Íslandsbanki

PILLAR 3 REPORT
2015

RISK AND CAPITAL MANAGEMENT — PILLAR 3 REPORT

Pillar 3 Report

CRO REVIEW 2015

This report provides comprehensive information on the risk position of Íslandsbanki and how the Bank manages its risk. The report also gives information on the regulatory environment and its development, particularly in Iceland. I hope that the report is accessible both for those looking for a bit of insight into how the Bank measures and manages risk, as well as experts desiring a deeper analytical basis to understand the Bank's risk position.

The Bank's capital position is strong and well in excess of requirements, with the total capital ratio at 30%. The Bank has set a medium term minimum target of 23% for this ratio, which exceeds regulatory requirements and reflects the importance of a strong capital position throughout the lifting of capital controls. This capital ratio, which is a risk adjusted measure, as well as the leverage ratio of 18% are quite high in comparison to international peer banks. Based on indications of increased systemic lending growth paired with signs of increased imbalances in the economy, the Icelandic Financial Stability Council (FSC) has recommended that a countercyclical capital buffer of 1% be applied in Iceland, effective early in 2017. This is in addition to other capital buffers imposed by regulation. A continuing challenge for the Bank in the years to come is to maintain an adequate return on equity in an environment of increased regulatory requirements and growing competition from less regulated entities.

The Bank's loan portfolio grew by 5% in 2015, reflecting the growth in economic activity in a competitive environment. The Bank's loan quality indicators have improved and compare well to international banks. In fact this manifests that the Bank's loan restructuring has been successful and the portfolio is robust and sustainable, which was a principal goal of the restructuring. The development and outlook related to oil production has had an impact on the Bank's exposure in the oil offshore service sector and the Bank has recognised an impairment to this exposure. The Bank has had intermittent presence tied to the Norwegian operators of offshore service vessels for over ten years, but the exposure is now only about 1% of the Bank's loan portfolio. There has been significant growth in the Icelandic tourism sector. The Bank's presence in this sector is primarily in hotels, car rentals and infrastructure, and these have performed well. While the outlook for further growth remains positive, the Bank is mindful that there are risks tied to such growth and remains selective in its risk positioning in this sector.

While Icelandic financial markets continued to grow in 2015, the Bank's market risk position decreased and remains modest. Imbalances in the Bank's balance sheet continue to be managed within reasonably tight limits, leaving the Bank only mildly exposed to unexpected fluctuations in exchange rates, interest rates and inflation.

The Bank's liquidity management assumes increased outflows of deposits related to further steps in the lifting of capital controls in 2016. Liquid assets increased by almost ISK 70 billion in 2015 to ISK 256 billion. At year end the liquidity (LCR) and funding (NSFR) ratios stood at 143% and 120%, respectively. These levels meet regulatory standards and compare well to international peer banks. The Bank's credit ratings have improved but capital controls remain an important factor for the credit rating of Iceland. However, important steps have been taken to lift controls, and further development is expected in 2016. The impact of this on the foreign funding opportunities for the Bank will however also be influenced by the development in foreign markets, where there has been some volatility recently.

Digitalisation of banking requires even more attention to operational risks related to information technology, cyber security and data governance. The Bank is taking various steps to address these risks, including a major overhaul of core payment systems, plans to replace core loan systems, an ongoing effort to improve the flow of timely and accurate data into a risk data warehouse and steps to address security risk by implementing international standards. The overhaul of core systems includes replacing legacy systems for deposits and payments, running on outdated technology platforms and should enable higher flexibility, agility and reliability for customers as well as improving operational stability. Although these projects will result in a significant reduction of operational risk in the long run, there are risks in the short term tied to their implementation, which the Bank tries to mitigate with risk assessment and contingency planning.

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 Íslandsbanki'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.

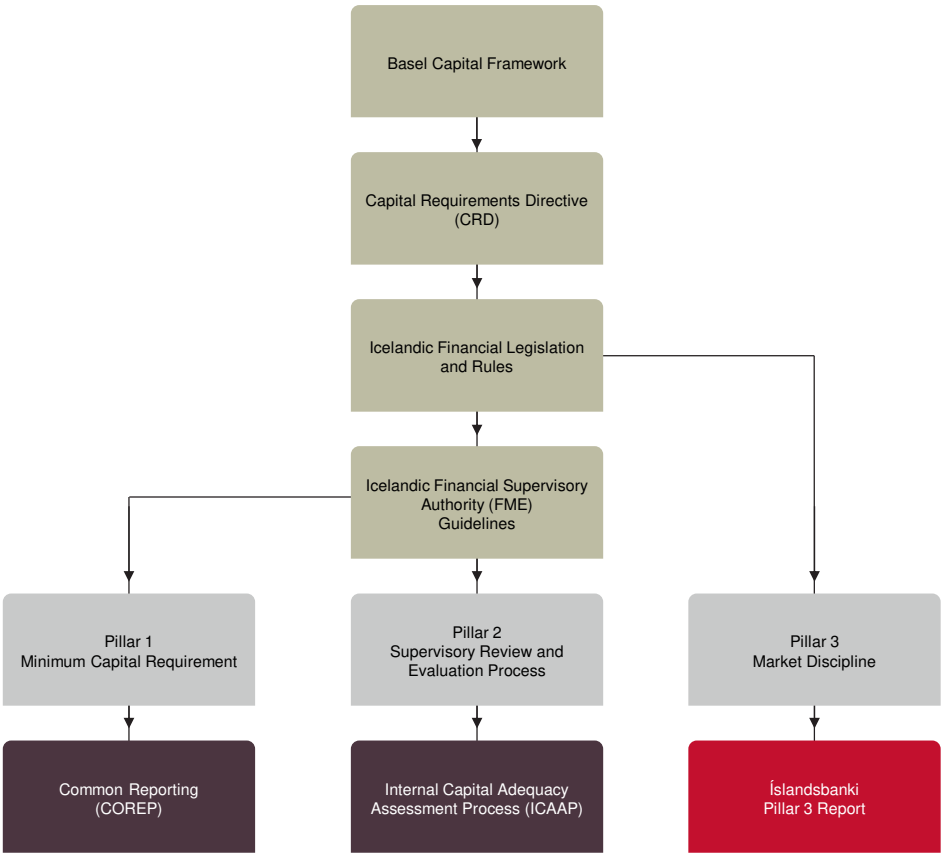

Exhibit 1.1. Regulation overview.

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 incorporate 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. According to the Icelandic Financial Supervisory Authority (FME) rules[2] Icelandic financial institutions should follow guidelines regarding Pillar 3 disclosure requirements that are stated in the CRD. Exhibit 1.1 provides an overview of the capital management regulatory framework under which Íslandsbanki operates.

The Basel Committee on Banking Supervision (BCBS) has introduced a revision of the Basel II framework, generally referred to as Basel III. The implementation of the revised framework within the European Union (EU) through the capital requirements directive, CRD IV, applies from 1 January 2014.

The CRD IV framework is not directly applicable in Iceland as Iceland is not an EU member state. The framework is however EEA-relevant and is intended to be incorporated into the EEA

[1] Capital Requirements Directive 2013/36/EU.

[2] FME Rules No. 215/2007 on the Capital Requirement and Risk Weighted Assets of Financial Undertakings.

Agreement. The transposition of the CRD IV into national law is still outstanding due to certain constitutional challenges in EEA EFTA States. Nonetheless, parts of the CRD IV framework have been implemented into Icelandic law by an amendment on the Act on Financial Undertakings.[3] The amendment incorporates the CRD IV capital buffer requirements into Icelandic law requiring Icelandic banks to hold a comprised minimum capital. The Central Bank has already adopted the CRD IV liquidity measures into the Icelandic rules on liquidity ratio.[4] 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 figures in the Pillar 3 report refer to the Bank on a consolidated level unless otherwise noted. Names and primary businesses of major subsidiaries at year-end 2015 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.[5] The Pillar 3 Report is reviewed annually and published in conjunction with the Annual Report and the Annual Statement. If material risk exposures change significantly between reporting periods, Íslandsbanki 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 2015.

The Pillar 3 Report has been prepared in accordance with the CRD[6], rather than in accordance with International Financial Reporting Standards (IFRS). This can cause some discrepancy between financial information in the Consolidated Financial Statement and information in the Pillar 3 Report. 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.

[3] Act No. 57/2015 amending Act No. 161/2002 on Financial Undertakings.
[4] Central Bank Rules No. 1055/2013 on Liquidity.
[5] https://www.islandsbanki.is
[6] Basel Committee on Banking Supervision Revised Pillar 3 disclosure requirements.

