

# RatingsDirect®

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## Arion Bank

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# Arion Bank

<b>SACP</b>	<b>bbb</b>		+	<b>Support</b>	<b>0</b>	+	<b>Additional Factors</b>	<b>0</b>
<b>Anchor</b>	<b>bbb-</b>			<b>ALAC Support</b>	<b>0</b>		<b>Issuer Credit Rating</b>  <b>BBB/Positive/A-2</b>	
<b>Business Position</b>	Adequate	<b>0</b>		<b>GRE Support</b>	<b>0</b>			
<b>Capital and Earnings</b>	Strong	<b>+1</b>		<b>Group Support</b>	<b>0</b>			
<b>Risk Position</b>	Adequate	<b>0</b>		<b>Sovereign Support</b>	<b>0</b>			
<b>Funding</b>	Average	<b>0</b>						
<b>Liquidity</b>	Strong							

## Major Rating Factors

Strengths:	Weaknesses:
<ul style="list-style-type: none"> <li>• Strong capital with high leverage ratios.</li> <li>• Stable franchise equally split between retail and corporates.</li> <li>• Ample liquidity buffers despite recent deposit outflows.</li> </ul>	<ul style="list-style-type: none"> <li>• Domestic economy limits diversification opportunities.</li> <li>• Uncertainty related to eventual sale or IPO and change of ownership.</li> </ul>

## Outlook: Positive

The positive outlook on Arion reflects S&P Global Ratings' expectations of extraordinary dividends and capital optimization as the bank prepares for an eventual sale or IPO over the next two years.

We could raise the rating if we see strong continued economic development in Iceland or if future capital levels exceed our current expectations. We would not expect a two-notch upgrade over the next two years, given the relatively concentrated and volatile nature of Iceland's economy.

We could revise the outlook to stable if we saw signs of a weakening of the strong economic development in Iceland or an increased risk of economic imbalances in the economy. An outlook revision to stable could also follow deterioration in Arion's asset quality or negative revaluation of its material equity holdings.

## Rationale

Our rating on Arion reflects our 'bbb-' anchor that 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, as our criteria define these terms. Our assessment of Arion's stand-alone credit profile (SACP) is 'bbb'.

### Anchor:'bbb-' for banks operating primarily in Iceland

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. The anchor for a commercial bank operating only in Iceland is 'bbb-', based on an economic risk score of '5 and an industry risk score of '5'.

Economic risk for Icelandic banks has, in our view, declined gradually, and we believe the 2008 financial crisis has largely worked its way through the banking system, as reflected by the banks' loan loss ratio at 15 basis points (bps) systemwide and private sector credit below 150% of GDP in 2015. In addition, we believe that economic resilience in Iceland is strengthening, as reflected by the trends of rising housing prices, strong economic growth, and low unemployment. With the recent auctions of Icelandic krona, we think the risk for a shock to the banking industry related to the currency overhang and removal of capital controls has decreased meaningfully. Although progress has been made, the last steps in removing the capital controls still create some uncertainty in the Icelandic economy in the near term.

We think industry risk has subsided following a move to a stronger regulatory system and an improved funding model based on domestic deposits and covered bonds, and significant equity levels, as well as improved access to foreign wholesale funding for the Icelandic banks. We expect returns will be based on what we believe to be sound commercial practices. Substantial one-off items have inflated the banks' profits over the past few years, but we expect future impact will be contained.

**Table 1**

Arion Bank Key Figures					
	--Year-ended Dec. 31--				
(Mil. ISK)	2016*	2015	2014	2013	2012
Adjusted assets	1,027,403.0	1,001,758.0	924,140.0	933,467.0	895,734.0
Customer loans (gross)	741,183.0	710,675.0	674,189.0	665,000.0	626,391.0
Adjusted common equity	195,929.0	192,609.0	139,484.8	131,431.0	125,178.0
Operating revenues	33,358.0	48,809.0	41,398.0	39,442.0	49,106.0
Noninterest expenses	22,006.0	27,389.0	26,464.0	25,395.0	24,668.0
Core earnings	3,749.8	9,814.5	8,782.8	3,318.0	8,644.8

\*Data as of Sept. 30. ISK--Iceland krona.

