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Corporate Banking & Securities

Icelandic bank competitiveness in a European context

November 2014

Passion to Perform

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Questions to address today…

1. What does the current European banking environment look like?
   Have we reached the “new normal”?

2. What are the key indicators of strong, well functioning and competitive banks?

3. How does the Icelandic banking sector compare to the wider European banking sector?

4. Challenges and outlook for Icelandic banks

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What does the current European banking environment look like? Have we reached “the new normal”?

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Where are we today?

- ✓ ECB/SSM oversight / Comprehensive Assessment
- ✓ Bank recapitalisations largely complete
- ✓ Basel 3/CRDIV clarity
- ✓ Ample liquidity
- ✓ Asset valuations stabilised/improving
- ✗ Low interest rate environment
- ✗ Low top line growth environment
- . . . Some regulatory uncertainty remains
- ? Risk weight harmonisation/FRTB/Leverage ratio calibration/TLAC

The "New Normal" ?

Bank competitiveness/stability/strength matters…

" Nordea chief says bank regulation chokes small business loans"

Financial Times, November 2014

"Bank lobby IIF warns regulation could hurt growth"

November 2010

"The pendulum has swung firmly in favour of financial services regulatory reform. But economic growth is likely to suffer-particularly in Europe – unless some of the rules are changed"

Centralbanking.com

"Though there is no unanimity among economists, including Nobel laureates, on the relevance of finance for growth, the crisis has provided ample evidence that a stable financial system will have a positive impact on both growth and equity and an unstable one will harm both these economic objectives"

BIS paper presented to CAFRAL-BIS International Conference, November 2011

"The operation of the financial system can have a key impact on economic growth and the stability of the economy. It affects long-term economic growth through its effect on the efficiency of intermediation between the savers and final borrowers of funds; … affecting thereby the productivity of capital employed"

OECD Economic Studies No 43, February 2006

"The financial crisis showed that a fundamental overhaul of the regulatory framework in the financial sector was necessary..... The reform agenda has been mindful of the need to minimise costs, allowing longer phasing-in and observation periods and adjusting rules where required. As a result, the financial reform agenda will help build a financial system that serves the economy and facilitates sustainable economic growth"

European Commission, Economic Review of the Financial Regulation Agenda, May 2014

"...for each percentage point increase in the target capita l ratio implemented over a four-year horizon, the level of GDP relative to the baseline path declines by a maximum of about 0.19% ...These results imply that the reforms proposed by the Basel Committee are likely to have, at most, a modest impact on aggregate output, provided that appropriate transition arrangements are in place"

BCBS / FSB Macroeconomic Assessment Group
"Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements", August 2010

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What are the key indicators of strong, well functioning and competitive banks?

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Regulation		
Ability to attract capital/funding	Ability to “manufacture” (efficiency)	Ability to provide lending into real economy
Bank stability/competitiveness		

1 Regulation

2 Stability/ financial strength	3 Asset quality/coverage
4 Funding costs/ access to funding	5 Efficiency
6 Profitability	7 Ability to grow lending

Bank stability/competitiveness

How does the Icelandic banking sector compare to the wider European banking sector?

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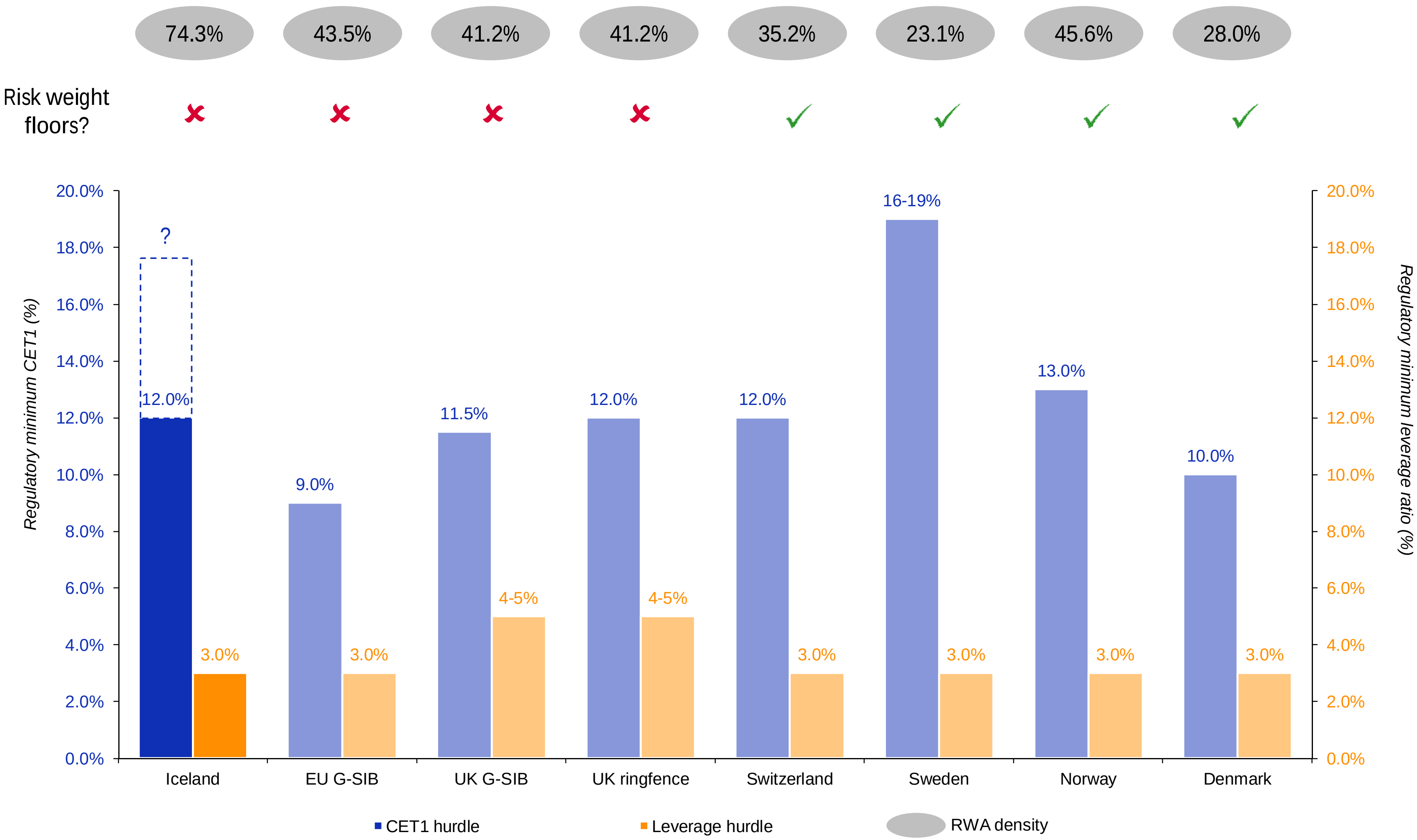
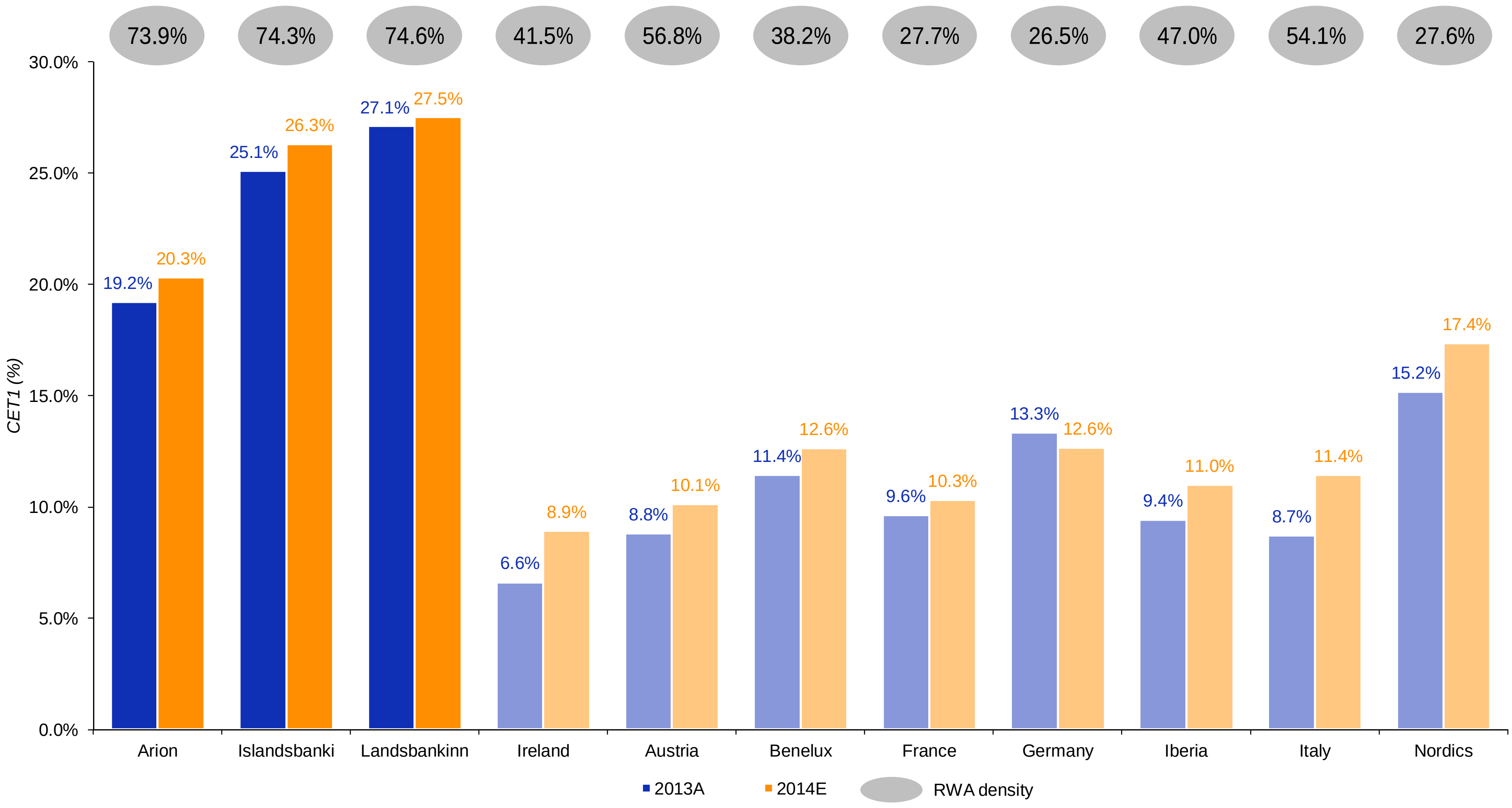
1 Regulatory environment



