MOODY'S INVESTORS SERVICE

CREDIT OPINION
14 December 2023

New Issue

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TABLE OF CONTENTS

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Arion Bank hf. - Mortgage Covered Bonds

New Issue – Icelandic covered bonds

Ratings

Exhibit 1

Cover Pool (ISK)	Ordinary Cover Pool Assets	Covered Bonds (ISK)	Rating
341,264,284,152	Residential Mortgage Loans	316,815,340,098	Aa2

All data in the report is as of 30 September 2023 unless otherwise stated.
Source: Moody's Investors Service

Summary

The covered bonds issued by Arion Bank h.f ("Arion" or "the issuer") under its mortgage programme are full recourse to the issuer and are secured by a cover pool of assets consisting mainly of residential mortgage loans in Iceland (97.9%) and the remaining amount in substitute assets.

Credit strengths include the full recourse of the covered bonds to the issuer, with a CB Anchor of A1, and support provided by the Icelandic legal framework for covered bonds, which provides for the issuer's regulation and supervision.

Credit challenges include a high level of dependency on the issuer and potentially high asset-liability mismatches due to cross-currency risk and CPI-linked exposures.

Our credit analysis estimates that the stressed level of losses on the cover pool assets is 28.1% for this transaction, compared to an average of 17.7% across all rated mortgage programmes. The likelihood of timely payment on the covered bonds after a CB anchor event is Very Improbable.

Credit strengths

» ***Recourse to the issuer:*** The covered bonds are full recourse to Arion Bank (A2(cr)). (See "Covered bond analysis")

» ***Support provided by the Icelandic legal framework:*** The covered bonds are governed by the Icelandic legal framework, which provides for the issuer's regulation and supervision and sets certain minimum requirements for the covered bonds and the cover pool. The legal framework is fully aligned with the EU harmonisation directive. (See "Covered Bond Legal Frameworks")

» ***High credit quality of the cover pool:*** The covered bonds are supported by a cover pool of prime residential mortgages in Iceland. Loans parts above 80% LTV and those in arrears for 90 days or more are not counted as cover pool assets for the purpose of coverage requirements under the law; therefore covered bonds will be backed by at least 105% of high quality assets. Around 46% of the mortgages are CPI-linked, which means their principal balance and interest payments vary according to changes in the consumer price index. This is an unusual feature that is not seen in other covered bond markets. Borrowers face a back-loaded repayment of principal burden and a higher debt service at the end of the loan term compared to non-CPI-linked mortgages; however, the interest rates for CPI-linked mortgages tend to be less volatile than for non-CPI-linked mortgages. (See “Cover pool analysis”)

» ***Systemic importance of covered bond funding:*** Covered bonds are a significant proportion of market funding in Iceland. Banks benefit from a large domestic investor base, as pension funds provide funding at multiple levels and are large covered bond investors. Pension funds also hold 18% of Icelandic mortgages, including CPI-linked products, which reduces the bonds' refinancing risk. In Iceland's severe financial crisis of 2008, there was no default on Icelandic covered bonds because all covered bond programmes were transferred from insolvent issuers to solvent state-owned entities ('good banks'). This positive outcome for covered bonds established a track record of effective support from Icelandic authorities that would likely be repeated if any covered bonds issuers fail in the future. Arion Bank is one of three domestic systemically-important banks.

Credit challenges

» ***High level of dependency on the issuer:*** As with most covered bonds, before the insolvency of the issuer, the issuer can materially change the nature of the programme and there are few restrictions on the future composition of the cover pool. These changes could affect the credit quality of the cover pool as well as the overall refinancing and market risks. Further, if the quality of the collateral deteriorates below a certain threshold, the issuer would have the ability, but not the obligation, to increase the OC in the cover pool beyond the legal minimum of 5%. (See “Covered bond analysis”)

» ***Unhedged currency risk:*** Iceland's covered bonds are exposed to unhedged currency risk due to absence of external swap counterparties, a material credit negative compared to most other countries. Icelandic mortgages are exclusively denominated in domestic currency (a credit positive), while 35% of covered bonds are denominated in foreign currency (Euro). There are some mitigants in the legal framework and structure but they provide only limited protections. Overall, Moody's does not consider there to be a significant structural mitigant to the FX risk exposure and reflects this in the expected loss and TPI assessment. (See “Covered bond analysis”)

» ***Inflation-linked mismatch:*** There is no requirement in the covered bond law to limit mismatches between CPI-linked assets and liabilities. However, 46% of the mortgages in the cover pool and 42% of outstanding covered bonds (only ISK denominated) are indexed to inflation, providing some natural hedging. Moreover, we understand the issuer intends to maintain sufficient OC levels both on a CPI-linked and non-CPI-linked basis. (See “Covered bond analysis”)

» ***Interest rate mismatch:*** 40% of the mortgage loans in the cover pool have floating interest rates, while 88% of the covered bonds are fixed rate, resulting in unhedged interest rate risk mismatches of assets and liabilities. As a mitigant, the covered bond law requires a stress test of interest rate risk in the NPV OC calculation. (See “Covered bond analysis”)

» ***Refinancing risk:*** To achieve timely principal payment following a CB anchor event, covered bondholders might need to rely on funds raised through the sale of, or borrowed against, the cover pool assets. The market value of these assets may be subject to high volatility after a CB anchor event. As a mitigant, Arion issues soft bullet bonds with a 12-month maturity extension period, which reduces refinancing risk. However, in keeping with many other European countries, the way the 180-day liquidity buffer is calculated provides only little protection. (See 'Covered bond analysis')

» ***Economic uncertainty:*** Our analysis has considered the effect on the performance of covered bonds of potential challenges to the Icelandic economic activity. The main risks to covered bonds stem from the small size of the country (economy, currency area) and consequently elevated volatility in currency and inflation rates. Mitigating factors include large foreign currency reserves held by the central bank and low reliance on imported energy. Iceland's foreign currency ceiling is Aa2.

» ***Time subordination:*** After a CB anchor event, later-maturing covered bonds are subject to time subordination. Principal cash collections may be used on a first-come, first-served basis, paying earlier-maturing covered bonds before later-maturing covered bonds. This subordination could lead to the erosion of OC before any payments are made to later-paying covered bonds. (See "Covered bond analysis")

ESG considerations

In general, we consider environmental and governance credit risks to be low and social credit risks to be moderate for this transaction.

» **Environmental:** Overall exposure to meaningful environmental risk is low in this programme as covered bondholders benefit from the issuer's liability to make payments on the covered bonds. However, covered bonds are exposed to event risks stemming from volcanic and seismic activity. (See Cover pool analysis - Environmental considerations).

» **Social:** Overall exposure to meaningful social risks is moderate in this programme mainly because social issues that affect lenders can also affect the cover pool. Social risks are mitigated by the covered bonds' dual recourse to both issuer and cover pool as well as the cover pool's diversification.

» **Governance:** Overall exposure to meaningful governance risk is low in this programme due to: (i) covered bonds' dual recourse to both issuer and cover pool; (ii) Icelandic covered bond law; (iii) key programme participants' adherence to obligations; and (iv) the operational and substantive provisions of the programme documents.

