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Moody's assigns definitive Aa2 to Arion Bank hf. - Mortgage Covered Bonds

Rating Action | *6 min read* | 14 Dec 2023 Moody's Investors Service

London, December 14, 2023 -- Moody's Investors Service ("Moody's") has today assigned definitive Aa2 long-term ratings to the euro-denominated mortgage covered bonds issued by Arion Bank hf. ("Arion Bank" or "the Issuer", LT Bank Deposits A2 Stable; Adjusted Baseline Credit Assessment baa2; LT Counterparty Risk (CR) Assessment A2(cr)), which are governed by the Icelandic covered bond act.

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cover pool). The ratings therefore reflect the following factors:

(1) The credit strength of Arion Bank hf. (LT Bank Deposits A2 Stable; Adjusted Baseline Credit Assessment baa2; CR Assessment A2(cr)) and a CB anchor of A1;

(2) Following a CB anchor event the value of the cover pool. The stressed level of losses on the cover pool assets following a CB anchor event (cover pool losses) for this transaction is 28.1%;

(3) Iceland's foreign currency country ceiling constrains the rating at Aa2.

Moody's considered the following factors in its analysis of the cover pool's value:

a) The credit quality of the assets backing the covered bonds. The mortgage covered bonds are backed by Icelandic residential mortgage loans. The collateral score for the cover pool is 13.4%;

b) The support provided by the Icelandic covered bond law.

c) The exposure to market risk, which is 19.1% for this cover pool.

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constrain the rating.

At present, the total value of the assets included in the cover pool is approximately ISK 341.3 billion, comprising 14,939 residential mortgage loans and substitute assets. The residential mortgage loans have a weighted-average (WA) seasoning of 37 months and WA unindexed and indexed loan-to-value (LTV) ratios of 62.8% and 44.9%, respectively. 44% of the mortgages in the cover pool and 39% of outstanding covered bonds are indexed to inflation.

KEY RATING ASSUMPTIONS/FACTORS

Moody's determines covered bond ratings using a two-step process: an expected loss analysis and a TPI framework analysis.

EXPECTED LOSS: Moody's uses its 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

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notch.

The cover pool losses for Arion Bank hf. - Mortgage Covered Bonds are 28.1%. This is an estimate of the losses Moody's currently models following a CB anchor event. Moody's splits cover pool losses between market risk of 19.1% and collateral risk of 9.0%. 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. Moody's derives collateral risk from the collateral score, which for this programme is currently 13.4%.

The over-collateralisation in the cover pool is 7.7%, of which the issuer provides 5.0% on a "committed" basis. Under Moody's COBOL model, the minimum OC consistent with the Aa2 rating is 0% (OC numbers on a nominal basis). These numbers show that Moody's is not relying on "uncommitted" OC in its expected loss analysis.

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TPI FRAMEWORK: Moody's assigns 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.

RATING METHODOLOGY

The principal methodology used in these ratings was "Moody's Approach to Rating Covered Bonds" published in December 2023 and available at https://ratings.moodys.com/rmc-documents/412158. 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 Moody's might lower the

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notches. This implies that Moody's might downgrade the covered bonds because of a TPI cap if it lowers the CB anchor by 3 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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