Íslandsbanki

RISK REPORT
2013

RISK REPORT

BASEL II PILLAR 3 DISCLOSURES

APRIL 2014

ÍSLANDSBANKI OFFERS UNIVERSAL BANKING SERVICES

Íslandsbanki, with roots tracing back to 1875, is a universal bank in Iceland. The Bank offers Icelandic individuals, corporate and institutional investors comprehensive financial services. With over 1,000 employees, and assets of around ISK 870 billion, Íslandsbanki is one of the country's largest banking and financial services groups. The Bank has a 20–40% market share across all domestic franchise areas; and operates an efficient branch network in Iceland.

Building on a heritage of lending to industry and commerce in Iceland, the Bank has developed a specific expertise in certain industry sectors: seafood, energy, tourism and municipalities. With its focused approach in these fields, Íslandsbanki offers valuable services to industry players and investors.

Íslandsbanki is majority-owned by Glitnir hf. which, on behalf of its creditors, holds 95% of the Bank's shares through its subsidiaries. The remaining 5% share is held by the Icelandic Government and is managed by Icelandic State Financial Investments.

Íslandsbanki has a long history of leading consolidation in the Icelandic financial sector. The Bank is a product of a line of mergers, the latest of which is the merger with Kreditkort on 1 April 2012 and Byr on 1 December 2011. Kreditkort was Íslandsbanki's subsidiary and the key objectives of the acquisition were both to gain stronger market share in the credit card business and to improve efficiency in the Bank's overall retail operations. Byr, itself a result of a four-way merger, was at the time Iceland's fourth largest commercial bank with assets of around ISK 120 billion.

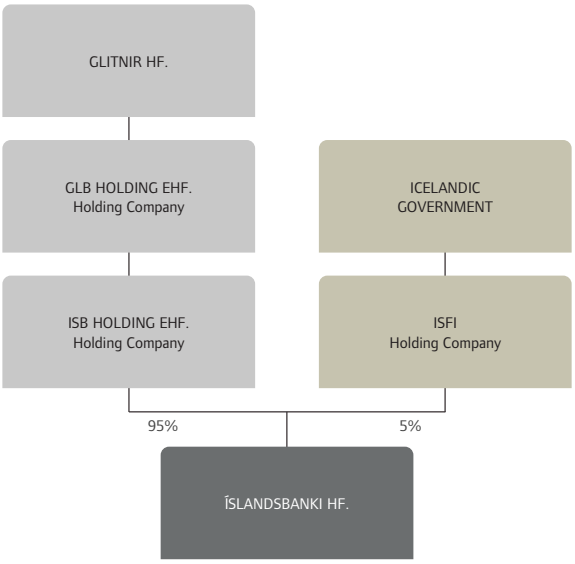

Exhibit 1. Íslandsbanki's ownership structure.

Since its inception, Íslandsbanki has placed great importance on mapping out a clear strategic direction for the Bank and developing its business model. Annual Strategy Summits involving Board of Directors, employees and customers have played a key role in defining particular aspects of the Bank's strategy, such as role, values and vision.

More information about the Bank, its activities and strategic direction can be found in the Annual Report 2013.

Key economic parameters	2013	2012	2011	2010
Gross Domestic Product (ISK bn)	1,786*	1,699*	1,628	1,536
Economic Growth	3.3%*	1.5%*	2.7%	(4.1%)
General government financial balance (ISK bn)	(37.1)*	(65.3)	(90.7)	(154.6)
Inflation	3.7%	4.5%	5.2%	2.6%
Policy rate CBI	6.0%	6.0%	4.8%	4.5%
EUR/ISK	158.5	169.8	158.8	153.8
Unemployment	5.4%	6.0%	7.1%	7.6%
Sovereign CDS Spread	177	182	317	265
Bond market turnover (ISK bn)	1,822	2,324	2,602	2,840
Equity market turnover (ISK bn)	251	88	60	25
OMX Iceland 6 PI ISK (Stock Index)	1,260	1,059	910	934

Exhibit 2. Key economic parameters over the past four years (EOY). Sources: Central Bank of Iceland, Statistics Iceland and NASDAQ OMX. *Preliminary figures

Rating agency	Foreign Currency	Domestic Currency
	LT/Outlook/ST	LT/Outlook/ST
Moody's (Dec. 2013)	Baa3/Stable/P-3	Baa3/Stable/P-3
Standard & Poor's (Jan. 2014)	BBB-/Stable/A-3	BBB-/Stable/A-3
Fitch Ratings (Dec. 2013)	BBB/Stable/F3	BBB+/Stable

Exhibit 3. The Republic of Iceland's Sovereign Credit Rating. Source: Central Bank of Iceland.

CRO REVIEW 2013

Risk management is at the heart of Íslandsbanki's operations and the Bank works constantly to improve its risk and capital management framework. The Bank allocates substantial resources to this area in order to meet the highest and latest international standards. The Bank's risk governance and risk appetite is implemented through policies approved by the Board of Directors (BoD). This report provides insight into the many aspects of the Bank's risk profile and risk management.

At year-end 2013, the Bank was in compliance with its defined risk appetite. All regulatory requirements were fulfilled and conventional risk measures show that the risk inherent in the Bank's operations is well managed. The restructuring of the Bank's loan portfolio has largely been completed, market risk is modest, liquidity is ample and the capitalisation is well in excess of both regulatory measures and internal targets.

The development of key risk figures between 2012 and 2013 are presented in Exhibit 4.

There are however some external factors that are a cause for concern. The capital controls continue to be a pressing economic and political issue and the influence on asset prices and investor behaviour remains a concern.

Also, extensive changes in the international regulatory environment require implementation in Iceland. These regulations, which are increasingly complex and technical, pose challenges for the legislative and regulatory bodies responsible for their successful implementation, as well as the institutions that need to operate by them. As regulation becomes more complex, more resources are required to implement them, and economies of scale become more important. For a small economy the costs can therefore be significant. In this context it is important that Iceland refrains from adding unnecessarily to this complexity and strives to keep Icelandic regulation effective and in line with international norms. This helps keep costs down, e.g. related to staff training, advisory services or IT implementation, while not compromising regulatory standards. As an example, Icelandic regulation should not, beyond international practice, require bank operations to be separated into distinct legal entities unless there is a clear and undisputed benefit that cannot be accomplished otherwise. It should be noted that fragmentation of this kind can weaken effectiveness and efficiency of important control functions. Fragmentation on the government side also leads to added costs in the system. For example, significantly increased authority has been provided to institutions, other than the FME, to obtain data on the business and customers of financial institutions. While it is important for Iceland that regulatory authorities have efficient means to assess risks in the financial system, serious consideration should be given to consolidation of the roles now played by different institutions, to reduce cost ultimately carried by the businesses and individuals of the Icelandic economy.

For Íslandsbanki, one of the main challenges over the coming years will be to establish a prudent balance between the Bank's capitalisation and a healthy return on shareholder's equity. However, any decision that would entail reducing the Bank's capital ratios, for example through dividend payments, will be based on an assessment of the Bank's operating environment, the Bank's target credit rating and the credit ratings of the Icelandic sovereign and the Bank's liquidity position taking into account the restrictions inherent in the capital controls and other external factors.

Capital base and capital requirement

The Bank's capital position continued to improve in 2013. The Tier 1 ratio and total capital ratio were 25.1% (2012: 22.0%) and 28.4% (2012: 25.5%) respectively. Risk-weighted assets (RWA) decreased by ISK 5 billion over the year, mainly related to increased credit quality of the loan portfolio, a reduction in the currency imbalance and a decline in the basic indicator for operational risk. These factors were partly offset by an increase in both non-current assets held for sale and property and equipment which is related to the restructuring of the loan portfolio and an increase in undrawn loan commitments. At the end of 2013, the Bank's RWA amounted to ISK 660 billion (2012: ISK 665 billion) with 84% related to credit risk, 4% to market risk and 12% to operational risk. The ratio of RWA to total assets has decreased from 81% to 76%.

The Bank's capital position is strong compared to domestic and European peers and the Bank is well prepared to address proposed changes in international regulation. The current minimum capital target approved by the Board of Directors is 18%. This target may be revised as more clarity is gained regarding the implementation of the new EU capital requirements directive (CRD IV) into Icelandic legislation.

Credit risk

At the end of 2013 the Bank's total exposure due to credit risk, including both on- and off-balance sheet items, amounted to ISK 817 billion (2012: ISK 786 billion). Loans to customers represent the largest part of the Bank's total credit risk exposure or ISK 558 billion (2012: ISK 560 billion). Loans to individuals have increased over the year, in particular due to new mortgage lending. The corporate portfolio on the other hand has seen net decrease with underlying factors being contractual instalments, prepayment, and appreciation of the ISK. The current environment for lending is quite competitive as the Icelandic banks are liquid and well capitalised, and with non-banking institutions offering credit funding for individuals and companies, e.g. for commercial real estate and retail mortgages.

Overall the credit quality of the loan portfolio has improved as more customers have completed financial restructuring and with progress in recalculation of currency-linked loans. Non-performing loans as defined by the FME have decreased from 13.7% to 8.3% and loans more than 90 days past due have decreased from 7.5%

to 4.2%. The Bank's cumulative write-offs and remissions in the restructuring of customers' debt in the period 2008–2013 now amount to ISK 548 billion, of which ISK 119 billion is to individuals and ISK 429 billion is to companies.

Market risk

The domestic financial markets developed further in 2013 with new commercial and covered bond issues and increasing turnover in the equity market. Three new companies were listed on the Icelandic stock exchange and further listings are expected in 2014.

The contribution of market risk to the Bank's risk-weighted assets decreased from 5% to 4% in 2013. The main decrease was due to a reduction in the currency imbalance from ISK 27.9 billion at the end of 2012 to ISK 23.7 billion at the end of 2013. The Bank's total equity exposure amounted to ISK 9.9 billion at the end of 2013 (2012: ISK 13.5 billion). The inflation imbalance was ISK 6.4 billion at the end of 2013 (2012: ISK 1.3 billion) while interest rate risk remained low.

Liquidity risk

Íslandsbanki maintained a very strong liquidity position throughout 2013. The Bank's liquidity back-up at the end of 2013 amounted to ISK 202 billion (2012: ISK 170 billion). In December 2013 the Central Bank adopted the Basel liquidity coverage ratio (LCR) into the Icelandic rules on liquidity ratios. Íslandsbanki's LCR ratio was 120% for the parent company and 143% at a consolidated level at the end of 2013.

The ratio of customer deposits to loans to customers was 88% at the end of 2013 (2012: 84%). The ratio of total deposits to total loans, which includes financial institutions, decreased from 87% to 83% over the same period.

The Bank issued ISK 9.9 billion in covered bonds in 2013. In addition, the Bank issued short-term unsecured papers throughout 2013 with an outstanding amount at year-end of just under ISK 9 billion. At the end of 2013, the Bank entered the international capital markets with a SEK 500 million 4-year bond under a newly established Global Medium Term Notes (GMTN) programme.

Operational risk

The development of the Bank's operational risk management framework continued in 2013. A new Quality Management Policy was approved by the Executive Board, as well as a Data Policy describing the Bank's data governance. The Bank continued the implementation of the Business Continuity Management Framework, and all business units have now prepared business continuity plans, and appointed business continuity teams.

In 2013 a total of 416 loss events were registered in the Bank's loss event database, indicating a strong awareness of the loss registration program by the Bank's employees. Most of the registered events occurred without causing a loss. Of the total losses due to operational risk in 2013, 92% were attributed to events related to execution, delivery and process management.

Sverrir Örn Þorvaldsson, Chief Risk Officer

Development of key financial and risk figures	2013	2012	Δ	
Total operating income (ISK bn)	42.6	47.6	(5.0)	↓
Profit (ISK bn)	23.1	23.4	(0.3)	↓
Return on equity after tax (ROE)	14.7%	17.2%	(2.5%)	↓
Net interest margin (total assets)	3.4%	4.1%	(0.7%)	↓
Cost to income ratio	58.5%	53.8%	4.7%	↑
Total capital ratio	28.4%	25.5%	2.9%	↑
Tier 1 ratio	25.1%	22.0%	3.1%	↑
Total regulatory capital (ISK bn)	187.3	169.3	18.0	↑
Loans to customers (ISK bn)	558.4	559.6	(1.2)	↓
Loans to individuals (ISK bn)	255.0	244.4	10.6	↑
Total deposits (ISK bn)	519.0	509.4	9.6	↑
Customer deposits / Loans to customers	88.2%	84.4%	3.8%	↑
Total risk weighted assets (ISK bn)	659.8	664.7	(4.9)	↓
RWA / Total assets	76.2%	80.7%	(4.5%)	↓
LPA metric	8.3%	13.7%	(5.4%)	↓
Loans to customers classified as impaired (ISK bn)	27.1	48.0	(20.9)	↓
Net currency imbalance (ISK bn)	23.7	27.9	(4.2)	↓
Inflation imbalance (ISK bn)	6.4	1.3	5.1	↑
Banking book interest rate sensitivity (BPV, ISK bn)	0.3	0.5	(0.2)	↓

Exhibit 4. Development of key financial and risk figures for Íslandsbanki. The Δ column indicates changes between year-end 2013 and 2012. The arrows indicate an increase or decrease. The colour indicates whether development has been positive (green), negative (red) or neutral (grey) for the Bank's risk profile.

1 INTRODUCTION

The objective of Íslandsbanki's Risk Report is to provide market participants and other stakeholders with information that facilitates a better understanding of Íslandsbanki's risk profile and capital adequacy, and thus comply with the Basel disclosure requirements. The Risk Report provides key information on the Bank's risk governance, risk assessment processes, material risk exposures, capital adequacy and capital composition. In addition, it provides information about the CRD IV implementation in Iceland together with a short introduction to other domestic legislative and regulatory changes. Information about the Bank's remuneration policy and processes as well as quantitative information is also disclosed in this report.

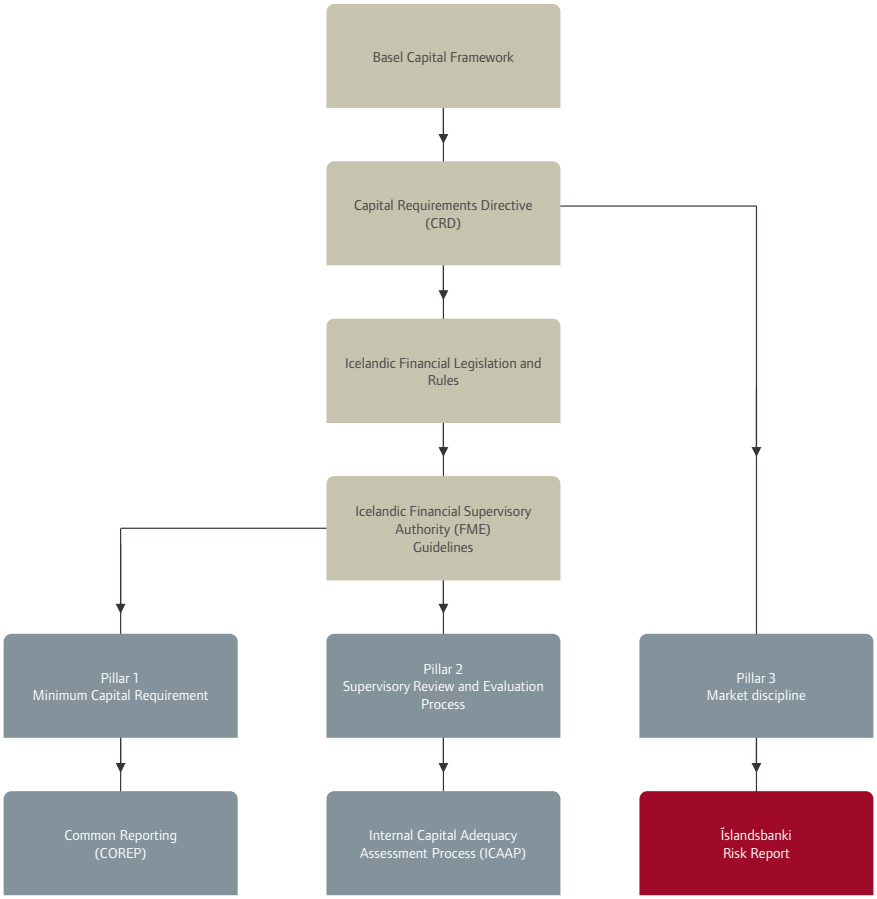

Exhibit 1.1. Regulation overview.

1.1 REGULATORY BACKGROUND

Íslandsbanki's capital management framework is based on the Basel II framework and the EU Capital Requirement Directive (CRD).[1] The CRD has been implemented in the European Union (EU). As part of the European Economic Area (EEA) agreement Iceland is required to implement the directive into Icelandic legislation.

The scope of the Basel II framework is broken into three pillars:

- Pillar 1 – Minimum capital requirement for credit, market and operational risk.
- Pillar 2 – Supervisory review and evaluation process (SREP) and framework for banks' Internal Capital Adequacy Assessment Process (ICAAP).
- Pillar 3 – Market discipline through disclosure requirements.

This report is intended to fulfil the requirements under Pillar 3. Chapters 2-7 further describe the Bank's approach to Pillar 1 and Pillar 2. Since the Icelandic Financial Supervisory Authority has not issued any guidelines regarding Pillar 3 disclosure, the report is based on the requirements as stated in the CRD. Exhibit 1.1 provides an overview of the capital management regulatory framework under which Íslandsbanki operates.

The Basel Committee on Banking Supervision (BCBS) has introduced a revision of the Basel II framework, generally referred to as Basel III. The implementation of the revised framework within the European Union (EU) through the capital requirements directive, CRD IV, applies from 1

[1] Capital Requirements Directive (CRD 2006/48&49/EC).

January 2014. The CRD IV framework has not been incorporated into the EEA Agreement, and it may not be possible to enact certain provisions of the directive into Icelandic law due to constitutional restraints. Nonetheless, proposals, at least for partial implementation of CRD IV, are expected to be introduced in the Icelandic parliament in 2014. The Central Bank has already adopted the CRD IV liquidity measures into the Icelandic rules on liquidity ratio and the FME has taken steps in adopting the CRD IV methodology for capital requirement assessment through the 2013 Supervisory Review and Evaluation Process. Further details about the implementation of the CRD IV can be found in Chapter 3 - Capital management and Chapter 6 - Liquidity risk.

1.2 CONSOLIDATION

The Risk Report applies to Íslandsbanki on a consolidated level, hereafter referred to as "the Bank" or "Íslandsbanki". The definition of Íslandsbanki on a consolidated level is the same as used in the Consolidated Financial Statement 2013. Names and primary businesses of major subsidiaries at year-end 2013 are listed in Exhibit 1.2.

1.3 DISCLOSURE POLICY

As required under Pillar 3, Íslandsbanki has in place a formal Disclosure and Communication Policy approved by the Board of Directors. The policy outlines the governing principles and framework for external disclosure and communication.

Risk and capital management disclosure aims at giving a true and fair view of the Bank's capital structure and adequacy, material risk exposures and risk assessment processes. Accordingly, Íslandsbanki may decide not to disclose information that is considered to be immaterial. In addition, the Bank will not disclose information that is deemed to be proprietary or confidential. The classification of proprietary and confidential information is based on Icelandic law and regulation.

The main channel for Íslandsbanki's risk and capital management disclosure is through the Risk Report, the Annual Report, the quarterly financial statements and investor presentations. All these documents are available on the Bank's website, www.islandsbanki.is/ir. The Risk Report is reviewed annually and published in conjunction with the Annual Report. If material risk exposures change significantly between reporting periods, the Bank can choose to disclose information thereon more frequently.

1.4 VERIFICATION

The Risk Report has not been audited by external auditors and does not form part of Íslandsbanki's audited financial statements. However, it has been appropriately verified internally and includes information from the audited Consolidated Financial Statement 2013.

The Risk Report has been prepared in accordance with the CRD, rather than in accordance with IFRS. This can cause some discrepancy between financial information in the Consolidated Financial Statement 2013 and information in the Risk Report 2013. For some parts, figures are only available or relevant on parent level and will be clearly marked as such.

The Risk Report is informative in nature, and should not be interpreted as a recommendation to take, or not to take, any particular investment action. All views expressed herein are those of the author(s) at the time of writing and may be subject to change without notice. Íslandsbanki holds no obligation to update, modify or amend this report in the event that any matter contained herein changes or subsequently becomes inaccurate. Nothing in this report shall be interpreted as an offer to customers nor is it intended to constitute a basis for entitlement of customers.

Name of significant subsidiaries	Primary business	Ownership	Location
Borgun hf.	Credit card acquirer	62.2%	Iceland
Íslandssjóðir hf.	Fund management	100%	Iceland
Midengi ehf.	Asset management	100%	Iceland
HTO ehf. (formerly Höfdatorg ehf.)	Real estate	72.5%	Iceland
Hringur eignarhaldsfélag ehf.	Holding company	100%	Iceland
Allianz Ísland hf.*	Life Insurance broker	100%	Iceland
D-1 ehf.	Real estate	100%	Iceland
EFF 4 ehf.	Real estate	100%	Iceland
Geysir Green Investment Fund slhf.	Holding company	100%	Iceland
Fergin ehf.	Holding company	80%	Iceland
Frumherji hf. **	Commerce and services	100%	Iceland

*Subsidiary of Hringur eignarhaldsfélag ehf.

**Subsidiary of Fergin ehf.

In addition to the subsidiaries listed above, the Bank has 32 other subsidiaries

Exhibit 1.2. Names and primary business of the major subsidiaries at year-end 2013. Fully consolidated.

2 RISK MANAGEMENT

Risk assessment and the prudent evaluation and pricing of risk are key elements in the Bank's operations. In turn, an efficient risk assessment framework forms the foundation of the Bank's risk and capital management strategy. Íslandsbanki aims for informed decision-making and strong risk awareness throughout the Bank. Risk Management strives to continuously improve its activities by virtue of its expertise and thereby increasing the value of the services and products provided by the Bank.

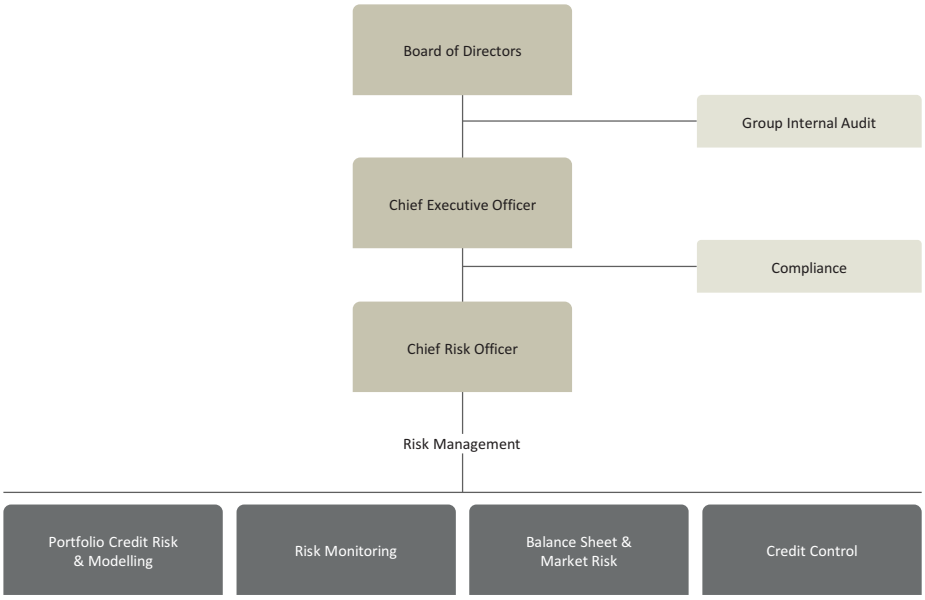

Exhibit 2.1. Risk governance and organisational structure of Risk Management.

2.1 RISK GOVERNANCE AND ORGANISATION

The Bank is exposed to various risk factors and managing these risk factors is an integral part of the Bank's operations. Íslandsbanki has an independent department, Risk Management, headed by the Bank's Chief Risk Officer (CRO), with staff of about 40 well educated and experienced employees.

The Bank's risk management and other control functions are organised as shown in Exhibit 2.1.

Íslandsbanki's management body has a dual structure, meaning that the Board of Directors has a supervising role and the CEO has responsibility for daily operations.

The ultimate responsibility for ensuring an adequate risk management framework lies with the Board of Directors. The Board defines and communicates the acceptable level of risk through the Bank's Risk Appetite Statement and the risk management policies.

The Chief Executive Officer (CEO) is responsible for developing and maintaining adequate and effective risk management and internal control functions within Íslandsbanki. In addition, the CEO appoints the Chief Risk Officer (CRO) as well as other members of the Executive Board, the Risk Committee, the Asset and Liability Committee and the Investment Committee.

Group Internal Audit conducts independent evaluations and provides assurance for the internal controls and risk management for its appropriateness, effectiveness and its compliance to the Bank's directives. The Chief Audit Executive (CAE) is appointed by the Board and accordingly has an independent position in the Bank's organisational chart. The CAE is responsible for internal audit within the Bank.

Compliance is responsible for monitoring that the Bank always fulfils its obligations as provided for in the Act on Securities Transactions, in concluding securities transactions and as the issuer of listed financial instruments, and as provided for in the Act on Actions to Combat Money Laundering and Terrorist Financing. Furthermore, the Compliance Officer oversees training, advice and assistance provided to employees carrying out activities subject to his supervision.

The Chief Risk Officer (CRO) is a member of the Executive Board and is responsible for the risk management organisation within Íslandsbanki. The CRO heads the risk management department and is responsible for defining the daily tasks of the department and to assess the adequacy of its professional skills. In addition, the CRO is responsible for organising risk management within Íslandsbanki in order to ensure that Íslandsbanki has the right resources and an appropriate organisation to manage its risks efficiently. This includes risk management functions in branches and subsidiaries.

Risk Management is responsible for maintaining and developing internal directives and frameworks regarding

risk management and internal control. The department is also responsible for setting competency standards, for training staff on the Bank's policies, internal directives and frameworks related to risk management and internal control. In addition, Risk Management provides the managers of business units with information and guidance regarding risk management and internal control issues.

Risk Management advises on risk and risk assessment. It develops, maintains and tests risk models and provides other forms of support within its expertise.

Risk Management reports on risk and compliance to limits to internal and external stakeholders and ensures an appropriate escalation in the event of limit breaches.

Risk Management is independent from business lines but provides strategic support aligned with the Bank's business objectives. The existence of an independent risk management department does not absolve management from its responsibility to manage all risks arising in their business and function.

Risk Management is comprised of four units:

2.1.1 PORTFOLIO CREDIT RISK AND MODELLING

The Portfolio Credit Risk and Modelling unit is responsible for measuring, monitoring and reporting on credit risk for all financial assets. This entails developing, maintaining and enhancing risk management models used for credit risk. The unit monitors credit risk limits set in the Credit Risk Policy and reports on credit risk to internal and external stakeholders. Any public or formal disclosure by the Bank on credit risk is reviewed by the unit. The Portfolio Credit Risk and Modelling unit does not take part in any individual credit decisions.

2.1.2 RISK MONITORING

The Risk Monitoring unit is responsible for the development of the Bank's operational risk management framework and efficient tools and techniques for measuring and monitoring operational risk throughout the Bank. Risk Monitoring collects operational risk loss event data and facilitates the risk and control self-assessment (RCSA) process for each business unit. Risk Monitoring measures key risk indicators (KRIs) in order to detect changes in the Bank's operational risk profile. The implementation of the Bank's business continuity management framework is coordinated by Risk Monitoring.

Risk Monitoring performs inspections on the execution of credit processes and procedures in the Bank. Uniform and pre-defined inspections of the execution of all credit processes at individual branches or business units are performed on a regular basis, as well as special investigations on the execution of specific processes throughout the Bank.

Risk Monitoring is responsible for the Bank's quality management framework and the development and maintenance of the Quality Management Policy. Support is provided to the Bank's units for various matters regarding quality management, i.e. operational documentation, project management, product approval process and other support to continuous improvement efforts within the Bank. In addition, Risk Monitoring is responsible for the Bank's data governance framework and the maintenance of the Bank's Data Policy.

2.1.3 BALANCE SHEET AND MARKET RISK

The Balance Sheet and Market Risk unit is responsible for the measuring, monitoring and reporting of market risk, liquidity risk and the Bank's capitalisation. This includes reporting to internal and external stakeholders on the respective risk positions.

The unit is responsible for the maintenance of the Bank's Market Risk Policy and Liquidity Risk Policy and the administration of the Asset and Liability Committee (ALCO) meetings.

