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Arion Bank

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Arion Bank

SACP	bb+

Anchor	bb	
Business Position	Adequate	0
Capital and Earnings	Strong	+1
Risk Position	Adequate	0
Funding	Average	0
Liquidity	Strong	

\+

Support	0
GRE Support	0
Group Support	0
Sovereign Support	0

\+

Additional Factors	0

Issuer Credit Rating

BB+/Positive/B

Major Rating Factors

Strengths:	Weaknesses:
• Strong capital, with high leverage ratios. • Ample liquidity buffers and a stable deposit funding base. • Stable franchise, equally split between retail and corporates.	• Uncertainty associated with capital controls in Iceland. • Domestic economy offers few diversification opportunities. • Still sizable nonrecurring items boosting profitability.

Outlook: Positive

The positive outlook on Icelandic commercial bank Arion Bank hf. reflects Standard & Poor's Ratings Services' view that Arion's stand-alone credit profile (SACP) is likely to develop alongside improvements in the Icelandic economy. We see a positive trend for economic risk in Iceland's banking sector, and would expect to lift the ratings on Arion Bank if we improved our view on the sector. We anticipate that the bank's risk-adjusted capital (RAC) ratio would move toward 11%-12% if it reduced risk-weighted assets while earnings generation remained sound. We expect the restructuring of the loan portfolio to be close to an end, and further impairments to be limited. Additionally, we expect the funding and liquidity profile to remain broadly in place. We see that the bank is gradually increasing its wholesale issuance, mainly using a mix of senior unsecured and long-term covered bonds.

We could raise our ratings on Arion Bank if our assessment of risks for the Icelandic sovereign and the Icelandic banking sector continue to improve. We could consider improving the bank's overall funding and liquidity assessment if risks associated with the non-resident deposits were to be resolved. This would improve the bank's financial flexibility and keep its funding metrics and ample liquidity strong.

We could revise the outlook to stable if the bank doesn't execute its plan to dispose of legacy assets as we expect, thereby lowering our expectations for the RAC ratio. Although unlikely, an unexpected substantial increase in provisioning in the legacy loan book and securities portfolio could also lead to such a revision. A situation whereby the sector does not continue to improve or slides into a reversal could also lead to an outlook revision to stable.

Rationale

Standard & Poor's rating on Arion Bank reflects the 'bb' anchor we assign to banks operating in Iceland, and our view of the bank's "adequate" business position, "strong" capital and earnings, "adequate" risk position, "average" funding, and "strong" liquidity.

Anchor: 'bb' for banks with Icelandic focus, but the economic risk trend is positive

We use our Banking Industry Country Risk Assessment's economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating under our bank criteria. The anchor for a commercial bank operating only in Iceland is 'bb', based on an economic risk score of '7' and an industry risk score of '6'.

Economic risk for Icelandic banks has, in our view, continued to decline. Imbalances have further reduced, and we expect the country's prosperous but concentrated economy to achieve annual real GDP growth of about 3% in 2014 and 2015. The Icelandic economy is steadily reducing its debt burden. The banks have all undergone significant restructuring efforts, including a reduction of nonperforming loan stocks. Although the perils associated with the eventual removal of the capital controls is an economic risk, our base-case scenario assumes the authorities will approach the task prudently, minimizing the impact to the economy and exchange rate.

We think industry risk has subsided following a move to a more robust regulatory system and a funding model based on mainly resident domestic deposits, away from the very high external wholesale dependence prior to the 2008 banking crisis. We expect profitability to be in line with that in the corporate sector and based on what we believe to be sound commercial practices.

Table 1

Arion Bank Key Figures					
		--Year-ended Dec. 31--			
(Mil. ISK)	**2014***	**2013**	**2012**	**2011**	**2010**
Adjusted assets	943,618	933,467	895,734	887,356	808,263
Customer loans (gross)	664,406	665,000	626,391	617,839	493,062
Adjusted common equity	143,989	131,431	125,178	109,405	104,559
Operating revenues	25,251	44,348	49,106	41,632	33,167
Noninterest expenses	12,776	25,395	24,668	22,016	18,292
Core earnings	6,458	5,181	8,645	4,448	(16,046)

*Data as of June 30. ISK--Icelandic krona.

