Íslandsbanki

PILLAR 3 REPORT
2014

RISK AND CAPITAL MANAGEMENT — PILLAR 3 REPORT

March 2015

Pillar 3 Report

ÍSLANDSBANKI OFFERS UNIVERSAL BANKING SERVICES

Íslandsbanki is a universal bank with total assets of over ISK 900 billion and a 25–50% market share across all domestic business segments. Building on over 140 years of servicing key industries in Iceland, Íslandsbanki has developed specific expertise in the seafood, energy and offshore service vessel industries domestically and in the North Atlantic region. With over 1,000 employees and an efficient network of 18 branches, Íslandsbanki proudly ranked first among banks in the Icelandic Customer Satisfaction Index (2014), was voted the "Best Bank in Iceland" by Euromoney (2013, 2014) and by the Banker (2014) and the "Best Investment Bank in Iceland" by Euromoney (2014).

Íslandsbanki is majority-owned by Glitnir hf. which 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.

Standard & Poor's assigned Íslandsbanki a rating of BB+/B with a stable outlook in April 2014 and revised its outlook to positive from stable in October. The rating is one notch below the rating assigned to the Icelandic Sovereign.

Since its inception, Íslandsbanki has emphasised the importance of mapping out a clear strategic direction for the Bank and developing its business model. Annual Strategy Summits involving the 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. The objective of the strategy is to create and deliver long-term sustainable value for all stakeholders of the Bank. The strategy is implemented with clear goals throughout the Bank.

More information about the Bank, its activities and strategic direction can be found in the Annual Report 2014.

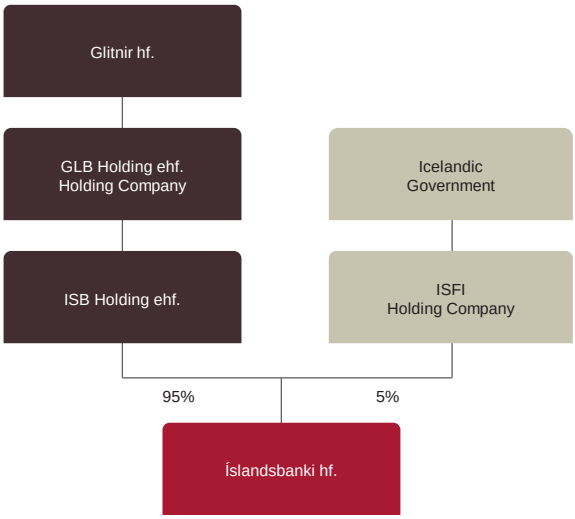

Exhibit 1. Íslandsbanki's ownership structure.

Key economic parameters	2014	2013	2012	2011
Gross Domestic Product (ISK bn)	1,993*	1,881	1,780	1,703
Economic Growth	1.9%*	3.6%	1.3%	2.4%
General government financial balance (ISK bn)	0.3*	(37.1)	(65.3)	(90.7)
Inflation	0.8%	4.2%	4.2%	5.3%
Policy rate CBI	5.25%	6.0%	6.0%	4.8%
EUR/ISK	154.3	158.5	169.8	158.8
Unemployment	5.0%	5.4%	6.0%	7.1%
Sovereign CDS Spread	150	177	182	317
Bond market turnover (ISK bn)	1,533	1,822	2,324	2,602
Equity market turnover (ISK bn)	292	251	88	60
OMX Iceland 8 GI ISK (Stock Index)	1,377	1,293	1,074	915

Exhibit 2. Key economic parameters over the past four years (EOY). Sources: Central Bank of Iceland, Statistics Iceland and NASDAQ Iceland. *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. 2015)	BBB-/Positive/A-3	BBB-/Positive/A-3
Fitch Ratings (Jan. 2015)	BBB/Positive/F3	BBB+/Positive

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

CRO REVIEW 2014

Throughout 2014, 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.

Key economic figures indicate that the economy is in good health but the upcoming wage negotiations and delays and uncertainty related to the lifting of capital controls pose a threat to the system in the short-term. In addition, a successful implementation of the revised European capital requirements directive (CRD IV) and the accompanying regulations will be a challenge for the legislative and regulatory bodies in Iceland, both due to constitutional issues and the scope of the changes that are needed on current legislation to ensure full and complete implementation into Icelandic law. These changes are costly and require extensive expert knowledge within the public bodies managing the implementation in order to contain the cost to the economy while at the same time ensuring that the regulatory environment is at par with international standards.

Capital base and capital requirement

The Bank's capital position continued to improve in 2014, the Tier 1 ratio and total capital ratio were 26.5% and 29.6% compared to 25.1% and 28.4% at the end of 2013. Risk-weighted assets (RWA) increased by ISK 35 billion over the year, mainly due to new lending. At the end of 2014, the Bank's RWA amounted to ISK 695 billion, with 84% related to credit risk, 5% to market risk and 11% to operational risk. The ratio of RWA to total assets is stable around 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 CRD IV into Icelandic legislation.

Credit risk

At the end of 2014, the Bank's total exposure due to credit risk, including both on- and off-balance sheet items, amounted to ISK 898 billion compared to ISK 817 billion at the end of 2013. Loans to customers represent the largest part of the Bank's total credit risk exposure or ISK 638 billion, compared to ISK 558 billion at the end of 2013.

Overall, the credit quality of the loan portfolio has improved as more customers have completed financial restructuring. Non-performing loans as defined by the FME have decreased from 8.3% to 5.9% and loans that are either impaired or more than 90 days past due have decreased from 7.4% to 3.5%. The Bank's cumulative write-offs and remissions in the restructuring of customers' debt in the period 2008–2014 now amount to ISK 588 billion, of which ISK 129 billion is to individuals and ISK 459 billion is to companies.

Market risk

The growth of the domestic financial markets continued in 2014 although at a slower pace than in 2013. The OMX Iceland 8 GI (gross return index) increased by 6.5%. Daily turnover increased by 18%, compared to 50% in 2013. Two new companies were listed on the Icelandic stock exchange and further listings are expected in 2015.

Development of key financial and risk figures	2014	2013	Δ
Total operating income (ISK bn)	42.4	42.6	(0.2)
Profit (ISK bn)	22.8	23.1	(0.3)
Return on equity after tax (ROE)	12.8%	14.7%	(1.9%)
Net interest margin (total assets)	3.0%	3.4%	(0.4%)
Cost to income ratio	57.7%	58.5%	(0.8%)
Total capital ratio	29.6%	28.4%	1.2%
Tier 1 ratio	26.5%	25.1%	1.4%
Total regulatory capital (ISK bn)	205.7	187.3	18.4
Loans to customers (ISK bn)	637.7	558.4	79.3
Loans to individuals (ISK bn)	262.8	255.0	7.8
Total deposits (ISK bn)	555.2	519.0	36.2
Customer deposits / Loans to customers	84.0%	88.2%	(4.2%)
Total risk weighted assets (ISK bn)	695.1	659.8	35.3
RWA / Total assets	76.3%	76.2%	0.1%
LPA metric	5.9%	8.3%	(2.4%)
Impaired loans and past due (>90 days) loans / Loans to customers	3.5%	7.4%	(3.9%)
Net currency imbalance (ISK bn)	26.6	23.7	2.9
Inflation imbalance (ISK bn)	57.5	6.4	51.1
Banking book interest rate sensitivity (Absolute BPV, ISK bn)	0.8	0.3	0.5

Exhibit 4. Development of key financial and risk figures for Íslandsbanki. The Δ column indicates changes from year-end 2013 to year-end 2014.

The contribution of market risk to the Bank's risk-weighted assets increased from 4.4% to 4.8% in 2014. The currency imbalance increased from ISK 23.7 billion in 2013 to ISK 26.6 billion in 2014. The Bank's total equity exposure amounted to ISK 10.5 billion at year-end 2014, compared to ISK 9.2 billion 2013, with most of the increase coming from higher positions in the trading book. New loans and lower inflation-linked liabilities affected both the inflation imbalance and interest rate risk in the banking book in 2014. The inflation imbalance increased from ISK 6.4 billion at the end of 2013 to ISK 57.5 billion at the end of 2014 partly due to increased demand for CPI–linked loans in the current environment of low inflation. Interest rate risk in the banking book, measured as basis-point-value (BPV), nearly tripled over the period although it is still considered modest.

Liquidity risk

The Bank maintained a strong liquidity position throughout 2014. At the end of 2014 the Central Bank adopted the net stable funding ratio (NSFR) for assets and liabilities in foreign currencies into the Icelandic rules on liquidity ratios. The initial minimum for the NSFR in foreign currencies in Iceland is 80%, increasing by 10 percentage points every year, reaching 100% in 2017.

The Bank's LCR ratio was 117% for the parent company and 130% at a consolidated level at the end of 2014. The ratio of total deposits to loans increased from 83% to 85% in 2014.

The Bank issued ISK 8.8 billion in covered bonds in 2014 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 2014 with an outstanding amount at year-end of just under ISK 5 billion. In 2014 the Bank issued a SEK 300 million tap into its inaugural SEK 500 million Floating Rate Note and the Bank furthermore issued its first Euro-denominated bond of EUR 100 million in May 2014.

Operational risk

In 2014, a total of 334 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 classification by business line and event type.

The category "External Fraud" accounts for 38% of the number of all loss events. The category however caused only 6% of the total loss amount. The increase in the category is mainly due to enhanced surveillance, increase in credit card frauds reported and an increase in the number of phishing attacks but no losses were registered due to such attacks in 2014.

In 2014, 70% of the total operational risk loss amounts were categorised as "Clients, Products and Business Practices".

Sverrir Örn Þorvaldsson, Chief Risk Officer

1 INTRODUCTION

The objective of Íslandsbanki's Pillar 3 Report is to provide market participants and other stakeholders with information that facilitates a better understanding of the Bank's risk profile and capital adequacy, in accordance with the Basel Pillar 3 disclosure requirements. The Pillar 3 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 is also disclosed in this report.

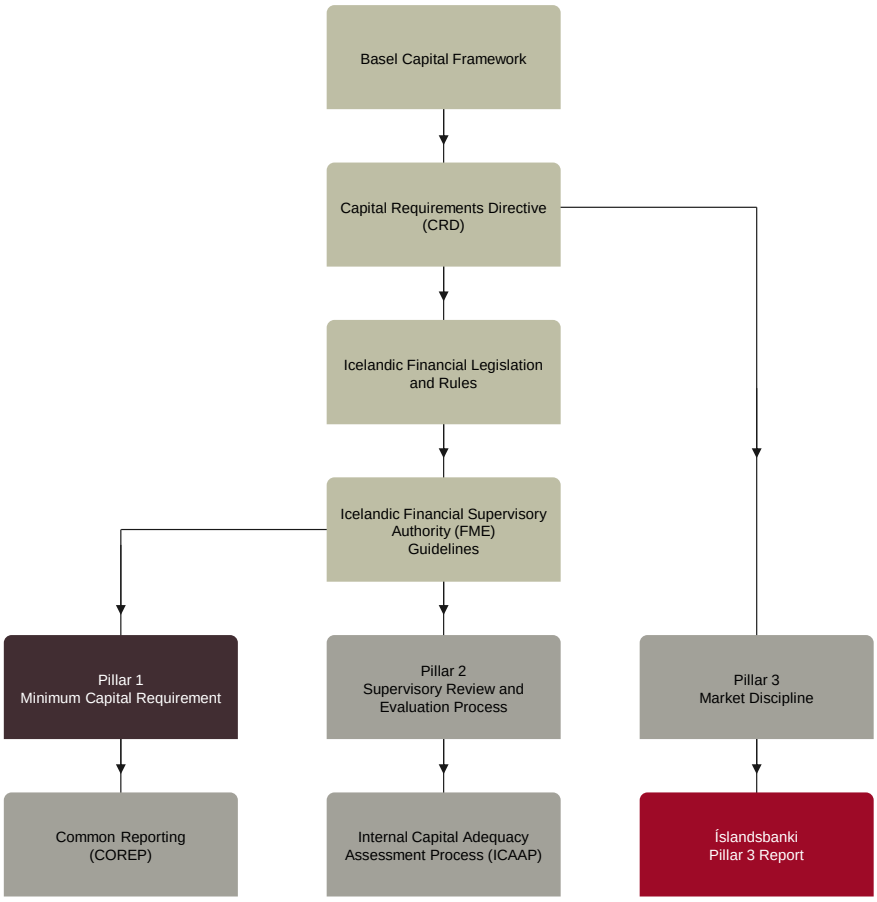

Exhibit 1.1. Regulation overview.

1.1 REGULATORY BACKGROUND

Íslandsbanki's capital management framework is based on the Basel 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 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, applied from 1 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, have been introduced in the Icelandic parliament in a

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

bill amending the law on financial undertakings.[2] The Central Bank has already adopted the CRD IV liquidity measures into the Icelandic rules on liquidity ratio. 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 Pillar 3 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 2014. Names and primary businesses of major subsidiaries at year-end 2014 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 as well as the Bank's own assessment.

The main channel for Íslandsbanki's risk and capital management disclosure is through the Pillar 3 Report, the Annual Report, the quarterly financial statements and investor presentations. All these documents are available on the Bank's website, www.islandsbanki.is. The Pillar 3 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 Pillar 3 Report has not been audited by external auditors and does not form a part of Íslandsbanki's audited financial statements. However, it has been appropriately verified internally and includes information from the audited Consolidated Financial Statement 2014.

The Pillar 3 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 2014 and information in the Pillar 3 Report 2014. For some parts, figures are only available or relevant on parent level and are clearly marked as such.

The Pillar 3 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 authors 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.

[2] Act No. 161/2002 on Financial Undertakings.

Name	Main Business	Ownership	Country
Borgun hf.	Payment processing	63.5%	Iceland
Íslandssjóðir hf.	Fund management	100%	Iceland
Miðengi ehf.	Asset management	100%	Iceland
Hringur eignarhaldsfélag ehf.	Holding company	100%	Iceland
Allianz Ísland hf.	Life Insurance broker	100%	Iceland
D1 ehf.	Real estate company	100%	Iceland
Geysir Green Investment Fund slhf.	Holding company	100%	Iceland
Fergin ehf.	Holding company	80%	Iceland
Frumherji hf.	Commerce and services	100%	Iceland

Exhibit 1.2. Íslandsbanki's major subsidiaries at year-end 2014.

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.

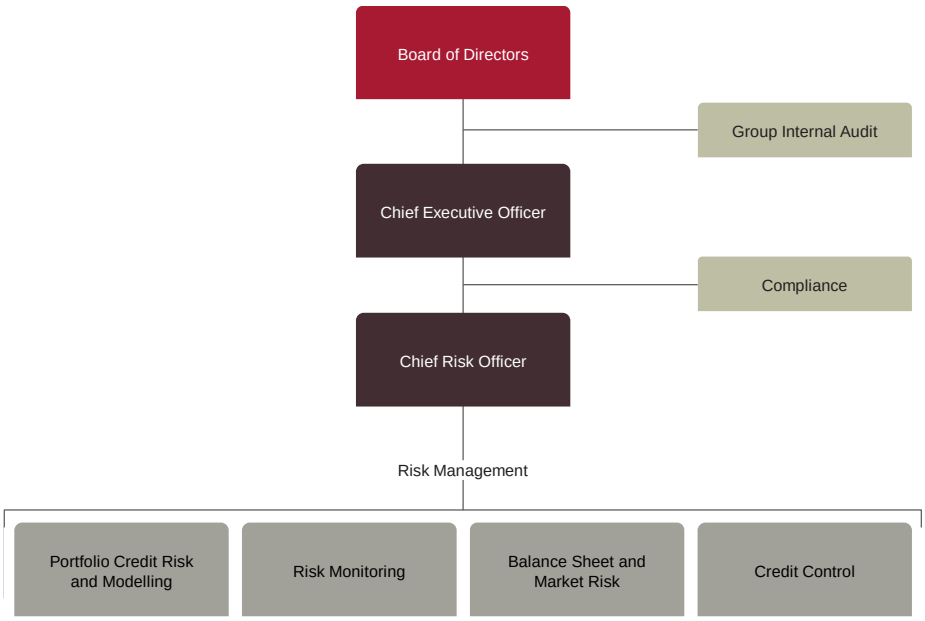

Exhibit 2.1. Risk governance and organisational structure of Risk Management.

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, 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.

The Bank's management body has a dual structure, meaning that the Board of Directors has a supervising role and the Chief Executive Officer 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.

The Chief Audit Executive (CAE) is appointed by the Board and directs Group Internal Audit by the Board's authorisation. The Chief Audit Executive is responsible for internal audit matters within the group, the Bank and its subsidiaries, including outsourced projects. Group Internal Audit provides the Bank with independent, objective assurance and consulting services designated to add value and improve the Bank's operations. It helps the Bank to evaluate and improve the effectiveness of its risk management, controls, and governance processes. Summary reports are regularly submitted to the Board Audit Committee, Board of Directors and external supervisory authorities. Furthermore, Group Internal Audit leads investigations of suspected fraudulent activities in the Bank's operations. Group Internal Audit is not responsible for internal control or its implementation.

The Compliance Officer is responsible for regular monitoring and assessment of the suitability and efficacy of the Bank's measures concerning securities transactions. Its aim is to ensure that the work of the Bank, its Board and employees is consistent at all times with the applicable internal and external regulatory framework and with sound, appropriate business practice. The Board is authorised to entrust the Compliance department with additional tasks if they are in accordance with statutory requirements. The Compliance Officer submits a report to the CEO and the Board at least twice a year.

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 and 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 Bank's operational risk management framework and the development and maintenance of the *Operational Risk Policy*. 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 Pillar 3 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 allocation.

2.1.4 CREDIT CONTROL

The Credit Control unit is responsible 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 Making Matrix*. The corporate governance structure is further described in the Annual Report 2014.

