S&P Global
Ratings

Research

Presale:

Arion Bank hf. Mortgage Covered Bond Program

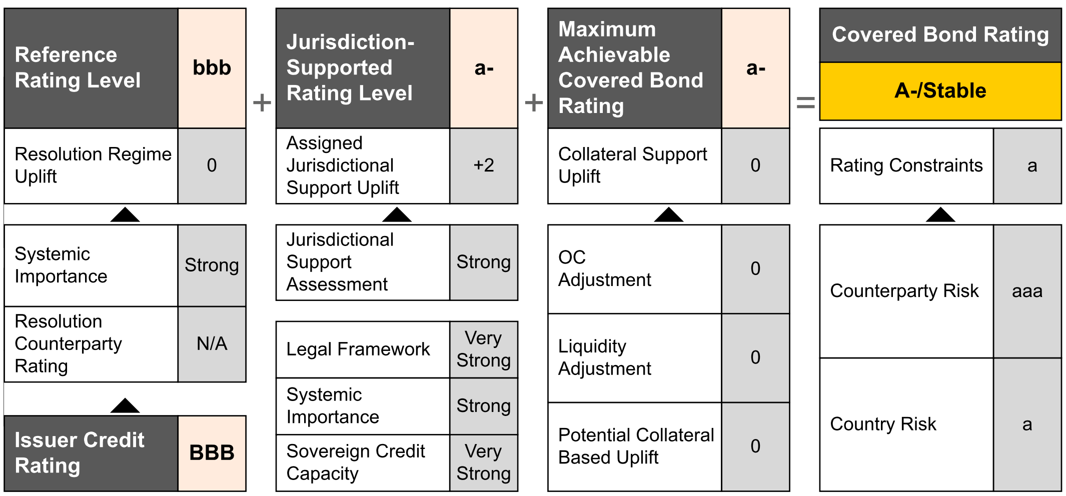
September 20, 2021

PRIMARY CREDIT ANALYST

Tristan Gueranger, CFA
London
+ 44 20 7176 3628
tristan.gueranger
@spglobal.com

SECONDARY CONTACT

Matteo Lanza
London
+ (44)2071766026
matteo.lanza
@spglobal.com



Major Rating Factors

Strengths

- The covered bond program benefits from strong jurisdictional support in Iceland.
- Icelandic legislation contains provisions related to foreign currency risk in the program, which allow us to assign a rating commensurate with jurisdictional support.

Weaknesses

- We need further clarity about the legislative and practical implementation of Iceland's Bank Resolution Act before we are able to assess the framework's implications for the bank's covered bonds.
- The available credit enhancement is not sufficient to assign any notches of collateral-based

uplift.

- The foreclosure frequency is driven by relatively high loan-to-value (LTV) and loan-to-income ratios.
- In our loss severity calculation, we assume a higher adjustment for inflation-linked mortgages to reflect their added risk on the borrower's home equity compared to non-indexed ones.

Rationale

S&P Global Ratings has assigned its preliminary 'A-' long-term credit rating to Arion Bank hf.'s covered bond program, its inaugural euro-denominated issuance, and all outstanding Icelandic krona (ISK)-denominated issuances (see "Arion Bank's Covered Bond Program And Related Issuances Assigned Preliminary 'A-' Ratings; Outlook Stable").

Our covered bond ratings process follows the methodology and assumptions outlined in our "Covered Bonds Criteria," published on Dec. 9, 2014, and "Covered Bond Ratings Framework: Methodology And Assumptions," published on June 30, 2015.

From our analysis of the legal and regulatory framework for Icelandic covered bonds, we concluded that the assets in the cover pool are isolated from the issuer's insolvency risk. The asset isolation allows us to rate the covered bond program at a higher rating level than the long-term issuer credit rating (ICR) on Arion Bank.

We conducted a review of Arion Bank's mortgage operations, which we view as prudent. We believe satisfactory procedures are in place to support our ratings on the covered bonds.

Arion Bank is domiciled in Iceland, which has recently adopted the EU's Bank Recovery and Resolution Directive (BRRD). However, at this stage, we do not consider the Icelandic regime to be fully effective, therefore we equalize the reference rating level (RRL) of the program with the ICR on the issuer (see "Icelandic Bank Resolution Act Completes The European Map, But Implementation And Effectiveness Remain Unclear," published on Sept. 1, 2020).

