S&P Global
Ratings

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Arion Bank

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Arion Bank

SACP	bbb+

\+

Support	0

\+

Additional Factors	0

Anchor	bbb	
Business Position	Adequate	0
Capital and Earnings	Very Strong	+2
Risk Position	Moderate	-1
Funding	Average	0
Liquidity	Adequate	

ALAC Support	0
GRE Support	0
Group Support	0
Sovereign Support	0

Issuer Credit Rating
BBB+/Stable/A-2

Major Rating Factors

Strengths:	Weaknesses:
• Very strong capital levels and high leverage ratios, despite capital-optimization plans. • Stable franchise equally split between retail and corporates.	• Uncertainty related to eventual sale and change of ownership. • Domestic economy limits opportunities to diversify risk.

Outlook: Stable

S&P Global Ratings' stable outlook on Iceland-based Arion Bank reflects our view that the bank's improved capital generation and progress in reducing its equity position has prepared it well for a potential near-term sale. We believe that the bank will materially reduce capital over the next three to four years as it recalibrates its capital base, but that it is unlikely to reduce its risk-adjusted capital (RAC) ratio below 15%.

We could lower the rating if we saw signs of material deterioration of asset quality for Arion Bank or the market as a whole, especially in combination with our projections of reduced equity capital. Such a development could result in us revising downward our assessment of the bank's anchor or no longer viewing its combined capital and risk as positive for the rating. We could also lower the rating if the pending sale results in unforeseen weakening of the bank's risk profile.

We currently consider a positive rating action unlikely, because we see limited room for an improved view of the Icelandic banking market and expect Arion Bank's outstanding capital strength and leverage position to reduce materially in coming years.

Rationale

Our rating on Arion Bank reflects our 'bbb' anchor that we assign to banks operating in Iceland, and our view of the bank's adequate business position, very strong capital and earnings, moderate risk position, average funding, and adequate liquidity. Our assessment of Arion Bank'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 '4' 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 declines in the banks' nonperforming assets, low new loan losses, private sector credit below 140% of GDP in 2016, and the successful release of capital controls in 2017. In addition, we believe that economic resilience in Iceland is strengthening, as reflected by strong economic growth, vastly improved sovereign finances, and low unemployment. We anticipate that the country's prosperous but concentrated economy will achieve annual real GDP growth of about 4% over the next two years, supported by a continued increase in tourism. While this is positive for the overall economic growth, we see a risk for general overheating, decreased competitiveness in other export sectors, and growing imbalances, underscored by the over 20% annual house price increase at mid-year 2017.

Several factors contribute to our view of industry risk. Since the financial crisis, Iceland has moved to a stronger regulatory system and an improved funding model based on domestic deposits and covered bonds, and high shares of equity capital and complemented by foreign wholesale funding for the Icelandic banks. We expect returns will continue to be based on sound commercial practices. Substantial one-off items have inflated banks' profits over the past few years, but we expect the future impact will be contained to sales of equity positions as they are reduced further.

Table 1

Arion Bank Key Figures					
		--Year-ended Dec. 31--			
(Mil. ISK)	**2017***	**2016**	**2015**	**2014**	**2013**
Adjusted assets	1,132,097	1,024,967	1,001,758	924,140	933,467
Customer loans (gross)	766,911	735,260	710,675	674,189	665,000
Adjusted common equity	202,766	194,862	192,609	139,485	131,431
Operating revenues	39,404	44,960	48,809	41,398	39,442
Noninterest expenses	20,438	29,563	27,389	26,464	25,395
Core earnings	10,238	5,469	9,815	8,783	3,318

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

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

Arion Bank has a broad presence in most business lines (retail and corporate banking, asset management, insurance, payment services and investment banking) in Iceland. Arion Bank was created in October 2008 with the transfer of the domestic assets and liabilities from the former Kaupthing Bank. Since its creation, Arion Bank has expanded its historic corporate footprint into the household segment, and its current franchise is equally split between corporates and retail. Arion Bank remains the largest provider of mortgages in Iceland besides state-owned Housing Financing Fund (Ibudalanasjodur), and has a market share of 20%. However, despite diversification across many business lines, Arion Bank and domestic peers remain relatively small banks by international comparison, with total assets of Icelandic krona (ISK) 1.145 trillion (€9.4 billion) on Sept. 30, 2017.