Name	Main Business	Ownership	Country
Borgun hf.	Payment processing	63.5%	Iceland
Íslandssjóðir hf.	Fund 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
Fergin ehf.	Holding company	80%	Iceland
Frumherji hf.	Commerce and services	80%	Iceland

Exhibit 1.2. Íslandsbanki's major subsidiaries at year-end 2015.

2 RISK MANAGEMENT AND CONTROL

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's risk governance is based on a three lines of defence framework and 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.

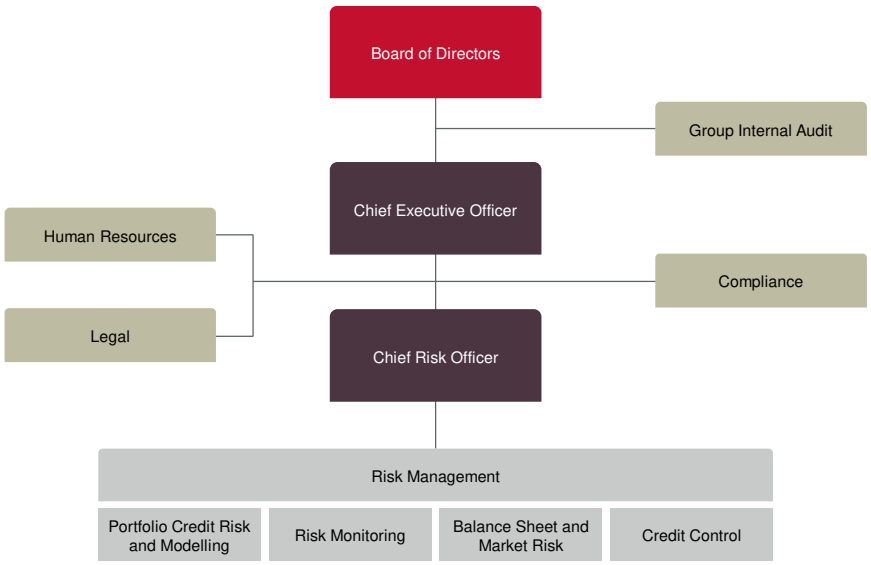

Exhibit 2.1. Risk governance and organisational structure of Risk Management.

2.1 RISK GOVERNANCE AND ORGANISATION

Íslandsbanki is exposed to various risk factors and managing these risks is an integral part of the Bank's operations. Risk governance within Íslandsbanki is based on a three lines of defence framework and aims for informed decision-making and strong risk awareness throughout the Bank.

The Bank's management body has a dual structure. The Board of Directors has a supervising role in monitoring the execution of set policies, the sound control of accounting and financial management and ensures that group internal audit, compliance and risk management are effective at all times. The Chief Executive Officer, the Chief Risk Officer, other members of the senior management and the senior management committees are responsible for implementing risk management practises and internal monitoring in accordance with Board authorisation.

Exhibit 2.1 provides an overview of the governance for risk management and control within Íslandsbanki.

The ultimate responsibility for ensuring an adequate risk management and internal control framework at Íslandsbanki lies with the Board of Directors. The Board defines and communicates the risk governance framework and the acceptable level of risk through the Bank's Risk Management and Internal Control Policy, the Risk Appetite Statement and other risk management policies.

Chief Executive Officer (CEO)

The CEO is responsible for the day-to-day operations of the Bank, pursuant to set policies and resolutions of the Board. Moreover, it is the task of the CEO to ensure that the Bank's operations are consistent at all times with applicable legislation and the Bank's Articles of Association which includes maintaining adequate and effective risk management and internal control functions. The CEO appoints the Chief Risk Officer (CRO), the Compliance Officer as well as other members of the Executive Board, the Risk Committee, the Asset and Liability Committee and the Investment Committee.

Chief Risk Officer (CRO)

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. The CRO is a member of the Executive Board.

The CRO reports directly to the Board and cannot be removed without its prior approval. Regular reporting from the CRO to the Board includes an overview of compliance to risk limits and risk appetite, review of risk aspects inherent in the Bank's remuneration system and adequacy of risk based pricing of assets and liabilities.

Risk Management

Íslandsbanki has an independent department, Risk Management, headed by the Bank's Chief Risk Officer, with staff of about 30 well educated and experienced employees.

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 as a

first line of defence to identify and manage all risks arising in their business and function.

Risk Management is responsible for maintaining and developing internal directives and processes regarding risk management and internal control. The department organises training for the Bank's employees on the Bank's policies, internal directives and processes 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 comprised of the four following 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 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 measuring, monitoring and reporting on operational risk 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 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 on 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. 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.

Chief Audit Executive (CAE)

The CAE is appointed by the Board and directs Group Internal Audit by Board authorisation. The CAE is responsible for internal audit matters within the Bank, including outsourced projects. The Internal Audit is not responsible for internal control or its implementation, but provides the Bank with independent, objective assurance and consulting services designed 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.

External Audit

As is provided for in the Articles of Association, the Bank's external audit firm is elected at the Annual General Meeting (AGM) for a term of five years. The external audit is responsible for the auditing of the annual accounts in accordance with accepted auditing standards and FME rules.[1]

Compliance Officer

As a financial undertaking licensed to conduct securities trading and an issuer of listed financial instruments, the Bank operates a compliance department. The Bank's Compliance Officer is appointed by the CEO, subject to Board confirmation. The Compliance Officer is responsible for regular monitoring and assessment of the suitability and efficacy of the Bank's measures concerning securities transactions and anti-money laundering in accordance to Icelandic law.[2]

2.2 RISK MANAGEMENT COMMITTEE STRUCTURE

Íslandsbanki emphasises sound governance principles. All business decisions and the resulting risks are initiated and owned by a business unit and go through a clearly defined internal approval and control process. The level of authority needed to approve each business decision depends on the size, complexity and risk

[1] FME Rules No. 532/2003 on the Auditing of Financial Undertakings.
[2] Act No. 64/2006 on Measures against Money Laundering and Terrorist Financing.

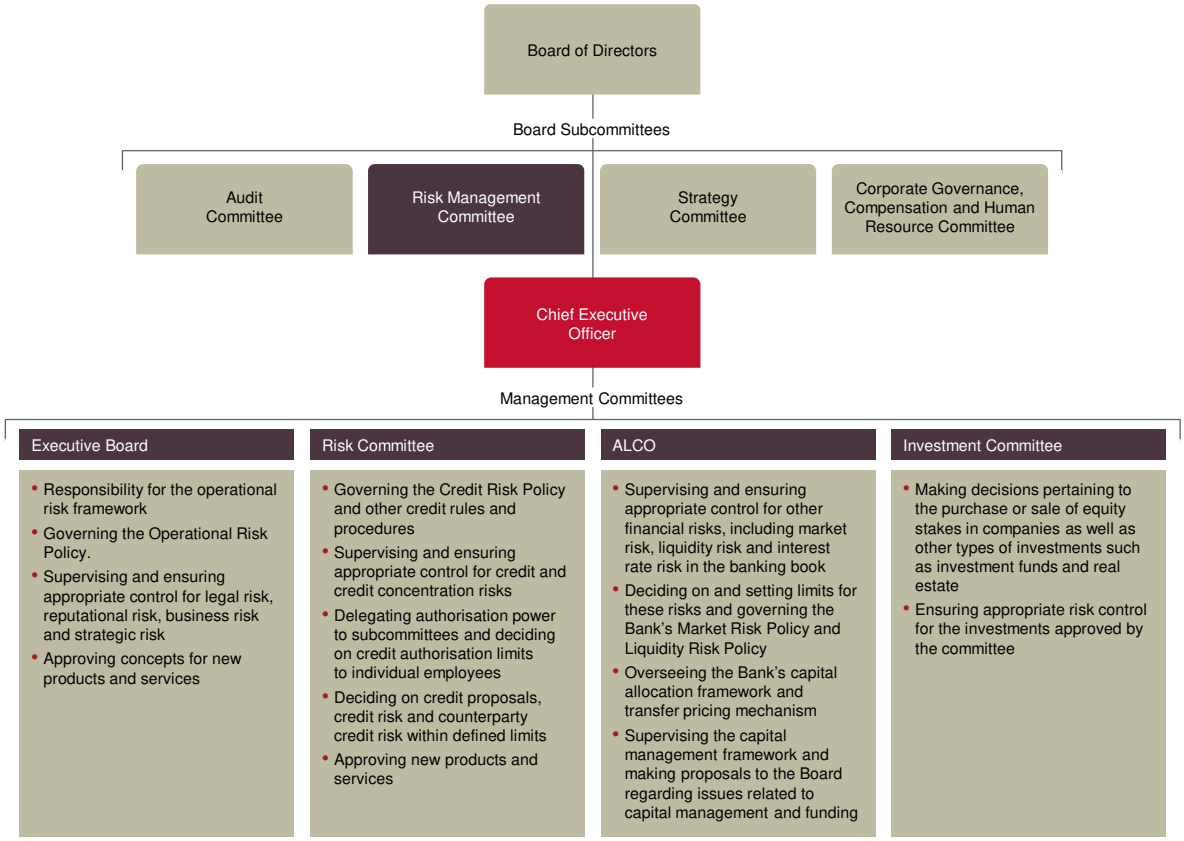

Exhibit 2.2. Risk Management committee structure.

involved. 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 *Good Governance Policy (see in Section 2.2.2)*. The corporate governance structure is further described in the Annual Report 2015.[3]

The organisational structure for committees governing the different risk factors that the Bank is exposed to is shown in Exhibit 2.3.