For further details, please see "ESG Considerations" section below.

Key characteristics

Exhibit 2
Covered bond characteristics

Moody's Programme Number:	499
Issuer:	Arion Bank hf.
Covered Bond Type:	Mortgage covered bond
Issued under Covered Bonds Law:	Yes
Applicable Covered Bonds Law:	Act on Covered Bonds, No.11/2008
Entity used in Moody's TPI analysis:	Arion Bank hf.
CR Assessment:	A2 (cr)
CB Anchor:	A1
LT Deposits	A2
Senior Unsecured	A3
Total Covered Bonds Outstanding:	ISK 316,815,340,098
Main Currency of Covered Bonds:	ISK (65.4%)
Extended Refinance Period:	Yes
Principal Payment Type:	Soft Bullet (12 month maturity extension)
Interest Rate Type:	Fixed rate covered bonds (88.0%), Floating rate covered bonds (12.0%)
Committed Over-Collateralisation:	5.0% (on a nominal basis)
Current Over-Collateralisation:	7.7% (on a nominal basis)
Intra-group Swap Provider:	n/a (no swap)
Monitoring of Cover Pool:	KPMG
Fiscal Agent:	The Bank of New York Mellon
Timely Payment Indicator:	Very Improbable
TPI Leeway:	2 notches (the CB rating is currently restricted by Iceland's Aa2 country ceiling)

Source: Moody's Investors Service, issuer data

Exhibit 3
Cover pool characteristics

Size of Cover Pool:	ISK 341,264,284,152
Main Collateral Type in Cover Pool:	Residential assets (97.9%)
Main Asset Location of Ordinary Cover Assets:	Iceland (100.0%)
Main Currency of Loans:	ISK (100.0%)
Loans Count:	14,939
Number of Borrowers:	12,182
WA Unindexed LTV:	62.8%
WA Indexed LTV:	44.9%
WA Seasoning:	3.1 years (37 months)
WA Remaining Term:	33 years (395 months)
Interest Rate Type:	Fixed rate mortgages (60.0%), Floating rate mortgages (40.%)
CPI-linked Mortgages:	CPI-linked mortgages (46.2%), Non-CPI-linked mortgages (53.8%)
Collateral Score:	13.4%
Cover Pool Losses:	28.1%
Further Cover Pool Details:	See “Cover pool description"
Pool Cut-off Date:	30 September 2023

Source: Moody's Investors Service, issuer data

Exhibit 4
Transaction counterparties

Counterparty Type	Transaction Counterparty
Sponsor	Arion Bank
Servicer	Arion Bank
Back-up Servicer	Not designated
Back-up Servicer Facilitator	Not designated
Cash Manager	Arion Bank
Back-up Cash Manager	Not designated
Account Bank	Arion Bank
Standby Account Bank	Not designated
Account Bank Guarantor	Not designated

Source: Moody's Investors Service, issuer data

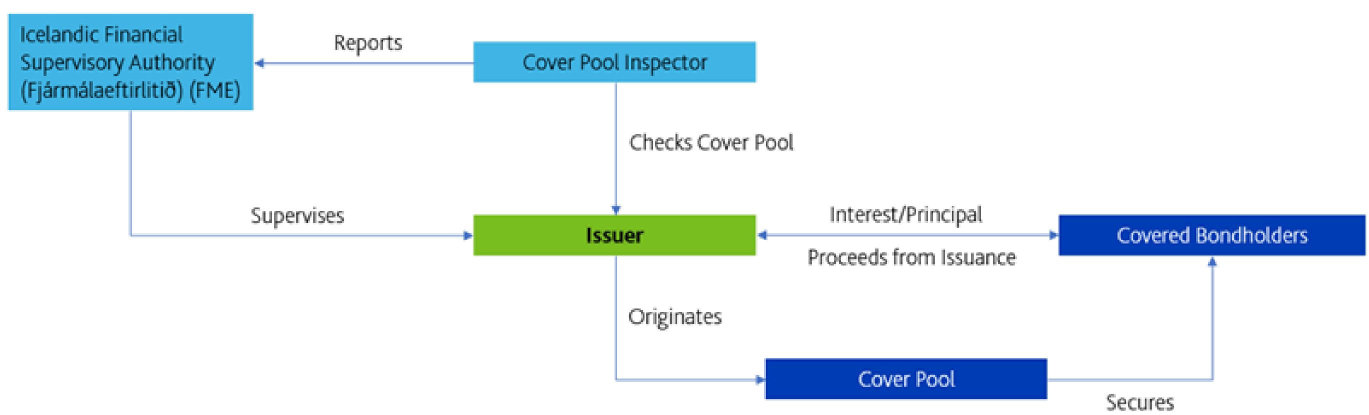
Covered bond description

The covered bonds issued under the mortgage covered bond programme of Arion Bank are full recourse to the issuer. Upon a CB anchor event, covered bondholders would have access to a cover pool consisting of predominantly residential mortgage loans, and substitute assets (cash collateral and securities).

This programme follows an on-balance sheet structure; cover pool assets and covered bonds are held on Arion Bank's balance sheet (see Exhibit 5 below).

Structural diagram

Exhibit 5
Structural diagram of Arion Bank's covered bond transaction.



Source: Arion Bank, Moody's Investors Service

Structure description

The bonds

The covered bonds have a soft bullet repayment profile, benefiting from a 12-month maturity extension period. The extension feature aligns with the EU directive, without reducing the effectiveness of soft bullets in mitigating refinancing risk. Subject to the approval from the Financial Supervisory Authority, maturities may only be extended when necessary to meet one of several objective conditions, including (1) to achieve the issuer's resolution objectives or (2) the prevention of forced asset sales at discounted prices. The extension of the maturity shall not constitute a default, an event of default or an acceleration of payment.

Also in keeping with the EU directive, the updated law says that maturities cannot be extended in a way that would invert the original sequencing of a covered bonds. It would be possible to simultaneously extend the maturity dates of multiple bonds or extend a maturity date more than once, which is credit positive because it means the requirement to maintain sequencing will not prevent the extension of soft-bullet maturities up to the latest final maturity date specified in the contractual terms of the bonds.

One series of bonds maturing in 2048 has a fully amortizing principal payment structure without a soft bullet maturity extension feature.

Issuer recourse

The covered bonds are full recourse to the issuer. Therefore, the issuer is obliged to timely repay principal and pay interest on the covered bonds.