We considered the likelihood for the provision of jurisdictional support. According to our criteria, covered bonds in Iceland have a strong systemic importance. In addition, we consider both the legal framework and the sovereign credit capacity to be very strong. Therefore, our jurisdictional support assessment for mortgage covered bond programs in Iceland is strong (see "Assessments For Jurisdictional Support According To Our Covered Bonds Criteria," published on Nov. 27, 2020). As a result, we assign two notches of uplift from the RRL, and the jurisdiction-supported rating level (JRL) is 'a-'.

We have reviewed the asset information provided as of June 30, 2021. The portfolio comprises solely Icelandic residential mortgages. Based on our cash flow analysis, the available credit enhancement does not exceed the target credit enhancement (TCE) and does not allow us to assign any notches of collateral-based uplift. In our view, the planned euro issuance will introduce currency risk in the transaction, which drives the TCE significantly higher than the available overcollateralization. As a result, the rating on the covered bond program is equalized with the JRL of 'a-'.

There are currently no rating constraints to the 'A-' ratings relating to legal, counterparty, or operational risks. The outlook on the program is stable, reflecting the outlook on the issuer.

Program Description

Table 1

Program Overview*

Jurisdiction	Iceland
Year of first issuance	2011
Covered bond type	Legislation-enabled
Outstanding covered bonds (bil. ISK)§	205.040
Redemption profile	Soft-bullet, amortizing§
Underlying assets	Residential mortgages
Jurisdictional support uplift	2
Unused notches for jurisdictional support	0
Target credit enhancement (%)	N/A
Credit enhancement commensurate with rating (%)†	0.33
Minimum contractual credit enhancement (%)	5.0
Available credit enhancement (%)	26.2
Collateral support uplift	0
Unused notches for collateral support	0
Total unused notches	0

*Based on data as of June 30, 2021. §Including accrued inflation for index-linked covered bonds. §All bonds, including the planned euro issuance, are soft-bullet, except for Series CBI 48, which is amortizing. †Credit enhancement commensurate with the rating based on coverage of commingling risk. N/A--Not applicable.

The issuer is a universal bank based in Iceland providing services for households, corporates, and institutional investors. The bank is privately owned and is the second largest provider of mortgages in Iceland and the third largest bank in terms of total assets. Following the financial crisis that hit the Icelandic banks in 2008, mortgage arrears reached very high levels. However, arrears have steadily decreased since 2010 to low levels now comparable to most other European banks, reflecting more prudent underwriting standards.

Established in November 2011, the Arion Bank program issues covered bonds secured by a portfolio of mortgages on residential properties located in Iceland, as well as some cash.

The issuer has contractually committed to a minimum of 5% overcollateralization. The license delivered by the Central Bank of Iceland (CBI) instructs that overcollateralization must not exceed 30% (except for collateral posting in the euro-denominated issuance). As a result, available overcollateralization in the program fluctuates between these two boundaries.

Covered Bond Program

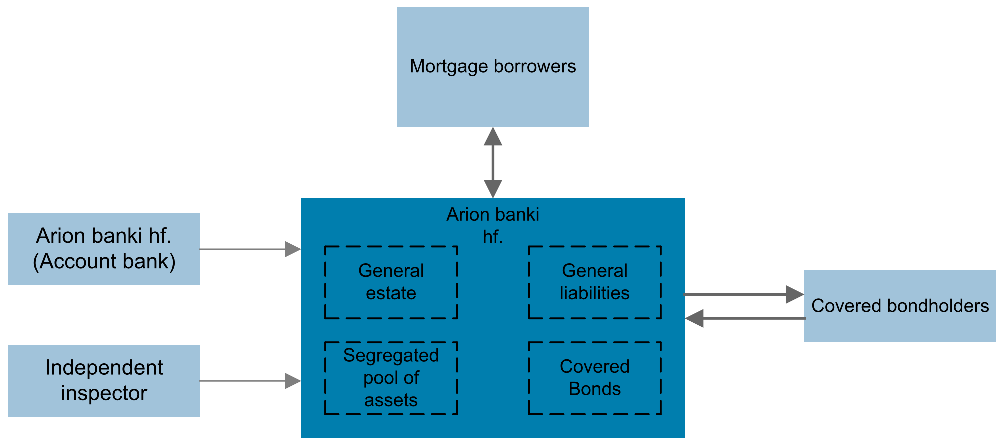


Table 2

Program Participants

Role	Name	Rating	Rating dependency
Issuer	Arion Bank hf.	BBB/Stable/A-2	Yes
Bank account provider	Arion Bank hf.	BBB/Stable/A-2	Yes
Originator	Arion Bank hf.	BBB/Stable/A-2	No
Servicer	Arion Bank hf.	BBB/Stable/A-2	No
Arranger	Barclays Bank PLC	A/Positive/A-1	No

Rating Analysis

Legal and regulatory risks

We analyze legal risks by applying our "Structured Finance: Asset Isolation And Special-Purpose Entity Methodology," published on March 29, 2017 and Covered Bond Ratings Framework: Methodology And Assumptions," published on June 30, 2015.