As mentioned, the ultimate responsibility for ensuring an adequate risk management and internal control framework lies with the Board of Directors. In order to assist the Board in fulfilling its oversight responsibilities, the Board has appointed four board subcommittees. Two of those committees, The Audit Committee and the Risk Management Committee, are provided for in Icelandic law.[4] The committee structure and responsibilities relevant to risk management is shown in Exhibit 2.2.

The implementation of the risk management policies and internal controls in accordance with Board authorisation is delegated to the management committees: the Executive Board, the Risk Committee, the Asset and Liability Committee (ALCO), and the Investment Committee. Under this authorisation, these management committees issue 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.

[3] Íslandsbanki's Annual Report 2015.
[4] Act No.161/2002 on Financial Undertakings.

2.2.1 BOARD SUBCOMMITTEES

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.

Risk Management Committee

The Board Risk Management Committee, comprising at least 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*, the *Risk Appetite Statement* and other risk related policies set by the 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.

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*. In addition, the Executive Board supervises reputational risk, business risk and strategic risk. The Executive Board approves concepts for new products and services 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. As described above all credit proposals that are decided upon by the Risk Committee or its subcommittees are initiated, and the respective risk owned, by a business unit.

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 7.11.

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 funding strategy and transfer pricing mechanism. The committee supervises the capital management framework, including the *Internal Capital Adequacy Assessment Process (ICAAP)* and the *Pillar 2 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, other than those originated in the trading book. The Investment Committee is responsible for ensuring appropriate risk control for the investment decisions approved by the committee.

Good Governance Policy

As part of the Bank's commitment to sound corporate governance, the Board adopted Íslandsbanki's *Good Governance Policy*, a matrix for material bank actions, in 2012. The policy is a decision-making matrix that 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 after consultation with the best-qualified parties within the Bank and on the basis of 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 reviews and decides on material risk factors within Íslandsbanki and accordingly defines the Bank's risk appetite. The Risk Management department is responsible for the process of 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 business 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 overall 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*.

Other risk types that are not covered in separate risk policies are assessed through the annual ICAAP process and addressed in other risk policies and management reports in accordance with their nature and importance.

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

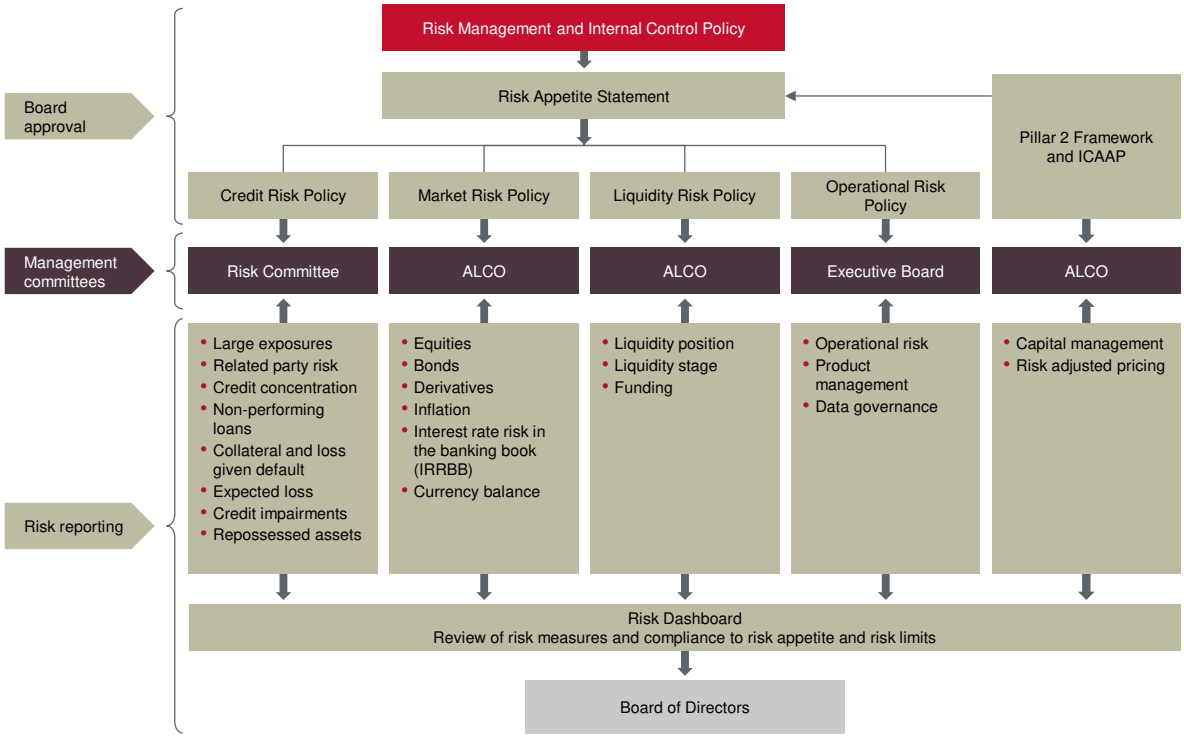

Exhibit 2.3. Risk Management organisational structure subject to Board approval and risk reporting structure.

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 and risk appetite 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 of the Capital Requirements Directive. The objective of the document is to provide a high level overview of how each of the Pillar 2 functional components is covered within the Bank's risk management and risk governance framework.

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.

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 and the Investment Committee. 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.

2.3.2 EXTERNAL REPORTING

The Bank publishes financial information mainly through the Annual Report, Financial Statements, the Pillar 3 Report and in investor presentations. All of these are available on the Bank's website.[5]

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 papers both on NASDAQ Iceland and on the Irish Stock Exchange. The framework for public disclosure regarding the Bank's risk and financial positions is described in a *Disclosure & Communication Policy* approved by the Board.

[5]www.islandsbanki.is

3 CAPITAL MANAGEMENT

The Bank's capital position continued to strengthen throughout 2015 and at the end of the year the Bank's capital ratio was 30.1%, well in excess of both the Bank's minimum capital target and regulatory requirements.

Íslandsbanki´s Board of Directors has decided to increase the Bank´s minimum capital ratio from 18% to 23% for the near and medium term. The increase is based on more conservative requirements set forth by the Icelandic regulator and on the Bank's view that it is prudent to retain a sizable strategic capital buffer through the near-term steps being taken towards the lifting of capital controls in Iceland. The Bank expects to be able to give more clarity on the medium- to long-term capital targets in the next 12–18 months, as further clarity is expected regarding the regulatory capital requirements and the Bank's operating environment.

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)[1] as adopted into Icelandic law.

The Board of Directors is responsible for the Bank's capital management 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) governs the capital management of the Bank in accordance with the capital targets set by the Board and reviews proposals to the Board regarding issues related to capital management including the dividend policy.

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 calculations of the allocated 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 for Board approval. Finance is responsible for reporting on the risk-adjusted performance down to individual business units.

3.2 TOTAL CAPITAL AND CAPITAL RATIOS

At year-end 2015 the Bank's total capital amounted to ISK 211 billion as compared to ISK 206 billion at year-end 2014. Most of the capital, ISK 198 billion, is comprised of Common Equity Tier 1 (CET1) 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 decreased by 20% in 2015 since the remaining term is less than five years. After that, there is an annual linear decrease by 20% until maturity in 2019. Items deducted from the capital base are intangible assets that are deducted from CET1 and holding in financial institutions which are deducted 50% from the CET1 and 50% from the Tier 2 capital. A breakdown of the Bank's total 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. Details regarding the Bank's capital requirements can be found in Section 3.2.1.