The Balance Sheet and Market Risk unit manages the Internal Capital Adequacy Assessment Process (ICAAP), the Risk Report and maintains the pricing model for loans. The unit provides strategic support to the Markets operations of the Bank as well as to other business units on aspects related to market risk, liquidity risk or capital consumption.

2.1.4 CREDIT CONTROL

The Credit Control unit is accountable for the execution and implementation of the credit process in accordance with the Bank's Credit Risk Policy and Credit Rules. This entails administration of credit committees and taking part in individual credit decisions at the committee level, ensuring that all credit decisions are in line with the Bank's Credit Risk Policy and Credit Rules. Credit Control is independent from the business units and provides an objective balance to the credit decision making process.

Credit Control provides support and guidance to business units on credit and credit processing, while interacting with business units on a daily basis on all issues regarding credit. This includes monitoring of watch–list credits, non–performing loans and defaults. Credit Control is responsible for the distressed credit workout process, processing of individual distressed cases, as well as the development and implementation of standardised restructuring solutions.

Credit Control is also responsible for the assessment of specific impairments as well as final write-offs.

2.2 RISK MANAGEMENT COMMITTEE STRUCTURE

Íslandsbanki focuses on sound governance principles and all major decisions go through an internal approval process. This is done in order to ensure that the decisions taken within the Bank fulfil the appropriate requirements at any given time. The responsibilities regarding such decisions are outlined in the Bank's risk policies and the Decision Matrix. The corporate governance structure is further described in the Annual Report 2013.

The organisational structure for committees governing the different risk factors that the Bank's is exposed to is shown in Exhibit 2.2.

As mentioned, the ultimate responsibility for ensuring an adequate risk management framework lies with the

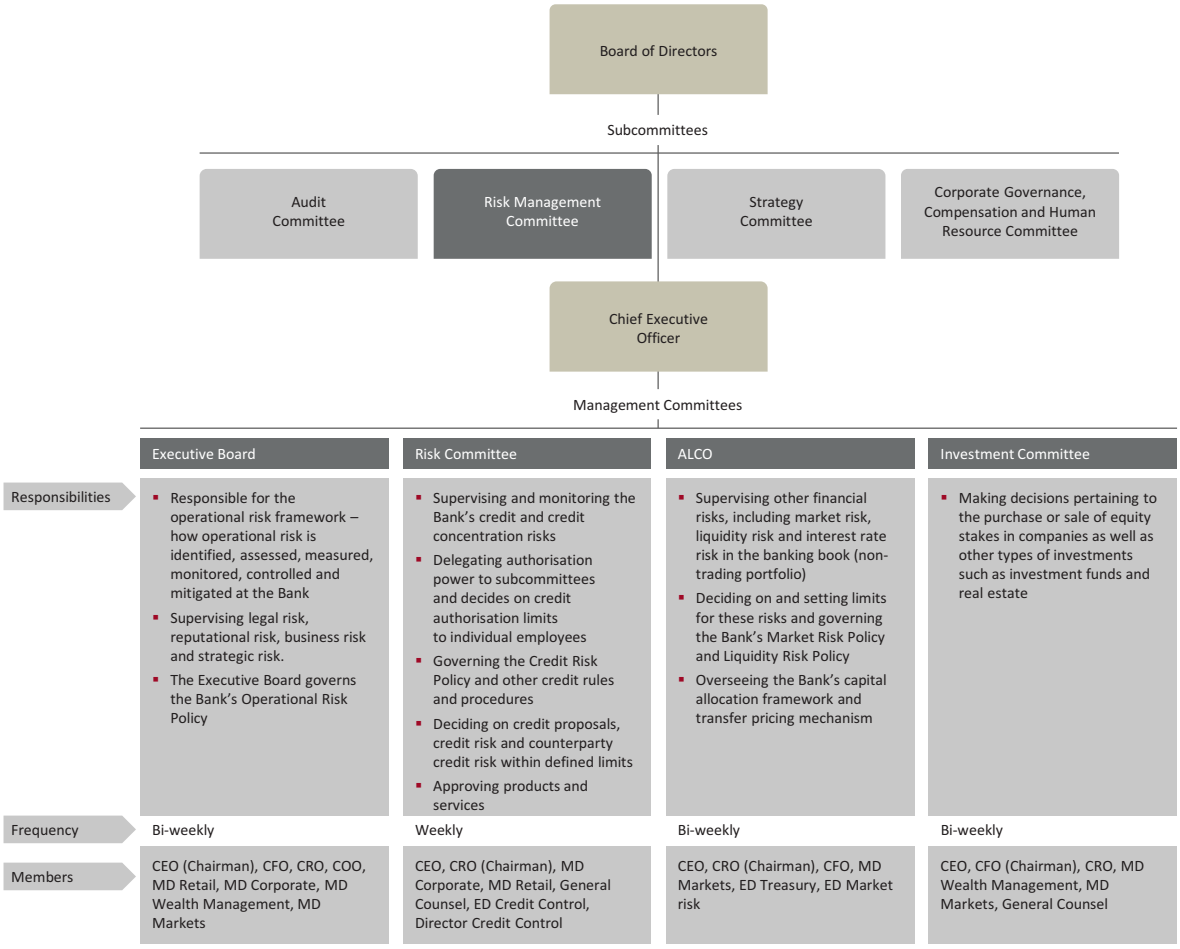

Exhibit 2.2. Risk management committee structure.

Board of Directors. The Board has appointed four Board subcommittees as shown in Exhibit 2.2.

The implementation of the risk management practises and internal monitoring in accordance with Board authorisation is delegated to the management committees: the Executive Board, the Risk Committee, the Asset and Liability Committee, and the Investment Committee. Under this authorisation, these management committees issue detailed guidelines for risk assessment and individual risk thresholds in accordance with the Bank's defined risk appetite. The members of the management committees are appointed by the CEO, and their mandate and rules of procedure are documented in a charter, presented to the Board.

2.2.1 BOARD SUBCOMMITTEES

Board Audit Committee

The Board Audit Committee has four Board members and assists the Board in fulfilling its oversight responsibilities concerning the financial reporting process, the system of internal control, the audit process, and the Bank's process for monitoring compliance with laws and regulations and its code of ethics. The Audit Committee's remit includes the parent company, its subsidiaries, and the group as a whole.

Board Risk Management Committee

The Board Risk Management Committee has four Board members. The Committee is responsible for overseeing and reviewing risks inherent in the Bank's operations, including but not limited to credit risk, market risk, operational risk and liquidity risk. The Committee is responsible for reviewing the Bank's risk appetite, risk policies and risk management practices and make recommendations on these topics to the Board.

Board Strategy Committee

The Strategy Committee has five Board members and oversees and approves key issues related to the strategy of the Bank and formulates general policies to effectively implement that strategy. The Committee sets out strategic and financial targets and priorities and monitors their progress.

Board Governance, Compensation and Human Resource Committee

The Board Governance, Compensation and Human Resource Committee has five Board members. The Committee is responsible for assisting the Board in setting goals for the Bank and overseeing the Bank's relationship with managers, the Board, shareholders, and other stakeholders, with the aim of clarifying areas of responsibility. The

Committee is also responsible for assisting the Board in evaluating Board members' performance.

2.2.2 MANAGEMENT COMMITTEES

Executive Board

The Executive Board is responsible for the operational risk framework and governs the Operational Risk Policy. The operational risk framework covers how operational risk is identified, assessed, measured, monitored, controlled and mitigated in the Bank. In addition, the Executive Board supervises legal risk, reputational risk, business risk and strategic risk.

Risk Committee

The Risk Committee is responsible for supervising and monitoring the Bank's credit risk and credit concentration risk. The Risk Committee governs the Bank's Credit Risk Policy and other credit rules and procedures. The Risk Committee can delegate authorisation power to subcommittees and decides on credit authorisation limits to individual employees.

The Risk Committee and each of its subcommittees have the authority to decide on credit proposals, credit risk and counterparty credit risk within defined limits. Decisions on exposures that exceed committee limits shall be referred to a more senior committee. In particular, if a credit decision exceeds the authorisation limits of the Risk Committee an extension of the limit needs to be approved by the Board.

The Risk Committee is also responsible for approving products and services according to the Bank's Product Approval Process as described in Section 7.5.

Asset and Liability Committee

The Asset and Liability Committee (ALCO) supervises other financial risks, including market risk, liquidity risk and interest rate risk in the banking book (non-trading portfolio). ALCO decides on and sets limits for these risks and governs the Bank's Market Risk Policy and Liquidity Risk Policy. ALCO also oversees the Bank's capital management framework and transfer pricing mechanism.

Investment Committee

The Investment Committee makes decisions pertaining to the purchase or sale of equity stakes in companies as well as other types of investments such as in investment funds and real estate.

2.3 RISK POLICIES AND REPORTING STRUCTURE

Each year the Board decides on material risk factors within Íslandsbanki and accordingly defines the risk appetite. The Risk Management department is responsible for identifying the risk inherent in the Bank's operations. The identification is done at business unit level and then consolidated throughout the Bank. The results from the risk identification process are compared to the Bank's risk strategy and risk appetite. For the key risk factors a specific risk policy is defined and approved by the Board of Directors. The need for a specific risk policy is based on the assessment of the proportionality of the respective risk factors to the Bank's operations and business strategy.

Currently, the following four risk types have been defined as key to the Bank's operations and business strategy and their assessment, management and limits are defined in specific risk policies:

- Credit risk (chapter 4).
- Market risk (chapter 5).
- Liquidity risk (chapter 6).
- Operational risk (chapter 7).

Concentration risk is defined as material but currently managed according to the source of concentration. Concentration risk is considered in the Credit Risk Policy, Market Risk Policy and Liquidity Risk Policy.

The Bank has also identified business risk, strategic risk and political risk as material to the Bank's operations. These risk types are not covered in separate risk policies, but closely monitored and addressed specifically in the regular ICAAP process.

The governing principles for risk management and internal control within Íslandsbanki are described in the Bank's Risk Management and Internal Control Policy.

Exhibit 2.3 provides an overview of the governance of risk management documents issued by the Board of Directors and the reporting lines for the respective risk positions.

Íslandsbanki's Risk Appetite Statement is a high level statement of the Bank's risk tolerance and financial targets. The Risk Appetite Statement is intended to support the Bank's business strategy by defining limits and targets for core factors in the Bank's risk profile and operations.

The Risk Appetite Statement is further implemented through the policies approved by the Board that provide more details for individual risk types. Finally, the risk appetite is translated to specific risk limits that are approved by the relevant committees.

The strategic targets of the management are further defined in the Bank's business plan that is approved by the Board of Directors. The business plan gives a 5-year view for the development of the Bank's operations and provides a basis for stress testing and capital planning.

The Internal Capital Adequacy Assessment Process (ICAAP) aims at identifying and assessing the risk inherent in the Bank's operations and for integrating the Bank's business strategy and business plan on one hand and its risk profile on the other hand. This is to ensure that the Bank at all times holds enough capital to support its risk profile and business strategy.

The Pillar 2 framework describes Íslandsbanki's approach for covering the Bank's responsibilities under Pillar 2 in the CRD. The objective of the document is to provide a high level overview of how each of the Pillar 2 functional components is covered within the Bank's risk management and risk governance framework.

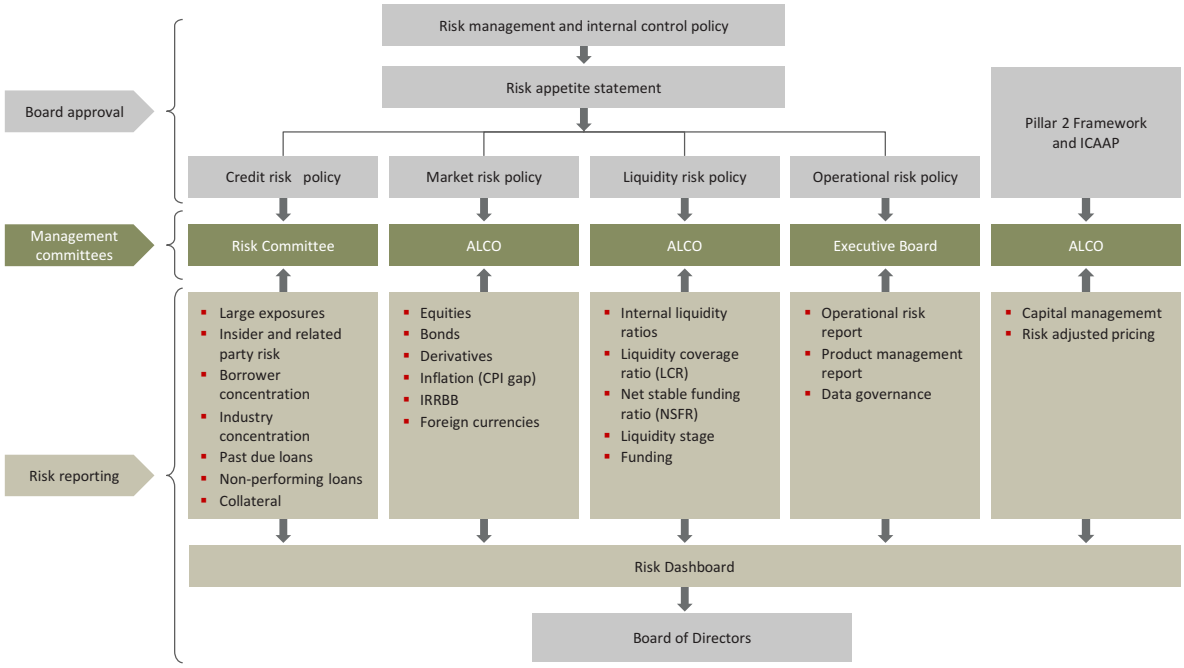

Exhibit 2.3. Risk Management documents subject to Board approval and risk reporting structure.

2.3.1 *INTERNAL REPORTING*

Íslandsbanki aims to have clearly defined and efficient reporting lines to ensure compliance with the approved risk limits and targets. Timely and accurate reporting on material risk factors is an essential part of the risk management and internal control governance. The Bank is continually working on improvements to the technological platform to better support risk management. Since the Bank's establishment, several initiatives have been taken to strengthen the risk governance by putting in place systems and work procedures required to manage and mitigate risk proactively.

Risk Management produces several internal reports. The main recipients of internal reports are the Board of Directors, the Executive Board, the Risk Committee, the Asset and Liability Committee, the Investment Committee, and, when applicable, Internal Audit. The frequency varies from daily or intraday reporting on positions that change frequently or are of special concern, to weekly, monthly and quarterly reporting on positions and portfolios that are more stable in nature. At least at every Board meeting, the Board and management receive a Risk Dashboard summarising the main risk positions as compared to internal and regulatory limits. The Compliance function has access to all reports to regulators.

2.3.2 *EXTERNAL REPORTING*

The main official information that the Bank publishes is in the Annual Report, Financial Statements, the Risk Report, and investor presentations. All of these are available on the website: www.islandsbanki.is/ir.

The Bank's financial accounts are prepared in accordance with International Financial Reporting Standards (IFRS). Regulatory reports are prepared based on the Capital Requirements Directive (CRD) along with discretionary rules and requirements made by the Central Bank (CB) and the Financial Supervisory Authority (FME).

Business segment	Credit risk	Market risk	Operational risk	Liquidity risk
Retail Banking	✓	-	✓	-
Corporate Banking	✓	-	✓	-
Markets	✓	✓	✓	-
Wealth Management	-	-	✓	-
Treasury	✓	✓	✓	✓
Subsidiaries and equity investments	✓	✓	✓	-

Exhibit 2.4. The key material risk factors identified within each business segment.

In addition, the Bank works and reports according to the guidelines issued by Nasdaq OMX Iceland for listed companies, since Íslandsbanki is an issuer of listed bonds. The framework for public disclosure regarding the Bank's risk and financial positions is described in the Disclosure & Communication Policy issued by the Board.

2.4 MATERIAL RISK ACROSS BUSINESS SEGMENTS

Íslandsbanki offers comprehensive financial services to individuals, households, corporations, municipalities and professional investors in Iceland. The risk inherent in each business segment differs depending on the products and services offered. Exhibit 2.4 shows the key risk factors identified in each business segment.

2.4.1 *RETAIL BANKING*

Retail Banking operates 19 branches and asset-based financing under the brand name Ergo. The branches provide services to individuals and small and medium-sized

enterprises. In addition, the Retail Banking division operates Kreditkort, which is a special credit card branch, a call centre and a centralised cash centre.

The main risk within Retail Banking is credit risk in relation to lending activities. Operational risk is inherently a part of the operations but is considered moderate in relative terms. Concentration risk arises through the lending activity of Retail Banking.

Any market risk, e.g. due to mismatches between assets and liabilities, along with concentration risk in relation to deposits in Retail Banking is transferred to the Treasury department which manages the risk through internal pricing, lending quotas and hedges where applicable.

2.4.2 CORPORATE BANKING

Corporate Banking provides lending and tailor-made financial services to larger companies and professional investors. Furthermore, Corporate Banking oversees the Bank's international business in the North Atlantic region where the focus is on the seafood, the offshore supply vessel and the energy industries.

Credit risk and credit concentration risk are the key risk factors for the Corporate Banking unit and some market risk is inherent in the operations in relation to bonds in the banking book. As with Retail Banking, any market risk due to mismatches between assets and liabilities in Corporate Banking is transferred to the Treasury department, which manages the risk through internal pricing and lending quotas where applicable.

2.4.3 MARKETS

Markets offer brokerage services in securities, foreign currencies and derivatives as well as providing money market lending and interbank services. The division further offers an extensive range of corporate finance services locally as well as to the international business in the North Atlantic region.

Operational risk is a material risk factor since the volume of transactions is fairly high.

Market risk is mainly related to flow trading and interbank trading activities, including management of the Bank's liquidity portfolio, which is subject to strict limits. Credit risk is mainly related to derivative contracts with customers where collateral positions are valued and monitored intraday. Margin calls are performed when required according to a strict framework approved by ALCO.

2.4.4 WEALTH MANAGEMENT

Wealth Management offers a range of wealth and asset management products and services for individuals, corporations as well as for institutional investors through the Wealth Management unit VÍB and the fund management company Íslandssjódir. Operational risk is the key risk factor within Wealth Management due to transaction volume and obligations towards the customer to invest and administer their assets in line with the agreed investment strategy.

2.4.5 TREASURY

Treasury is a part of the Finance and Treasury department. Treasury is responsible for optimising the Bank's balance sheet in strict adherence to the risk limits approved by the Board of Directors. One of the main responsibilities of Treasury is the management of the Bank's funding and liquidity risk. Market risk is also an integral part of Treasury's operations, since mismatches between the Bank's assets and liabilities are managed by Treasury. Operational risk is a material risk factor but is considered moderate in relative terms. Concentration risk is a material risk factor, mainly on the liability side and related to single large depositors or groups of depositors.

2.4.6 SUBSIDIARIES AND EQUITY INVESTMENTS

Subsidiaries and equity investments include equity investments in the banking book and subsidiaries. The main subsidiaries are listed in Exhibit 1.2. The main risks identified are credit risk through the credit card acquirer Borgun and market risk through the equity investments. In addition, operational risk is a key risk factor through their operations and transaction volume.

3 CAPITAL MANAGEMENT

Íslandsbanki's capital position continued to strengthen throughout 2013 and at the end of the year the Bank's capital ratio was 28.4%, well in excess of both the Bank's current minimum capital target and regulatory requirements.

The Bank's capital position is strong compared to both domestic and European peers and the Bank is well prepared to address proposed changes in international regulation. The current minimum capital target ratio approved by the Board of Directors is 18%. This target may be revised as more clarity is gained regarding the implementation of the new EU capital requirements directive (CRD IV) into Icelandic legislation.

For Íslandsbanki, one of the main challenges over the coming years will be to establish a prudent balance between the Bank's capitalisation and a healthy return on shareholder's equity. However, any decision that would entail reducing the Bank's capital ratios, for example through dividend payments, will be based on an assessment of the Bank's operating environment, the Bank's target credit rating and the credit ratings of the Icelandic sovereign and the Bank's liquidity position taking into account the restrictions inherent in the capital controls and other external factors.

DEFINITION OF CAPITAL

Banks' capital is intended to provide a buffer for unexpected losses or volatility in banks' earnings and thereby provide protection for depositors and other creditors as well as promoting stability of the financial system.

The eligible capital for calculating the capital ratio is defined in law and further outlined in rules and regulations. The Icelandic law, which is based on the European capital requirements directive, defines both the type of capital eligible and restrictions to the reliance on specific instruments.

3.1 STRATEGY, ORGANISATION AND RESPONSIBILITY

Íslandsbanki's capital management framework is based on the Basel rules and the EU capital requirements directive (CRD) as adopted into Icelandic law.

The Board of Directors is responsible for the Bank's capital framework and for ensuring that the Bank's capitalisation is adequate in relation to the risk inherent in the operations taking into account the Bank's business strategy and operating environment.

The Asset and liability committee (ALCO) supervises the capital management framework and makes proposals to the Board regarding issues related to capital management.

Risk management is responsible for internal and external reporting on the Bank's capital adequacy. Risk management is also responsible for the Bank's internal capital adequacy assessment process (ICAAP) and for the allocation of capital to individual business units.

Treasury is responsible for the management of the Bank's capital in accordance with the targets set by the Board and for reporting on the risk-adjusted performance down to individual business units. Treasury is also responsible for developing the Bank's dividend policy.

3.2 CAPITAL POSITION AND MINIMUM CAPITAL REQUIREMENTS

At year-end 2013 Íslandsbanki's total capital base amounted to ISK 187 billion as compared to ISK 169 billion at year-end 2012. Most of the capital base, ISK 166 billion, is comprised of core tier 1 capital. In addition, the Bank has issued one 10-year EUR-denominated tier 2 bond to the Icelandic government. The eligibility of the bond as tier 2 capital will decrease by 20% in 2015 since the remaining term, at that point in time, isonly five years. After that, there is an annual linear decrease by 20% until maturity in 2019. A breakdown of the Bank's capital base is shown in Exhibit 3.1.

The Bank's minimum capital requirements, the corresponding RWA under Pillar 1 and the resulting capital ratios are shown in Exhibit 3.2. A further description of how the minimum capital requirements are calculated can be found in section 3.3.1.

Exhibit 3.3 shows the main components contributing to changes in Íslandsbanki's risk-weighted assets over the year 2013.

The largest increase during the year was in the categories non-current assets held for sale and property and equipment, both of which are related to the restructuring of the loan portfolio. Off-balance sheet liabilities also increased the RWA, mainly due to an increase in undrawn loan commitments.

The decrease in RWA was mostly related to improved credit quality of the loan portfolio, a reduction in the currency imbalance, and a decline in the basic indicator used to calculate operational risk capital requirements.

Capital	31.12.2013	31.12.2012
Tier 1 Capital	165,585	146,214
Ordinary share capital	10,000	10,000
Share premium	55,000	55,000
Other reserves	2,471	2,834
Retained earnings	98,548	78,551
Non-controlling interests	1,299	1,275
Tax assets	(1,275)	(864)
Intangible assets	(299)	(261)
Other regulatory adjustments	(160)	(322)
Tier 2 capital	21,730	23,129
Qualifying subordinated liabilities	21,890	23,450
Other regulatory adjustments	(160)	(322)
Capital base	187,315	169,342

Exhibit 3.1. Breakdown of the capital base at year-end 2013 and 2012 (ISK m).

Íslandsbanki's capital requirements and RWA	Minimum capital requirements	RWA	Minimum capital requirements	RWA
	31.12.2013		31.12.2012	
Credit risk	44,155	551,938	43,963	549,535
Central governments or central banks	69	865	39	488
Regional governments or local authorities	77	968	99	1,244
Administrative bodies and non-commercial undertakings	150	1,874	170	2,126
Financial institutions	799	9,983	978	12,228
Corporates	20,517	256,466	20,367	254,582
Retail	11,792	147,395	11,490	143,622
Secured by real estate property	2,777	34,710	2,248	28,100
Past due items	1,617	20,211	3,597	44,963
Collective investments undertakings (CIU)	31	392	31	387
Property, equipment, non-current assets held for sale and other assets	5,191	64,886	3,843	48,038
Fair value shares, investment in associates and shares held for sale	1,135	14,189	1,101	13,758
Market risk	2,308	28,849	2,715	33,940
Traded debt instruments	269	3,366	281	3,512
Equity	139	1,739	200	2,494
Foreign Exchange	1,900	23,744	2,235	27,934
Operational risk	6,318	78,970	6,434	81,214
Total	52,781	659,758	53,112	664,689
Tier 1 capital		165,585		146,214
Capital base		187,315		169,342
Tier 1 capital ratio		25.1%		22.0%
Capital ratio		28.4%		25.5%

Exhibit 3.2. Minimum capital requirements, risk-weighted assets and capital ratios at year-end 2013 and 2012 (ISK m).

3.3 INTERNAL CAPITAL ADEQUACY ASSESSMENT AND CAPITAL TARGET

As required in the CRD the Board sets a minimum capital target for the Bank, expressed as the ratio between capital and risk-weighted assets.

Íslandsbanki filed the latest ICAAP report to the FME in May 2013. The supervisory review and evaluation process (SREP) based on that report is in its final stages but the Bank had not received a final conclusion from the FME in relation to the process when this report was being prepared.

The current minimum capital target ratio approved by the Board of Directors is 18%. This target may be revised as more clarity is gained regarding the implementation of

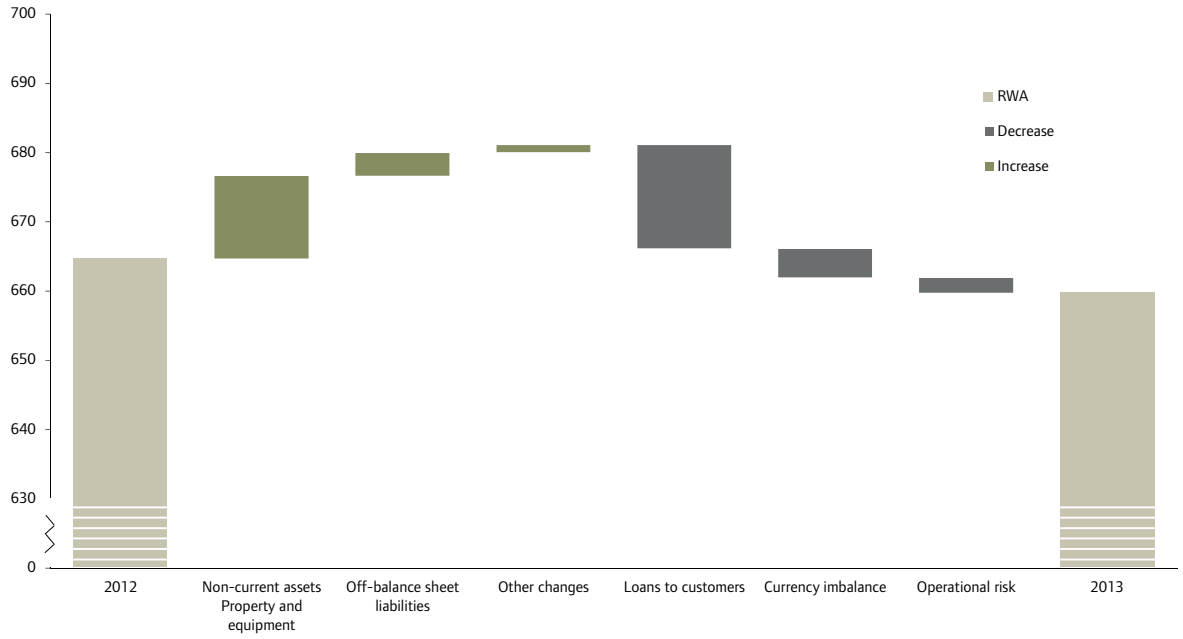

Exhibit 3.3. Changes in risk-weighted assets (ISK bn).

the new EU capital requirements directive (CRD IV) into Icelandic legislation. The building blocks for defining the minimum capital target for the Bank are outlined in Exhibit 3.4 and further described in the following section.

3.3.1 MINIMUM CAPITAL REQUIREMENTS UNDER PILLAR 1

The first pillar of the CRD defines the minimum capital requirements for credit risk, market risk and operational risk. The capital ratio, calculated as the ratio between the capital base and risk-weighted assets, must exceed 8%.

RISK-WEIGHTED ASSETS

For each of the Pillar 1 risk factors the CRD allows for different methods to be used for calculating the minimum capital requirement and thereby risk-weighted assets (RWA).