Recourse to cover pool and over-collateralisation

If the issuer becomes insolvent, the covered bondholders would have priority claims over a pool of assets (cover pool). (See "Cover pool description" for the cover pool characteristics and "Cover pool analysis" for our analysis of the pool)

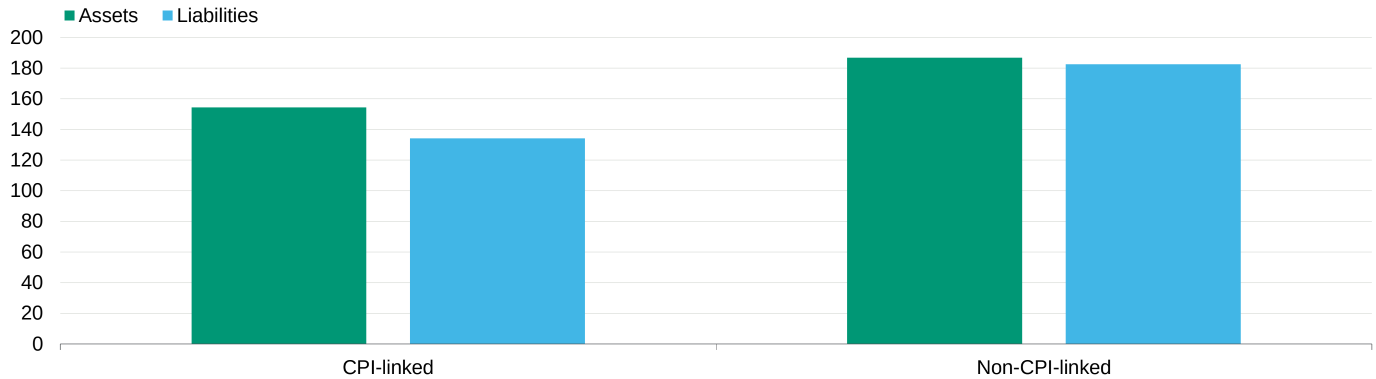
As of September 2023, the level of OC in the programme is 7.7% on a nominal basis and 40.5% on a net present value basis. This OC calculation (i) excludes collateral posted by Arion Bank under its FX risk covenant mitigant; (ii) includes loan parts above the 80% LTV threshold; (iii) includes loan parts that may be subject to set-off risk.

We understand the issuer intends to maintain minimum OC levels both on a CPI-linked and non-CPI-linked basis, thereby assuring some level of natural hedging.

Exhibit 6

Over-collateralisation would be maintained on both a CPI-linked and non-CPI-linked basis

Assets and liabilities in ISK bn



*Euro denominated bonds are all non-CPI-linked.

Source: Moody's Investors Service, Arion Bank

The law requires the amount of cover pool assets to exceed the principal balance of the bonds by (i) 5% on a nominal basis, and (ii) 0% on a net present value (NPV) basis. Cash collateral posted by Arion under its FX risk covenant to mitigate FX risk is counted as part of the cover pool for statutory OC testing purposes. The NPV OC test needs to be met assuming some interest rate and currency exchange rate stresses, unless the issuer enters into a hedging arrangement.

In the covered bond issuance license granted to Arion Bank, the Icelandic FSA has set a maximum limit to the amount of OC the issuer can provide; however, this limit does not consider collateral posting under the FX risk covenant.

Moody's looks primarily at the OC excluding cash collateral posting for FX risk purposes to assess whether the OC is consistent with the covered bond rating. However, currently, 0.0% of nominal OC is sufficient to maintain the covered bond rating, which is lower than the statutory committed OC.

Although the issuer has the ability to increase the OC in the cover pool beyond the 5% legal minimum OC, if collateral quality deteriorates below a certain threshold, the issuer does not have an obligation to do so. The failure to increase OC following a deterioration of the collateral could lead to a negative rating action.

Legal framework

The covered bonds are governed by the Icelandic Act on Covered Bonds.

Aspects of the legislation which are credit positive include:

» Robust coverage requirements which mitigate collateral and market risks.

» Protections of covered bond investors in the resolution of the issuer, which reduces refinancing risk.

» Provisions to minimise commingling risk, which reduces market risk.

Aspects of the legislation which are credit negative include:

» The law does not explicitly address how cover pool assets may be used to raise liquid funds following issuer default, in order to repay covered bonds in a timely fashion. (See "Covered bond analysis: Refinancing risk")

» Set-off risk is not addressed. Similar to EU member states, Icelandic depositors benefit from the deposit protection scheme. (See "Covered bond analysis: Market risk")

See "Covered Bonds: Iceland - Iceland's updated covered bonds law meets EU standards but market practices raise credit risks", February 2023, for a description of the general legal framework governed by the Act on Covered Bonds.

As per the Icelandic legal framework for covered bonds, deposits need to be held in a bank with the equivalent of a minimum senior unsecured rating of Baa3. Separately, Arion Bank has covenanted that it aims to maintain the programme accounts at a bank rated at least Baa3(cr), subject to certain conditions. Further, Arion has covenanted, subject to certain conditions, that cash collateral held for FX risk purposes (as necessary) would be deposited only at a bank with deposit rating of at least A3. Currently, all accounts are held at the issuer itself.

The Icelandic covered bond law is fully aligned with the EU directive, which means that covered bonds issued under Iceland's revised law will attract favourable treatment under EU regulations. In particular, the issuer has advised they will qualify for preferential capital risk weights and liquid asset classifications in the hands of EU-based credit institutions. In addition, Icelandic covered bonds will be eligible as collateral for central bank repo transactions with the European Central Bank as well as the Central Bank of Iceland. Favourable regulatory treatment will widen demand for Iceland's covered bonds, which is credit positive because it will help issuers to meet their funding needs and reduce refinancing risk following issuer default.

Covered bond analysis

Our credit analysis of the covered bonds primarily focuses on the issuer's credit quality, refinancing risk, interest rate risk and currency risk, as well as the probability that payments on the covered bonds would be made in a timely fashion following a CB anchor event, which we measure using the Timely Payment Indicator. (See "Timely Payment Indicator")

Primary analysis

Sovereign and banking system analysis

The rating of the Iceland's sovereign debt is A2, with a positive outlook.

Moody's country ceilings determine the maximum credit ratings achievable for domestic issuers. The local-currency ceiling for Iceland is Aa1, reflecting the very volatile currency, which exposes all issuers in the country to a higher level of exchange rate risk than is standard in most other advanced economies. The foreign-currency ceiling for Iceland is Aa2, reflecting that the central bank retains the option to reintroduce capital controls in an emergency situation. The foreign currency ceiling currently constrains the rating on foreign currency covered bonds at the same Aa2 level.

Our macro profile for Iceland is Strong- and our rating outlook for Iceland's banking system is stable.

Iceland's credit strengths include low reliance on imported energy, favourable demographics, and large foreign currency reserves. Growth is volatile, reflecting the economy's limited diversification, which increases its vulnerability to sector-specific and external shocks. Icelandic banks benefit from operating in a developed country with high institutional and government strength.

The main risks to the banking sector stem from the country's small size and currency area with limited diversification of its economy, which could create the risk of sudden currency volatility and contagion in the event of sector specific shocks. A material increase in the rate of household debt accumulation driven by high house price inflation, or a sudden reversal of house price growth, could put negative pressure on Iceland's banking system. For further information, see Icelandic Banks: Domestic focus and strong capital buffers support Icelandic banks' strong performance.