Exhibit 3.3 shows the main changes in risk weighted assets during the year 2015. The largest increase in RWA during the year was due to new lending, which was offset by a decrease in the currency imbalance.

CAPITAL REQUIREMENTS

The Board of Directors sets a minimum capital target for the Bank, expressed as the ratio between capital and risk-weighted assets. The minimum capital target is intended to ensure that the Bank's capitalisation remains above regulatory requirements at all times. The target is based on the results from the Internal Capital Adequacy Assessment Process (ICAAP), the views expressed by the regulator through the Supervisory Review and Evaluation Process (SREP), implementation of the CRD IV capital buffers and other factors such as uncertainties in the operating environment, a possible target rating or other external factors. The following sections describe each component in more detail.

3.2.1 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%.

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 requirements and thereby risk-weighted assets (RWA). For credit risk and market risk, the Bank uses the standardised approach to calculate the capital requirements and for operational risk the Basic indicator approach. The minimum capital requirements under Pillar 1 are 8% of RWA.

[1] Capital Requirement Directive 2013/36/EU.

Capital	31.12.2015	31.12.2014
Common equity Tier 1 Capital	198,117	184,347
Ordinary share capital	10,000	10,000
Share premium	55,000	55,000
Other reserves	6,002	2,535
Retained earnings	127,288	116,288
Non-controlling interests	3,937	1,664
Tax assets	-	(521)
Intangible assets	(1,331)	(619)
Other regulatory adjustments	(2,779)	
Tier 2 capital	12,835	21,730
Qualifying subordinated liabilities	19,517	21,306
Adjustment to eligible capital instruments	(3,903)	
Other regulatory adjustments	(2,779)	
Total Capital base	210,952	205,653

Exhibit 3.1. Breakdown of the capital base at year-end 2015 and 2014 (ISK m). Consolidated.

Íslandsbanki's capital requirements and RWA	Pillar 1 capital requirements	RWA	Pillar 1 capital requirements	RWA
	31.12.2015		31.12.2014	
Credit risk	48,527	606,591	46,670	583,375
Central governments or central banks	51	633	76	954
Regional governments or local authorities	207	2,587	231	2,884
Administrative bodies and non-commercial undertakings	87	1,093	93	1,162
Financial institutions	651	8,134	632	7,906
Corporates	28,280	353,501	25,578	319,730
Retail	11,792	147,399	11,998	149,976
Secured by real estate property	3,852	48,144	3,235	40,442
Past due items	817	10,207	1,125	14,066
Collective investments undertakings (CIU)	23	290	5	67
Property, equipment, non-current assets held for sale and other assets	2,145	26,811	2,904	36,305
Fair value shares, investment in associates and shares held for sale	623	7,792	791	9,884
Market risk	1,329	16,607	2,666	33,327
Traded debt instruments	268	3,350	318	3,975
Shares and equity instruments	527	6,582	210	2,620
Foreign exchange	534	6,676	2,139	26,732
Operational risk	6,120	76,495	6,272	78,401
Total	55,975	699,693	55,608	695,102
Tier 1 capital		198,117		184,347
Capital base		210,952		205,653
Tier 1 capital ratio		28.3%		26.5%
Capital ratio		30.1%		29.6%

Exhibit 3.2. Pillar 1 capital requirements, RWA and capital ratios at year-end 2015 and 2014 (ISK m). Consolidated.

Credit risk

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.

Market risk

For traded debt instruments, the capital requirement is generally in the range of 0–12% of the net exposure, based on the creditworthiness of the issuer and the term of the instrument. For traded equity instruments, the capital requirement is 16% of the net exposure. For foreign exchange risk, the minimum capital

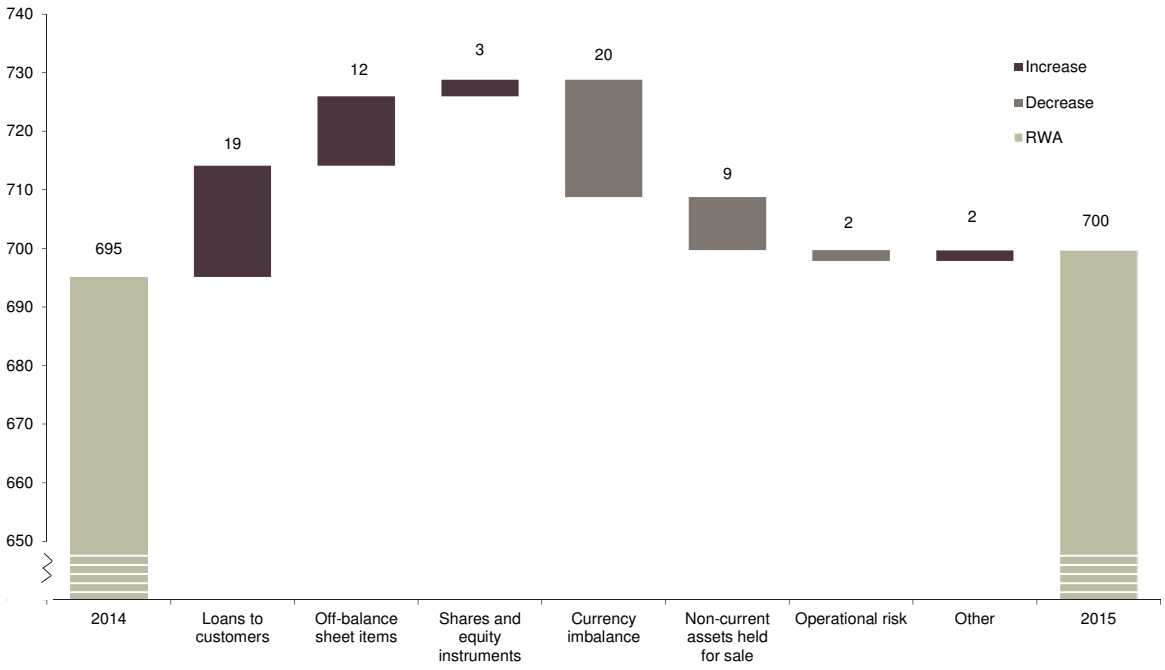

Exhibit 3.3. Changes in risk-weighted assets (ISK bn).Consolidated.

requirement is 8% of the maximum of the Bank's total long and total short positions in foreign currencies.

Operational risk

The Bank uses the Basic Indicator Approach, where 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 RWA for credit risk.

3.2.2 PILLAR 2 ADDITIONAL CAPITAL REQUIREMENTS

In addition to the minimum capital requirements for credit risk, market risk and operational risk under Pillar 1 financial institutions are required to make their own assessment of the overall capital requirements of the institution. These additional capital requirements, taking into account the risk profile of the institution, are referred to as Pillar 2 capital requirements.

In the ICAAP 2015, the main factors contributing to additional capital requirements under Pillar 2 for Íslandsbanki were:

- *Additional capital requirements for risk factors already covered under Pillar 1:* Credit risk and market risk.
- *Additional capital requirements for risk factors not addressed under Pillar 1:* Interest rate risk in the banking book (IRRBB), market risk arising from equities in the banking book, the inflation imbalance and legal risk.

The Pillar 2 capital requirements are presented as a proportion of RWA in addition to the regulatory capital minimum of 8% under Pillar 1. Based on the 2015 SREP, the additional capital required for Íslandsbanki under Pillar 2 was 3.9%.

The ICAAP/SREP is a dynamic process and the resulting capital requirements under Pillar 2 can change somewhat over time. Further clarity regarding some issues, for example relating to the interaction between items covered under Pillar 2 and in the CRD IV capital buffers, is expected through the dialogue with the FME in the 2016 SREP.