Credit risk

Íslandsbanki uses the standardised approach for calculating RWA for credit risk under Pillar 1. The RWA for credit risk are derived by assigning a risk weight, in the range of 0–150%, to the Bank's assets depending on the creditworthiness of the counterparty, the underlying collateral and the type and term of the exposure. The minimum capital requirement for credit risk is then calculated as 8% of RWA.

Market risk

Íslandsbanki uses the standardised approach for calculating capital requirements for market risk.

For traded debt instruments, the capital requirement is generally in the range of 0–12%, based on the creditworthiness of the issuer and the term of the instrument taking into account netting within each category.

For equities the capital requirement is calculated by multiplying the net position with a risk charge between 8–12%, depending on the estimated liquidity of the underlying market.

For foreign exchange risk, RWA are calculated as the maximum of the Bank's total long and total short positions in foreign currencies. The minimum capital requirement for foreign exchange risk is then calculated as 8% of the RWA.

Operational risk

Under the Basic Indicator Approach, the minimum capital requirement for operational risk is equal to 15% of the relevant indicator, where the relevant indicator is the average over three years of the sum of net interest income and net non-interest income.

Total risk-weighted assets are determined by multiplying the capital requirements for market risk and operational risk by 12.5 (the reciprocal of the minimum capital ratio of 8%) and adding the resulting figures to the sum of risk-weighted assets for credit risk.

3.3.2 ADDITIONAL CAPITAL REQUIREMENTS UNDER PILLAR 2

The Pillar 1 minimum capital requirements cover uncertainties that affect the banking population as a whole. In addition to the minimum capital required under Pillar 1 further capital might be required under Pillar 2 due to other bank-specific risk factors or due to understatement of the Pillar 1 risk factors.

At Íslandsbanki the main factors contributing to additional capital requirements under Pillar 2 are concentration risk, non-performing loans, interest rate risk in the banking book (IRRBB), equities in the banking book and court cases with possible impact for the Bank.

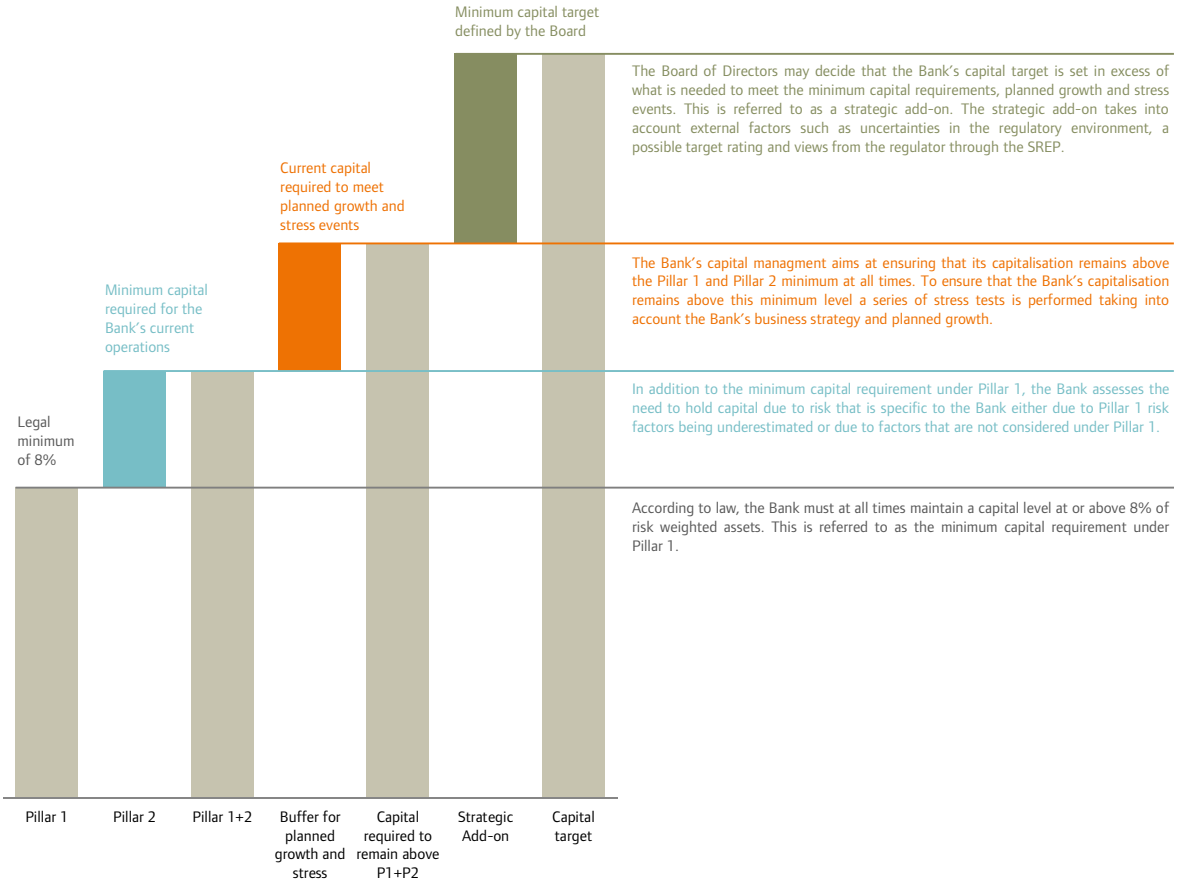

Exhibit 3.4. Building blocks of the Bank's capital target.

The Pillar 2 capital requirement is presented as an add-on to the regulatory capital minimum of 8% as a proportion of risk-weighted assets. The capital requirements under Pillar 1 and Pillar 2 form a baseline capital requirement specific to Íslandsbanki and the Bank's capital management aims at ensuring that the capitalisation remains above that baseline level.

3.3.3 *CAPITAL BUFFER TO ACCOUNT FOR STRESS EVENTS AND PLANNED GROWTH*

The baseline capital requirement is estimated based on "normal business conditions". The Bank however needs to make sure that its capital is sufficient to support the business under stressed market conditions taking into account the Bank's business strategy and planned growth.

Íslandsbanki's business plan is formulated with a bottom-up approach with the participation of all business units of the Bank. Each business unit prepares its individual business plan based on a baseline economic scenario provided by the economic research unit and the consolidated business plan, approved by the Board, is then used as a basis for stress testing and capital planning.

In order to estimate the size of the capital buffer needed under stress, the Bank's business plan is stressed based on various assumptions relevant to the Bank's risk profile and business strategy. The stress testing process consists of impact assessment for different risk factors and the key drivers of the Bank's operations. The assessment is based both on statistical models and expert judgement.

The additional capital requirements under Pillar 2, the results from the stress testing process and the resulting capital plan constitute the main components of the Bank's internal capital adequacy assessment (ICAAP) and provide an important input for defining the capital target for the Bank.

3.3.4 *STRATEGIC ADD-ON*

The Board of Directors may decide that the Bank's capital target is set in excess of what is needed to meet the minimum capital requirements, planned growth and stress events. The difference is referred to as a strategic add-on in Íslandsbanki's capital management framework. The strategic add-on takes into account factors such as uncertainties in the regulatory or operating environment, a possible target rating and views from the regulator through the latest SREP.

3.4 SUPERVISORY REVIEW AND EVALUATION PROCESS

The regulator's supervisory review and evaluation process (SREP) is an important component of the second pillar of the CRD. Through the SREP the regulator assesses the risk management framework of the Bank and whether the Bank's capitalisation is adequate to its risk profile and business strategy. As part of the SREP, the regulator

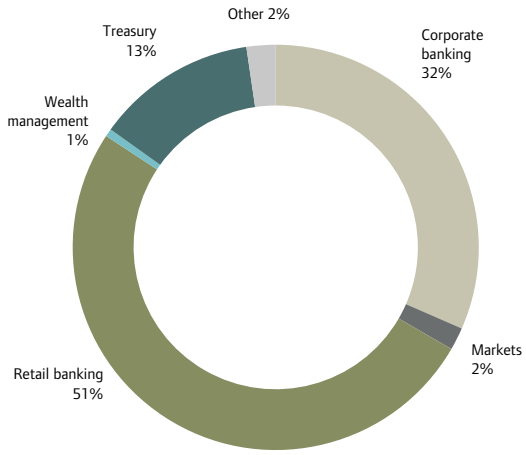

Exhibit 3.5. Proportional split of allocated capital in 2013.

reviews the Bank's ICAAP report but the review can also include on- or off-site inspections of specific parts of the operations.

Through the SREP, the supervisor has the authority to require institutions to hold own funds due to risk or risk elements not covered by the pillar 1 minimum requirement. The CRD emphasises that if a supervisor chooses to set target or trigger ratios or to set categories of capital in excess of the regulatory minimum of 8%, factors that may be considered in doing so should be publicly available. Where the capital requirements are set above the minimum for an individual bank, the supervisor should explain to the bank the risk characteristics specific to the bank which resulted in the requirement and any remedial action necessary.

According to the CRD, supervisors will typically require banks to operate with a capital buffer over the baseline capital requirements to anticipate a combination of events that could impact the bank's capital position.

3.5 CAPITAL ALLOCATION

Allocation of capital across business units and individual positions is a key element in the Bank's capital management, pricing and performance measurement. Capital is allocated to all business segments, down to branch or department level, based on each unit's risk exposure. The return on allocated capital is then calculated for each unit as a risk-adjusted performance measure. Exhibit 3.5 shows the proportional split of allocated capital in 2013.

3.6 NEW REQUIREMENTS THROUGH THE CRD IV – CAPITAL BUFFERS

The implementation of the new European capital requirements directive (CRD IV), often referred to as Basel III, into Icelandic law started in 2013 and is still ongoing. Íslandsbanki adapts its capital management framework and capital targets to the new rules and regulations as information thereon becomes available. One of the main changes following CRD IV relates to the introduction of various capital buffers. The combined buffer requirement consists of

- a capital conservation buffer intended to strengthen banks' ability to withstand adverse changes in the environment by requiring them to hold a capital buffer outside periods of stress;
- a countercyclical capital buffer intended to protect the economy from system-wide risk by building up excess capital during periods of excessive credit growth which is then to be released in an economic downturn;
- a systemic risk buffer which is intended to prevent and mitigate long term non-cyclical systemic or macro-prudential risks not covered elsewhere;
- a specific capital surcharge for systemically important financial institutions.

The FME has indicated how the capital buffers will be introduced in Iceland through the current SREP.

Exhibit 3.7 displays the different components of capital requirements considered by the FME under CRD IV and a reference range for the utilisation of each add-on component. The exhibit also shows how the FME intends to apply the capital add-ons through the current SREP and how these requirements interact with the Bank's internal capital target described in Section 3.3.

	2013	2012
Tier 1 capital	166	146
Total exposure	891	895
RWA	660	665
Total assets	866	823
Leverage ratio	18.6%	16.3%
RWA/Total assets	76.2%	80.7%

Exhibit 3.6. Leverage ratio and RWA over total assets (ISK bn).

3.7 NEW REQUIREMENTS THROUGH CRD IV – LEVERAGE RATIO

The leverage ratio is a new measure introduced in the CRD IV, supplementing the risk-based capital requirements. It is intended to prevent excessive leverage of the balance sheet. The leverage ratio is not risk based and calculated as Tier 1 capital over total exposure, which consists of total assets and adjusted off-balance sheet exposures. Because the Bank uses the standardised approach to calculate capital requirements, the ratio between risk-weighted assets and total assets is relatively high. The new leverage ratio is therefore not expected to be restrictive in any way for the Bank. Currently, no minimum has been set for the leverage ratio under the CRD. Exhibit 3.6 shows the leverage ratio at year-end 2013 and 2012 as well as the ratio between RWA and total assets.

Exhibit 3.7. Capital buffers and capital target.

REGULATORY CHANGES

The implementation of the CRD IV into Icelandic legislation started in 2013 and is still ongoing. Íslandsbanki adapts its capital management framework and capital targets to the new rules and regulations as information thereon becomes available.

Other new regulatory changes in 2013 had a limited impact on the Bank's capital management.

4 CREDIT RISK

The Bank undertakes credit risk by offering loans, guarantees and other credit products. Credit risk is the primary risk factor in the Bank's operations and taking on credit risk is a core activity of the Bank.

The Bank has policies and procedures dedicated to accepting, measuring and managing credit risk. The objective of the Bank's credit risk management is to achieve an appropriate balance between risk and return and to minimise potential adverse effects of credit risk on the Bank's financial performance.

At the end of 2013 the Bank's total exposure due to credit risk amounted to ISK 817 billion compared to ISK 786 billion at the end of 2012. This represents an increase of 4%. New loans and refinancing of outstanding loans amounted to ISK 141 billion in the year 2013 but because of contractual instalments, additional payments, and appreciation of the ISK, the loan portfolio did not increase.

The credit quality of the loan portfolio did however continue to increase as more customers have received financial restructuring resulting in an improved financial standing. The LPA metric drops from 13.7% to 8.3% and loans that are more than 90 days past due have been decreasing as well, from 7.5% to 4.2%. Only a handful of restructuring projects have had to be re-addressed which indicates that the Bank's process is thorough and carefully prepared.

The Bank's cumulative write-offs and remissions in the restructuring of customers' debt in the period 2008-2013 now amount to ISK 548 billion, of which ISK 119 billion is to individuals and ISK 429 billion is to companies.

This chapter includes a description of the Bank's risk assessment models and a breakdown of the loan portfolio by risk classes, which gives an indication of credit quality. In addition, we show a breakdown of the portfolio by number of days past due which gives a good indication of how well the customers fulfil their obligations.

DEFINITION OF CREDIT RISK

Credit risk is defined as current or prospective risk to earnings and capital arising from an obligor's potential failure to meet the terms of any contract with the Bank or otherwise fail to perform as agreed. This risk comprises credit concentration risk, default risk, recovery risk, country risk and settlement risk.

Credit concentration risk is the significantly increased risk of any type that is driven by common underlying factors, e.g. sector, economy, geographical location, type of financial instrument or due to connections or relations among counterparties. This includes large individual exposures to parties under common control and significant exposures to groups of counterparties whose likelihood of default is driven by common underlying factors.

4.1 STRATEGY, ORGANISATION AND RESPONSIBILITY

The Bank's strategy is to maintain a modest credit risk profile. At a consolidated level the Bank aims to have long-term average annual credit losses less than 0.9% of the credit portfolio. This risk appetite is reflected in the credit risk limit structure and guided through the use of credit risk assessment models.

Credit risk activities are controlled through exposure limits applied to counterparties, countries and sectors and with limits specific for different products.

The Bank's credit process is based on a committee structure shown in Exhibit 4.1. The Risk Committee is responsible for supervising and monitoring credit and counterparty risk and governs the Bank's credit rules and procedures. The Risk Committee appoints credit committees and allocates credit authorisation limits to its subcommittees and to individual employees. The Risk Committee handles credit cases in accordance with the authorisation limit set by the Board.

Branch managers and credit managers are assigned credit authorisation limits. If a proposed customer exposure exceeds credit authorisation limit, the credit proposal is taken to a committee that has the sufficient authorisation limit. All credit decisions at the individual authorisation level are based on the "four eyes principle", where at least two authorised employees must approve each decision. All credit decisions are documented and registered. Each customer is assigned a credit limit which is reviewed at least annually.

The Credit Control unit is accountable for the execution and implementation of the credit process in accordance with the Bank's Credit Risk Policy and Credit Rules.

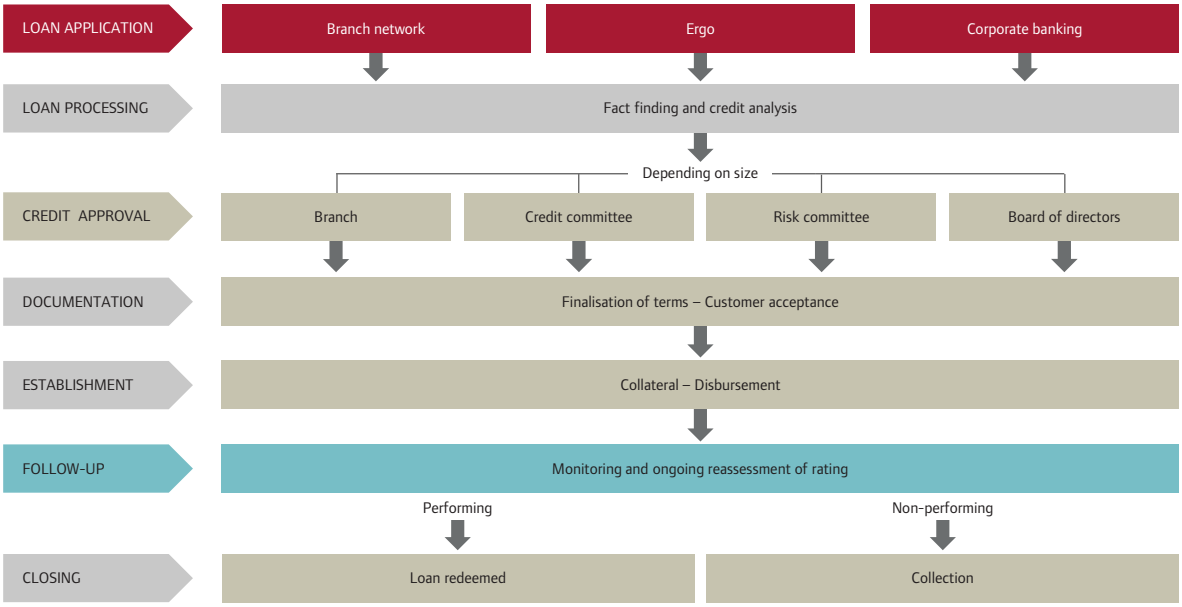

Exhibit 4.1. Schematic overview of the Bank's credit process.

The Risk Monitoring unit performs inspections on the execution of credit processes and procedures in the Bank. The Portfolio Credit Risk and Modelling unit is responsible for measuring, monitoring, and reporting of credit risk. Further details on Risk Management organisation structure can be found in Chapter 2.

4.2 THE CREDIT PROCESS

The Bank's Credit Rules outline the general principles governing loans, guarantees and other products that expose the Bank to credit risk. All credit decisions are based on careful evaluation of the inherent credit risk involved, the customers' financial standing, future projected cash flows and overall creditworthiness. Trust between the Bank and its clients is a prerequisite for all lending. Sufficient collateral alone cannot justify lending to customers with insufficient payment capacity.

To mitigate risk the Bank requires collateral that is appropriate for the product offered. Since the Bank does not seize collateral unless a borrower faces serious repayment difficulties, the valuation of collateral focuses on its future expected value at the time of insolvency. The Risk Committee has appointed a Collateral Board that reviews and proposes guidelines for the valuation of collateral and pledged assets. A specially assigned Quota Board does the same for credit mitigants in the seafood sector, including fishing quota. The objective is to ensure that the valuation of collateral is co-ordinated throughout the Bank.

The main types of collateral accepted by the Bank are commercial and residential real estate, fishing vessels including the fishing quota assigned to the vessel, vehicles, and financial collateral. The potential correlation between collateral value and the obligor's financial condition is taken into consideration

4.3 MEASUREMENT AND MONITORING

To ensure that the Bank charges an adequate margin and that it has sufficient capital reserves to ensure long-term sustainability, the Bank estimates expected and unexpected losses of its loan portfolio.

The Bank charges the long-term expected credit loss on the loan portfolio from its customers as a part of the loan margin. Due to correlations between obligors, the actually experienced annual losses can fluctuate significantly around the long-term average, sometimes up to an order of magnitude. These correlations might be due to common dependencies on macroeconomic factors, or due to business relations between individual obligors. In order to be able to cover these unexpected losses at any time, the Bank holds a substantial capital buffer against these fluctuations. The required return on this capital buffer as expected by the shareholders also needs to be covered by the loan margin.

The annual expected loss (EL) for a single obligor depends on the probability that the obligor defaults within the horizon of one year (PD), the expected exposure at time of default (EAD) and the loss given default (LGD), expressed as a fraction of the exposure at default:

$$EL = PD \cdot LGD \cdot EAD.$$

The unexpected portfolio loss, on the other hand, strongly depends on correlations between obligor defaults within the portfolio. Its estimation requires either simplifying assumptions about the default correlations within the portfolio, as made in the Basel II regulations, for example, or application of numerical simulation techniques. Under Basel II, the Bank is required to test in its annual Internal Capital Adequacy Assessment Process (ICAAP) if these simplifying assumptions are met and to revise its estimates otherwise.

Obligor type	PD assessment	Number of obligors	Exposure
		(count)	(%)
Individuals	Statistical model	88,000	30.0%
Small companies	Statistical model	8,200	9.5%
Large companies	Hybrid model	480	35.6%
Foreign banks	External rating agencies	42	5.5%
Regional governments	Expert model	29	0.5%
Sovereigns	External rating agencies	13	18.8%
Public sector entities	Expert model	9	0.2%

Exhibit 4.2. Methods used to assess risk of different obligor types, number of obligors and relative size of exposure. Parent.

Risk group	Risk class	Large companies	Small companies	Individuals
		(%)	(%)	(%)
Low	1	0.3	0.1	0.1
	2	0.4	0.2	0.2
	3	0.8	0.3	0.3
	4	1.3	0.5	0.5
Medium	5	2.3	1.0	1.3
	6	4.1	2.9	2.5
Increased	7	7.1	8.0	5.3
	8	12.5	16.0	10.6
High	9	21.8	35.0	32.0

Exhibit 4.3. Average long-term PD levels per risk class for the different rating models. Parent.

4.3.1 *PROBABILITY OF DEFAULT (PD)*

The way an obligor's probability of default is assessed depends on the obligor type. Exhibit 4.2 shows the methods used to assess the risk of different obligor types and the corresponding number of obligors and relative size of exposure.

The Bank uses internal rating models to assess the default probability of companies and individuals. The rating of large companies is based on a company's most recent financial statement, together with a qualitative assessment of its management, market position and industry sector. The model assigns each obligor to one of ten risk classes. One risk class is for obligors in default (10), and nine risk classes are for performing obligors (1–9).

For individuals and small companies the Bank uses two different statistical rating models. One model is for individuals and another is for small companies with a total exposure to the Bank of less than ISK 150 million. These models are behavioural scoring models and use information about a customer's payment history, amount of debt and deposits and demographic variables to assess the probability that a customer will default on any of his obligations within 12 months of the rating assessment.

Exhibit 4.3 shows the mapping from risk classes to default probability (PD) for the three different rating models. The PD corresponds to the observed long-term average default rate, where 90-day past due or specific impairment is used as the default criterion.

Note that PD values are relatively high in international comparison, especially for individuals and small companies. This is however not necessarily a reflection of a worse portfolio quality but rather an indication that the 90-day past due criterion is too sensitive as an indicator of payment difficulties for Icelandic payment behaviour. Most cases where loans go more than 90 days past due are resolved without any actions taken by the Bank. Individuals that have a history of being more than 90 days past due in the last 12 months have a higher probability to default again. This explains the high fraction of individuals currently in risk class 9.

4.3.2 *LOSS GIVEN DEFAULT (LGD)*

The loss given default mostly depends on the collateralization but in many cases defaulted customers become performing again without the need to seize collateral. This is a reflection of the payment behaviour discussed above. To take historically observed loss experience into account, while also allowing for a risk-sensitive differentiation of the portfolio, loss given default (LGD) is therefore modelled using loss severity and implied loss rate:

$$\text{LGD} = \text{loss rate} \cdot \text{loss severity}.$$

Loss rate is the probability that the Bank will need to seize collateral or experience a loss given that the obligor defaulted. Loss severity is the percentage of exposure at default that is lost in the case of loss or repossession of collateral. The loss rate is assumed to be the same for all assets within the same asset class but the loss severity depends on the collateral allocated to a particular loan. The asset classes used are mortgages, leasing and other loans to individuals, small companies and large companies.[1]

Loss severity is computed from allocated collateral using a scenario-based approach, where different economic scenarios are assumed to occur with certain probabilities. For each scenario, collateral type dependent haircuts are applied to current collateral valuations and the resulting amounts are allocated to eligible exposures by minimising the total uncollateralised exposure amount subject to constraints imposed by the collateral agreements. These haircuts take cost of sales, depreciation of value and discounting of recovery cash flows into account. The recovery amount for an exposure in the case of repossession is

[1]The Bank does not yet use an internal LGD model for loans to regional governments, sovereigns and banks.

Asset Class	EAD	Loss rate	Severity	LGD	EL
	(% of portfolio)	(%)	(%)	(%)	(%)
Individuals - Mortgage	33	10	17	1.7	0.2
Individuals - Leasing	2	20	19	3.7	0.7
Individuals - Other	10	15	73	10.9	1.3
Small companies	8	40	35	13.9	2.1
Large companies	47	55	32	17.7	0.8
Total	100				0.7

Exhibit 4.4. Exposure at default (EAD), loss rate, severity, loss given default (LGD) and expected loss (EL) for various asset classes. Only the performing part of the portfolio is considered here. Parent.

then obtained as the scenario-weighted value of allocated collateral.

The implied loss rate is inferred from historical loss experience and loss severities based on current collateralisation levels and the loss parameters. This takes the historical long-term losses into account while allowing for a risk-sensitive differentiation of the portfolio.

To model exposure at default, Íslandsbanki applies the supervisory credit conversion factors (CCF) stipulated by Basel II to unutilised amounts:

$$\text{EAD} = \text{drawn amount} + \text{CCF} \cdot \text{undrawn amount.}$$

Having obtained the risk parameters PD, LGD and EAD the expected loss can be computed. Exhibit 4.4 summarises the results for the performing part of the loan portfolio at year-end 2013. Loans to banks, sovereigns and regional governments are excluded from this analysis.

4.3.3 EXPOSURE MEASUREMENTS

A loan is defined as having been acquired at a deep discount when the fair value purchase price is considerably lower than the claim value according to the terms of the loan. A large part of the Bank's assets was acquired at a deep discount. The deep discount was intended to meet both incurred credit losses at the acquisition date and expected future losses.

The difference between claim value and carrying amount has been decreasing in risk classes 1–9 over the past few years and was finally eliminated at year-end 2013. The difference in claim value and carrying amount is now limited to specifically impaired loans in risk class 10. The difference between claim value and carrying amount is further explained in the 2011 Risk Report, Chapter 4.4.2.

4.4 CREDIT CONCENTRATION

Íslandsbanki monitors credit concentration risk which arises from an unequal distribution of exposure to single borrowers, industry or geographic sectors.

4.4.1 BORROWER CONCENTRATION

The Bank actively seeks to limit large exposures. A large exposure is defined as an exposure to a group of connected clients that is 10% or more of the Bank's regulatory capital. The exposure is evaluated both gross and net of credit risk mitigating effects eligible according to FME rules no. 625/2013. When assessing the exposure, both on-balance sheet items and off-balance sheet items from all types of financial instruments are included.

The Bank has internal criteria that define connections between clients. These criteria reflect the Bank's interpretation of Article (1)(a) in Law no. 161/2002 on Financial Undertakings, where groups of connected clients are defined.

At year-end 2013, the Bank had no large exposure above 10% of capital base net of mitigating effects. In particular, no large exposure exceeds the maximum 25% set by law.

The Bank also seeks to minimise borrower concentration risk and has an internal limit on the aggregated exposures to the 20 largest groups of connected clients. This limit is reported internally on a monthly basis.

4.4.2 INDUSTRY SECTOR CONCENTRATION

The Bank's industry sectors are groups of entities that have similar primary activities, underlying risk factors, and behaviour characteristics. A "see-through principle" is applied for holding companies that own other companies but do not produce goods or services, i.e. the holding company can be classified in the same sector as its investments and not as an investment company.

The Bank has limits on both the exposure to any single economic industry sector as well as the aggregated exposure to the three largest economic industry sectors as a percentage of the Bank's total credit exposure. Exposure to retail individuals, as a separate economic industry sector, is also considered separately. These concentrations are reported internally on a monthly basis.

4.4.3 GEOGRAPHIC CONCENTRATION

Country risk is the risk of losses that may occur due to economic difficulties or political unrest in countries to which the Bank has exposures. Country risk includes political risk, exchange rate risk, economic risk, sovereign risk and transfer risk, i.e. economic factors that could have significant influence on the business environment.

Specific geographical limits are established to manage country risk. The geographic limits apply to the country from where the credit risk arises. Iceland is considered to be a home market and is as such not subject to geographic limits. These limits are reported internally on a monthly basis.

Credit risk	31.12.2013	31.12.2012
Loans to customers	558.4	559.6
Balances with the Central Bank and loans to credit institutions	155.9	139.5
Bonds and debt instruments	75.2	64.0
Guarantees and undrawn commitments	24.7	20.8
Derivatives	2.4	1.6
Total	816.5	785.6

Exhibit 4.5. The main sources for credit risk at year-end 2012 and 2013 (ISK bn). Consolidated.

