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New Issue: Landsbankinn hf. Covered Bond Programme

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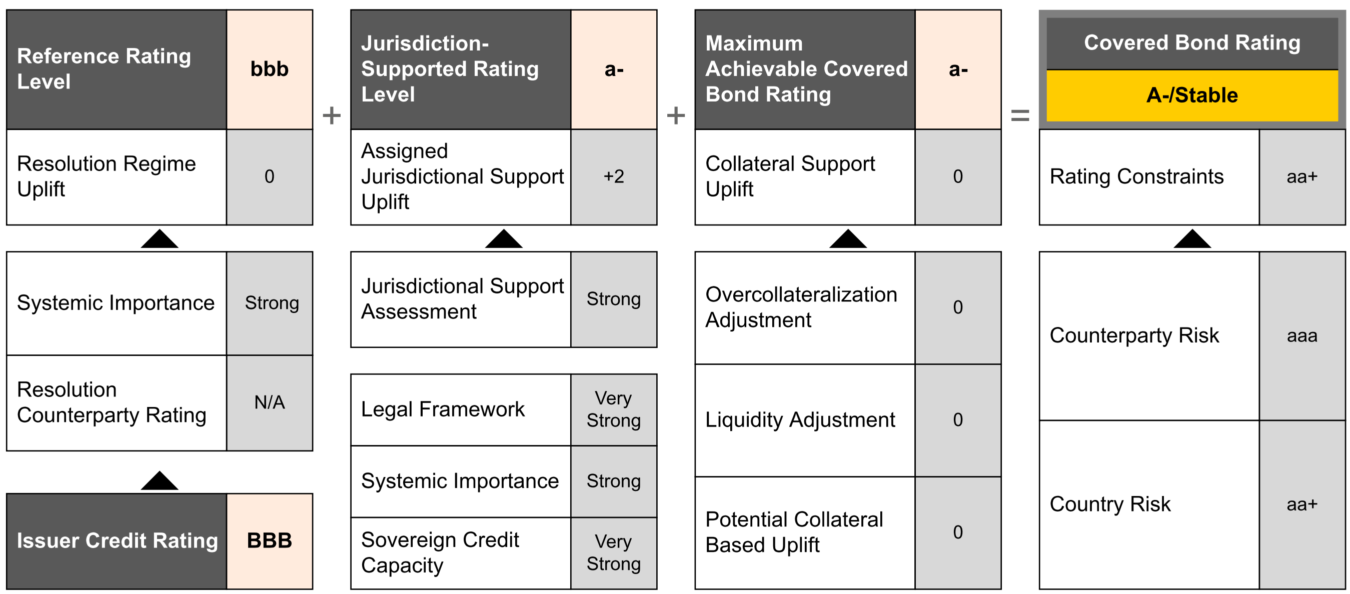
Ratings Detail



Major Rating Factors

Strengths

- The cover pool comprises residential mortgages with relatively low current cover pool loan-to-value (LTV) ratios compared to the archetype for Iceland.
- Covered bonds benefit from strong jurisdictional support in Iceland.

Weaknesses

- We need further clarity about the legislative and practical implementation of Iceland's Bank Resolution Act before we are able to assess the implications of the framework for the bank's covered bonds.
- Based on our collateral analysis, the available credit enhancement is not sufficient to assign any notch of collateral-based uplift.
- Our collateral analysis considers that 8.6% of the mortgage assets' balance could be subject to full setoff risk by depositors.

- Cover pool assets are currently paying less than liabilities due to the current low interest rates environment.
- 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 'A-' long-term credit rating to Landsbankinn hf.'s (Landsbankinn) covered bond program and its outstanding public issuances.

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 Landsbankinn.

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

Landsbankinn 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 July 14, 2020. The portfolio comprises solely Icelandic residential mortgages. Based on our cash flow analysis, the available credit enhancement does not exceed the required credit enhancement for our 'AAA' credit risk and does not allow us to assign any notch of collateral-based uplift. 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	2013
Covered bond type	Legislation-enabled
Outstanding covered bonds (bil. ISK)§	171.6
Redemption profile	Soft-bullet
Underlying assets	Residential mortgages
Jurisdictional support uplift	2
Unused notches for jurisdictional support	0
Target credit enhancement (%)	31.7
Credit enhancement commensurate with rating (%)	1.5
Available credit enhancement without cash/nominal (%)	23.3/27.0
Collateral support uplift	0
Unused notches for collateral support	0
Total unused notches	0

*Based on data as of July 14, 2020. §Including accrued inflation for index-linked covered bonds.

