

Rating Action: Moody's assigns first time long-term deposit ratings of A3 and issuer ratings of Baa1 to Arion Bank; outlook positive

12 Jul 2022

London, July 12, 2022 -- Moody's Investors Service ("Moody's") has assigned first time A3 long-term and Prime-2 short-term foreign and local currency bank deposit ratings, and Baa1 long term issuer ratings to Iceland's Arion Bank (Arion). The assigned long-term deposit and issuer ratings carry a positive outlook.

Moody's also assigned a Baseline Credit Assessment (BCA) and Adjusted BCA of baa3, an A3(cr) long-term and P-2(cr) short-term Counterparty Risk (CR) Assessment, and A3 long-term and P-2 short-term foreign and local currency Counterparty Risk Ratings (CRRs).

The ratings reflect Arion's robust capitalisation as evident by its strong leverage ratio, coupled with good and improving core profitability, low level of problem loans and adequate liquidity balanced against single name and geographical concentrations, market related risks, and reliance on market funding.

The positive outlook reflects the bank's improved risk profile and the agency's expectation that profitability will be less volatile in the next 12-18 months which will support the bank's performance.

A full list of affected ratings can be found at the end of the press release.

RATINGS RATIONALE

MACRO PROFILE

Arion's "Strong-" macro profile reflects that the bulk of its operations are concentrated in Iceland (A2, stable). Iceland's "Strong-" macro profile reflects the economy's flexibility, wealth, competitiveness and favourable demographics. The main risks to the banking sector stem from the small size of the country and the closed nature of its economy, which could create a risk of contagion and spillover in case of sector specific shocks, as well as the extensive use of market funding.

BASELINE CREDIT ASSESSMENT

Arion's BCA reflects its strong capitalisation. The bank, in-line with the rest of the Icelandic banks, benefits from very strong capital ratios which is reflective of high capital requirements and robust internal capital generation. Arion reported a Common Equity Tier 1 (CET1) ratio of 18.8% against a requirement of 15.6% at end September 2022 and a leverage ratio of 12.5%, which compares favourably to the European average of close to 6%. Going forward Moody's expects capitalisation to remain strong, albeit at slightly lower levels as the bank optimises its capital structure.

The bank's core profitability is strong and improving. The bank benefits from a relatively diversified income stream as net interest income accounts for 55% of revenues, due to its sizeable asset management, investment banking and insurance operations. However, the bank's profitability has been greatly impacted in the past years from discontinued operations that were held for sale. Moody's recognises the bank's efforts to successfully dispose the majority of these operations, however, there are still some risks associated with the ones not yet disposed. We expect the bank's profitability to be at lower levels than the 2.2% return on tangible assets reported in 2021, due to a muted earnings outlook for the insurance business for 2022 and 2023, lower financial income and return to a normalised cost of risk but still at a higher level than the historical average of 0.6%, during 2018-2020, reflective of the bank's balance sheet clear out and new strategic focus on profitable growth.

The bank's operations are also supported by adequate liquidity, with liquid banking assets to tangible banking assets ratio of 18% at end 2021 and an LCR ratio of 195%. The bank's liquidity pool constitutes mostly of cash and deposits with central banks and Icelandic government bonds.

Arion Bank's asset quality has improved with a reported non-performing loans ratio (stage 3 loans to gross loans) of 1.6% at end March 2022, from its peak of 2.9% in 2019, reflective of Iceland's improving economic

environment and the bank's revised risk framework. However, the bank continues to exhibit single name and geographical concentrations and is exposed to market risk through its investment banking operations. The agency expects the bank's NPL ratio to stabilise at current levels, after a prolonged balance sheet clean up that the bank has undergone in the past years, supported by Iceland's growth outlook.

The BCA also includes the agency's expectation that the bank will increase its use of market funds to finance lending growth in the next 12-18 months. Although more than half of the bank's market funding is in the form of domestically issued covered bonds which the rating agency considers to be a more stable source of funding. The bank has also started issuing in the international markets, which although it provides diversification in its investor base it also increases somewhat the FX risk due to the absence of counterparties to provide currency swaps for these issuances.

The assignment of ratings to Arion also takes into account its governance risks as part of Moody's environmental, social and governance (ESG) considerations. Governance is highly relevant to the banking sector. Moody's has no particular governance concerns in relation to Arion. Nonetheless, corporate governance remains a key credit consideration and would require ongoing monitoring, as is the case for all financial institutions.