Business position: Diversified lender within the limitations of the Icelandic economy

We regard Arion Bank as having broad presence in most business lines in Iceland, in line with the industry risk we assess for the Icelandic banking system. Arion was created in October 2008 upon the transfer of the domestic assets and liabilities from what was previously the corporate-focused Kaupthing Bank. Since then, Arion has expanded its footprint in the household segment, and its current franchise is now equally split between corporates and retail. However, it remains a small bank in an international comparison, with total assets of Icelandic krona (ISK) 949 billion (€6.2 billion) at June 30, 2014.

The population concentration in Iceland--only 320,000 inhabitants--is evident in Arion Bank's profile, as it depends on the economic prospects of a country with a just a few key industries. Nevertheless, the bank's revenue base is rather diversified among its different business lines, with about 60% of revenues from net interest income split evenly between corporate and retail customers; 25% derives from fee income driven by card-transaction fees and assets under management, and the remainder from market-related revenues. We expect the current business mix to remain as is. We consider the bank to have been well managed through a difficult economic environment since its creation in 2008. We believe the bank has focused on addressing the pressing relevant issues such as the reduction of non-performing loans, and that it has prepared itself well for any future removal of capital controls or other adverse scenarios, by improving the liquidity and capital buffers.

Table 2

Arion Bank Business Position					
		--Year-ended Dec. 31--			
(%)	**2014***	**2013**	**2012**	**2011**	**2010**
Loan market share in country of domicile	22.3	23.0	20.2	19.9	16.1
Deposit market share in country of domicile	29.9	30.4	30.1	31.9	32.4
Total revenues from business line (mil. ISK)	34,872	53,846	63,933	83,085	74,014
Commercial banking/total revenues from business line	12.4	17.3	17.5	28.0	32.0
Retail banking/total revenues from business line	21.9	27.0	13.7	(1.9)	16.1
Commercial & retail banking/total revenues from business line	34.3	44.3	31.2	26.2	48.0
Trading and sales income/total revenues from business line	16.1	8.2	8.8	1.1	(2.6)
Asset management/total revenues from business line	6.2	6.9	6.5	4.5	5.2
Other revenues/total revenues from business line	43.4	40.6	53.5	68.2	49.4

Table 2

Arion Bank Business Position (cont.)					
Investment banking/total revenues from business line	16.1	8.2	8.8	1.1	(2.6)