Asset risk	31.12.2013	31.12.2012
Repossessed assets held for sale	10.7	10.2
Assets of disposal groups classified as held for sale	36.4	28.9
Total	47.1	39.1

Exhibit 4.6. Asset risk at year-end 2012 and 2013 (carrying amount, ISK bn). Consolidated.

4.5 SETTLEMENT RISK

Settlement risk is the risk that a party will fail to deliver on the terms of a contract at the time of settlement. Settlement loss can occur because of default at settlement and because of any timing differences in settlement between two parties. The amount at risk or the potential loss is the principal of the transaction.

To mitigate settlement risk on individual counterparties, the Bank utilises the services of clearing houses and also applies the general rule of delivery versus payment. If such a rule is not applicable due to the nature of the business relationship, a settlement limit is assigned to the counterparty to limit the risk. Capital requirements for settlement risk are covered as part of operational risk capital.

4.6 CREDIT PORTFOLIO EXPOSURES

Credit risk exposure comprises both on-balance sheet and off-balance sheet items. Exposure to credit risk for on-balance sheet assets is the carrying amount as reported in the Consolidated Financial Statements before the latent impairment is subtracted. The exposure for off-balance sheet items is the amount that the Bank might have to pay out against financial guarantees and loan commitments, less provisions the Bank has made because of these items. Because of off-balance sheet items the credit exposure does not reconcile with the carrying amount in the Consolidated Financial Statements. For capital requirement purposes, credit conversion factors are applied to guarantees and undrawn commitments. For derivative contracts the exposure is calculated by adding expected future credit exposure to the market value of the contract. The Bank currently has no credit exposure to securitisation.

Exhibits 4.5 and 4.6 show the main sources for credit risk and asset risk at year-end 2012 and 2013. Exhibit 4.7 shows the development of credit risk from year-end 2011.

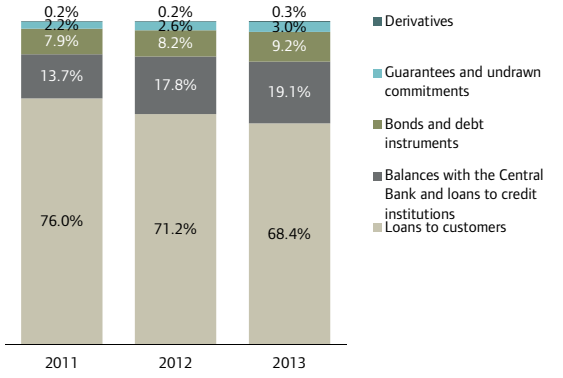

Exhibit 4.7. Credit risk at year-end 2011–2013. Consolidated.

4.6.1 LOANS TO CUSTOMERS

Loans to customers, both individuals and companies represent the largest part of the Bank's credit risk exposure. At year-end 2013 the loan portfolio amounted to ISK 558 billion.

Currency Composition of Loans to Customers

As a principle, the Bank aims to have the currency composition of loans to customers in balance with customer needs. In particular, loans to customers whose income is predominantly in ISK should be denominated in ISK. The Bank has actively been working on aligning its customers' currency balances through recalculation and principal adjustment of foreign currency loans. Exhibit 4.8 shows a breakdown of loans to customers by industry sector and four currency and indexation types. Exhibit 4.9 shows the development of the currency composition of customer loans from year-end 2011 to 2013. The remaining FX loans to customers with ISK cash flow are either in legal proceedings or to performing customers that prefer keeping their loans in FX until maturity.

Industry sector	Non-indexed	CPI-linked	Foreign currency	Foreign currency with ISK cash flow	Total
Individuals	119.7	134.0	0.3	1.0	255.0
Commerce & services	67.4	11.5	1.7	0.9	81.5
Construction	13.1	3.5	1.8	0.2	18.6
Energy	2.5	0.7	0.4	-	3.6
Financial services	0.0	0.0	-	-	0.0
Industrials and transportation	31.6	4.7	9.9	0.2	46.4
Investment companies	6.8	1.8	1.7	0.1	10.3
Public sector & NPO's	5.0	1.7	-	0.1	6.9
Real estate	35.8	20.1	10.3	0.5	66.6
Seafood	5.8	1.0	62.5	0.0	69.3
Total	287.7	179.0	88.5	3.2	558.4

Exhibit 4.8. Currency composition of loans to customers at year-end 2013 (carrying amount, ISK bn). Consolidated.

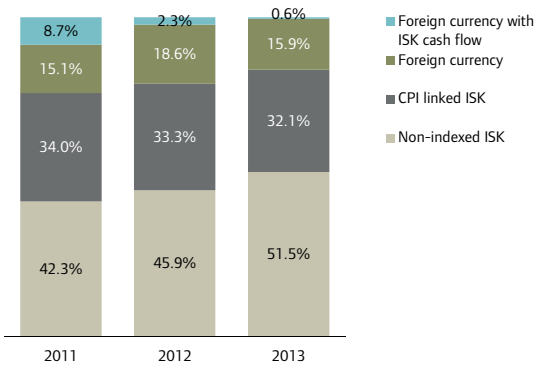

Exhibit 4.9. Currency composition of loans to customers at year-end 2011–2013 (percentage of portfolio). Consolidated.

Loans to Individuals

Loans to individuals amounted to ISK 255 billion at the end of the year 2013 compared to ISK 244 billion the year before. New loans and refinancing of outstanding loans amounted to ISK 28 billion in the year 2013.

Loans to individuals derive from lending activities to individuals and households and can be broken down by five product types namely mortgages, term loans, credit cards, overdrafts and leasing.

Mortgages are granted to individuals to buy or refinance a real estate for their own use. Mortgages should be secured by the first lien on the real estate or consecutive liens from and including the first lien. Mortgages are discussed in detail later in this chapter.

Term loans to individuals are often secured with residential real estate but do not satisfy all the requirements needed to be classified as mortgage loans. These loans may have non-standard term structure or the purpose of the loan may not have been to acquire the underlying property.

Credit cards and overdrafts to individuals are usually uncollateralised short-term consumer loans.

Leasing agreements are provided to individuals for vehicle purchases. Leasing is discussed later in this chapter.

Exhibit 4.10 shows the loan product types broken down by number of days past due. Note that amounts refer to the total loan and not only the payment or sum of payments that are past due. Payments three days in arrears or less are not considered relevant for past due analysis. Exhibit 4.11 shows the development of loans to individuals broken down by days past due at year-end 2011 to 2013.

Mortgages

The largest part of loans to individuals is in the form of residential real estate mortgages.

The loan-to-value (LTV) ratio is an important risk factor when measuring risk of a mortgage portfolio. The LTV for a single mortgage is the current carrying amount of the loan divided by the value of the property. The value of the

Loans to individuals	Not past due	4-90 days past due	> 90 days past due	Total	> 90 days past due
Mortgages	157.3	8.7	10.4	176.4	5.9%
Term loans	31.6	3.1	3.5	38.1	9.1%
Credit cards	15.4	0.5	0.1	16.0	0.7%
Overdrafts	13.8	0.7	0.4	14.9	2.6%
Leasing	8.2	1.0	0.4	9.6	4.6%
Total	226.1	14.1	14.8	255.0	5.8%

Exhibit 4.10. Breakdown of loans to individuals by product type and number of days past due at year-end 2013 (carrying amount, ISK bn). Consolidated.

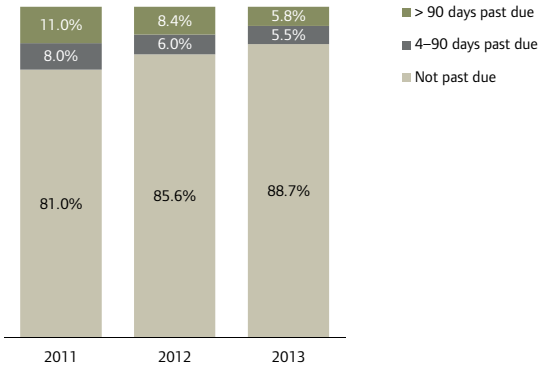

Exhibit 4.11. Loans to individuals broken down by number of days past due at year-end 2011–2013 (carrying amount). Consolidated.

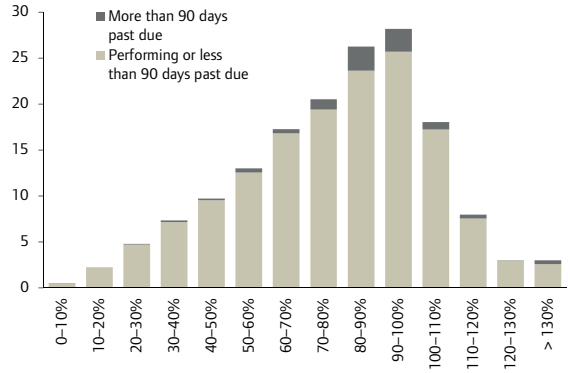

Exhibit 4.12. Breakdown of the mortgage portfolio by the LTV calculated for each property, year-end 2013 (carrying amount, ISK bn). Parent.

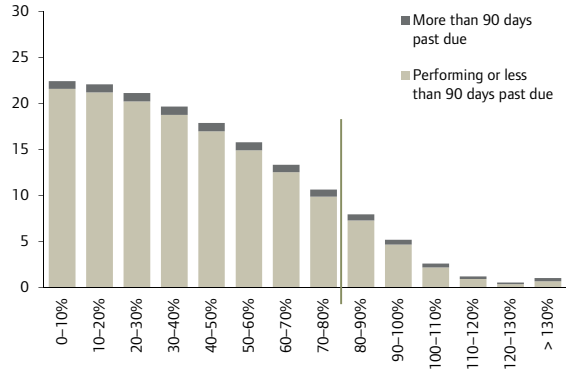

Exhibit 4.13. Breakdown of the mortgage portfolio by LTV bands of each ISK, year-end 2013 (carrying amount, ISK bn). Parent.

property is usually taken as the tax value obtained from Registers Iceland. For mortgages that are not on the first lien, the combined loan to value (CLTV) is the sum of the current carrying amount of the loan under consideration and the outstanding balance of all previous liens, divided by the value of the property. For a portfolio of mortgages, however, the LTV can be represented in various different ways depending on the intended usage. Here two such representations are presented.

The first representation is from the property point of view. To find the average LTV of a mortgage portfolio we assign each property the maximum CLTV value of the Bank's mortgages on that property and weight that value with the total carrying amount of the Bank's loans on the property. The end-of-year weighted average LTV calculated in that way was 79% compared to 85% at the end of year 2012. The change between years is mostly explained by an increase in real estate prices.

Exhibit 4.12 shows the LTV distribution by categorising the total carrying amount of the Bank's loans on each property in the mortgage portfolio by the maximum LTV for that property. The top part of the columns identify loans that are more than 90 days past due.

Another way to represent the LTV of a mortgage portfolio is to consider how each ISK lent is distributed in loan-to-value bands. In the breakdown, every ISK is categorised according to its seniority in the total debt on the property. The first band represents the part of the portfolio that falls in the 0–10% LTV band, the second represents the part that falls in the 10–20% LTV band and so on.

For example, if a loan with a current carrying amount of ISK 6 million is on the first lien of a property valued at ISK 20 million, then ISK 2 million are assigned to each of the 0–10%, 10–20% and 20–30% LTV bands (totalling to ISK 6 million). If the same loan had been on the second lien of the same property and another loan on the first lien amounts to ISK 10 million then ISK 2 million are assigned to each of the 50–60%, 60–70% and 70–80% LTV bands.

Exhibit 4.13 shows how the mortgage portfolio is distributed in loan-to-value bands defined in this way.

For capital requirement purposes, residential real estate mortgages to individuals are divided into two segments, the part that is covered up to 80% LTV and the amount that exceeds 80% LTV. The part with an LTV below 80% is potentially eligible for a 35% risk weight when calculating the capital requirements as compared to 75% for the remaining part.[2] One of the benefits of the representation shown in Exhibit 4.13 is that the part of the mortgage portfolio that is potentially eligible for a 35% risk weight is on the left side of a vertical line drawn at 80% LTV in Exhibit 4.13. Such a line cannot be drawn in Exhibit 4.12.

Loans to Companies

The category called loans to companies includes loans to companies as well as municipalities and public sector entities. These loans comprise a significant part of the Bank's balance sheet and operation. Exhibit 4.14 shows the company loan portfolio by sector and number of days past due. Exhibit 4.15 shows the development of the portfolio of loans to companies broken down by number of days past due at year-end 2011 to 2013.

Loans to companies amounted to ISK 303 billion at the end of the year 2013 compared to ISK 315 billion a year before. New loans and refinancing of outstanding loans amounted to ISK 113 billion in the year 2013, but because of contractual instalment, prepayments and changes in the exchange rate, the balance measured in ISK decreased between years. Loans more than 90 days past due were 3%

[2] See more on risk weights in Exhibit 4.38.

Loans to companies by sector	Not past due	4-90 days past due	> 90 days past due	Total	> 90 days past due
Commerce & services	76.2	2.8	2.5	81.5	3.1%
Construction	17.1	0.6	0.9	18.6	4.7%
Energy	3.6	-	-	3.6	-
Financial services	0.0	-	-	0.0	-
Industrials & transportation	44.2	0.7	1.6	46.4	3.3%
Investment companies	9.6	0.4	0.4	10.3	3.8%
Public sector & NPO's	6.8	0.0	0.0	6.9	0.2%
Real estate	62.8	1.8	2.1	66.6	3.1%
Seafood	67.3	1.1	0.9	69.3	1.4%
Total	287.6	7.4	8.4	303.4	2.8%

Exhibit 4.14. Loans to companies by sector and by number of days past due at year-end 2013 (carrying amount, ISK bn). Consolidated.

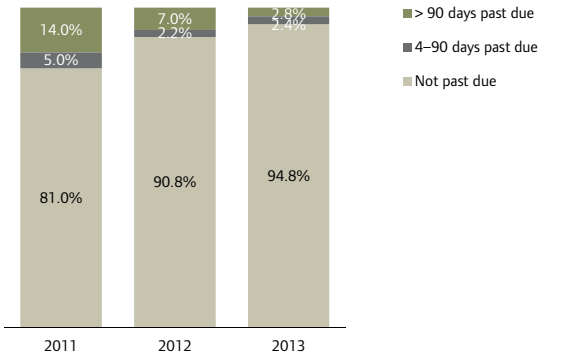

Exhibit 4.15. Loans to companies broken down by number of days past due at year-end 2011–2013 (carrying amount). Consolidated.

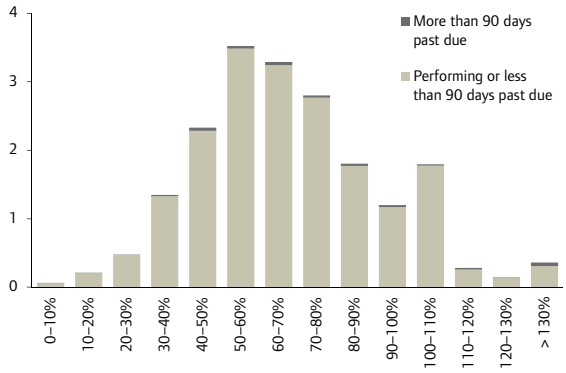

Exhibit 4.16. Breakdown of the leasing portfolio calculated for each car at year-end 2013 (carrying amount, ISK bn). Parent.

of total loans at the end of 2013 compared to 7% the year before.

Leasing

Leasing agreements are made under a special brand called Ergo which is the asset based financing part of Íslandsbanki. Ergo specialises in the financing of industrial equipment, commercial vehicles and commercial property for companies, and the financing of vehicles for individuals.

The underlying asset of the lease agreement is the collateral for the Bank. The Bank obtains a third party collateral valuation for a large part of the leasing portfolio.

Exhibits 4.16 and 4.17 show the LTV distribution of the portfolio of lease agreements provided for vehicle purchases. Exhibit 4.16 shows the LTV distribution by categorising the total carrying amount of the Bank's loans on each vehicle in the portfolio by the maximum LTV for that vehicle. The top part of the columns identify loans that are more than 90 days past due. The weighted average LTV percentage of the portfolio is calculated from the maximum LTV for each vehicle, weighted by the total carrying amount of the Bank's loans on that vehicle. The end-of-year weighted average LTV was 68%. The rather large column at 100–110% is due to stock financing of car dealerships.

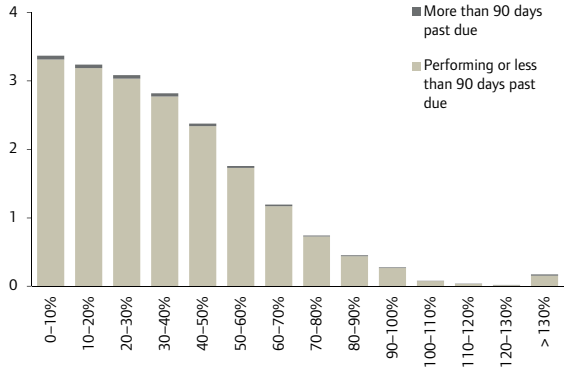

Exhibit 4.17. Breakdown of the leasing portfolio by LTV bands at year-end 2013 (carrying amount, ISK bn). Parent.

Exhibit 4.17 shows how each ISK lent in the portfolio is distributed in LTV bands and the proportion of loans that are more than 90 days past due.

4.6.2 *BALANCES WITH THE CENTRAL BANK AND LOANS TO CREDIT INSTITUTIONS*

Cash and balances with the Central Bank and loans to credit institutions are amounts that can fluctuate considerably between periods due to liquidity management. Exhibit 4.18 shows loans to Central Bank and credit institutions at year-end 2012 and 2013. Exhibit 4.19 shows the development from year-end 2011.

Loans to the Central Bank and credit institutions	31.12.2013	31.12.2012
Central Bank	111.8	85.5
Domestic credit institutions	2.1	5.7
Foreign credit institutions	42.0	48.3
thereof rated AA- and above	10.4	4.4
thereof rated A- to A+	31.4	43.3
thereof rated BBB+ and lower	0.3	-
thereof unrated	-	0.6
Total	155.9	139.5

Exhibit 4.18. Loans to Central Bank and credit institutions at year-end 2012 and 2013 (carrying amount, ISK bn). Consolidated.

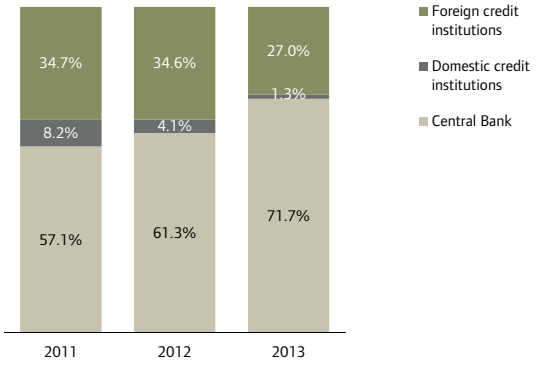

Exhibit 4.19. Loans to the Central Bank and credit institutions at year-end 2011–2013 (carrying amount). Consolidated.

Cash and balances with the Central Bank totalled ISK 112 billion at the end of 2013. This includes certificates of deposits, mandatory reserve deposits and other balances with the Central Bank.

The Bank has exposures to Icelandic and foreign credit institutions, mostly in the form of money-market deposits and nostro accounts. Loans to credit institutions amounted to ISK 44 billion at the end of 2013, of which ISK 42 billion were loans to foreign credit institutions. Exposures to foreign financial institutions are classified further in the country risk exposure section.

Exposures are only allowed with credit institutions that have been allocated a credit limit by the Risk Committee. When applying for a credit limit for a specific credit institution a thorough analysis of the institution is presented to the committee including credit ratings from rating agencies.

4.6.3 *BONDS AND DEBT INSTRUMENTS*

The Bank is exposed to credit risk as a result of trading and investing in bonds and debt instruments, e.g. as part of the Bank's liquidity management, and as a result of restructuring activities.

Exhibit 4.20 presents the Bank's position in bonds and debt instruments. The credit rating here is based on Standard and Poor's ratings or equivalent. Exhibit 4.21 shows bonds and debt instruments at year-end 2011 to 2013.

4.6.4 *GUARANTEES AND UNDRAWN COMMITMENTS*

The Bank's credit exposure deriving from guarantees and undrawn commitments totalled ISK 25 billion at the end of 2013 compared to 21 billion the year before. The exposure is measured using regulatory credit conversion factors. Exhibit 4.22 shows guarantees and undrawn commitments at year-end 2011 to 2013.

4.6.5 *DERIVATIVES*

The Bank uses derivatives to hedge currency, interest and inflation exposure. The Bank carries relatively low indirect exposure due to margin trading with clients and

Bonds and debt instruments	31.12.2013	31.12.2012
Icelandic government and government guaranteed bonds	34.3	31.5
Foreign government bills	34.6	26.7
thereof rated AAA	31.1	11.3
thereof rated AA+	3.5	15.4
thereof unrated	-	0.0
Domestic corporates	1.4	3.7
Domestic credit institutions	4.5	1.7
Foreign credit institution	0.3	0.4
Total	75.2	64.0

Exhibit 4.20. Bonds and debt instruments by rating class at year-end 2012 and 2013 (carrying amount, ISK bn). Consolidated.

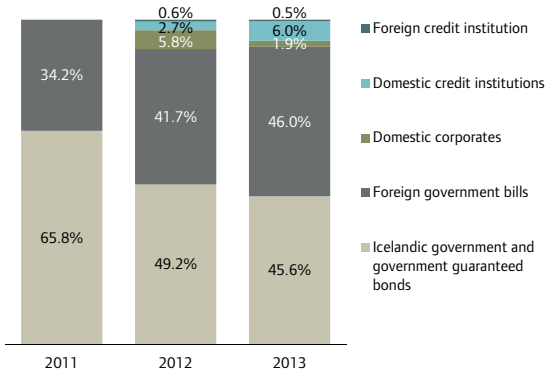

Exhibit 4.21. Bonds and debt instruments year-end 2011–2013 (carrying amount). Consolidated.

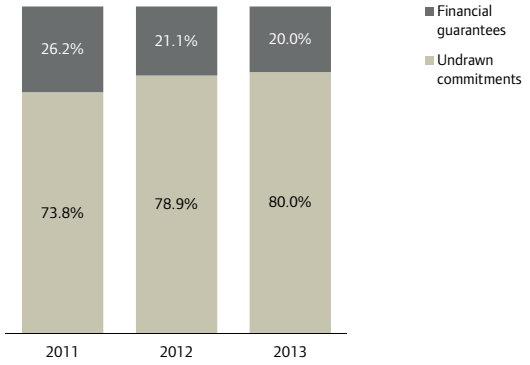

Exhibit 4.22. Guarantees and undrawn commitments at year-end 2010–2012. Parent.

in these cases the Bank holds collateral for possible losses. Derivatives amounted to ISK 2.4 billion at year-end 2013 compared with ISK 1.6 billion the year before. Derivative trading can also be the source of indirect exposure discussed in the next chapter.

Derivative exposures are generally made under ISDA master agreements with Credit Support Annex or corresponding terms with pledged collateral in the form of cash and government bonds.

See also Chapter 5 for further details on derivatives.

4.6.6 *INDIRECT EXPOSURE*

The Bank has indirect exposure to counterparties, i.e. an exposure that is not direct but becomes direct at the event of default of other counterparties. The indirect exposures are classified by the issuer's industry sector and whether the direct exposure originates from derivative trading or lending. Exhibit 4.23 shows indirect exposure at year-end 2013.

Type of issuer	Derivative trading	Lending	Total
Central governments	0.2	0.0	0.2
Financial services	3.2	1.0	4.3
Corporates	1.7	3.4	5.2
Total	5.2	4.5	9.6

Exhibit 4.23. Indirect exposure at year-end 2013 (ISK bn). Parent.

4.6.7 *COUNTRY RISK EXPOSURE*

Exposure to countries other than Iceland amounted to ISK 93 billion at the end of 2013 compared to ISK 89 billion the year before. This exposure relates mainly to the management of the Bank's foreign liquidity reserves.

Exhibit 4.24 shows a breakdown of credit exposure by country of domicile. Exposures to financial institutions, central government and individuals are shown separately. Loans to individuals are mostly loans that were granted in Iceland and later the individual moved to another country. Íslandsbanki has no retail lending activities outside of Iceland.

Country	Financial institutions	Central Government	Individuals	Other obligor types	Total country exposure
USA	12.5	13.8	0.6	0.0	26.9
Norway	7.3	3.8	3.1	2.4	16.6
Sweden	6.6	5.4	0.8	0.0	12.8
UK	7.6	1.9	0.7	0.5	10.7
Germany	1.1	4.8	0.3	0.1	6.3
Canada	3.3	-	0.1	1.3	4.7
Switzerland	3.0	-	0.2	0.0	3.1
Denmark	0.4	1.1	1.4	0.1	3.0
Netherlands	0.0	2.4	0.1	-	2.5
France	-	1.6	0.0	0.0	1.6
Faroe Islands	-	-	0.0	1.5	1.5
Other countries	1.0	-	2.1	0.1	3.3
Total	42.9	34.6	9.4	6.1	93.0

Exhibit 4.24. Credit exposure by country and obligor type at year-end 2013 (carrying amount, ISK bn). Parent.

Risk group	Not past due	4-90 days past due	>90 days past due	Total
Risk classes 1-4	63.7	0.5	-	64.2
Risk classes 5-6	196.7	0.6	-	197.3
Risk classes 7-8	161.4	3.7	-	165.1
Risk class 9	62.6	11.3	-	73.9
Risk class 10	29.4	5.9	22.6	57.9
thereof collateralised	22.0	5.7	22.6	50.3
Total	513.7	22.1	22.6	558.4

Exhibit 4.25. Loans to customers by risk groups and number of days past due at year-end 2013 (carrying amount, ISK bn). Consolidated.

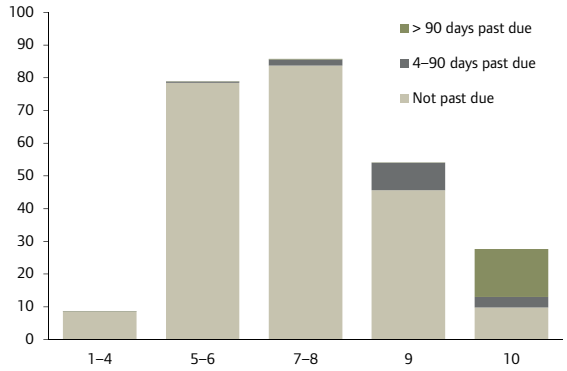

Exhibit 4.26. Loans to individuals by risk groups and number of days past due at year-end 2013 (carrying amount, ISK bn). Consolidated.

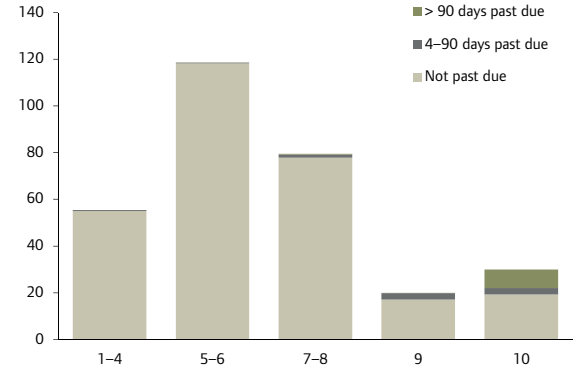

Exhibit 4.27. Loans to companies by risk groups and number of days past due at year-end 2013 (carrying amount, ISK bn). Consolidated

4.7 RISK PROFILE, CUSTOMER LOAN PORTFOLIO

As described in Chapter 4.3, each obligor is assigned a risk class 1–10, risk class 10 for customers in default and 1–9 for performing obligors.

Exhibit 4.25 sums the risk classes up into five groups, risk classes 1–4 represent low risk, risk classes 5–6 moderate risk, risk classes 7–8 increased risk, risk class 9 high risk and risk class 10 represents those classified as defaults. The exposure is then shown by number of days of past due.

The carrying amount of loans more than 90 days due in risk class 10 is fully collateralised, which means that the loans have been impaired at least down to collateral value. Note that the same customer can have loans that are more than 90 days past or impaired, and at the same time other loans that are neither past due nor impaired. The relatively large part of obligors in risk class 9 is a reflection of the Icelandic payment behaviour discussed in Section 4.3.1.

Exhibit 4.26 shows the portfolio of loans to individuals and Exhibit 4.27 shows the portfolio of loans to companies by risk groups and number of days past due. For the total loan portfolio risk class migration was positive in the year 2013, that is, upgrades exceeded downgrades. This can be seen in Exhibit 4.28.