Arion Bank's revenue base is rather diversified among its different domestic business lines, with approximately 50%-60% of revenues from net interest income split evenly between corporate and retail customers. Fee and commission income, 25%-30% of revenues, includes fees on assets under management and is improving due to domestic banking fee initiatives and the international growth of payment services company Valitor. Unlike domestic peers, Arion Bank operates life and property and casualty (P/C) insurance companies, providing moderate diversification, and alongside Valitor will drive an increase in the relative share of nonbank revenues in the group.

Following the complete relaxation of capital controls in Iceland in March 2017, Arion Bank announced an ownership change with a private placement sale of 29.1% to a consortium of U.S. and U.K. investors. Following this transaction, Kaupthing continued to hold its majority 57.41% ownership share in the bank (through Kaupskil) and the Icelandic government its 13% stake. The new owners have the option to increase their aggregate stake by an additional 21.9% at a higher price, prior to an expected sale of the bank and have been granted approval to increase their ownership shares up to 33% (Kaupthing, Taconic) and 20% (Attestor).

We consider this a significant step for the bank's future and expect the key parameters for the rating (such as future capitalization and ownership) will be clarified as the sales process progresses in early 2018. We do not believe that the bank's relationship with Kaupthing has any substantial impact on the bank's management. Further decisions in regard to the bank's sales process will not be taken until next year due to recent parliamentary elections and further negotiations between Kaupthing and the newly-elected government leadership. However, we anticipate that a larger share of the bank will be sold in the spring of 2018. In the event of an anticipated IPO, we believe that Arion Bank will have a diversified ownership structure, which we foresee as neutral for the ratings.

We view management's strategy as more focused on diversifying revenues that peers, which has contributed to a gap in cost efficiency to its commercial peers. Arion Bank is 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 for the bank to earn higher fees on cross-border asset management for its clients and more foreign exchange hedging and transaction activity now that capital controls and foreign investment restrictions have been removed.

Table 2

Arion Bank Business Position					
		--Year-ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Loan market share in country of domicile	N/A	24.9	22.7	22.1	22.3

Table 2

Arion Bank Business Position (cont.)

		--Year-ended Dec. 31--			
(%)	2017*	2016	2015	2014	2013
Deposit market share in country of domicile	N/A	25.3	28.4	29.1	32.5
Total revenues from business line (ISK mil.)	41,694	66,305	91,611	65,893	53,846
Commercial banking/total revenues from business line	16.5	11.8	7.7	14.4	17.3
Retail banking/total revenues from business line	36.6	28.2	17.8	23.2	27.0
Commercial & retail banking/total revenues from business line	53.1	39.9	25.5	37.6	44.3
Trading and sales income/total revenues from business line	2.5	5.6	39.8	11.6	8.2
Asset management/total revenues from business line	7.6	6.6	5.3	6.3	6.9
Other revenues/total revenues from business line	36.7	47.9	29.4	44.5	40.6
Investment banking/total revenues from business line	2.5	5.6	39.8	11.6	8.2
Return on equity	6.4	10.5	23.7	18.9	9.7

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

Capital and earnings: Exceptional capital metrics to be maintained following capital optimization

We project Arion Bank's capital to remain very strong, despite expectations of material recalibration of equity and hybrid capital levels in the coming years. The bank has indicated that it believes its current 26.6% common equity tier 1 (CET1) ratio is well above its long-term capital targets of 17%, which is why we expect a reduction of the CET1 ratio in the next three to four years.

We expect that Arion Bank will eventually resume dividend payments in connection with an anticipated sale during the spring of 2018. As with its domestic peers, we expect Arion Bank to issue capital instruments to offset a significant reduction in common equity and to optimize its capital base. As such, we believe Arion Bank will issue capital instruments to offset some of the payouts of common equity in 2018 and is likely to test the additional tier 1 market by the end of 2019. Given these expectations, we believe that its RAC ratio will fall from the pro forma midyear level of 21.9% (including recent changes to our view of Icelandic economic risks), but will stay above 16% through 2019.