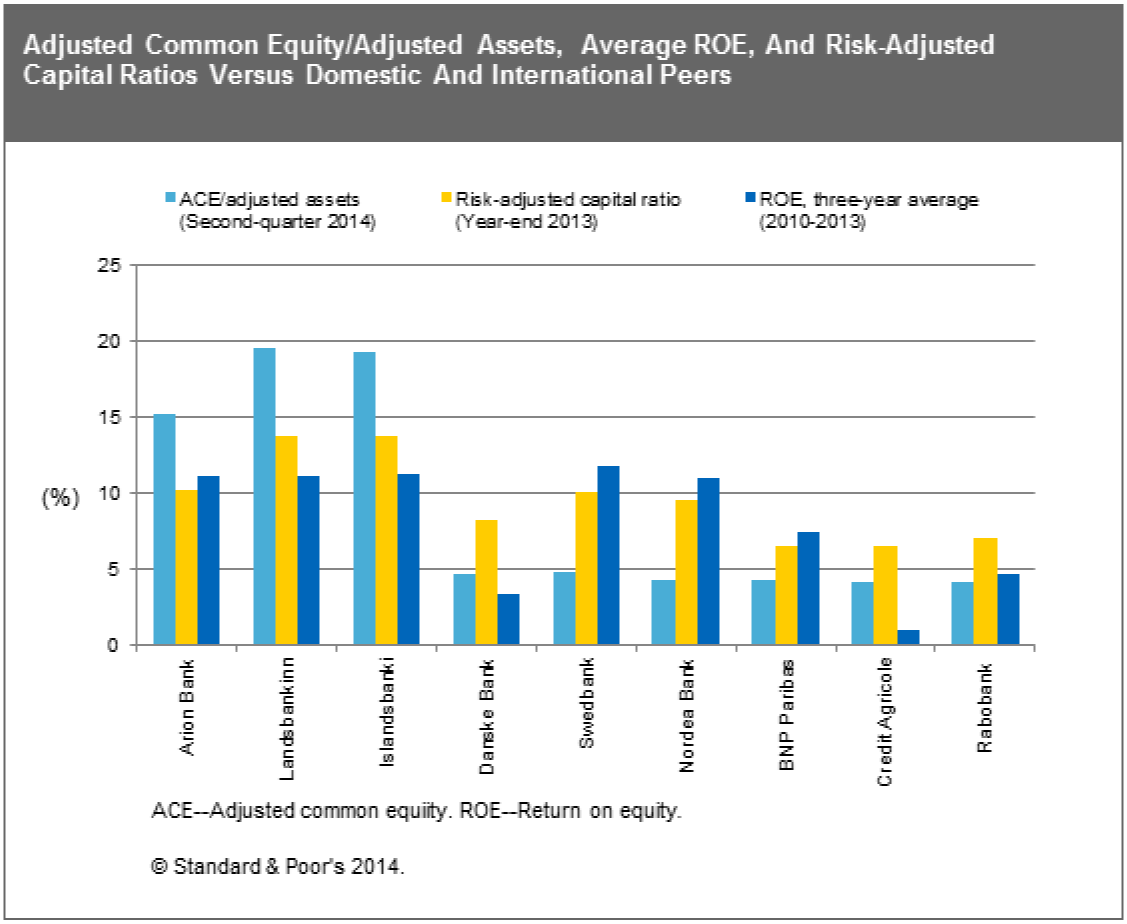
*Data as of June 30. ISK--Icelandic krona. N/A--Not applicable.

Capital and earnings: Capital strong and earnings stabilizing

We expect Arion Bank's RAC ratio to approach 11%-12% over the next 18-24 months, after 10.2% at the end of 2013. The main contributor to the improved capital position is the bank's partial execution of its plan to divest legacy assets in the form of equity exposures that it took over as a part of debt restructurings. We do not expect the capital build to be as strong as in recent years, although we note that an eventual improvement in our view of the economic risks within the Icelandic BICRA could improve ratios by more than 100bps, given subsequent lower risk weights for the bank's credit exposures.

We believe that the proposed capital requirements by the Icelandic FSA reduce the possibility of extraordinary dividends, despite the relatively high regulatory Tier 1 ratio of 21.1% at June 30, 2014, and we assume 50% of net income for future dividend payments in our forecast. We note that the bank's strong leverage ratio, measured by adjusted common equity as a share of adjusted assets, was 15.3% at June 2014, and despite being somewhat lower than domestic peers', it is considerably higher than its primary Nordic peers and most global commercial banks (see chart 1). Additionally, the Icelandic banks are reporting high average return on equity despite their much higher capital base, which in our view is commensurate for a banking system that is operating in a riskier environment featuring higher inflation.

Chart 1



We expect Arion Bank's net interest margin to fall somewhat from 3% as the retail portfolio becomes a larger share of the balance sheet and drives the volume growth in the lending portfolio. We expect an increase of around 5% in the bank's fees and commissions, driven over the coming years by expanding card-transaction volumes and other initiatives to diversify fee-based revenues. We anticipate a relatively stable cost development for 2014, lower impairments, and the new bank tax levy, which we estimate will reach ISK2.6 billion in 2014. We estimate net earnings from core business of ISK14 billion-ISK15 billion, equivalent to an ROE of around 9%-10%. Further, the bank continues to receive returns from the revaluation of loan assets acquired at deep discount and sales of non-core assets (the sale of HB Grandi, with a positive effect of ISK6.5 billion), which has totaled ISK8.5 billion through the first half of 2014. We expect these one-off impacts to decrease over time, although there is still room for some extraordinary revenues through continued sale efforts.