The issuer is a universal bank based in Iceland providing services for households, corporates, and institutional investors. The bank is owned by the National Treasury of Iceland with a 98.2% shareholding. It is the market leader in the Icelandic banking sector as well as in the domestic mortgage market.

Landsbankinn issues covered bonds secured by a portfolio of mortgages on residential properties located in Iceland, as well as some cash. Under the Icelandic legislative framework, cover pool assets remain on the balance sheet of the issuer but are kept by the issuer in a register. This ensures that, upon Landsbankinn's insolvency, the cover pool will remain at all times segregated from the insolvency estate of the issuer until covered bonds are fully repaid.

The issuer has contractually committed to a minimum of 20% overcollateralization. The license delivered by the Central Bank of Iceland (CBI) instructs that overcollateralization must not exceed 30%. As a result, available overcollateralization in the program fluctuates between these two boundaries.

Covered Bond Program

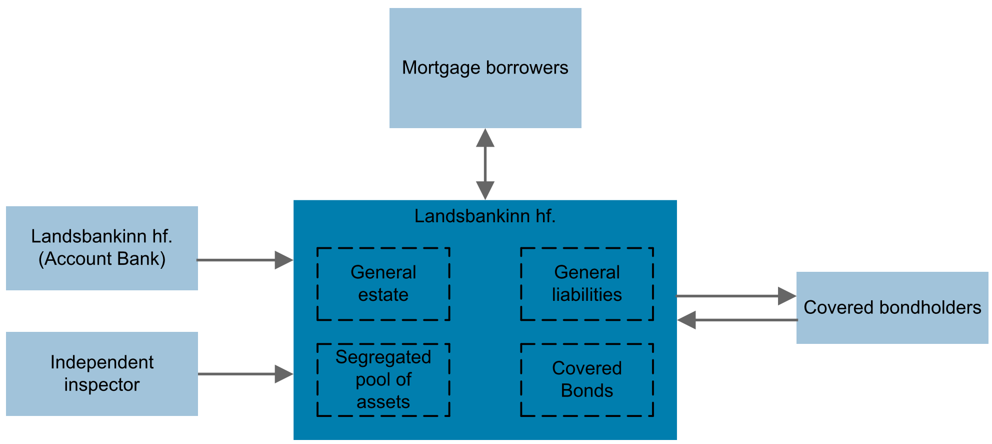


Table 2

Program Participants

Role	Name	Rating	Rating dependency
Issuer	Landsbankinn hf.	BBB/Stable/A-2	Yes
Originator	Landsbankinn hf.	BBB/Stable/A-2	No
Servicer	Landsbankinn hf.	BBB/Stable/A-2	No
Bank account provider	Landsbankinn hf.	BBB/Stable/A-2	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 Landsbankinn's insolvency, the cover pool will remain at all times segregated from the insolvency estate of the issuer 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 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.

However, the program is exposed to deposit setoff risk, which as of July 14, 2020, amounted to ISK18,219 billion, or 8.6% of the mortgage assets. This is because Iceland generally allows setoff risk. At this stage, in all of our rating scenarios we do not consider the available mitigants to setoff to be sufficient to reduce this risk. Therefore, we have incorporated full deposit setoff risk in our cash flow analysis. Hence our 'AAA' credit risk and target credit enhancement results incorporate this risk, so we can compare these figures with the available credit enhancement in the program.

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 LTV ratio for the collateral 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 assets 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 Landsbankinn'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 (see "Icelandic Bank Resolution Act Completes The European Map, But Implementation And Effectiveness Remain Unclear," published on Sept. 1, 2020). As a result, the RRL of 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.

Under our criteria, we believe 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 only (see table 6). We base our analysis on loan-by-loan data as of a cut-off date of July 14, 2020.