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 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,

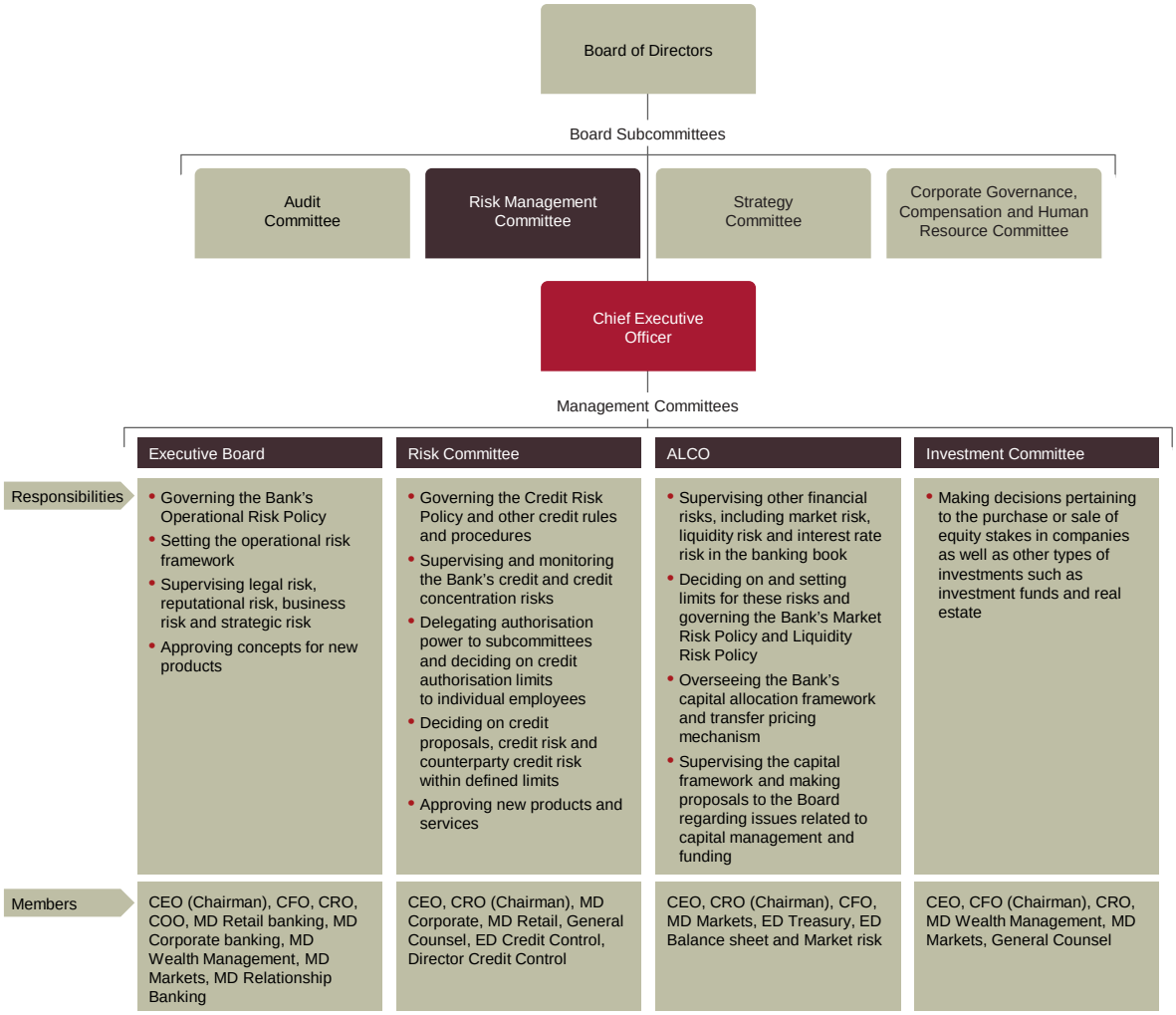

Exhibit 2.2. Risk Management committee structure.

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.

2.2.1 BOARD SUBCOMMITTEES

Board Audit Committee

The Board Audit Committee, comprising three Board members, 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, comprising three Board members, is responsible for assisting the Board of Directors in providing oversight of senior management's activities in managing risk relevant to the Bank's operations. It is also responsible for reviewing the *Risk Management and Internal Control Policy*, *Risk Appetite Statement* and other risk related policies set by the Board.

Board Strategy Committee

The Board Strategy Committee, comprising four Board members, oversees and approves key issues related to the Bank's overall strategy and formulates general policies to implement that strategy effectively. The committee sets out strategic and financial targets and priorities and monitors their progress.

Board Corporate Governance, Compensation and Human Resource Committee

The Board Corporate Governance, Compensation, and Human Resource Committee, comprising four Board members, assists the Board in overseeing the development and the regular assessment of the Bank´s approach to corporate governance issues and board effectiveness. Furthermore it is responsible for providing oversight regarding compensation and human resource issues.

2.2.2 MANAGEMENT COMMITTEES

Executive Board

The Executive Board is responsible for the operational risk framework and governs the Bank's *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 reputational risk, business risk and strategic risk. The Executive Board approves concepts for new products and its approval is a prerequisite for product development according to the Bank's formal product approval process.

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 must be referred to a more senior committee. If credit decisions exceed the limit of the Risk Committee then the Board of Directors can grant increased authorisation limits for particular cases.

The Risk Committee is also responsible for final approval of products and services according to a formal product approval process within the Bank 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 allocation framework and transfer pricing mechanism. The committee supervises the capital management framework and makes proposals to the Board regarding issues related to capital management and funding.

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.

The Decision Making Matrix

As part of the Bank's commitment to sound corporate governance, the Board adopted Íslandsbanki's *Good Governance Policy*, a decision-making matrix, in 2012. The policy was updated in 2014. The Decision Making Matrix outlines all major decisions that the Bank may wish to take under given circumstances. The matrix sets specific conditions for all major decision-making and requires that all such decisions be taken both with the input of the best qualified parties within the Bank and on the basis of the best information available at the time. This procedure was introduced in order to foster improved decision-making and ensure that decisions taken within the Bank fulfil the appropriate requirements at any given time.

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*, the *Market Risk Policy* and the *Liquidity Risk Policy*.

The Bank has also identified business risk, strategic risk, IT risk, settlement 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 management committees.

The strategic targets of the management are further defined in the Bank's business plan, 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

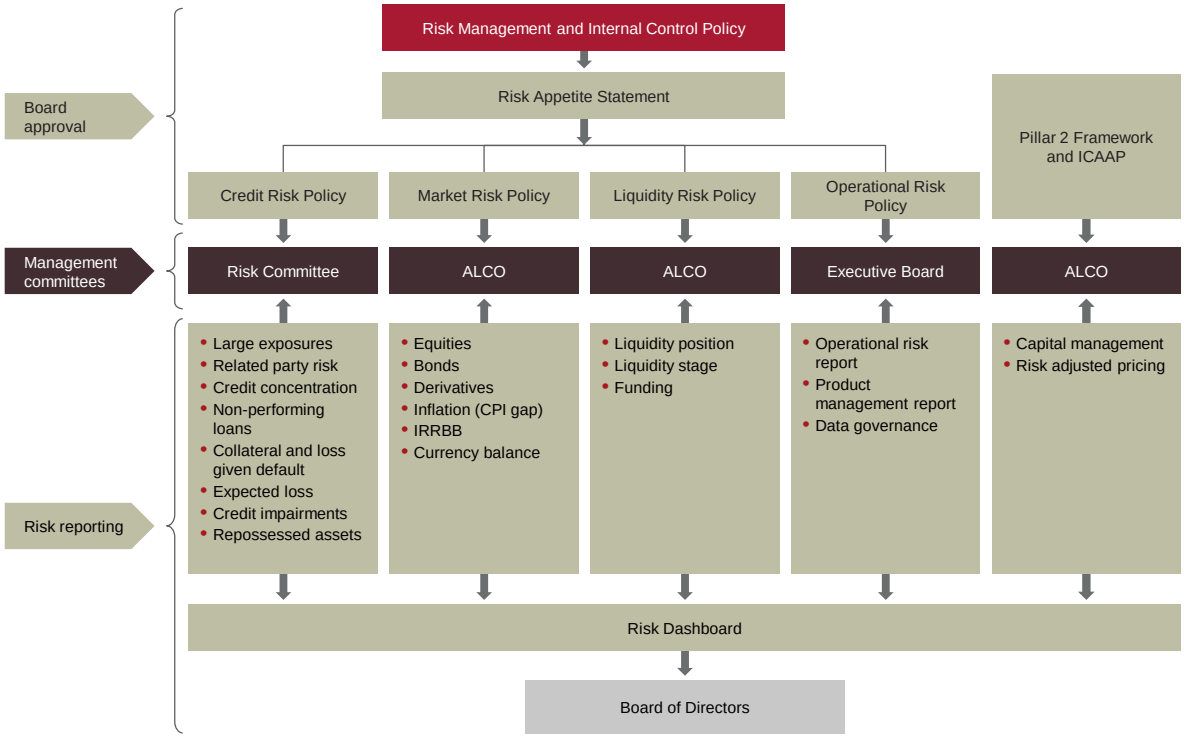

Exhibit 2.3. Risk Management organisational structure subject to Board approval and risk reporting structure.

how each of the Pillar 2 functional components is covered within the Bank's risk management and risk governance framework.

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 various 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 Pillar 3 Report, and investor presentations. All of these are available on the website: www.islandsbanki.is/ir.

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.

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 set by the Central Bank (CB) and the Financial Supervisory Authority (FME).

In addition, the Bank works and reports according to the guidelines issued by NASDAQ 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 18 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 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 can arise 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. 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.

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 set 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

The Bank's capital position continued to strengthen throughout 2014 and at the end of the year the Bank's capital ratio was 29.6%, 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 the Bank, 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 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

The Bank'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 is responsible for developing the Bank's dividend policy. Finance is responsible for reporting on the risk-adjusted performance down to individual business units.

3.2 CAPITAL POSITION AND MINIMUM CAPITAL REQUIREMENTS

At year-end 2014 the Bank's total capital base amounted to ISK 206 billion as compared to ISK 187 billion at year-end 2013. Most of the capital base, ISK 184 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, is only 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 the Bank's risk-weighted assets over the year 2014.

The largest increase in RWA during the year was due to new lending. Increase in market risk positions and a larger currency imbalance also contribute to the RWA growth. The increase in RWA is partly offset by a decrease in non-current assets held for sale and fair value shares.

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.

The current minimum capital target ratio approved by the Board of Directors is 18%. The target is supported by the Bank's ICAAP results and the views expressed by the FME through the Supervisory Review and Evaluation Process (SREP). 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. 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 PILLAR 1 MINIMUM CAPITAL REQUIREMENTS

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%.

Capital	31.12.2014	31.12.2013
Tier 1 Capital	184,347	165,585
Ordinary share capital	10,000	10,000
Share premium	55,000	55,000
Other reserves	2,535	2,471
Retained earnings	116,288	98,548
Non-controlling interests	1,664	1,299
Tax assets	(521)	(1,275)
Intangible assets	(619)	(299)
Other regulatory adjustments	-	(160)
Tier 2 capital	21,306	21,730
Qualifying subordinated liabilities	21,306	21,890
Other regulatory adjustments	-	(160)
Capital base	205,653	187,315

Exhibit 3.1. Breakdown of the capital base at year-end 2014 and 2013 (ISK m).

Íslandsbanki's capital requirements and RWA	Minimum capital requirements	RWA	Minimum capital requirements	RWA
	31.12.2014		31.12.2013	
Credit risk	46,670	583,375	44,155	551,938
Central governments or central banks	76	954	69	865
Regional governments or local authorities	231	2,884	77	968
Administrative bodies and non-commercial undertakings	93	1,162	150	1,874
Financial institutions	632	7,906	799	9,983
Corporates	25,578	319,730	20,517	256,466
Retail	11,998	149,976	11,792	147,395
Secured by real estate property	3,235	40,442	2,777	34,710
Past due items	1,125	14,066	1,617	20,211
Collective investments undertakings (CIU)	5	67	31	392
Property, equipment, non-current assets held for sale and other assets	2,904	36,305	5,191	64,886
Fair value shares, investment in associates and shares held for sale	791	9,884	1,135	14,189
Market risk	2,666	33,327	2,308	28,849
Traded debt instruments	318	3,975	269	3,366
Equity	210	2,620	139	1,739
Foreign Exchange	2,139	26,732	1,900	23,744
Operational risk	6,272	78,401	6,434	78,970
Total	55,608	695,102	52,897	659,758
Tier 1 capital		184,347		165,585
Capital base		205,653		187,315
Tier 1 capital ratio		26.5%		25.1%
Capital ratio		29.6%		28.4%

Exhibit 3.2. Minimum capital requirements, risk-weighted assets and capital ratios at year-end 2014 and 2013 (ISK m).

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

The Bank 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.

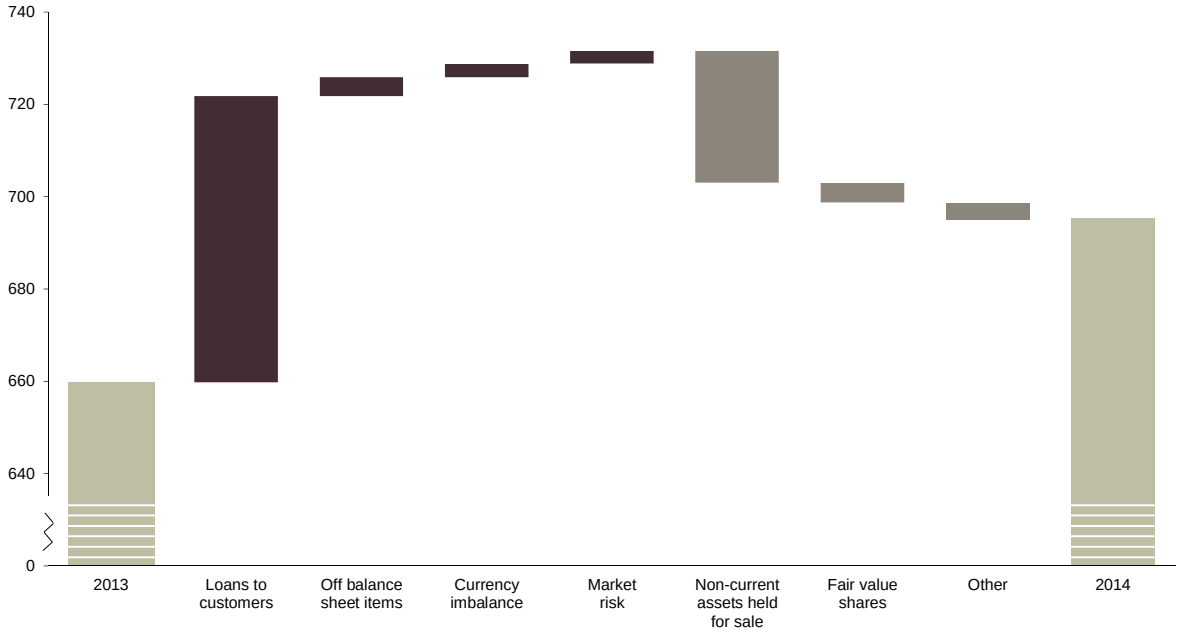

Exhibit 3.3. Changes in risk-weighted assets (ISK bn).

Market risk

The Bank 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 PILLAR 2 ADDITIONAL CAPITAL REQUIREMENTS

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.

The main factors contributing to additional capital requirements under Pillar 2 are concentration risk, interest rate risk in the banking book (IRRBB), equities in the banking book and the inflation imbalance (CPI gap).

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 the Bank and the it'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.

The Bank'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 ICAAP process and provide an important input for defining the capital target for the Bank.

As a part of the ICAAP process the business units performed a reverse stress test. A key objective of such stress testing is

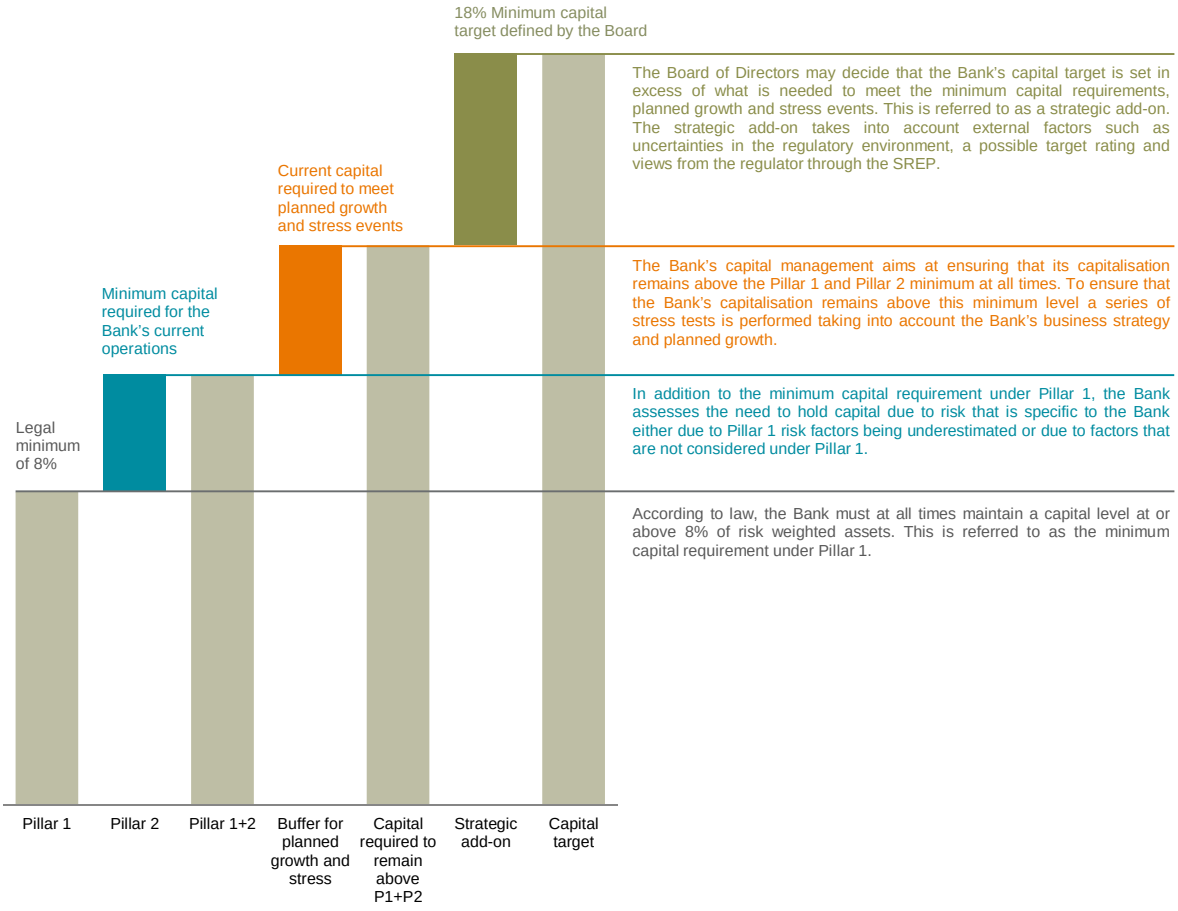

Exhibit 3.4. Building blocks of the Bank's capital target. (Not drawn to scale)

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 of identifying a significant negative outcome and then identifying the causes and consequences that could lead to such an outcome.