The bank's earnings buffer, which measures the ability to meet our calculation of its normalized losses, is expected to remain about 90bps in our forecast, signifying a slowdown in capital generation. However, we note that the buffer underestimates our expectations for actual profitability, given the assumption for annual normalized losses of more than ISK9.3 billion--a level we expect the bank to significantly outperform through our two-year forecast, as the asset quality in Iceland improves.

Table 3

Arion Bank Capital And Earnings

	--Year-ended Dec. 31--				
(%)	**2014***	**2013**	**2012**	**2011**	**2010**
Tier 1 capital ratio	21.1	19.2	19.1	16.4	15.2
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	47.4	53.7	55.3	56.2	59.7
Fee income/operating revenues	26.1	25.3	21.9	25.7	20.7
Market-sensitive income/operating revenues	12.7	3.7	4.1	5.6	14.6
Noninterest expenses/operating revenues	50.6	57.3	50.2	52.9	55.2
Preprovision operating income/average assets	2.6	2.1	2.7	2.3	1.9
Core earnings/average managed assets	1.4	0.6	1.0	0.5	(2.0)

*Data as of June 30.

Table 4

Arion Bank Risk-Adjusted Capital Framework

(ISK 000s)	**Exposure***	**Basel II RWA**	**Average Basel II RW (%)**	**Standard & Poor's RWA**	**Average Standard & Poor's RW (%)**
Credit risk					
Government and central banks	105,042,015	1,667,683	2	43,590,235	41
Institutions	102,743,469	23,019,804	22	41,523,675	40
Corporate	306,227,269	287,436,833	94	417,177,991	136
Retail	327,092,095	172,458,904	53	290,279,567	89
Of which mortgage	226,627,004	103,394,914	46	144,806,864	64
Other assets	76,401,193	78,063,414	102	161,534,078	211
Total credit risk	917,506,041	562,646,637	61	954,105,546	104
Market risk					
Equity in the banking book¶	37,586,995	43,567,943	116	306,254,450	815
Trading book market risk	--	4,993,333	--	7,489,999	--
Total market risk	--	48,561,276	--	313,744,450	--
Insurance risk					
Total insurance risk	--	--	--	16,007,750	--
Operational risk					
Total operational risk	--	76,097,000	--	84,041,080	--
(ISK 000s)		**Basel II RWA**		**Standard & Poor's RWA**	**% of Standard & Poor's RWA**
Diversification adjustments					
RWA before diversification		687,304,913		1,367,898,825	100
Total Diversification/concentration adjustments		--		812,023,350	59
RWA after diversification		687,304,913		2,179,922,175	159

Table 4

Arion Bank Risk-Adjusted Capital Framework (cont.)				
(ISK 000s)	**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**Standard & Poor's RAC ratio (%)**
Capital ratio				
Capital ratio before adjustments	130,873,890	19.0	139,242,000	10.2
Capital ratio after adjustments§	130,873,890	18.2	139,242,000	6.4