The covered bonds are secured by mortgage assets on the issuer's balance sheet pursuant to the Act on Covered Bonds adopted by the Icelandic Parliament on March 4, 2008. Under this framework, cover pool assets are kept in a register by the issuer. This ensures that, upon Arion Bank's insolvency, the cover pool will remain at all times segregated from the issuer's insolvency estate until covered bonds are fully repaid.

The issuance of covered bonds requires a license from the CBI, which is also the supervisory authority for the covered bond program. The issuer must also appoint an independent inspector to supervise the issuance of covered bonds and the CBI must approve this appointment.

We generally consider setoff risk in Iceland unless specifically mitigated by the issuer. The program has a provision to cover deposit setoff risk through an asset coverage test, however this feature does not affect our analysis, given that we rate the covered bonds only on the basis of our jurisdictional support assessment.

We believe that the framework addresses the main legal aspects that we assess when looking at covered bond legislation, in particular the isolation of the cover pool assets from the risk of bankruptcy or insolvency of the issuer. As a result, in our opinion, the ratings on the covered bonds can exceed the ICR on the issuer.

Eligibility criteria

The cover pool may only consist of mortgages on real property designated for residential purposes, and an on-demand deposit with a financial institution. Residential mortgages may form part of the cover pool only to the extent that on the date of registration, the collateral's LTV ratio does not exceed 80% of the property's market value.

The market value of properties is based on either a property valuation carried out by Registrar Iceland, which maintains the national property register, updated annually, or on the purchase price for newly acquired properties.

The mortgages may not be registered in the cover pool if payment is in arrears of 90 days or more.

Operational and administrative risks

Based on our operational risk analysis, which covered a review of origination, underwriting, collection, and default management procedures, as well as cover pool management and administration, we view Arion Bank's underwriting criteria as prudent. We conclude that the ratings on the covered bonds are not constrained by operational risk.

Our analysis of operational risk follows the principles laid out in our covered bond ratings framework and our covered bonds criteria.

Resolution regime analysis

On June 24, 2020, the Icelandic Parliament adopted a bill transposing the EU's BRRD into local legislation. However, we do not currently give any benefit to these provisions, as we consider that the effectiveness of the new legislation needs further clarity. As a result, the RRL on the issuer is the same as its ICR.

Jurisdictional support analysis

In our jurisdictional support analysis, we assess the likelihood that a covered bond program facing stress would receive support from a government-sponsored initiative instead of from the liquidation of collateral assets in the open market.

The euro issuance will give rise to unhedged foreign currency risk, however we understand that the local legislation includes provisions to address foreign currency, as well as interest rate risks. Given the existence of such provisions, we assume jurisdictional support for the covered bond program.

In order for the covered bonds to reach the JRL, the program only needs to cover commingling risk (currently equivalent to 0.33% of the outstanding covered bonds), although contractually the program needs to cover a 5.0% overcollateralization. As of June 30, 2021, the available overcollateralization including cash was 26.25%.

Under our criteria, we consider that covered bonds in Iceland have a strong systemic importance and we deem both the legal framework and the sovereign credit capacity to be very strong. As a result, our jurisdictional support assessment for mortgage covered bond programs in Iceland is strong. Therefore, we assigned two notches of uplift from the RRL, and the JRL is 'a-'.

Collateral support analysis

The cover pool comprises Icelandic residential mortgages and cash (see table 9). We base our analysis on loan-by-loan data as of the June 30, 2021, cutoff date.

All mortgages are amortizing, first lien, and are lent on owner-occupied properties. About 47.9% of mortgages pay interest based on a standard variable rate, 49.5% are fixed reset (with either a three-year or a five-year interest rate reset frequency), and 2.7% are fixed for life. Approximately 52% of the mortgages are inflation-linked, for which interest and amortizing principal are paid based on the outstanding principal balance adjusted for inflation monthly.

Most properties (72.7%) are located in the Capital Region, reflecting the concentration of the population in the Reykjavík area.

We analyzed Arion Bank's mortgage cover pool based on our "Global Methodology And Assumptions: Assessing Pools Of Residential Loans", published on Jan. 25, 2019. We also used specific assumptions reflecting the Icelandic mortgage market (see below).