Our capital forecast also considers the bank's business plans and strategic initiatives. Most importantly, we project further reductions in risk-weighted assets (RWAs) as Arion Bank reduces its listed and unlisted equity exposures. We expect revenue to improve due to increased lending volumes of 7%-8% annually as well as a focus on improving fee income from the banking business and expansion of payment services. The addition of P/C company Vördur makes it clear that Arion Bank sees an opportunity for growth in bancassurance across its customer base, which should improve stable fee-based revenues. In addition, we include the Icelandic bank levy throughout our forecast at around 1.5% of current equity. We do not expect that the implementation of IFRS 9 will have a significant impact on our view of the bank's capital.

The second and third quarter results for 2017 were weighed down by the one-off impairment charges related to United Silicon, which had substantial negative effects on Arion's earnings. United Silicon is now a recovery case and is classified as a disposal group held for sale. Arion Bank has fully provisioned for ISK1.2 billion in equity investments and ISK0.7 billion in bonds related to United Silicon. Moreover, the bank has related loan impairment of ISK3.7 billion. Total exposure remaining at end-September 2017 was 0.5% of Arion Bank's balance sheet, to be compared with an adjusted equity balance of 17.9%. Given Arion Bank's very strong capital, we believe it can manage the associated risks, but the issue highlights some of the concentration risk in the portfolio.

Since its creation, Arion Bank has reported gains from the revaluation of loan assets acquired at deep discount and sales of noncore assets. However, we expect nonrecurring income to be limited to the impact of further equity sales through 2018 and for profitability to normalize and stabilize in the coming years. We forecast that Arion Bank's earnings buffer, which measures the ability to meet our normalized losses (measured at 44 basis points [bps] of outstanding loans), will remain around 190 bps, indicating capital generation of 1.8% of S&P Global Ratings' RWA per year, which is in line with top performing Nordic banks.

Table 3

Arion Bank Capital And Earnings

		--Year-ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Criteria reflected in RAC ratios	2017 RAC Criteria	2017 RAC Criteria	2010 RAC Criteria	2010 RAC Criteria	2010 RAC Criteria
Tier 1 capital ratio	26.6	26.5	23.4	21.8	19.2
S&P Global Ratings' RAC ratio before diversification	N/A	17.4	12.4	9.6	9.6
S&P Global Ratings' RAC ratio after diversification	N/A	12.1	9.8	7.2	6.0
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	57.3	66.5	55.3	58.5	60.3
Fee income/operating revenues	27.2	31.1	29.7	32.1	28.5
Market-sensitive income/operating revenues	5.8	(5.4)	10.0	1.6	(3.3)
Noninterest expenses/operating revenues	51.9	65.8	56.1	63.9	64.4
Preprovision operating income/average assets	2.3	1.5	2.2	1.6	1.5
Core earnings/average managed assets	1.3	0.5	1.0	0.9	0.4

*Data as of Sept. 30. N/A--Not applicable. RAC--Risk-adjusted capital.

Table 4

Arion Bank Risk-Adjusted Capital Framework Data

(ISK 000s)	**Exposure***	**Basel III RWA**	**Average Basel III RW (%)**	**S&P Global Ratings' RWA**	**Average S&P Global Ratings' RW (%)**
Credit risk					
Government and central banks	213,250,240	1,636,344	1	5,300,900	2
Institutions and CCPs	89,236,267	18,998,827	21	24,793,042	28
Corporate	380,810,869	362,700,220	95	355,071,834	93
Retail	399,431,480	198,831,866	50	195,143,449	49
Of which mortgage	288,855,018	119,713,245	41	105,270,592	36
Securitization§	0	0	0	0	0
Other assets†	51,690,386	48,768,245	94	40,022,500	77
Total credit risk	1,134,419,242	630,935,502	56	620,331,724	55

Table 4

Arion Bank Risk-Adjusted Capital Framework Data (cont.)

Credit valuation adjustment					
Total credit valuation adjustment	--	2,769,674	--	0	--
Market risk					
Equity in the banking book	17,770,126	22,132,009	125	170,968,007	962
Trading book market risk	--	12,661,938	--	18,992,908	--
Total market risk	--	34,793,948	--	189,960,915	--
Operational risk					
Total operational risk	--	86,489,663	--	118,344,591	--
		Basel III RWA		**S&P Global Ratings' RWA**	**% of S&P Global Ratings' RWA**
Diversification adjustments					
RWA before diversification		754,988,786		928,637,230	100
Total Diversification/Concentration Adjustments		--		304,962,886	33
RWA after diversification		754,988,786		1,233,600,115	133
		Tier 1 capital	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global Ratings' RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		209,609,000	27.8	203,813,239	21.9
Capital ratio after adjustments‡		209,609,000	27.8	203,813,239	16.5

*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Other assets includes Deferred Tax Assets (DTAs) not deducted from ACE. ‡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, 2017, S&P Global.