### Business position: Diversified revenues within the limitations of the Icelandic economy

We view Arion's business position as adequate, reflecting its broad presence in most business lines (retail and corporate banking, asset management and investment banking) in Iceland. Arion was created in October 2008 with 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 equally split between corporates and retail. Arion remains the largest provider of mortgages in Iceland besides state-owned Housing Financing Fund (Ibudalanasjodur), and has a market share of 23%. However, as with its domestic peers, it remains a small bank in an international comparison with total assets of Icelandic krona (ISK) 1.038 trillion (€8.1 billion) on Sept. 30, 2016.

Arion's revenue base is rather diversified among its different domestic business lines, with approximately 60%-70% of revenues from net interest income split evenly between corporate and retail customers, 25%-30% from fee income driven by card transaction fees and assets under management, and the remainder from market-related revenues. We expect the share of non-lending revenues to increase due to strong growth in wholly-owned subsidiaries Valitor (domestic and global payment services company) and Okkar (domestic life insurance). In addition, revenues from the acquisition of Vördur, the fourth largest non-life insurance company in Iceland, start contributing to profits in the fourth quarter of 2016.

We believe that Arion is prepared for the continued liberalization of capital controls and an eventual change of ownership from Kaupthing. We do not expect the bank's relationship with Kaupthing to have any substantial impact on the bank's management, though the sales process could curb Arion's capitalization and balance sheet in the next two years. The bank prepaid USD252 million of this loan in April and expects to be fully repaid by the end of 2018.

We view management's strategy as appropriate, while the bank is working to close the efficiency gap to its commercial peers, it is also investing in the expansion of the Icelandic economy and benefitting from its tourism boom, including its exclusive branch at the airport, as well as investing in the global expansion of Valitor's e-commerce payment services. Moreover, we expect opportunities to develop for the bank after capital controls are lifted given the potential for higher fees on cross border asset management for its clients and more foreign exchange hedging and transaction activity.

**Table 2**

Arion Bank Business Position					
	--Year-ended Dec. 31--				
(%)	2016*	2015	2014	2013	2012
Loan market share in country of domicile	N/A	N/A	22.8	23.0	20.2
Deposit market share in country of domicile	N/A	N/A	28.2	30.4	30.1
Total revenues from business line (mil. ISK)	51,185.0	91,611.0	65,893.0	53,846.0	63,933.0
Commercial banking/total revenues from business line	11.4	7.7	14.4	17.3	17.5
Retail banking/total revenues from business line	27.5	17.8	23.2	27.0	13.7
Commercial & retail banking/total revenues from business line	38.9	25.5	37.6	44.3	31.2
Trading and sales income/total revenues from business line	5.7	39.8	11.6	8.2	8.8
Asset management/total revenues from business line	6.3	5.3	6.3	6.9	6.5
Other revenues/total revenues from business line	49.1	29.4	44.5	40.6	53.5
Investment banking/total revenues from business line	5.7	39.8	11.6	8.2	8.8
Return on equity	11.2	23.7	18.9	9.7	14.0