Issuer analysis - Credit quality of the issuer

The issuer's CR Assessment is A2(cr). The outlooks for the Long Term Issuer Rating and Deposit Rating are positive. (For a description of the issuer's rating drivers, see Credit Opinion, published September 2023.)

The reference point for the issuer's credit strength in our analysis is the CB anchor, which for covered bond programmes under the covered bond law in Iceland is the CR Assessment plus one notch.

Issuer analysis - Dependency on the issuer's credit quality

The credit quality of the covered bonds depends primarily on the credit quality of the issuer. If the issuer's credit strength were to deteriorate, there would be a greater risk that a CB anchor event would occur, leading to refinancing risk for the covered bonds. Consequently, the credit quality of the covered bonds would deteriorate unless other credit risks were to decrease.

In the event that the CB anchor deteriorates, the issuer would have the ability, but not the obligation, to increase the OC in the cover pool. Failure to increase the level of OC under these circumstances could lead to a negative rating action.

Reasons for linkage between the credit quality of covered bonds and the issuer also include exposure to decisions made by the issuer in its discretion as manager of the covered bond programme. For example, before a CB anchor event, the issuer may add new assets to the cover pool and remove assets from the cover pool, issue further bonds and enter new hedging arrangements. Such actions could reduce the value of the cover pool.

As with most covered bonds in Europe, there are few contractual restrictions on the future composition of the cover pool, which creates substitution risk. Nevertheless, cover pool quality over time will be protected by, among other things, the requirements of the Icelandic legal framework, which specifies what types of assets are eligible. (See “Covered Bond Legal Frameworks”)

Refinancing risk

Following a CB anchor event, the natural amortization of the cover pool assets alone cannot be relied on to timely repay the principal. We assume that funds must be raised against the cover pool at a discount if covered bondholders are to receive timely principal payment. Where the portion of the cover pool that is potentially exposed to refinancing risk is not contractually limited, our expected loss analysis typically assumes that this amount is in excess of 50% of the cover pool.

After a CB anchor event, the market value of these assets may be subject to volatility. Examples of the refinancing margins we use are published in our Rating Methodology. (See “Moody's Approach to Rating Covered Bonds”.)

The refinancing-positive aspects of this covered bond programme include:

» The cover pool consists of prime residential mortgage loans as its primary asset and benefits from strict asset eligibility and coverage requirements, as per the legal framework. This should mean the cover pool is perceived as having assets of strong credit quality that could attract a willing purchaser.

» Protections in case of the resolution of the issuer, which increase the likelihood that the covered bond liabilities of a failing issuer will be transferred to a newly-capitalised 'good bank'.

» Provisions to allow for a bond maturity extension by 12 months, which should allow time to maximize the sale value of the cover pool following a CB anchor event, and increase chances of timely principal payments on the covered bonds. (See “Additional analysis - Extension Period”.)

» Banks benefit from a large domestic investor base. Pension funds are important covered bond investors and pension funds hold a significant share of Icelandic mortgages, particularly CPI-linked products.

The refinancing-negative aspects of this covered bond programme include:

- The law requires covered bond issuers to maintain a 180-day liquidity buffer. However, like in several other covered bond markets, in most situations, the requirement will not result in any significant buffer amount of liquid assets, as the issuer may calculate the required liquidity by reference to extended, rather than initial, maturity dates.
- The law does not explicitly specify measures to address liquidity shortfalls following a CB anchor event, such as provisions to facilitate the sale of cover pool assets to raise liquidity.
- 60% of the cover pool mortgages are fixed-rate products. A potential sale of fixed-rate assets to meet payments due on covered bonds following a CB anchor event could lead to a crystallization of mark-to-market losses resulting from upward interest rate movements. However, fixed rate periods are typically no longer than 3 to 5 years.
- In line with other European covered bond programmes, upon a CB anchor event, we expect the cover pool assets will have a significantly longer weighted average life than the outstanding covered bonds.
- The law does not provide for the appointment of a special cover pool administrator in the case of issuer insolvency; instead, the bankruptcy official of the insolvent issuer would represent the interests of both covered bondholders and general creditors.

Interest rate and currency risk

There is potential for interest rate and currency risks, which could arise from the different payment promises and durations made on the cover pool and the covered bonds. The currency risk of this programme is significantly higher than that of most other European covered bond programmes, resulting in potentially higher cover pool losses.

Exhibit 7

Overview of assets (including substitute collateral) and liabilities

	WAL Assets (Years)	WAL Liabilities (Years)	Assets (%)	Liabilities (%)
Fixed rate	22.3	4.3	43.5%	88.4%
Variable rate	20.9	1.8	56.5%	11.6%

WAL = weighted average life
NB: In this table, fixed rate loans which reset within the next 12 months are treated as variable rate
Source: Moody's Investors Service, issuer data

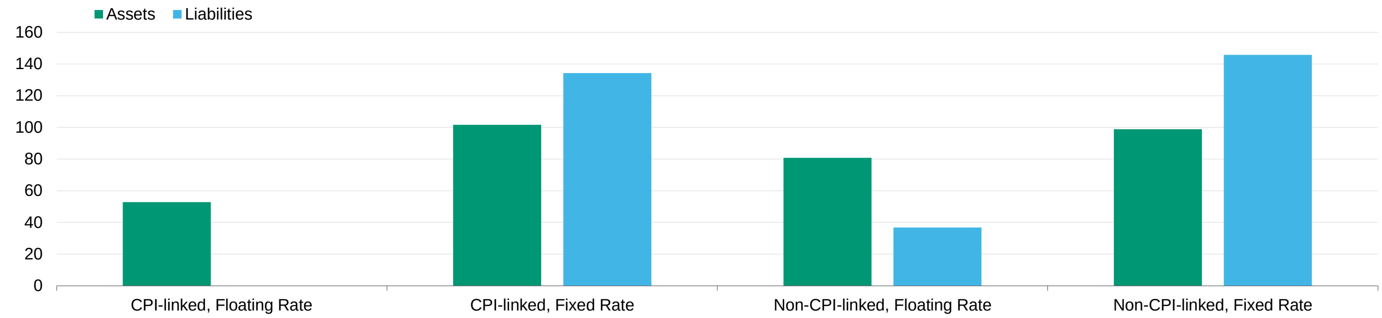
In the event of issuer insolvency, we do not assume the maintenance of any natural hedge between the cover pool and covered bonds. Therefore, we separately assesses the impact of increasing and decreasing interest rates on the expected loss of the covered bonds, taking the path of interest rates that leads to the worst result. The interest rate and currency stresses used over different time horizons are published in our rating methodology.

Asset liability mismatches exist because interest and principal payment terms differ between the mortgage loans and the covered bonds. The differences relate to fixed versus floating interest rates and CPI-linked versus non-CPI-linked payments.