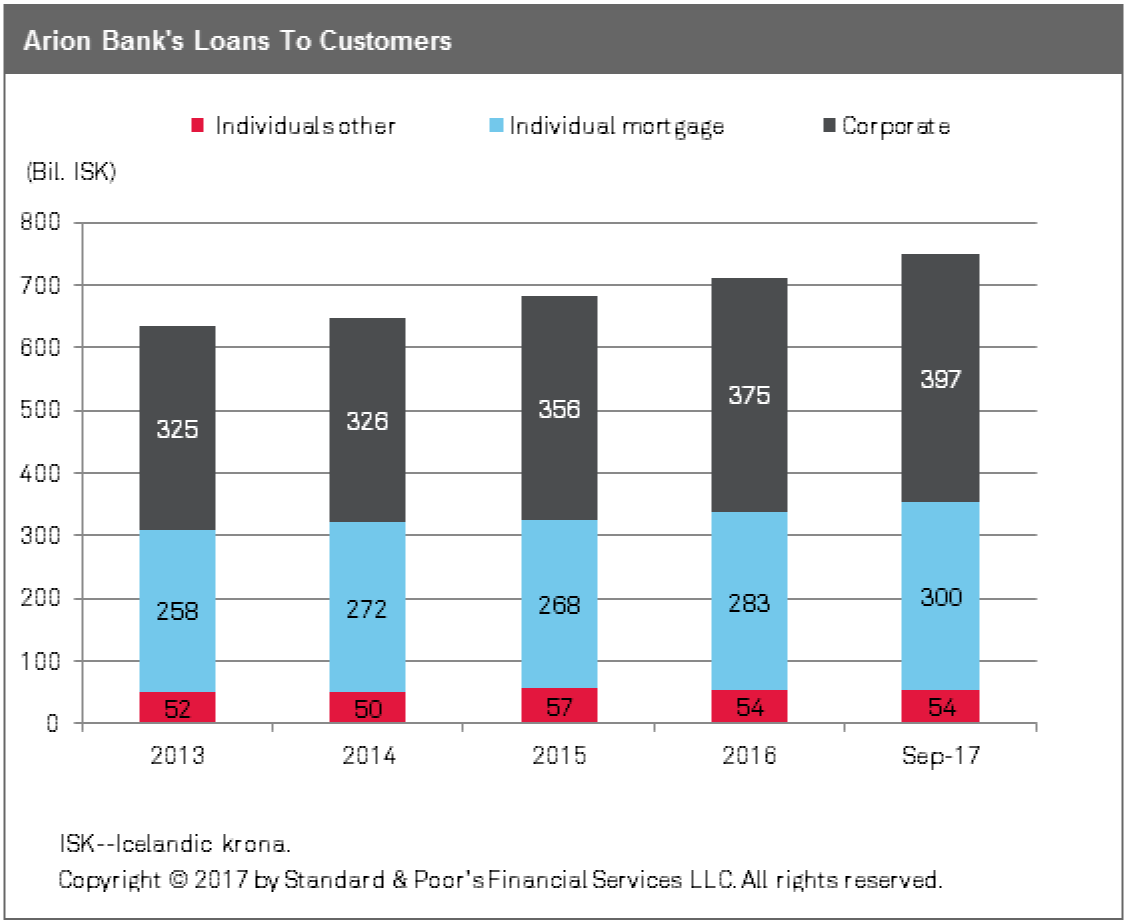
Risk position: Moderate risk position reflects the limits of risk diversification in a small economy

Arion Bank's credit portfolio lacks geographic diversification given its presence in a concentrated market, which is a weakness when compared with the banks with a similar economic risk and anchor. As such, we consider the risk position in combination with our capital and earnings assessment, and believe that the combination improves the bank's credit worthiness, but to a level limited by the nature of the exposure to the Icelandic economy.