3.2.3 CAPITAL BUFFER TO ACCOUNT FOR STRESS EVENTS

Íslandsbanki's stress testing framework aims at detecting the sensitivity of the Bank's operations to changes in the operating environment. The results are used to assess the need for additional capital to ensure that even under stress the Bank's capitalisation remains above the minimum requirements. The stress tests performed can be split into five categories:

- *Sensitivity analysis:* Assessing the impact of a predefined shift in risk factors on the Bank's income statement and balance sheet.
- *Business stress scenario*: Assessing the impact of an adverse development of key drivers in the business plan, irrespective of the state of the economy.
- *Singular adverse events:* Assessing the combined impact at a predefined confidence level of a series of singular events that the Bank believes might occur with a defined probability.
- *Reverse stress tests:* Given a significant negative outcome, the business units try to identify possible causes and consequences that could have led to such an outcome. The results are used in identifying vulnerabilities in the business plan and in constructing the economic stress scenario.
- *Economic stress scenario*: Assessing the combined impact of a shock to the economy on the Bank's income statement and balance sheet. The results from both the sensitivity analysis and the reverse stress tests are used to derive at a severe but plausible macro-economic stress scenario.

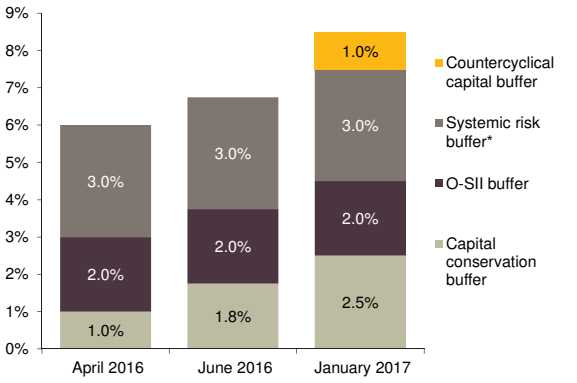

Exhibit 3.4. Implementation plan for the CRD IV capital buffers. * The Systemic risk buffer only applies to domestic RWA.

The combined results from the above stress testing components comprise the capital buffer needed to ensure that the Bank's capitalisation remains above the minimum capital requirements.

3.2.4 CRD IV CAPITAL BUFFERS

The interpretation of the Basel III framework and the resulting implementation differs somewhat between countries. The capital buffers, as provided in the CRD IV, were incorporated into Icelandic law with a bill amending the Act on Financial Undertakings.[2]

The Financial Supervisory Authority is authorised to determine the size of the capital buffer for systemically important financial institutions (O-SII buffer), the systemic risk buffer and the countercyclical capital buffer based on recommendations from the Financial Stability Council[3], whereas according to law the size of the capital conservation buffer is fixed at 2.5% as of 1 January 2017. Exhibit 3.4 shows implementation plan for the capital conservation buffer and the suggestion, from the Financial Stability Council, for the implementation of other CRD IV capital buffers in Iceland. The systemic risk buffer only applies to domestic RWA and translates to 2.5% of total RWA for Íslandsbanki.

3.2.5 STRATEGIC ADD-ON AND CAPITAL TARGET

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.

The current minimum capital target ratio approved by the Board of Directors is 23% for the near to medium-term. The capital target is above the regulatory requirements and has been increased from the earlier target of 18%. The increase is based on more conservative requirements set forth by the Icelandic regulator and on the Bank's view that it is prudent to retain a sizable strategic capital buffer through the near-term steps being taken towards the lifting of capital controls in Iceland. The Bank expects to be able to give more clarity on the medium to long-term targets in the next 12–18 months, subject to further clarity on regulatory capital requirements.

[2] Act No. 161/2002 on Financial Undertakings.
[3] Article 84(b), Paragraph 1 through Article 84(d) of Act No. 161/2002 on Financial Undertakings.

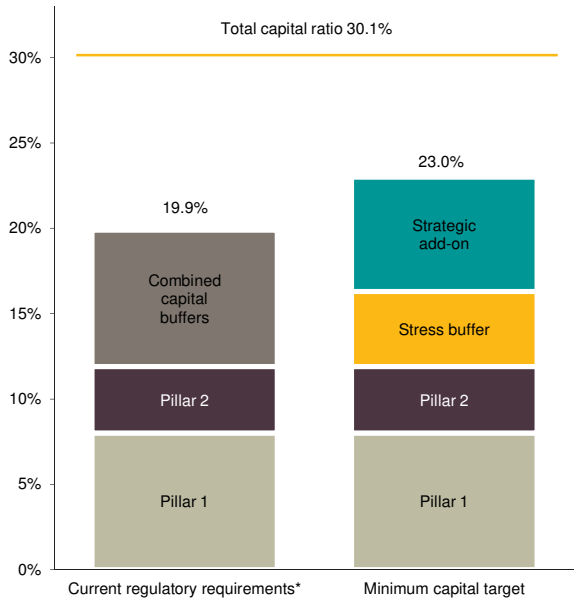

Exhibit 3.5. Current regulatory requirements compared with Íslandsbanki's minimum capital target. *Assuming full implementation of capital buffers as shown in Exhibit 3.6.

3.3 CAPITAL COMPOSITION

According to the CRD, the following restrictions apply to the composition of capital held under Pillar 1:

- Common equity Tier 1 (CET1) at a minimum 4.5% of RWA
- Tier 1 capital including alternative Tier 1 (AT1) at a minimum 6.0% of RWA
- A total capital ratio including Tier 2 debt at a minimum 8.0% of RWA

The CRD IV capital buffers shall be comprised only of Common Equity Tier 1 capital. In addition, the FME has proposed that capital held under Pillar 2 is subject to the same proportional restrictions as capital held under Pillar 1. Exhibit 3.6 shows the composition of the Bank's capital and the minimum requirements for CET1 capital under Icelandic rules.

3.4 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 3.7 shows the average proportional split of allocated capital in 2015.

3.5 CRD IV – LEVERAGE RATIO

The leverage ratio is a measure introduced in the CRD IV, supplementing the risk-based capital requirements. A lower leverage ratio indicates higher leverage. The leverage ratio is calculated by dividing Tier 1 capital with the sum of total assets and adjusted off-balance sheet exposures. Currently, no minimum has been set for the leverage ratio under CRD IV but based on the levels discussed until now the leverage ratio is not expected to be restrictive for Íslandsbanki.

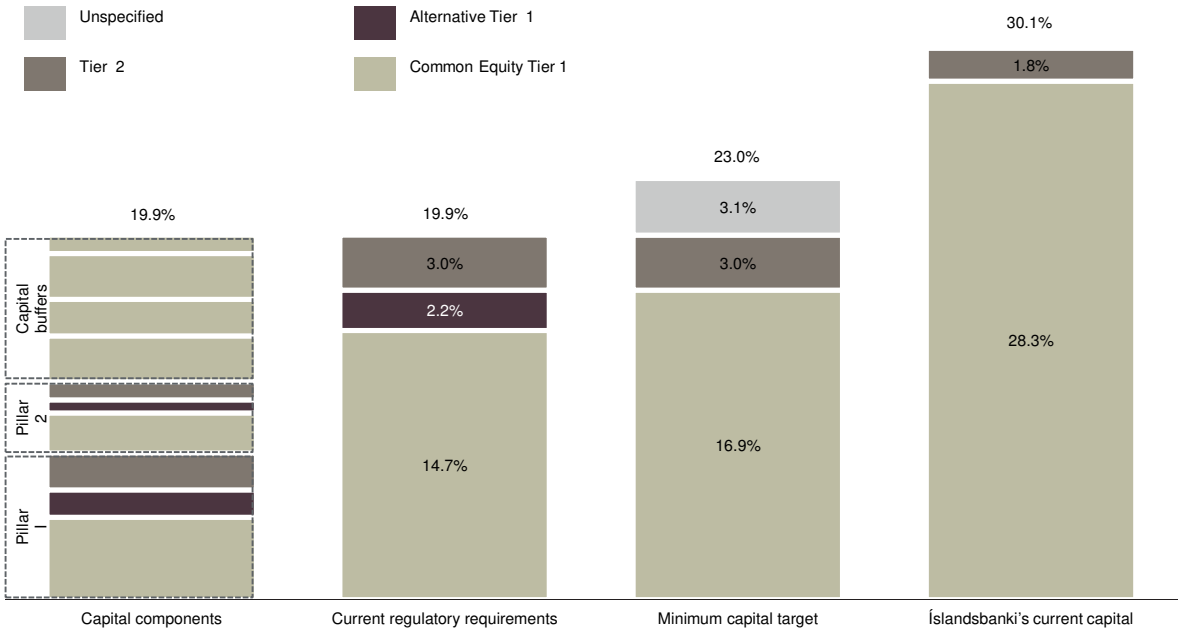

Exhibit 3.6. Composition of the Bank's capital, the target composition of the capital target and the minimum requirements for CET1 capital under Icelandic rules.