4.8 FME'S LOAN PORTFOLIO ANALYSIS

In order to monitor the progress of the restructuring of the Icelandic banking system, the FME has defined a standardised monthly report, the so-called Loan Portfolio

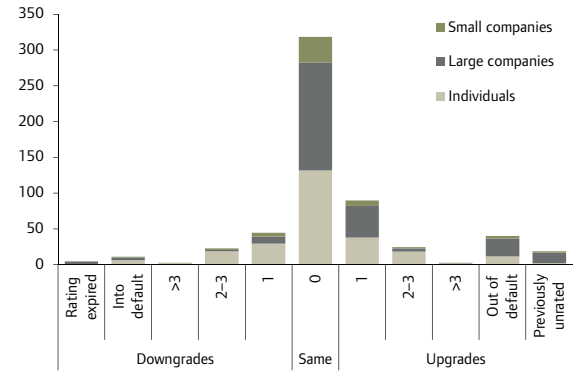

Exhibit 4.28. Migration of risk classes in the year 2013 (carrying amount, ISK bn). Consolidated.

Analysis (LPA) report. The report divides obligors into 19 categories, depending on which restructuring programme they have gone through or according to the severity of their financial difficulties. The categorisation is on the obligor level, not the facility level, so that all loans to a given obligor belong to the category of the loan in the most severe category.

The Bank's management monitors on a monthly basis the LPA metric which is defined on the basis of these reports. The LPA metric is the carrying amount of loans to customers which belong to LPA categories seen as non-performing or sub-performing. This includes customers that are more than 90 days past due, customers that are currently in or waiting for formal restructuring and customers in legal collection or liquidation. This

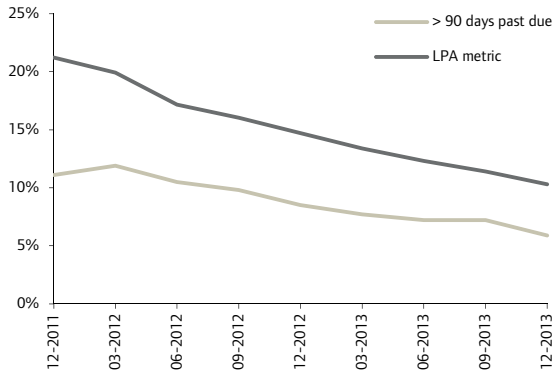

Exhibit 4.29. Two credit quality measures for the portfolio of loans to individuals.

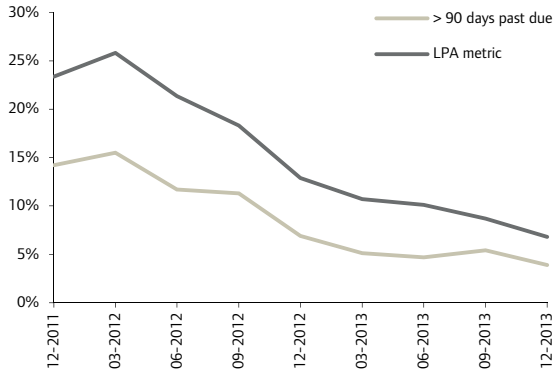

Exhibit 4.30. Two credit quality measures for the portfolio of loans to companies.

measurement is stricter than conventional cross default approach, both because customers with forbearance are included and because customers that have been restructured twice are included for 12 months post restructuring. At the end of year 2013 the LPA metric was 8.3% of the total loan portfolio, compared to 13.7% a year earlier. This means that a much smaller part of the loan portfolio is still in need of restructuring.

The facility based non-performance measurement of loans to customers that are more than 90 days past due, either impaired or not impaired, has also been decreasing, being 4.2% at the end of year 2013 compared to 7.5% a year earlier. For further details on loans that are past due see Chapter 4.6.1.

Exhibits 4.29 and 4.30 show the historical development of these two credit quality measures. The first graph is for individuals and the second is for companies.

4.9 FORBEARANCE

As the economic situation in Iceland returns to normal following the events of 2008 and the subsequent large scale restructuring of debt nears completion it becomes more and more important to develop tools and processes to monitor forbearance measures which are granted to customers facing temporary challenges or financial difficulties. Such forbearance measures are granted for a predefined time period and entail adjustments to the repayment schedule, interest-only payments, extension of terms, fixed payments or payment holidays.

For households, forbearance measures are used to accommodate temporary changes in household disposable income for example due to illness, unemployment or parental leave. Temporary changes in terms are also granted to companies when needed, for example to meet adverse changes in the operating environment, which affect revenue and cash flows, or to meet necessary but unforeseen capital expenditures. Also covenants are sometimes waived when customers are in minor difficulties. The customer is expected to resume normal repayments after the concession period.

Forbearance is increasingly attracting the attention of regulators. For example, the European Securities and Markets Authority (ESMA) has stated that financial institutions should include qualitative and quantitative disclosures about forbearance practices in financial statements for the year 2013.

Since this is a new area of disclosure there is some uncertainty about how wide the definition of forbearance measures should be taken. In a narrow sense it refers only to those measures where the terms of a loan are modified due to the debtor not being able to meet the original terms. On the other hand it happens regularly that loan contracts are modified as part of banks' normal business practices. If the modifications are not made due to obligors' financial difficulties and the modified terms to not represent a substantially increased credit risk then these activities are not forbearance measures in the narrow sense. However, changes in the amount of these activities as a portion of the whole loan portfolio may be indicative of upcoming system-wide problems and the activities therefore constitute forbearance activities in a wider sense of the word.

In note 67 to the Consolidated Financial Statements, Íslandsbanki lists the carrying amount of loans discharged from restructuring and that of other loans where forbearance agreements were made in 2013. The first item, Loans discharged from restructuring in 2013, is included because the process of discharging from restructuring involves evaluating the obligor and their loans as a whole and resetting the terms of the loans to a sustainable level.

Íslandsbanki intends to develop the processes for monitoring forbearance further in the year 2014.

4.10 LOANS COVERED BY COLLATERAL

Collateral and other credit mitigants vary between types of obligors and credit facilities. Loans to selected credit institutions are usually unsecured. For loans to individuals the principal collateral taken is residential property against mortgages. Unsecured loans to individuals are mostly short-term consumer loans such as overdrafts and credit cards. In the case of large companies the Bank takes a charge over assets such as real estate, fishing vessels, cash and securities, as well as other collateral including accounts receivables, inventory, vehicles and equipment. Loans to government entities and to municipalities are more often than not unsecured.

In some cases the Bank uses guarantees as a credit enhancement but since guarantees effectively transfer

Collateral	Real estate	Fishing vessels	Cash & securities	Vehicles & equipment	Other collateral	Credit exposure	Unsecured Q4 2013	Unsecured Q4 2012
Individuals	202,593	26	1,410	8,791	5	255,044	17%	15%
Commerce & services	30,764	217	1,098	12,998	5,193	81,518	38%	42%
Construction	8,912	143	84	3,961	1,418	18,640	22%	28%
Energy	3,242	-	87	-	122	3,614	5%	44%
Financial services	4	-	-	-	-	34	88%	65%
Industrials & transportation	18,161	-	98	4,682	5,029	46,433	40%	54%
Investment companies	4,108	-	2,783	44	55	10,306	32%	12%
Public sector & NPO's	1,438	3	3	223	-	6,894	76%	64%
Real estate	47,377	25	445	155	21	66,647	28%	25%
Seafood	4,648	59,074	887	199	2,760	69,289	2%	9%
Total	321,247	59,488	6,895	31,053	14,603	558,419	22%	23%

Exhibit 4.31. Financial effect of allocated collateral at year-end 2013 (ISK m). Consolidated.

credit risk from one counterparty to another they do not represent a reduction in exposure to credit risk although it may strengthen its quality. Covenants in loan agreements are also an important credit enhancement but do not reduce credit exposure.

For income producing real estate companies the collateral is sometimes in the form of a charge over rental agreements as well as the underlying property.

Valuation of collateral is based on market price, official valuation from the Registers Iceland or the expert opinion of the Bank's employees, depending on availability. In the case of fishing vessels the associated fishing quota is included in the valuation of financial effect, based on a conservative valuation by the Bank's Quota Board.

For the simplest collateral agreements it is possible and useful to define and calculate the loan-to-value (LTV). This has been done for mortgages and car loans in previous sections. For more complicated collateral constellations where multiple loans are collateralised with many different assets the concept of LTV is not as well defined and not as useful. Instead the Bank allocates collateral to loans using an elaborate optimisation algorithm.

Collateral is measured without including the effect of overcollateralisation. This means that if some loans have collateral values in excess of their claim value, then the excess is removed in order to reflect the Bank's actual exposure to credit risk.

Exhibit 4.31 shows the financial effect of allocated collateral at year-end 2013 broken down by sector and type of collateral.

4.11 LOAN WRITE-OFFS AND REMISSIONS

Final write-offs of loans are generally made when all means of legal recourse have been exhausted, when an agreement has been reached with a borrower on a final settlement of a claim or when a decision has been made by courts that limit recourse. Final write-offs are also made through restructuring schemes where part of loans

Restructuring measure	Write-offs and remissions
Recalculation of FX loans	41.8
110% adjustment of mortgages	12.0
Principal adjustment	10.8
FX loans	8.3
CPI-linked loans	2.4
Interest rate discount	4.5
Specific debt adjustment	3.8
Other restructuring measures	46.2
Total	119.1

Exhibit 4.32. Cumulated write-offs and remissions for individuals (ISK bn). Parent.

are written off in order to lower the debt of obligors. These schemes include the 110% mortgage adjustment, debt adjustment, principal adjustment and more. In the notes to the Financial Statement, the amount written off refers only to the part of the claim value that is visible in the statements. This means that when only the deep discount is used against write-offs then nothing is shown in the Financial Statement.

In this section, however, the cumulative write-offs and remissions based on claim value are presented. This gives the perspective as seen from the customers' point of view. The term remission is used here for recalculations and principal reductions that are not write-offs in the usual sense but rather correction of claims due to their legitimacy or because of general offers made by the Bank.

At year-end 2013, the Bank had written off or remitted ISK 548 billion to its customers, of which ISK 119 billion were to individuals, thereof ISK 17 billion in the year 2013, and ISK 429 billion to companies, thereof ISK 57 billion in the year 2013.

Exhibits 4.32 and 4.33 show cumulated write-offs and remissions to individuals and companies divided into various programs offered by the Bank and exhibit 4.34 shows the development from 2008.

Restructuring measure	Write-offs and remissions
Recalculation of FX loans	45.8
Debt adjustment	18.3
Principal adjustment of FX loans	13.2
Other restructuring measures	351.8
Total	429.1

Exhibit 4.33. Cumulated write-offs and remissions for companies (ISK bn). Parent.

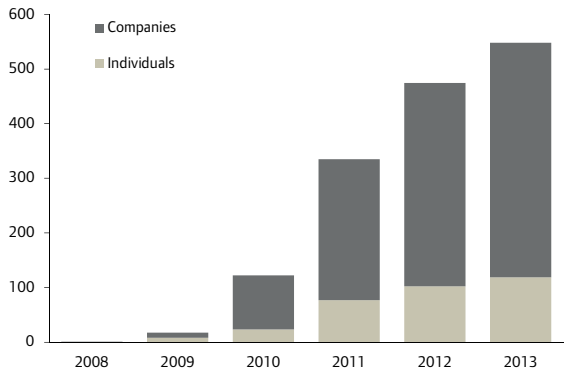

Exhibit 4.34. Cumulative write-offs and remissions 2008-2013 (ISK bn). Parent.

The interest rate discount that was offered in connection with principal adjustments is considered a remission. The interest rate discount also includes the Bank's refund to 20,000 customers in March 2013 but that amount had already been accounted for in the Bank's financial statements 2012. The refund amounted to ISK 2.5 billion which is 30% of the interest payments made on mortgages and general debt over the course of 2012.

4.11.1 RECALCULATION OF FX LOANS

In February 2012 the Supreme Court in Iceland passed a ruling (no. 600/2011) that affected the legitimacy of the Icelandic banks' method of recalculating loans that were illegally linked to the value of foreign currencies, so-called "Receipt Ruling". In October 2012 the Court passed a ruling (no. 464/2012) that supplemented the findings of the Receipt Ruling and explained, to a certain extent, how the loans should be recalculated. Recent rulings in 2013, both in district courts and the Supreme Court, have clarified the legal view on the recalculation methodology. The Bank's general recalculation methodology was developed according to the Receipt Ruling and around three main ideas: (1) the recalculation can be done efficiently, (2) the Bank's promise that "customers do not forfeit any future rights by accepting restructuring offers" is fulfilled, and (3) that customers are no worse off for having continued servicing their debt. The Bank has recalculated according to the Receipt Ruling loans to various types of borrowers, including individuals, companies and municipalities as well as loans that are both long and short term.

Two verdicts by the Supreme Court in the year 2013 affected the Bank's recalculation process, no. 386/2012 and no. 430/2013. Both of these verdicts increased the number of loans to be recalculated according to the "Receipt Ruling".

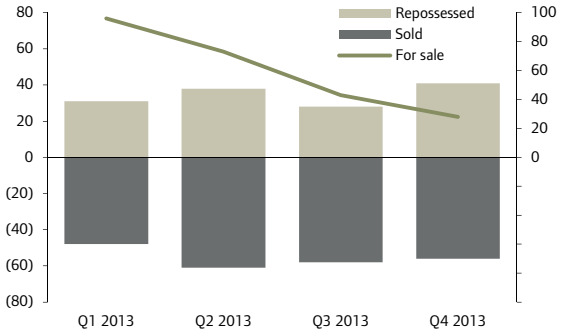

Exhibit 4.35. Number of repossessed and sold vehicles (left hand axis) and vehicles for sale (right hand axis) at quarter-end 2013. Consolidated.

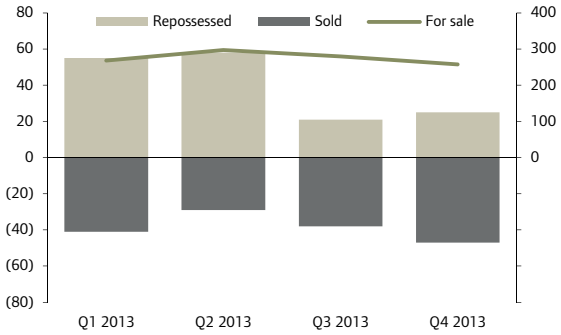

Exhibit 4.36. Number of repossessed and sold residential properties (left hand axis) and residential properties for sale (right hand axis) at quarter-end 2013. Consolidated.

At year-end 2013 the Bank had recalculated according to the Receipt Ruling approximately 11,900 loans out of 14,000 illegal loans.

4.12 REPOSSESSED ASSETS HELD FOR SALE

It is in the best interest of the Bank and the customer to improve the customer's position and their ability to serve their loans rather than to acquire assets from the customer. The Bank acquires assets only if all other means to improve the customer's financial standing have been exhausted. The Bank acquires these assets through repossessions following loan defaults, debt restructuring and bankruptcies of its customers.

Repossessed assets held for sale are classified into two groups, repossessed collateral and assets of disposal groups classified as held for sale. The first group represents collateral that has been repossessed and the second group represents assets of companies in which the Bank holds more than 50% share, without being consolidated subsidiaries. These companies also have corresponding liabilities which are not subtracted here.

At year-end 2013 the Bank's repossessed collateral amounted to ISK 10.7 billion, of which ISK 8.5 billion were residential property. In comparison, repossessed collateral amounted to ISK 10.2 billion at the end of the year 2012 of

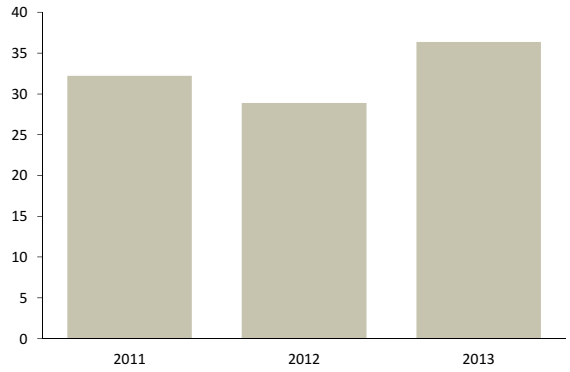

Exhibit 4.37. Assets of disposal groups classified as held for sale at year-end 2011–2013 (carrying amount, ISK bn). Consolidated.

which ISK 8.2 billion were residential property. Exhibits 4.35 and 4.36 show the development of the number of repossessed assets held for sale through the year 2013 and the factors influencing that number.

At year-end 2013 Íslandsbanki had 258 residential properties held for sale. This number is partially explained by the fact that the former owners are usually permitted to rent their homes for a certain time period after foreclosure. Out of 258 properties owned by the Bank, 116 are being rented out.

Exhibit 4.37 shows assets of disposal groups held for sale, those are assets of companies that the Bank holds more than 50%. Two real estate companies that will likely be sold in the first half of 2014 represent more than half of the total asset value.

4.13 STRESS TESTING

As part of the annual ICAAP process, the Bank performs a stress test on its loan book. Stress testing is the process of determining the effect of extreme but realistic events on the portfolio. To compute expected loss under the stress scenario, assumptions about the development of default probability and loss given default are required. The development of risk class distributions is computed by migration of the existing risk class distribution using scenario specific yearly migration matrices.

Loss given default is computed by applying severe haircuts to the value of collateral that is then allocated to eligible loans.

The effect of increased losses on operational income and, therefore, available capital on one hand and capital requirements on the other hand are then used to assess the effect of the stress scenario on the solvency of the Bank.

As a part of the ICAAP process the income generating units performed a reverse stress test. A key objective of such stress testing is to overcome disaster myopia and the possibility that a false sense of security might arise from regular stress testing in which institutions identify manageable impacts.

Reverse stress testing consists in identifying a significant negative outcome and then identifying the causes and consequences that could lead to such an outcome.

4.14 CAPITAL REQUIREMENTS

The Bank reports its Pillar 1 capital requirements for credit risk according to the standardised Basel II approach. Exhibit 4.38 shows exposure amounts, risk weights and corresponding risk-weighted assets for the different portfolios as at year-end 2013. Currently, only residential real estate, commercial real estate, and securities issued by the Central government are used as credit risk mitigants to reduce capital requirements. The Financial Collateral Simple Method is applied for securities. Furthermore the Bank holds one exposure that is secured by a government guarantee.

Capital add-on for credit risk under Pillar 2 is estimated in the annual ICAAP/SREP process. This add-on includes underestimation of risk under Pillar 1 and factors such as concentration risk.

	On balance sheet	Off balance sheet (after CCF)	Guarantees	Financial collateral	Inflow	RWA
Central governments or central banks	142,638	4,619	-	-	8,749	865
0%	142,638	2,889	-	-	5,290	-
50%	-	-	-	-	1,730	865
100%	-	-	-	-	-	-
Regional governments or local authorities	4,152	293	-	-	-	968
20%	4,054	293	-	-	-	869
100%	98	-	-	-	-	98
Financial institutions	44,835	423	-	-	-	9,983
20%	43,717	376	-	-	-	8,819
100%	1,118	47	-	-	-	1,164
Administrative bodies and non-commercial undertakings	1,815	59	-	-	-	1,874
100%	1,815	59	-	-	-	1,874
Collective investment undertakings (CIU)	392	-	-	-	-	392
100%	392	-	-	-	-	392
Corporates	244,834	15,833	3,480	722	-	256,466
100%	244,834	15,833	3,480	722	-	256,466
Retail	117,863	10,036	-	656	-	95,432
75%	117,863	10,036	-	656	-	95,432
Secured by real estate	168,455	-	-	-	-	86,673
35%	99,171	-	-	-	-	34,710
75%	69,284	-	-	-	-	51,963
Past due items	19,536	17	-	414	-	20,211
50%	2,399	-	-	-	-	1,200
100%	12,599	8	-	410	-	12,197
150%	4,538	9	-	4	-	6,815
Other items	74,349	-	-	-	-	79,076
100%	64,895	-	-	-	-	64,895
150%	9,454	-	-	-	-	14,181
Grand total	818,867	31,279	3,480	1,792	8,749	551,938

Exhibit 4.38. Exposure, risk weights and risk-weighted assets per asset class at year-end 2013 (ISK m). Consolidated.

REGULATORY CHANGES

Act No 33/2013 on Consumer Credit Agreements

The Icelandic parliament passed new legislation regarding consumer loans on 18 March 2013, in effect adapting to the directive 2008/48/EC of the European parliament on credit agreements for consumers (full harmonization), which took effect on 1 November 2013.

The Act's aim is to offer a sufficient degree of consumer protection by defining prudent credit practices, such as disclosure of pre-contractual information, e.g. loan expenses and interest rates. As a result, consumers can base credit decisions on adequate and predefined information and efficiently compare credit cost. In addition, the aim is to protect consumers against unfair or misleading lending practices and increase the quality of consumer lending.

The scope of the law is broader than of the directive in respect that the law applies to credit agreements secured by mortgages on immovable property.

Amendment to Act No 91/1991 on Civil Procedure

The Icelandic Parliament passed an interim act amending the Act on Civil Procedure on 25 June 2013, affording an accelerated procedure to disputes concerning the legality of loans in foreign currency. The relevant provision is only valid until 1 January 2015.

Act No 138/2013 on Stamp Duty

The Icelandic Parliament passed a new Act on Stamp Duty on 19 December 2013. Stamp duty is only charged on documents concerning the transfer of assets in Iceland and ships over 5 gross tons, registered in Iceland. Stamp duty will no longer be charged on loan documents or amendments thereto.

Amendment to Act No 90/1991 on Judicial Sale

The Icelandic Parliament passed an interim act amending the Act on Judicial Sale on 19 December 2013. The provision adds a stipulation that relevant district commissioner must grant the judgment debtors stayed proceedings until 1 September 2014 in relation to property on which the judgment debtor is domiciled and resides.

New FME Rules No 625/2013 on Large Exposures

The Rules are based on Directive 2009/111/EC. Equivalent rules in Norway and Denmark were used as a reference for the adaptation. The Rules state, among other things, that financial institutions are now obliged to look through collective investment undertakings, including UCITS funds, to the underlying exposure when calculating risk-weighted exposures. Furthermore the new rules specify a single ceiling on large exposures, i.e. 25% of the own funds of a credit institution. Additional rules were added relating to exposures to financial undertakings, to the effect that the limit is now either 25% of the credit institution's own funds or ISK 500 million, whichever is greater.

The Government Action Plan for Household Debt Relief

In November 2013, the Prime Minister and Minister of finance presented the government's housing debt relief plan. The plan allows for tax relief as well as debt cancellation of up to ISK 4 million on CPI-indexed mortgages per affected household. The plan is set to cost ISK 150 billion for the whole system and will be distributed over the next four years. The Government expects the implementation of the write-downs to take place around mid-2014. However, some details of the plan have not been finalised and it still has to be passed by Parliament.

In the long run, it is expected that the Government's plan will strengthen the Bank's loan portfolio but the likely short term effect on the Bank will be increased costs related to the recalculation of loans and through increased tax payments, as the Government will fund the write-down through taxes on financial institutions (old and new banks).

The write-downs could reduce the Bank's outstanding mortgages by ISK 10-15 billion and the tax exemption for personal pension savings could reduce the balance by additional ISK 5 billion per year for the next three years.

5 MARKET RISK

The rise of the domestic stock market continued in 2013 as the average daily turnover increased by over 50% and the OMXI6 index rose by 19%. Three new companies, Tryggingamidstödin hf., Vátryggingafélag Íslands hf. and N1 hf., were listed and further listings are expected in 2014. At the Bank, market risk due to trading equities increased in line with the development of the market as reflected in a much higher average position in 2013 than in 2012. In the fixed income market the Bank's main activity was still in Icelandic Treasury bonds and government-guaranteed bonds issued by the Housing Financing Fund (HFF) but the first corporate bonds were issued in 2013 and they are expected to play a bigger role in the coming years. Íslandsbanki's net securities issuance in 2013 was ISK 29 billion, mainly in covered bonds and bills, but the Bank also issued its first foreign notes in December for SEK 500 million (ISK 9.1 billion) at 400 basis points over STIBOR. The Bank's currency imbalance decreased in 2013, mainly due to revaluation of loans, offsetting cross-currency swaps and the ISK appreciating by 10%. The inflation imbalance increased in 2013 as CPI-linked lending increased while CPI-linked liabilities decreased.

DEFINITION OF MARKET RISK

Market risk is the current or prospective risk to earnings and capital arising from adverse movements in the level or volatility of prices of market instruments, such as those that arise from changes in interest rates, equity prices and foreign exchange rates.

5.1 STRATEGY, ORGANISATION AND RESPONSIBILITY

Market risk has been identified as one of the material risk factors in the Bank's operations. The Bank takes on market risk as a part of its business strategy and aims to maintain a moderate market risk profile. Market risk mainly originates in the banking book due to mismatches in assets and liabilities with respect to currencies, interest reset dates and inflation indexation and due to shares and equity instruments acquired through restructuring. These positions are managed within strict limits according to the Bank's market risk appetite as approved by the Board of Directors. The Bank also takes on market risk in relation to its trading activities or other activities of the Markets or Treasury units. Those positions are also subject to a strict limit structure, both end-of-day and intraday, and are closely monitored by Risk Management.

The Board has defined the market risk appetite for the Bank relative to the Bank's capital. Given predetermined shifts in risk factors, the amount at risk shall not exceed 20% of Tier 1 capital.

The overall responsibility for managing market risk within the Bank lies with the Board of Directors. The Board determines the market risk appetite for the Bank in the Market Risk Policy which also states the roles and responsibilities in relation to market risk management.

The objective of the market risk management framework is to manage and control market risk exposures, while optimising the return on risk and ensuring that the market risk profile is in line with the Bank's appetite. This strategy is reflected in the overall market risk limits applied on a consolidated level and reported to the Board of Directors at each meeting.

The Asset and Liability Committee (ALCO) supervises market risk. The committee decides on market risk limits for single units and portfolios that take on market risk in the Bank, based on the overall limit set by the Board. Risk Management is responsible for monitoring and reporting on the Bank's overall market risk position and compliance to limits. The subsidiaries that have market-risk-related business operations are responsible for identifying, measuring, monitoring and reporting on the risk in their operations.

The Bank separates market risk exposures into two portfolios, trading book and banking book (non-trading portfolio). Positions in the trading portfolio are undertaken mainly as a part of the Bank's flow trading and through the Bank's liquidity portfolio. The positions are managed with specific limits on risk factors, products and portfolios. Limits are also set to manage the concentration risk towards single issuers or instruments, as well as to manage trading liquidity risk which is significant in the current domestic environment.

The Bank is also exposed indirectly to market risk through customers' derivative positions. Those positions are however subject to strict margin requirements.

Banking book positions that contribute to market risk are subject to various limits. Positions in the banking book mainly relate to assets and liabilities from commercial and retail banking activities, or within the Treasury unit, which contribute to the Bank's interest rate, inflation and currency risk exposures. All equity exposures in the banking book are included when managing the equity risk in the Bank. The Bank's equity exposure is both in listed and unlisted shares.

5.2 MEASUREMENT AND MONITORING

The Bank uses various tools to monitor and limit market risk exposures. These tools consist of conventional risk measures, such as limits on notional amounts and sensitivity measures, which contribute to the limit hierarchy

Risk type	Description	Origination	Main limit types
Interest rate risk	Current or prospective risk to earnings or capital arising from adverse movements in interest rates. Main sources of interest rate risk are as follows: - Re-pricing risk: Arising from differences between the timing of rate changes and the timing of cash flows. - Yield curve risk: Arising from changing rate relationships across the spectrum of maturities (change in slope and shape of the yield curve). - Basis risk: Arising from changing rate relationships among yield curves that affect the institution's activities. - Optionality risk: Arising from interest-rate related options embedded in the institution's products.	- Bonds and debt instruments. - Interest rate derivatives. - Loans and deposits.	- End-of-day BPV (basis point value). - Total long and short positions in underlying securities. - Open delta position of underlying securities. - Duration of underlying securities.
Inflation risk	The risk that earnings or capital may be negatively affected from adverse movements in inflation level.	- Inflation-linked bonds and debt instruments. - Inflation-linked loans and deposits. - Inflation-linked derivatives.	- Limit on the amount of the inflation imbalance.
Credit spread risk	The risk that earnings or capital may be negatively affected from adverse movements in bond risk premium for an issuer.	- Bonds and debt instruments.	- Issuer-specific notional limits.
Currency risk	The risk that earnings or capital may be negatively affected from the fluctuations of foreign exchange rates, due to transactions in foreign currencies or holding assets or liabilities in foreign currencies.	- Spot positions in currencies. - Foreign exchange derivatives. - Foreign-currency-denominated loans and deposits.	- Total open position per currency. - Total notional in underlying derivatives.
Price risk	The risk that earnings or capital may be negatively affected from the changes in the price level or volatility of debt instruments or equity instruments.	- Equities. - Bonds and debt instruments. - Interest rate and equity derivatives.	- Total position in equities. - Total position in specific stocks.
Trading liquidity risk	The risk that the Bank is unable to easily liquidate or offset a particular position without moving market prices due to inadequate market depth or market disruption, thus negatively affecting the earnings or capital.	- Bonds and debt instruments. - Equities. - Derivatives.	- Total position in specific stocks. - Total notional of foreign exchange derivatives.