The positive revaluation of assets transferred to Arion Bank from Kaupthing at a substantial discount to book value has been relatively well matched, with subsequent impairment needs since Arion Bank's inception. We note that provisions have been volatile, but we anticipate that loan loss provisions will be at 30 bps of loans in 2018 and 2019. Likewise, we believe any remaining positive revaluations of the loan book will be more limited.

Arion Bank's loan book is geographically concentrated in Iceland (96%). Loans to corporates comprise 53% of the portfolio and are focused on collateralized real estate and fishing exposures, as well as construction, matching the country's industrial sector breakdown. As of September 2017, mortgage loans formed 40% of total customer loans, and we expect the bank to continue to steadily increase its mortgage lending as deposit-taking institutions and pension funds continue to take market share from the state-owned Housing Financing Fund (HFF) (see chart 1). Arion Bank does provide foreign currency lending, but only to foreign borrowers or Icelandic corporations with strong foreign currency cash flows, such as fisheries or other exporters.

Chart 1



Arion Bank, along with the other major banks in the market, is showing marked improvement in its gross nonperforming loan stock, which stood at 1.4% as of September 2017, compared with 60% at year-end 2010. 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. We note that the bank's issues with a single client, namely United Silicon, during 2017 materially affected returns year to date (see Capital & Earnings section above).

Arion Bank has a meaningful portion of its S&P Global Ratings' RWAs associated with equities in the banking book as a result of various debt restructurings (18.8% at end-December 2016). In 2015 and 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. We project a continued effort to reduce these equity holdings, which have also led to high one-time value gains in connection with selling assets, and believe further reductions will reduce the bank's risk profile and profit volatility.

Table 5

Arion Bank Risk Position

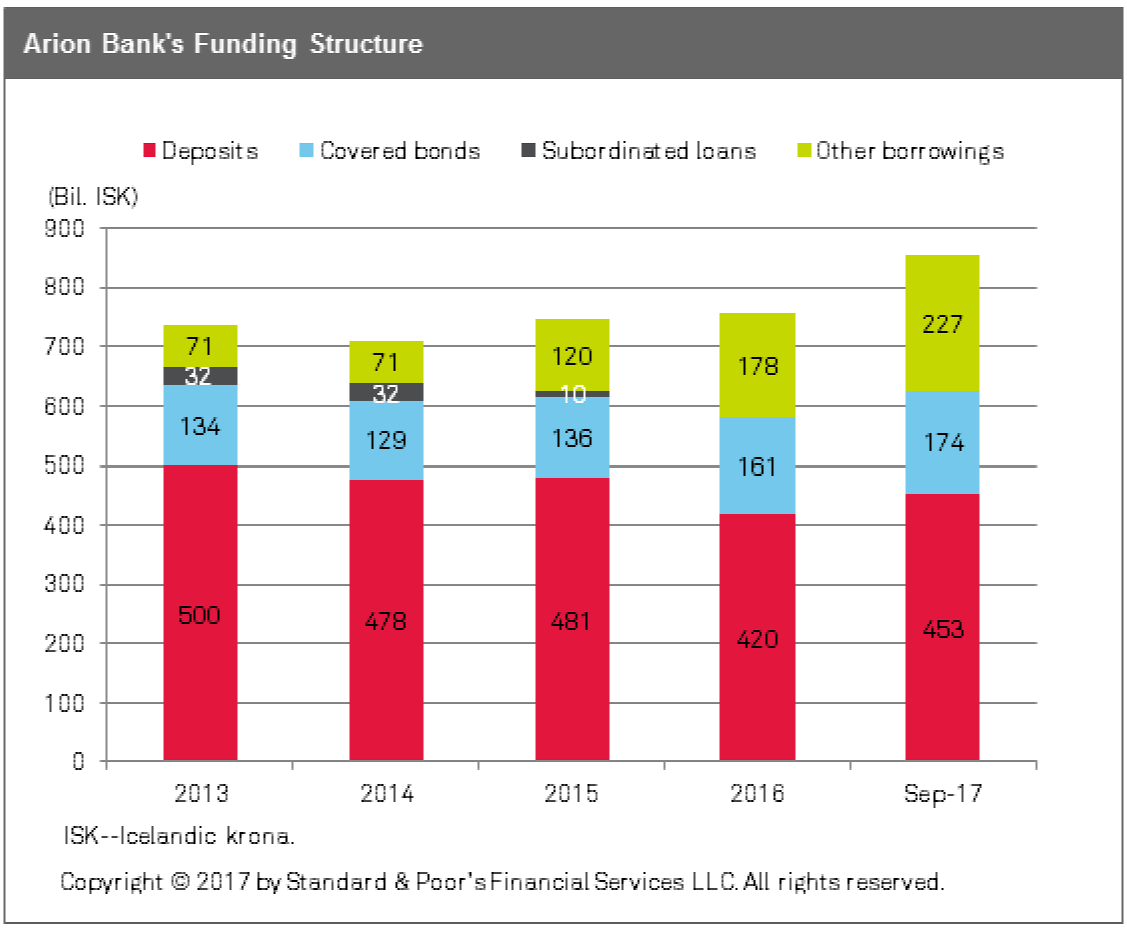
		--Year-ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Growth in customer loans	5.7	3.5	5.4	1.4	6.2
Total diversification adjustment/S&P Global Ratings' RWA before diversification	N/A	43.9	26.5	34.2	59.4
Total managed assets/adjusted common equity (x)	5.6	5.3	5.2	6.7	7.1
New loan loss provisions/average customer loans	0.5	0.7	1.1	0.4	1.2
Net charge-offs/average customer loans	1.2	1.5	0.6	0.8	5.5
Gross nonperforming assets/customer loans + other real estate owned	3.8	4.7	6.7	8.0	11.1
Loan loss reserves/gross nonperforming assets	54.0	66.4	63.6	48.9	39.0