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 the Bank'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 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 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 banks' 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 average proportional split of allocated capital in 2014.

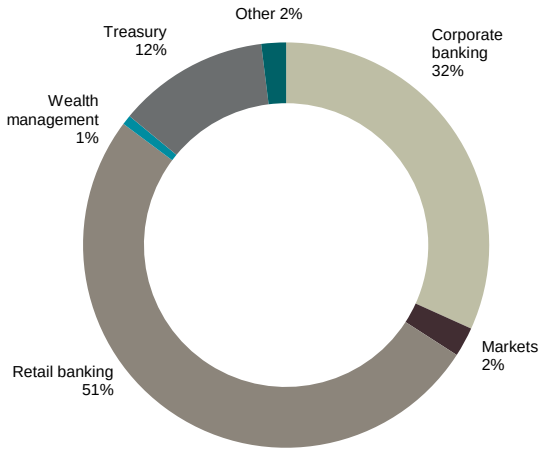

Exhibit 3.5. Proportional split of allocated capital in 2014.

3.6 NEW REQUIREMENTS IN 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. The Bank 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 SREP.

Exhibit 3.8 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-on through the SREP and how these requirements interact with the Bank's internal capital target described in Section 3.3.

CRD IV Pillar 1 add-on	
New risk weights for financial institutions	598
CVA	284
Equities in the trading book - increased risk weight	70
Cross default	276
Total CRD IV add-on	1,228

Exhibit 3.6. Effects of the changes in Pillar 1 in CRD IV (ISK m).

	2014	2013
Tier 1 capital	185	166
Total exposure	945	891
RWA	695	660
Total assets	911	866
Leverage ratio	19.5%	18.6%
RWA/Total assets	76.3%	76.2%

Exhibit 3.7. Leverage ratio and RWA over total assets (ISK bn).

3.7 NEW REQUIREMENTS THROUGH CRD IV – INCREASE IN RISK-WEIGHTED ASSETS

As a part of the CRD IV implementation, the standardised Pillar 1 capital requirement calculations will be revised. The main components are a new method to determine risk weights for financial institutions where the rating of the institution is used instead of the sovereign rating; Credit Valuation Adjustment (CVA), an additional capital charge to cover the risk of mark-to-market losses on the expected counterparty risk; increased risk weight for equities in the trading book and cross default for corporates instead of facility based defaults in the current calculations. Exhibit 3.6 shows the changes in Pillar 1 capital requirements in relation to the CRD IV implementation, based on year-end 2014 positions.

3.8 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 is 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 3.7 shows the leverage ratio at year-end 2014 and 2013 as well as the ratio between RWA and total assets.

Exhibit 3.8. Capital buffers and capital target. *Under special circumstances the requirement can be higher.

REGULATORY CHANGES

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

Other new regulatory changes in 2014 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 2014 the Bank's total exposure due to credit risk amounted to ISK 898 billion compared to ISK 817 billion at the end of 2013. This represents an increase of 10%.

Although the lending environment in Iceland has been quite competitive, the loan portfolio grew by almost 15% in 2014. New loans and refinancing exceeded instalments and other redemptions. A part of the growth comes from large loans to new and existing customers. As a result, the Bank now has one large exposure that amounts to 12% of the capital base. The Bank has emphasised to adhere to its prudent underwriting standards despite increased competition in the lending market, and pricing, as always, is risk based.

The credit quality of the loan portfolio continued to increase as more customers have received financial restructuring resulting in an improved financial standing. The LPA metric drops from 8.3% to 5.9% and loans that are either impaired or more than 90 days past due are down to 3.5% which is lower than the median for European banks.

The Bank's cumulative write-offs and remissions in the restructuring of customers' debt in the period 2008–2014 now amount to ISK 588 billion, of which ISK 129 billion is to individuals and ISK 459 billion is to companies.

This chapter includes a description of the Bank's credit process, risk assessment models and a detailed breakdown of the loan portfolio which gives an indication of concentration and credit quality. In particular, the chapter contains a discussion on things to consider when defining non-performing ratios and graphs that show the development of three such ratios. The Bank's write-offs and remissions are disclosed as well as the capital required to absorb both expected and unexpected credit loss in the future.

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 increase in risk 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 loan 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 the credit authorisation limit of the manager handling the case, the credit proposal is taken to a committee that has sufficient authorisation to approve the proposal. 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.

The Credit Control unit is responsible for the execution and implementation of the credit process in accordance with the Bank's *Credit Risk Policy* and *Credit Rules*. 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 on credit risk. Further details on the Risk Management organisation structure can be found in Chapter 2.

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 a careful evaluation of the inherent credit risk involved, the customers' financial standing, future projected cash flows and overall creditworthiness. Trust

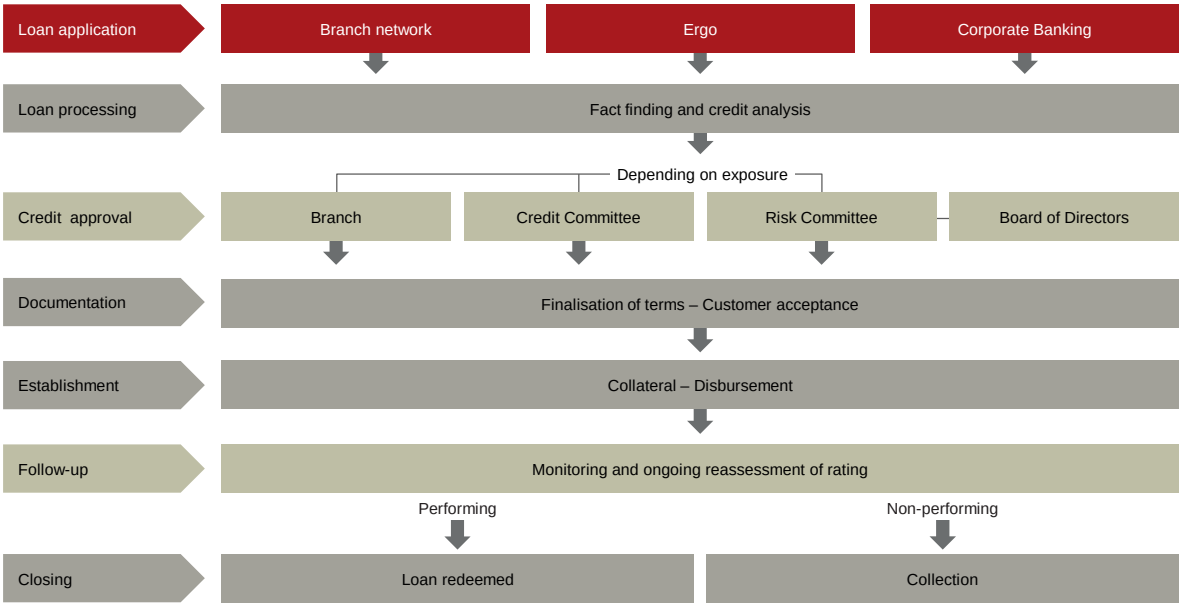

Exhibit 4.1. Schematic overview of the Bank's credit process.

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. For some products, e.g. relatively small overdrafts to individuals, no collateral is required. 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 default. The Risk Committee has appointed a Collateral Board and a Quota Board that review and propose guidelines for the valuation of collateral and pledged assets. 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, vehicles and financial collateral. The potential correlation between collateral value and the obligor's financial condition is taken into consideration.

4.2 MEASUREMENT AND MONITORING

To ensure that the Bank charges an adequate interest rate 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's interest rate margin. Due to various underlying factors which make obligors correlated, the actually experienced annual losses can fluctuate significantly around the long-term average, sometimes up to an order of magnitude. These correlations may 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's interest rate 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 regulations, for example, or an application of numerical simulation techniques. In the annual Internal Capital Adequacy Assessment Process (ICAAP), the Bank is required to test whether these simplifying assumptions are met and to revise its estimates if needed.

4.2.1 PROBABILITY OF DEFAULT (PD)

Obligors are in default according to the Bank's definition when they are more than 90 days past due on a material credit obligation or when a specific credit impairment has been recognised. Note that the definition is on the obligor level rather than the facility level.

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. Risk class 10 is for obligors in default and risk classes 1-9 for other obligors.

For individuals and small companies the Bank uses two different statistical rating models. A small company is here defined as a company with a total exposure to the Bank of less than ISK 150

Obligor type	PD assessment	Number of obligors	Exposure
		(count)	(%)
Individuals	Statistical model	90,000	29.2
Small companies	Statistical model	8,900	9.5
Large companies	Hybrid model	430	36.1
Foreign banks	External rating agencies	42	4.7
Regional governments	Expert model	23	1.6
Sovereigns	External rating agencies	11	18.8
Public sector entities	Expert model	9	0.1

Exhibit 4.2. Methods used to assess the default 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	0.2	0.1
	2	0.4	0.4	0.2
	3	0.8	0.8	0.3
	4	1.3	1.7	0.5
Medium	5	2.3	2.7	1.3
	6	4.1	5.0	2.5
Increased	7	7.1	8.5	5.3
	8	12.5	17.0	10.6
High	9	21.8	41.1	32.0

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

million. These models are behavioural scoring models and use information about a customer's payment history, amount of debt, 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.

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 and a consequence of the definition of default being on the obligor level. Generally, when loans go more than 90 days past due, they become performing again without any action 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. Further discussion on the risk profile is found in Section 4.7.

4.2.2 LOSS GIVEN DEFAULT (LGD)

The loss given default mostly depends on the collateralisation 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 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, the Bank applies the supervisory credit conversion factors (CCF) stipulated by Basel 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 2014. Loans to banks, sovereigns and regional governments are excluded from this analysis.

4.3 CREDIT CONCENTRATION

The Bank monitors credit concentration risk which arises from an unequal distribution of exposure to single borrowers, industry or geographic sectors. The portfolio concentration is both monitored with so called Herfindahl-Hirschmann Indices and relative to limits set in the *Credit Risk Policy*.

[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	27.7	23	16	4	0.3
Individuals – Leasing	1.5	28	21	6	0.7
Individuals – Other	10.5	26	71	18	2.3
Small companies	10.6	29	47	14	1.7
Large companies	49.6	35	36	13	0.4
Total	100.0				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.

4.3.1 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 eligible credit risk mitigating effects 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 2014, the Bank had one large exposure amounting to 12% of its capital base. In particular, no large exposure is above the maximum 25% single large exposure limit set by the law.

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

4.3.2 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.

4.3.3 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 geographical 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 geographical limits. The usage of these limits is reported internally on a monthly basis.

4.4 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 a 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 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.

4.5 LOAN 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 collective 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 the 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 2013 and 2014. Exhibit 4.7 shows the development of credit risk from year-end 2012. Asset risk is further explained in Section 4.11.

4.5.1 LOANS TO CUSTOMERS

Loans to customers, both individuals and companies represent the largest part of the Bank's credit risk exposure. At year-end 2014 the loan portfolio was ISK 638 billion, having grown from ISK 558 billion at year-end 2013. The growth is mainly due to new lending to new and existing customers. The new lending surpasses instalments, repayments, write-offs and other items such as changes in overdrafts and credit cards. Exhibit 4.8 shows the development of the loan portfolio through the year 2014.

Credit risk	31.12.2014	31.12.2013
Loans to customers	637.7	558.4
Balances with the Central Bank and loans to credit institutions	138.5	155.9
Bonds and debt instruments	87.3	75.2
Guarantees and undrawn commitments	30.0	24.7
Derivatives	4.1	2.4
Total	897.6	816.5

Exhibit 4.5. The main sources for credit risk at year-end 2014 and 2013 (ISK bn). Consolidated.

Asset risk	31.12.2014	31.12.2013
Repossessed assets held for sale	8.6	10.7
Assets of disposal groups classified as held for sale	13.1	36.4
Total	21.6	47.1

Exhibit 4.6. Asset risk at year-end 2014 and 2013 (carrying amount, ISK bn). Consolidated.

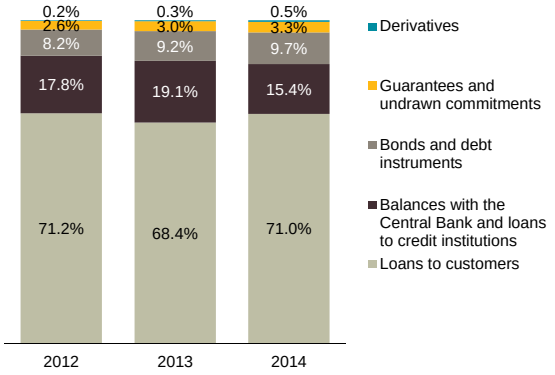

Exhibit 4.7. Credit risk at year-end 2012–2014. Consolidated.

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 4.9 shows a breakdown of loans to customers by industry sector and three currency and indexation types. Exhibit 4.10 shows the development of the currency composition of customer loans from year-end 2012 to 2014.

Loans to Individuals

Loans to individuals amounted to ISK 263 billion at the end of the year 2014 compared to ISK 255 billion the year before. New loans and refinancing amounted to ISK 40 billion in the year 2014.

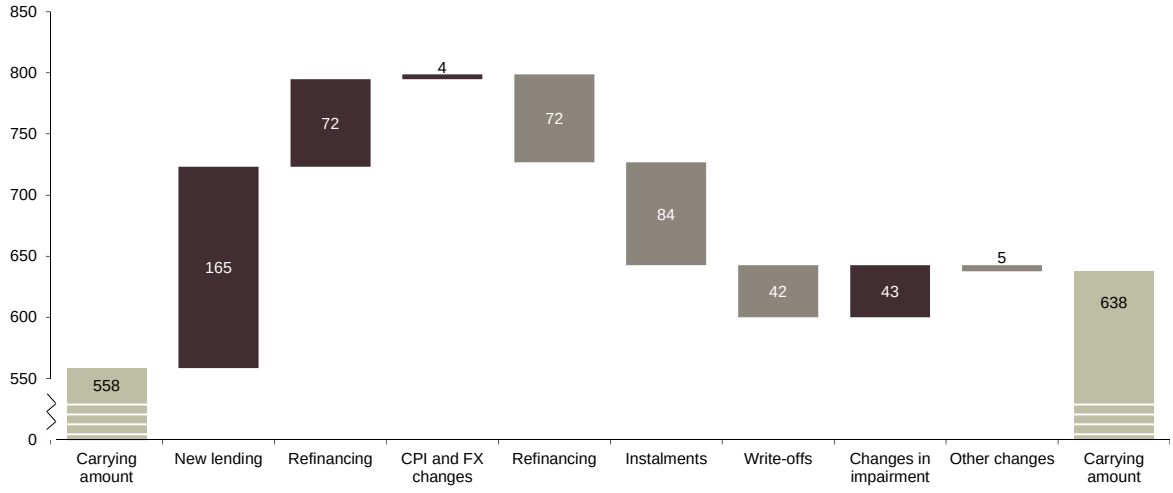

Exhibit 4.8. Loan bridge showing the main sources of changes in carrying amount from year-end 2013 to year-end 2014. Outstanding loans that are refinanced within the Bank are shown both as an increase and a decrease in the carrying amount. The effect of facilities that do not have a fixed repayment schedule such as overdrafts and credit cards is in Other changes. (ISK bn). Consolidated.

Industry sector	Non-indexed	CPI-linked	Foreign currency	Total
Individuals	123.2	139.0	0.7	262.8
Commerce & services	67.6	9.7	2.3	79.7
Construction	14.2	2.6	2.0	18.8
Energy	6.1	0.9	0.4	7.3
Financial services	0.1	-	-	0.1
Industrials and transportation	31.5	4.3	26.1	61.9
Investment companies	7.6	1.6	4.8	13.9
Public sector & NPO's	8.6	3.5	0.1	12.2
Real estate	38.9	50.6	10.0	99.5
Seafood	5.9	0.7	74.8	81.4
Total	303.6	213.0	121.1	637.7

Exhibit 4.9. Currency composition of loans to customers at year-end 2014 (carrying amount, ISK bn). Consolidated.

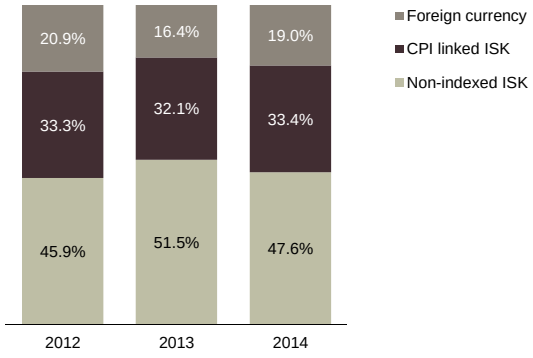

Exhibit 4.10. Currency composition of loans to customers at year-end 2012–2014 (percentage of portfolio). Consolidated.

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 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 the product type mortgages. These loans may have a 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 4.11 shows the loan product types broken down by number of days past due or specific impairment. 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 4.12 shows the development of this breakdown for loans to individuals at year-end 2012 to 2014.

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 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

Loans to individuals	Neither past due nor impaired	4-90 days past due	> 90 days past due	Impaired	Total	> 90 days past due or impaired
Mortgages	168.8	8.1	4.6	5.0	186.6	5.2%
Term loans	32.4	2.6	1.3	1.4	37.7	7.1%
Credit cards	15.2	0.4	0.0	0.0	15.6	0.3%
Overdrafts	11.9	0.5	0.2	0.1	12.8	2.6%
Leasing	9.0	0.8	0.1	0.3	10.2	4.5%
Total	237.3	12.5	6.3	6.8	262.8	5.0%

Exhibit 4.11. Breakdown of loans to individuals by product type and number of days past due at year-end 2014 (carrying amount, ISK bn). Consolidated.