Exhibit 8

Mismatches for indexation can occur for both principal and interest repayment

Assets and liabilities in ISK bn



Substitute assets not included. All euro denominated bonds are non-CPI-linked.
Source: Moody's Investors Service, Arion Bank

Aspects of this covered bond programme that are market-risk positive include:

» The requirement under the covered bond law that the net present value of the cover pool must at least match the net present value of outstanding covered bonds assuming some level of stress reflecting interest rate and foreign-exchange risks. Stresses include (i) interest rates: the coverage test must be passed assuming a sudden and permanent parallel shift in the yield curve by 100bps in either direction, (ii) foreign currency: mismatches are stressed assuming a sudden and sustained 10% adverse movement of the currency exchange rate. If an issuer enters into an (internal or external) swap, then this can be counted as hedging for interest rate and currency risk.

» Measures to minimize commingling risk in the legal framework. The law requires the issuer to keep cover pool collections in a separate account that is segregated from its other assets. Further, the issuer has advised that borrowers' payments can be redirected quickly via the Icelandic clearing house.

Aspects of this covered bond programme that are market-risk negative include:

» There is an unhedged FX risk with no access to external counterparties for ISK/EUR swaps, a material credit negative compared to most other countries. Icelandic covered bonds are exclusively denominated in domestic currency (a credit positive) while 34% of covered bonds are denominated in foreign currency (euro).

  – Arion provides a FX risk covenant to hold collateral in a reserve fund for mark-to-market posting, which imitates the posting requirement that would be required by a swap counterparty. However, this obligation only kicks in if the issuer is rated below Baa1(cr) and is subject to further conditions. Collateral could be in the form of cash deposits as long as the deposit taking bank is rated at least A3.

  – Arion provides a covenant to use reasonable endeavours to find an external swap counterparty. However, this obligation only kicks in if the issuer is rated below Baa3(cr) and is subject to further conditions. In practice, we would at this stage not expect that Arion would find an external swap counterparty but do not expect that Arion would then be forced to stop issuing non-ISK denominated bonds.

  – Overall, Moody's does not consider there to be a significant structural mitigant to the FX risk exposure and reflects this in the expected loss and TPI assessment.

» 46% of the mortgage loans in the cover pool and 42% of the covered bonds (ISK denominated only) are CPI-linked, providing some natural hedging between assets and liabilities. However, there is no requirement within the covered bond law to minimize or stress test mismatches. We understand the issuer intends to maintain OC levels on both a CPI-linked and non-CPI-linked basis. (See “Covered bond analysis”).

- 40% of cover pool loans feature floating interest rates, while 88% of the covered bonds are fixed rate, resulting in unhedged interest rate risk mismatches of assets and liabilities. This is partly mitigated by the interest rate stress test in the CB law.
- The law does not exclude set-off risk. However, the Icelandic deposit protection scheme, which guarantees deposits up to the equivalent of €100,000, partially mitigates set-off risk for covered bonds.

Timely Payment Indicator

We have assigned a Timely Payment Indicator (TPI) of "Very Improbable" to Arion's covered bonds. For the definition of TPI, see our Rating Symbols and Definitions.

Based on the current TPI of "Very Improbable", the TPI leeway for this programme is two notches. This implies that we might downgrade the covered bonds' rating because of a TPI cap if we were to lower the CB anchor by more than two notches, all other variables being equal. The covered bond rating is capped by the Icelandic foreign currency ceiling of Aa2.

The TPI-positive aspects of this covered bond programme include:

- The strength of the Icelandic covered bond legislation, including provisions for extendable maturities and protections in case of the resolution of the issuer, which are in line with the EU standards.
- The high level of government and financial market involvement, with a history of providing support to covered bonds in Iceland.
- The credit quality of the cover pool assets, consisting of prime residential mortgages.

The TPI-negative aspects of this covered bond programme include:

- CPI-linked assets and liabilities are not matched, although there is significant natural hedging in market practice.
- There is a high currency mismatch in the programme, and there are likely no external swap counterparties available to hedge EUR/ISK risk for covered bond purposes.
- The covered bond programme does not benefit from any designated source of liquidity in case cover pool cash flows are interrupted.
- Due to the small size of the country (economy, currency area), Iceland is vulnerable to relatively volatile currency and inflation rates.

Additional analysis

Liquidity

Liquidity risk is partially mitigated by:

- The 12 month maturity extension period on the covered bonds. (See "Extension Period")
- The legal requirement to maintain a minimum OC level of (i) 5% on a nominal basis and (ii) 0% on an NPV basis.

Time subordination

After a CB anchor event, later-maturing covered bonds would be subject to time subordination. Principal cash collections may be used on a first-come, first-served basis, paying earlier-maturing covered bonds before later-maturing covered bonds. Such payments could result in the erosion of OC before any payments are made to later-paying covered bonds.

Cover pool description

Pool description as of 30 September 2023

As of 30 September 2023, the cover pool consisted of residential mortgage loans backed by properties in Iceland (97.9%), and substitute collateral (2.1%).

On a nominal value basis, the cover pool assets total ISK 341.3 billion, which back ISK 316.8 billion in covered bonds, resulting in an OC level of 7.7% on a nominal basis. (For Arion Bank's underwriting criteria, see “Appendix: Income underwriting and valuation”)

The weighted average loan-to-value (LTV) ratios of the mortgage loans are 62.8% on an unindexed and 44.9% on an indexed property value basis. Unindexed refers to the property value at time of loan origination whilst indexed refers to the last updated (current) property value. In both cases, the numerator is the current loan balance (for CPI-linked mortgages, the principal amount adjusted in line with inflation).

Exhibits 9 and 10 show more details about the cover pool characteristics.

Residential mortgage loans

Exhibit 9

Cover Pool Summary - Residential Assets

Overview		Specific Loan and Borrower characteristics	
Asset type:	Residential	Loans with an external guarantee in addition to a mortgage:	n/a
Asset balance:	333,960,000,000	Interest only Loans	0.0%
Average loan balance:	22,354,940	Loans for second homes / Vacation:	0.0%
Number of loans:	14,939	Buy to let loans / Non owner occupied properties:	0.0%
Number of borrowers:	12,182	Limited income verified:	0.0%
Number of properties:	12,182	Adverse credit characteristics (**)	0.0%
WA remaining term (in months):	395		
WA seasoning (in months):	37	**Performance**	
		Loans in arrears (≥ 2months - < 6months):	0.4%
Details on LTV		Loans in arrears (≥ 6months - < 12months):	0.0%
WA Unindexed LTV (*)	62.8%	Loans in arrears (≥ 12months):	0.0%
WA Indexed LTV:	44.9%	Loans in a foreclosure procedure:	0.0%
Valuation type:	Market Value		
LTV threshold:	80%	**Multi-Family Properties**	
Junior ranks:	n/a	Loans to tenants of tenant-owned Housing Cooperatives:	n/a
Loans with Prior Ranks:	0.5%	Other type of Multi-Family loans (***)	n/a