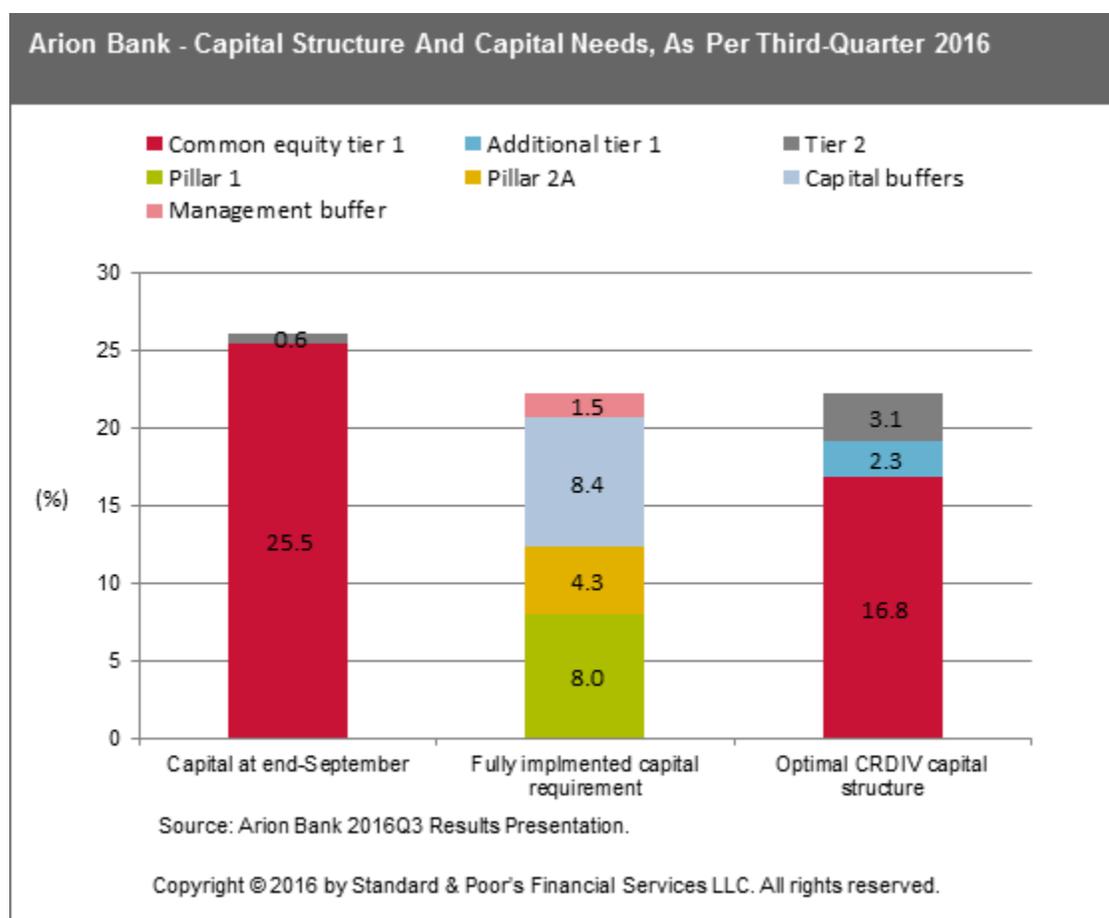
\*Data as of Sept. 30. ISK--Icelandic krona. N/A--Not applicable.

### Capital and earnings: Strong capital and stabilizing earnings

We assess Arion's capital and earnings as strong, based on our projected risk-adjusted capital (RAC) ratio, which we expect will be between 14%-15% over the next 18-24 months. The proforma RAC ratio, taking into consideration our recent improved assessment of economic risk in Iceland, was 17.6% as of end-June 2016. Our forecast considers a reduction in equity as part of a capital optimization to align capital levels of the bank to the market requirements for an eventual sale or IPO.

We expect Arion to remain adequately capitalized according to the new Basel III capital requirements, although we expect capitalization will decline from current high levels (CET1 ratio of 25.5% at end-September 2016) due to extraordinary dividend distributions. We note that in its optimal capital structure, presented with third-quarter results, Arion demonstrated that CET 1 would represent 16.8% versus its 22.2% total capital requirement.

**Chart 1**



We note that the bank's strong leverage ratio, measured as adjusted common equity as a share of adjusted assets, was 19% at end-September 2016, and is considerably higher than its primary Nordic peers and most global commercial banks. We do not anticipate the leverage ratio to fall significantly below 15% following extraordinary dividends given regulatory capital requirements.