We assess the credit quality of a typical residential mortgage cover pool by estimating the credit risk associated with each mortgage in the pool.

We then calculate the aggregate risk to assess the cover pool's overall credit quality. To quantify the potential losses associated with the entire pool, we weight each mortgage's foreclosure frequency and loss severity by its percentage of the total pool balance. The product of this weighted-average foreclosure frequency (WAFF) and weighted-average loss severity (WALS) estimates the required loss protection, assuming all other factors remain unchanged.

As of June 30, 2021, we estimate a WAFF of 26.69%. The WAFF is comparatively higher than the base foreclosure frequency of 18.00%. This is due to the elevated share (15.5% of the pool) of current LTV ratios above 80% (after adjusting for an estimated overvaluation of 18.02%), above our archetypal LTV of 75%, as well as adjustments we make for high loan to income ratios, for which we apply a 1.5x adjustment to over half of the pool.

In this program, we base our LTV calculations solely on the current LTV ratio as we consider it to be a better indicator of relative risk, in the absence of comprehensive information on original LTV.

The WALS of 52.07% is relatively high compared to other Nordic issuers, mostly due to the 1.875x adjustment for inflation-linked mortgages.

In assessing the credit quality of an Icelandic residential mortgage pool, we analyze the portfolio benchmarked against a defined archetypal pool.

Our mortgage market analysis (MMA) in a given jurisdiction consists of an assessment on a six-point scale ranging from very low risk to extremely high risk. The MMA for Iceland is intermediate risk according to the subfactors listed in table 3.

Table 3

Subfactors

Factors	Subfactors (description from global criteria)	Iceland
Economic risk		
Economic resilience	Economic structure and stability, macroeconomic policy flexibility, and political risk.	Intermediate risk
Economic imbalances	Expansionary phase, private-sector credit growth, residential real estate prices, equity prices, and current-account balance and external debt position; or correction phase and expected impact on the banking sector.	Intermediate risk
Credit risk in the economy	Private-sector debt capacity and leverage, lending and underwriting standards, payment culture, and rule of law.	Intermediate risk
Industry risk		
Institutional framework	Banking regulation and supervision, regulatory track record, and governance and transparency.	Intermediate risk
Competitive dynamics	Risk appetite, industry stability, and market distortions.	High risk
Market sensitivity	Unemployment variability and welfare support levels.	Low risk
Lender - recourse assessment	In practice or by law, lenders may predominantly only rely on the mortgaged property as collateral to repay the loan in the event a borrower defaults (we refer to this as limited recourse versus full recourse in other jurisdictions).	Full recourse
Mortgage market assessment	Six-point scale ranging from very low risk to extremely high risk.	Intermediate risk

By applying our residential loans criteria, we conclude that the MMA for Iceland is intermediate risk. Although the 'AAA' base foreclosure frequency for intermediate risk is typically 10% to 15%, we believe there are additional risks in the Icelandic mortgage market that are not captured in this assessment, in particular the prevalence of inflation-linked mortgages, which we deem riskier given stretched affordability in times of high inflation. In addition, we note a limited performance history on residential mortgages and the lack of an RMBS market. As a result, we assumed a 'AAA' base foreclosure frequency of 18%.

Based on the MMA assessment, we set the 'AAA' foreclosure frequency anchor for the archetypal pool for Iceland and the current 'B' foreclosure frequency assumption according to table 4.

Table 4

Foreclosure Frequency Assumptions

Rating level*	Archetypal foreclosure frequency (%)§
AAA	18.0
AA	14.4
A	10.8
BBB	7.4
BB	3.8
B	3.0

*Assumptions for intermediate rating levels are interpolated. §Intermediate rating levels numbers are rounded to the nearest tenth of a percent.

Archetypal pool

The archetypal pool in each jurisdiction or market represents a somewhat idealized version of the average pools historically observed.