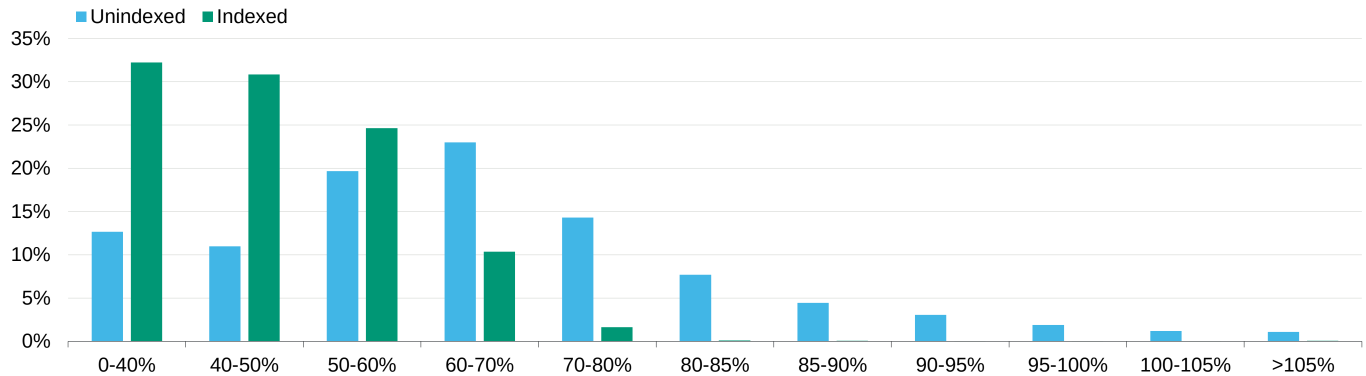
(note *) Typically borrowers with a previous personal bankruptcy or borrowers with record of court claims against them at time of origination
(note **) This "other" type refers to loans directly to Housing Cooperatives and to Landlords of Multi-Family properties (not included in Buy to Let).
Source: Moody's Investors Service, issuer data

Residential mortgage loans

Exhibit 10
Cover pool characteristics

Exhibit A

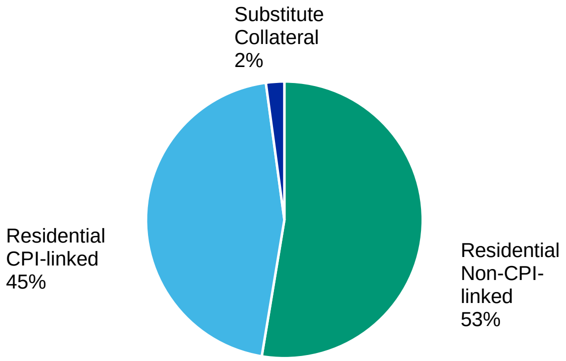
Loan Balance per LTV Band on an unindexed and indexed property value basis



Sources: Moody's Investors Service and issuer data

Exhibit B

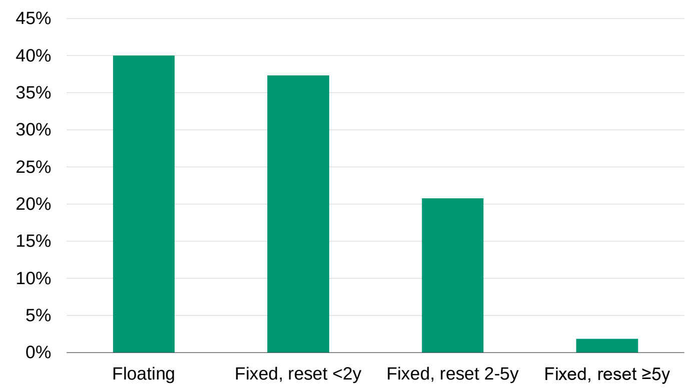
Percentage of residential assets



Sources: Moody's Investors Service and issuer data

Exhibit C

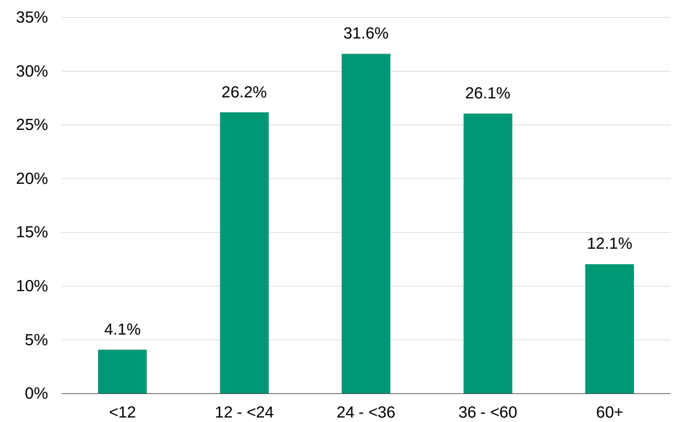
Interest rate type



Sources: Moody's Investors Service and issuer data

Exhibit D

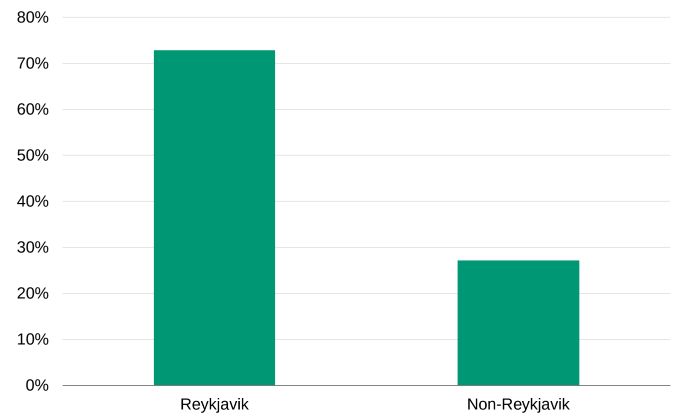
Seasoning (in months)



Sources: Moody's Investors Service and issuer data

Exhibit E

Regional distribution



Sources: Moody's Investors Service and issuer data

Substitute assets

Substitute assets are limited to 20% of the total cover pool assets (the regulator may approve a higher share, up to 30% of the cover pool value).

Of the cover assets, ISK 7.3 billion (2.1%) are substitute assets. The substitute assets currently consist primarily of cash collateral reserves (deposits) held at the issuer. These cash deposits are held at banks rated at least Baa3.

Besides those substitute assets that are counted as part of the cover pool and hence constitute OC for our rating purposes, there is potentially also euro cash collateral (deposits) that is for Moody's analysis not considered in the OC calculation as far as it is posted to mitigate FX risk under the FX risk covenant and swap collateral posting. (“See section: Covered bond analysis”)

Cover pool monitor

Pursuant to the Icelandic covered bond legislation, the issuer shall appoint an independent cover pool inspector ('asset monitor'), validated by the regulator. The inspector's tasks include (1) monitoring the registry of cover pool assets, derivatives, and bonds, (2) verifying that the issuer's cover asset valuations comply with the legal framework's principles and (3) ensuring that the issuer complies with matching and market risk limits. The cover pool inspector reports to the FSA on a semi-annual and ad-hoc basis, based on on-site inspections and sample surveys.

The inspector is required to notify the regulator immediately of any circumstances that may results in a violation of the law or in a situation in which the issuer is unable to meet its obligations under the covered bond programme.

