Research Update:

Iceland-Based Arion Bank Outlook Revised To Negative On Uncertain Capital Trajectory; Ratings Affirmed At 'BBB/A-2'

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Overview

- Rapid corporate loan growth and increased capital distributions have lowered Arion Bank's risk-adjusted capital (RAC) ratio to 13.6% as of Dec. 31, 2022, from 14.3% at year-end 2021, amid Iceland's firm economic rebound from the pandemic-induced recession in 2020.
- Although we expect Iceland's economic recovery to continue, we remain mindful of shifts in key sectors and housing market dynamics, which could pressure Arion's asset quality.
- In our base case, we expect the RAC ratio to recover beyond our 15% threshold for a very strong assessment over the next 12-24 months, but risks to capital building and prevailing global macroeconomic uncertainty cloud our forecasts.
- We have therefore revised our outlook on Arion Bank to negative from stable and affirmed 'BBB/A-2' issuer credit and resolution counterparty ratings.
- The negative outlook indicates that we could lower the ratings if the bank is unable to restore its RAC ratio to at least 15% over the next two years or if the bank's asset-quality metrics deteriorated, such as the nonperforming loan ratio, coverage of impaired loans, and cost of risk.

Rating Action

On May 10, 2023, S&P Global Ratings revised its outlook on Iceland-based Arion Bank to negative from stable and affirmed its 'BBB/A-2' long- and short-term issuer credit ratings.

At the same time, we affirmed our 'BBB+/A-2' resolution counterparty ratings on the bank.

Rationale

Arion's RAC ratio has weakened owing to an expanding loan book and capital distributions. Arion's extensive corporate loan growth (close to 23%) and large shareholder distributions in 2022 exceeded our expectations, resulted in the RAC ratio decreasing to 13.6% as of Dec. 31, 2022, from 14.3% at year-end 2021 or from 16.2% before our revised view on economic risk and application of our higher risk weights on domestic household and corporate exposures. Regulatory capital ratios have developed similarly, with the common equity tier 1 (CET 1) ratio declining to 18.3% as of March 31, 2023, from 18.8% as of Dec. 31, 2022, and 19.6% at year-end 2021. That said, Arion retains a comfortable margin against its regulatory requirement of 15.8%.

We expect Arion to restore its RAC ratio over the next two years, although we see risks from uncertainty linked to the bank's capital planning and the global economic environment. Under our base case, we project Arion can restore its RAC ratio to 14.5%-15.5% over 2023-2024. This is supported by our view of Arion's strong earnings capacity, which should allow it to strengthen its capital base organically, and its ability to actively manage growth of RWA. We expect the high interest-rate environment will support earnings growth in 2023-2024 and project Arion's pretax profit at Icelandic krone (ISK) 37 billion to ISK42 billion (€248 million-€281 million), compared with ISK30.4 billion in 2022. We expect the higher earnings to be only partly offset by cost inflation and normalizing loan loss provisions. Moreover, we project loan growth and credit RWA to moderate as persistent inflation and rising borrowing costs constrain the demand for credit. Assuming a decline in shareholder distributions, following Arion's capital optimization program in 2021-2022, to approximately 50% of net income annually, this would result in annual earnings retention of ISK13 billion-ISK15 billion or 105 basis points-115 basis points of S&P Global Ratings' RWA metric through 2024.

We anticipate asset quality pressures to rise moderately. A strongly performing economy and robust domestic labor market should contain a material deterioration of Arion's asset quality metrics over the next two years. Nevertheless, we still expect higher borrowing costs and broad-based cost inflation will increasingly weigh on Icelandic households' and corporates' financial position. Specifically, we project Arion's nonperforming loans to rise to 1.6%-1.9% of gross loans from 1.4% as of March 31, 2023, with the cost of risk at 22 basis points-27 basis points through 2024. We also remain mindful of the potential for unexpected shifts in Iceland's key economic sectors and developments in the domestic housing market, where we continue to see elevated imbalances although the gap between nominal prices and underlying fundamentals has narrowed.

