MOODY'S
INVESTORS SERVICE

Rating Action: Moody's assigns first time long-term issuer and deposit ratings of Baa2 to Kvika Banki hf.; outlook stable

11 May 2022

London, May 11, 2022 -- Moody's Investors Service ("Moody's") has assigned first time Baa2 long-term and Prime-2 short-term foreign and local currency bank deposit and Baa2 long-term foreign and local currency issuer ratings to Iceland's Kvika Banki hf. (Kvika). The assigned long-term deposit and issuer ratings carry a stable outlook.

Moody's also assigned a Baseline Credit Assessment (BCA) and Adjusted BCA of ba1, a Baa1(cr) long-term and P-2(cr) short-term Counterparty Risk (CR) Assessment, and Baa1 long-term and P-2 short-term foreign and local currency Counterparty Risk Ratings (CRRs).

The ratings reflect Kvika's robust capitalisation coupled with strong profitability and liquidity, reflective of the group's diversified revenue stream and the increasing importance of non-capital-intensive banking operations as well as the profit contribution from its insurance operations via TM tryggingar hf. These strengths are balanced against 1) Moody's expectation of increased reliance on market funds 2) high operational and non-credit related risks as well as 3) the group's complexity driven by its investment banking operations and series of mergers and acquisitions, evolving strategy and track record of acquisitive corporate behaviour.

A full list of affected ratings can be found at the end of the press release.

RATINGS RATIONALE

MACRO PROFILE

The primary driver for the deposit ratings of Baa2/Prime-2 assigned to the group is its standalone credit profile as captured by its BCA of ba1, which is supported by its "Strong-" macro profile. Kvika's "Strong-" macro profile reflects that the bulk of its operations are concentrated in Iceland (A2, stable). Iceland's "Strong-" macro profile reflects the economy's flexibility, wealth, competitiveness and favourable demographics, all of which support its long-term growth prospects and help it to absorb shocks. The main risks to the banking sector stem from the small size of the country and the closed nature of its economy, which could create a risk of contagion and spillover in case of sector specific shocks, as well as the extensive use of market funding.

BASELINE CREDIT ASSESSMENT

Kvika's BCA reflects its strong capitalisation. Due to its classification as a financial conglomerate, the group is required to calculate (1) a consolidated capital adequacy ratio for the banking sub-group excluding the insurance and (2) an insurance Solvency II ratio for the consolidated group overall. The banking operations benefit from a robust level of capital with a reported Common Equity Tier 1 (CET 1) ratio of 30.4% at end 2021, already well above the minimum requirement of 14%. Its total capital adequacy ratio stands at 33.8%, providing a significant buffer above the expected minimum requirement of 22.6% at the end of 2022. The banking operations also benefit from a very strong leverage ratio of 18.5% compared to the European average of close to 6%. As regards the insurance operations, they are also soundly capitalised, with a reported Solvency II ratio of 166% at end 2021. We expect capitalisation to remain strong, albeit at slightly lower levels as business grows, supported by the group's internal capital generation.

Kvika's profitability benefits from a diversified revenue stream, in the form of net interest income, insurance premiums, financial income and asset management fees. During 2021 the group recorded a return to tangible assets of 5% as a result of strong results in the asset management business, lower funding costs, strong performance of the insurance operations and sizeable non-recuring income in the form of financial income and performance fees (accounting for more than 30% of total earnings). We expect the group's recurring profitability to remain strong but at lower levels due to a muted earnings outlook for the insurance business for 2022 and 2023.

The banking operations are supported by adequate liquidity, with a liquid banking asset to tangible banking assets ratio of 30% at end 2021. The bank's liquidity pool constitutes mostly of cash with central banks and

Icelandic government bonds.

These strengths are balanced against credit related risks of the banking operations and the expansion in the bridge financing sector in the UK, following the acquisition of Ortus, which carries higher risk than the bank's existing loan book. The bank's problem loan ratio was at 3.1% at end of 2021 and has increased markedly since the outbreak of Covid-19 (1.1% in 2019), reflective of the bank's exposure to the commercial vehicles sector (c.12.6% of gross loans) and the real estate sector (c.14.2% of gross loans). The group is also exposed to market risks relating to its market making and insurance operations through an asset allocation with high weight on equities and high share of unrated fixed income investments.

The BCA also reflects the agency's expectation that the group will increase its use of market funds to finance its lending operations in the next 12-18 months, from the current level of 17% of tangible banking assets. Although the bank is refinancing more expensive indexed debt with cheaper senior unsecured debt, both domestically and abroad which we view positively as it diversifies its investor base, higher use of market funds still exposes the bank to swings in investor sentiment.

Furthermore, the BCA also includes two negative notches for opacity and complexity reflecting the increased operational complexity driven by the investment banking operations of the group as well as the mergers and acquisitions in the recent years which pose a significant operational risk while systems, processes and procedures are being aligned and streamlined across the group. Kvika's BCA also factors in a negative notch for corporate behaviour, reflecting the bank's rapidly evolving strategy and growth through sustained M&A activity, a high risk appetite and in Moody's view a weaker strategic rationale for some acquisitions. These considerations represent key governance risks under Moody's ESG framework.