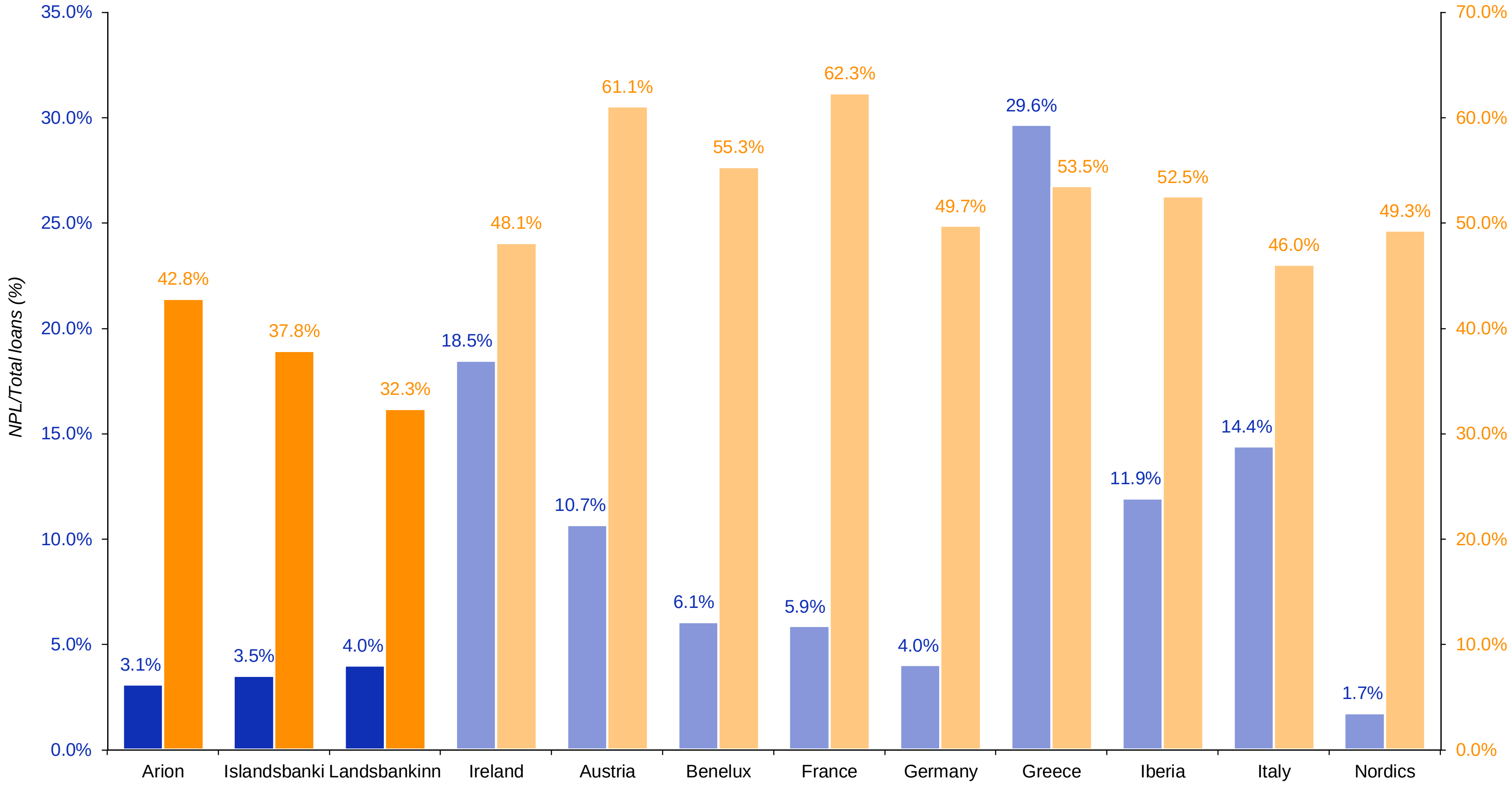
Note: All CET1 minima except for Icelandic banks (Core Tier 1 per FME). RWA density equals RWA divided by total assets (as at 30 June 2014 for Iceland and 31 December 2013 for others)