Arion has reported high return on equity (ROE) despite their high share of equity, primarily driven by significant

one-time gains on sales of assets and revaluations of assets acquired at a discount. By our measures, the bank's core earnings are about 5.8% from 2014-2016 and expected to increase toward 7%-8% depending on how much equity levels are adjusted, including the impact of the government's bank tax levy of ISK2.8 billion, or about 1.5 percentage points of equity per year.

Arion reported gains from the revaluation of loan assets acquired at deep discount, sales of noncore assets, and profit from sale of shareholding of Visa Europe Ltd. to Visa Inc., totaling more than ISK17.8 billion in the first nine months of 2016. This compares with core revenues of ISK33.4 billion in the same period the previous year. We expect nonrecurring income to be limited to the impact of further equity sales in 2017 and 2018.

Arion's earnings buffer, which measures the ability to meet our normalized losses, is adequate, and should approach 130 bps in our forecast.

**Table 3**

<b>Arion Bank Capital And Earnings</b>					
	<b>--Year-ended Dec. 31--</b>				
<b>(%)</b>	<b>2016*</b>	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>
Tier 1 capital ratio	25.5	23.4	21.8	19.2	19.1
S&P RAC ratio before diversification	N.M.	12.4	9.6	9.6	N.M.
S&P RAC ratio after diversification	N.M.	9.8	7.2	6.0	N.M.
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	66.1	55.3	58.5	60.3	55.3
Fee income/operating revenues	30.6	29.7	32.1	28.5	21.9
Market-sensitive income/operating revenues	(4.7)	10.0	1.6	(3.3)	4.1
Noninterest expenses/operating revenues	66.0	56.1	63.9	64.4	50.2
Provision operating income/average assets	1.5	2.2	1.6	1.5	2.7
Core earnings/average managed assets	0.5	1.0	0.9	0.4	1.0

\*Data as of Sept. 30. RAC--Risk-adjusted capital. N.M.--Not meaningful.

**Table 4**

<b>Arion Bank Risk-Adjusted Capital Framework Data</b>					
<b>(ISK 000s)</b>	<b>Exposure*</b>	<b>Basel II RWA</b>	<b>Average Basel II RW (%)</b>	<b>S&amp;P Global Ratings' RWA</b>	<b>Average S&amp;P Global Ratings' RW (%)</b>
<b>Credit risk</b>					
Government and central banks	146,956,787	1,787,855	1	45,575,895	31
Institutions	93,261,410	24,906,984	27	43,949,209	47
Corporate	364,628,628	354,261,782	97	468,939,614	129
Retail	386,938,163	201,962,294	52	285,379,610	74
Of which mortgage	267,082,229	106,690,724	40	143,860,615	54
Securitization§	0	0	0	0	0
Other assets	42,787,082	40,517,608	95	73,711,518	172
Total credit risk	1,034,572,070	623,436,521	60	917,555,845	89

Table 4

Arion Bank Risk-Adjusted Capital Framework Data (cont.)					
<b>Market risk</b>					
Equity in the banking book†	25,796,097	33,121,372	128	230,616,757	894
Trading book market risk	--	3,004,625	--	4,506,938	--
Total market risk	--	36,125,997	--	235,123,695	--
<b>Insurance risk</b>					
Total insurance risk	--	--	--	22,764,575	--
<b>Operational risk</b>					
Total operational risk	--	81,441,200	--	108,573,244	--
(ISK 000s)				<b>S&amp;P Global Ratings' RWA</b>	<b>% of S&amp;P Global Ratings' RWA</b>
		<b>Basel II RWA</b>			
<b>Diversification adjustments</b>					
RWA before diversification	--	741,003,718	--	1,284,017,360	100
Total Diversification/Concentration Adjustments	--	--	--	314,124,751	24
RWA after diversification	--	741,003,718	--	1,598,142,111	124
(ISK 000s)				<b>Total adjusted capital</b>	<b>S&amp;P Global Ratings' RAC ratio (%)</b>
		<b>Tier 1 capital</b>	<b>Tier 1 ratio (%)</b>		
<b>Capital ratio</b>					
Capital ratio before adjustments	--	198,956,000	26.8	199,692,000	15.6
Capital ratio after adjustments‡	--	198,956,000	26.8	199,692,000	12.5