Table 5

Iceland--Archetypal Pool

Characteristics by type	Archetypal features
Pool	Archetypal features from global criteria.
Pool size	At least 250 loans at issuance.
Originator	No adjustment factor related to the quality of the lender's underwriting or for features not specifically covered by other adjustments.
Geographic distribution	Diversified nationally.
Borrower type	Borrower is a private individual.
Employment type	Borrower is not self-employed.
Performance status	Not delinquent.
Borrower credit history	Borrower(s) do not have negative credit history.
Affordability	Originator has assessed the borrower's income.
Loan	
Currency/denomination	ISK
Seasoning	Up to 60 months.
Loan amortization profile	Fully amortizing at maturity.
Loan product	No payment shock feature and no initial interest-only discount period.
Security/lien status	First-lien mortgage on the property.
Interest rate	Fixed or floating rate.Inflation or non-inflation linked.
Loan purpose	Purchase of a residential property for owner occupation or refinancing the balance on an existing loan (where the lender has fully re-underwritten the loan).
LTV	75% (calculated weighting the original LTV and current indexed LTV in an 80:20 ratio).
Debt income at origination	The ratio of the loan balance to borrower's pretax annual income (income multiple) is a maximum 3.5x.
Origination	Originated by the issuer (i.e., not from third-party brokers or intermediaries).
Property	
Property type	Residential.
Occupancy status	Owner-occupied and primary residence.
Valuation method	Purchase price, full valuations assessed by a real estate appraiser.
Valuation amount	Up to the applicable jumbo valuation threshold.

LTV--Loan to value.

Specific adjustments for foreclosure frequency

Table 6 shows the foreclosure frequency adjustments for Iceland.

Table 6

Foreclosure Frequency Adjustments

Factor	Adjustment to foreclosure frequency	Comment
LTV*	Type 2 LTV curve: full-recourse market. See chart 1.	The LTV is calculated weighting 80% of the original LTV and 20% of the current LTV. The current LTV calculation incorporates any applicable valuation haircuts. For covered bonds only, the LTV may be based solely on the current LTV, and adjusted for our view of over/under valuation. We may also consider the maximum drawable balance, further advances, and purchase price in our analysis.
Originator adjustment	0.7x-1.3x or higher.	Applied at the loan or pool level.
Loan affordability	Typically 1.5x if income multiple is >5x; 1.2x if income multiple is >3.5x and, No adjustment for loans older than 18 months.	In the event of co-borrowers, we consider both incomes when determining the adjustment factor: 1.5x if income multiple is >3.25x; 1.2x if income multiple is >2.75x; and, No adjustment for loans older than 18 months.If the factor for combined income results in a greater adjustment than would have been the case using only one of the two incomes, then the lower adjustment is used for that loan.
Borrower occupancy status: investment property (BTL)	We typically apply adjustments for BTL loans of 1.70x. Typically, borrower-related adjustments like income multiple and self-employment do not apply to BTL loans.	We do not apply an interest-only adjustment to BTL loans as the sale of the property is a viable exit strategy for a borrower given the property is not their residence.
Borrower occupancy status: second home	We typically apply adjustments for second home loans-–such as vacation houses--of 1.30x.	
Adverse credit history	Originator adjustments apply to loans to borrowers with adverse credit history, for example reference agency registrations.	We do not apply adjustments for bankrupt borrowers, or prior repossessions when they occurred more than six years from the date of our analysis.
Payment shock	1.2x adjustment to mortgage loans, which allow the issuer to require amortization following a short interest-only period. The adjustment may be 1.1x if the loan switches to amortization more than 25 years before the maturity date.	Adjustments are applied to all loans considered to have the potential for an immediate and significant increase in monthly payment, for example flexible loans callable by the lender.
Interest only	Typically 1.5x or lower adjustment applied for the term of the loan.	A lower adjustment may be considered where we have evidence that the loan has been underwritten on a full repayment basis. Not applicable to BTL loans.
Geographic concentration	1.20x, which is applied to the excess above the regional concentration threshold. If a pool has significant geographic concentration risk that we believe is not sufficiently captured, we may increase the adjustment.	The region concentration thresholds (% of pool balance): Capital Region 65%, Southern Peninsula 15%, Western Region 10%, Westfjords 4%, Northwestern Region 4%, Northeastern Region 15%, Eastern Region 7%, Southern Region 15%.
Self-employed borrower	1.15x.	

