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## Research Update:

# Arion Bank Upgraded To 'BBB/A-2' On Improved Operating Conditions For Icelandic Banks; Outlook Positive

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## Research Update:

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## Overview

- The operating environment for banks in Iceland is improving, with falling private-sector leverage and improved access to foreign debt capital markets.
- In addition, we think Arion Bank's continued reduction in legacy equity positions is promoting further improvement in its capital.
- As a result, we are raising our long- and short-term ratings on Arion Bank to 'BBB/A-2' from 'BBB-/A-3'.
- The positive outlook reflects the potential for further capital improvements once the uncertainty of the ongoing sales process recedes.

## Rating Action

On Oct. 25, 2016, S&P Global Ratings raised its ratings on Iceland's Arion Bank to 'BBB/A-2' from 'BBB-/A-3'. The outlook is positive.

## Rationale

We upgraded Arion primarily because of the reduced uncertainty and improving operating conditions for Iceland's banking sector (see "Various Positive Rating Actions On Four Icelandic Banks On Receding Economic Risks and Improved Access To Funding," published Oct. 25, 2016, on RatingsDirect). We expect a trend of decreasing risks related to domestic credit following the deleveraging of Icelandic households and corporations in recent years. In addition, we see the continued liberalization of capital controls leading to further improvements in the economic resilience of Iceland's economy and reducing the downside risks in the operating environment for Icelandic banks.

We also view the trend for industry risk in the Icelandic banking sector as positive. This is based on demonstrated access to external funding, material improvements in banking regulation and supervision, as well as proactive measures to avoid a repeat of the excessive growth that preceded the boom of the 2000s, for example by mitigating cross border flows associated with the carry trade. Arion and its commercial bank peers benefit from the improved access to external funding, which has allowed them to diversify their funding and refinance expensive bonds with new issues made on better terms.

We have consequently revised up our anchor for banks operating in Iceland to

'bbb-' from 'bb+'. This anchor is our starting point for calculating bank ratings.

While Arion continues to reduce its legacy equity exposures, its capital levels remain somewhat below that of peers. On a pro forma basis, we measure Arion's risk-adjusted capital (RAC) ratio at 17.6% on June 30, 2016 (which also includes our improved assessment of Icelandic economic risks). We anticipate that capital levels will be reduced as a part of an eventual sale or IPO. As such, we include a 5%-6% reduction in the regulatory tier 1 capital ratio into our two year capital forecast. This will be part of the sales process and should improve return on equity for potential investors. In addition, we anticipate that Arion will pay out normal dividends of 50% of net profits over the coming years and will continue to reduce its equity exposures in the banking book. As a result, we project Arion's longer term RAC levels at about 14%-15%. A material difference in this level could impact our view of capital levels, as could the future ownership structure and effect on the bank's strategy.

The higher anchor for the Icelandic banking sector results in a revised stand-alone credit profile of 'bbb' for Arion, which is at the same level as the counterparty credit rating, owing to our view of the government's support for Icelandic commercial banks as uncertain. We expect Arion to maintain its adequate business position, underpinned by its market position among the top-three banks and its business diversity in Iceland. We note the acquisition of a non-life insurer as a step to further diversify revenues. We also note that the breadth of Arion's revenues contributes to a somewhat higher cost-to-income ratio than that of domestic peers. We project a return on equity from core earnings of nearly 6% based on current equity levels, but we could see an increase if leverage ratios are reduced due to extraordinary dividends.

We expect to see a continued stabilization of Arion's credit risk from the strong economic performance in Iceland and lower private-sector debt levels. As such, we continue to see Arion's risk position as adequate and well within our strong capital and earnings assessment. Finally, we continue to view the bank's funding as average for Icelandic banks and its liquidity position as strong, given its strong liquidity buffers in Icelandic krona and other currencies and its low share of debt maturing over the next 12 months.

## **Outlook**

The positive outlook on Arion reflects our 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 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.

## Ratings Score Snapshot

	To	From
Issuer Credit Rating	BBB/Positive/A-2	BBB-/Positive/A-3
SACP	bbb	bbb-
Anchor	bbb-	bb+
Business Position	Adequate (0)	Adequate (0)
Capital and Earnings	Strong (+1)	Strong (+1)
Risk Position	Adequate (0)	Adequate (0)
Funding and Liquidity	Average and Strong (0)	Average and Strong (0)
Support	(0)	(0)
ALAC Support	(0)	(0)
GRE Support	(0)	(0)
Group Support	(0)	(0)
Sovereign Support	(0)	(0)
Additional Factors	(0)	(0)

## 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

- Various Positive Rating Actions On Four Icelandic Banks On Receding Economic Risks and Improved Access To Funding, Oct. 25, 2016
- Nordic Banks' Capital Growth Tapers Off, June 14, 2016
- The Future Of Banking: Nordic Banks Looking Svelte In The Fintech Race, June 14, 2016
- Two Icelandic Bank Outlooks Revised To Positive On Improving Economic Resilience; 'BBB-/A-3' Ratings Affirmed, Jan. 19, 2016

## Ratings List

Upgraded

	To	From
Arion Bank		
Counterparty Credit Rating	BBB/Positive/A-2	BBB-/Positive/A-3
Senior Unsecured	BBB	BBB-

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.globalcreditportal.com](http://www.globalcreditportal.com) and at [spcapitaliq.com](http://spcapitaliq.com). All ratings affected by this rating action can be found on the S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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