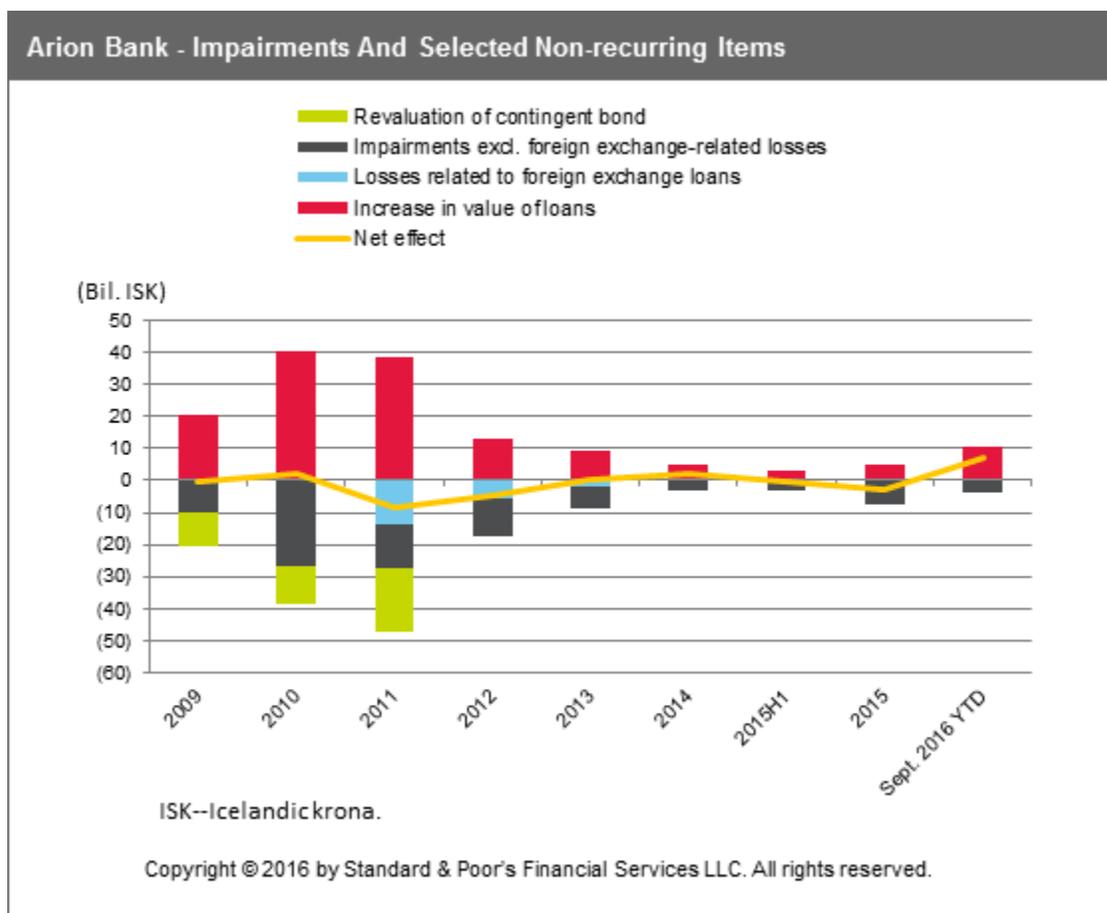
\*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Exposure and S&P Global Ratings' risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. ‡Adjustments to Tier 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--Iceland krona. Sources: Company data as of June. 30, 2016, S&P Global Ratings.

### Risk position: Adequate, in line with systemic risks in Iceland's banking industry

We assess Arion's risk position as adequate, reflecting our view that the majority of the restructurings of its loan portfolio have been carried out and that the remaining impact on the bank will likely be limited. Our assessment further incorporates our view that the bank's risk profile and loan portfolio largely reflect the risks in the market where it operates.