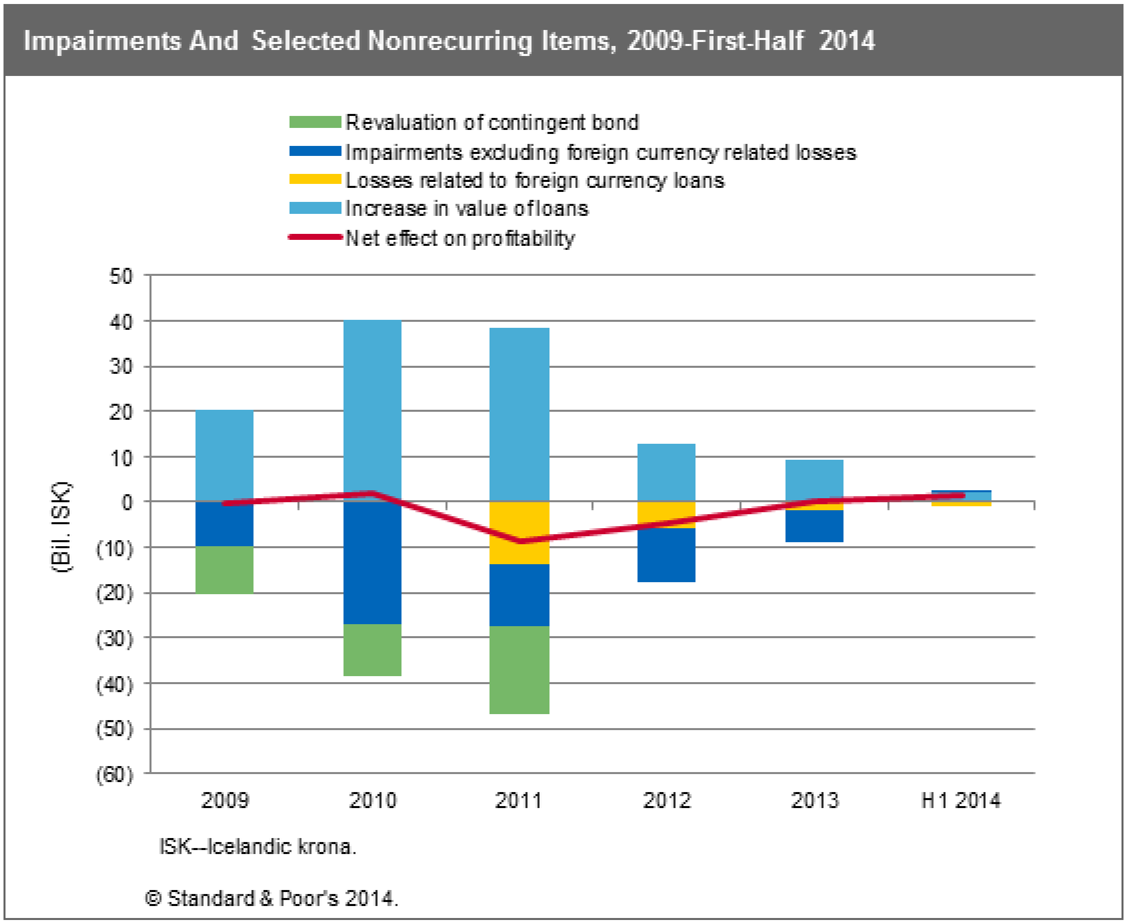
*Exposure at default. ¶Exposure and Standard & Poor's risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. §Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. ISK--Icelandic krona. Sources: Company data as of Dec. 31, 2013, Standard & Poor's.

Risk position: In line with systemic risks in Iceland's banking industry

We view the majority of Arion Bank's loan portfolio restructurings as complete, and expect the remaining impact on the bank to be limited. Our assessment further incorporates our view that the bank's risk profile and loan portfolio largely reflect the risks in its market, and we believe that the bank's progress of restructuring is close to the average of the Icelandic commercial banks, including Landsbankinn and Islandsbanki.