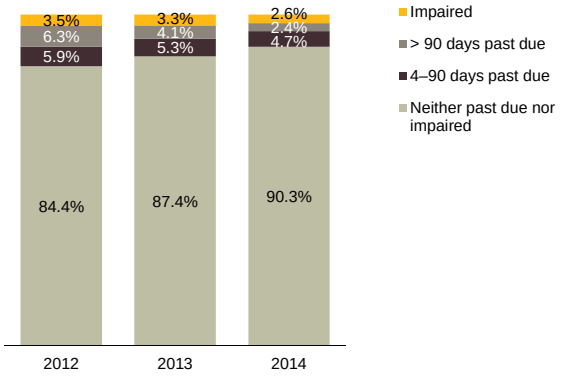

Exhibit 4.12. Loans to individuals broken down by past due status at year-end 2012–2014 (carrying amount). Consolidated.

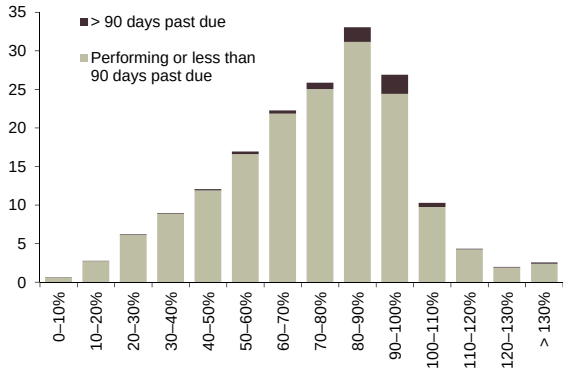

Exhibit 4.13. Breakdown of the mortgage portfolio by the LTV calculated for each property, year-end 2014 (carrying amount, ISK bn). Parent.

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 each property is assigned the maximum CLTV value of the Bank's mortgages on that property and that value is weighted with the total carrying amount of the Bank's loans on the property. The weighted average LTV calculated in that way was 74% year-end 2014 compared to 79% at year-end 2013. The change between years is mostly explained by an increase in real estate prices.

Exhibit 4.13 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 CLTV for that property. The top parts of the columns represent 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 is 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

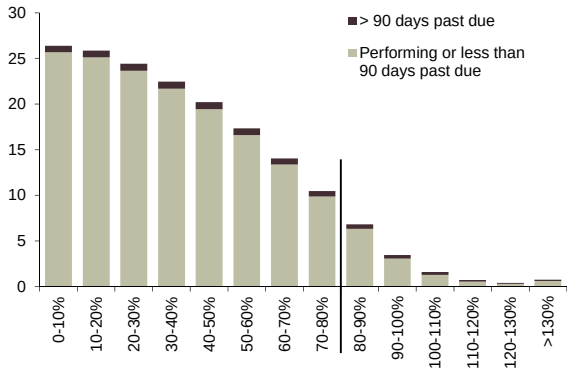

Exhibit 4.14. Breakdown of the mortgage portfolio by LTV bands, year-end 2014 (carrying amount, ISK bn). See main text for further explanation. Parent.

is assigned to each of the 50–60%, 60–70% and 70–80% LTV bands.

Exhibit 4.14 shows how the mortgage portfolio is distributed in loan-to-value bands defined in this way.

For capital requirement assessment 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 4.14 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 4.14. Such a line cannot be drawn in Exhibit 4.13.

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. Loans to companies amounted to ISK 375 billion at year-end 2014 compared to ISK 303 billion at year-end 2013. New loans and refinancing of outstanding loans amounted to ISK 198 billion in the year 2014.

Loans more than 90 days past due or impaired were 2.5% of total loans at year-end 2014 compared to 7.2% the year before. Exhibit 4.15 shows the company loan portfolio by sector and number of days past due. Exhibit 4.16 shows the development of this breakdown for the portfolio of loans to companies at year-end 2012 to 2014.

Leasing

Leasing agreements are made under the brand Ergo which is the asset based financing part of the Bank. 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 4.17 and 4.18 show the LTV distribution of the portfolio of lease agreements provided for vehicle purchases. Exhibit 4.17

[2] See more on risk weights in Exhibit 4.44.

Loans to companies by sector	Neither past due nor impaired	4-90 days past due	> 90 days past due	Impaired	Total	> 90 days past due or impaired
Commerce & services	75.6	1.9	0.3	1.8	79.7	2.7%
Construction	17.3	0.6	0.3	0.5	18.8	4.3%
Energy	7.3	-	-	-	7.3	-
Financial services	0.1	0.0	-	-	0.1	-
Industrials & transportation	60.3	0.7	0.2	0.7	61.9	1.5%
Investment companies	12.5	0.6	0.2	0.6	13.9	6.2%
Public sector & NPO's	12.2	0.1	-	-	12.2	-
Real estate	96.9	1.7	0.3	0.7	99.5	0.9%
Seafood	76.5	1.4	0.6	2.9	81.4	4.3%
Total	358.6	6.9	1.9	7.3	374.8	2.5%

Exhibit 4.15. Loans to companies by sector and by number of days past due at year-end 2014 (carrying amount, ISK bn). Consolidated.

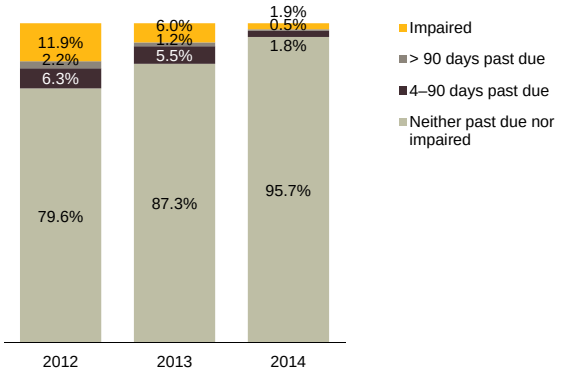

Exhibit 4.16. Loans to companies broken down by number of days past due at year-end 2012–2014 (carrying amount). Consolidated.

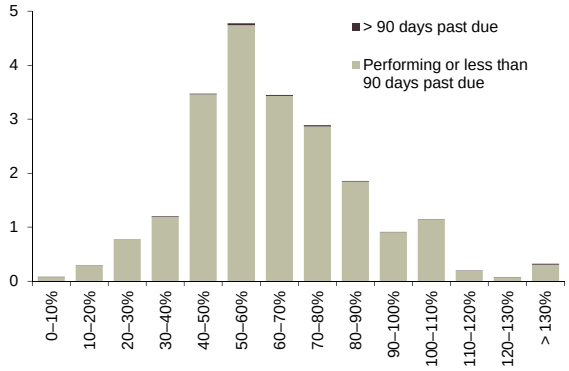

Exhibit 4.17. Breakdown of the leasing portfolio by the LTV calculated for each car at year-end 2014 (carrying amount, ISK bn). Parent.

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 weighted average LTV was 69% at year-end 2014 compared to 68% the year before.

Exhibit 4.18 on the other hand shows how each ISK lent in the portfolio is distributed in LTV bands. Note that in these Exhibits leasing contracts to both individuals and companies are considered.

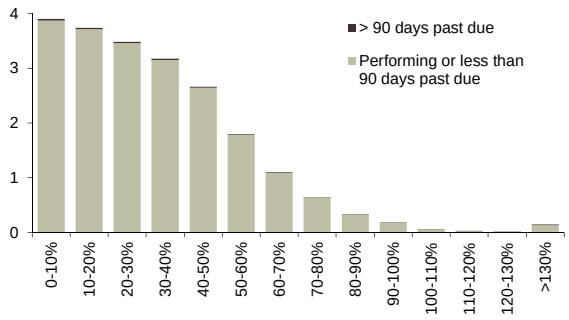

Exhibit 4.18. Breakdown of the leasing portfolio by LTV bands at year-end 2014 (carrying amount, ISK bn). Parent.

4.5.2 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 4.19 shows loans to Central Bank and credit institutions at year-end 2013 and 2014. Exhibit 4.20 shows the development from year-end 2012.

Cash and balances with the Central Bank totalled ISK 103 billion at the end of 2014. 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. Exposures to foreign financial institutions are classified further in the country risk exposure section.

Exposures are only allowed to 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.

4.5.3 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.

Loans to the Central Bank and credit institutions	31.12.2014	31.12.2013
Central Bank	103.4	111.8
Domestic credit institutions	1.6	2.1
Foreign credit institutions	33.5	42.0
thereof rated AA- and above	1.7	10.4
thereof rated A- to A+	31.5	31.4
thereof rated BBB+ and lower	0.3	0.3
thereof unrated	-	-
Total	138.5	155.9

Exhibit 4.19. Loans to Central Bank and credit institutions at year-end 2014 and 2013, with ratings based on Standard & Poor's ratings or equivalent (carrying amount, ISK bn). Consolidated.

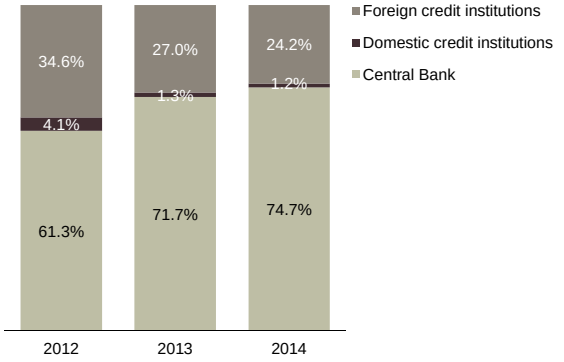

Exhibit 4.20. Loans to the Central Bank and credit institutions at year-end 2012–2014 (carrying amount). Consolidated.

Bonds and debt instruments	31.12.2014	31.12.2013
Icelandic government and government guaranteed bonds	35.6	34.3
Foreign government bills	45.5	34.6
thereof rated AAA	38.6	31.1
thereof rated AA+	-	3.5
thereof rated AA	6.9	-
Domestic corporates	1.3	1.4
Domestic credit institutions	4.9	4.5
Foreign credit institution	-	0.3
Total	87.3	75.2

Exhibit 4.21. Bonds and debt instruments at year-end 2014 and 2013, with ratings based on Standard & Poor's ratings or equivalent (carrying amount, ISK bn). Consolidated.

Exhibit 4.21 presents the Bank's position in bonds and debt instruments. Exhibit 4.22 shows bonds and debt instruments at year-end 2012 to 2014.

4.5.4 GUARANTEES AND UNDRAWN COMMITMENTS

The Bank's credit exposure deriving from guarantees and undrawn commitments totalled ISK 30 billion at year-end 2014 compared to ISK 25 billion the year before. The exposure is measured using regulatory credit conversion factors.

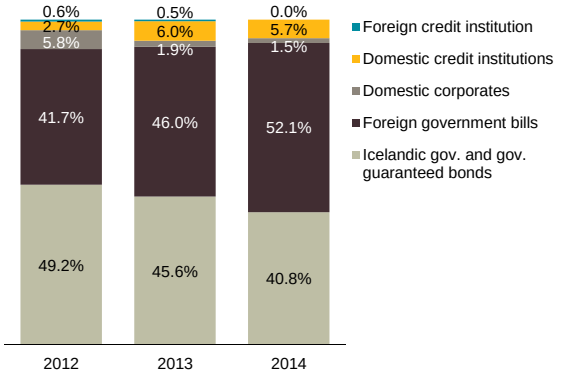

Exhibit 4.22. Bonds and debt instruments year-end 2012–2014 (carrying amount). Consolidated.

Type of issuer	Derivative trading	Lending	Total
Central governments	0.1	0.2	0.2
Financial services	5.8	0.2	6.0
Corporates	2.6	2.5	5.1
Total	8.4	2.8	11.3

Exhibit 4.23. Indirect exposure at year-end 2014 (ISK bn). Parent.

4.5.5 DERIVATIVES

The Bank uses derivatives to hedge currency, interest and inflation exposure. The Bank carries relatively low exposure due to margin trading with clients and in these cases the Bank holds collateral for possible losses. Credit risk for derivatives amounted to ISK 4.1 billion at year-end 2014 compared to ISK 2.4 billion the year before. Derivative trading can also be the source of indirect exposure discussed in the next section.

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 eligible bonds.

See also discussion on derivatives in Section 5.3.5.

4.5.6 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 2014 and Exhibit 4.24 shows the development from 2012.

4.5.7 COUNTRY RISK EXPOSURE

Exposure to countries other than Iceland amounted to ISK 103 billion at year-end 2014 compared to ISK 93 billion the year before. This exposure relates mainly to the management of the Bank's foreign liquidity reserves.

Exhibit 4.25 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. the Bank has no retail lending activities outside of Iceland.

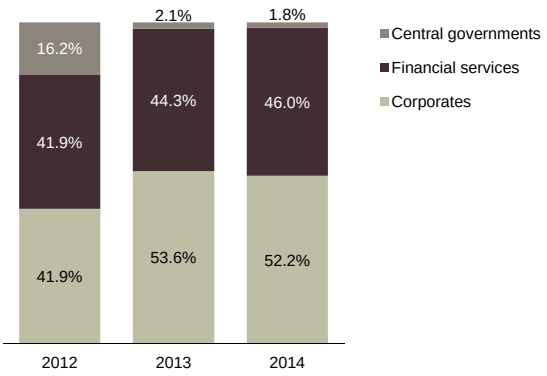

Exhibit 4.24. Indirect exposure at year-end 2012–2014. Consolidated.

4.6 LOANS COVERED BY COLLATERAL

Collateral and other credit risk mitigants vary between types of obligors and credit facilities. Loans to eligible 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 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 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 4.26 shows the financial effect of allocated collateral at year-end 2014 broken down by sector and type of collateral.

4.7 RISK PROFILE, CUSTOMER LOAN PORTFOLIO

As described in Section 4.2.1, each obligor is assigned a risk class 1–10, risk class 10 for customers in default and 1–9 for performing obligors. Not all subsidiaries of the Bank have risk classes for their customers which means that on a consolidated basis some obligors are unrated.

Exhibit 4.27 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 past due status.

Note that the same customer can have loans that are more than 90 days past due 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 4.2.1.

Exhibit 4.28 shows the portfolio of loans to individuals and Exhibit 4.29 shows the portfolio of loans to companies by risk groups and past due status. For the total loan portfolio, risk class migration was positive in the year 2014, that is, upgrades exceeded downgrades. This can be seen in Exhibit 4.30.

Country	Central government	Financial institutions	Individuals	Other obligor types	Total country exposure
Germany	15.4	9.3	0.2	0.0	25.0
Norway	1.7	7.4	2.6	6.2	17.9
USA	8.2	1.7	0.6	0.0	10.5
UK	-	7.7	0.6	1.2	9.5
Netherlands	6.9	-	0.2	-	7.1
France	6.9	-	0.0	0.0	7.0
Canada	1.1	0.2	0.1	5.3	6.7
Sweden	4.1	1.1	0.8	0.0	6.0
Denmark	1.0	1.9	1.2	0.0	4.2
Switzerland	-	3.9	0.2	0.0	4.1
Other countries	-	1.6	2.1	1.3	5.0
Total	45.5	34.8	8.6	14.1	103.0

Exhibit 4.25. Credit exposure by country and obligor type at year-end 2014 (carrying amount, ISK bn). Parent.

Collateral	Real estate	Fishing vessels	Cash & securities	Vehicles & equipment	Other collateral	Credit exposure	Unsecured Q4 2014	Unsecured Q4 2013
Individuals	213,550	41	469	9,901	12	262,848	15%	17%
Commerce & services	40,484	290	472	14,525	8,838	79,658	19%	38%
Construction	13,217	269	59	2,473	1,592	18,751	6%	22%
Energy	1,260	-	411	1	152	7,315	75%	5%
Financial services	39	-	32	1	-	121	41%	88%
Industrials & transportation	16,487	-	148	5,760	7,914	61,878	51%	40%
Investment companies	4,973	-	3,434	248	2,642	13,910	19%	32%
Public sector & NPO's	1,510	-	11	179	-	12,215	86%	76%
Real estate	94,859	0	650	143	564	99,540	3%	28%
Seafood	4,760	73,432	305	242	2,460	81,412	0%	2%
Total	391,139	74,032	5,991	33,472	24,174	637,650	17%	22%

Exhibit 4.26. Financial effect of allocated collateral at year-end 2014 (ISK m). Consolidated.

Risk group	Neither past due nor impaired	4-90 days past due	>90 days past due	Impaired	Total
Risk classes 1-4	131.0	0.0	-	-	131.0
Risk classes 5-6	254.7	0.5	-	-	255.2
Risk classes 7-8	140.3	2.7	0.0	-	143.1
Risk class 9	53.9	14.1	0.3	-	68.2
Risk class 10	11.7	1.8	8.0	14.1	35.5
thereof collateralised	8.8	1.6	7.5	14.1	32.1
Unrated	4.3	0.3	-	-	4.7
Total	595.9	19.4	8.2	14.1	637.7

Exhibit 4.27. Loans to customers by risk groups and past due status at year-end 2014 (carrying amount, ISK bn). Consolidated.

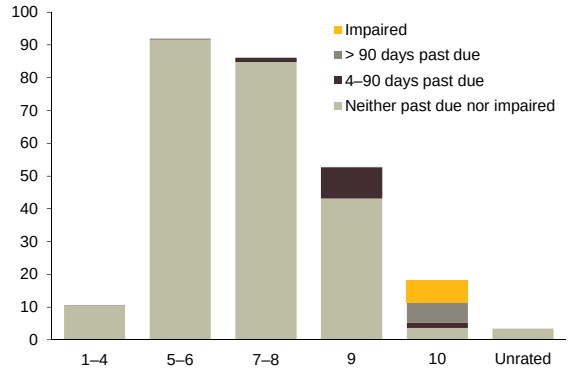

Exhibit 4.28. Loans to individuals by risk groups and number of days past due at year-end 2014 (carrying amount, ISK bn). Consolidated.