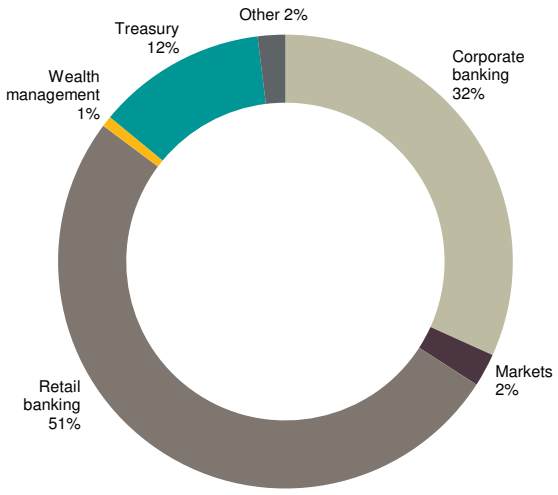

Exhibit 3.7. Proportional split of allocated capital in 2015. Parent.

Exhibit 3.8 shows the leverage ratio at year-end 2015 and 2014 as well as the ratio between RWA and total assets. The change in the leverage ratio is explained by balance sheet growth and the changes in the ratio between RWA and total assets throughout 2015 are mainly due to increase in assets with low risk weight in the liquidity portfolio.

	31.12.2015	31.12.2014
Tier 1 capital	195	185
Total exposure	1,082	945
RWA	700	695
Total assets	1,046	911
Leverage ratio	18.1%	19.5%
RWA/Total assets	66.9%	76.3%

Exhibit 3.8. Leverage ratio and RWA over total assets (ISK bn). Consolidated.

REGULATORY CHANGES

Amendments to Act No. 161/2002 on Financial Undertakings (implementing the CRD IV)

The amendment was made to adapt Icelandic legislation to EU rules on financial operations. The amendment implemented Directive 2013/36/EU of the European Parliament, the CRD IV, into Icelandic legislation. The amendments mainly regarded provisions on operating licenses, treatment of risks, qualifying holding, Board of Directors and personnel, internal control, performance based remuneration schemes, large exposures, own funds and capital buffers. The amendment also stipulated that financial undertakings are required to maintain a capital conservation buffer of 2.5% of their total risk exposure amount. The Financial Supervisory Authority is further authorised to impose a capital buffer for systemically important financial institutions, a systemic risk buffer and a countercyclical capital buffer upon receipt of recommendations from the Financial Stability Council. The amendments came to effect on 16 July 2015.

Other new regulatory changes in 2015 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 2015 the Bank's total exposure to credit risk amounted to ISK 1,046 billion compared to ISK 904 billion at the end of 2014. This represents an increase of almost 16%. Despite the competitive lending market in Iceland, the loan portfolio grew by 5% in 2015 after a 15% increase in the previous year.

The credit quality of the loan portfolio continued to increase. Problem loans, namely loans that are either impaired or more than 90 days past due, are down from 3.5% to 2.2%, which is around the 25% quantile for European banks.

The Bank has in the last few years built up some exposure in the North-Atlantic region and a part of that exposure has been affected by the volatility of oil prices in 2015 and early 2016. The Bank has at year-end 2015 already recognised the impairment loss deemed appropriate, based on the risks related to the exposure.

This chapter includes a description of the Bank's credit process, risk assessment models and a detailed breakdown of the loan portfolio that gives an indication of concentration and credit quality. There are a few new disclosures compared to last year's report. The observed default frequency is compared to the predicted probability of default and the changes in stock of defaulted loans is shown. The distribution in loan to value bands is now shown for all types of loans while only mortgages and leasing agreements were shown in last year's report.

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.

Credit concentration risk is the increase in risk that is driven by common underlying factors, such as 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 probability 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 and 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, shown in Exhibit 4.1, is based on a committee structure. 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 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, such as relatively small overdrafts to individuals, no collateral is required, given that the customer's creditworthiness meets the Bank's criteria. 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 that reviews and proposes guidelines for the valuation of collateral and pledged

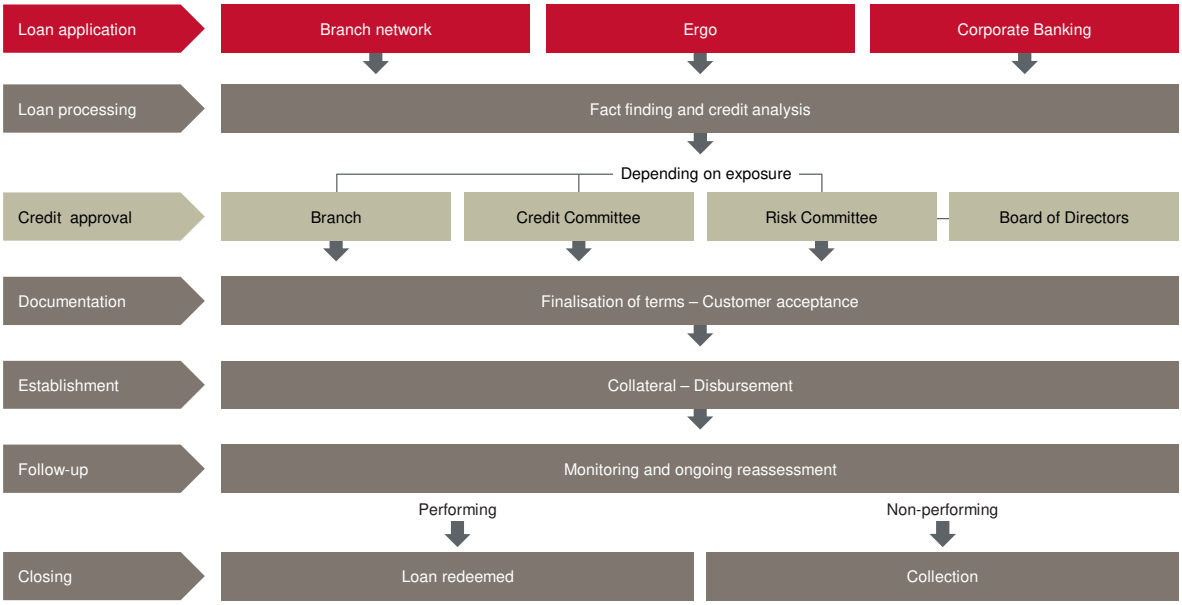

Exhibit 4.1. Schematic overview of the Bank's credit process.

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.

Monitoring of the loan portfolio is continuous and customers' performance is reassessed periodically. Collection procedures are set to be agile and swift to keep arrears at minimum. Loan covenants are specially monitored and actions are taken to protect the Bank's interests if there are covenant breaches.

Customers who show signs of being in financial difficulties are put on a watch-list and monitored carefully. When restructuring measures are considered to be more appropriate than collection procedures, the Bank can offer several measures and restructuring frameworks for its customers in financial difficulties. These forbearance measures include temporary payment holidays, extension of loan terms, capitalisation of arrears and waiving of covenants. In many cases these measures are precursors to a more formal restructuring process.

Formal legal collection and liquidation of collateral is the final step of the collection process if other measures are not successful.

4.2 MEASUREMENT AND MONITORING

Portfolio credit risk is measured both in terms of current events and possible future events. Current events include non-performing ratios, the scope of forbearance agreements and impairment allowance, while possible future events are captured by measurements such as the probability of default which is described in this section.

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 long-term expected credit loss on the loan portfolio is covered by a part of the interest rate margin. Due to various underlying factors, the observed annual losses can fluctuate significantly around the long-term average, sometimes up to an order of magnitude. 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 also needs to be covered by the 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. These correlations may be due to common dependencies on macroeconomic factors or due to business relations between individual obligors.

4.2.1 PROBABILITY OF DEFAULT (PD)

Obligors are considered to be 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. Defaults are defined 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 for different obligor types and the number of obligors and relative size of exposure for each obligor type.

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

IFRS 9 FINANCIAL INSTRUMENTS

A new accounting standard that changes requirements for credit risk impairment must be adopted from 1 January 2018 with early application permitted. The impairment model in the new standard is an expected credit loss model and will replace the IAS 39 incurred loss model.

All loans will be required to carry an impairment allowance of either 12-month expected credit loss or, in case there has been a significant increase in credit risk since origination, lifetime expected loss.

It will therefore be more costly for the Bank to have loans with a significant increase in credit risk. Forbearance agreements and being more than 30 days past due are examples of indicators that should be used to identify increased credit risk.

