDON (S&P Global Ratings) July 13, 2022--S&P Global Ratings said today that it has affirmed its 'BBB/A-2' long- and short-term issuer credit ratings and 'BBB+/A-2' resolution counterparty ratings on Icelandic D-SIBs Arion Bank, Islandsbanki, and Landsbankinn. The outlooks on all three banks are stable. The affirmations reflect our view that the banks' improving profitability should support their capacity to absorb the elevated risk of a correction in the housing market and its potential consequences. We also expect that the banks would be able to withstand any significant re-emergence of nonbank lender competition, should it occur.

Ebullient House Prices Raise Economic Risks

We believe that significant and persistent property price growth over the past two years has rapidly raised the economic risks facing Iceland's lenders. In the two years to April 2022, property prices have risen 30% above the general level of other consumer prices in the economy. This has decoupled house prices from their fundamental determinants, most notably wages. In addition, the jump in household debt to above 80% of GDP--structurally higher than close to 75% before the pandemic--is unlikely to unwind and could rise further. Taken together, we believe this has raised the risk of a correction and its potentially severe consequences for Icelandic banks.

The domestic consumer price index (CPI) inflation rate of 8.8% in Iceland is significantly higher than the Central Bank of Iceland's (CBI's) 2.5% target. In recent months, house price growth has contributed almost half of the CPI inflation. In response, the CBI has initiated a fierce tightening cycle. The bank has raised the policy rate by 400 basis points (bps) since April 2021 to 4.75% today. Further hikes are priced. In our view, the debt-serviceability shock to households will be significant and occur with relative speed. Almost all households refinanced their mortgages to take advantage of record-low borrowing costs during the pandemic, and with half of the systemwide mortgage stock on variable-rate terms, we estimate that most households' mortgage debt will reprice within 12 months.

We envisage that some borrowers will seek relief from rising serviceability pressures by switching to inflation-indexed mortgages that pay a lower, real rate of interest. While this can ease serviceability risk, we consider that it could lead to households taking on additional solvency risk, as debt loads adjust upward with inflation. To preserve households' home equity, and limit potential losses for the banks, nominal price gains must follow suit. This creates a conflict with the CBI's aim to limit further house price gains to meet its inflation target.

That said, while the risk of a correction has risen, we believe that several factors indicate banks' resilience. Macroprudential measures implemented early in the build-up phase, while less effective at arresting imbalances than we anticipated, have reduced the risk of severe losses for the banks. Only 5% of the banks' mortgages have LTVs above 80%, partly because of loan-to-value (LTV) restrictions that have gradually tightened since 2017. Consequently, we would expect banks' potential exposure to losses to be limited in a modest nominal drawdown scenario. That said, the prospect of consistently negative real property price growth could expose the banks to incremental losses on CPI-indexed mortgages, as principal inflates ahead of collateral values. Nevertheless, the banks' improving profitability represents an important mitigant to the potential for capital erosion from a severe property market downturn.

While our base case considers an orderly slowdown of property prices, downside risks are higher than we had previously considered. We expect systemwide credit losses to remain 30 bps of gross loans. This is below the long-term average we expect for Icelandic banks of closer to 85 bps of gross loans. That said, credit losses could rise well above our base case if house prices were to unwind in a disorderly manner.

An easing in housing market imbalances and correction risk could occur if property prices stabilize and wages rise in step with rising interest rates. This would providing incremental capacity for households to absorb debt-serviceability pressures, in the process significantly limiting the prospect of disorderly downturn. An orderly, gradual unwinding characterized by a modest correction and stabilization in nominal house prices without a significant rise in bank credit losses could also ease these risks. Lower household indebtedness against GDP as the economy continues to recover and a falling risk of significant losses from indexed lending via principal inflation would also support an easing of risks.