The positive revaluation of assets transferred to Arion from Kaupthing at a substantial discount to book value has been relatively well matched with subsequent impairment needs since Arion's inception (see chart 2). We note that provisions have been volatile, but we anticipate that loan loss provisions will reduce toward 50 bps annually on average for the next two years. Likewise, we believe any remaining positive revaluations of the loan book will be more limited, with the potential exception of a few larger counterparties.

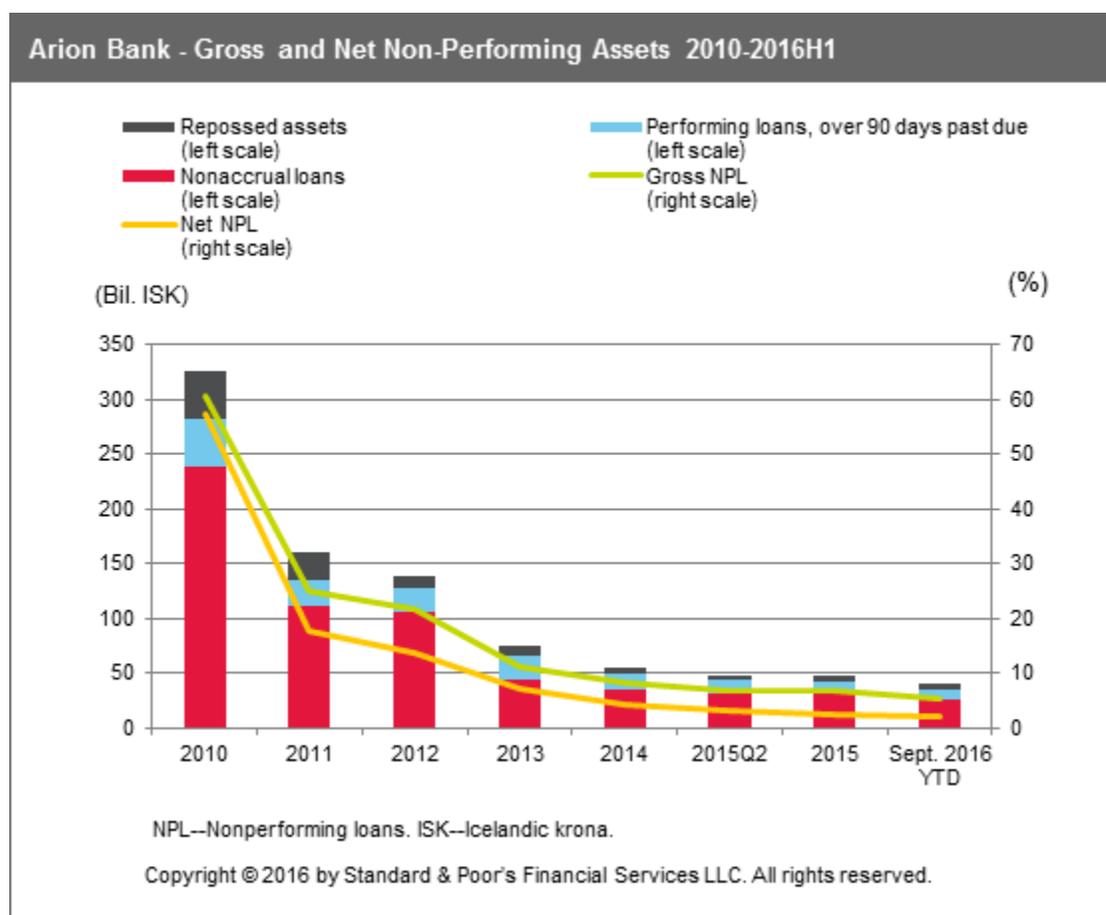
Chart 2



Arion's loan book is geographically concentrated in Iceland, representing 94.5%. Loans to corporates comprise 54% of the portfolio and are focused on collateralized real estate and fishing exposures, as well as construction, matching the country's industrial sector breakdown. Mortgage loans formed 40% of total customer loans, and we expect the bank will increase its mortgage lending by taking market share from the state-owned Housing Financing Fund (HFF). Furthermore, Icelandic corporations borrowing in foreign currency typically have matching hard currency revenues.