Exhibit 5.1. Main types of market risk within Íslandsbanki.

used to manage market risk. The Bank also uses stress tests to simulate the effects on the portfolios from extreme but plausible market events and Value-at-Risk (VaR) measures are used for selected portfolios. These tools provide complementary information to notional limits and sensitivity measures but the formal limit structure for market risk is not VaR based.

Limit Structure

All market risk limits are set by ALCO and must be in accordance with the appetite defined by the Board. Risk Management monitors the trading activities of the Bank and ensures that positions and margin requirements comply to limits. All breaches are handled in accordance with the Bank's limit breach process and are reported to ALCO, which decides on appropriate actions, depending on the severity of the breach. Exhibit 5.1 shows the risk factors related to market risk in the Bank's operations, their origination and main limit types.

5.3 MARKET RISK EXPOSURE

Exhibit 5.2 displays the main categories of the Bank's market risk trading book exposures in 2013 and 2012. Since many of these exposures are quite volatile in nature, the figures displayed represent the maximum, minimum and average exposure in each category over each year. A more detailed discussion on the methodology for measuring the interest rate risk in the banking book can be found in Section 5.3.2.

Exhibit 5.3 displays the market risk exposures in the banking book at the end of 2013 and 2012. Overall the equity risk decreased in 2013 mainly due to the Bank selling a 5% share in Icelandair Group hf. and a 21% share in N1 hf. in relation to its listing in December. Interest rate

Exposure	Maximum	Minimum	Average	Maximum	Minimum	Average
		2012			2012	
Equity risk (net position)	2,944	358	1,651	1,783	13	404
Interest rate risk (100 bp parallel upward shift)	445	8	170	172	(219)	(17)
FX risk (net position)	996	(1,372)	(38)	910	(2,522)	(33)

Exhibit 5.2. Market risk trading book exposure (ISK m). Consolidated.

Exposure	31.12.2013	31.12.2012
Equity risk (net position)	6,302	7,610
Interest rate risk (weighted 100 bp shift)	332	538
Inflation risk (net position)	6,389	1,313
FX risk (net position)	23,477	27,239
Derivatives (total MV)	196	(5,148)

Exhibit 5.3. Market risk exposure in the banking book at year-end 2013 and 2012 (ISK m). Consolidated.

risk in the banking book remained relatively unchanged over the year as the effect from the net issuance of the Bank was offset by the effect from interest reset on a part of the housing loans portfolio. The total market value of outstanding derivatives contracts increased in 2013 mainly due to the ISK appreciating by almost 10% and the Bank paying up a part of its outstanding cross currency interest rate swaps. Further details on the changes in the market risk exposure can be found in Sections 5.3.1 to 5.3.5.

5.3.1 SHARES AND EQUITY INSTRUMENTS

The Bank's equity exposure arises mainly from shares acquired through restructuring of companies but also from flow trading. Most of the shares are denominated in ISK. Limits on both the aggregated market value and the maximum exposure in single securities are aimed at containing the equity risk and concentration risk in the Bank's portfolio. An overview of the Group's equity position can be found in Exhibit 5.4. In line with the development in the equity market the Bank's trading equity exposure increased in 2013 with the average position four times higher in 2013 than in 2012. This also explains the increase in securities used for hedging as the demand for derivatives also followed the development in the market. The market value of fair value shares and shares held for sale decreased after the Bank sold a 5% share in Icelandair Group hf. and a 21% share in N1 hf.

Sensitivity Analysis

For sensitivity analysis the Bank uses a 20% decrease in equity prices for the trading portfolio and a 40% decrease for the banking book. At year-end 2013 and 2012 the impact of the sensitivity measure was ISK 3.0 billion and ISK 4.7 billion, respectively.

5.3.2 INTEREST RATE RISK

To manage interest rate risk the Bank uses sensitivity measures like basis point value (BPV). The BPV measures the effect of a 0.01 percentage point (1 basis point) parallel upward shift in the yield curve on the market value of the underlying position. Thus a BPV of ISK 1 million means that a 0.01 percentage point parallel upward shift in the yield curve would result in a reduction of approximately ISK 1 million in the market value of the underlying position.

Interest Rate Risk in the Trading Portfolio

The fixed income trading book is divided into three portfolios: Flow trading, hedge portfolio and liquidity portfolio.

The *flow trading portfolio* consists of positions that the Bank takes on as a market maker for Icelandic Treasury bonds and government-guaranteed bonds issued by the Housing Financing Fund (HFF) as well as bonds issued by Municipality Credit Iceland (LSS), Reykjavík City and real estate funds. The role of the Bank as a market maker is to

	Held for trading	Designated at fair value	Non-current assets and disposal groups held for sale	Securities used for hedging	Total
31.12.2013					
Listed	1,167	3,322	-	1,927	6,417
Unlisted	-	2,791	677	-	3,468
Total	1,167	6,113	677	1,927	9,885
31.12.2012					
Listed	1,663	3,681	-	1,172	6,516
Unlisted	-	3,929	3,054	-	6,983
Total	1,663	7,610	3,054	1,172	13,499

Exhibit 5.4. Shares and equity instruments at year-end 2013 and 2012 (ISK m). Consolidated.

enhance price formation in the secondary market and to be a provider of liquidity to clients.

The flow trading portfolio invests mainly in highly liquid government bonds and HFF bonds, but significantly less in municipal and corporate bonds. Government bonds can be either non-index linked or linked to the Icelandic Consumer Price Index (CPI). Duration ranges up to nine years for the non-indexed bonds, while the CPI-linked HFF bonds have duration of up to 13 years.

All positions in the flow trading portfolio are subject to BPV limits, both intraday and end-of-day limits. In addition to BPV limits, both the total short and long positions in the underlying bonds are limited. As a part of the market making agreements with the Government Debt Management and the Housing Financing Fund the Bank has limited access to securities lending which enables the Bank to take short positions in government and government-guaranteed bonds. Inflation risk in the trading book is minimal and is not separately reported but included in the Bank's total exposure to the CPI.

At the end of 2013, the total BPV for indexed and non-indexed bonds in the flow trading portfolio was ISK -1.9 million, compared to ISK -0.9 million in 2012.

The Bank's liquidity management assumes that part of the *liquidity portfolio* in foreign currencies can be invested in highly liquid bills issued by foreign governments with a long-term issuer rating of AA- from S&P or Fitch or Aa3 from Moody's. At year-end 2013 the Bank held a significant amount of foreign Aa1 and Aaa credit-rated government bills for liquidity management purposes. These bills have a duration ranging up to six months and the sensitivity measured in BPV was ISK -0.9 million at the end of 2013 (2012: ISK -0.4 million). Exhibit 5.5 displays the origin of the Bank's position in foreign government bills in its liquidity portfolio.

The *hedge portfolio* consists of hedge positions against bond options, bond forward and interest rate swap contracts. Bond options and interest rate swaps are subject to BPV limits. Additionally the bond options are subject to, for example, net delta limits. The net BPV of unhedged positions was close to zero at the end of 2013.

Country	MV	BPV	MV	BPV
	31.12.2013		31.12.2012	
Denmark	1,063	(0.02)	-	-
France	1,585	(0.01)	5,094	(0.04)
Germany	4,755	(0.09)	2,547	(0.05)
Netherlands	2,377	(0.02)	7,641	(0.13)
Norway	3,760	(0.13)	1,149	(0.02)
Sweden	5,375	(0.13)	-	-
UK	1,902	(0.02)	-	-
USA	14,433	(0.44)	10,298	(0.17)
Total	35,249	(0.86)	26,729	(0.41)

Exhibit 5.5. Origin of government issued bills and BPV in the Bank's liquidity portfolio (ISK m) at year-end 2013 and 2012. Consolidated.

The maximum total position in the trading portfolios over the year, excluding the hedge portfolio, was ISK 43.7 billion (2012: ISK 28.8 billion), mainly related to the liquidity portfolio, whereof the largest position in indexed securities was ISK 3.8 billion (2012: ISK 1.9 billion) and the largest position in non-indexed securities was ISK 41.3 billion (2012: ISK 28.0 billion). Exhibit 5.6 displays the total market value and BPV of the trading portfolios at the end of 2013 and 2012.

For the sensitivity analysis of the trading portfolios, the Bank uses a severe but plausible shift in interest rates. Exhibit 5.7 demonstrates sensitivity to the change in interest rates, with all other variables held constant.

Interest Rate Risk in the Banking Book

Interest rate risk in the banking book arises from the Bank's core banking activities. The main source of this type of interest rate risk is the risk of loss from fluctuations in future cash flows or fair value of financial instruments as market rates change over time, reflecting the fact that the Bank's assets and liabilities are of different maturities and are priced relative to different interest rates.

The Bank's main source of interest rate risk in the banking book is fixed rate mortgage loans, covered bond debt, loans in adjustments to the repayment schedule and fixed-term deposits.

Risk Management is responsible for measuring, monitoring and reporting on the Bank's interest rate risk in the

	MV	Duration	BPV	MV	Duration	BPV
		31.12.2013			31.12.2012	
Long positions						
Indexed	3,282	7.41	(2.43)	1,589	11.01	(1.75)
Non-indexed	35,848	0.32	(1.13)	26,933	0.18	(0.50)
Total	39,130	0.91	(3.56)	28,522	0.79	(2.25)
Short positions						
Indexed	291	6.39	0.19	521	10.65	0.55
Non-indexed	2,878	2.23	0.64	1,592	2.21	0.35
Total	3,170	2.61	0.83	2,113	4.29	0.90
Net position	35,960	0.76	2.74	26,409	0.50	(1.35)

Exhibit 5.6. Bonds and debt instruments in the trading portfolio at year-end 2013 and 2012 (ISK m). Consolidated.

Currency	Parallel upward shift in yield curve (basis points)	Profit or loss	Profit or loss
		31.12.2013	31.12.2012
ISK, indexed	100	(243)	(120)
ISK, non-indexed	100	(28)	27
CHF	40	-	-
EUR	20	(2)	(4)
GBP	40	(1)	-
JPY	20	-	-
USD	40	(18)	(7)
Other	40	-	(1)
Total		(291)	(105)

Exhibit 5.7. Sensitivity analysis for bonds and debt instruments in the trading portfolio at year-end 2013 and 2012 (ISK m). Consolidated.

banking book. The Treasury unit is responsible for managing the Bank's interest rate risk within limits set by ALCO.

Interest rate risk in the banking book is managed using limits based on the Bank's market risk appetite. All assets and liabilities are divided into four interest rate groups and given weights based on historical interest rate volatilities in the respective groups. These four groups are:

- ISK indexed interest rates.
- ISK non-indexed interest rates.
- Interest rates in EUR or JPY.
- Interest rates in other currencies.

These weights are used to scale the base shift of the yield curves. In Exhibits 5.8 and 5.9 all interest bearing assets and liabilities are bucketed according to their next interest reset as at year-end 2013 and 2012. Sensitivity calculations are however based on the duration of the underlying assets and liabilities. The calculations exclude loans with specific impairment since the valuation of such loans is based on the underlying collateral and is thus not affected by changes in the underlying interest rates.

For the sensitivity analysis in the banking book the Bank considers a 100 bp shift in ISK non-indexed interest rates to be reasonable. Shifts in other currencies are chosen using the same scaling factors as for the trading portfolios. ISK index-linked rate shifts are also scaled down since on longer time scales a significantly stronger mean reversion

	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
Assets							
Balances with Central Bank	111,779	-	-	-	-	-	111,779
Bonds and debt instruments	31,302	632	20	1,275	154	493	33,875
Loans to credit institutions	43,917	161	-	-	-	-	44,078
Loans to customers	401,401	46,565	57,552	38,803	1,586	12,516	558,423
Total assets	588,399	47,358	57,572	40,078	1,740	13,009	748,155
Off-balance sheet items	19,191	30,980	1,001	4,733	-	-	55,905
Liabilities							
Short positions	2,439	399	-	832	-	-	3,670
Deposits from Central Bank	63	-	-	-	-	-	63
Deposits from credit institutions	29,225	401	-	-	-	-	29,626
Deposits from customers	476,312	2,944	-	2,885	7,190	-	489,331
Debt issued and other borrowed funds	20,518	4,369	2,450	45,263	7,208	9,386	89,193
Subordinated loans	21,890	-	-	-	-	-	21,890
Total liabilities	550,447	8,113	2,450	48,980	14,398	9,386	633,773
Off-balance sheet items	20,046	23,638	5,338	8,195	-	-	57,217
Net interest gap on 31 December 2013	37,097	46,587	50,786	(12,364)	(12,658)	3,622	113,070

Exhibit 5.8. Interest rate reset periods in the banking book at year-end 2013 (ISK m). Consolidated.

	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
Assets							
Balances with Central Bank	83,493	-	-	-	-	-	83,493
Bonds and debt instruments	33,424	795	403	382	575	58	35,637
Loans to credit institutions	53,891	151	-	-	-	-	54,042
Loans to customers	422,980	48,961	27,250	46,197	1,314	12,893	559,595
Total assets	593,788	49,907	27,653	46,579	1,889	12,951	732,767
Off-balance sheet items	47,981	28,259	-	-	113	-	77,353
Liabilities							
Short positions	-	3,226	1,140	850	-	-	5,216
Deposits from Central Bank	54	-	-	-	-	-	54
Deposits from credit institutions	37,837	381	-	-	-	-	38,218
Deposits from customers	459,233	1,657	888	2,743	6,635	-	471,156
Debt issued and other borrowed funds	7,420	-	-	6,018	48,193	4,940	66,571
Subordinated loans	23,450	-	-	-	-	-	23,450
Total liabilities	527,994	5,264	2,028	9,611	54,828	4,940	604,665
Off-balance sheet items	52,896	9,479	10,552	9,754	-	-	82,681
Net interest gap on 31 December 2013	60,879	64,423	15,073	27,214	(52,826)	8,011	122,774

Exhibit 5.9. Interest rate reset periods in the banking book at year-end 2012 (ISK m). Consolidated.

Currency	Parallel upward shift in yield curve (basis points)	Fair value impact	Fair value impact
		31.12.2013	31.12.2012
ISK, indexed	40	(113)	(228)
ISK, non-indexed	100	(206)	(301)
CHF	40	2	2
EUR	20	6	3
GBP	40	(1)	(1)
JPY	20	(1)	(4)
USD	40	(14)	(4)
Other	40	4	1
Total		(323)	(532)

Exhibit 5.10. Sensitivity analysis for bonds and debt instruments in the banking book at year-end 2013 and 2012 (ISK m). Consolidated.

is exhibited for index-linked rates than for non-indexed rates.

Exhibit 5.10 shows the net fair value impact of the applied shifts on the Bank's assets and liabilities based on the duration of the underlying exposures.

Exhibit 5.11 displays the development of the Bank's interest rate risk in the banking book in 2013. The changes in the interest rate risk in the banking book were relatively modest over the year. The BPV effect of the Bank's net issuance of ISK 29 billion in 2013 was partially offset by the BPV effect from interest rates being reset on a large part of the mortgage portfolio in the autumn.

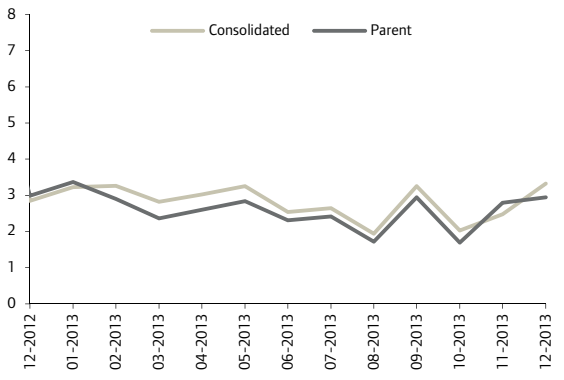

Exhibit 5.11. Monthly development of interest rate risk in the banking book in 2013 (total BPV in ISK m). Consolidated and parent.

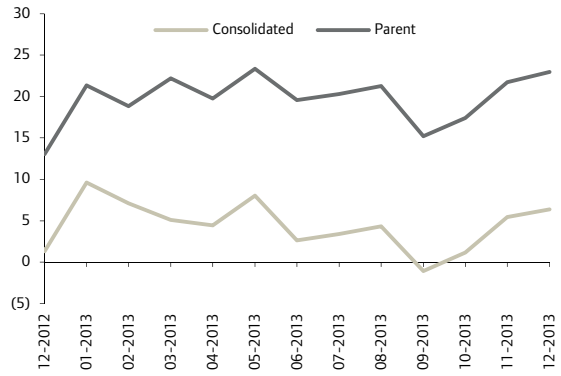

Exhibit 5.12. Monthly development of the inflation imbalance in 2013 (ISK bn). Consolidated and parent.

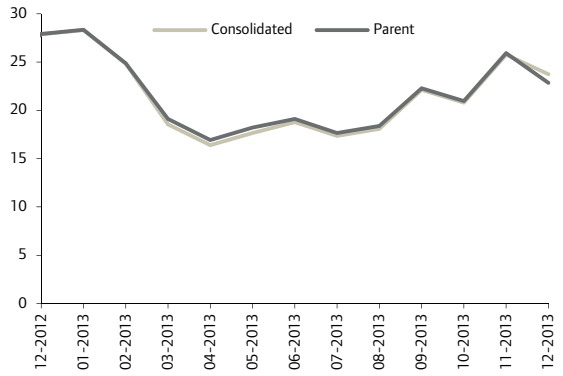

Exhibit 5.13. Monthly development of the currency imbalance in 2013 (ISK bn). Consolidated and parent.

5.3.3 *INFLATION RISK*

The Bank is exposed to inflation in Iceland since assets linked to the Consumer Price Index (CPI) exceed liabilities linked to the CPI. The carrying amount of all indexed assets and liabilities changes according to changes in the CPI at any given time and all changes in the CPI affect the Bank's profit and loss through interest income. The mismatch between the CPI-indexed assets and liabilities is reported to ALCO and is subject to a limit decided by the committee. At year-end 2013 the CPI gap amounted to ISK 6.4 billion (2012: ISK 1.3 billion). Thus a 1% unexpected increase in the index would lead to an ISK 64 million increase in the balance sheet and a 1% decrease would result in a corresponding decrease, all other factors held constant. The inflation imbalance increased in 2013 mainly due to an increase in CPI-linked loans to customers and a reduced liability side but the Bank's CPI-linked covered bond issuances and CPI-linked interest rate swaps partially offset the increase.

Note that real estate is used as collateral for a part of the Bank's loan portfolio and the value of this real estate is not as sensitive to changes in inflation as the loans themselves. Thus, for a sudden and sharp increase in inflation the value of loans may decrease in real terms at the same time as the Bank's liabilities increase in value. Exhibit 5.12 shows the development of the Bank's inflation imbalance in 2013. The difference between the parent inflation imbalance and the consolidated inflation imbalance is mainly due to an internal inflation-linked loan from the parent company to one of its subsidiaries.

5.3.4 *CURRENCY RISK*

Currency risk arises when financial instruments are not denominated in the Bank's reporting currency, especially if there is a mismatch in the currency denomination of assets and liabilities.

Currency risk is managed within limits approved by the Board. Exhibit 5.13 displays the development of the Bank's currency imbalance in 2013. The currency imbalance decreased in 2013, mainly due to recalculation and revaluation of loans, offsetting cross-currency swaps and the ISK appreciating by 10%.

5.3.5 *DERIVATIVES*

The Bank offers interest rate swaps (IRS), cross currency interest rate swaps (CIRS), bond options, foreign currency options (FX options), foreign exchange swaps (FX swaps), outright forwards (FX forwards), equity forwards, bond forwards and repurchase agreements (REPOs) either for customers' speculative or hedging purposes. All derivative positions that carry market risk are subject to market risk limits. The overall position in interest rate swaps and cross currency interest rate swaps is limited with BPV and maturity limits while options are subject to several limits, including a limit on the open delta position per underlying instrument.

Derivatives that do not carry direct market risk (due to hedging), e.g. forward agreements for foreign currency and securities, are subject to notional limits that cap the Bank's indirect exposure to the underlying risk factors. The Bank uses derivatives to hedge out currency exposure, interest rate risk in the banking book as well as inflation risk. Other derivatives in the Bank held for trading or for other purposes are insignificant.

5.3.6 *USE OF MODELS*

The Bank uses conventional risk measurements, such as limits on notional amounts and sensitivity measures, to measure market risk exposures.

The Bank also uses Value-at-Risk based methods for the following purposes:

- In-house regular reporting of currency risk.
- Margin requirement calculations.
- Internal capital calculations for counterparty risk.
- Determination of trading limits.

5.4 CAPITAL REQUIREMENTS

The Bank uses the standardised approach for calculating its capital requirements for market risk. Exhibit 5.14 shows the Pillar 1 capital requirements for market risk at the Bank at year-end 2013 and 2012. The Bank's market risk profile changed somewhat in 2013 with market risk accounting for 4.4% of the Bank's capital requirement under Pillar 1 at the end of 2013 compared to 5.1% at the end of 2012. The capital requirement and risk-weighted assets decreased for each of the underlying factors. Most of the decrease

Risk exposure	Capital requirement	RWA	Capital requirement	RWA
	31.12.2013		31.12.2012	
Equity risk	139	1,739	200	2,494
Foreign exchange risk	1,900	23,744	2,235	27,934
Interest rate risk	269	3,366	281	3,513
Total	2,308	28,849	2,715	33,940

Exhibit 5.14. Pillar 1 capital requirements and risk-weighted assets (RWA) for market risk at year-end 2013 and 2012 (ISK m). Consolidated.

in the total capital requirements for market risk can be explained by a lower end-of-year position in the equity trading book and a lower currency imbalance.

The Bank accounts for the market risk not covered under Pillar 1 in its internal capital adequacy assessment under Pillar 2 (ICAAP).

5.5 STRESS TESTING

As a part of the ICAAP process, the Bank runs stress tests on both its trading and banking book in order to quantify the effect that severe changes in micro- and macroeconomic factors might have on the Bank's balance sheet and total capital. These two portfolios are handled differently due to their inherent differences. The following risk exposures are simulated on a forward looking basis:

- Equities: All shares owned by the Bank.
- Interest rate risk: All market bonds as well as interest rate risk in the banking book.
- Foreign exchange risk: The Bank's currency imbalance.
- Inflation risk: The Bank's inflation imbalance.
- Direct market risk through derivatives: For example, bond options, FX options, interest rate swaps and currency interest rate swaps carry direct market risk.
- Indirect market risk through derivatives: Credit losses can occur in the case of severe market movements and insufficient collateral.

In 2011 the Bank issued its first covered bonds which were CPI-linked and in 2012 the Bank issued its first non-index linked covered bonds. The Bank issued one new non-index linked covered bond series in 2013 and added to the already outstanding series of one non-index linked and four index-linked covered bonds. The Bank's net covered bond issuance (including payments on outstanding covered bonds) in 2013 was ISK 11 billion.

According to law 11/2008 and FME´s regulation 528/2008 the Bank runs weekly stress tests comparing the net present value of the issued covered bonds (the liabilities) and the loans in the cover pool (the assets) under various stress scenarios, including a sudden and permanent interest rate shock of 100 basis points and a 2.5% change in the CPI. At year-end 2013 the Bank passed all of these stress tests.

REGULATORY CHANGES

Amendment to Act No. 108/2007 on Securities Transactions

The Icelandic Parliament passed an amendment to the Act on Securities Transactions on 27 March 2013. The main focus of the amendment is to reduce burdensome requirements towards companies and financial undertakings in the European Economic Area (EEA) when increase in share capital. The amendment moreover seeks to simplify and improve the Act's application and to increase efficiency, i.a. in relation to share offerings and initial public offerings on regulated markets. Improving the competitiveness of the relevant undertakings, especially small and medium-sized enterprises (SMEs) as it is defined in the EEA. In addition the amendment seeks to increase investor protection in the information provided in prospectuses better serve the intended purpose and meet the needs of retail investors, ensuring informed investment decisions. The amendment was made in order to rectify shortcomings of prospectuses in relation to investor protection revealed after the credit crisis.

6 LIQUIDITY RISK

Íslandsbanki maintained a very strong liquidity position throughout 2013. At the end of 2013 the Central Bank adopted the Basel liquidity coverage ratio (LCR) into the Icelandic rules on liquidity ratios. The initial minimum for the LCR in Iceland is 60%, increasing by 10 percentage points every year, reaching 100% in 2017. Íslandsbanki's LCR ratio was 120% for the parent company and 143% at a consolidated level at the end of 2013. Deposits levels remained stable in 2013 despite increased investment opportunities in the equity and bond markets. This is reflected in high deposit–to-loan ratios throughout the system. The ratio of customer deposits to loans to customers was 88% at the end of 2013 compared to 84% at the end of 2012. The ratio of total deposits to total loans decreased from 87% to 83% over the same period.

The Bank issued ISK 9.9 billion in covered bonds in 2013 and expects to issue ISK 10–13 billion per annum over the next few years. In addition, the Bank issued short-term unsecured papers throughout 2013 with an outstanding amount at year-end of just under ISK 9 billion. At the end of 2013, the Bank entered the international capital markets with a SEK 500 million 4-year bond under a newly established GMTN programme.

DEFINITION OF LIQUIDITY RISK

Íslandsbanki defines liquidity risk as the risk of not being able to fund its financial obligations or planned growth, or only being able to do so substantially above the prevailing market cost of funds.

6.1 STRATEGY, ORGANISATION AND RESPONSIBILITY

Liquidity risk is considered a material risk factor in the Bank's operations. The core activity of the Bank relates to accepting deposits of very short to medium term and extending debt to borrowers that is generally of a longer term. This transformation of maturity between depositors and borrowers exposes the Bank to liquidity risk. The Bank's strategy for managing liquidity risk assumes that the Bank can at all times meet its financial obligations as they fall due.

Taking on liquidity risk is an integral part of the Bank's operations. The risk appetite approved by the Board is reflected in the liquidity risk limit structure and guided through the liquidity risk management framework:

- The Bank has back-up liquidity resources to meet all its maturing liabilities for at least 12 months without access to the funding markets, i.e. under severely stressed market conditions.
- The Bank maintains a prudent balance between the maturity of assets and liabilities.

Sound and efficient management of liquidity risk is a key factor to ensure the viability of the Bank's operations and to achieve and maintain access to funding markets. The Bank takes a conservative and prudent approach to the management of liquidity risk and its liquidity strategy assumes that the Bank can sustain a prolonged period of stress. This strategy is fulfilled by ensuring that the Bank:

- Enforces a prudent amortisation profile on its portfolio of loans to customers in order to reduce the refinancing risk of both the Bank's customers and the Bank itself.
- Has a clear limit with respect to liquidity risk in the main operating currencies.
- Fulfils external limits on liquidity at all times.
- Has in place well defined liquidity risk stages and a contingency plan that details the management actions at each stage.

The overall responsibility for Íslandsbanki's liquidity risk management lies with the Board of Directors. The Board defines the Bank's risk appetite and approves the Bank's Liquidity Risk Policy which also states the roles and responsibilities regarding liquidity risk management.

The Asset and Liability Committee (ALCO) supervises liquidity risk. The committee decides on and implements the risk limits set forth in the Liquidity Risk Policy by the Board of Directors.

The Risk Management department is responsible for communicating the Bank's Liquidity Risk Policy to the Bank's business units and the subsidiaries. Risk Management makes proposals to ALCO and the Board of Directors on the liquidity risk appetite, limit structure and the liquidity risk management framework. Risk Management is also responsible for reporting on the Bank's overall liquidity position both for the parent company and the consolidated bank, compliance to limits, both internally and externally.

The Treasury unit is responsible for managing the liquidity of the Bank within limits set by ALCO and for reporting on the funding status of the Bank. Treasury makes proposals to ALCO for internal pricing. Day-to-day liquidity management is delegated to the interbank desk.