2 Capital strength – CET1 ratio (fully loaded)



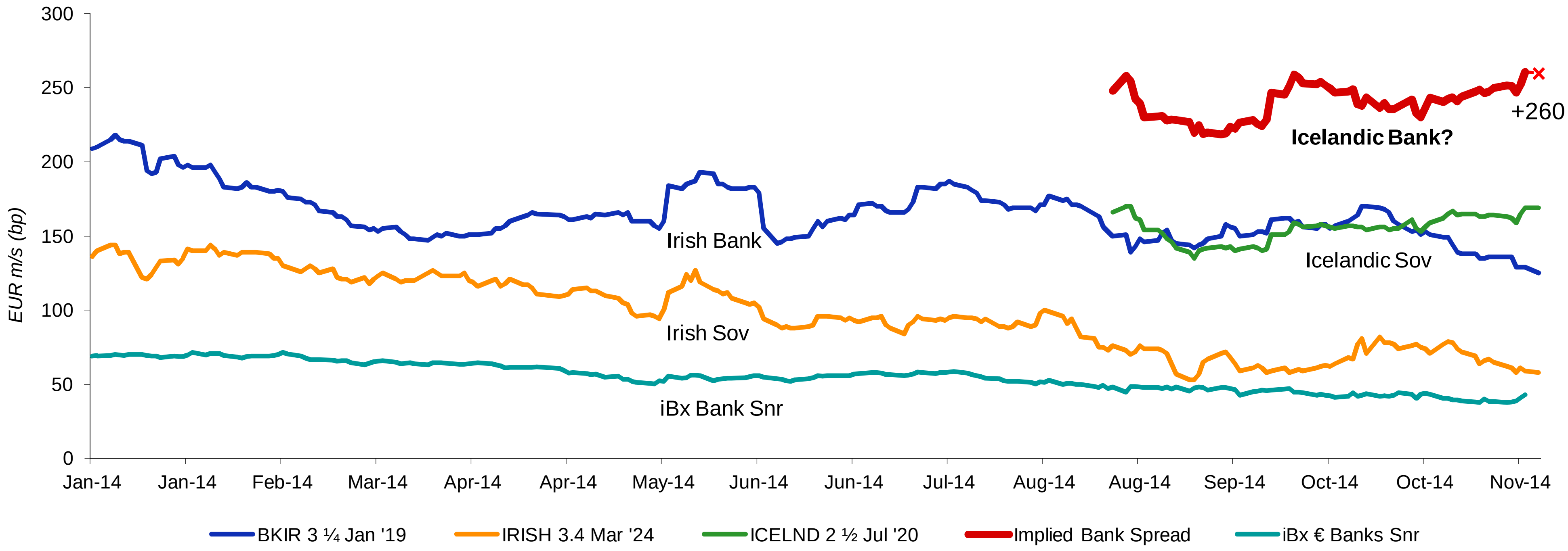
Note: All fully loaded Basel 3/CRDIV CET1 ratio except for Icelandic banks (Tier 1 ratio, 2013A and 9M14A)
RWA density equals RWA divided by total assets (as at 30 June 2014 for Iceland and 31 December 2013 for others)

3 Asset quality/coverage – NPL and coverage ratio



Note: Country averages represent Deutsche Bank Equity Research coverage universe. All data as at 31-Dec-13 except Icelandic banks (30-Jun-14)
Icelandic bank coverage equals specific and generic provisions divided by impaired loans and >90 days past due
NPL ratio only >90 days past due

4 Funding/funding costs
Are credit spread drivers the same for Iceland and Europe?



Credit drivers in Europe:

- Regulatory uncertainty
- Central Bank Crowding Out
- Supply-Demand balance depending on asset class
- Overall yield/spread vs risk
- Quantitative easing

Credit drivers in Iceland:

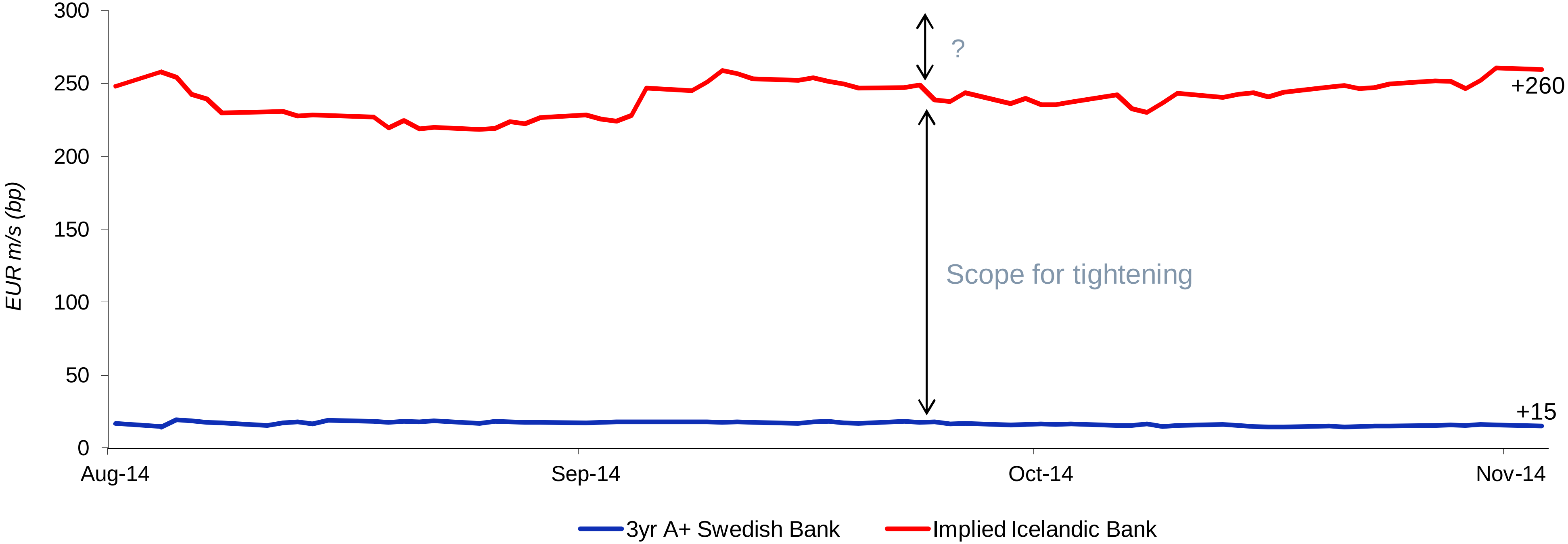
- Capital Controls
    - Uncertainties (macro, political)
- Restructuring of Banking Sector
    - Banks' balance sheets (asset concentration)
- Size of economy and banking sector
- No relevant benchmark outstanding

Source: BBG and Deutsche Bank estimates

4 Funding/funding costs
What is the scope for improving funding costs?

- **Improve** ratings
- **Choose** “right” funding markets
- **Build** long term investor base
- **Remove** uncertainties
- **Transparent** and strong ownership structures