Arion, along with the other major banks in the market, is showing marked improvement in its gross nonperforming loan stock, by our measures, which stood at 5.3% (including foreclosed assets) as of Sept. 30, 2016, compared with 60% at year-end 2010 (see chart 3). We expect further improvement as the economy continues its recovery, and we expect loan losses of about ISK4 billion per year over our two-year forecast.

Chart 3



Arion has a meaningful portion of its S&P Global Ratings' risk-weighted assets associated with equities in the banking book as a result of various debt restructurings (18% at end-June 2016). In 2015 and over the first nine months of 2016, the bank made significant progress in reducing a substantial part of its unlisted equity exposures, in particular the sale of its Bakkavor holdings during the first half of 2016. The continued sale of these equity holdings, which have also led to high one-time value gains in connection with selling assets, will further reduce the bank's risk profile and profit volatility.

Table 5

Arion Bank Risk Position					
--Year-ended Dec. 31--					
(%)	2016*	2015	2014	2013	2012
Growth in customer loans	5.7	5.4	1.4	6.2	1.4
Total diversification adjustment / S&P RWA before diversification	N.M.	26.5	34.2	59.4	N.M.
Total managed assets/adjusted common equity (x)	5.3	5.2	6.7	7.1	7.2
New loan loss provisions/average customer loans	0.7	1.1	0.4	1.2	1.9
Net charge-offs/average customer loans	1.6	0.6	0.8	5.5	1.5
Gross nonperforming assets/customer loans + other real estate owned	5.3	6.7	8.0	11.1	21.8

**Table 5**

<b>Arion Bank Risk Position (cont.)</b>					
	<b>--Year-ended Dec. 31--</b>				
<b>(%)</b>	<b>2016*</b>	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>
Loan loss reserves/gross nonperforming assets	64.2	63.6	48.9	39.0	43.0

\*Data as of Sept. 30. RWA--Risk-weighted assets. N.M.--Not meaningful.

### **Funding and liquidity: Strong liquidity position and funding metrics**

We consider Arion's funding as average, balancing the bank's relatively strong funding metrics compared with domestic and European peers with the deposit outflows and restructuring of funding. Although Arion and its peers have strong liquidity positions and demonstrate healthy funding metrics, we expect this will remain a neutral factor for the ratings given the small balance of maturing debt due to the relatively short history of wholesale funding for the new bank.

Arion Bank relies on wholesale funding as well as customer deposits for its funding needs. At end-September 2016, customer deposits formed 56% of the total funding base, with the rest being wholesale funding, primarily consisting of senior unsecured bonds and covered bonds. The stable funding ratio by our measures was 117.8% at end-September 2016. Given the bank's relatively short history of capital market issuance, the maturity profile shows no meaningful redemptions until 2018. Recent issues by Arion and its domestic peers have demonstrated their ability to find investors in Scandinavia and Europe at reasonable spreads. We believe Arion will continue to increase its wholesale market funding partly through covered bonds in the domestic market, taking market shares from the state-owned HFF, while also issuing senior unsecured bonds in the international markets to finance its foreign exposures.

In October 2016, private investors were authorized to invest up to ISK30 million (approximately €0.25 million) abroad, but we believe that movements have been muted for Icelandic banks' deposits. While we could see a larger impact when the limit is lifted to ISK100 million (€0.82 million) in January 2017, available yields are much higher in Iceland than abroad.