Tourism Recovery Eases Corporate-Sector Risks

Corporate-sector loan performance continues to improve and, in our view, no longer poses a significant risk for the Icelandic banks. The tourism-led economic recovery has materially improved the banks' asset-quality metrics. Systemwide migration of loans into stage 1 from stage 2 in the year to March 31, 2022 has materially cut the share of total loans with elevated credit risk. Stage 2 and stage 3 loans are now close to 8% of systemwide gross loans, broadly consistent with Nordic peer jurisdictions following Icelandic banks' relative underperformance through the pandemic. In addition, stage 2 and stage 3 corporate loans that required forbearance measures (for example, principal or interest payment moratoria) to manage the pandemic-related downturn had almost halved from their peak by the end of 2021, falling below 5% of gross loans.

Systemwide coverage metrics are strong despite provision releases in 2021. The one-off gain to bank earnings was on average across the D-SIBs equal to 30 bps of gross loans. Notwithstanding this, coverage of stage 2 and stage 3 loans has improved. In particular, the banks have retained elevated provisions against stage 3 tourism-dependent corporates, with the level of sector-wide coverage improving to 37% at the end of 2021 from 27% one year earlier. We expect a cautious release of further pandemic-related provisions as the risk of left-tail scenarios continues to fall away.

Improving Profitability And Lower Distortions Cut Industry Risks

We consider that the now-lower nonbank participation in the mortgage market has reduced the threat to Icelandic banks' capacity to price rationally for risk. At the same time, we think the banks' improving risk-adjusted earnings will continue to underpin their resilience to the significant re-entry of nonbank players, should it occur. Together, these factors underpin our view that Icelandic banks now face lower industry risk.

The pension funds' share of the mortgage market peaked at close to 30% in the first quarter of 2020. Their share has since fallen and stabilized closer to 20%, reflecting broad refinancing into the banks amid weak new lending volumes from the funds. We believe this is likely to remain below highs, lowering the risk of market distortion for the banks and its detrimental effects on sector stability. While rising interest rates may marginally increase the pension funds' mortgage-market presence in the coming two years, we believe this is likely to coincide with improving bank margins and profitability. Consequently, we expect that the banks can absorb a modest rise in nonbank competition.

In our view, Icelandic banks' structural earning capacity is improving. Pandemic-related credit losses and subsequent release underwrote volatile profitability over the past two years. Looking forward, the D-SIBs' returns on equity should stabilize at 8%-10% through 2023, compared with closer to 6% on average between 2017 and 2019. This is a level we consider high among developed banking jurisdictions globally, particularly in the context of Iceland's highly capitalized banking system. We also view strong profitability as an important rating support to offset high economic risk in the system. D-SIBs' net interest margins should rise back toward 3% as lending yields reprice upward after falling in step with interest rates during the pandemic. Consequently, we project a structural improvement in cost-to-income metrics toward 45%. We see Icelandic banks' efficiency as a key strength in a global comparison and an important driver of their strong earning capacity.

Bank Ratings Affirmed With Unchanged Stable Outlook

While housing market risks facing the banks are now higher, features of resilience provide counterweight and underpin our stable outlooks. Improving profitability, high capitalization, good collateral coverage, and limited risk of competitive pressures from the pension funds should mitigate the effects of any blow from housing. In addition, we consider that the conflict between Russia and Ukraine has limited consequences for the growth prospects for Iceland's recovering economy.

In view of the higher housing market risks facing the banks, we now apply higher risk weights in calculating their risk-adjusted capital (RAC) ratios. Importantly, the rating affirmations reflect our view that the banks will maintain their capitalization at a level we consider to be very strong through our two-year forecast horizon. This is notwithstanding a decline in the banks' RAC ratios of 1.5%-2.5% of S&P Global Ratings' risk-weighted assets, mostly reflecting the now higher charges applied to domestic household and corporate credit exposures.

Outlooks

Arion

The stable outlook reflects our expectation that risk-adjusted capitalization will remain very strong, notwithstanding the bank's larger and earlier than peer distribution of excess capital as the economy emerges from the pandemic. In our base case, we anticipate that profitability will remain strong in the coming two years and remain marginally higher than peers as margins rebound from lows during the pandemic and credit losses revert to about 30 bps of gross loans. In addition, we expect costs to remain contained amid high inflation as the bank continues to service most customers digitally. The stable outlook also reflects our view that the bank should be able to absorb the effects of a moderate correction in the housing market, should it materialize.