Iceland Senior vs Swedish Senior



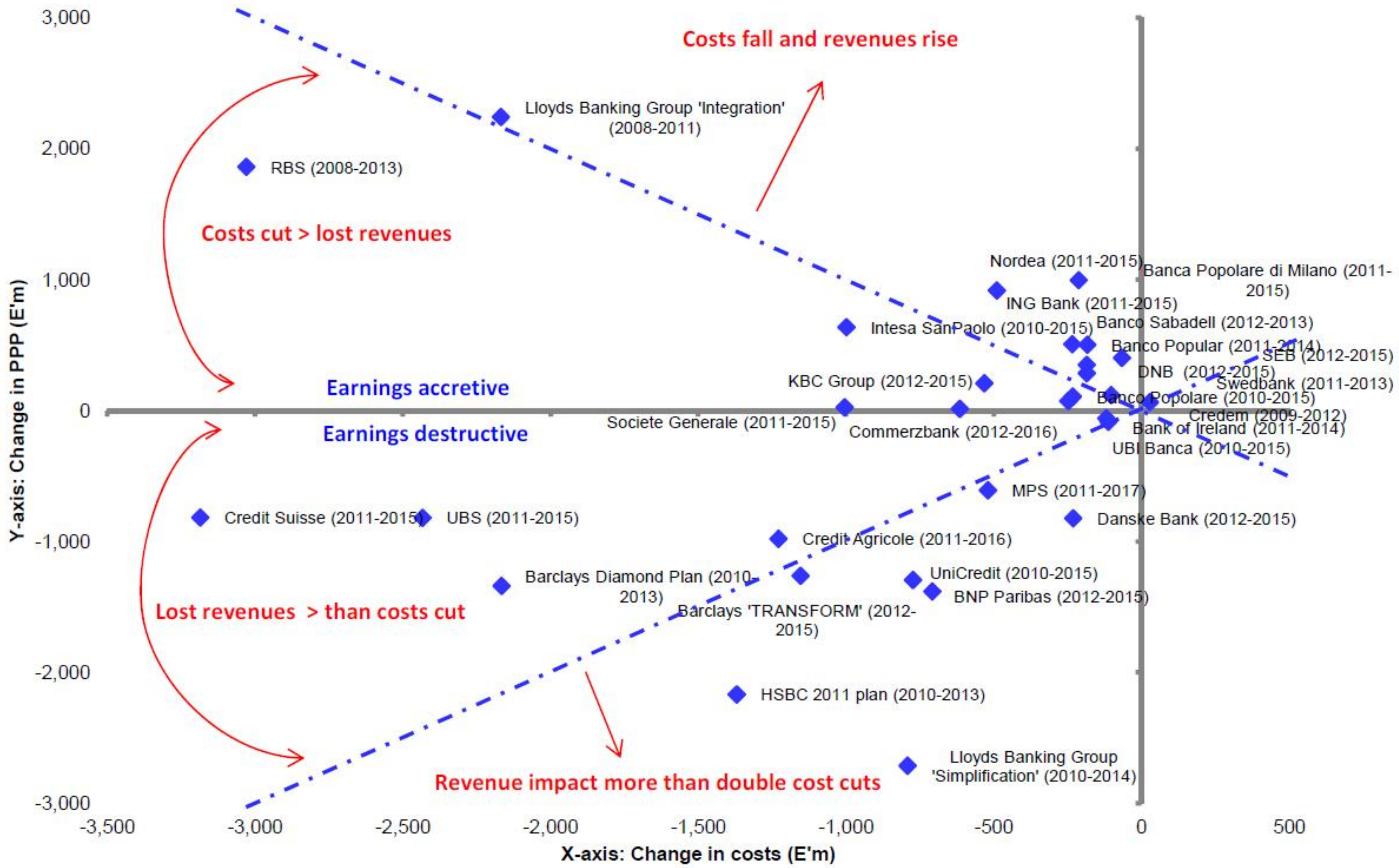
Source: BBG and Deutsche Bank estimates

4 Funding/funding costs
New issues and performance of banks from smaller European countries

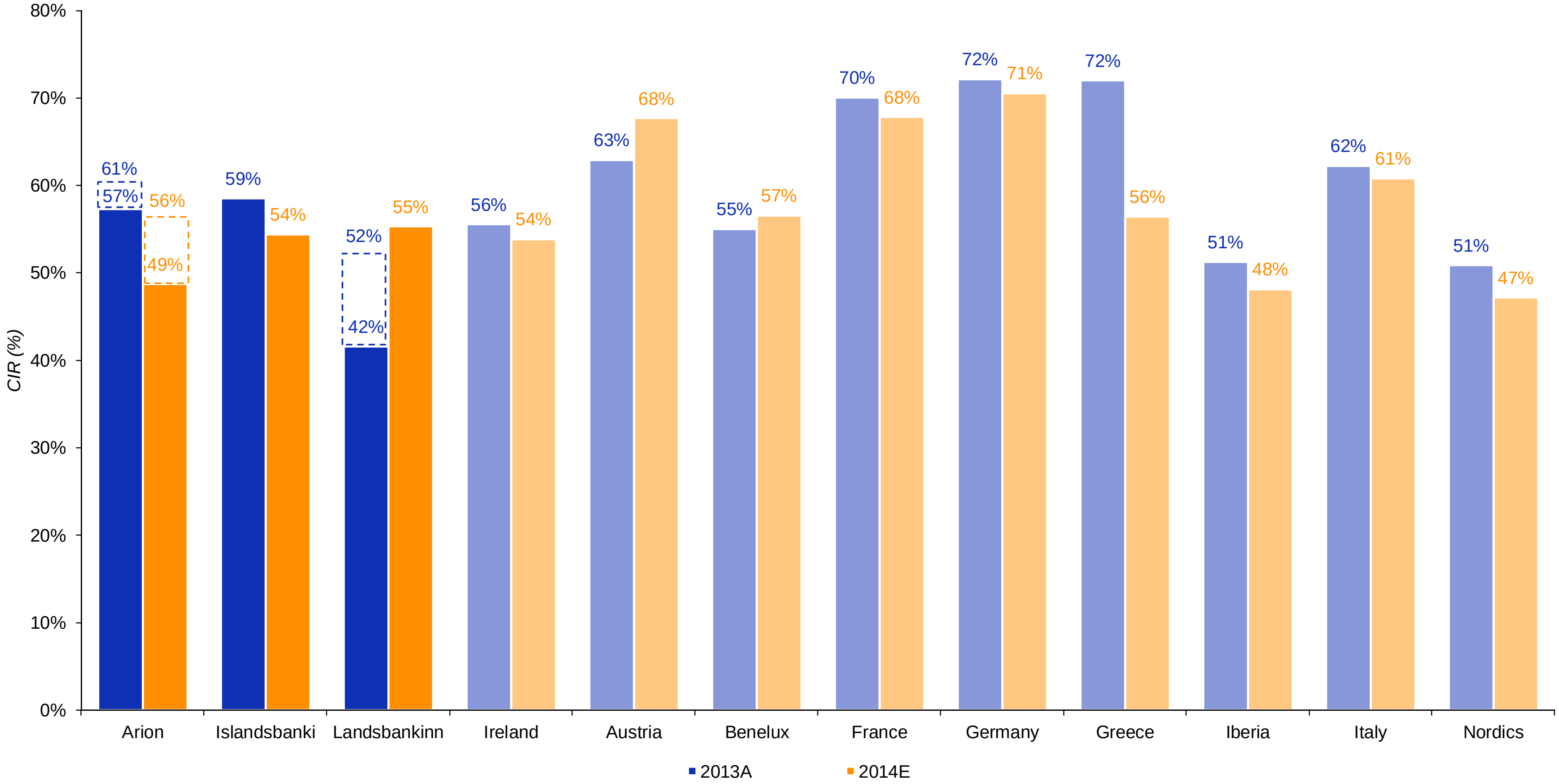
Date	Issuer	Size (€ mn)	Coupon (%)	Maturity	Tenor (yrs)	Issue spread (bp)	Current spread (bp)	Change in spreads (bp)
08-Jan-13	Novo Banco	500	4.75	15-Jan-18	5	380	603	+223
29-May-13	Bank of Ireland	500	2.75	05-Jun-16	3	220	98	-122
20-Nov-13	Allied Irish Banks	500	2.875	28-Nov-16	3	235	120	-115
08-Jan-14	Bank of Ireland	750	3.25	15-Jan-19	5	210	124	-86
13-Jan-14	Novo Banco	750	4	21-Jan-19	5	285	542	+257
19-Feb-14	Millennium BCP	500	3.375	27-Feb-17	3	285	253	-32
09-Apr-14	Allied Irish Banks	500	2.75	16-Apr-19	5	180	140	-40
28-Apr-14	Novo Banco	750	2.625	08-May-17	3	208	623	+415
30-Apr-14	Bank of Ireland	750	2	08-May-17	3	150	115	-35