All mortgages are amortizing, first lien, and are lent on owner-occupied properties. About 76% of mortgages pay interest based on a standard variable rate, 17% are fixed reset (with either a three-year or a five-year interest rate reset frequency), and 6% are fixed for life. Approximately 63.5% 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 (68.69%) are located in the Capital Region, reflecting the concentration of the population in the Reykjavík area.

We analyzed Landsbankinn'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).

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.	Low 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.	High 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.

Table 5

Iceland--Archetypal Pool (cont.)

Characteristics by type	Archetypal features
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

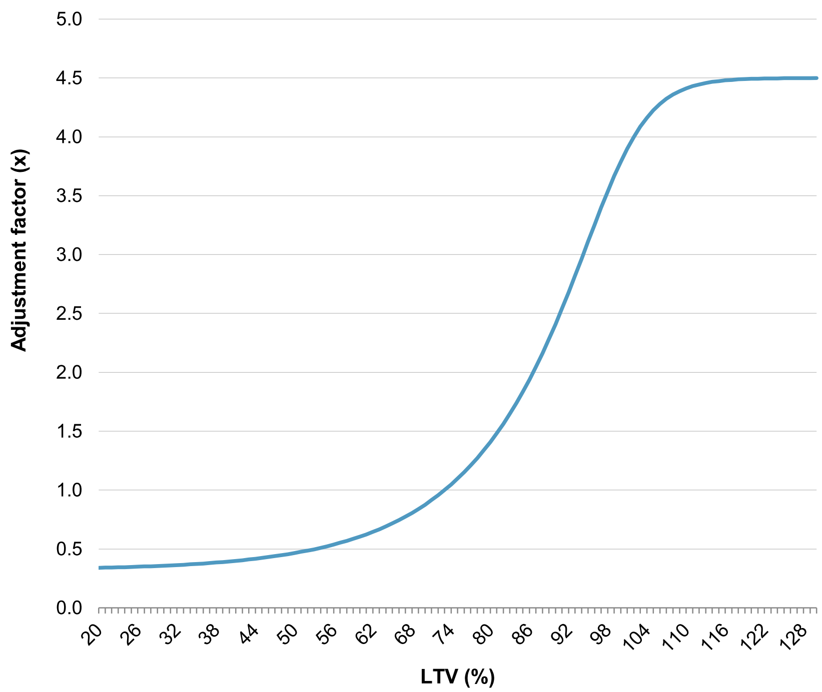
Foreclosure Frequency Adjustments (cont.)

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 weighted-average loss severity (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 basispoints.

Key credit characteristics

The tables below summarize the cover pool's composition.

Table 9

Cover Pool Composition

	As of July 14, 2020	
Asset type	**ISK**	**Percentage of cover pool**
Residential mortgages	211,590,828,751	97.07%
Cash	6,383,552,923	2.93%
Total	217,974,381,674	

Table 10

Key Credit Metrics

	As of July 14, 2020
Average mortgage balance (ISK)	21,144,282
Weighted-average current LTV ratio (%)	56.1
Weighted-average loan seasoning (months)*	43.4
Balance of mortgages in arrears (% of total mortgage balance)	1.04
Inflation-linked mortgages (% of total mortgage balance)	63.5
Jumbo valuations (% of total mortgage balance)	21.2
Credit analysis results	

Table 10

Key Credit Metrics (cont.)

	As of July 14, 2020
Weighted-average foreclosure frequency (%)	14.28%
Weighted-average loss severity (%)	49.30%

*Seasoning refers to the elapsed mortgage term.

Table 11

Current LTV Ratios

	Percentage of cover pool
Residential assets (%)	As of July 14, 2020
0-60	47.75
60-70	33.36
70-80	18.37
80-90	0.46
90-100	0.05
Above 100	0.01

LTV--Loan to value.

Table 12

Mortgages Seasoning Distribution*

	Percentage of cover pool
Residential mortgages	As of July 14, 2020
In arrears	1.04
>0 and <=2years	39.45
>2 and <=4 years	32.03
>4 and <=5 years	7.36
>5 and <=6 years	6.08
>6 and <=7 years	3.09
>7 and <=8 years	1.89
>8 and <=9 years	1.44
>9 and <=10 years	0.29
>10 years - 0.50x	7.33
Weighted-average loan seasoning (months)	43.4

*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 July 14, 2020
Capital Region	68.89
Southern Peninsula	9.03
Western Region	3.81
Westfjords	0.87
Northwestern Region	1.01

Table 13

Geographic Distribution Of Mortgage Assets (cont.)