Cover pool analysis

Primary cover pool analysis

The result of our cover pool analysis is the collateral score. We calculate the collateral score using a scoring model for the residential mortgages in the cover pool. Our analysis takes into account, among other things, the impact of concentration on borrower, regional and country levels, as well as the different types of properties securing the loans.

For this programme, the collateral score of the current pool is 13.4%. For comparison, the average collateral score across EMEA for residential covered bond programmes is 7.8%. (For details, see “Moody's Global Covered Bonds Sector Update, Q3 2023”)

Iceland's covered bond legislation allows residential mortgages (LTV limit: 80%), commercial mortgages (60%) and agriculture mortgages (70%) secured on properties located in the EEA, Switzerland, and Faroe Islands as cover pool assets. Arion Bank's covered bond license is for a cover pool of residential and a limited amount of commercial mortgages, and we understand Arion Bank's intention is to solely use residential mortgages (and substitute assets) to form the cover pool.

Around 46% of Iceland's mortgages are CPI-linked, which means their principal balance and hence the regular amortization amount, and interest payments, are adjusted according to the consumer price index (CPI index) based on the movement of the CPI index from a point fixed at the date of loan origination. Movements can be in either direction but are floored to the original index point, hence preventing the erosion of principal lower than the initial outstanding amount (this principle also applies to CPI-linked covered bonds).

There is a wide product offering for mortgage borrowers. For example, CPI-linked as well as non-CPI-linked mortgages are offered with floating or fixed interest rates (fixing periods typically up to 5 years). Borrowers tend to choose different products or a combination of both parts, with the ability to transition between product types during the loan term, as agreed with the lender.

Arion's property valuations are based on the national registry which provides appraisals on all Icelandic properties that are updated annually, for the purposes of taxation and fire insurance. These appraisals are based on key property characteristics recorded for each property but do not involve internal or external inspections.

The following factors support the credit quality of the pool:

» 99.6% of the assets are performing. We expect the cover pool quality to remain high given mortgages that have been in arrears for 90 days or more will be regarded as non-performing and will be assigned a value of zero when counting the cover pool value for statutory OC purposes. There is no legal obligation to remove such loans from the cover pool. Restructured loans are counted as cover pool assets only if the bank expects full repayment.

» In the cover pool, mortgage loans are counted as cover pool assets only up to the LTV limits (80% for residential mortgages). There is a soft LTV limit whereby if the value of property declines so that the LTV limit is breached, the amount of the related loan that counts for the coverage test is reduced, but the entire loan remains registered in the cover pool and available to covered bond investors on a priority basis vis-à-vis other creditors of the issuer.

» All of the residential mortgage loans are denominated in Icelandic Krona (local currency). Therefore, borrowers are not exposed to currency risk.

» 90% of the properties in the pool are the main residence of the borrower, hence supporting the likelihood of repayment as borrowers will be strongly incentivized to avoid foreclosure.

We view the following characteristics as credit negative:

» The pool is highly concentrated in several aspects, which is to be expected considering the population of Iceland is roughly 375,000 people. The concentrations include a low loan count of 14,939 and a high regional concentration of mortgage loans in the capital of Reykjavik (72.9%). On a country level, there are other concentrations, for example more than 70% of the country's export revenues come from three sectors: tourism (23% of total in 2021), marine products (24%) and aluminium (23%). A downturn in one of these sectors could lead to the deterioration of mortgage loan constituting a significant proportion of the cover pool.

» 46% of mortgages in the cover pool are CPI-linked. Borrowers of CPI-linked mortgages face a back loaded principal repayment profile and higher debt service at the end of the loan term than borrowers of non-CPI-linked mortgages. However, interest rates for CPI-linked mortgages tend to be lower and more stable in comparison to non-CPI-linked mortgages. This is because capital providers are compensated due to the increase in principal linked to inflation in the case of CPI-linked mortgages. This stability can be a mitigant in periods of high inflation or rising interest rate environments because there is a lower immediate spike of the borrower's debt service burden than in the case of non-CPI-linked mortgages.

» 40% of the mortgages have floating interest rates and 24% of the cover pool are non-CPI-linked with floating interest, which exhibit higher interest rate fluctuations than the CPI-linked loans and hence may lead to higher pool arrears due to increasing debt service payments.

» The cover pool has a short weighted average seasoning of 3.1 years.

Comparables

Exhibit 11

Arion Bank hf. - Mortgage Covered Bonds and other selected deals

PROGRAMME NAME	Arion Bank hf. - Mortgage Covered Bonds	Luminor Bank AS - Mortgage Covered Bonds	Raiffeisenbank a.s. - Mortgage Covered Bonds	Yorkshire Building Society - Mortgage Covered Bonds
Overview				
Programme is under the law	Iceland	Estonia	Czech Republic	United Kingdom
Main country in which collateral is based	Iceland	Lithuania	Czech Republic	UK
Country in which issuer is based	Iceland	Estonia	Czech Republic	UK
Total outstanding liabilities	ISK 333,960,450,878	EUR 1,750,000,000	CZK 9,048,249,000	GBP 4,765,050,000
Total assets in the Cover Pool	ISK 341,264,284,152	EUR 3,052,617,711	CZK 29,122,304,283	GBP 7,722,383,965
Issuer name	Arion Bank hf.	Luminor Bank AS	Raiffeisenbank, a.s.	Yorkshire Building Society
Issuer CR assessment	A2(cr)	A2(cr)	A2(cr)	A1(cr)
Main collateral type	Residential	Residential	Residential	Residential
Collateral types	Residential 98%	Residential 97%	Residential 100%	Residential 100%
Ratings				
Covered bonds rating	Aa2	Aa1	Aa1	Aaa
Entity used in Moody's EL & TPI analysis	Arion Bank hf.	Luminor Bank AS	Raiffeisenbank, a.s.	Yorkshire Building Society
CB anchor	A1	A1	A1	Aa3
CR Assessment	A2(cr)	A2(cr)	A2(cr)	A1(cr)
LT Deposit	A2	A3	A3	A3
Unsecured claim used for EL analysis	Yes	Yes	Yes	Yes
Value of Cover Pool				
Collateral Score	13.4%	10.0%	6.3%	4.0%
Collateral Score excl. systemic risk	n/a	n/a	n/a	3.5%
Collateral Risk	9.0%	6.7%	4.2%	2.7%
Market Risk	19.2%	11.1%	28.8%	11.8%
Over-Collateralisation Levels				
Committed OC*	5.0%	5.0%	10.0%	10.5%
Current OC	7.7%	74.4%	221.9%	62.1%
OC consistent with current rating	0.0%	0.5%	13.0%	5.5%
Surplus OC	7.7%	73.9%	208.9%	56.6%
Timely Payment Indicator & TPI Leeway				
TPI	Very Improbable	Improbable	Improbable	Probable
TPI Leeway	2	1	1	3
Reporting date	30 September 2023	30 June 2023	30 June 2023	30 June 2023

*We consider this level of OC as committed according to our methodology even though the level of OC provided via the asset cover test might be higher because the issuer could reduce the level of OC down to this level without a rating impact on our covered bond rating.
Source: Moody's Investors Service

ESG considerations

We assess Environmental, Social and Governance (ESG) credit risks in our analysis based on general principles described in detail in the ESG cross-sector rating methodology available on moodys.com.