Source: Deutsche Bank quotes from BBG

5 Efficiency – impact of cost rationalisation programmes



5 Efficiency – cost-to-income ratio



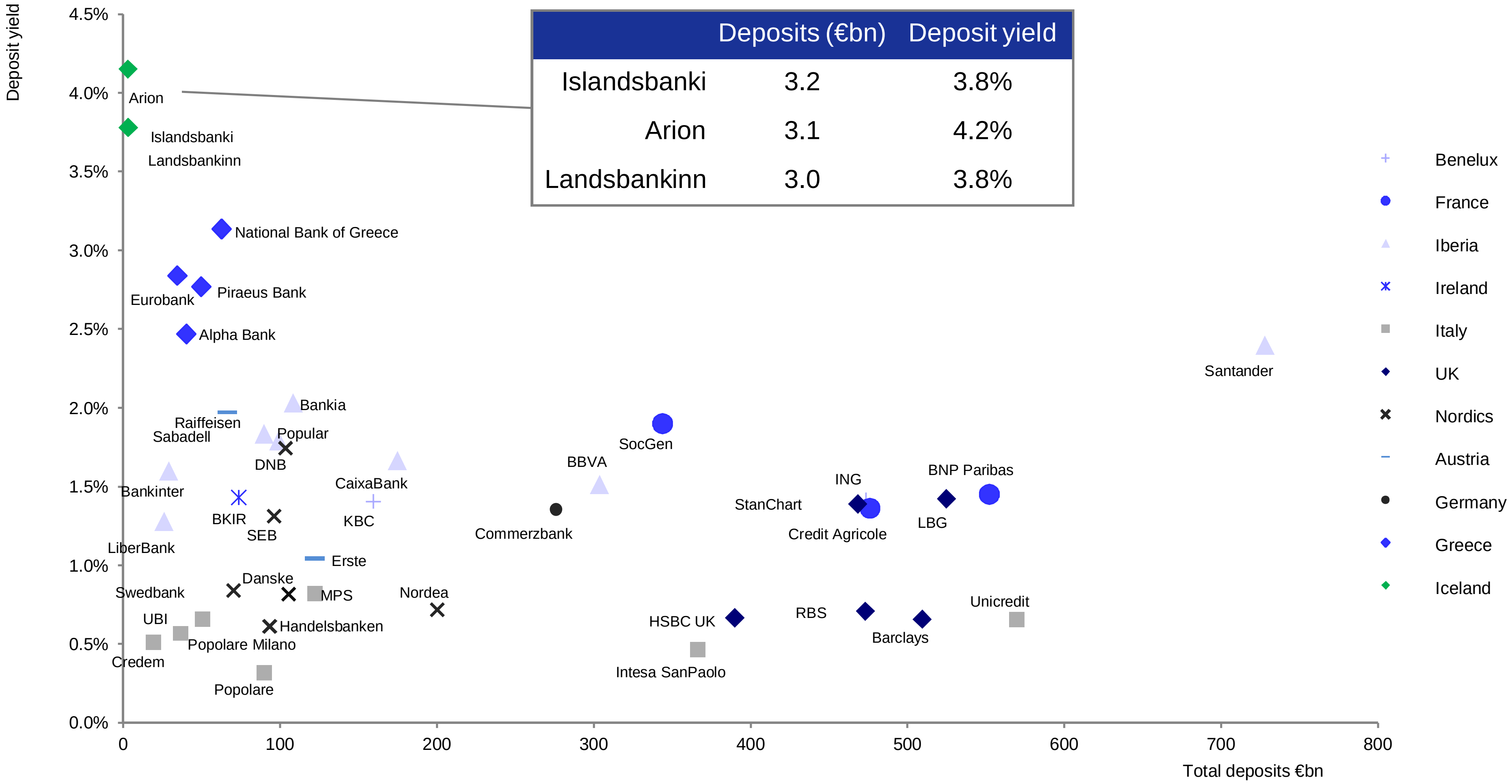
Note: Country averages represent Deutsche Bank Equity Research coverage universe
Icelandic banks denote 2013A and 9M14A

(a) Arion's reported 9M14 adjusted cost:income ratio reflecting removal of valuation changes in discontinued operations and real estate companies of 55.8%
Islandsbanki and Landsbankinn's cost:income ratios as reported (and excluding net valuation adjustments)

(b) Islandsbanki's reported cost:income ratio calculated as (administrative expenses + deposit guarantee fee – one off items)/total operating income

(c) Landsbankinn's 2013A reported cost:income ratio adjusted to remove net valuation adjustments, net impairment losses and FV adjustment on contingent bond

