MOODY'S
RATINGS

Rating Action: Moody's Ratings upgrades Arion Bank hf. - Mortgage Covered Bonds

24 Sep 2024

Euro 750 million of covered bonds affected

London, September 24, 2024 -- Moody's Ratings (Moody's) has upgraded to Aa1 from Aa2 the covered bond ratings issued by Arion Bank hf. (("Arion Bank" or "the Issuer", deposits A2 stable; adjusted baseline credit assessment baa2; counterparty risk (CR) assessment A2(cr)), which are governed by the Icelandic covered bond law.

RATINGS RATIONALE

Today's rating action on Icelandic covered bonds follows our increase of Government of Iceland's foreign-currency country ceiling to Aaa from Aa2, which in turn follows our upgrade of Government of Iceland's sovereign rating to A1 with a stable outlook from A2 on 20 September 2024. Therefore, Iceland's covered bond ratings are no longer constrained by the country ceiling. Arion Bank's covered bond ratings benefit from OC consistent with their new rating levels. For more information about the sovereign rating action, see "Moody's Ratings upgrades Iceland's ratings to A1, changes outlook to stable".

KEY RATING ASSUMPTIONS/FACTORS

We determine covered bond ratings using a two-step process: an expected loss analysis and a TPI framework analysis.

EXPECTED LOSS: We use our Covered Bond Model (COBOL) to determine a rating based on the expected loss on the bond. COBOL determines expected loss as (1) a function of the probability that the issuer will cease making payments under the covered bonds (such cessation, a CB anchor event); and (2) the estimated losses that will accrue to covered bondholders should a CB anchor event occur. We express the probability of a CB anchor event as a point on our alpha-numeric rating scale (i.e. the CB anchor), which is typically one notch higher than the issuer's CR assessment.

The CB anchor for this programme is A1, being the CR assessment of Arion Bank plus 1 notch.

The cover pool losses for Arion Bank's covered bonds are 26.2%. This is an estimate of the losses we currently model following a CB anchor event. We split cover pool losses between market risk of 17.3% and collateral risk of 8.9%. Market risk measures losses stemming from refinancing risk and risks related to interest-rate and currency mismatches (these losses may also include certain legal risks). Collateral risk measures losses resulting directly from cover pool assets' credit quality. We derive collateral risk from the collateral score, which for this programme is currently 13.3%.

The over-collateralisation in the cover pool is 14.3%, of which Arion Bank provides 5.0% on a "committed" basis. Under our COBOL model, the minimum OC consistent with the Aa1 rating is 4.5%, of which 0% needs to be in "committed" form to be given full value (numbers in nominal value terms). These numbers show that we are not relying on "uncommitted" OC in our expected loss analysis.

For further details on cover pool losses, collateral risk, market risk, collateral score and TPI Leeway across covered bond programmes rated by us please refer to "Covered Bonds Sector Update ", published quarterly.

TPI FRAMEWORK: we assign a "timely payment indicator" (TPI), which is our assessment of the likelihood of timely payment of interest and principal to covered bondholders following a CB anchor event. TPIs are assessed as Very High, High, Probable-High, Probable, Improbable or Very Improbable. The TPI framework limits the covered bond rating to a certain number of notches above the CB anchor.

For Arion Bank's covered bonds, we have assigned a TPI of Very Improbable.

RATING METHODOLOGY

The principal methodology used in these ratings was "Moody's Approach to Rating Covered Bonds" published in March 2024 and available at https://ratings.moodys.com/rmc-documents/416197 . Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of this methodology.

Factors that would lead to an upgrade or downgrade of the ratings:

The CB anchor is the main determinant of a covered bond programme's rating robustness. A change in the level of the CB anchor could lead to an upgrade or downgrade of the covered bonds. The TPI Leeway measures the number of notches by which we might lower the CB anchor before we downgrade the covered bonds because of TPI framework constraints.

Based on the current TPI of "Very Improbable", the TPI Leeway for this programme is

1 notch. This implies that we might downgrade the covered bonds because of a TPI cap if it lowers the CB anchor 2 notches all other variables being equal.

A multiple-notch downgrade of the covered bonds might occur in certain circumstances, such as (1) a country ceiling or sovereign downgrade capping a covered bond rating or negatively affecting the CB anchor and the TPI; (2) a multiple-notch downgrade of the CB anchor; or (3) a material reduction of the value of the cover pool.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions .

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