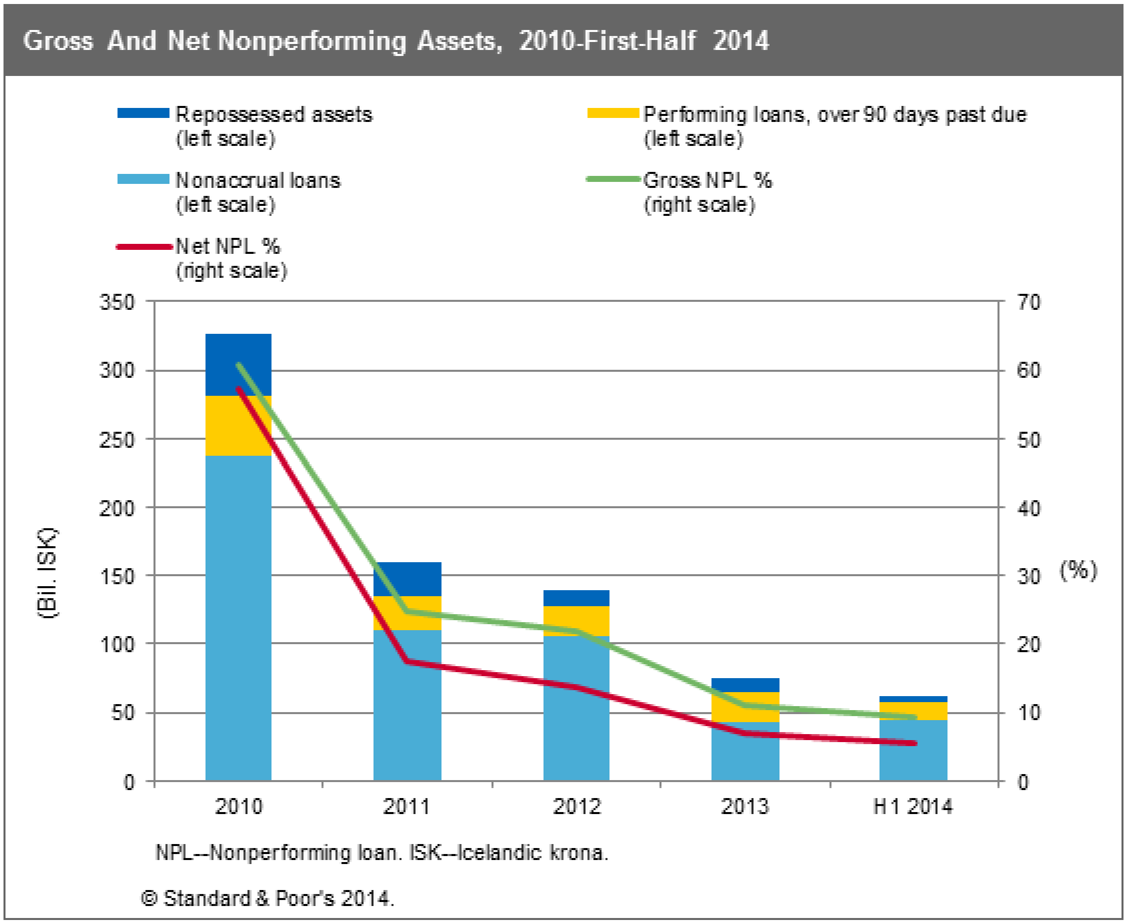
The positive revaluation of assets transferred to Arion Bank from Kaupthing at significant discount to book value has been relatively well matched with subsequent impairment needs since Arion's inception (see chart 2). Reversals of previous loss reserves exceeded new loss provisions during the first half of 2014, with total loan loss provisions of minus 2 basis points (-0.02%) of customer loans compared to 1.2% in 2013. We note that there are a few large loss reserves tied up in the court system, and expect provisions to be somewhat volatile over the next two years, but we expect loan loss provisions to reduce toward 50 basis points annually on average for the next two years. Likewise, we believe any remaining positive revaluations of the loan book to be more limited, with the potential exception of a few larger counterparties.

Chart 2



Arion Bank, along with the other major banks in the market, is showing significant improvement in its gross non-performing loan stock, by our measures, which stood at 9.25% (including foreclosed assets) as of June 30, 2014, compared with 60% at year-end 2010 (see chart 3). We expect the improvement to continue as the economy continues its recovery and as last year's debt relief to the household sector improves household balance sheets.

Chart 3



Aside from Arion Bank's domestic focus, we do not believe there are meaningful concentrations in the loan portfolio. The 20 largest gross exposures account for roughly 150% of the capital base (net of collateral and impairments the number goes down to below 30%). In addition to its credit risk, the bank has a meaningful portion (23% as of end 2013) of its Standard & Poor's risk-weighted assets associated with equities in the banking book as a result of various debt restructurings. The bank has started to reduce these exposures, and we expect it to continue reducing risks from this portfolio through various listings and alternative sales processes that we expect to be largely completed by the end of 2015.