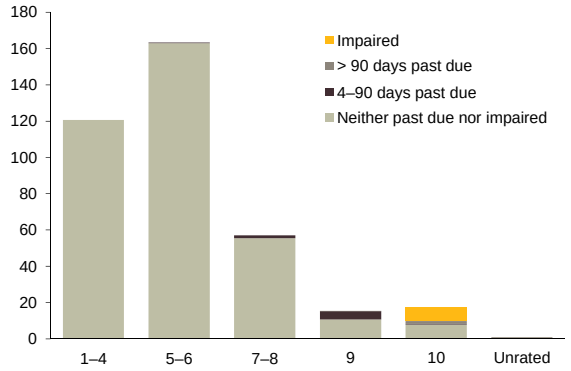

Exhibit 4.29. Loans to companies by risk groups and number of days past due at year-end 2014 (carrying amount, ISK bn). Consolidated.

4.8 DEFINITION OF NON PERFORMING RATIOS

In order to measure asset quality it is convenient to consider non-performing ratios. It is important to keep in mind that non-performing ratios and past due ratios can be defined in a variety of ways. Unfortunately, a harmonised definition does not exist which complicates comparison of asset quality between banks, countries and time periods. There are at least four degrees of freedom that need to be fixed in order to define a non-performing ratio. These decisions involve asset classes, exposure type, cross default and non-performing triggers, e.g. as displayed in Exhibits 4.31, 4.32 and 4.35.

The Bank has for the past few years shown two measures of asset quality in the Pillar 3 Report, namely the 90 days past due ratio and the so-called LPA ratio. These measurements have also been used in the Bank's presentation for the financial results.

The 90 days past due ratio is a facility based measurement of loans to customers that are more than 90 days past due, either impaired

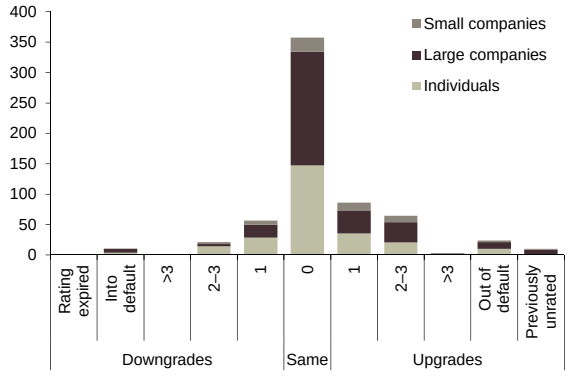

Exhibit 4.30. Migration of risk classes in the year 2014 (carrying amount, ISK bn). Consolidated.

or not impaired. See Exhibit 4.31. The exposure is measured by carrying amount which means that specific impairment has been subtracted from the claim value. This ratio has been decreasing, being 2.5% at year-end 2014 compared to 4.2% a year before.

The other non-performing ratio that the Bank has used is called the LPA ratio. It is based on a monthly report that is submitted to the FME with the purpose to monitor the restructuring progress of the loan portfolio. This ratio is a customer based (not facility based) non-performing measurement of loans to customers. See Exhibit 4.32. This measurement is stricter than the 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. This is sometimes called a cure period.

At year-end 2014 the LPA metric was 5.9%, compared to 8.3% a year earlier. This means that a smaller part of the loan portfolio is still in need of restructuring.

Exhibits 4.33 and 4.34 show the historical development of these two credit quality measures. The first graph is for individuals and the second is for companies.

Another non-performing ratio has become more popular in recent years and is e.g. used by the European Banking Authority (EBA).

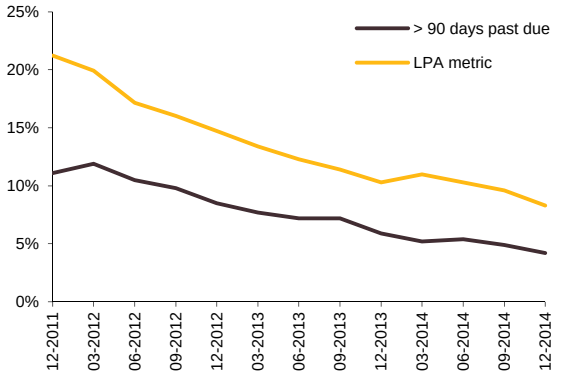

Exhibit 4.33. Two credit quality measures for the portfolio of loans to individuals. The ratios are defined in Exhibits 4.31 and 4.32.

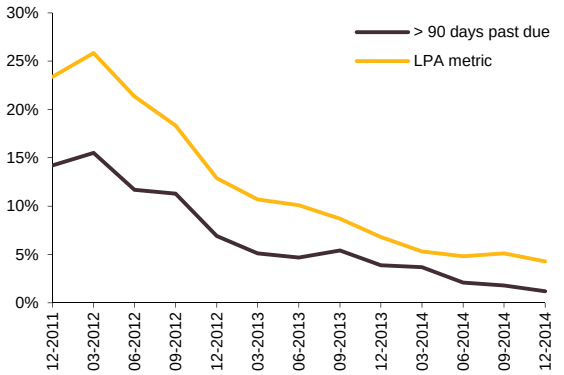

Exhibit 4.34. Two credit quality measures for the portfolio of loans to companies. The ratios are defined in Exhibits 4.31 and 4.32.

The ratio is based on impaired loans and loans that are more than 90 days past due, see Exhibit 4.35. One of the benefits of this definition is the fact that the ratio can be calculated for various banks based on mandatory information in financial statements. The difference between this measurement and the 90 days past due ratio that the Bank has used, lies in loans that have been specifically impaired without being more than 90 days past due.

Asset classes	Exposure	Cross default	Non-performing criteria
(can choose many)	(choose one)	(choose one)	(can choose many)
Loans to customers	Claim value	Per facility	>90 days past due
Loans to banks	Carrying amount	Per customer	Specific impairment
Other assets	Payments in arrears	Per group of connected clients	Forbearance
			Cure period

Exhibit 4.31. Definition of the 90 days past due ratio indicated with the shaded items.

Asset classes	Exposure	Cross default	Non-performing criteria
(can choose many)	(choose one)	(choose one)	(can choose many)
Loans to customers	Claim value	Per facility	>90 days past due
Loans to banks	Carrying amount	Per customer	Specific impairment
Other assets	Payments in arrears	Per group of connected clients	Forbearance
			Cure period

Exhibit 4.32. Definition of the LPA ratio indicated with the shaded items.

Asset classes	Exposure	Cross default	Non-performing criteria
(can choose many)	(choose one)	(choose one)	(can choose many)
Loans to customers	Claim value	Per facility	>90 days past due
Loans to banks	Carrying amount	Per customer	Specific impairment
Other assets	Payments in arrears	Per group of connected clients	Forbearance
			Cure period

Exhibit 4.35. Definition of the impaired loans and past due (>90 days) loans non-performing ratio used by EBA indicated with the shaded items.

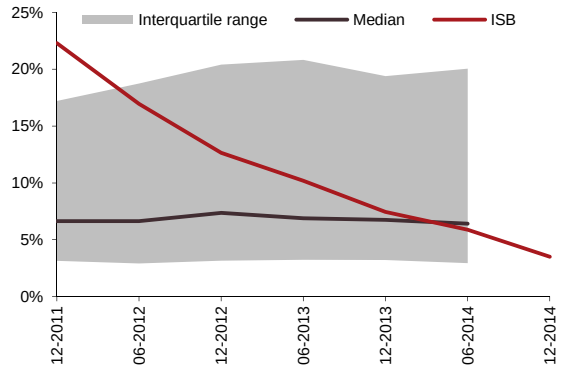

Exhibit 4.36. Impaired loans and past due (>90 days) loans as defined in Exhibit 4.35. Comparison between Íslandsbanki and over 50 large European banks. Data for the European banks not yet available for year-end 2014. Source: Íslandsbanki and EBA.

Exhibit 4.36 shows a comparison between Íslandsbanki and 56 large European banks. The ratio has been decreasing for Íslandsbanki and is now below the European median. At year-end 2014 the ratio was 3.5%, compared to 7.4% a year earlier.

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 e.g. due to illness, unemployment or parental leave. Temporary changes in terms are also granted to companies when needed, e.g. to meet adverse changes in the operating environment, which affect revenue and cash flows or to meet necessary but unforeseen capital expenditures. The customer is expected to resume normal repayments after the concession period. Furthermore, covenants are sometimes waived when customers are in minor difficulties.

There is some uncertainty about how wide or narrow 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.

Restructuring measure for individuals	Write-offs and remissions	Thereof in 2014
Recalculation of FX loans	32.9	0.5
110% adjustment of mortgages	12.0	-
Principal adjustment	10.8	-
FX loans	6.6	-
CPI-linked loans	2.4	-
Interest rate discount	4.5	-
Specific debt adjustment	4.3	0.5
Other restructuring measures	55.0	8.8
Total	129.0	9.9

Exhibit 4.37. Aggregated write-offs and remissions for individuals 2008–2014 (ISK bn). Parent.

4.10 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 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 of 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[3].

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.

Exhibits 4.37 and 4.38 show aggregated write-offs and remissions to individuals and companies divided into various programs offered by the Bank and Exhibit 4.39 shows the cumulative development from 2008.

[3]For more information on the deep discount on loans acquired from Glitnir and the difference between claim value and carrying amount, see the Bank's Risk Report from 2011, Section 4.4.2.

Restructuring measure for companies	Write-offs and remissions	Thereof in 2014
Recalculation of FX loans	48.9	3.0
Debt adjustment	18.4	0.1
Principal adjustment of FX loans	13.2	-
Other restructuring measures	378.4	26.6
Total	458.8	29.7

Exhibit 4.38. Aggregated write-offs and remissions for companies 2008–2014 (ISK bn). Parent.

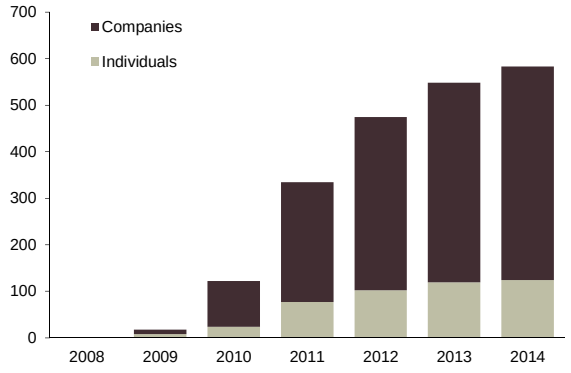

Exhibit 4.39. Cumulative write-offs and remissions 2008–2014 (ISK bn). Parent.

4.10.1 RECALCULATION OF FX LOANS

In 2012 the Supreme Court in Iceland passed two rulings (no. 600/2011 and no. 464/2012) 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". 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 rulings by the Supreme Court in the year 2013 (no. 386/2012 and no. 430/2013) affected the Bank's recalculation process. Both of these rulings increased the number of loans that were recalculated according to the Receipt Ruling. New rulings in 2014 did not significantly affect the recalculation methodology in Íslandsbanki.

At year-end 2014 the Bank had recalculated according to the Receipt Ruling approximately 12 thousand loans out of approximately 15 thousand illegal loans.

4.10.2 THE GOVERNMENT CPI-LINKED MORTGAGE RELIEF SCHEME

Following extensive preparation, the first applications for the Government CPI-linked mortgage relief scheme were processed in the very last days of 2014. The scheme is eventually expected to decrease the claim value of loans at Íslandsbanki by around ISK 7 billion, whereof 75% will fall in 2015 and 25% in 2016, subject to approval in the Government budget. The Government will compensate Íslandsbanki using a fair value-inspired approach to accomplish the goal that banks should realise neither profit nor loss as a consequence of the scheme.

The implementation is that each qualifying loan is divided into a stub which the Government pays and a remainder which remains the responsibility of the obligor. Exhibit 4.40 shows the division of the mortgage portfolio at year-end 2014 into stubs and remainders which were created before end of February 2015.

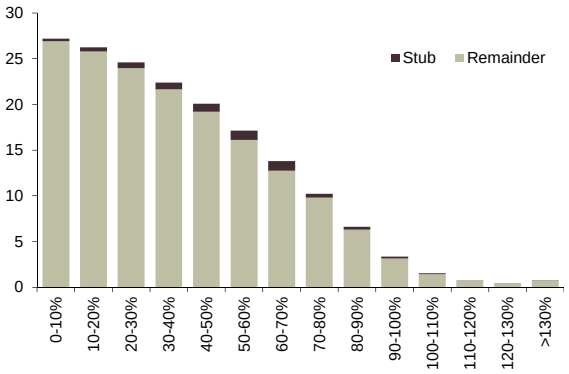

Exhibit 4.40. Division of each ISK in the mortgage portfolio at year-end 2014 by LTV bands showing whether the ISK was moved to a stub before end of February 2015. Parent.

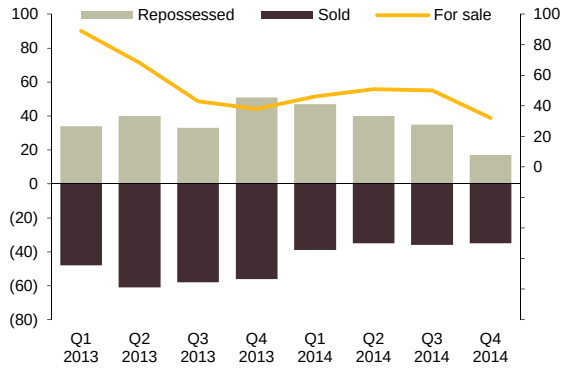

Exhibit 4.41. Number of repossessed and sold vehicles (left hand axis) and vehicles for sale (right hand axis) at quarter-end 2013 and 2014. Consolidated.

4.11 REPOSSESSED ASSETS HELD FOR SALE

In most cases 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. The Bank's employees are not permitted to purchase repossessed assets.

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 2014 the Bank's repossessed collateral amounted to ISK 8.6 billion, of which ISK 8.2 billion were land and property. In comparison, repossessed collateral amounted to ISK 10.7 billion at the year-end 2013 of which ISK 8.5 billion were land and property. Exhibits 4.41 and 4.42 show the development of the

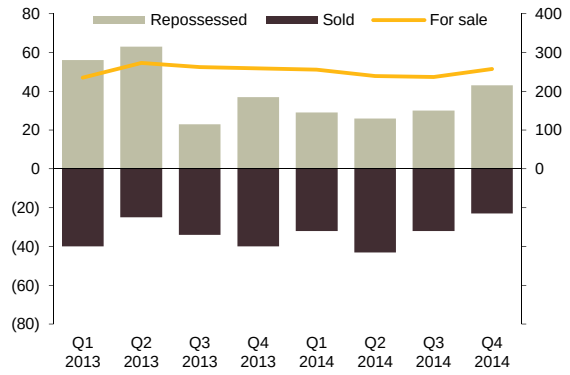

Exhibit 4.42. Number of repossessed and sold residential properties (left hand axis) and residential properties for sale (right hand axis) at quarter-end 2013 and 2014. Consolidated.

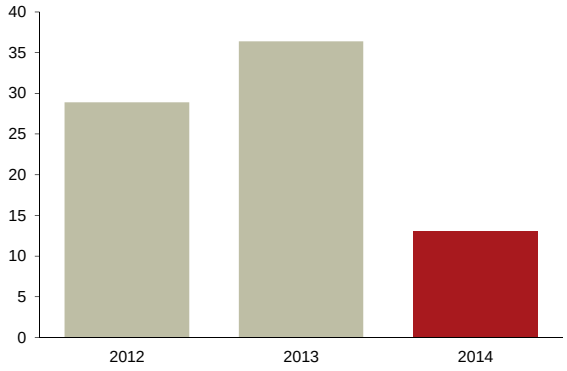

Exhibit 4.43. Assets of disposal groups classified as held for sale at year-end 2012–2014 (carrying amount, ISK bn). Consolidated.

number of repossessed vehicles and residential properties held for sale through the last two years and the factors influencing that number.

At year-end 2014 the Bank had 257 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 257 properties owned by the Bank, 95 are being rented out.

Exhibit 4.43 shows assets of disposal groups held for sale, those are assets of companies in which the Bank holds more than 50% of the shares.

4.12 CAPITAL REQUIREMENTS

The Bank reports its Pillar 1 capital requirements for credit risk according to the standardised Basel approach. Exhibit 4.44 shows exposure amounts, risk weights and corresponding risk-weighted assets for the different portfolios as at year-end 2014. Currently, residential real estate, commercial real estate and securities issued by the Central government are used as credit risk mitigants to reduce capital requirements. Furthermore the Bank has exposure to one counterparty 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 concentration risk and underestimation of credit risk under Pillar 1. The ICAAP/SREP discussion with the regulator in Iceland is still maturing but for the last few years the add-on for credit risk in Pillar 2 has included an increased risk weight for certain asset classes where the standardised approach may not be representative of the inherent risk. These asset classes comprise municipalities with low payment capacity, loans to holding companies to buy shares in operating companies and cross default using the LPA definition.

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 need on the other hand are then used to assess the effect of the stress scenario on the solvency of the Bank.

	On balance sheet	Off balance sheet (after CCF)	Guarantees	Financial collateral	Inflow	RWA
Central governments or central banks	135,894	1,917	-	-	8,687	954
0%	135,894	9	-	-	4,871	-
50%	-	-	-	-	1,908	954
Regional governments or local authorities	10,108	3,961	-	-	-	2,884
20%	10,021	3,961	-	-	-	2,796
100%	87		-	-	-	87
Financial institutions	37,557	40	-	-	-	7,906
20%	37,113	-	-	-	-	7,423
100%	443	40	-	-	-	483
Administrative bodies and non-commercial undertakings	1,140	21	-	-	-	1,162
100%	1,140	21	-	-	-	1,162
Collective investment undertakings (CIU)	67		-	-	-	67
100%	67		-	-	-	67
Corporates	310,433	13,617	3,509	810	-	319,730
100%	310,433	13,617	3,509	810	-	319,730
Retail	189,893	10,478	-	403	-	149,976
75%	189,893	10,478	-	403	-	149,976
Secured by real estate	114,699		-	-	-	40,442
35%	112,719		-	-	-	39,452
50%	1,980		-	-	-	990
Past due items	12,903	7	-	151	-	14,066
50%	1,218		-	-	-	609
100%	7,770	3	-	65	-	7,708
150%	3,915	4	-	86	-	5,749
Other items	42,894		-	-	-	46,188
100%	36,305					36,305
150%	6,589		-	-	-	9,884
Grand total	855,588	30,042	3,509	1,364	8,687	583,375

Exhibit 4.44. Exposure, risk weights, flow between exposure classes (outflow due to guarantees and financial collateral and corresponding inflow) and risk-weighted assets per asset class at year-end 2014 (ISK m). Consolidated.