*Data as of Sept. 30. N/A--Not applicable. RWA--Risk-weighted assets.

Funding and liquidity: Adequate liquidity position and funding metrics

We consider Arion Bank's funding to be in line with domestic peers, balancing the bank's relatively strong funding metrics compared domestic and European peers with the expectation that the funding profile will level out over the coming years, given that the bank has now fully regained access to capital markets.

Chart 2



Arion Bank relies on wholesale funding as well as customer deposits for its funding needs. As of September 2017, customer deposits formed 53% of the total funding base, with the rest being wholesale funding, primarily consisting of covered bonds (see chart 2). The stable funding ratio by our measures was 120.45% at end-September 2017, constantly increasing from 2014. Given the bank's relatively short history of capital market issuance, the maturity profile shows no meaningful redemptions until 2018. Recent issues by Arion Bank and its domestic peers have demonstrated their ability to find investors in Scandinavia and Europe at reasonable spreads. We believe Arion Bank 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 March 2017, capital controls were completely lifted in Iceland, but that has not impacted the bank's funding metrics as we see that movements have been muted for Icelandic banks' deposits.

We view Arion Bank's liquidity position as moderately weaker than domestic peers', given that it is the first of the commercial banks to have a material bond maturing in March 2018 and due to some uncertainty associated with a potential dividend reducing liquidity as part of the anticipated sales process in the spring of 2018. While the bank has very solid ratios by our measures, with broad liquid assets to short-term wholesale funding at 4.7x at end-September 2017, they do not reflect the fact that Arion Bank's recently issued debt will begin to mature in 2018. Beginning in 2018, the bank will have higher annual wholesale debt refinancing needs, which we anticipate will reduce its currently high liquidity metrics (see chart 3).