LOSS GIVEN FAILURE (LGF)

Kvika's long-term deposit and issuer ratings of Baa2 are underpinned by the bank's Adjusted BCA of ba1 and Moody's Advanced LGF analysis which takes into account the severity of loss faced by the different liability classes in the event of a failure. The LGF analysis for Kvika indicates a very low loss-given-failure for depositors and senior unsecured creditors, leading to two notches of rating uplift from the bank's ba1 Adjusted BCA for deposit and issuer ratings.

Kvika's CR Assessment (CRA) is Baa1(cr)/Prime-2(cr), three notches above the bank's Adjusted BCA of ba1, based on the substantial cushion against default provided by subordinated instruments to the senior obligations represented by the CRA. Concurrently, the CRRs of Baa1/Prime-2 are three notches above the Adjusted BCA of ba1, reflecting also the extremely low loss-given-failure from the high volume of instruments that are subordinated to CRR liabilities.

GOVERNMENT SUPPORT

We assume a low probability of government support for Kvika's deposit, CRA, and CRR ratings reflecting Iceland's implementation of the EU's Bank Recovery and Resolution Directive (BRRD) and the bank's small size relative to the banking system and limited systemic importance to the national payment system.

OUTLOOK

The stable outlook on Kvika's long-term deposit and issuer ratings reflects Moody's expectation that the group will continue to benefit from a strong capital position, and diversified sources of income, balanced against credit and non-credit related risks and the group's complicated structure, in the next 12 to 18 months.

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

Upward rating momentum could develop if Kvika demonstrates (1) a successful completion of the integration of Ortus Financing, TM tryggingar and Lykill without compromising its financial performance or crystalising operational risk; (2) a simplified group structure; (3) a scale down of the investment banking operations relating to the bank's hedge portfolio; (4) sustained robust earnings without compromising its risk profile or (5) lower use of confidence sensitive market funds.

Downward pressure could emerge if (1) Kvika's asset quality was to deteriorate from current levels; (2) credit growth in the higher risk areas of the bank's lending activities was to increase significantly above market rates; (3) the bank holds a lower stock of liquid assets; (4) the group's risk profile increases driven by non-credit related risks; (5) financing conditions were to become more difficult or (6) the macroeconomic environment deteriorates significantly leading to a lower Macro Profile.

Furthermore, a reduction in the rating uplift as a result of our LGF analysis triggered by structural funding changes to the bank's balance sheet could lead to downward rating pressure.

LIST OF AFFECTED RATINGS

..Issuer: Kvika Banki hf.

Assignments:

....Adjusted Baseline Credit Assessment, Assigned ba1

....Baseline Credit Assessment, Assigned ba1

....Long-term Counterparty Risk Assessment, Assigned Baa1(cr)

....Short-term Counterparty Risk Assessment, Assigned P-2(cr)

....Long-term Counterparty Risk Ratings, Assigned Baa1

....Short-term Counterparty Risk Ratings, Assigned P-2

....Long-term Issuer Ratings, Assigned Baa2, Outlook Assigned Stable

....Long-term Bank Deposit Ratings, Assigned Baa2, Outlook Assigned Stable

....Short-term Bank Deposit Ratings, Assigned P-2

Outlook Action:

....Outlook, Assigned Stable

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Banks Methodology published in July 2021 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1269625 . Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

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 at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

For ratings issued on a program, series, category/class of debt or security this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series, category/class of debt, security or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the credit rating action on the support provider and in relation to each particular credit rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

For any affected securities or rated entities receiving direct credit support from the primary entity(ies) of this credit rating action, and whose ratings may change as a result of this credit rating action, the associated regulatory disclosures will be those of the guarantor entity. Exceptions to this approach exist for the following disclosures, if applicable to jurisdiction: Ancillary Services, Disclosure to rated entity, Disclosure from rated entity.

The ratings have been disclosed to the rated entity or its designated agent(s) and issued with no amendment resulting from that disclosure.

These ratings are solicited. Please refer to Moody's Policy for Designating and Assigning Unsolicited Credit Ratings available on its website www.moodys.com.

Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1288235 .

At least one ESG consideration was material to the credit rating actions(s) announced and desribed above.

The Global Scale Credit Rating on this Credit Rating Announcement was issued by one of Moody's affiliates outside the EU and is endorsed by Moody's Deutschland GmbH, An der Welle 5, Frankfurt am Main 60322, Germany, in accordance with Art.4 paragraph 3 of the Regulation (EC) No 1060/2009 on Credit Rating Agencies. Further information on the EU endorsement status and on the Moody's office that issued the credit rating is available on www.moodys.com.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

Please see the ratings tab on the issuer/entity page on www.moodys.com for additional regulatory disclosures for each credit rating.

Effie Tsotsani
Asst Vice President - Analyst
Financial Institutions Group
Moody's Investors Service Ltd.
One Canada Square
Canary Wharf
London, E14 5FA
United Kingdom
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

Simon Ainsworth
Associate Managing Director
Financial Institutions Group
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

Releasing Office:
Moody's Investors Service Ltd.
One Canada Square
Canary Wharf
London, E14 5FA
United Kingdom
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

MOODY'S
INVESTORS SERVICE