Low external funding maturities limit risks from market access fluctuations and widening spreads. Arion has a balanced maturity profile with limited upcoming external funding maturities, at about 1% of the funding base for the remainder of 2023 and approximately 7%-8% in 2024-2025, which in our view limits refinancing risk. Moreover, we anticipate Arion will maintain stable access to the domestic covered bond market, which accounts for approximately 38% of its total wholesale funding. Combined with the bank's key funding source, stable domestic deposits (63% of total funding), we project Arion's funding metrics will remain sound. As of March 31, 2023, we estimate our stable funding ratio at 115% (116% at year-end 2022), which compares favorably to that of domestic and global peers. Further mitigating funding pressures is Arion's adequate liquidity buffers, which at first-quarter 2023 stood at ISK266 billion, representing about 33% of total deposits.

Outlook

The negative outlook reflects Arion's declining RAC and our view that there is a one-in-three probability that the RAC ratio will not recover sustainably to a very strong 15% or higher over the next two years.

That said, in our base case, we anticipate that Arion's profitability will remain strong, supporting the bank's capacity to increase its capital organically. This reflects our projection of stable revenue generation, normalizing credit losses, and operating costs being contained amid high inflation as the bank continues to service most customers digitally.

Downside scenario

We could lower the rating if we saw a lower probability of the bank restoring the RAC ratio to 15% or higher, which could materialize if the development of total adjusted capital (TAC) were weaker or growth of S&P Global Ratings RWA stronger than we currently expect.

We could also take a negative action if we saw a deterioration of the bank's asset-quality metrics compared with that of domestic peers, such as higher nonperforming loans, lower coverage of impaired loans, and an increased cost of risk.

Upside scenario

We would revise the outlook to stable if Arion, while maintaining a sound financial position, restored the RAC ratio sustainably above 15%.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	**BBB/Negative/A-2**	**BBB/Stable/A-2**
Stand-alone credit profile	bbb	bbb
Anchor	bbb-	bbb-
Business position	Adequate 0	Adequate 0
Capital and earnings	Very strong +2	Very strong +2
Risk position	Moderate -1	Moderate -1
Funding and liquidity	Adequate 0	Adequate 0
Comparable ratings analysis	0	0
Support	0	0
ALAC support	0	0
GRE support	0	0
Group support	0	0
Sovereign support	0	0
Additional factors	0	0

ESG credit indicators: E-2, S-2, and G-2

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions , March 2, 2022
- Criteria | Financial Institutions | General: Financial Institutions Rating Methodology , Dec. 9, 2021
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions , Dec. 9, 2021
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings , Oct. 10, 2021
- General Criteria: Group Rating Methodology , July 1, 2019
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology , July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Principles Of Credit Ratings , Feb. 16, 2011

Related Research

- Banking Industry Country Risk Assessment: Iceland, Mar. 24, 2023
- Iceland, Nov. 15, 2022
- Nordic Banks: Robust Capital Provides Cushion Against Tougher Times, Sept. 6, 2022
- Arion Bank, Aug. 20, 2022
- Icelandic Bank Ratings Affirmed As Risks Shift Amid High House Prices And Rising Rates; Outlooks Stable, July 13, 2022
- Bulletin: Single Resolution Board Says That Banks Must Go The Distance To Ensure Full Resolvability, July 13, 2022
- Iceland's MREL Requirements Result In Ratings Uplift For Icelandic Covered Bonds, May 27, 2022

Ratings List

Ratings Affirmed	
Arion Bank	
Resolution Counterparty Rating	BBB+/--/A-2
Arion Bank	
Senior Unsecured	BBB
Subordinated	BB+
Junior Subordinated	BB-

Ratings Affirmed; Outlook Action

	To	From
Arion Bank		
Issuer Credit Rating	BBB/Negative/A-2	BBB/Stable/A-2