6.2 LIQUIDITY MEASURES

The Bank uses various metrics and measures, both static and forward looking, to assess and quantify its liquidity

Composition and amount of liquidity back-up	31.12.2013	31.12.2012
Cash and balances with Central Bank	105,161	81,458
Domestic bonds eligible as collateral against borrowing at the Central Bank	20,873	12,704
Foreign government bonds	34,618	26,730
Total High Quality Liquid Assets (HQLA)	160,652	120,891
Short-term placements with credit institutions	41,192	49,264
Total liquidity back-up	201,844	170,156

Exhibit 6.1. Composition and amount of liquidity back-up (ISK m). Parent.

position and thereby its liquidity risk. The main measures are based on:

- Analysing the mismatch in cash flows from assets and liabilities under normal and stressed business conditions.
- Assessing the balance between long-term assets and long-term funding sources.
- Assessing the ratio between the Bank's liquidity back-up and maturing liabilities.

The assumptions for the internal liquidity measures are reviewed regularly.

Regulatory reports on the liquidity position are provided on a monthly basis as required by the Central Bank and the FME.

6.3 LIQUIDITY POSITION

Íslandsbanki maintained a very strong, and relatively stable, liquidity position throughout 2013 and all regulatory and internal metrics were well above limits.

The Bank's liquidity strategy aims at maintaining a healthy ratio of liquid assets in order to fulfil internal and external liquidity requirements but at the same time earning an acceptable return on the Bank's assets. Exhibit 6.1 shows the composition of the Bank's liquidity backup at the end of 2013 and 2012.

In addition to internal limits, the Bank is subject to liquidity requirements posed by the FME and the Central Bank of Iceland.

6.4 REGULATORY REQUIREMENTS

6.4.1 Liquidity coverage ratio and net stable funding ratio

The Central Bank of Iceland, which is the main supervisory authority regarding liquidity risk, has incorporated the liquidity coverage ratio (LCR) based on the CRD IV standards into the Rules on liquidity ratio[1]. As of 1 December 2013 the Central Bank requires that the Icelandic banks maintain a LCR of 60% increasing the limit by 10 percentage points on 1 January every year until the long-term limit of 100% is reached in January 2017. Specifically, the LCR for liabilities in foreign currency (FX-LCR) is set at 100% from the onset. This change places the Icelandic banks two years ahead of the general EU implementation. These rules apply to both the parent company and on a consolidated level. The new Rules on liquidity ratio will replace the previous Central Bank liquidity requirements and the liquidity requirements introduced by the FME in 2009.

The Board of Íslandsbanki has approved a target range for the Bank's LCR during the phase-in period to ensure compliance to these new requirements. At year-end 2013 the overall LCR for Íslandsbanki was 120% and for foreign currencies 290% at parent level and 143% for all currencies and 326% for foreign currencies on a consolidated level.

In addition the Central Bank is preparing implementation of the Net Stable Funding Ratio (NSFR) based on the CRD IV standards in both ISK and foreign currency. Full implementation of the CRD IV liquidity standards is considered an important step in preparing for the removal of the capital controls as it will require credit institutions to be well prepared to tolerate potential outflows of foreign denominated deposits.

Definition of the Liquidity Coverage Ratio

In December 2010, The Bank for International Settlements (BIS) introduced new regulatory standards for liquidity risk management in the document International Framework for Liquidity Risk Measurement, Standards and Monitoring[2]. These new standards are a part of the CRD IV framework and are focused on implementing common liquidity measures for all banks, i.e. the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR).

The liquidity coverage ratio (LCR) is defined as the proportion of high quality liquid assets (HQLA) to net cash outflow over the next 30 calendar day period.

$$\frac{\text{Stock of HQLA}}{\text{Cash outflow} - \text{Minimum}\{\text{Cash inflow, 75\% Cash outflow}\}}$$

High quality liquid assets (HQLA) are defined as assets that can be easily and immediately converted into cash at little or no loss of value. Those include Central Bank certificates of deposits, government bonds, corporate debt securities and quality equities. The main outflow

[1] Central Bank rules on liquidity no. 1055 from 1 December 2013, http://www.sedlabanki.is/sedlabankinn/um-sedlabankann/log-og-reglur/.

[2] International Framework for Liquidity Risk Measurement, Standards and Monitoring (http://www.bis.org/publ/bcbs188.pdf).

factors include on-demand deposits, committed credit and liquidity facilities, contractual lending obligations within a 30-day period, derivative cash outflow and increased collateral needs. This is offset by cash inflows that include contractual inflows from outstanding exposures that are fully performing and derivative cash inflows.

In order to prevent banks from relying too much on anticipated inflows to meet their liquidity requirements the amount of inflows that can offset outflows is capped at 75% of total expected cash outflows. This requires that banks must maintain a minimum stock of HQLA equal to 25% of the total cash outflows.

EU currently plans to introduce the LCR limit in a phase-in arrangement which aligns with those that apply to the Basel III capital adequacy requirements and the NSFR will become a minimum standard by January 2018[3]. The LCR minimum will be introduced within the EU on 1 January 2015 with the minimum requirement beginning at 60% and rising in equal annual steps to reach 100% in 2019. As described in the beginning of the section the plans for implementation of the LCR requirements in Iceland are two years ahead of the general EU implementation plan.

The Net Stable Funding Ratio

The NSFR measures the proportion of stable funding to long-term assets for a time horizon of over one year. In particular, the NSFR is structured to ensure that long-term assets are funded with at least a minimum amount of stable liabilities and thus to limit over-reliance on short-term wholesale funding. In the EU banks have until January 2018 to meet the NSFR standard and over time the ratio will be reviewed as proposals are developed and industry standards implemented.

6.4.2 FME LIQUIDITY RATIOS

In 2009, the FME introduced two liquidity measures that Icelandic banks were required to fulfil. The cash ratio requires banks to hold cash and cash-like assets amounting to at least 5% of on-demand deposits and the liquidity ratio requires the Bank to hold liquid assets amounting to at least 20% of all deposits. These rules applied to and were reported for the parent company throughout the year 2013 but have now been replaced by the new LCR requirements through changes in the Central Bank rules on liquidity ratios.

Exhibit 6.2 shows the development of the FME liquidity ratios for Íslandsbanki in 2013. Both the cash ratio and the liquidity ratio were above the required minimum during 2013.

6.4.3 CENTRAL BANK LIQUIDITY RATIOS

The previous Central Bank liquidity requirements stipulated that liquid assets, according to definitions provided by the Central Bank, shall cover maturing liabilities over one and three months. These rules applied to and were reported for the parent company throughout the year 2013 but have now been replaced by the LCR.

[3]The Liquidity Coverage Ratio and liquidity risk monitoring tools (http://www.bis.org/publ/bcbs238.pdf).

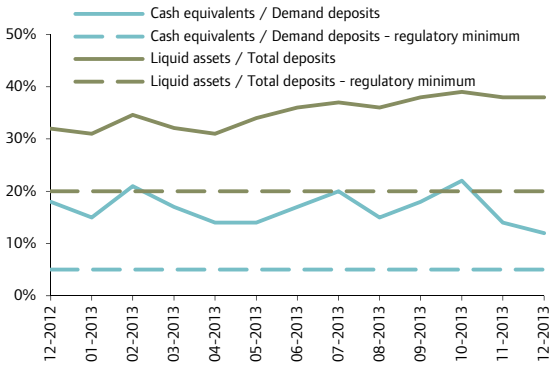

Exhibit 6.2. FME liquidity ratios. Parent.

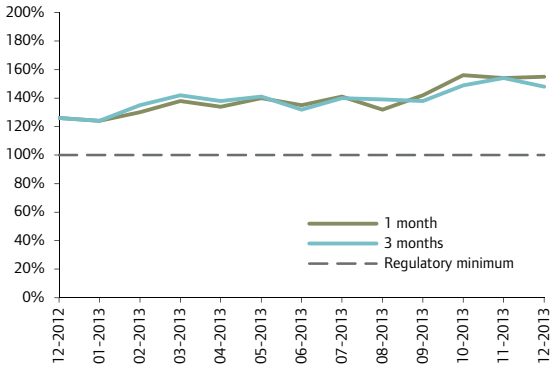

Exhibit 6.3. Central Bank liquidity ratios. Parent.

Exhibit 6.3 shows the development of the Central Bank liquidity ratios for Íslandsbanki in 2013. Both the 1-month and 3-month liquidity ratios were above the required minimum throughout 2013.

6.5 LIQUIDITY STRESS TESTING

The Bank has in place a stress testing framework for liquidity that incorporates multiple scenarios with varying degree of likelihood and severity. The stress tests are intended to assess the development of the Bank's liquidity position under stressed market conditions without access to new funding and develop a strategic course of action. The stress testing framework is supplemented by a liquidity contingency plan. The results from all stress tests are reported to the Board of Directors.

6.6 LIQUIDITY CONTINGENCY PLAN

Íslandsbanki's Liquidity Risk Policy presumes that the Bank has in place a Liquidity Contingency Plan. The main purpose of the contingency plan is to identify liquidity or funding problems as early as possible and thereby to improve the Bank's ability to respond to such situations. As a part of the Liquidity Contingency Plan, the Bank has defined five liquidity stages reflecting different levels of severity. The liquidity stage is determined based on both predefined risk triggers and on qualitative assessment. For each stage, management and reporting actions have been defined and communicated to the relevant parties, including the Board of Directors, the Central Bank and the

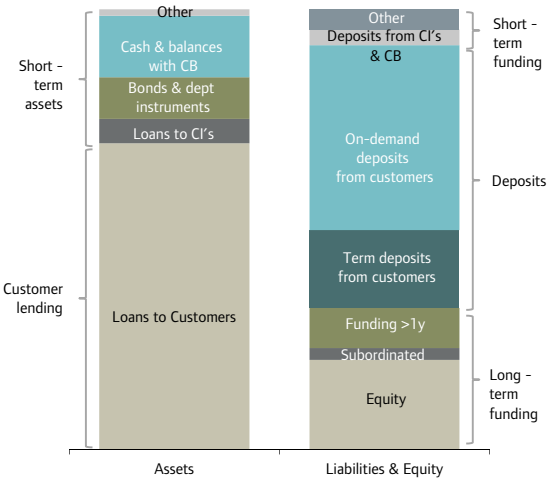

Exhibit 6.4. Funding profile and the Bank's matching assets at year-end 2013. Parent.

FME. The Liquidity Contingency Plan is tested annually and the findings from the test are used to improve the contingency plan if needed. The results from the Liquidity Contingency Plan test are reported to the Board of Directors.

6.7 FUNDING

Deposits remain the Bank's main source of funding. The ratio of total deposits to total loans was 88% at the end of 2013, whilst the ratio of customer deposits to customer loans was 87%. The deposit-to-loan ratio has remained relatively stable for the last few years, ranging from 84% to 88%, despite an increase in the supply of other investment opportunities. The Bank is actively working on increasing the diversity of its funding base and has been successful in doing so with issuance of bonds, notes and bills both domestically and abroad. Deposits however are expected to remain the Bank's main source of funding.

The overall deposit/loan ratios in Iceland are at the moment very high in a historical context. Deposit ratios could be expected to converge to a lower long-term average in the coming years but the path for such an adjustment is highly dependent on various external factors such as the possible lifting of capital controls. A diversification of the Bank's funding sources has been an important theme for Íslandsbanki in recent years and successful entries, as an issuer, in the capital markets has been achieved in several areas.

6.7.1 *Bond issuance*

Firstly, the Bank established a position as the market leader in the issuance of covered bonds in the domestic market in December 2011. The Bank issued ISK 9.9 billion of covered bonds in 2013, slightly more than the ISK 9.4 billion issued the previous year. The total outstanding amount of covered bonds at year-end 2013 was ISK 23.3 billion. The Bank has been able to issue at relatively attractive terms and the spread between yields on the Bank's covered bonds and government-guaranteed

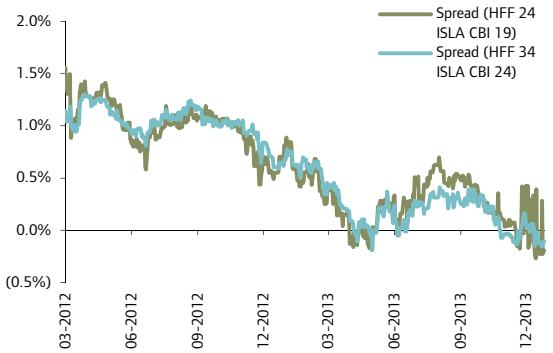

Exhibit 6.5. Development of covered bond spread relative to HFF bonds.

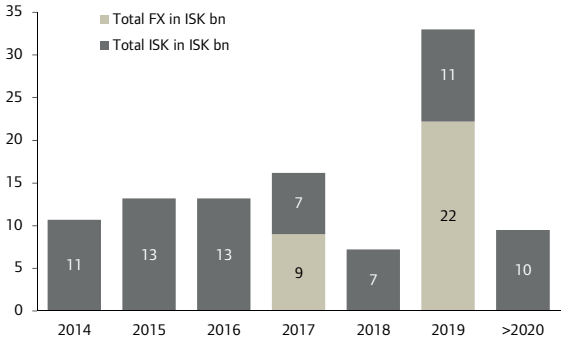

Exhibit 6.6. Maturity profile of long-term funding (ISK bn). Parent.

bonds has narrowed considerably since the program was launched, see Exhibit 6.5.

Secondly, in April 2013 the Bank began issuing unsecured short-dated bonds (i.e. commercial papers) in the domestic market–the first listed issue of such securities by an Icelandic bank since the autumn of 2008. At year-end the Bank had just under ISK 9 billion of debt outstanding in short-term unsecured bonds, with maturities ranging from one to six months.

Finally, the Bank entered the international capital markets in December 2013 with a SEK 500 million 4-year bond issue in the wake of signing an USD 250 million Global Medium Term Note (GMTN) Program earlier in the year. The senior unsecured bond pays a quarterly coupon of 3-month STIBOR + 400bp.

6.7.2 *Asset encumbrance*

Asset encumbrance, or the percentage of assets pledged as collateral, is drawing increased attention from regulators, investors and others. The Banks asset encumbrance comes mainly in the form of:

- Loans and securities serving as collateral for covered bond issuance which is one of the Bank's strategic long-term funding sources.
- Loans and securities as collateral for a mortgage-backed bond.
- Loans and securities as collateral for currency swap agreements.

Deposit class	CRD IV criteria	CRD IV deposit run-off rates
Financial institutions and fiduciaries	Financial institutions, insurance companies, fiduciaries, beneficiaries and special purpose vehicles	100%
Non-financial corporate	Legal entities with total deposits greater than €1,000,000, as well as sovereign, central bank and public sector entities	40%
Individuals and small businesses, less stable	Individuals and legal entities with total deposits less than €1,000,000, part of deposits that are not covered by an effective deposits insurance scheme or do not have other established relationships with the Bank	10%
Individuals and small businesses, between €20,887 and €100,000	Individuals and legal entities with total deposits less than €1,000,000, deposits that would be fully covered by an effective deposits insurance scheme within the EU and have other established relationships with the Bank	10%
Individuals and small businesses, less than €20,887	Individuals and legal entities with total deposits less than €1,000,000, deposits that are fully covered by an effective deposits insurance scheme in Iceland and have other established relationships with the Bank	5%

Exhibit 6.8. CRD IV criteria for deposit categorisation.

	Percent of total assets pledged as collateral
2010	8.6%
2011	9.6%
2012	11.5%
2013	12.2%

Exhibit 6.7. Development of asset encumbrance as a percentage of total assets. Parent.

Exhibit 6.7 shows the development of asset encumbrance as percentages of total assets.

6.7.3 *Deposits*

In an effort to reduce liquidity risk the Bank has put emphasis on maintaining a stable deposit base of customer term deposits. This is evident through the introduction of new term deposit products and considerable marketing effort in that area. The share of term deposits was 30% at the end of 2013 and has remained stable since the end of 2012. Íslandsbanki puts emphasis on managing its deposits to reduce concentration. The Bank's deposits have been categorised into five different groups, based on the classification of the CRD IV criteria. The groups are listed in Exhibit 6.8 in order of estimated stability and CRD IV deposit run-off rate.

Exhibit 6.9 shows a breakdown of the Bank's deposits totalling ISK 533 billion at year-end 2013, according to the CRD IV definitions in Exhibit 6.8.

The share of retail deposits from individuals and small businesses remained little changed at 47% at the end of 2013. Thereof, 13% are considered stable in nature and 34% less stable, compared to 14% and 35% at the end of 2012. The distinction between stable and less stable deposits is based on the type of relationship that the Bank has with the customer and the fraction of the deposits that are fully covered by an effective deposit insurance scheme. Currently the Icelandic Deposit insurance scheme covers €20,887 whereas most EU members have increased

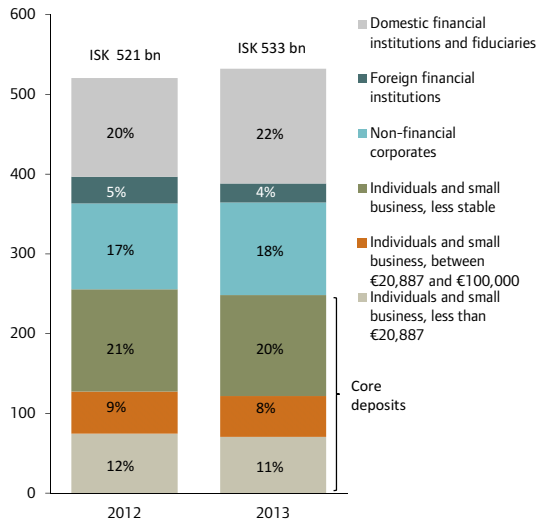

Exhibit 6.9. Breakdown by LCR categorisation at year-end 2013. Parent.

the maximum insured amount to €100,000. The Bank assumes that the Icelandic legislation will follow that precedent in the near future thereby increasing the proportion of stable deposits. The deposits category labelled "between €20,887 and €100,000" refers to the amount of deposits that would be considered stable under the EU deposit scheme but less stable under the current Icelandic scheme. Exhibit 6.9 shows how the deposit composition changed in 2013.

6.7.4 *Funding Outlook*

As the Icelandic securities market continues to recover domestic investors are expected to partly move their investments from deposits to other investment instruments and deposit/loan ratios for the system are expected to decrease accordingly. As a result, the Bank's reliance on other funding sources will increase.

Demand for covered bonds has been strong since the inaugural issues in 2011. The Bank plans to issue ISK

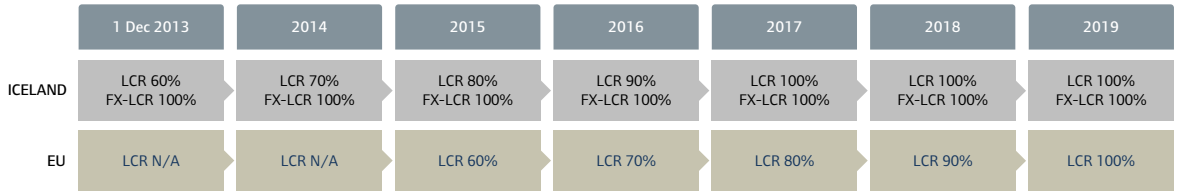

Exhibit 6.10. The planned implementation of the LCR in Iceland compared to the EU plan.

10–13 billion in covered bonds per annum in the coming years, which is assumed to form the basis for new mortgage lending.

The Bank also aims to use the capital markets to issue unsecured bonds both domestically and abroad. Improving terms, which can be seen in the Bank's recent tap issue of its SEK bond at STIBOR + 330 bps, and improved access to international markets could allow the Bank to refinance current sources of foreign currency debt at more attractive terms.

Domestically, there is a risk is that investors' appetite for covered bonds will not be sufficient to fund the demand for new mortgages which could result in a spike in yields which would in turn suppress demand. Internationally, volatility in the Icelandic economy associated with lifting of capital controls could result in increased costs of funding in foreign currency. A successful lifting of the controls is vital for the long-term health and stability of the financial system. The Bank is well prepared to deal with the short-term outflow of funds that could be associated with the lifting of capital controls.

6.8 REGULATORY CHANGES AND OUTLOOK

The Icelandic regulators, Central Bank and Financial Supervisory Authority, have already implemented the liquidity coverage ratio (LCR) into the Icelandic liquidity rules, see Exhibit 6.10. Preparation for the implementation of the NSFR is already underway but since the final definitions are still subject to change there is considerable uncertainty regarding the time frame.

REGULATORY CHANGES

Central Bank liquidity rule no. 105/2013 on the implementation of the LCR

The Central Bank of Iceland has issued new Rules on Liquidity Ratio[a], no. 1055/2013, in accordance with the provision contained in Article 12 of the Act on the Central Bank of Iceland, no. 36/2001. The Rules took effect on 1 December 2013, on which date the previous Central Bank Rules on Liquidity Ratio became a void.

These rules are based on the standards developed by the Basel Committee on Banking Supervision which were issued in 2010 and their incorporation into European law this year via the so-called CRD IV package. The Central Bank Rules are therefore based on international rules but are adapted to Icelandic conditions, in part through the inclusion of requirements on foreign currency liquidity and the consideration given to risks related to the winding-up of the old banks.

Rules on credit institutions' minimum net stable funding ratio (NSFR) in ISK and foreign currency are currently in preparation. Such rules cover a longer horizon than liquidity rules and aim to limit maturity mismatches, particularly in foreign currencies. This is considered important in view of Iceland's recent experience and the prospective removal of the capital controls, which will require credit institutions to be well prepared to tolerate potential outflows of foreign-denominated liabilities.

Amendment to the Act no. 36/2001 on the Central Bank of Iceland (rules on credit institution's minimum or average liquid assets, in ISK and FX, access to information etc.)

On 5 July 2013, the Icelandic Parliament passed a bill amending the Act on the Central Bank of Iceland. The Central Bank's right to information was broadened in relation to the Bank's aim of easing restrictions on foreign exchange transactions. Furthermore, the Central Bank's authority to impose rules on liquidity and minimum stable funding in local and/or foreign currency as well as to regulate the foreign exchange balance, in particular to specify which assets and liabilities fall within the foreign exchange balance and their weight. The amendment was intended to consolidate the control of liquidity and funding of financial institutions on the basis of expected new liquidity rules.

[a]New liquidity rules for credit institutions no 38/2013: www.cb.is/publication-new-and-speeches/news-and-speeches/news/2013/12/02/New-liquidity-rules-for /-credit-institutions/.

7 OPERATIONAL RISK

In 2013, a total of 416 loss events were registered in the Bank's loss event database. Most of the registered operational risk events occurred without causing a loss. The loss events are categorised according to Basel II convention. The category "Execution, delivery and process management" accounts for 35% of all loss events, and the category "Business disruption and system failures" accounts for 23% of all loss events. The loss events in the category "Execution, delivery and process management" account for 92% of the total loss amount attributed to operational risk in 2013.

DEFINITION OF OPERATIONAL RISK

The Bank has adopted the definition of operational risk from the CRD 2006/48/EC of the European Parliament and of the European Council, where operational risk is defined "as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events". The Bank's definition of operational risk includes legal risk, compliance risk, and reputational risk.

7.1 STRATEGY, ORGANISATION AND RESPONSIBILITY

The Board of Directors has approved an Operational Risk Management Policy, applicable to the Bank and its subsidiaries. The policy outlines a framework for operational risk management in the Bank. The operational risk management framework is described in further detail in several subdocuments, such as the Quality Management Policy, Data Policy, the Business Continuity Management Framework, the Security Policy, and the Crisis Communication Policy, all of which are approved by the Executive Board.

According to the Operational Risk Management Policy, the Executive Board is responsible for the operational risk framework, and the Risk Monitoring Unit within Risk Management is responsible for the implementation of the operational risk framework throughout the Bank.

7.2 OPERATIONAL RISK MANAGEMENT

The Bank has implemented an operational risk management framework within the parent company that fulfils the Basel II Accord's requirements for the standardised approach.

The main tools for operational risk management are:

- Registration of all significant operational risk loss events occurring in the Bank.
- Risk and Control Self-Assessment (RCSA) throughout the Bank.
- Monitoring of Key Risk Indicators (KRI) throughout the Bank.
- Business Continuity Management.
- Management reporting that provides operational risk reports to relevant functions within the Bank.

Limits for acceptable quarterly losses are defined in the Operational Risk Management Policy. If the loss exceeds a lower limit a report of the causing events and risk mitigation plan is delivered to the Executive Board. However if the loss exceeds a higher limit a report and mitigation plans are delivered to the Board of Directors.

Risk Monitoring is responsible for the development of the operational risk management framework and for monitoring operational risk, whereas each business unit is primarily responsible for managing and controlling its own operational risk. The Risk Monitoring unit produces management reports intended to provide an overview of the Bank's operational risk profile to support or stimulate the management's decisions. The reports are based on registered operational risk losses, KRI measurements and RCSA results and are submitted at least quarterly to the Board of Directors, the Executive Board and relevant business owners.

7.3 LOSS EVENT DATA

The Bank has implemented a framework to capture both actual and potential operational risk losses.

Operational risk loss events which result in losses of more than ISK 100,000 and incidents that could potentially cause substantial losses (near-misses) are collected through a web-based system and are registered in the Bank's loss event database. The database holds information on all significant actual losses, categorised according to Basel II convention, and provides a basis for management reports. Also, the loss event data are necessary for the development of more sophisticated methods of capital requirements assessment.

In 2013 a total of 416 loss events were registered in the Bank's loss event database. The category "Execution, delivery and process management" accounts for 35% of all loss events, and the category "Business disruption and system failures" accounts for 23% of all loss events.

In 2013 92% of the total operational risk losses were categorised as "Execution, delivery and process management".

Further division of loss events is presented in exhibit 7.1 and 7.2.

7.4 RISK AND CONTROL SELF ASSESSMENT

In addition to the collection of loss data, the Bank uses the Risk and Control Self Assessment (RCSA) process to identify and assess potential operational risks. The

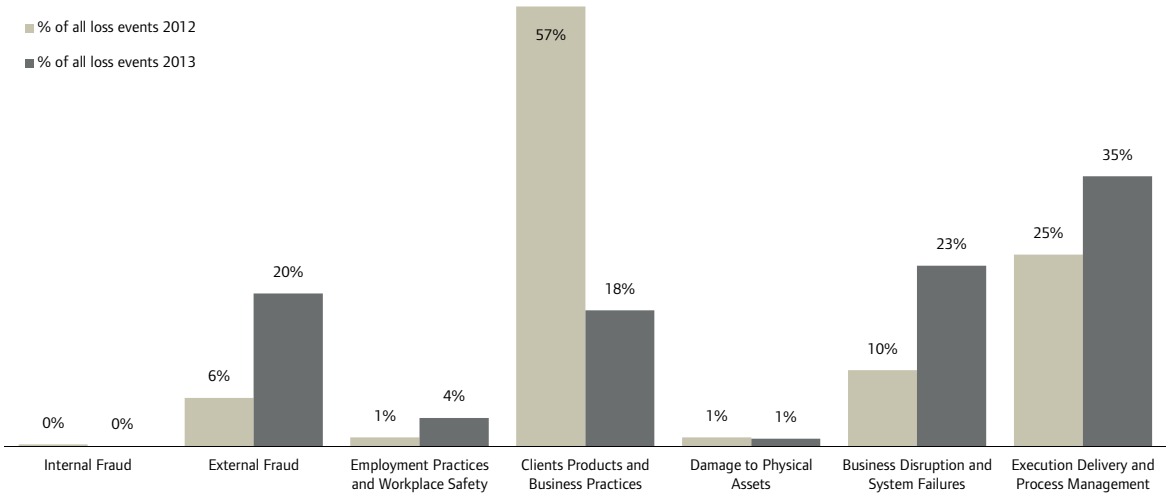

Exhibit 7.1. Breakdown of number of loss events in 2012-2013 based on Basel II event categories. Parent.