Table 6

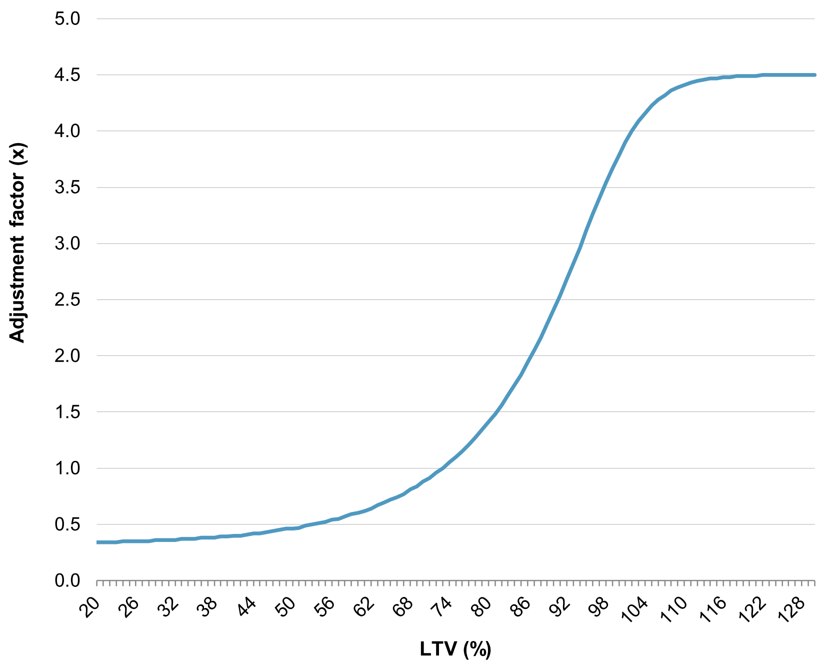
Foreclosure Frequency Adjustments (cont.)

Factor	Adjustment to foreclosure frequency	Comment
Reperforming loans	We apply adjustments for reperforming loans when a portfolio contains a material portion of reperforming loans. We typically apply adjustments for reperforming loans as follows. Months since last 90 days+ in arrears or restructure dates: >12 >24 >36: no adjustment. We may consider higher adjustments on a case-by-case basis, depending on the servicers' restructure policies, track record, and performance data provided.	We typically define a reperforming loan as a loan that has been 90 or more days past due or restructured in the three years leading up to the analysis date and is current as of that date. When a reperforming arrangement is made, it is typical that a full reassessment of the borrower's affordability capacity is made; we consider this akin to a reunderwriting of the loan. Accordingly, for pools classified as reperforming, we calculate potential future seasoning credit based on the date a loan was last 90 or more days in arrears or restructured. In addition to the original loan and borrower information provided, we may also consider updated data sourced through the restructuring process in our analysis of reperforming loans where available, on a case-by-case basis. In addition, as part of the analytical process, we analyze data from the issuer/servicer on re-default rates stratified by forbearance type. This analysis is used to calibrate the originator adjustment for such transactions.
Second lien loans	1.3x-1.7x.	1.3x: Where we consider that the loan does not have significant risk layering, or where the second lien was not taken out to consolidate debt (is akin to a further advance), and where there is data relating to the first lien holder. 1.5x: Where the borrower is using the second lien for consumption or consolidation of debt and where we consider that there is risk layering. 1.7x: Where there is insufficient data to back up other second lien adjustments. In all cases above the loan purpose adjustment does not apply.
Loan purpose	1.2x for cash-out loans, and/or equity release loans.	
Arrears	2.50x for loans currently 30-59 days delinquent; 5.0x for loans currently 60-89 days delinquent; 100% FF for loans currently 90 days or more delinquent.	As a proxy to the number of days in arrears we calculate arrears as the outstanding arrears balance/current monthly installment.
Seasoning (adjustment factors for loan seasoning)	0.75x for seasoning >5 and 6 and 0.65x for seasoning >7 and 0.60x for seasoning >8 and 0.55x for seasoning >9 and 0.50x for seasoning >10 years. Factor applies only to loans that are not in arrears.	If corresponding data are available, the criteria may consider the seasoning of the performing relationship between the borrower and the mortgage lender of an existing mortgage loan being refinanced, instead of seasoning of the new loan that results from such refinancing. For instance, a loan may have been refinanced with a new loan that has the same term or a shorter term, and the loan balance and interest rate are the same or lower. In that case, seasoning could be based on the origination date of the original loan rather than the date of the refinancing.

*The loan-level data is aggregated at a borrower level. In case of multiple properties securing a mortgage loan, the aggregation considers the characteristics of the largest security for the mortgage loan. LTV--Loan to value. BTL--Buy to let. FF--Foreclosure frequency.

Chart 1

Iceland LTV Curve



LTV--Loan to value.

Specific adjustments for loss severity

In our loss severity analysis, we apply a market-value decline (MVD) stress to the property valuations backing the mortgages and derive the MVD of the repossessed properties (repo MVD) after considering the effect of any over/undervaluation in the market and the forced-sale discount. The table below shows the loss severity adjustments for Iceland.