REGULATORY CHANGES

Act No. 9/2014 on financial assistance, for the payment of collateral security for costs of bankruptcy proceedings

The Act's aim is to make it possible for individuals, who are experiencing severe payment difficulties and have sought remedies for payment difficulties without success, to receive financial assistance to pay a court requested collateral security for the costs of bankruptcy proceedings. Applications for financial assistance should be sent to the Debtors' Ombudsman, who evaluates whether requirements for the assistance are fulfilled.

Act No. 35/2014 on the CPI-linked mortgage relief scheme

In November 2013, the Government's mortgage relief scheme was presented. The plan allowed for tax relief as well as debt cancellation of up to ISK 4 million on CPI-indexed mortgages per affected household. With Act no. 35/2014, the plan was put into effect. The Act entails that all individuals who had indexed mortgages in 2008–2009 can apply to have their loans reduced by the amount corresponding to the difference between real inflation compensation and adjusted inflation compensation for up to a maximum of ISK 4 million for each household. The Treasury will pay the adjusted part of the loan over the next year, the final payment being subject to Parliament approval.

Act No. 40/2014 on personal pension savings and their use for mortgage payments and for down payment on a new home

The Act is part of the Government's housing debt relief plan. Households with mortgages can use payments which would otherwise go to personal pension savings as additional payments for their mortgages or, in the event that an applicant is not a home owner, as down payment on a new home. The Treasury will waive income tax on the wage earner's contribution of up to 4% of the salary together with the employer's contribution of up to 2%. However the maximum tax exemption will be ISK 500,000 per individual or up to ISK 750,000 per household, per annum over the period mid-2014 to mid-2017. The amount accumulated over the three year period can be used as down payment for a new home for first time buyers until 30 June 2019.

Amendment to Act No. 38/2001 on interest and price indexation, with changes (statute of limitation for claims to recalculate illegal foreign currency loans), no. 38/2014

The amendment prescribes that the limitation of the settlement of claims arising from illegal foreign currency loans will be eight years, measured from 16 June 2010. The Act is intended to prevent the limitation of such claims to expire on 16 June 2015.

Amendment to Act No. 90/1991 on Judicial Sale

In December 2013, the Icelandic Parliament passed an interim act amending the Act on Judicial Sale. The provision added a stipulation that a 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. In September 2014 the provision to grant stayed proceedings was extended and stayed proceedings shall be granted until 1 March 2015. A condition was added that the obligation to grant stayed proceedings would only apply to debtors who have applied for debt relief under Act no. 35/2014 on the CPI-linked mortgage relief scheme. In February 2015, the provision was extended until 1 October 2015, for stayed proceedings up to three months at a time.

5 MARKET RISK

The rise of the domestic stock market slowed down in 2014. The market started and ended the year positively but between mid-January and mid-October the OMXI8 gross return index decreased by 10% and daily turnover decreased. However from mid-October the daily turnover started to catch up and the index increased by 15% until year-end 2014. Overall, the index increased by 6.5% in 2014 compared to 19% in 2013. The average daily turnover increased by 18% compared to 50% in 2013. Two new companies, Sjóvá and HB Grandi, were listed in 2014 and further listings are expected in 2015.

The Bank's market risk profile changed somewhat in 2014 with market risk accounting for 4.8% of the Bank's risk-weighted assets at year-end 2014 compared to 4.4% at year-end 2013. The Bank's trading equity exposure increased in 2014 as the average position was considerably higher than in 2013. 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 corporate bonds market is gradually increasing and is expected to play a bigger role in the coming years. The Bank's currency imbalance increased in 2014, mainly due to revaluation of loans as the ISK trade-weighted index changed only marginally over the year. The inflation imbalance and the interest rate risk in the banking book increased in 2014, mainly due to increased CPI-linked lending and maturing CPI-linked liabilities.

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 key 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. The objective of the market risk management framework is to manage and control market risk exposures and ensure that the market risk profile is in line with the Bank's risk appetite.

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 initially acquired through restructuring. The Bank also takes on market risk in relation to its trading activities or other activities of the Markets or Treasury units.

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 Asset and Liability Committee (ALCO) supervises market risk. The committee decides on market risk limits for individual positions and desks based on the overall market risk appetite approved by the Board. Risk Management is responsible for monitoring and reporting on the Bank's overall market risk exposure and limit compliance to ALCO and to the Board on a consolidated level. Individual business units are responsible for adhering to the Bank's risk management policies and procedures, defining investment policies where applicable and managing their market risk within approved limits. Subsidiaries that have market risk related business operations are responsible for identifying, measuring, monitoring and reporting on the risk in their operations.

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 used to manage market risk. The Bank also uses stress tests to simulate the effects on portfolios from extreme but plausible market events and Value-at-Risk (VaR) based measures for margin requirement calculations, capital calculations and determination of trading limits. These tools provide complementary information to notional limits and sensitivity measures but the limit structure for market risk is not formally VaR based.

Risk Management monitors the trading activities of the Bank and ensures that positions and margin requirements comply with limits. All market risk limit 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.

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 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. The Bank's equity exposure includes both listed and unlisted shares.

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 unexpected changes in inflation.	• Inflation-linked bonds and debt instruments. • Inflation-linked loans and deposits. • Inflation-linked derivatives.	• Size 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 individual securities.
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 individual securities. • Total notional of foreign exchange derivatives.

Exhibit 5.1. Main types of market risk within Íslandsbanki.

5.3 MARKET RISK EXPOSURE

The Bank's market risk appetite defines the maximum market risk exposure that the Bank is willing to take on. The market risk exposure is measured according to an internal framework taking into account the amount and volatility of the underlying positions. The Board has set the market risk appetite relative to the Bank's capital such that for predetermined shifts in risk factors, the amount at risk shall not exceed 20% of Tier 1 capital. Exhibit 5.2 shows how the Bank's market risk exposure evolved in 2014 with respect to the average quarterly contribution of each risk factor according to the market risk framework. Currency risk, including the CPI-imbalance, was the largest market risk factor in 2014. Equity risk decreased towards the end of 2014 at the same time as interest rate risk increased.

Exhibit 5.3 displays the main categories of the Bank's market risk trading book exposures in 2014 and 2013. Since many of these exposures are quite volatile in nature, the figures displayed represent the maximum, minimum and average exposure in each

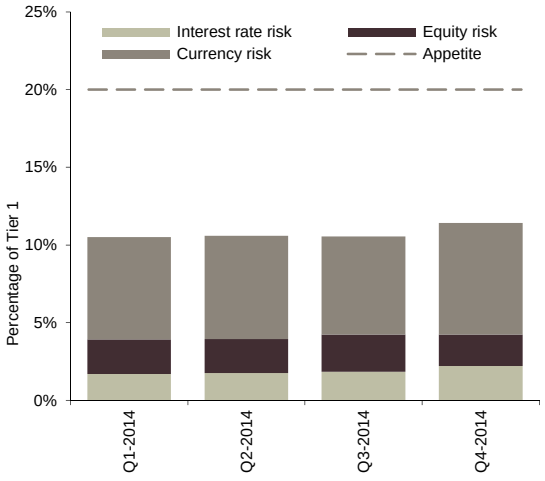

Exhibit 5.2. Market risk exposure and market risk appetite, average positions. Consolidated.

Exposure	Maximum	Minimum	Average	Maximum	Minimum	Average
		2014			2013	
Equity (net position)	4.585	630	3.019	2.944	358	1.651
Interest rate (100 bp parallel upward shift)	335	83	213	445	8	170
Foreign currency (net position)	1.601	(602)	166	996	(1.372)	(38)

Exhibit 5.3. Market risk trading book exposure (ISK m). Consolidated.

Exposure	31.12.2014	31.12.2013
Equity risk (net position)	5,721	6,113
Interest rate risk (weighted 100 bp shift)	(807)	(323)
Inflation risk (net position)	57,547	6,389
Currency risk (net position)	25,514	23,477
Derivatives (total MV)	(999)	196

Exhibit 5.4. Market risk exposure in the banking book at year-end 2014 and 2013 (ISK m). Consolidated.

category per year. As shown in Exhibit 5.3 the average trading book position in 2014 was higher in every category than in 2013. 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.

The market risk exposures in the banking book at year-end 2014 and 2013 are displayed in Exhibit 5.4. Overall equity risk in the banking book decreased in 2014, mainly due to the Bank selling shares originally acquired through restructuring of customer debt. Interest rate risk in the banking book increased in the last quarter of 2014 but still remains modest. The total market value of outstanding derivatives contracts decreased in 2014 mainly due to 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 and market making. Most of the shares are denominated in ISK. The Bank was a market maker for nine listed companies on the domestic stock exchange at the end of 2014. The overall equity risk is managed through limits on the aggregated market value and concentration risk is further managed through limits on the maximum exposure in single securities. An overview of the equity position on a consolidated basis is presented in Exhibit 5.5. The Bank's trading equity exposure increased in 2014 with the average position about 80% higher in 2014 than in 2013. The equity hedge portfolio consists of hedge positions against customers' equity forward contracts. In line with the development in the equity market the demand for derivatives increased which explains the increase in securities used for hedging. The market value of fair value shares and shares held for sale decreased, mainly due to the Bank selling a 2.0% share in Icelandair Group, a 4.7% share in N1 and an 8.6% share in Sjóvá in relation to its listing in April 2014.

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 2014 and 2013 the impact of the sensitivity measure was a decrease of ISK 2.7 billion and ISK 2.5 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

	Held for trading	Designated at fair value	Non-current assets and disposal groups held for sale	Securities used for hedging	Total
31.12.2014					
Listed	1,746	2,917	-	3,064	7,727
Unlisted	-	2,804	365	-	3,169
Total	1,746	5,721	365	3,064	10,896
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

Exhibit 5.5. Shares and equity instruments including held-for-sale equities at year-end 2014 and 2013 (ISK m). Consolidated.

Country	MV	BPV	MV	BPV
	31.12.2014		31.12.2013	
Canada	1,094	(0.02)	-	-
Denmark	1,036	(0.02)	1,063	(0.02)
France	6,944	(0.30)	1,585	(0.01)
Germany	15,434	(0.41)	4,755	(0.09)
Netherlands	6,944	(0.18)	2,377	(0.02)
Norway	1,708	(0.04)	3,760	(0.13)
Sweden	4,109	(0.14)	5,375	(0.13)
UK	-	-	1,902	(0.02)
USA	9,323	(0.24)	14,433	(0.44)
Total	46,593	(1.34)	35,250	(0.86)

Exhibit 5.6. Origin of government issued bills and BPV in the Bank's liquidity portfolio (ISK m) at year-end 2014 and 2013. Consolidated.

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 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 CPI-linked. Duration ranges up to ten 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 access to securities lending which enables the Bank to take short positions in government and government-guaranteed bonds.

At year-end 2014, the total BPV for indexed and non-indexed bonds in the flow trading portfolio was ISK -1.9 million, the same as at year-end 2013.

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 2014 the Bank held a significant amount of foreign AAA and AA+ credit-rated government bills for liquidity management purposes. These bills have a duration ranging up to seven months and the sensitivity measured in BPV was ISK -1.3 million at year-end 2014 compared to ISK -0.9 million at year-end 2013. Exhibit 5.6 displays the origin of the Bank's position in foreign government bills through its liquidity portfolio.

The hedge portfolio consists of hedge positions against customers' bond options, bond forward and interest rate swap contracts. Bond options and interest rate swaps are subject to BPV limits. Additionally, bond options are subject to, for example, net delta limits. The net BPV of unhedged positions was close to zero at the end of 2014.

The maximum total position in the trading portfolios over the year, excluding the hedge portfolio, was ISK 53.0 billion compared to ISK 43.7 billion in 2013 and mainly originated in the liquidity portfolio. The largest aggregated position in indexed securities was ISK 5.0 billion compared to ISK 3.8 billion in 2013 and the largest aggregated position in non-indexed securities was ISK 51.2 billion compared to ISK 41.3 billion in 2013. Exhibit 5.7 displays the total market value and BPV of the trading portfolios at year-end 2014 and 2013.

For the sensitivity analysis of the trading portfolios, the Bank uses a substantial but plausible shift in interest rates. The Bank applies a 100 bps shift in ISK, non-indexed and indexed interest rates. Shifts in rates in other currencies are scaled down to reflect lower volatility. Exhibit 5.8 shows 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.

	31.12.2014			31.12.2013		
	MV	Duration (years)	BPV	MV	Duration (years)	BPV
Long positions						
Indexed	1,772	8.03	(1.42)	3,282	7.41	(2.43)
Non-indexed	48,260	0.41	(1.96)	35,848	0.32	(1.13)
Total	50,032	0.68	(3.38)	39,130	0.91	(3.56)
Short positions						
Indexed	-	-	-	291	6.39	0.19
Non-indexed	73	7.39	0.05	2,878	2.23	0.64
Total	73	7.39	0.05	3,169	2.61	0.83
Net position	49,959	0.67	(3.33)	35,961	0.76	(2.73)

Exhibit 5.7. Bonds and debt instruments in the trading portfolio at year-end 2014 and 2013 (ISK m). Consolidated.

Currency	Parallel upward shift in yield curve	Profit or loss	Profit or loss
	(basis points)	31.12.2014	31.12.2013
ISK, indexed	100	(142)	(243)
ISK, non-indexed	100	(59)	(28)
CHF	40	-	-
EUR	20	(18)	(2)
GBP	40	-	(1)
JPY	20	-	-
USD	40	(10)	(18)
Other	40	-	-
Total		(229)	(292)

Exhibit 5.8. Sensitivity analysis for bonds and debt instruments in the trading portfolio at year-end 2014 and 2013 (ISK m). Consolidated.

The Bank issued one new index-linked and one new non-indexed covered bond series in 2014 and now has two non-index linked and four index-linked covered bonds series outstanding. The market value of outstanding covered bonds increased by ISK 9 billion in 2014, mainly due to new issuance. The Bank issued its first EUR-denominated notes in May 2014 for EUR 100 million and added SEK 300 million to its outstanding SEK-denominated notes. Including domestic covered bonds the Bank's total net securities issuance in 2014 was ISK 25 billion.

Interest rate risk in the banking book is managed using limits reflecting 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

The weights are used to scale the base shift of the yield curves. In Exhibits 5.9 and 5.10 all interest bearing assets and liabilities are bucketed according to their next interest reset as at year-end 2014 and 2013. Sensitivity calculations are 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 stronger mean reversion is exhibited for index-linked rates than for non-indexed rates.

The net fair value impact of the applied shifts on the Bank's assets and liabilities based on the duration of the underlying exposures is shown in Exhibit 5.11.

The Bank measures interest rate risk in the banking book both in terms of parallel shifts and adverse shifts in interest rates. The development of the Bank's interest rate risk in the banking book in 2014 based on weighted adverse shifts is shown in Exhibit 5.12. The changes in the interest rate risk in the banking book were relatively large over the year mainly due to new lending and maturing offsetting liabilities. However, the interest rate risk in the banking book is still modest.

	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	> 10 years	Total
Assets							
Balances with Central Bank	103,389	-	-	-	-	-	103,389
Bonds and debt instruments	31,119	-	67	1,230	291	367	33,074
Loans to credit institutions	35,072	-	-	-	-	-	35,072
Loans to customers	451,191	47,768	29,963	97,052	1,868	9,809	637,650
Total assets	620,771	47,768	30,030	98,282	2,159	10,176	809,185
Off-balance sheet items	68,186	7,508	21,649	113	-	-	97,455
Liabilities							
Short positions	-	-	-	-	-	-	-
Deposits from Central Bank	69	-	-	-	-	-	69
Deposits from credit institutions	25,306	421	-	-	-	-	25,727
Deposits from customers	514,898	3,643	1,030	2,383	7,493	-	529,447
Debt issued and other borrowed funds	17,723	9,403	22,760	34,421	12,582	-	96,889
Subordinated loans	21,306	-	-	-	-	-	21,306
Total liabilities	579,302	13,467	23,790	36,804	20,075	-	673,438
Off-balance sheet items	77,732	3,272	7,701	17,850	-	-	106,555
Net interest gap on 31 December 2014	31,924	38,537	20,188	43,741	(17,916)	10,176	126,648

Exhibit 5.9. Interest rate reset periods in the banking book at year-end 2014 (ISK m). Consolidated.

Currency	Parallel upward shift in yield curve	Fair value impact	Fair value impact
	(basis points)	31.12.2014	31.12.2013
ISK, indexed	40	(891)	(113)
ISK, non-indexed	100	82	(206)
CHF	40	5	2
EUR	20	7	6
GBP	40	(1)	(1)
JPY	20	(0)	(1)
USD	40	(5)	(14)
Other	40	(4)	4
Total		(807)	(323)

Exhibit 5.11 . Sensitivity analysis for bonds and debt instruments in the banking book at year-end 2014 and 2013 (ISK m). Consolidated.

5.3.3 INFLATION RISK

The Bank is exposed to inflation risk since assets linked to the 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 2014 the CPI gap amounted to ISK 57.5 billion compared to ISK 6.4 billion at year-end 2013.

The inflation imbalance increased in 2014 mainly due to an increase in CPI-linked loans to customers and a reduction in CPI-linked liabilities. Exhibit 5.13 displays the development of the Bank's inflation imbalance in 2014. The parent and consolidated inflation imbalances converged in 2014 following the sale of one of the Bank's subsidiaries which had an inflation-linked loan from the parent company.

