MOODY'S
RATINGS

Rating Action: Moody's Ratings affirms Arion Bank hf.'s and Islandsbanki's A2 long-term deposit and A3 long-term issuer ratings with stable outlook, following potential merger announcement

18 Feb 2025

London, February 18, 2025 -- Moody's Ratings (Moody's) affirmed Islandsbanki's (ISB) and Arion Bank hf.'s (Arion) A2 long-term and P-1 short-term foreign and local currency deposit ratings, the A3 long-term foreign and local currency issuer ratings and A3 senior unsecured ratings with stable outlooks on the long-term ratings, the baa2 Baseline Credit Assessment (BCA) and Adjusted BCA.

We have also affirmed the senior unsecured, junior senior unsecured and subordinated local and foreign currency medium-term note (MTN) program ratings at (P)A3, (P)Baa2 and (P)Baa3 respectively. The long- and short-term Counterparty Risk Ratings (CRR) of A2/P-1 and long- and short-term Counterparty Risk Assessments (CR Assessment) of A2(cr)/P-1(cr) were also affirmed. Arion's preferred stock rating of Ba2 (hyb) was also affirmed.

The rating action follows the announcement from Arion that its board of directors has proposed opening merger talks with the board of directors of Islandsbanki. Any transaction would be subject to a range of approvals from the Competition Authority and the Central Bank as well as the Icelandic government, in its capacity as a shareholder in ISB currently owning 42.5% of its share capital.

RATINGS RATIONALE

The affirmation of Arion's and ISB's BCAs and subsequent ratings reflects that the credit profiles of both banks benefit from similar performance characteristics and a potential successful merger between the two entities could benefit from economies of scale, resulting in improved efficiencies.

We also note that the proposed merger is a large undertaking and more complex than the more modestly-sized acquisitions that both banks have previously targeted, resulting in heightened operational risks. However, these short term risks are balanced by medium term benefits, in the form of improved liquidity in the financial markets leading to lower funding costs and better market access.

For a transaction to proceed, the shareholders of both banks would need to endorse the terms of the potential merger. The board of ISB has yet to substantively respond to the indicative offer. Furthermore due to the large market share the two banks command in the domestic market, there is heightened uncertainty in relation to the proposed transaction securing regulatory approvals from the Icelandic Competition Authority.

OUTLOOK

The stable outlook on Arion's and ISB's long-term deposit and issuer ratings, reflects our expectation that the underlying performance of both banks will remain sound in the next 12-18 months. The stable outlook also reflects our expectation that the medium term benefits of a potential merger transaction between the two entities counterbalance the integration and operational related risks, resulting in an entity with similar credit fundamentals to the individual banks.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Upward pressure could develop if Arion and ISB, on a standalone basis, improve further their risk profiles by reducing single name and sector concentrations in combination with a reduction in the use of market funds while maintaining strong capitalisation and strong earnings' generation capacity across the credit cycle. For the long-term issuer ratings, upward rating pressure could also develop because of a larger cushion of loss absorbing obligations protecting creditors in case of failure.

Downward pressure for Arion and/or ISB could emerge if a merger process resulted in deteriorating fundamental standalone performance and/or due to crystallization of higher risks related to the integration of the two entities leading to increased operational risks.

In addition Arion's and ISB's standalone ratings could be downgraded if (1) asset quality and risk profile was to deteriorate, for example as a result of increased exposures to more volatile sectors and/or increased single name concentrations; (2) risk profile increases driven by non-credit related risks such as market risk and foreign exchange risk and/or increasing CPI imbalance; (3) recurring profitability weakens significantly limiting the bank's internal capital generation; (4) financing conditions were to become more difficult; or (5) the macroeconomic environment deteriorates significantly leading to a lower Macro Profile. Furthermore, a reduction in the rating uplift as a result of our Advanced Loss Given Failure (LGF) analysis triggered by structural funding changes to the bank's balance sheet could lead to downward rating pressure.

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Banks published in November 2024 and available at https://ratings.moodys.com/rmc-documents/432741 . Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of this methodology.

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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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