	Percentage of cover pool (%)
Northeastern Region	7.27
Eastern Region	1.72
Southern Region	7.39

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 WALS estimates the required loss protection, assuming all other factors remain unchanged.

As of July 14, 2020, we estimate a WAFF of 14.28%. The WAFF is comparatively lower than the base foreclosure frequency, mostly due to a low current LTV ratio of 61.7% (adjusted for overvaluation of 18.02%) compared to the 75% in the archetype.

In this program, as in some other Nordic covered bond programs, 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 49.30% is relatively high compared to other Nordic issuers, mostly due to the adjustment factor of 1.875x for inflation-linked mortgages.

All covered bonds pay a fixed coupon and most of the program's assets pay based on variable rates. These are standard variable rates set at the bank's discretion, with no caps or floors, and are not directly linked to any particular index. However, the recent sharp reduction in the Central Bank of Iceland's interest rates has resulted in much lower variable mortgage rates charged to customers. Since the cost of funding adjusts at a slower pace compared to interest received on the assets, the program is exposed to negative excess spread. We believe this to be a temporary situation and that excess spread is bound to return to more normal levels, by increasing interest rates on the assets and/or by readjusting the cost of funding. We understand that, were the issuer to default, in accordance with the terms of the mortgage documentation, there would be nothing preventing an administrator from changing variable rates charged to customers, and that such an administrator would act in the best interest of covered bondholders. We believe that the primary goal of the administrator would be to cover the cost of the outstanding liabilities.

Further to the above, we have assumed in our cash flow analysis that interest earned on the assets is floored at the cost of liabilities. We ran different interest rate scenarios, where the down interest rates scenario is the most stressful on cash flow results given the fixed nature of liabilities. In addition, we applied a constant flat interest rate based on the current policy rate, where interest earned on the assets equals the cost of liabilities. This reflects a situation where the discount factor applied to calculate refinancing costs is based on current interest rates as opposed to interest rates close to 0% in our down interest rates scenario. The cash flow figures presented below are based on this flat interest scenario.

The program features inflation-linked assets and liabilities. As of July 14, 2020, amounts outstanding were ISK134,308 billion and ISK130,322 billion respectively. In addition, we understand that the balance between inflation-linked assets and liabilities is closely monitored by both the issuer and the CBI, with a view to maintain the current ratio. Therefore, considering the current ratio, we view inflation risk as appropriately mitigated in the program.

We have assumed a constant prepayment rate of 1% during the simulated recession period as per table 8. Before and after the recessionary period we have assumed a low prepayment rate based on historical prepayment rates for the relevant jurisdiction and originator. We set this rate at 5%, which reflects our expectation of prepayments based on information we have. This is also in line with most other Nordic covered bond programs.

In order to calculate the discount rate for asset sales in our model, we use a target asset spread (see "Assessments For Target Asset Spreads According To Our Covered Bonds Criteria," published Nov. 27, 2020). We have placed Iceland in asset bucket 2, entailing a 700 basis points spread to calculate refinancing risk. This reflects the status of Iceland as an intermediate country. On the one hand, it has relatively moderate spreads for covered bonds compared to sovereign bonds (used as a proxy for the reference funding rate). On the other, there is limited historical data, in particular due to the lack of an RMBS market.

Under our assumptions described above, the target credit enhancement is 31.73% and the 'AAA' credit risk is 24.74%. Both figures exceed our measure of available credit enhancement without cash of 23.29%, therefore we do not assign any notch of collateral-based uplift.

Therefore, the long-term rating on the covered bonds is the same as the JRL, or 'A-'. In order for the covered bonds to reach this rating, and given that the Icelandic framework prescribes a minimum overcollateralization rate of 0%, the program only needs to cover commingling risk (equivalent to 0.4% of the overcollateralization). However, the overcollateralization commensurate with the 'A-' rating is floored at 1.5%, which is the level of stress that is commensurate with a 'A' rating category under our covered bonds criteria.