LOSS GIVEN FAILURE (LGF)

Arion's long-term deposit ratings of A3 are underpinned by the bank's Adjusted BCA of baa3 and Moody's Advanced LGF analysis which takes into account the severity of loss faced by the different liability classes in the event of a failure. The LGF analysis for Arion indicates an extremely low loss-given-failure for depositors, leading to three notches of rating uplift from the bank's baa3 Adjusted BCA for the deposit ratings. This is reflective of the full depositor preference currently in place in Iceland as well as the high volume of instruments that are subordinated deposits.

Arion's long-term issuer ratings of Baa1 are underpinned by the bank's Adjusted BCA of baa3 and Moody's Advanced LGF analysis which takes into account the severity of loss faced by the different liability classes in the event of a failure. The LGF analysis for Arion indicates a very low loss-given-failure for senior debt holders, leading to two notches of rating uplift from the bank's baa3 Adjusted BCA for the issuer ratings.

Arion's CR Assessment (CRA) is A3(cr)/Prime-2(cr), three notches above the bank's Adjusted BCA of baa3, based on the substantial cushion against default provided by subordinated instruments to the senior obligations represented by the CRA. Concurrently, the CRRs of A3/Prime-2 are three notches above the Adjusted BCA of baa3, reflecting also the extremely low loss-given-failure from the high volume of instruments that are subordinated to CRR liabilities.

GOVERNMENT SUPPORT

Despite Arion's significant deposit market share of 27% and its systemically important status, we assume a low probability of government support for its CRA, CRRs, deposit ratings and issuer ratings reflecting Iceland's implementation of the EU's Bank Recovery and Resolution Directive (BRRD) and the country's past track record on providing no support to the financial sector during the 2008 financial crisis.

OUTLOOK

The positive outlook on Arion's long-term deposit and issuer ratings reflects the bank's improved performance during the past 18 months in terms of asset quality metrics and overall risk profile. The outlook also incorporates Moody's expectation that the bank will exhibit lower earnings volatility going forward, reflective of the successful disposal of some of the discontinued operations, tighter underwriting criteria and further integration of the insurance operations in the bank's activities.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

The positive outlook could transform into a rating upgrade in the next 12-18 months, provided that Arion continues to demonstrate resilience in its financial performance while sustaining strong asset quality and capitalisation while it successfully disposes of its remaining discontinued operations currently held for sale. For the issuer ratings, upward rating pressure could also develop because of a larger cushion of loss absorbing obligations protecting creditors and depositors in case of failure.

Downward pressure could emerge if Arion's (1) asset quality and risk profile was to deteriorate, for example as a result of increased exposures to more volatile sectors and/or increased single name concentrations; (2) risk

profile increases driven by non-credit related risks such as market risk and fx risk (3) the bank's recurring profitability weakens significantly limiting the bank's internal capital generation (4) financing conditions were to become more difficult or (5) the macroeconomic environment deteriorates significantly leading to a lower Macro Profile.

Furthermore, a reduction in the rating uplift as a result of our LGF analysis triggered by structural funding changes to the bank's balance sheet could lead to downward rating pressure.

LIST OF AFFECTED RATINGS

..Issuer: Arion Bank

Assignments:

...Adjusted Baseline Credit Assessment, Assigned baa3

...Baseline Credit Assessment, Assigned baa3

...Long-term Counterparty Risk Assessment, Assigned A3(cr)

...Short-term Counterparty Risk Assessment, Assigned P-2(cr)

...Long-term Counterparty Risk Ratings, Assigned A3

...Short-term Counterparty Risk Ratings, Assigned P-2

...Long-term Bank Deposit Ratings, Assigned A3, Outlook Assigned Positive

...Short-term Bank Deposit Ratings, Assigned P-2

...Long-term Issuer Ratings, Assigned Baa1, Outlook Assigned Positive

Outlook Action:

...Outlook, Assigned Positive

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Banks Methodology published in July 2021 and available at <https://ratings.moodys.com/api/rmc-documents/71997>. Alternatively, please see the Rating Methodologies page on <https://ratings.moodys.com> for a copy of this methodology.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on <https://ratings.moodys.com/rating-definitions>.

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Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://ratings.moody.com/documents/PBC_1288235.

At least one ESG consideration was material to the credit rating action(s) announced and described above.

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