Table 7

Iceland Specific Loss Severity Adjustment Factors

	Adjustment to loss severity calculation
Property indexation	Based on the OECD national house price index.
Jumbo valuation threshold*	ISK80,000,000 in the Capital Region, ISK45,000,000 in other regions
Valuation haircut	5% if the valuation is not a full appraisal carried out by a chartered surveyor or actual purchase price. For example, we apply this haircut to properties whose valuation is solely based on the national house prices database.
Foreclosure costs	ISK800,000 for both first and second lien and 3% of the post-repo valuation.
Foreclosure timeline/period	24 months for owner-occupied properties.

Table 7

Iceland Specific Loss Severity Adjustment Factors (cont.)

	Adjustment to loss severity calculation
Mortgages linked to inflation	See below.

*We increase MVD assumptions for jumbo valuations. We apply an adjustment of 20% on the excess above the jumbo threshold. For example, for a property based in the Capital Region valued at ISK100,000,000, we apply an adjustment on the difference between ISK100,000,000 and ISK80,000,000. The product of this calculation (20%*ISK20,000,000) is then deducted from the post-repo MVD property valuation. Repo--Repossession. MVD--Market-value decline.

Furthermore, for mortgages indexed to inflation, in circumstances where the consumer price index (CPI) rises faster than the house price index (HPI), this can result in increasing LTV ratios despite mortgages all being amortizing. The corresponding decline in the equity buffer in the property may result in a higher loss severity than similar mortgages, which are not indexed to inflation. As a result, we reflected this added risk by multiplying the outstanding balance of inflation-linked mortgages by a factor, which is calibrated by looking at comparable mortgages in other countries. Based on the historical evolution of CPI and HPI, we have assumed a factor of 1.875, which is applied for the sole purpose of calculating the WALS.

Specific adjustments for cash flow

Table 8

Iceland Cash Flow Adjustment Factors

	Adjustment
Prepayment scenarios	Pre- and post-recession:24% (high) and 1% (low);during recession: 1%.
Modeling of senior fees and expenses	Higher of1.5x actual or 35 basis points.

Key credit characteristics

The tables below summarize the cover pool's composition.

Table 9

Cover Pool Composition

	As of June 30, 2021	
Asset type	Bil. ISK	Percentage of cover pool (%)
Residential mortgages	239.367	92.5
Cash	19.486	7.5
Total	258.853	

Table 10

Key Credit Metrics

	As of June 30, 2021
Average mortgage balance (ISK)	24,686,180
Weighted-average current LTV ratio (%)	63.9

Table 10

Key Credit Metrics (cont.)

	As of June 30, 2021
Weighted-average loan seasoning (months)*	30.0
Balance of mortgages in arrears (% of total mortgage balance)	0.38
Inflation-linked mortgages (% of total mortgage balance)	51.9
Jumbo valuations (% of total mortgage balance)	21.3
Credit analysis results	
Weighted-average foreclosure frequency (%)	26.69
Weighted-average loss severity (%)	52.07

*Seasoning refers to the elapsed mortgage term.

Table 11

Current LTV Ratios

	Percentage of cover pool
Residential mortgages (%)	As of June 30, 2021
0-60	34.46
60-70	21.15
70-80	28.93
80-90	11.57
90-100	2.84
Above 100	1.05

LTV--Loan to value.

Table 12

Mortgages Seasoning Distribution*

	Percentage of cover pool
Residential mortgages	As of June 30, 2021
In arrears	0.38
>0 and <=2years	60.67
>2 and <=4 years	22.75
>4 and <=5 years	5.92
>5 and <=6 years	2.93
>6 and <=7 years	2.06
>7 and <=8 years	1.34
>8 and <=9 years	0.82
>9 and <=10 years	0.66
>10 years - 0.50x	2.46

Table 12

Mortgages Seasoning Distribution* (cont.)

	Percentage of cover pool
Weighted-average loan seasoning (months)	30.0

*Seasoning refers to the elapsed term for mortgages not in arrears.

Table 13

Geographic Distribution Of Mortgage Assets

	Percentage of cover pool (%)
Regional concentrations	As of June 30, 2021
Capital Region	72.69
Southern Peninsula	3.38
Western Region	4.57
Westfjords	0.22
Northwestern Region	1.60
Northeastern Region	7.63
Eastern Region	1.94
Southern Region	7.98

At closing, the program will not include any swap for interest rate and foreign currency risks. However, the issuer will be posting collateral reflecting the mark-to-market exposure of the euro-denominated covered bonds against the Icelandic krona. The collateral posting is registered in the cover pool and will form part of the assets available to the covered bondholders. We will consider these assets in our analysis, however we do not consider that this posting mitigates foreign currency risks in the program.