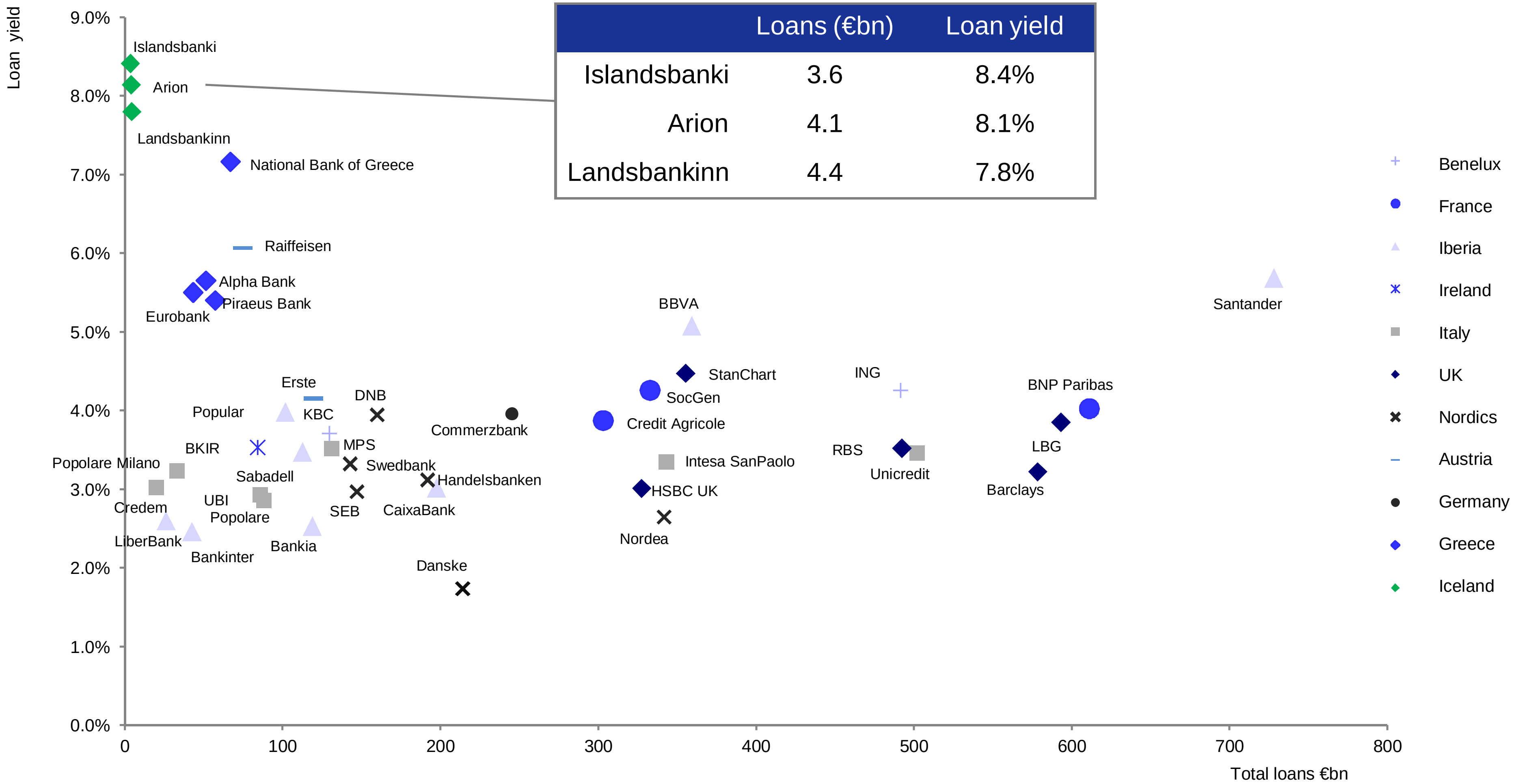
6 Profitability
Customer deposit yield



	Deposits (€bn)	Deposit yield
Islandsbanki	3.2	3.8%
Arion	3.1	4.2%
Landsbankinn	3.0	3.8%

Source: Deutsche Bank Equity Research and company disclosure

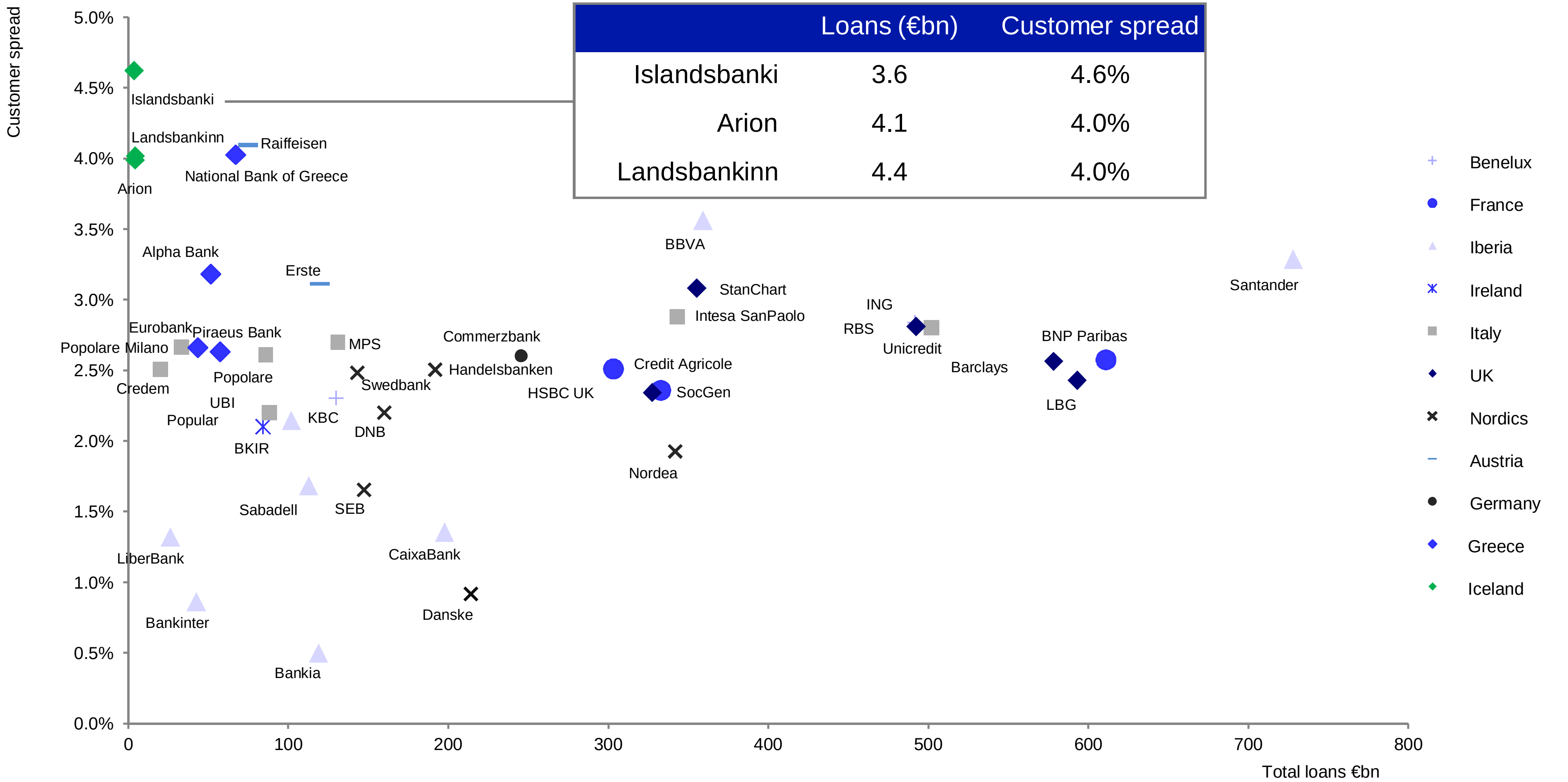
6 Profitability
Customer loan yield



	Loans (€bn)	Loan yield
Islandsbanki	3.6	8.4%
Arion	4.1	8.1%
Landsbankinn	4.4	7.8%