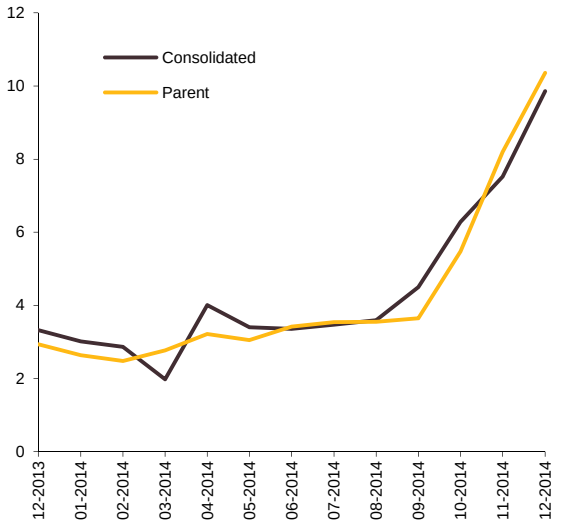

Exhibit 5.12. Monthly development of interest rate risk in the banking book in 2014 (weighted adverse BPV in ISK m). Consolidated and parent.

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 and also subject to regulatory limits where the net position per currency and the overall currency imbalance may not exceed

	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	> 10 years	Total
Assets							
Balances with Central Bank	111,779	-	-	-	-	-	111,779
Bonds and debt instruments	31,302	632	20	1,275	154	493	33,876
Loans to credit institutions	43,917	161	-	-	-	-	44,078
Loans to customers	401,397	46,565	57,552	38,803	1,586	12,516	558,419
Total assets	588,395	47,358	57,572	40,078	1,740	13,009	748,152
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	89,194
Subordinated loans	21,890	-	-	-	-	-	21,890
Total liabilities	550,447	8,113	2,450	48,980	14,398	9,386	633,774
Off-balance sheet items	20,046	23,638	5,338	8,195	-	-	57,217
Net interest gap on 31 December 2013	37,093	46,587	50,785	(12,364)	(12,658)	3,623	113,066

Exhibit 5.10. Interest rate reset periods in the banking book at year-end 2013 (ISK m). Consolidated.

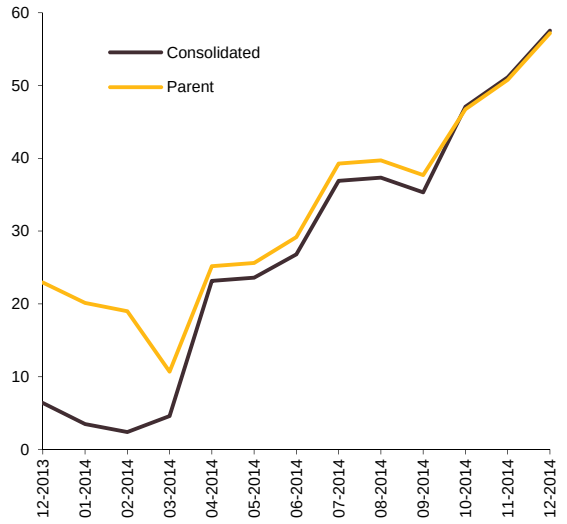

Exhibit 5.13. Monthly development of the inflation imbalance in 2014 (ISK bn). Consolidated and parent.

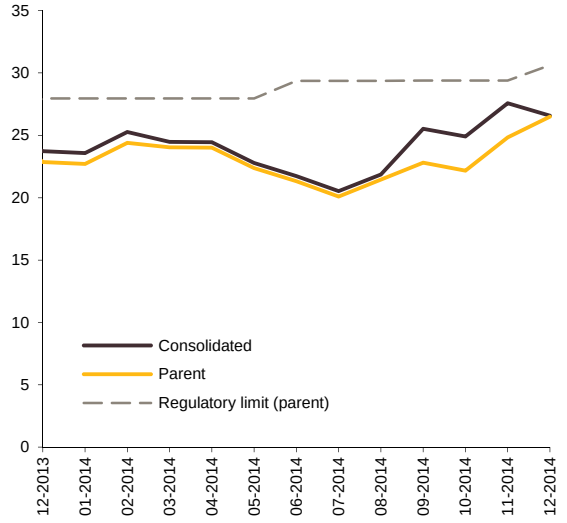

Exhibit 5.14. Monthly development of the currency imbalance in 2014 (ISK bn). Consolidated and parent.

15% of the Bank's capital base. Exhibit 5.14 displays the development of the Bank's currency imbalance in 2014. The currency imbalance at year-end 2014 was slightly higher than at year-end 2013, mainly due to revaluation of loans and new cross-currency interest rate swaps as the ISK trade-weighted index changed only marginally over the year.

5.3.5 DERIVATIVES

The Bank offers various types of derivative products to its customers. The main products are 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). 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.

5.4 CAPITAL REQUIREMENTS

The Bank uses the standardised approach for calculating its capital requirements for market risk. Exhibit 5.15 shows the Pillar 1 capital requirements for market risk at the Bank at year-end 2014 and 2013. The Bank's market risk profile changed somewhat in 2014 with market risk accounting for 4.8% of the Bank's capital requirement under Pillar 1 at year-end 2014 compared to 4.4% at year-end 2013. The capital requirement and risk-weighted assets increased for each of the underlying factors due to larger end-of-year position in the trading book for both equities and bonds and a slightly larger currency imbalance.

The implementation of the new Capital Requirements Regulation and Directive (CRD IV) is imminent in the year 2015. Under the new directive the Pillar 1 capital requirements for market risk will increase due to higher requirements for trading equities and new requirements (CVA or Credit Value Adjustment) regarding counterparty risk related to derivatives transactions. Based on positions at year-end 2014 the changes would result in a roughly 13% increase in the Pillar 1 capital requirement for market risk.

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

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

Risk exposure	Capital requirement	RWA	Capital requirement	RWA
	31.12.2014		31.12.2013	
Equity risk	210	2,620	139	1,739
Currency risk	2,139	26,732	1,900	23,744
Interest rate risk	318	3,974	269	3,366
Total	2,666	33,326	2,308	28,849

Exhibit 5.15. Pillar 1 capital requirements and risk-weighted assets (RWA) for market risk at year-end 2014 and 2013 (ISK m). Consolidated.

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.
- Currency 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.

According to law 11/2008 and FME's regulation 528/2008 the Bank runs weekly stress tests for its covered bond issuance comparing the net present value of issued covered bonds and the collateralised loans 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 2014 the Bank withstood all of these stress tests.

REGULATORY CHANGES

The following Acts will affect the Bank's inflation imbalance and interest rate risk in the banking book, see Regulatory Changes in Chapter 4 for details. All else equal, they are expected to lower both the inflation imbalance and the interest rate risk in the banking book.

Act No. 35/2014 on the CPI-linked mortgage relief scheme

Act No. 40/2014 on personal pension savings and their use for mortgage payments and for down payment on a new home

6 LIQUIDITY RISK

The Bank maintained a strong liquidity position throughout 2014 and all regulatory and internal metrics were well above limits. At year-end 2014, the Bank's LCR ratio was 117% for the parent company and 130% at a consolidated level. The deposit base remained fairly stable in 2014 despite increased investment opportunities in the equity and bond markets. This is reflected in high deposit–to-loan ratios throughout the banking system. The ratio of customer deposits to loans to customers was 84% at the end of 2014 compared to 88% at the end of 2013. The ratio of total deposits to total loans increased from 83% to 85% over the same period.

The Bank issued ISK 8.8 billion in covered bonds in 2014. In addition, the Bank issued short-term unsecured papers throughout 2014 with an outstanding amount at year-end of just under ISK 5 billion. In 2014 the Bank issued a SEK 300 million tap into its inaugural SEK 500 million Floating Rate Note and the Bank furthermore issued its first Euro-denominated bond of EUR 100 million in May 2014.

DEFINITION OF LIQUIDITY RISK

The Bank 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

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:

- Has a portfolio of liquid assets to be able to honour its obligations as they fall due, even under stressed conditions in funding markets.
- 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 which details the management actions at each stage.

The overall responsibility for the Bank'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 unit 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 and compliance to limits, both internally and externally.

Treasury 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.

The Bank complies with the Guidelines no. 2/2010 for Sound Liquidity Risk Management and Supervision issued by the FME. These Guidelines are based on the Principles for Sound Liquidity Risk Management and Supervision, issued by the Basel Committee on Banking Supervision.

According to the Central Bank rules on liquidity ratios, the Bank submits monthly reports on the LCR and NSFR ratios to the Central Bank.

6.2 MEASUREMENT AND MONITORING

The Bank uses various metrics and measures, both static and forward looking, to assess and quantify its liquidity position and thereby its liquidity risk. The main measures are based on:

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

The assumptions for the internal liquidity measures are reviewed regularly.

6.3 LIQUIDITY POSITION

The Bank maintained a very strong, and relatively stable, liquidity position throughout 2014 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 2014 and 2013.

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

Composition and amount of liquidity back-up	31.12.2014	31.12.2013
Cash and balances with Central Bank	92,651	105,161
Domestic bonds eligible as collateral against borrowing at the Central Bank	29,478	20,873
Foreign government bonds	45,517	34,618
Total High Quality Liquid Assets (HQLA)	167,645	160,652
Short-term placements with credit institutions	32,505	41,192
Total liquidity back-up	200,151	201,844

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

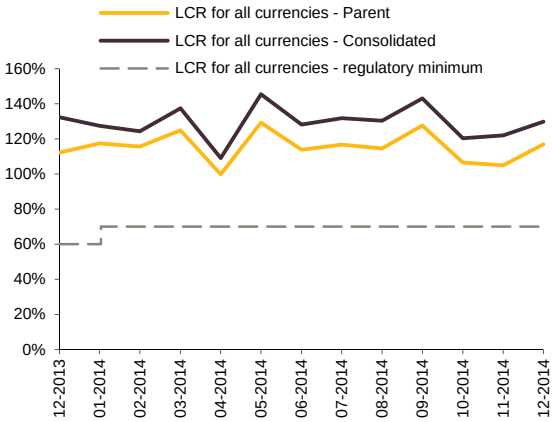

Exhibit 6.2. LCR for all currencies.

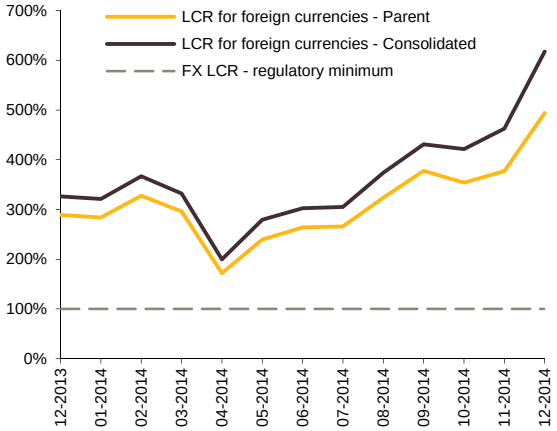

Exhibit 6.3. LCR in foreign currency.

6.4 REGULATORY REQUIREMENTS

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) and the Net Stable Funding Ratio (NSFR) based on the CRD IV standards into the *Rules on liquidity ratio*[1] and the *Rules on funding ratio in foreign currencies*[2]. Full implementation of the CRD IV liquidity standards, especially with respect to foreign currency denominated liabilities, is considered an important step in preparing for the removal of the capital controls.

The LCR implementation started in December 2013 with the current regulatory minimum at 100% for LCR in foreign currencies and at 80% for the total LCR. As of 1 December 2014 the Central Bank requires that the Icelandic banks maintain a minimum NSFR in foreign currencies of 80%. Exhibit 6.10 displays the implementation plan for the LCR and NSFR in Iceland compared to the EU implementation guidelines.

At year-end 2014 the total LCR for the Bank was 117% and for foreign currencies 494% at parent level and 130% for all currencies and 617% for foreign currencies on a consolidated level. The FX-NSFR was above regulatory limits at year-end 2014.

Exhibit 6.2 and 6.3 shows the development of the LCR liquidity ratios for the Bank in 2014.

[1]Central Bank rules on liquidity no. 1055 from 1 December 2013
[2]Central Bank rules on funding ratio in foreign currencies no. 1032 from 1 December 2014

Definition of the Liquidity Coverage Ratio

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.

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

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. These include Central Bank deposits, government bonds and corporate debt securities. The main outflow factors include on-demand deposits, committed credit and liquidity facilities, contractual lending obligations within a 30-day period, derivative cash outflow and other contractual cash outflows. This is offset by contractual cash 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.

Definition of the Net Stable Funding Ratio

At the end of 2014, The Bank for International Settlements introduced reforms to the NSFR standards and implementation timeline. 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.

$$\text{NSFR} = \frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}}$$

The amount of Available Stable Funding (ASF) is measured based on the broad characteristics of the relative stability of an institution's funding sources, including the contractual maturity of its liabilities and the differences in the propensity of different types of funding providers to withdraw their funding. The available amount of stable funding is mainly comprised of retail deposits, wholesale deposits with remaining maturity of greater than one year, equity and borrowings with a residual maturity over 1 year. The amount of Required Stable Funding (RSF) is measured based on the broad characteristics of the liquidity risk profile of an institution's assets and off-balance sheet exposures. The required amount of stable funding is mainly in the form of encumbered assets for a period of one year or more, unencumbered residential mortgages with a residual maturity of one year or more that would qualify for a 35% or lower risk weight under the Basel standardised approach for credit risk, other loans that do not qualify for the 35% or lower risk weight under the Basel standardised approached for credit risk and have residual maturities of one year or more and other assets. All categories are weighted by the appropriate ASF or RSF factor.

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

The Bank's *Liquidity Risk Policy* postulates 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 FME. The *Liquidity Contingency Plan*, which forms a part of the Bank's *Business Continuity Plan*, which is discussed in Chapter 7, is tested regularly and the findings from the test are used to improve the contingency plan if needed.

6.7 FUNDING

Deposits remain the Bank's main source of funding. At the end of 2014, the ratio of total deposits to total loans was 85%, whilst the ratio of customer deposits to customer loans was 84%. The deposit-to-loan ratio has remained relatively stable for the last few years, ranging from 84% to 88%, despite an increase in other investment opportunities and in an environment of falling interest rates. 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 in foreign markets. Deposits are however expected to remain the Bank's main source of funding, Exhibit 6.4.

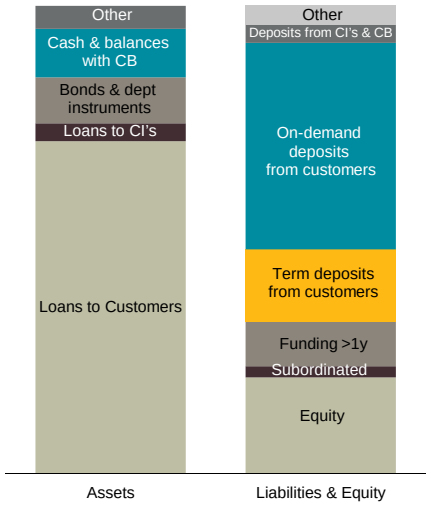

Exhibit 6.4. Funding profile and the Bank's matching assets at year-end 2014. Parent.

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 and the removal of the state guarantee of deposits.

6.7.1 DEPOSITS

In an effort to manage liquidity risk the Bank has put emphasis on increasing the portion of customer deposits with effective term of 31 days or greater. 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 2014 compared to 26% at the end of 2013. The Bank puts emphasis on managing its deposits to reduce concentration. The Bank's deposits have been categorised into six different groups, based on the CRD IV categorisation. The groups are listed in Exhibit 6.5 in order of estimated stability and the respective LCR run-off rates as adapted by the Central Bank of Iceland.

Exhibit 6.6 shows a breakdown of the Bank's deposits at year-end 2013 and 2014, according to the CRD IV definitions in Exhibit 6.5.

The share of on-demand retail deposits from individuals and small businesses remained unchanged at 44% between years. Thereof, 10% have a term period greater than 31-days, 11% are considered stable in nature and 23% less stable. 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 EUR 20,887 whereas most EU members have increased the maximum insured amount to EUR 100,000.

Deposit class	CRD IV criteria	LCR run-off rates
Foreign entities and financial institutions	Financial institutions, foreign individuals and foreign legal entities	100%
Domestic Financial institutions and fiduciaries	Financial institutions, insurance companies, fiduciaries, beneficiaries and special purpose vehicles	100%
Non-financial corporates	Legal entities with total deposits greater than EUR 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 EUR 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, stable	Individuals and legal entities with total deposits less than EUR 1,000,000, deposits that are fully covered by an effective deposits insurance scheme in Iceland and have other established relationships with the Bank	10%
Term deposits from individuals and small businesses	Deposits with an effective term period of 31 days or greater from individuals and small businesses	0%
Term deposits form other entities	Deposits with an effective term period of 31 days or greater	0%

Exhibit 6.5. CRD IV criteria for deposit categorisation.

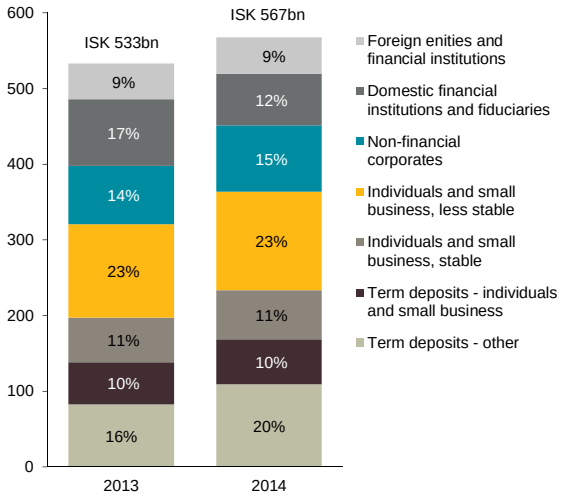

Exhibit 6.6. Deposits by LCR categorisation at year-end 2014. Parent.

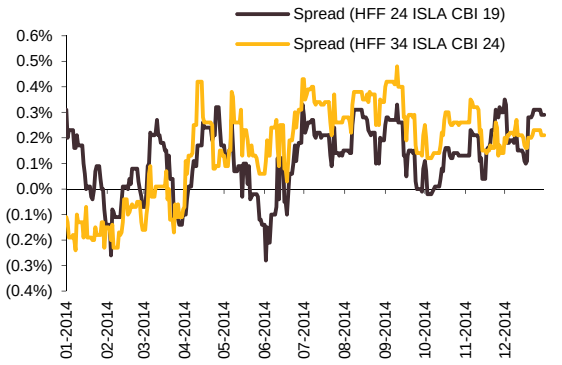

Exhibit 6.7. Development of covered bond spread relative to HFF bonds.