Environmental considerations

Overall exposure to meaningful environmental credit risks is low in this programme due to the issuer's liability to make payment on the covered bonds. In the event of shocks in connection with regulation or physical hazards, the impact on property collateral will be partly mitigated by borrowers' liability to repay mortgage loans regardless of property value.

Covered bonds are exposed to event risk, including disruptions from volcanic and seismic activity along two major fault lines. Iceland's unique geological features imply some exposure to physical climate risks but also offer opportunities for the country's key sectors. For example, around 11% of Iceland's land mass consists of glaciers; while the melting of glaciers increases the risk of landslides, it also increases the availability of hydropower, at least for several decades.

In respect of physical risks to the cover pool, the geographical diversification of the cover pool is low. The largest concentration is with 75% in the capital city of Reykjavik. By Icelandic law, all households are required to insure against fires. A small portion of the fire insurance premium goes to the Natural Catastrophe Fund which insures all households against earthquakes, volcanic eruptions, landslides, avalanches, and floods.

Social considerations

Overall exposure to social factors is moderate for this programme. Covered bond holders benefit from the issuer's liability to make payments on the covered bonds, meaning the bondholders will not be directly exposed to social factors affecting the cover pool unless the issuer defaults. Misconduct, poor handling of data security and customer privacy breaches by lenders are the most significant social risks that may in due course affect the credit quality of the cover pool, although lenders' financial and operational flexibility and track record of adjusting to social issues may mitigate this.

Social factors that potentially affect the cover pool have varied implications. Social risks can arise from changing demographic trends such as aging, urbanization, an increase in telecommuting and flight from cities, population declines or ways of living trends in general that impact the supply or demand for housing in particular areas, which can reduce home values. Societal and demographic trends will be relevant but typically develop over an extended time frame that smooths out materiality for expected loss.

Social issues may also be driven also by a political agenda related to housing and consumer protection, particularly in down cycles, creating pressure on recovery values. Borrower-friendly legislation as a reaction to consumer activism can affect both the underwriting and the servicing of mortgage loans in the cover pool. For example, during the 2008 financial crisis, Iceland's government modified the terms of CPI-linked mortgages so that interest payments were linked to a wage price inflation rather than consumer price inflation (with resulting reduction in debt servicing costs being added to the principal balance of mortgages). Social policy-driven decisions in Iceland, such as lowering underwriting standards at government-sponsored enterprises to increase homeownership, would reduce the credit quality of the cover pool.

Governance considerations

Overall exposure to meaningful governance credit risks is low in this programme due to covered bonds' dual recourse to both issuer and cover pool and the considerations set out below.

The principal sources of governance for this programme are: (i) Icelandic covered bond law; (ii) key programme participants' adherence to obligations; and (iii) the operational and substantive provisions of the programme documents. In this programme, there are control mechanisms in place that are designed to protect covered bondholders from mistakes, misallocation of cash flows and misappropriation of assets, and that promote compliance with the covered bond legal framework and operational and reporting requirements.

In particular, we note that (i) the issuer is a regulated credit institution and maintains the cover pool on its balance sheet, incentivising it to maximise cover pool value and aligning its interest with that of covered bond investors; (ii) the cover pool inspector is a role prescribed by the covered bond law and owes duties to bondholders; (iii) the covered bond law contains provisions addressing treatment of ineligible and non-performing assets and contains detailed reporting requirements; and (iv) there is a high level of legal certainty over the segregation of the cover pool and the parties' respective rights to it.

Methodology and monitoring

The primary methodology we use in rating the issuer's covered bonds is "Moody's Approach to Rating Covered Bonds", published in December 2023. Other methodologies and factors that may have been considered in the rating process can also be found on https://ratings.moodys.com. In addition, we publish a weekly summary of structured finance credit, ratings and methodologies, available to all registered users of our website, at //www.moodys.com/SFQuickCheck.

We expect the issuer to deliver certain performance data to us on an ongoing basis. In the event that this data is not made available to us, our ability to monitor the ratings may be impaired. This lack of data availability could negatively affect the ratings or, in some cases, our ability to continue to rate the covered bonds.

Appendix: Income underwriting and valuation

A. Residential Income Underwriting	
1 Is income always checked?	Yes
2 Does this check ever rely on income stated by borrower ("limited income verification") ?	No, only official government databases used. Sometimes borrowers have new employment contracts or revenues from lease agreements that we take into consideration in our payment assessment
3 Percentage of loans in Cover Pool that have limited income verification	N/A
4 If limited income verification loans are in the Cover Pool, describe what requirements lender has in place for these loans.	N/A
5 Does income in all cases constrain the amount lent (for example through some form of Income Sufficiency Test ("IST")?	Yes
6 If not, what percentage of cases are exceptions.	N/A
For the purpose of any IST:	
7 Is it confirmed that income after tax is sufficient to cover both interest and principal?	Yes
8 If so over what period is it assumed principal will be paid (typically on an annuity basis)? Any exceptions?	25 years for CPI-linked mortgages, 40 years for non-CPI-linked mortgages
9 Does the age of the borrower constrain the period over which principal can be amortised?	No
10 Are any stresses made to interest rates when carrying out the IST? If so when and for what type of products?	No
11 Are all other debts of the borrower taken into account at the point the loan is made?	Yes
12 How are living expenses of the borrower calculated? And what is the stated maximum percentage of income (or income multiple if relevant) that will be relied on to cover debt payments. (specify if income is pre or post tax)	Statistical agency data, financial supervisor guidelines
Other comments	

B. Residential Valuation	
1 Are valuations based on market or lending values?	Valuations are either based on official property valuation as determined by the Icelandic Housing and Construction Authority (refinance) or purchasing agreement.
2 Are all or the majority of valuations carried out by external valuers (with no direct ownership link to any company in the Sponsor Bank group)?	No, only a tiny amount of valuations are carried out by certified realtors. This is very much the exception and has been for the last 2-3 years.
3 How are valuations carried out where an external valuer not used?	Only certified realtors are allowed to turn in a valuation and the Credit Officer of Arion banki has listed the names of those on the intranet. The bank also buys property valuations from Invector/Gangverd but these are not used in the mortgage underwriting
4 What qualifications are external valuers required to have?	Certified realtors working at and realtor office that the bank trust based on their reputation, market share and history
5 What qualifications are internal valuers required to have?	Internal valuations are not being practised. The bank only uses inhouse calculations to calculate building costs if individuals need financing during construction
6 Do all external valuations include an internal inspection of a property?	No
7 What exceptions?	N/A
8 Do all internal valuations include an internal inspection of a property?	No
9 What exceptions?	N/A
Other comments	

Source: Arion Bank

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