The Bank is currently designing and implementing the necessary changes to systems and processes to adopt the expected credit loss model. The new requirement is expected to lead to greater loss allowances but it is not yet clear exactly how large the effect will be. This change will reduce the Bank's capital base but should at the same time reduce regulatory capital requirements.

The new accounting standard might also lead to changes in the way the Bank conducts business. Any payment behaviour that leads to impairment allowance of lifetime expected loss will for example be strongly discouraged.

Obligor type	PD assessment	Number of obligors	Exposure
		(count)	(%)
Individuals	Statistical model	90,000	26.7
Small companies	Statistical model	9,000	8.1
Large companies	Hybrid model	300	33.7
Foreign banks	External rating agencies	50	3.8
Regional governments	Expert model	20	1.2
Sovereigns	External rating agencies	10	26.4
Public sector entities	Expert model	10	0.1

Exhibit 4.2. Methods used to assess the default risk of different obligor types, number of obligors and relative size of exposure at year-end 2015. 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.

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. Here the Bank defines a small company as a company with a total exposure to the Bank of less than ISK 150 million. These models are behavioural scoring models and use information about a customer's payment history, amount of debt, deposits and demographic variables to assess the probability that a customer will default on any of their obligations within 12 months of the rating assessment.

Exhibit 4.3 shows the mapping from risk classes to the probability of default (PD) for the three different rating models. The PD corresponds to the observed long-term average default rate.

4.2.2 COMPARISON OF OBSERVED DEFAULT FREQUENCY AND PREDICTED PROBABILITY OF DEFAULT

The Bank's PD models predict the average long-term default rate while the observed default frequency (ODF) depends on the current state of the economy, which in the year 2015 was considered to be better than average.

In the year 2015 there were only about a dozen of observed defaults for large companies which translates to a 5.2% default frequency compared to a predicted default probability of 5.4%. The defaults were too few to make a meaningful comparison of observed default frequency and predicted probability of default per risk class.

For individuals and small companies, however, the number of defaults allow for a breakdown by risk classes as shown in Exhibits 4.4 and 4.5. Risk classes 1 through 4 are grouped together due to few defaults in those risk classes. Error bars on each observed default frequency represent 95% confidence intervals based on the observed defaults in 2015. As expected, given the current state of the Icelandic economy, the observed default frequency is predominantly lower than the predicted long-term default rate. The observed default frequency was 3.1% compared to the 8.0%

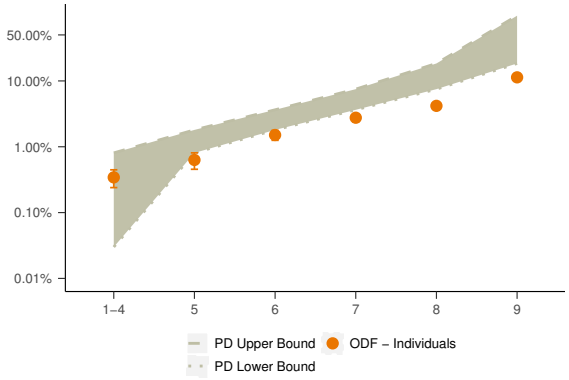

Exhibit 4.4. Observed default frequency and predicted probability of default by risk class for individuals in 2015.

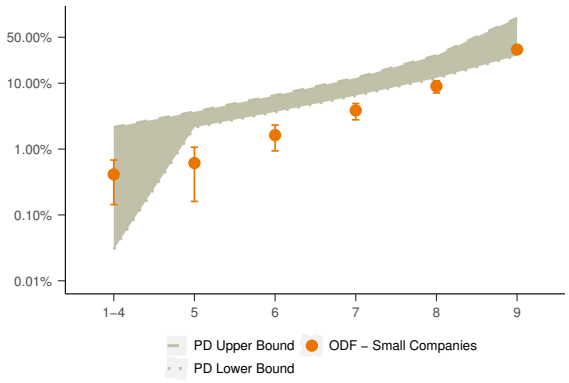

Exhibit 4.5. Observed default frequency and predicted probability of default by risk class for small companies in 2015.

predicted probability of default for individuals, corresponding rates were 5.5% and 9.1% for small companies, respectively.

4.2.3 LOSS GIVEN DEFAULT (LGD)

The loss given default (LGD) represents the percentage of the exposure which is expected to be lost if an obligor goes into default. The loss given default mostly depends on collateralisation and other credit mitigants but in many cases defaulted customers become performing again without the need to seize collateral. To take historically observed loss experience into account, while also allowing for a risk-sensitive differentiation of the portfolio, loss given default is therefore modelled using loss severity and 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 to individuals, other loans to individuals, loans to small companies and loans to large companies. The Bank does not use an internal LGD model for loans to regional governments, sovereigns and banks.

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, haircuts dependent on collateral type 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. The haircuts take into account cost of sale, depreciation of value and discounting of recovery cash flows.

The loss rates are inferred from historical loss experience while the loss severities are based on current collateralisation levels and the loss parameters for each collateral type. This method takes the historical long-term losses into account while allowing for a risk-sensitive differentiation of the portfolio.

4.2.4 EXPOSURE AT DEFAULT (EAD)

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

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

The Bank is in the process of developing a more sophisticated model for exposure at default that will be used in calculations of both the 12-month and life-time expected credit losses in IFRS 9. In the more sophisticated model the expected amortisation schedule will be taken into account.

4.2.5 EXPECTED CREDIT LOSS

Having obtained the risk parameters PD, LGD and EAD, the long-term expected credit loss can be computed. Exhibit 4.6 summarises the results for the performing part of the loan portfolio at year-end 2015. Loans to banks, sovereigns and regional governments are excluded from this analysis.

These results do not incorporate forward-looking information as will be required in IFRS 9 and therefore the 12-month expected credit loss cannot be used unchanged as an indication of the impairment allowance after the adoption of IFRS 9.

4.3 CREDIT CONCENTRATION

The Bank monitors credit concentration risk which arises from the unequal and granular distribution of exposure to borrowers, industry sectors and geographic regions. The portfolio concentration is monitored with Herfindahl-Hirschman Indices and relative to limits set in the *Credit Risk Policy*.

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[1]. 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 in line with Icelandic law[2] where groups of connected clients are defined.

[1] FME Rules No. 625/2013 on Large Exposures.
[2] Article (1)(a) in Act No. 161/2002 on Financial Undertakings.

Asset class	EAD	Loss rate	Severity	LGD	EL
	(% of portfolio)	(%)	(%)	(%)	(%)
Individuals - Mortgage	28.6	23	12	3	0.3
Individuals - Leasing	1.6	28	25	7	0.9
Individuals - Other	9.8	26	70	18	2.2
Small companies	9.8	29	42	12	1.8
Large companies	50.1	35	32	11	0.4
Total	100.0				0.7

Exhibit 4.6. Exposure at default (EAD), loss rate, severity, loss given default (LGD) and expected loss (EL) for various asset classes at year-end 2015. Only the performing part of the portfolio is considered here. Parent.

At year-end 2015, 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 limit 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. a holding company may be classified in the sector of its investments and not as an investment company if all the investments are in the same sector. This is done to better capture the underlying risk of economic industry sectors.

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 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, for example 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, that is 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.

Most of the Bank's activities are in Iceland but in the last few years the Bank has increased its international activities. The overseas strategy is built on a heritage of servicing the core industries in Iceland, primarily focusing on the seafood industry and offshore service vessels. The strategy focuses on the North Atlantic region, including Norway, the Faroe Islands, Greenland, Canada and the United States.

4.3.4 PRODUCT CONCENTRATION AND COLLATERAL CONCENTRATION

The Bank regularly monitors product concentration and collateral concentration but neither type is currently considered to be material.

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 direct credit exposure to securitisation.

Exhibit 4.7 summarises and describes the main sources of credit risk, while Exhibits 4.8 and 4.9 show the main sources for credit risk and asset risk at year-end 2014 and 2015. Asset risk is further explained in Section 4.10.

4.5.1 LOANS TO CUSTOMERS

Loans to customers, both individuals and companies, represent the largest part of the Bank's credit risk exposure. This section discusses the portfolio of loans to customers and shows a breakdown by various risk factors separately for loans to individuals and loans to companies.