6.7.2 BOND ISSUANCE

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 8.8 billion of covered bonds in 2014, compared to ISK 9.9 billion issued the previous year. The total outstanding amount of covered bonds at year-end 2014 was ISK 32.1 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 bonds has narrowed considerably since the program was launched. On average there is a spread of 12 bps for shorter bonds and 16 bps for longer bonds in 2014, see Exhibit 6.7.

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 4.4 billion of debt outstanding in short-term unsecured bonds, with maturities ranging from one to six months.

In the spring, the Bank issued a SEK 300 million tap of its inaugural SEK 500 million December 2017 Floating Rate Note. The new tranche was issued at a lower spread to maturity of 3-month STIBOR + 330 bps, 70bp tighter than the original issue in December 2013.

In May 2014, the Bank followed that transaction with a EUR 100 million fixed rate bond, paying 3% coupon for a 2-year maturity. This issue was the first in Euros issued by an Icelandic bank since 2008, and was predominantly placed with investors in Germany and Scandinavia.

Exhibit 6.8 shows the maturity profile of the Bank's bond issues.

6.7.3 RATING

In April, Standards & Poor's assigned Íslandsbanki a credit rating of BB+/B with a stable outlook. In October, the outlook was revised to positive. The Bank's ratings are somewhat constrained by the

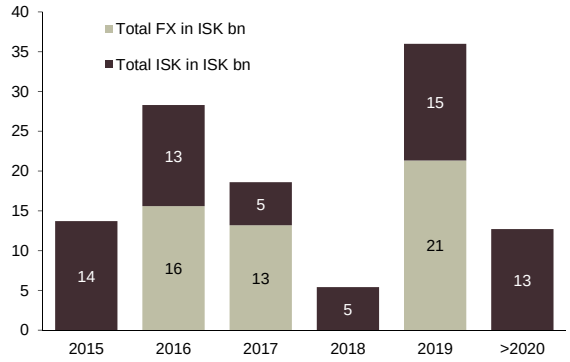

Exhibit 6.8. Maturity profile of long-term funding (ISK bn). Parent.

BBB- rating of the Republic of Iceland, so progress with the government's plans to ease capital controls will have a significant bearing on the Bank's own ratings.

6.7.4 ASSET ENCUMBRANCE

Asset encumbrance, the percentage of assets pledged as collateral, is a measure that has gained increased attention from regulators, investors and others. The Bank's 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 mortgage-backed bonds.
- Loans and securities as collateral for currency swap agreements.

Exhibit 6.9 shows the development of asset encumbrance as percentages of total assets.

6.7.5 FUNDING OUTLOOK

The deposit to loan ratio has remained relatively stable in recent years despite increasing number of other investment opportunities and an environment of falling interest rates. Deposits are expected to remain the main source of funding for the Bank, but a lowering of the deposit to loan ratio over the course of the next few years may be expected as banks are dis-intermediated in the face of a broadening choice for investors. The Bank's funding

	Percent of total assets pledged as collateral
2010	8.6%
2011	9.6%
2012	11.5%
2013	12.2%
2014	10.8%

Exhibit 6.9. Development of asset encumbrance as a percentage of total assets. Parent.

diversification strategy is squarely aimed at managing such a possibility.

It is assumed that an annual covered bond issuance of around ISK 10 billion in the domestic market will form the basis for the Bank's new mortgage lending.

The Bank also aims to use the capital markets to issue unsecured bonds both domestically and abroad. The Bank increased the size of its Global Medium Term Note Programme ("GMTN") in the summer to a headline USD 750 million. The GMTN, which enables the listing of transactions on the Irish Stock Exchange, is the Bank's principal vehicle for foreign currency term funding. It will afford the Bank all the usual flexibilities an MTN programme can offer and enable the refinancing of 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 foreign markets as well as 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.

6.7.6 REGULATORY CHANGES AND OUTLOOK

The Central Bank of Iceland, has already implemented the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio into the Icelandic liquidity rules well ahead of the general implementation plan in Europe. Exhibit 6.10 outlines the implementation plan for Iceland as compared to Europe.

	1 Dec 2014	2015	2016	2017	2018	2019
ICELAND	LCR 70% FX-LCR 100% FX-NSFR 80%	LCR 80% FX-LCR 100% FX-NSFR 80%	LCR 90% FX-LCR 100% FX-NSFR 90%	LCR 100% FX-LCR 100% FX-NSFR 100%	LCR 100% FX-LCR 100% FX-NSFR 100%	LCR 100% FX-LCR 100% FX-NSFR 100%
EU	LCR N/A NSFR N/A	LCR 60% NSFR N/A	LCR 70% NSFR N/A	LCR 80% NSFR N/A	LCR 90% NSFR 100%	LCR 100% NSFR 100%

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

REGULATORY CHANGES

Central Bank liquidity rule no. 1032/2014 on the implementation of the NSFR

The Central Bank of Iceland has issued new Rules on foreign currency funding ratios[3], no. 1032/2014, 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 2014. The funding ratio is intended to ensure a minimum level of stable one-year funding in foreign currencies and therefore restrict the degree to which the commercial banks can rely on unstable short-term funding to finance long-term foreign-denominated lending.

In view of experience, the Central Bank considers it important to reduce the risk that could result from excessive maturity mismatches between the commercial banks' assets and liabilities by explicitly limiting maturity mismatches in foreign currency. The funding ratio that the Bank has now adopted is based on the Basel Committee's rules concerning Net Stable Funding Ratio (NSFR).

The Central Bank intends to implement the rules on funding ratios, which are designed to cover periods ranging up to three years, in 2015. This is in accordance with the declared objectives set forth in the Central Bank publication "Prudential Rules Following Capital Controls", according to which domestic financial institutions should be able to withstand closure of foreign credit markets for up to three years.

Amendment to the liquidity rules no. 1031/2014 on the liquidity ratios

On 31 December 2014, the Central Bank of Iceland tightened the rules on liquidity ratios (LCR) regarding the treatment of deposits from financial institutions. From 1 January 2015 to 1 October 2015, the outflow rate for foreign currency denominated deposits with term ranging from 30-days to 6-months will increase stepwise from 25% to 100%.

[3]New liquidity rules for credit institutions, No. 1032/2014.

7 OPERATIONAL RISK

In 2014, a total of 334 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 convention. The category "External Fraud" accounts for 38% of all loss events, and the category "Execution, Delivery and Process Management" accounts for 35% of all loss events. The loss events in the category "Clients Products and Business Practices" account for 70% of the total loss amount attributed to operational risk in 2014.

DEFINITION OF OPERATIONAL RISK

The Bank has adopted the definition of operational risk from the CRD 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, and includes legal risk". The Bank's definition of operational risk includes 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.

The operational risk strategy can be summarised by the following principles:

- Increase operational risk awareness, and promote a culture of reliable business continuity.
- Accept no unnecessary operational risk unless the cost of avoiding risk outweighs the benefits.
- Mitigate unacceptable risks and prevent loss.

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 MEASUREMENT AND MONITORING

The Bank has implemented an operational risk management framework within the parent company that fulfils the Basel 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.

Thresholds for acceptable quarterly losses are defined in the *Operational Risk Management Policy* in accordance with the Risk Appetite Statement, approved by the Board of Directors. If the loss exceeds a lower threshold a report of the causing events and a risk mitigation plan is presented to the Executive Board. However, if the loss exceeds a higher threshold, a report and a mitigation plan is presented to the Board of Directors.

The Risk Monitoring Unit 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 loss events, 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 convention, and provides a basis for management reports. Also, the loss event data are used in the Internal Capital Adequacy Assessment Process (ICAAP) to model the Bank's operational risk profile in order to assess the appropriate capital requirements for operational risk.

In 2014 a total of 334 loss events were registered in the Bank's loss event database. The category "External Fraud" accounts for 38% of all loss events, and the category "Execution, delivery and process management" accounts for 35% of all loss events. The increase in the category "External Fraud" is mainly due to enhanced surveillance, an increase in credit card frauds reported and an increase in the number of phishing attacks but no losses were registered due to such attacks in 2014.

In 2014, 70% of the total operational risk losses were categorised as "Clients Products and Business Practices".

Further division of loss events is presented in Exhibits 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

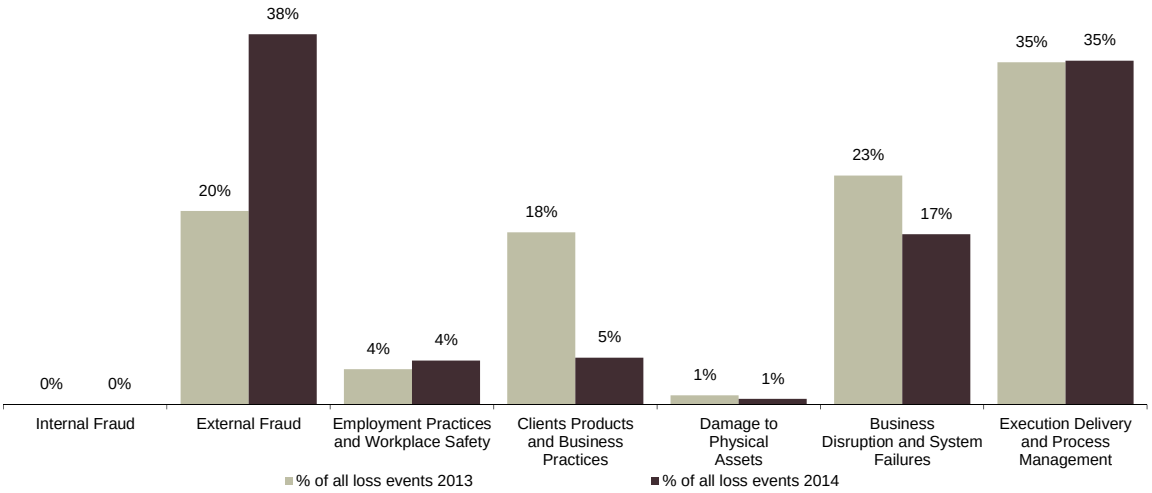

Exhibit 7.1. Number of loss events in 2013–2014 based on Basel event categories. Parent.

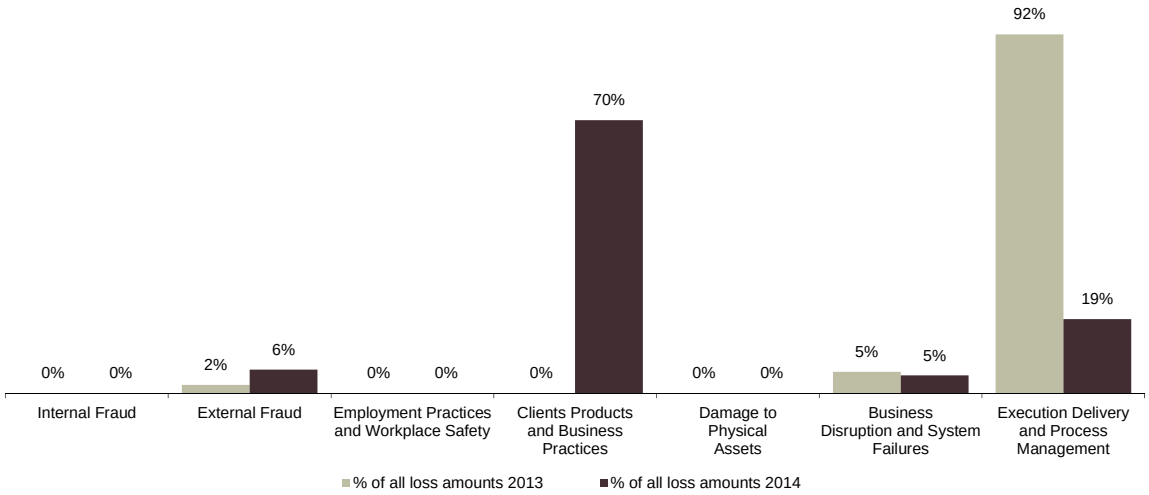

Exhibit 7.2. Loss amounts in 2013–2014 based on Basel event categories. Parent.

potential operational risks. The 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. All risks identified in the RCSA process throughout the Bank are registered in a database, managed by Risk Monitoring. The database is used for management reporting on the Bank's operational risk profile.

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 convention. The main objective is to ensure implementation of products in compliance with the Bank's policy and legal requirements. The process is a synchronisation and communication tool between product stakeholders, as well as a monitoring and risk management tool for new products. It also gives an overview of the full product range and the diversity of products within the Bank. 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

The Bank's 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 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 a 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 Undertakings 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 statistical modelling, based on registered loss events and risks discovered in the RCSA process 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.

To address reputational risk, internal procedures have been set up to limit reputational risk. 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 AND COMPLIANCE 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 Financial Statement 2014, note 57. 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. A special consideration is given to possible financial implications of legal disputes in the ICAAP process.

Compliance risk is defined as the risk of legal or regulatory sanctions, financial loss, or damage to the Bank's reputation in the event of failure to comply with applicable laws, regulations, and codes of conduct and standards of good practice.

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. Main competition issues are described further in the Financial Statement 2014, note 57.

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

The Bank 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. The Bank'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. An *Outsourcing Policy*, which all outsourcing contracts must comply to, has been approved by the Executive Board. The *Outsourcing Policy* reflects the provisions of FME rules No. 670/2013 regarding Sound Business Practices of Financial Undertakings, FME Guidelines No. 2/2014 on the IT-Operations of Supervised Entities and FME Guidelines No. 6/2014 on outsourcing for regulated entities.

REGULATORY CHANGES

Act No. 78/2014 on cross-border payments in Euro

The Act implements EU regulations no. 924/2009 and no. 260/2012 into national law. The Act contains standardised rules on transfers and direct payments in euros in the EEA area when both the payment service provider of the payer and the payment service provider for the recipient of the payment are located within the EEA or the only payment service provider involved in the payment is situated within area. The basic principle is that the charges for payment transactions offered by a payment service provider have to be the same, for the payment of the same value, whether the payment is national or cross-border.

Amendments to Act No. 87/1992, on Foreign exchange (dividends and penalty provisions)

On 16 May 2014, two amendments were made to the provisions of Act no. 87/1992. First concerning the definition of what dividends are exempt from the Act. A paragraph was added that stated that dividends, which derive from a reduction in share capital or the liquidation of a company, are not exempt. Secondly, a new paragraph was added to the penalty provisions of the Act which states that a legal entity may be fined for violations of the Act regardless whether a violation was committed intentionally or negligently by an employee or a representative of the legal entity. If an employee or a representative is guilty of a violation of the Act, in addition to the punishment to the individual involved, the legal entity may be fined and deprived of its operating license if the violation was made for the benefit of the legal entity or the legal entity has profited from the violation.

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 the current 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 its Board of Directors. The *Remuneration Policy* shall be reviewed at least annually and the Bank shall account for the *Remuneration Policy* to the FME. According to the rules the 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 control functions.

A recent bill in the parliament proposes changes to the Act on Financial Undertakings. This includes changes to restrictions on variable remuneration and introduces into Icelandic law the concept of material risk takers, employees whose professional activities have a material impact on the institution's risk profile. The bill is still subject to change and thus the effect of it and any rules set based on it is still uncertain.

[1] Rules No. 700/2011 on remuneration policy for financial undertakings
[2] Changes No. 75/2010 to the Act No. 161/2002 on Financial Undertakings

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 held seven meetings in the year 2014.

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. 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. Examples 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.

8.4 REMUNERATION IN 2014

In 2014, 102 employees were a part of the variable remuneration system at Íslandsbanki. Performance based remuneration is at the moment only in the form of cash and the Bank offers no share-based remuneration to employees.

Information on remuneration including the salaries and other benefits of the Bank's management and Board of Directors are disclosed in the Annual Report.

The Bank will provide Pillar 3 remuneration disclosure when the domestic legal and regulatory definitions and requirements have been clarified.

[3] www.islandsbanki.is
[4] See the Company part of the Annual Report 2014 for more information about the governance structure.

DEFINITIONS

Asset risk The risk of loss that may occur due to changes in value of assets held for sale.

Basel 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.

Basis risk Arising from changing rate relationships among yield curves that affect the institution's activities.

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 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 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 IV).

Carrying amount Book value of loans as displayed in the Financial Statements.

Claim value The remaining amount of obligor's 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.

Collective 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.

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 before the collective 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.

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.

Default Obligors are in default according to the Bank's definition when they are more than 90 days past due on a material credit obligation or when a specific credit impairment has been recognised. Note that the definition is on the obligor level rather than the facility level.

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 (HQLA) 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, referred to as CPI gap.

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 re-pricing risk, yield curve risk, basis risk and optionality risk.

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.

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 (LCR) The proportion of 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 (LGD) 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 (NSFR) 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.

Optionality risk Arising from interest rate related options embedded in the institution's products.

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 (PD) 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 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.

Re-pricing risk Arising from differences between the timing of rate changes and the timing of cash flows.

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 (RCSA) 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 categorised 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 (RWA) 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.

Yield curve risk Arising from changing rate relationships across the spectrum of maturities (change in slope and shape of the yield curve).

ABBREVIATIONS

ALCO	Asset and Liability Committee
ASF	Available Stable Funding
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
CFO	Chief Financial 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
CVA	Credit Valuation Adjustment
EAD	Exposure at Default
EBA	European Banking Authority
ED	Executive Director
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
IRRBB	Interest Rate Risk in the Banking Book
IRS	Interest Rate Swap
ISDA	International Swaps and Derivatives Association
ISK	Icelandic Krona
KPI	Key Performance Indicators
KRI	Key Risk Indicators
LCR	Liquidity Coverage Ratio
LED	Loss Event Data
LGD	Loss Given Default
LPA	Loan Portfolio Analysis
LTV	Loan to Value
MD	Managing Director
MV	Market Value
NPO	Non-profit Organisation
NSFR	Net Stable Funding Ratio
PD	Probability of Default
RCSA	Risk and Control Self-Assessment
ROE	Return on Equity
RSF	Required Stable Funding
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

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