Downside scenario: The most likely downside scenario in the next two years is a rapid and severe disorderly correction in the housing market. This could cause a self-reinforcing cycle of 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 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.

Upside scenario: The prospect of a higher rating in the next two years is remote, but could materialize if housing market imbalances and correction risk ease significantly, alongside still robust sector profitability and stability.

We could also raise the rating if the bank plans to build significant additional buffers of gone-concern loss-absorbing capital, in the process meaningfully reducing default risk for senior preferred debt holders, in addition to maintaining very strong going-concern risk-adjusted capitalization.

Islandsbanki

The stable outlook reflects our expectation that risk-adjusted capitalization will remain very strong, notwithstanding the bank's ongoing privatization and the potential for distribution of excess capital as the economy emerges from the pandemic. In our base case, we anticipate that profitability will remain high as margins rebound from lows during the pandemic and credit losses revert to about 30 bps of gross loans in the coming two years. In addition, we expect costs to remain contained amid high inflation as the bank continues to scale its digital presence. The stable outlook also reflects our view that the bank should be able to absorb the effects of a moderate correction in the housing market, should it materialize.

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Upside scenario: The prospect of a higher rating in the next two years is remote, but could materialize if housing market imbalances and correction risk ease significantly, alongside still robust sector profitability and stability.

We could also raise the rating if the bank plans to build significant additional buffers of gone-concern loss-absorbing capital, in the process meaningfully reducing default risk for senior preferred debt holders, in addition to maintaining very strong going-concern risk-adjusted capitalization.

Landsbankinn

The stable outlook reflects our expectation that risk-adjusted capitalization will remain very strong, notwithstanding the potential for distribution of excess capital as the economy emerges from the pandemic. In our base case, we anticipate that profitability will remain strong in the coming two years, if slightly below peers, as margins rebound from lows during the pandemic and credit losses revert to about 30 bps of gross loans. In addition, we expect the bank to maintain its leading market position and continue to service most customers digitally, allowing for cost containment notwithstanding high inflation. The stable outlook also reflects our view that the bank should be able to absorb the effects of a moderate correction in the housing market, should it materialize.

Downside scenario: The most likely downside scenario in the next two years is a rapid and severe disorderly correction in the housing market. This could cause a self-reinforcing cycle of 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 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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Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- Criteria | Financial Institutions | General: Financial Institutions Rating Methodology, Dec. 9, 2021
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment

Methodology And Assumptions, 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

- Ratings On Icelandic D-SIBs Affirmed As Pandemic Recovery Risk Lingers; Outlooks Remain Stable, Jan. 25, 2022
- Banking Industry Country Risk Assessment: Iceland, Feb. 21, 2022
- Banking Industry Country Risk Assessment Update: June 2022, June 28, 2022
- Resolution Counterparty Ratings Jurisdiction Assessment For Iceland Completed, May 17, 2022
- Icelandic Bank Ratings Unaffected By Sufficiently Effective Resolution Regime; 'BBB+' RCRs Assigned; Outlooks Stable, May 17, 2022

BICRA Score Snapshot--Iceland

	To	From
BICRA group	5	5
Economic risk	5	4
Economic resilience	3	3
Economic imbalances	4	3
Credit risk in the economy	3	3
Trend	Stable	Negative
Industry risk	5	6
Institutional framework	3	3
Competitive dynamics	3	4
Systemwide funding	4	4
Trend	Stable	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).

Ratings List

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Ratings Affirmed	
Arion Bank	
Issuer Credit Rating	BBB/Stable/A-2
Resolution Counterparty Rating	BBB+/--/A-2
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Ratings Affirmed	
Islandsbanki hf	
Issuer Credit Rating	BBB/Stable/A-2
Resolution Counterparty Rating	BBB+/--/A-2
*** * * * * * * * * * * * * * * Landsbankinn hf. * * * * * * * * * * * * * * ***	
Ratings Affirmed	
Landsbankinn hf.	
Issuer Credit Rating	BBB/Stable/A-2
Resolution Counterparty Rating	BBB+/--/A-2