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## Research Update:

# Iceland-Based Arion Bank Assigned 'BB+/B' Ratings; Outlook Stable

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## Research Update:

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## Overview

- In our view, Arion Bank, a commercial bank created from the default of Kaupthing in 2008, holds important market positions in Iceland.
- Although operating in a high-risk environment, Arion Bank benefits from what we view as a strong capital position, ample liquidity, and a largely restructured loan book.
- We are assigning our 'BB+/B' ratings to Arion Bank.
- The stable outlook reflects our view that the bank's capital position will improve following the planned divestment of its equity portfolio and that the final restructuring of its loan book will require only limited additional impairments.

## Rating Action

On Jan. 10, 2014, Standard & Poor's Ratings Services assigned its 'BB+' long-term and 'B' short-term counterparty credit ratings to Iceland-based Arion Bank. The outlook is stable.

## Rationale

The ratings reflect our 'bb' anchor for banks operating in Iceland and our view of Arion Bank's "adequate" business position, "strong" capital and earnings, "adequate" risk position, "average" funding, and "strong" liquidity, as our criteria define these terms. The stand-alone credit profile (SACP) is at 'bb+'.

We view Arion Bank's business position as "adequate" because of its sound presence in most business lines in Iceland. Arion Bank was created in October 2008 from the domestic assets and liabilities of the now defunct Kaupthing Bank. Since then, it has expanded in the household segment and its current franchise is equally split between corporate and retail business. However, it remains small in an international comparison with assets totalling Icelandic krona (ISK) 936 billion (about €5.8 billion) on Sept. 30, 2013.

Despite the concentration to Iceland, Arion Bank's revenue base is diverse. Approximately 60% of revenues come from net interest income, 25% from fee income, and the remainder from market-related revenues. We expect the current business mix to remain unchanged and consider the bank to have been well managed in the difficult economic environment in Iceland since 2008.

We assess Arion Bank's capital and earnings as "strong" based on our risk-adjusted capital (RAC) ratio, which we project will approach 11.5% at year-end 2015 after 9.7% in June 2013. The main contributor to the improvement will be the bank's partial execution of its plan to divest legacy equity exposures that it took over as a part of debt restructurings. We do not expect capital buildup to be as strong as in recent years, however, because of a new bank tax levy to partly financing the government's proposed debt reduction for borrowers with inflation-linked loans. We estimate that this levy will reduce Arion Bank's net earnings to ISK10 billion-ISK11 billion over the next two years from an expected ISK13 billion in 2013. We also expect that, given the bank's high regulatory Tier 1 ratio of 19.5% on Sept. 30, 2013, there is room to pay dividends of up to 50%-60% of net income. Arion Bank has only distributed dividends once, in 2011. Positively, we note that the bank's leverage ratio (adjusted common equity to adjusted assets) was strong at over 14% in September 2013, which is one of the highest among global commercial banks.

Our assessment of Arion Bank's risk position as "adequate" reflects our view that the majority of loan restructurings have been completed and remaining loan impairments will likely be limited. Nonperforming loans comprised 9.1% of the loan book as of Sept. 30, 2013, compared with 54% at year-end 2010. The asset transfer in 2008 was at a significant discount to the loans' book value; therefore subsequent impairment needs and compensation to Kaupthing's creditors have been relatively well matched by positive revaluations of the exposures. The net position since 2009, representing positive revaluations less impairments and compensation paid, is negative ISK13.3 billion.

New loan loss provisions during the first three quarters of 2013 were 0.58% of customer loans, compared with 1.88% in 2012, and we forecast them to fall further in 2014. Likewise, we believe any remaining positive revaluations will be limited. In addition to credit risk, the bank has a meaningful proportion of equity risk. As of June 30, 2013, about 22% of Arion Bank's Standard & Poor's risk-weighted assets associated with equities in the banking book resulted from debt restructuring.

We consider Arion Bank's funding to be "average," balancing the bank's relatively stronger funding metrics than some domestic and European peers with the risk of potential deposit outflows. We believe about ISK100 billion, of which 50% is denominated in foreign currencies, could initially be at risk when capital controls in Iceland are lifted. However, we cannot rule out that some domestic money could also leave the bank. Our stable funding ratio for Arion Bank, which was 122% as of Sept. 30, 2013, could fall to 108% should lost nonresident deposits not be replaced by other sources of stable funding. However, we see potential for the bank to obtain other types of stable funding considering its moderate asset encumbrance of about 20%. The maturity profile for capital market funding appears strong in our view with no meaningful redemptions until 2020.

Arion Bank's liquidity is "strong," according to our measures. In September 2013, Arion Bank's liquidity ratio (reported broad liquid assets to short-term

wholesale funding) was 5.79x, indicating very high coverage of maturing debt. In addition, liquid securities and cash fully cover all potential outflows of foreign deposits. In such an outflow scenario, without considering any new stable funding, the liquidity ratio would still exceed 2x within a 12 month period.

We consider the bank to have high systemic importance in Iceland; however, we do not add any notches of uplift to the SACP because future extraordinary government support is uncertain. This reflects our view of the Icelandic government's poor track record and still limited but improved capacity to support the new smaller banking system in a severe stress scenario.

## Outlook

The stable outlook reflects our view that asset disposals will improve Arion Bank's capital position, with our RAC ratio increasing toward 11.5% by 2015 while earnings generation remains sound. We believe the restructuring of the loan portfolio is almost completed, therefore further impairments will likely be limited. In addition, we expect the bank's funding and liquidity profile to remain broadly unchanged and its reliance on wholesale funding, mainly through long-term covered bonds, to increase gradually.

We could take a positive rating action on Arion Bank if risks for Iceland's economy and banking sector were to diminish. In addition, if the bank maintained strong funding metrics and ample liquidity, despite a loss of nonresident deposits, we could revise our assessment of its overall funding and liquidity profile upward, which might lead to an upgrade.

Setbacks in the plan to divest legacy assets could result in a negative rating action if it resulted in a lower RAC ratio. Although unlikely, an unexpected substantial increase in loss provisions on the legacy loan book and securities portfolio could also lead to a negative rating action.

## Ratings Score Snapshot

Issuer Credit Rating	BB+/Stable/B
SACP	bb+
Anchor	bb
Business Position	Adequate (0)
Capital and Earnings	Strong (+1)
Risk Position	Adequate (0)
Funding and Liquidity	Average and Strong (0)
Support	0

GRE Support	0
Group Support	0
Sovereign Support	0
Additional Factors	0

## Related Criteria And Research

### Related criteria

- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

### Related research

- Banking Industry Country Risk Assessment: Iceland, Aug. 19, 2013

## Ratings List

New Rating

Arion Bank

Counterparty Credit Rating BB+/Stable/B

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