Chart 3

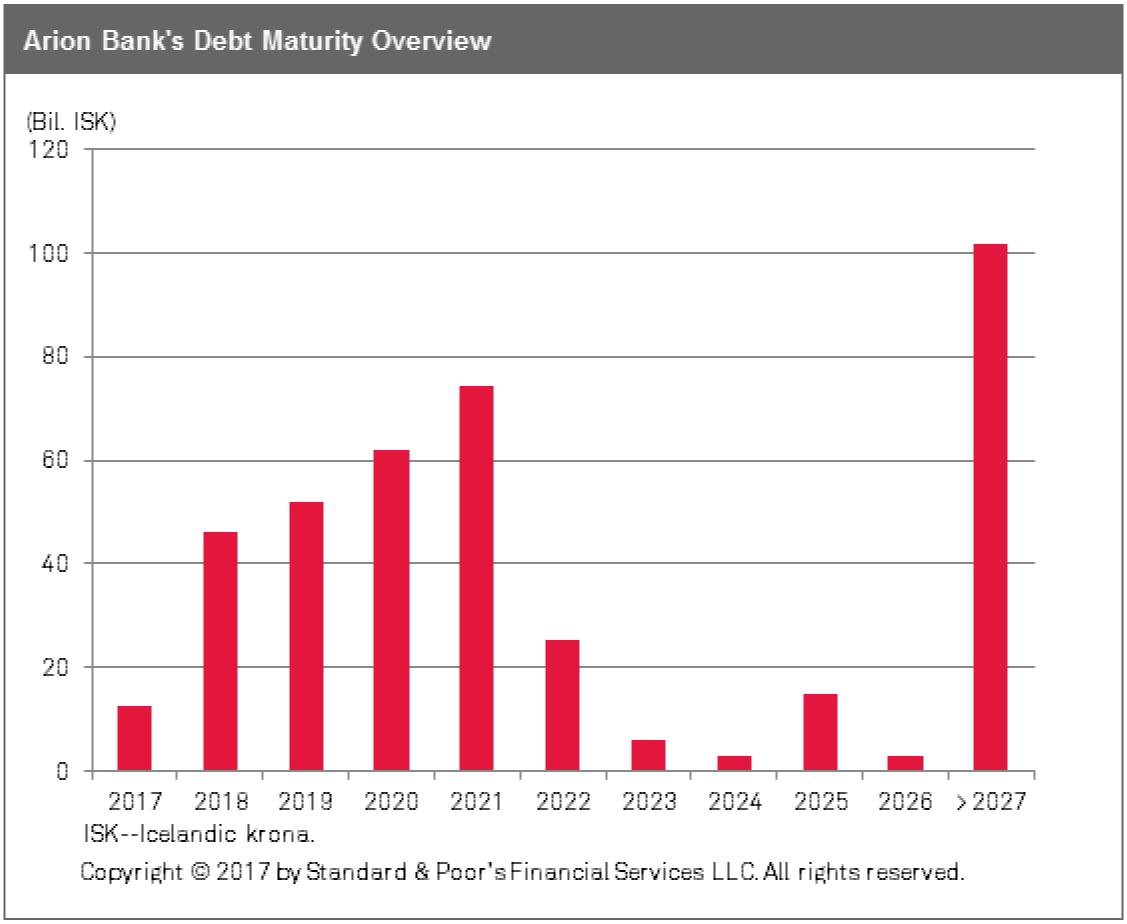


Table 6

Arion Bank Funding And Liquidity

	--Year-ended Dec. 31--				
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Core deposits/funding base	52.2	54.1	62.4	63.3	63.4
Customer loans (net)/customer deposits	168.4	172.9	145.0	142.3	134.7
Long-term funding ratio	94.4	96.5	97.1	93.9	95.4
Stable funding ratio	120.5	118.3	115.8	111.9	114.3
Short-term wholesale funding/funding base	7.0	4.4	3.6	7.4	5.4
Broad liquid assets/short-term wholesale funding (x)	4.7	6.8	7.3	3.6	4.8
Net broad liquid assets/short-term customer deposits	51.9	48.3	38.2	33.3	34.2
Short-term wholesale funding/total wholesale funding	14.6	9.6	9.7	20.1	14.8
Narrow liquid assets/3-month wholesale funding (x)	13.4	11.4	9.3	7.3	6.2

*Data as of Sept. 30.

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. 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 one to two 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.

Related Criteria

- 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
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Positive Rating Actions Taken On Four Icelandic Lenders On Improving Economic Conditions, Oct. 25, 2017
- Iceland-Based Arion Bank Upgraded To 'BBB+' On Improved Economy And Higher Capital; Outlook Stable, Oct. 25, 2017
- Ownership Change Has No Immediate Impact On Arion Bank Ratings, Mar. 21, 2017

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 December 15, 2017)

Arion Bank	
Counterparty Credit Rating	BBB+/Stable/A-2
Senior Unsecured	A-2
Senior Unsecured	BBB+
Counterparty Credit Ratings History	
25-Oct-2017	BBB+/Stable/A-2
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)	A/Stable/A-1

*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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