Source: Deutsche Bank Equity Research and company disclosure

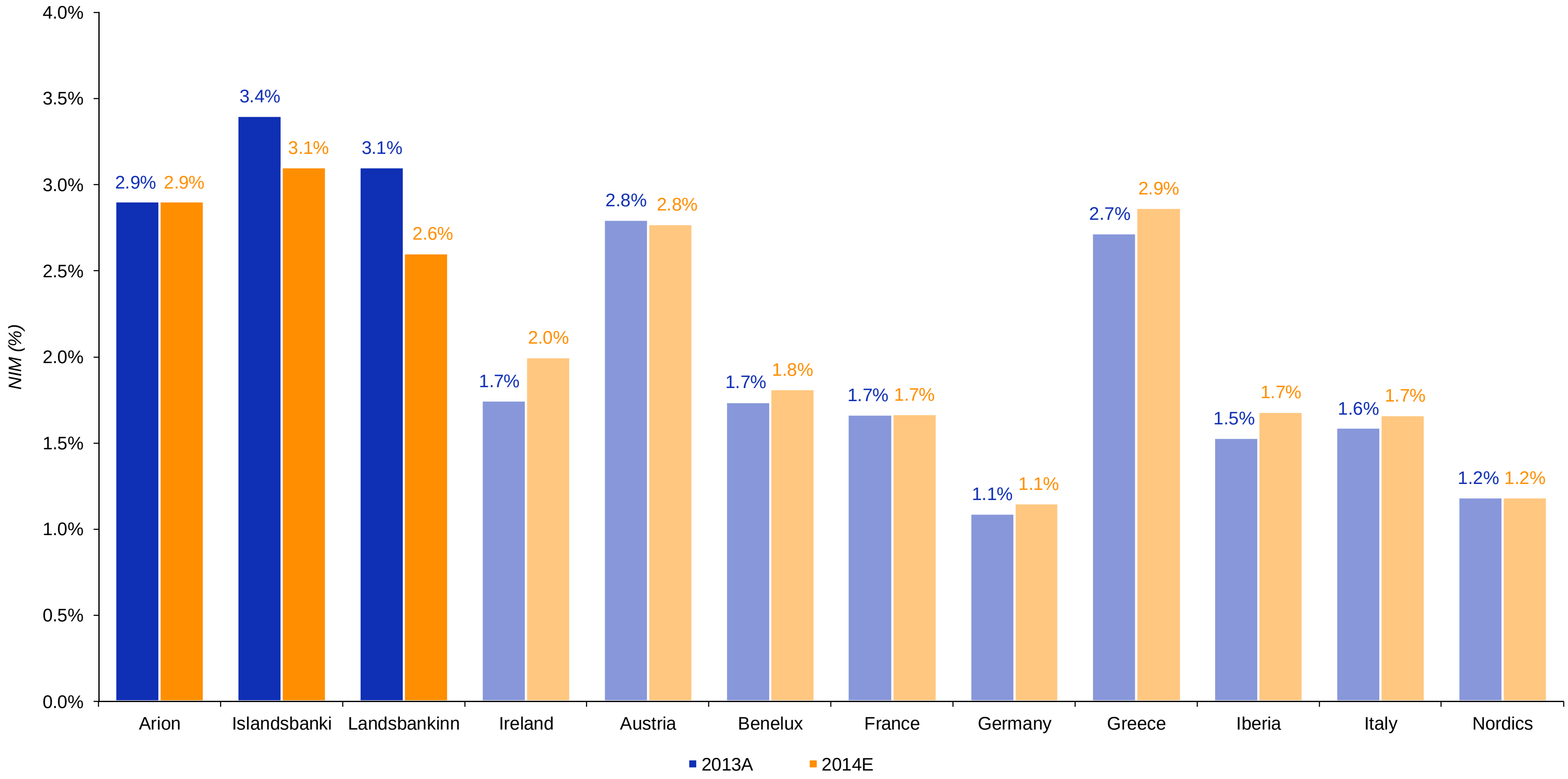
6 Profitability
Customer spread



	Loans (€bn)	Customer spread
Islandsbanki	3.6	4.6%
Arion	4.1	4.0%
Landsbankinn	4.4	4.0%

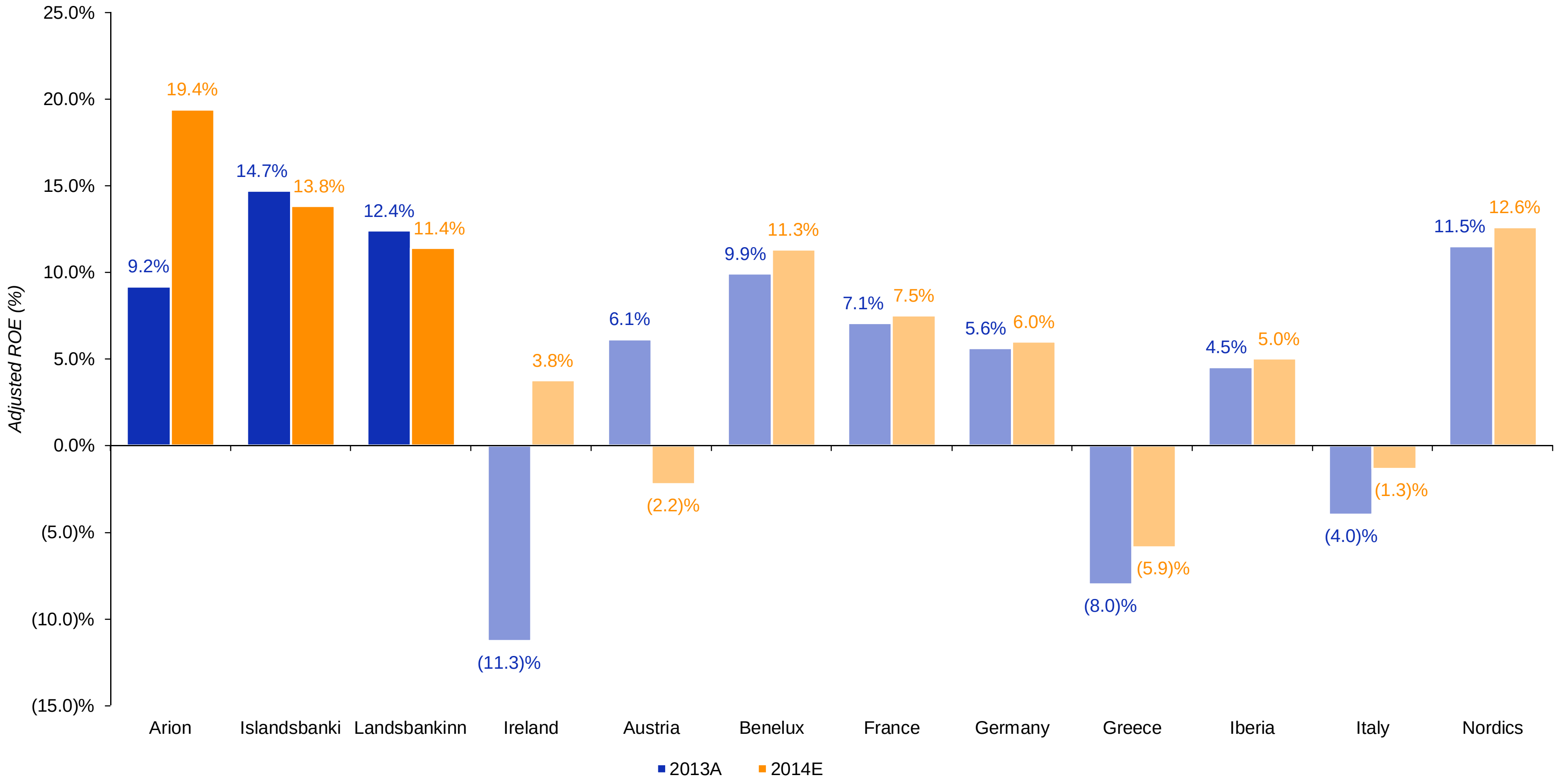
Source: Deutsche Bank Equity Research and company disclosure