As a part of its composition agreement with the government, Kaupthing provided a seven-year, USD748 million (ISK 97 billion) loan to replace its foreign currency deposits and Arion's foreign currency loan from the central bank. We note that the Kaupthing loan was partly prepaid with USD252 million in April 2016, in connection with a senior unsecured bond issuance of €300 million. We anticipate that the remaining portion will be repaid by 2018.

We assess the bank's liquidity as strong, given its very solid ratios by our measures, with broad liquid assets to short-term wholesale funding at 7x at end-September 2016, which is substantially above European peers', indicating high coverage of upcoming maturities of capital market funding within one year.

**Table 6**

<b>Arion Bank Funding And Liquidity</b>					
	<b>--Year-ended Dec. 31--</b>				
<b>(%)</b>	<b>2016*</b>	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>
Core deposits/funding base	56.0	62.4	63.3	63.4	62.0
Customer loans (net)/customer deposits	165.7	145.0	142.3	134.7	126.3

Table 6

Arion Bank Funding And Liquidity (cont.)					
	--Year-ended Dec. 31--				
(%)	2016*	2015	2014	2013	2012
Long term funding ratio	96.8	97.1	93.9	95.4	93.3
Stable funding ratio	117.8	115.8	111.9	114.3	117.3
Short-term wholesale funding/funding base	4.0	3.6	7.4	5.4	7.9
Broad liquid assets/short-term wholesale funding (x)	7.1	7.3	3.6	4.8	3.9
Net broad liquid assets/short-term customer deposits	45.0	38.2	33.3	34.2	38.9
Short-term wholesale funding/total wholesale funding	9.1	9.7	20.1	14.8	20.7
Narrow liquid assets/3-month wholesale funding (x)	11.3	9.3	7.3	6.2	N/A

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

### External support: Government Support for Icelandic banks is uncertain

In our view, the likelihood of government support for Icelandic banks remains uncertain. We base this assessment on the authorities' poor track record and, in our view, still-limited, albeit improved, capacity to support the now-smaller banking system in a severe stress scenario.

At present, we do not regard the bank resolution framework as effective. As such, for our ratings on Icelandic banks, we do not consider additional loss-absorbing capacity (see "Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity," published April 27, 2015, on RatingsDirect). We regard the current framework as open ended but, in our view, the authorities' method of dealing with failing banks so far indicates a tendency to safeguard depositors rather than senior unsecured creditors. Over the next two to three years, we expect Iceland to implement a framework similar to the EU's Banking Recovery And Resolution Directive and, with it, bail-in powers that could lead us to change our view.

### Additional rating factors:

No additional factors affect this rating.

## Related Criteria And Research

### Related Criteria

- General Criteria: Group Rating Methodology - November 19, 2013
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions - January 29, 2015
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions - July 17, 2013
- Criteria - Financial Institutions - Banks: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework - June 22, 2012
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions - November 09, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions - November 09, 2011
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions - December 06, 2010
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks - March 23, 2004

- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

## Related Research

- Arion Bank Upgraded To 'BBB/A-2' On Improved Operating Conditions For Icelandic Banks; Outlook Positive – October 25, 2016
- Various Positive Rating Actions On Four Icelandic Banks On Receding Economic Risks and Improved Access To Funding - October 25, 2016
- Nordic Banks' Capital Growth Tapers Off - August 02, 2016
- The Future Of Banking: Nordic Banks Looking Svelte In The Fintech Race - June 14, 2016
- Iceland Ratings Affirmed At 'BBB+/A-2'; Outlook Stable - July 15, 2016

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 30, 2016)

### Arion Bank

Counterparty Credit Rating	BBB/Positive/A-2
Senior Unsecured	A-2
Senior Unsecured	BBB

### Counterparty Credit Ratings History

25-Oct-2016	BBB/Positive/A-2
19-Jan-2016	BBB-/Positive/A-3
21-Jul-2015	BBB-/Stable/A-3
14-Oct-2014	BB+/Positive/B
10-Jan-2014	BB+/Stable/B

### Sovereign Rating

Iceland (Republic of)	BBB+/Stable/A-2
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\*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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