Table 5

Arion Bank Risk Position					
	--Year-ended Dec. 31--				
(%)	**2014***	**2013**	**2012**	**2011**	**2010**
Growth in customer loans	(0.2)	6.2	1.4	25.3	27.6
Total managed assets/adjusted common equity (x)	6.6	7.1	7.2	8.2	7.8
New loan loss provisions/average customer loans	(0.0)	1.2	1.9	2.4	6.1
Net charge-offs/average customer loans	0.6	5.5	1.5	2.3	1.7
Gross nonperforming assets/customer loans + other real estate owned	9.3	11.1	21.8	24.8	60.7

Table 5

Arion Bank Risk Position (cont.)					
Loan loss reserves/gross nonperforming assets	44.2	39.0	43.0	35.3	12.8

*Data as of June 30.

Funding and liquidity: Strong liquidity, even considering potential outflows of foreign currency deposits

We regard Arion Bank as successfully balancing its relatively strong funding metrics, compared to some domestic and European peers with the risk for potential deposits outflows in its customer base. We believe about ISK100 billion held by non-residents, denominated in both ISK and foreign currencies, could be at risk initially when capital controls are lifted, but cannot rule out that some domestic money could also leave the bank. We calculated a stable funding ratio of Arion Bank of 114% at the end of 2013 (estimated as 117% at mid-2014)--a level that could fall to 108% should these foreign currency deposits not be replaced by other sources of stable funding. However, we see potential for the bank to source other types of stable funding considering its moderate asset encumbrance of around 25%. The maturity profile for capital markets funding looks strong to us, with no meaningful redemptions until 2020.

We believe Arion Bank will increase its share of wholesale market funding, primarily through covered bonds in the domestic market when taking market shares from the state-owned Housing Financing Fund, but also through issuance of senior unsecured bonds in the international markets.

The bank has very solid liquidity ratios by our measures. On June 30, 2014, Arion Bank reported broad liquid assets to short-term wholesale funding of 4.8x, indicating high coverage of upcoming maturities of capital markets funding within one year. Additionally, liquid securities and cash fully cover all potential outflows of foreign deposits. In such an outflow scenario, without considering any new stable funding, our liquidity coverage would still stand above 2x short-term wholesale funding, indicating a double coverage of maturing wholesale liabilities within a 12-month horizon.

Table 6

Arion Bank Funding And Liquidity					
		--Year-ended Dec. 31--			
(%)	**2014***	**2013**	**2012**	**2011**	**2010**
Core deposits/funding base	63.9	63.4	62.0	67.2	71.0
Customer loans (net)/customer deposits	134.3	134.7	126.3	114.6	98.5
Long term funding ratio	95.0	95.4	93.3	96.0	87.3
Stable funding ratio	117.0	114.3	117.3	120.0	101.1
Short-term wholesale funding/funding base	6.0	5.4	7.9	4.6	14.7
Broad liquid assets/short-term wholesale funding (x)	4.8	4.8	3.9	6.5	1.7
Net broad liquid assets/short-term customer deposits	38.6	34.2	38.9	39.7	14.8
Short-term wholesale funding/total wholesale funding	16.8	14.8	20.7	13.9	50.7
Narrow liquid assets/3-month wholesale funding (x)	6.8	6.2	N/A	N/A	N/A

*Data as of June 30. N/A--Not applicable.

External support: Government support for Icelandic banks is uncertain

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

Additional rating factors:None

No additional factors affect the ratings.

Related Criteria And Research

Related Criteria

- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2014
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

Related Research

- Outlooks For Iceland's Top 3 Banks Revised To Positive On Our More Favorable View Of The Economy, Oct. 14, 2014
- Banking Industry Country Risk Assessment: Iceland, Aug. 19, 2013
- Iceland-Based Arion Bank Assigned 'BB+/B' Ratings; Outlook Stable, Jan. 10, 2014

Anchor Matrix

Industry Risk	Economic Risk									
	1	2	3	4	5	6	**7**	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	**bb**	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of November 4, 2014)	
Arion Bank	
Counterparty Credit Rating	BB+/Positive/B
Senior Unsecured	B
Senior Unsecured	BB+

Ratings Detail (As Of November 4, 2014) (cont.)	
Counterparty Credit Ratings History	
14-Oct-2014	BB+/Positive/B
10-Jan-2014	BB+/Stable/B
Sovereign Rating	
Iceland (Republic of)	BBB-/Positive/A-3

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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