6 Profitability – net interest margin



Note: Country averages represent Deutsche Bank Equity Research coverage universe
Icelandic banks denote 2013A and 9M14A (reported)

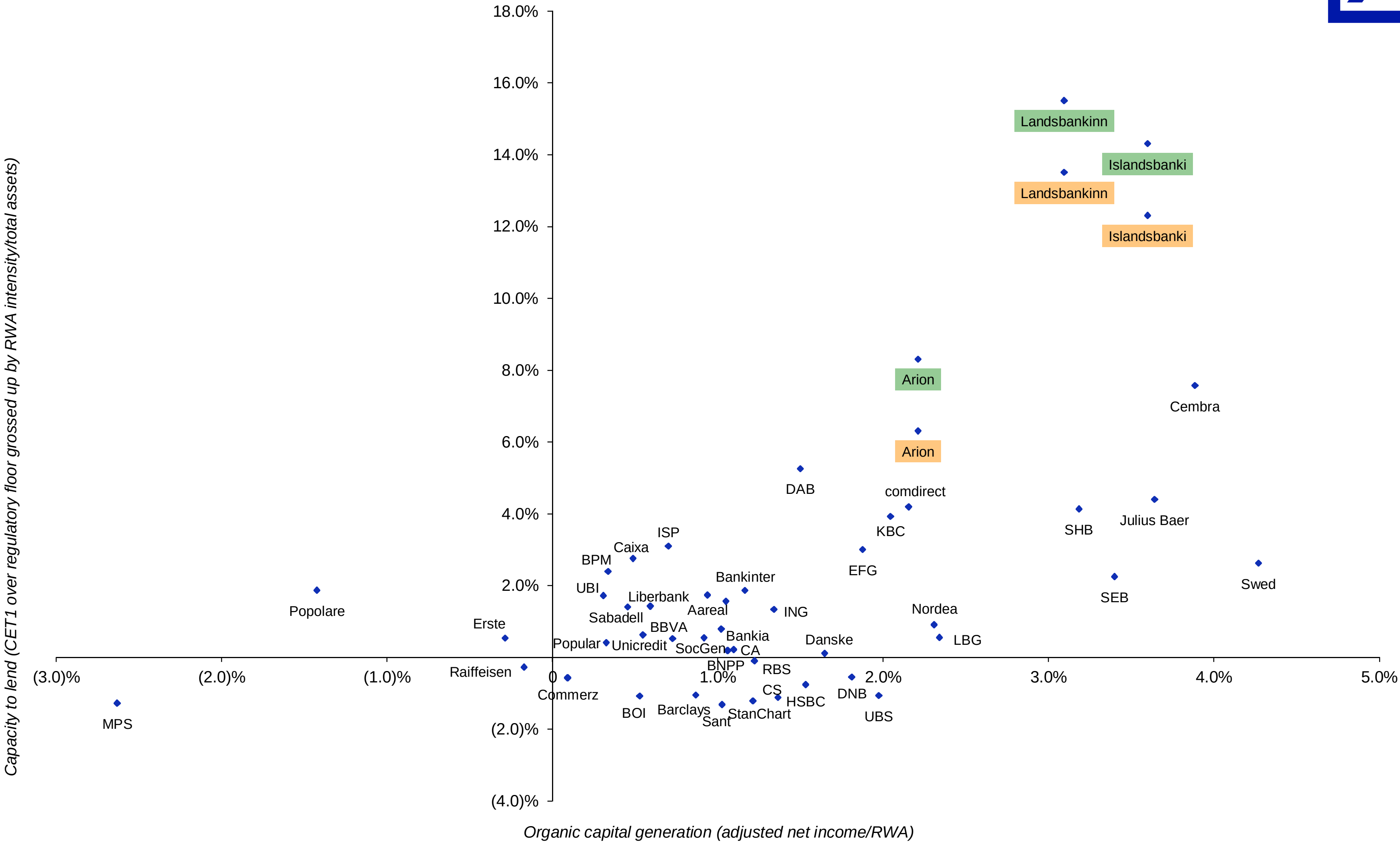
6 Profitability – return on equity



Note: Country averages represent Deutsche Bank Equity Research coverage universe
Based on DB Equity Research adjusted net profit except Icelandic banks (based on reported net profit)
Icelandic banks denote 2013A and 9M14A (annualised)

(a) Arion's reported ROE includes net valuation changes and net gains from discontinued operations. Reported adjusted ROE 9.9% 9M14
(b) Islandsbanki's reported ROE includes net valuation adjustments and profit from discontinued operations
(c) Landsbankinn's reported ROE includes net valuation adjustments

7 Ability to grow



Note: All figures are DB Equity Research 2014E except
Icelandic banks (reported 9M14 with organic capital generation annualised)
Arion capital generation based on disclosed 9M14 net earnings from core operations adjusted for net valuation changes on loans

12% CET1 floor / Unadjusted net income 2013A

14% CET1 floor / Unadjusted net income 2013A

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Challenges and outlook for Icelandic banks

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Icelandic banks in European context
Summary observations

- Post crisis uncertainty in the European banking sector has lessened with greater clarity on regulatory capital requirements and therefore business model sustainability
- The focus on business model refinement and cost base rationalisation, in particular the impact of technology on processes and distribution, will continue and is taking on increased importance as banks seek to improve ROEs in the “new normal” environment
- Icelandic banks are in a similar position, with regulatory clarity expected by 2015. Business model refinement and cost base rationalisation has been a key focus as banks have worked through legacy issues/evolve towards normalised profitability
- Iceland’s specific challenges remain for the banks: small economy, asset concentration risk, dependence on domestic funding sources and capital controls
- However, after several years of restructuring/refinement, the Icelandic banking sector is well placed to address ongoing challenges and improve competitiveness

Icelandic banks in European context
Summary observations (continued)

Ability to attract capital/funding

- Investment case now clear and trajectory to normalised, sustainable returns understood. The banks again represent leveraged plays on the Icelandic economy; no longer speculative restructuring plays
- International funding markets are re-open, as the sovereign has improved and bank stability become clearer. However, Iceland-specific factors will mean elevated funding costs (to larger Nordic peers) remain
- Getting the balance right between stability and competitiveness will be very important in defining the regulatory framework and capital control exit strategy

Ability to "manufacture"/efficiency

- Icelandic banks have managed their cost bases well in response to revenue normalisation but further improvements necessary to achieve best-in-class industry standard, particularly given relative funding cost disadvantage. Further improvements will be essential to extent asset margins come under pressure as larger Nordics interest in lending into Iceland increases

Ability to lend into the economy

- Attractive margins support new lending volumes
- Balance sheet strength and good liquidity positions provide strong capacity to grow loan books
- Moderate regulatory capital floors will be important for this capacity to remain/incremental ROE's to remain attractive
- Challenge remains competing with larger Nordic peers for corporate business

Next steps for Icelandic banks

- Clarity on regulatory environment
- Normalise capital structure
- Resolution of legacy issues
- Profitable growth/delivering on financial and returns targets
- Increased international investor focus to support re-privatisation process