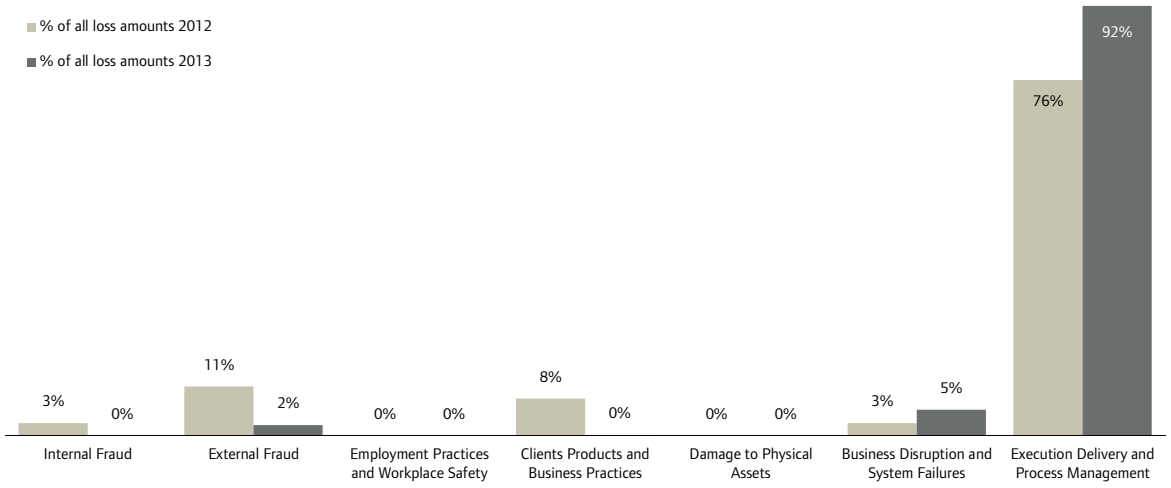

Exhibit 7.2. Breakdown of loss amounts in 2012-2013 based on Basel II event categories. Parent.

purpose of this framework is to improve the way the Bank operates through regular review of policies, processes and systems.

The risk identification is based on a thorough review of current processes. Each business unit reviews processes that are critical to the sound delivery of its products and services, and if any weaknesses are found, the probability of a loss event and the expected loss amount are estimated, thereby giving a measure of the value at risk. For all risks determined unacceptable, a mitigation plan is created. The RCSA is undertaken at least once a year by all business units within the Bank and the main findings and mitigation plans are reported to senior management.

7.5 QUALITY MANAGEMENT

The Quality Management unit, within Risk Monitoring, is responsible for supervising, maintaining and developing the Bank's Quality Management Policy. The policy is based on seven quality management principles: business process management, continuous improvement, good governance, product management, project management, quality management framework and record management.

The Product Management Policy documents the product approval process within the bank, in accordance with Basel II convention. The main objective is to ensure implementation of products in compliance with the Bank's policy and legal requirements. The process is a synchronization and communication tool between product stakeholders, as well as monitoring and risk management tool for new products. It also gives an overview of the full product range and the diversity of products within Íslandsbanki. All new products have to be approved by the Risk Committee before they are implemented and launched to the market.

7.6 DATA GOVERNANCE

Risk Monitoring is responsible for the Bank's data governance framework and the maintenance of the Bank's Data Policy.

In general the data governance aim is to ensure the availability, usability, integrity, consistency, auditability and security of the Bank's data. This is achievable through the interworking of data standards, data strategy, communication, policies and processes.

The Bank's Data Policy lays the foundation on how the Bank's data should be treated. The Data Policy is based on the Basel Committee on Banking Supervision (BCBS) consultative document Principles for Effective Risk Data Aggregation and Risk Reporting.

7.7 BUSINESS CONTINUITY MANAGEMENT

Íslandsbanki Business Continuity Management Framework documents the measures taken by the Bank to mitigate risks that could disrupt the Bank's operations, resulting in a loss or negative customer´s experience. The primary objective of the framework is to create a culture of business continuity by raising employee and management awareness, and providing guidelines for creating Business Continuity Plans for the Bank's business units.

Employees, systems and processes are included in the scope of the Business Continuity Plans. The consideration given to each element depends on the element's sensitivity to disruption and importance in the assurance of business continuity. Sensitivity and importance are evaluated by each of the Bank's business units, as well as the accompanying alert levels and testing frequencies. Each business unit appoints a Business Continuity Team and is responsible for maintaining its Business Continuity Plan.

The Business Continuity Management Framework is reviewed annually and approved by the Executive Board of Íslandsbanki. Risk Monitoring is responsible for the coordination of all efforts by the Bank described in the Business Continuity Management Framework.

In case of serious disruption in the Bank's operations a Crisis Management Plan has been documented in order to provide a set of guidelines for the Bank's Executive Board. The document also states the principles that should guide the Executive Board in case of a major disruption and specifies which of the Bank´s functions should be the Executive Board´s main concern during a major disruption.

7.8 CAPITAL REQUIREMENT

The Bank uses the Basic Indicator Approach of the Capital Requirements Directive (CRD) to calculate the capital requirements for Pillar 1 operational risks, in accordance with Rules on the Capital Requirement and Risk Weighted Assets of Financial Under takings no. 215/2007.

Under the Basic Indicator Approach the capital requirement for operational risk is equal to 15% of the relevant indicator. The relevant indicator is the average over three years of the sum of net interest income and net non-interest income.

The Bank uses operational risk scenario analysis in the ICAAP process to assess the need (if any) for Pillar 2 capital in addition to the Pillar 1 regulatory minimum.

7.9 REPUTATIONAL RISK

Reputational risk is the risk to earnings or capital arising from adverse perceptions of the Bank by customers, counterparties, shareholders, investors, or regulators.

Unfavourable perceptions can affect the Bank's ability to maintain existing business relationships or establish new relationships, and a serious harm to the Bank's reputation may limit the Bank's access to funding.

Following the collapse of the Icelandic banking sector in 2008 the public perception of financial institutions in Iceland was extremely unfavourable. However recent measurements suggest that a public sentiment to financial institutions is improving.

To address reputational risk, internal procedures have been set up to minimise reputational risk. All larger projects in the Bank that are identified as posing reputational risk must have a special communication plan. The Executive Board has also approved a Crisis Communication Policy where responses to reputational crises are outlined.

Changes in the Bank's reputation according to specific measures are portrayed in management reports on operational risk.

7.10 LEGAL RISK

Legal risk is the risk to earnings or capital arising from uncertainty in the applicability or interpretation of contracts, law or regulation, for example when legal action against the Bank is concluded with unexpected results or when contracts are not legally enforceable or rendered illegal by a court's ruling. Legal risk is defined as part of operational risk and managed as such. There are various legal issues that the Bank faces that could significantly impact the Bank's financial and reputational standing. The main legal issues are described further in the Annual Report 2013, note 58. The Bank is actively reviewing contract documentation in order to mitigate possible further litigation cases of significance to the Bank. Should a significant financial implication become likely from legal proceedings, the Bank will address such issues immediately and report to the Board of Directors and if relevant through the financial statements.

The Bank has implemented a Competition Policy approved by the Executive Board of Íslandsbanki. The main objective of the policy is to ensure that the Bank operates in every respect in accordance with the competition laws and rules. The Bank´s legal division is responsible for controlling the Bank´s competitive issues. The Icelandic Competition Authority has initiated an investigation concerning alleged violations of the competition law by the Bank. Main competition issues are described further in the Annual Report 2013, note 58.

7.11 IT RISK

IT risk is defined as the risk of loss to earnings or capital due to a malfunction or unintended action of the Bank´s IT systems. IT risk events can involve loss

of confidentiality through the unintended disclosure of data, loss of integrity through accidental corruption of data and loss of availability or data due to a system malfunction. The Bank relies heavily on its IT systems in the processing of financial transactions and serious malfunctions in the IT systems may result in disruptions in the processing of financial transactions, causing both financial and reputational damage to the Bank.

The Bank gives information security high priority. Appropriate preventive and monitoring measures are taken in the IT operations, and disruptions are handled according to business continuity plans which are updated regularly. The Bank´s security managers perform regular risk assessments on the Bank´s IT-systems and certain measures of IT risk are among the KRIs presented to the Executive Board.

7.12 INSURANCE

Íslandsbanki takes out insurance against operational risk loss events when it is deemed to be a cost effective mitigation of operational risk.

The insurance coverage limits financial loss caused by serious unexpected events or legal liabilities that occur in spite of other operational risk management procedures. Íslandsbanki´s insurance policies include: Bankers Comprehensive Crime policy, Professional Indemnity policy and Directors and Officers Liability Insurance.

7.13 OUTSOURCING

The Bank has outsourced some of its operations to various service providers. The Executive Board has approved an Outsourcing Policy with which all outsourcing contracts must comply. The Outsourcing Policy reflects the provisions of FME Guidelines no. 1/2012 on the IT-Operations of Supervised Entities.

REGULATORY CHANGES

Amendments to Act No 87/1992 on Foreign Exchange

The Icelandic Parliament passed a bill amending the Foreign Exchange Act as relates to the capital controls in place on 26 March 2013. With the amendment, allowance for living expenses (repatriation) is raised, the timeframe for re-investment has been extended, options for currency exchange in relation to business operations have been added and allowance for foreign lending/borrowing is extended. Monitoring of payments of interest, indexation, dividends and contractual instalments has been fortified and the CBI's permission to request information in relation to the monitoring is widened and extended as in relation to the CBI's investigations of the same. The frame for fines has been extended and currently the maximum fine for an individual is ISK 65 million and for a legal entity ISK 250 million.

Amendment to Act No 163/2007 on Statistics Iceland and Official Statistics

The Icelandic Parliament passed an amendment to the Act on Statistics Iceland and Official Statistics on 17 September 2013. Authorizing Statistics Iceland to collect information from financial undertakings and other companies and public bodies, engaged in the provision of credit services (lending), regarding loans granted to individuals and undertakings. This authorization is restricted to fundamental information on each loan, e.g. the identity of borrowers, the remaining principal and the credit terms.

FME rules No 670/2013 regarding Sound Business Practices of Financial Undertakings

Article 19 of Act No 161/2002 stipulates that financial undertakings shall operate in accordance with proper and sound business practices and customs in the financial market. In accordance with the Act, FME has issued rules as to what are considered proper and sound business practices.

8 REMUNERATION

Íslandsbanki's Remuneration Policy is based on principles of good corporate governance and is intended to support the Bank's policy of providing exceptional services while laying the foundation for acceptable return on equity, taking into consideration the long-term interests of the company, its shareholders, customers and employees.

The Bank's remuneration practices aim at supporting a sound risk culture that does not encourage excessive risk taking but at the same time attract, develop and retain highly motivated employees with the right competence and skills. The Bank's policy is to offer its employees competitive compensation that is aligned with their responsibilities and contribution to the Bank's performance and appropriate to the Bank's size and environment in which it operates.

8.1 REGULATORY FRAMEWORK

The Icelandic Financial Supervisory Authority (FME) has published rules on remuneration policy for financial undertakings[1] in adherence to amendments of the Act on Financial Undertakings[2]. The rules reflect a conservative framework for remuneration schemes within the financial sector. According to the rules a bank intending to pay variable remuneration to one or more employees is required to have in place a remuneration policy approved by the board of directors. The remuneration policy shall be reviewed at least annually and the bank taking shall account for the remuneration policy to the FME. According to the rules the remuneration policy shall fulfil the following requirements:

- Not encourage unreasonable risk taking.
- Not contravene the long-term interests of the bank and the stability of the financial system.
- Conform to viewpoints related to the protection of the bank´s customers, its creditors and shareholders.
- Conform in other respects to proper and sound business practices.

The rules state that the aggregate of variable remuneration including deferred payments shall not amount to more than 25% of the annual salary of the person in question, exclusive of variable remuneration. Payment of at least 40% of the variable remuneration shall be deferred for a minimum of three years. If the total sum of an employee's variable remuneration, on yearly basis, is less than 10% of his fixed salary without variable remuneration, the bank can pay out the variable part without delay. Risk management, compliance and internal audit shall review and analyse whether variable remuneration complies with the bank's remuneration policy and the FME rules. Variable remuneration cannot be paid to employees in risk management, internal audit or compliance.

In July 2011 the Basel Committee issued additional Pillar 3 requirements on remuneration. The requirements are intended to allow market participants to assess the quality of banks' compensation practices. In addition it will contribute to promote a greater convergence and consistency of disclosure on remuneration.

[1]Rules on remuneration policy for financial undertakings (700/2011): http://en.fme.is/media/frettir/Rules-on-remuneration-policy-for-financial-undertakings.pdf.
[2]Changes (75/2010) to the Act on Financial Undertakings (161/2002).

8.2 REMUNERATION GOVERNANCE

Íslandsbanki's Remuneration Policy is approved by the Annual Shareholder's Meeting. The Remuneration Policy is in compliance with Icelandic law and regulation described in section 8.1 and is published on the official website of the Bank[3].

The Board's Corporate Governance, Compensation and Human Resource Committee[4] provides general guidance on remuneration within the Bank. The Committee also provides guidance on other terms of employment, appointment or dismissal of the CEO, and stock option plans for employees. The Committee held 8 meetings in the year 2013.

The CEO and Head of Human Resources submit proposals to the Committee regarding variable remuneration at the Bank. Such proposals are subject to a review from Risk Management, Compliance and Internal Audit.

8.3 CURRENT VARIABLE REMUNERATION SYSTEM

In 2012 a variable remuneration system was introduced at Íslandsbanki and the system was further developed during 2013. In 2013, 107 employees were a part of the variable remuneration system. The system is a budgeted performance plan (BPP) where a variable performance payment can materialise if specific budgeted numbers and key performance indicators (KPI's) are met. The system metrics are based on the operational performance of the relevant business unit, the performance of the relevant employee and the overall profit of the Bank. Example of employee performance metrics are: leadership skills, customer satisfaction, employee engagement, cost control initiatives and corporate responsibility and ethics. The system is designed with a view to the Bank's long-term interests. The model for calculating the variable payment is risk adjusted and discourages excessive risk taking.

8.3.1 Material risk takers

The definition of material risk takers within the Bank focuses on employees whose professional activities can have a material impact on the Bank's risk profile through approving financial instruments, investing group funds, granting major credit or monitoring compliance to risk limits. Currently, all such major decisions require approval

[3]See http://www.islandsbanki.is/um-islandsbanka/skipulag/stjornarhaettir/stjornskipulag/adalfundir/.
[4]See the Annual Report 2013 for more information about the governance structure.

Total remuneration earned in the financial year 2013 broken down by fixed and performance based remuneration	Board of Directors	Executive Board	Other material risk takers
Total annual remuneration	48	287	216
Number of beneficiaries	10	8	10
Total fixed remuneration	48	234	201
Total variable remuneration	-	53	15
Cash	-	53	15
Shares	-	-	-
Share-linked instruments	-	-	-
Other	-	-	-
Variable remuneration % of fixed	-	22.9%	7.3%
Outstanding deferred remuneration for the financial year 2013	-	53	15
Vested	-	-	-
Unvested	-	53	15
Total variable remuneration earned in 2012	-	45	8
Paid out in 2013	-	25	5
Reduced through performance adjustments	-	3	-
Deferred	-	17	3
Sign-on and severance pay granted during the financial year 2013			
Total amount	-	-	-
Number of beneficiaries	-	-	-
Highest individual award	-	-	-

Exhibit 8.1. Total remuneration for the Board of Directors, Executive Board and other material risk takers broken down by fixed and performance-based remuneration (ISK m).

in one of the Bank's four management committees described in Exhibit 2.2. The Bank has designated a total of 18 individuals as material risk takers based on their membership in the relevant committees; thereof 12 are part of the variable pay system.

8.4 REMUNERATION IN 2013

Exhibit 8.1 provides total remuneration for the Board of Directors, the Executive Board, and other material risk takers in the financial year 2013. The amounts are broken down into fixed and performance-based remuneration where fixed remuneration figures include pension contributions and other salary related benefits that are not tied to the variable remuneration scheme. The number of beneficiaries represents the number of material risk takers that received remuneration from the Bank in any form in 2013.

Performance based remuneration is at the moment only in the form of cash and the Bank has no share-based remuneration to employees.

Deferred remuneration is split into vested and unvested amounts where the vested amount refers to guaranteed payments earned in 2013 and due to be paid in 2014 or later. The unvested amount is the additional amount that could become vested for the financial year 2013. The unvested amount could at year-end 2014 have been paid, vested and deferred or reduced through performance evaluation.

None of the variable remuneration payments in 2013 were earned under a variable remuneration scheme in 2011 or earlier since the scheme was introduced in 2012.

No sign-on or severance pay was granted to the employees in scope during the financial year 2013.

The salaries and other benefits of the Bank's management and Board of Directors are disclosed in the Annual Report, according to IFRS standards[5].

[5]Note 22 in the Consolidated Financial Statements 2013.

DEFINITIONS

Basel II International recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision.

Basel III A pending set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector.

Basis point value (BPV) The BPV measures the effect of a 0.01 percentage point (1 basis point) parallel upward shift in the yield curve on the market value of the underlying position. Thus a BPV of ISK 1 million means that a 0.01 percentage point upward shift in the yield curve would result in a reduction of approximately ISK 1 million in the market value of the underlying asset.

Business risk The risk that operating income decreases because of lower revenues or increases in costs not caused by one of the other risk types.

Capital Requirements Directive (CRD) The CRD rules are based on the Basel II guidelines and came into force on 1 January 2007. The supervisory framework in the EU is designed to ensure the financial soundness of credit institutions and reflects the Basel II rules on capital measurement and capital standards. The European Commission has proposed a series of amendments which they have numbered for ease of reference (CRD I – IV).

Carrying amount Book value of loans.

Claim value The remaining value of obligors debt.

Collateral Board The Risk Committee has appointed a Collateral Board that reviews and proposes guidelines for the valuation of collateral and pledged assets to ensure that the valuation of collateral is co-ordinated throughout the Bank.

Concentration risk The significantly increased risk of any type that is driven by common underlying factors, e.g. sector, economy, geographical location, type of financial instrument or due to connections or relations among counterparties. This includes large individual exposures or liabilities to parties under common control and significant exposures to groups of counterparties whose likelihood of default is driven by common underlying factors.

COREP Common Reporting is the term used to describe harmonised European Capital Requirements Directive reporting.

Country risk The risk of losses that may occur due to economic difficulties or political unrest in countries to which the Bank has exposures.

Credit risk Current or prospective risk to earnings and capital arising from an obligor's potential failure to meet the terms of any contract with the Bank or otherwise fail to perform as agreed.

Credit risk exposure Credit risk exposure comprises both on-balance sheet and off-balance sheet items. Exposure to credit risk for on-balance sheet assets is the carrying amount as reported in the Consolidated Financial Statements. The exposure for off-balance sheet items is the amount that the Bank might have to pay out against financial guarantees and loan commitments, less provisions the Bank has made because of these items.

Credit spread risk The risk that earnings or capital may be negatively affected by the adverse movements in bond risk premium for an issuer.

Currency risk The risk that earnings or capital may be negatively affected from the fluctuations of foreign exchange rates, due to transactions in foreign currencies or holding assets or liabilities in foreign currencies.

Deep discount A loan is defined as having been acquired at a deep discount when the fair value purchase price is considerably lower than the claim value according to the terms of the loan. A large part of the Bank's assets was acquired at a deep discount. The deep discount was intended to meet both incurred credit losses at the acquisition date and expected future losses.

European Economic Area (EEA) Agreement On 1 January 1994 the EEA signed agreement that allows the EFTA states to participate in the Internal Market. The EEA agreement is concerned principally with the four fundamental pillars of the Internal Market, i.e. freedom of movement of goods, persons, services and capital.

Exposure at default Expected credit exposure of facility at time of default.

Financial Collateral Simple Method Method to determine the effects of financial collateral on solvency requirements under the Basel II Standardised approach. Institutions that apply the Standardised approach may choose between the Financial Collateral Simple Method and the Financial Collateral Comprehensive Method.

Forbearance An agreement modifying the terms of a loan agreement to accommodate temporary financial difficulties on the side of the borrower.

High quality liquid assets Assets that can be easily and immediately converted into cash at little or no loss of value and include Central Bank certificates of deposits, government bonds, corporate debt securities and quality equities.

Indirect exposure An exposure to counterparties that is not direct but becomes direct at the event of default of other counterparties.

Inflation risk The risk that earnings or capital may be negatively affected from the adverse movements in inflation level.

Interest rate risk Current or prospective risk to earnings or capital arising from adverse movements in interest rates. Main sources of interest rate risk are as follows:

- *Re-pricing risk*: Arising from differences between the timing of rate changes and the timing of cash flows.
- *Yield curve risk*: Arising from changing rate relationships across the spectrum of maturities (change in slope and shape of the yield curve).
- *Basis risk*: Arising from changing rate relationships among yield curves that affect the institution's activities.
- *Optionality risk*: Arising from interest rate related options embedded in the institution's products.

Internal Capital Adequacy Assessment Process (ICAAP) The ICAAP includes an evaluation of the capital needed under Pillar 2. The Bank identifies and measures its risks and ensures that it has sufficient capital in relation to its risk appetite statement. The assessment is based on minimum capital under Pillar 1, capital add-on for other risk factors under Pillar 2 and reduction in available capital due to stress testing results. Once a year a full ICAAP report is submitted to the FME.

IT risk The risk of loss to earnings or capital due to a malfunction or unintended action of the Bank´s IT systems.

Large exposure An exposure to a group of connected clients that is 10% or more of the Bank's regulatory capital. The exposure is evaluated net of credit risk mitigating effects eligible according to FME rules no. 625/2013.

Latent impairment Reflects losses that have been incurred but not identified in the reporting period. These losses are estimated on a portfolio level and cannot be allocated to individual loans.

Legal risk The risk to earnings or capital arising from uncertainty in the applicability or interpretation of contracts, law or regulation, for example when legal action against the Bank is concluded with unexpected results, when contracts are not legally enforceable or rendered illegal by a court's ruling.

Liquidity coverage ratio The proportion of high quality liquid assets (HQLA) to net cash outflow over the next 30 calendar day period.

Liquidity risk The risk of not being able to fund its financial obligations or planned growth, or only being able to do so substantially above the prevailing market cost of funds.

Loan Portfolio Analysis (LPA) metric Total carrying amount of loans to customers that are in need of further restructuring (as defined by the FME) divided by the total carrying amount of loans to customers.

Loss given default Expected loss on a credit facility in the case of default as fraction of the exposure at default.

Loss rate The probability that the Bank will need to claim collateral or experience a loss given that the obligor defaulted.

Loss severity The percentage of exposure at default that is lost in the case of loss or repossession of collateral.

Market risk Current or prospective risk to earnings and capital arising from adverse movements in the level or volatility of prices of market instruments, such as those that arise from changes in interest rates, equity prices and foreign exchange rates.

Net stable funding ratio The proportion of long-term assets to long-term stable funding with a time horizon of one year.

Obligor: A customer that has a loan or other credit facility with the Bank.

Operational risk The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

Pillar 1 This contains generic rules for calculating credit, market and operational risks to determine a bank's risk-weighted assets (RWA). It also stipulates the minimum capital requirement.

Pillar 2 This sets forth the framework for the supervisory review and evaluation process (SREP) and the framework for banks' internal capital adequacy assessment process (ICAAP). Pillar 2 concerns banks' risks in a wider sense, including risks not defined under Pillar 1 (e.g. business, pension and concentration risks as well as the banks' situation and expectations in general). It also covers stress tests.

Pillar 3 Market discipline sets disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment process, and hence the capital adequacy of the institution.

Political risk The risk that a government policy, significantly different from current law or regulation, will be enforced, resulting in new legislation or new regulation that adversely affects the Bank's business or the value of the Bank's assets.

Price risk The risk that earnings or capital may be negatively affected from the changes in the price level or volatility of debt instruments, equity instruments or commodity products.

Probability of default Probability that a counterparty is going to default within the time horizon of 12 months. Default is defined as a counterparty being more than 90 days overdue on a material credit obligation, or existence of a specific provision against counterparty's credit obligation.

Quota Board The Risk Committee has appointed a Quota Board that reviews and proposes guidelines for the valuation of for credit mitigants in the seafood sector, including fishing quota, to ensure that the valuation of collateral is co-ordinated throughout the Bank.

Recalculation Correction of the claim value of loans that were illegally linked to the value of foreign currencies.

Receipt Ruling Ruling passed by the Supreme Court in Iceland on 15 February 2012 clarifying the method to be used for recalculation of loans that were illegally linked to the value of foreign currencies.

Remission The term remission is used for recalculations and principal reductions that are not write-offs in the usual sense but rather correction of claims due to their legitimacy or because of general offers made by the Bank.

Reputational risk The risk to earnings or capital arising from adverse perceptions of the Bank by customers, counterparties, shareholders, investors, or regulators.

Risk and Control Self Assessment A structured approach to identify and assess all potential risks in order to plan appropriate actions to mitigate them, The ultimate purpose of this framework consists in improving the way a bank operates through regular review of policies, processes and systems. The RCSA process is undertaken at least once a year by all units within the Bank.

Risk class Each obligor is categorized in one of ten risk classes. The risk classes 1–9 are for performing obligors and indicate the 12 month probability of default. Risk class 10 is for obligors that are in default.

Risk-weighted assets Assets adjusted for their associated risks using weightings established in accordance with the Basel Capital Accord. Certain assets are not weighted but deducted from capital.

Settlement risk The risk that a party will fail to deliver on the terms of a contract at the time of settlement. Settlement loss can occur because of default at settlement and because of any timing differences in settlement between two parties. The amount at risk or the potential loss is the principal of the transaction.

Specific impairment Loans are classified as impaired or with specific impairment if contractual cash payments are not expected to be fully honoured and the financial restructuring of the obligor is expected to lead to a loss for the Bank.

Strategic risk The current or prospective risk to earnings and capital arising from changes in the business environment and from adverse business decisions, improper implementation of decisions or lack of responsiveness to changes in the business environment.

Subordinated loans Debt that ranks after other debts should a company fall into receivership or go bankrupt.

Supervisory Review and Evaluation Process (SREP) The heart of the second pillar of the Basel II rules. Through the SREP the regulator assesses the risk management framework of the Bank and whether the Bank's capitalisation is adequate to its risk profile and business strategy. As part of the SREP, the regulator reviews the Bank's ICAAP report but the review can also include on- or off-site inspections of specific parts of the operations.

Tier 1 capital Is composed of Common tier 1 capital and tier 1 hybrid capital:

- *Common tier 1 capital*: Consists of paid-in share capital, share premium account and other premium accounts, reserve accounts and retained earnings, net of the book value of own shares or guarantee capital certificates, goodwill, deferred tax credit and other intangible assets.
- *Tier 1 hybrid capital*: Contingent convertible capital and non-innovative hybrid capital subject to conditions on maturity, repayment, interest and conversion to equity as defined in rules and regulations.

Tier 2 capital Tier 2 allows for inclusion of subordinated loans which state clearly that the repayment period of the loan is not less than five years with further restrictions defined in rules and regulations.

Tier 3 capital Tier 3 capital includes short-term subordinated loans which clearly state that the repayment period is not less than two years. Further restrictions to repayments of Tier 3 subordinated debt is described in rules and regulations.

Total capital base Tier 1 capital in addition to Tier 2 and Tier 3 capital.

Total capital ratio Total capital base divided by risk-weighted assets. (Also referred to as solvency ratio.)

Trading liquidity risk The risk that the Bank is unable to easily liquidate or offset particular position without moving market prices due to inadequate market depth or market disruption, thus negatively affecting the earnings or capital.

Value-at-risk (VaR) A statistical method used to measure and quantify the level of financial risk within a portfolio over a specified time horizon at given confidence levels.

ABBREVIATIONS

ALCO	Asset and Liability Committee
BCBS	Basel Committee on Banking Supervision
BIS	The Bank for International Settlements
BoD	Board of Directors
BPP	Budgeted Performance Plan
BPV	Basis Point Value
CAE	Chief Audit Executive
CB	Central Bank
CCF	Credit Conversion Factor
CEO	Chief Executive Officer
CET1	Core Tier 1 Capital
CIRS	Cross Currency Interest Rate Swap
CLTV	Combined Loan to Value
COO	Chief Operating Officer
COREP	Common Reporting
CPI	Consumer Price Index
CRD	Capital Requirement Directive
CRO	Chief Risk Officer
EAD	Exposure at Default
EEA	European Economic Area
EL	Expected Loss
ESMA	European Securities and Markets Authority
EU	European Union
FME	Financial Supervisory Authority, Iceland
FX	Foreign Currency
GMTN	Global Medium Term Note
HFF	Housing Financing Fund
HQLA	High Quality Liquid Assets
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
ISDA	International Swaps and Derivatives Association
IRS	Interest Rate Swap
ISK	Icelandic Krona
KPI	Key Performance Indicators
KRI	Key Risk Indicators
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
LPA	Loan Portfolio Analysis
LTV	Loan to Value
MD	Managing Director
MV	Market Value
NPO	Non-profit organisations
NSFR	Net Stable Funding Ratio
PD	Probability of Default
RCSA	Risk and Control Self-Assessment
RWA	Risk-Weighted Assets
SME	Small and Medium-sized Enterprises
SREP	Supervisory Review and Evaluation Process
STIBOR	Stockholm Interbank Offered Rate
VaR	Value-at-Risk