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Research Update:

Iceland-Based Arion Bank Upgraded To 'BBB+' On Improved Economy And Higher Capital; Outlook Stable

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Overview

- The strong economic growth in Iceland continues, with improving economic resilience and falling private sector leverage, only partly offset by concerns of increasing economic imbalances.
- As such, our view of the Icelandic banking sector has improved, as has our expectation for Iceland-based Arion Bank's risk-adjusted capital position given significant reductions in equity positions.
- We anticipate that the bank's likely upcoming IPO, which could be delayed by the elections this fall, will be neutral for the ratings.
- As a result, we are raising the long-term ratings on Arion Bank to 'BBB+' from 'BBB', and affirming the 'A-2' short-term rating.
- The stable outlook reflects our expectation that the Icelandic economy will remain stable, and that Arion Bank will maintain very strong capital levels and improve the diversification of its ownership even after the expected IPO.

Rating Action

On Oct. 25, 2017, S&P Global Ratings raised its long-term issuer credit rating on Iceland-based Arion Bank to 'BBB+' from 'BBB' and affirmed its 'A-2' short-term rating. The outlook is stable.

We also raised our long-term issue rating on Arion Bank's senior unsecured notes to 'BBB+' from 'BBB', in line with the issuer rating.

Rationale

The upgrade reflects Arion Bank's improved capital position, and our expectation that the bank will maintain a very strong risk-adjusted capital (RAC) ratio. It also reflects our improved view of the economic risks in the Icelandic banking sector, as the economic environment remains supportive following the release of capital controls earlier this year, and private-sector credit to GDP remains on a negative trend (for details, see " Positive Rating Actions Taken On Four Icelandic Lenders On Improving Economic Conditions," published on Oct. 25, 2017, on RatingsDirect). For Icelandic banks, this translates into a lower capital charge for domestic exposures and an improvement in our anchor, the starting point in assigning an issuer credit rating, to 'bbb' from 'bbb-'.

We expect continued strong development in the Icelandic economy, with GDP growth at 4% for 2017 and a flourishing tourism sector. The sovereign's financial position continues to improve due to a strong economic performance and current account surpluses. At the same time, private-sector leverage continues to decrease. However, the positive impact on the banking sector is limited, because we also see increasing risks for overheating and rapidly rising house prices. House prices have outgrown household income in the last year, creating concerns for affordability and economic imbalances.

Arion Bank has been successful in reducing equity holdings and has significantly improved its capital position by maintaining dividend payments in recent years. The upgrade also reflects our expectation that Arion Bank's eventual sale will be neutral for the ratings and that the reduction of capital from current levels that we anticipate will not materially affect our view of the bank's ability to absorb losses from an improved domestic economy.

Arion Bank is the first of the Icelandic banks to be sold, in part, to international investors following Kaupthing's sale of 29.1% of the bank in March 2017. We anticipate that a larger share of the bank will be sold in an expected IPO in the spring of 2018, postponed by the need for Iceland to create a new government this fall. Following the likely IPO, we anticipate that Arion Bank will have a diversified ownership structure, which we foresee as neutral for the ratings.

We expect that Arion Bank will eventually resume dividend payments in connection to and after the expected IPO. 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 anticipate that share capital will be replaced by Additional Tier 1 debt issuances to some extent, which we include in our capital forecast for 2019, allowing the pro forma midyear RAC ratio of 22.5% to stay above 16% through 2019. This view is supported by Arion Bank's medium-term target to reduce regulatory Common Equity Tier 1 ratios to about 17%, a plan we expect will take three to four years to achieve.

Given that the bank's credit exposure is concentrated in a market with limited diversification, we think that its capital and risk positions are well reflected at the 'BBB+' rating level, especially based on our current projections of reduced equity capital and the near-term sales process.

We have also revised our view of the bank's liquidity position to adequate from strong to reflect that our liquidity metrics are somewhat lower than domestic peers' as well as the fact that, as its debt maturity profile matures, the bank will have higher annual refinancing needs, reducing its currently high liquidity metrics.

Outlook

The stable outlook on 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 IPO. 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 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.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	BBB+/Stable/A-2	BBB/Positive/A-2
SACP	bbb+	bbb
Anchor	bbb	bbb-
Business Position	Adequate (0)	Adequate (0)
Capital and Earnings	Very Strong (+2)	Strong (+1)
Risk Position	Moderate (-1)	Adequate (0)
Funding and Liquidity	Average and Adequate (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)

ALAC--Additional loss-absorbing capacity. SACP--Stand-alone credit profile.

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

Ratings List

Upgraded; Ratings Affirmed

	To	From
Arion Bank		
Counterparty Credit Rating	BBB+/Stable/A-2	BBB/Positive/A-2
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 for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at 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

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