Under our covered bonds criteria, we consider liquidity risk to be covered by the three-year extendibility provisions applying to all covered bonds.

Since the issuer has committed to a 20% minimum overcollateralization, which is below the current overcollateralization requirements, we would deduct one notch from any collateral-based uplift we would assign. However, as explained above, we do not currently assign any notch of collateral-based uplift.

Table 14

Collateral Uplift Metrics

	As of July 14, 2020
Asset WAM (years)	31.6
Liability WAM (years)*	8.1
Available credit enhancement without cash (%)	23.29
AAA credit risk (%)	24.74
Required credit enhancement for first notch of collateral uplift (%)	26.49

Table 14

Collateral Uplift Metrics (cont.)	
	As of July 14, 2020
Required credit enhancement for second notch of collateral uplift (%)	28.24
Required credit enhancement for third notch Collateral Uplift (%)	29.98
Target credit enhancement for maximum uplift (%)	31.73
Potential collateral-based uplift (notches)	0
Adjustment for liquidity (Y/N)	N
Adjustment for committed overcollateralization (Y/N)	N
Collateral support uplift (notches)	0

*Based on extended maturity dates. WAM--Weighted-average maturity.

Counterparty risk

Landsbankinn is the only counterparty in the program, as issuer, originator, servicer, and bank account provider.

There are no swaps in the program.

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

There are no downgrade remedies on the bank account that holds cash for the benefit of the cover pool. Despite cash being held on a dedicated account, we consider that there is a risk that this cash may be lost in case of a severe stress of the issuer given its fungible nature. As a result, in our cash flow analysis we compare our measures of credit enhancement with the available credit enhancement excluding cash of 23.29% (see table 14). The available credit enhancement including cash is 27.0%.

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 0.4%.

Country risk

We analyze country risk under our structured finance sovereign risk criteria. The assets are residential mortgages and the issuing bank is based in Iceland, which is not part of a monetary union. However, the program covers liquidity risk for at least 12 months, since the covered bonds benefit from 36-months' worth of maturity extension. Therefore, we classify the program's sensitivity to sovereign risk as moderate. Given that all assets and liabilities are in ISK, this allows the ratings on the program to achieve four notches of uplift above the long-term sovereign rating on Iceland (A/Stable/A-1). Since this cap at 'aa+' exceeds the ratings that covered bonds can otherwise achieve, sovereign risk does not constrain our ratings on the covered bonds.

Potential effects of COVID-19

As vaccine rollouts in several countries continue, S&P Global Ratings believes there remains a high degree of uncertainty about the evolution of the coronavirus pandemic and its economic effects. Widespread immunization, which certain countries might achieve by midyear, will help pave the way for a return to more normal levels of social and economic activity. We use this assumption about vaccine timing in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Environmental, social, and governance factors

Our rating on Landsbankinn's mortgage covered bond program reflects our analysis of the jurisdictional support and does not currently 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 all covered bonds have three-year extensions and therefore we consider liquidity risk to be addressed under our covered bonds criteria. In addition, the minimum level of overcollateralization in the program that Landsbankinn commits to is below the level required for the first notch of collateral-based uplift and, in line with regulatory requirements, the maximum overcollateralization in the program is capped at 30%. This however, does not affect the current covered bond rating, which is based on the jurisdictional-supported rating level.

Related Criteria

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- Criteria | Structured Finance | General: Counterparty Risk Framework: Methodology And Assumptions, March 8, 2019
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- Criteria | Structured Finance | RMBS: Global Methodology And Assumptions: Assessing Pools Of Residential Loans, Jan. 25, 2019
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Related Research

- Global Covered Bond Insights Q4 2020, Dec. 17, 2020
- Global Covered Bond Characteristics And Rating Summary Q4 2020, Dec. 17, 2020
- Assessments For Target Asset Spreads According To Our Covered Bonds Criteria, Nov. 27, 2020
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- Iceland 'A/A-1' Ratings Affirmed; Outlook Stable, Nov. 13, 2020

- Bulletin: Icelandic Bank Resolution Act Completes The European Map, But Implementation And Effectiveness Remain Unclear, Sept. 1, 2020
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- Landsbankinn hf., May 26, 2020
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