This currency mismatch results in elevated required credit enhancement levels, which are not commensurate with any notches of collateral-based uplift.

Counterparty risk

Arion Bank is the main counterparty in the program, as issuer, originator, servicer, and bank account provider.

At closing, the program will not include any swaps for interest rate and foreign currency risks. We do not give credit in our analysis to the collateral framework posting that will be put into place upon the euro issuance.

Borrowers pay to a bank account held with Arion Bank. Funds are then used to acquire new mortgages to be transferred to the cover pool or remain in the issuer's general estate.

The program features downgrade remedies on the bank account that holds cash for the benefit of the cover pool. If the rating on Arion Bank falls below 'BBB-', Arion Bank shall within 90 calendar days establish a transaction account with a bank rated at least 'BBB-'. Considering the sizable proportion of cash in the program, we assess this as a nonderivative limited risk exposure. Given the documented rating trigger, we have concluded that the replacement language supports our covered bond ratings up to 'A-', as a result we currently give credit to cash in our measure of available credit enhancement.

If the bank became insolvent, collections it receives from the cover pool assets but does not reinvest in new mortgages could be commingled with the funds of the general insolvency estate. Based on monthly repayments by borrowers, we have assumed that one third of collections are commingled over a two-month period: one month during which the issuer could be accumulating cash and another month representing the notification period after insolvency. The overcollateralization requirement to cover commingling risk is 0.33%.

Sovereign risk

We analyze sovereign risk under our structured finance sovereign risk criteria. Arion Bank's covered bond program has issued local-currency denominated bond (ISK) and is planning to also issue euro-denominated bonds.

Under our criteria, a foreign-currency obligation backed by local- or foreign-currency assets in a single jurisdiction is capped at the transfer and convertibility (T&C) assessment for that jurisdiction, unless there are structural mitigants for T&C risk, such as political risk insurance or third-party guarantees. We understand that there are no such T&C mitigants in place in the program.

In the absence of such mitigants, the preliminary ratings on the planned euro-denominated covered bond is capped at 'A' (the T&C assessment for Iceland).

Environmental, social, and governance factors

Our rating on Arion Bank's covered bond program reflects our analysis of the jurisdictional support and does not incorporate any collateral-based uplift. Consequently, environmental and social credit factors do not affect the credit enhancement required for the current rating. In terms of governance, we note that the issuer has a 5% overcollateralization commitment and has introduced an asset coverage test to mitigate deposit setoff risk. This however does not affect the current covered bond rating, which is based on the jurisdictional-supported rating level.

Related Criteria

- Criteria | Structured Finance | General: Global Framework For Payment Structure And Cash Flow Analysis Of Structured Finance Securities, Dec. 22, 2020
- Criteria | Structured Finance | General: Counterparty Risk Framework: Methodology And Assumptions, March 8, 2019
- Criteria | Structured Finance | General: Incorporating Sovereign Risk In Rating Structured Finance Securities: Methodology And Assumptions, Jan. 30, 2019
- Criteria | Structured Finance | RMBS: Global Methodology And Assumptions: Assessing Pools Of Residential Loans, Jan. 25, 2019
- Legal Criteria: Structured Finance: Asset Isolation And Special-Purpose Entity Methodology, March 29, 2017
- Criteria | Structured Finance | Covered Bonds: Covered Bond Ratings Framework: Methodology And Assumptions, June 30, 2015

- Criteria | Structured Finance | Covered Bonds: Covered Bonds Criteria, Dec. 9, 2014
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Arion Bank's Covered Bond Program And Related Issuances Assigned Preliminary 'A-' Ratings; Outlook Stable, Sept. XX, 2021
- Global Covered Bond Insights Q2 2021, June 30, 2021
- Global Credit Conditions: Reopening, Reflation, Reset, June 30, 2021
- Iceland 'A/A-1' Ratings Affirmed; Outlook Stable, May 14, 2021
- Banking Industry Country Risk Assessment: Iceland, Dec. 18, 2020
- Assessments For Jurisdictional Support According To Our Covered Bonds Criteria, Nov. 27, 2020
- ESG Industry Report Card: Covered Bonds, Nov. 9, 2020
- Bulletin: Icelandic Bank Resolution Act Completes The European Map, But Implementation And Effectiveness Remain Unclear, Sept. 1, 2020
- S&P Global Ratings Definitions, Aug. 7, 2020
- How COVID-19 Will Change Covered Bonds, July 8, 2020
- Arion Bank, May 26, 2020
- Glossary Of Covered Bond Terms, April 27, 2018