Item	Obligor type	Description
Loans to customers	Individuals	Loans to individuals derive from lending activities to individuals and households. The largest product type is mortgages but it also includes leasing agreements, term loans, credit cards and overdrafts.
	Legal entities, municipalities and state guaranteed obligors	Loans to companies as well as municipalities and public sector entities. This includes long-term facilities, leases and assets based financing, working capital facilities and other short-term financing, project finance and financing of income producing real estate.
Balances with the Central Bank and loans to credit institutions	Financial institutions and central banks	Mandatory reserve deposits and other balances with the Central Bank as well as other exposure to international banks and financial institutions, for example as part of the Bank's liquidity management.
Bonds and debt instruments	Government entities, issuers of listed bonds approved by the Bank's credit committees	The Bank is exposed to credit risk as a result of trading and investing in debt instruments, for example as part of the Bank's liquidity management and its trading activities
Guarantees and undrawn commitments		This includes unused overdrafts and credit card limits, letters of credit and export documentary credits
Derivatives	Qualified counterparties with defined credit limits at the Bank	Derivatives and other financial instruments that involve contingent exposures
Other financial assets		Unsettled transactions, account receivables

Exhibit 4.7. The main sources of credit risk.

Credit risk	31.12.2015	31.12.2014
Loans to customers	668.2	637.7
Balances with the Central Bank and loans to credit institutions	252.3	138.5
Bonds and debt instruments	78.6	87.3
Guarantees and undrawn commitments	37.0	30.0
Derivatives	4.4	4.1
Other financial assets	5.5	6.6
Total	1,046.1	904.2

Exhibit 4.8. The main sources for credit risk at year-end 2015 and 2014 (ISK bn). Consolidated.

Asset risk	31.12.2015	31.12.2014
Repossessed assets held for sale	5.5	8.6
Assets of disposal groups classified as held for sale	7.3	13.1
Total	12.8	21.6

Exhibit 4.9. Asset risk at year-end 2015 and 2014 (carrying amount, ISK bn). Consolidated.

Development of the Loan Portfolio

At year-end 2015 the loan portfolio was ISK 668 billion, having grown from ISK 638 billion at year-end 2014. The growth is mainly due to new lending to new and existing customers. New lending surpasses instalments, repayments, write-offs and other items such as changes in overdrafts and credit cards. Exhibit 4.10 shows the development of the loan portfolio through the year 2015.

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 believes that there are currently no FX loans in the portfolio serviced with ISK cash flow. Exhibit 4.11 shows a breakdown of loans to customers by industry sector and currency types. Exhibit 4.12 shows the development of the currency composition of customer loans from year-end 2010 to 2015.

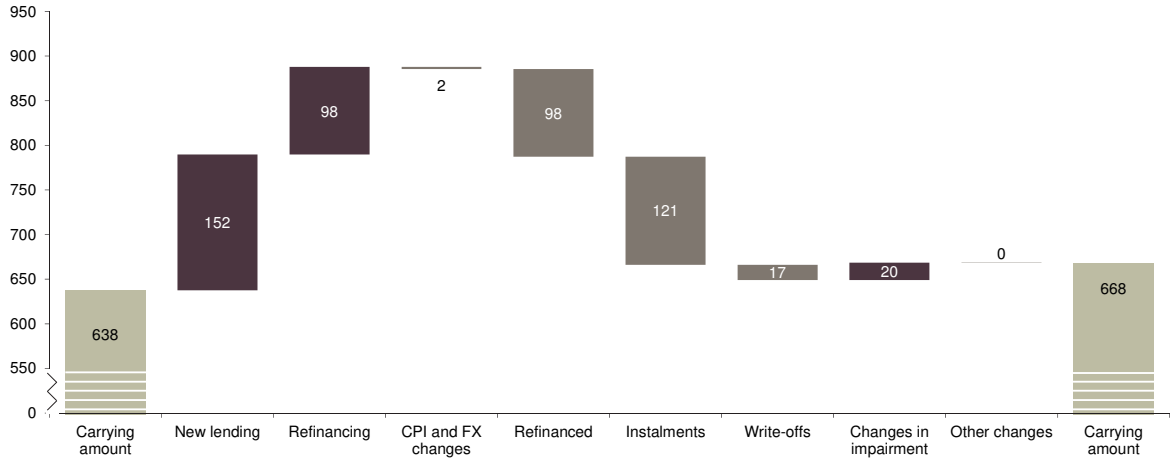

Exhibit 4.10. Waterfall chart showing the main sources of changes in carrying amount from year-end 2014 to year-end 2015. Outstanding loans that are refinanced within the Bank are shown both as an increase and a decrease in the carrying amount. The effect of facilities that do not have a fixed repayment schedule such as overdrafts and credit cards is in *Other changes*. (ISK bn). Consolidated.

Industry sector	Non-indexed	CPI-linked	Foreign currency	Total
Individuals	128.6	143.5	0.5	272.6
Commerce & services	80.7	7.4	1.7	89.8
Construction	19.6	2.6	0.8	23.0
Energy	2.6	0.9	0.3	3.7
Financial services	0.1	-	-	0.1
Industrials and transportation	33.8	4.1	22.8	60.7
Investment companies	12.1	2.0	5.3	19.4
Public sector & non-profit organisations	7.4	6.4	0.1	13.9
Real estate	34.2	55.4	9.4	99.1
Seafood	6.7	0.7	78.5	85.9
Total	325.7	223.0	119.5	668.2

Exhibit 4.11. Currency composition of loans to customers at year-end 2015 (carrying amount, ISK bn). Consolidated.

Loans to Individuals

Loans to individuals amounted to ISK 273 billion at the end of the year 2015 compared to ISK 263 billion the year before. New loans and refinancing amounted to ISK 44 billion.

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.

The largest part of loans to individuals is in the form of residential real estate mortgages. Mortgages are granted to individuals to buy or refinance real estate for their own use. Mortgages are secured by the first lien on the residential real estate or consecutive liens from and including the first lien. The Bank actively manages the mortgage portfolio, for example by having highly trained mortgage consultants in most branches, by making payment processing effortless with automatic transfers and by actively initiating collection procedures in a timely manner by contacting customers immediately if payments are late.

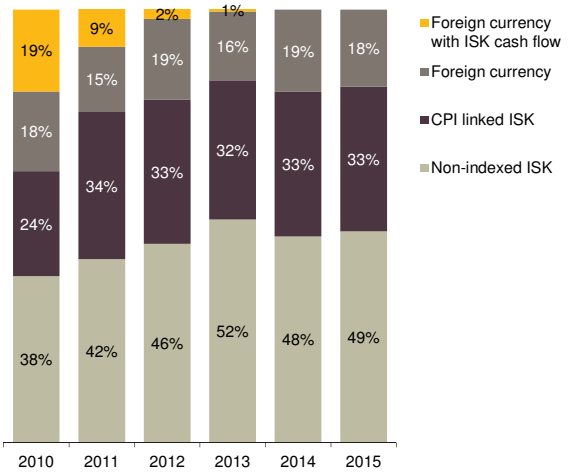

Exhibit 4.12. Currency composition of loans to customers at year-end 2010–2015 (percentage of portfolio). Consolidated.

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	184.1	7.3	3.4	2.5	197.3	3.0%
Term loans	32.7	2.3	1.0	0.7	36.7	4.6%
Credit cards	15.6	0.2	0.0	0.0	15.8	0.2%
Overdrafts	11.3	0.4	0.1	0.1	11.9	1.4%
Leasing	10.1	0.6	0.1	0.1	10.8	1.3%
Total	253.8	10.9	4.5	3.4	272.6	2.9%

Exhibit 4.13. Breakdown of loans to individuals by product type and number of days past due at year-end 2015 (carrying amount, ISK bn). Consolidated.

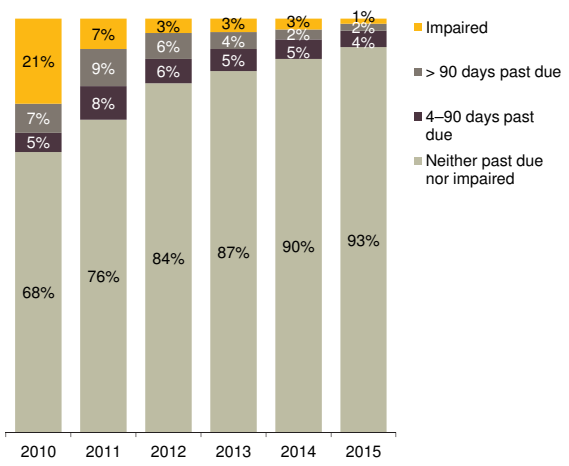

Exhibit 4.14. Loans to individuals broken down by past due status at year-end 2010–2015 (carrying amount). Consolidated.

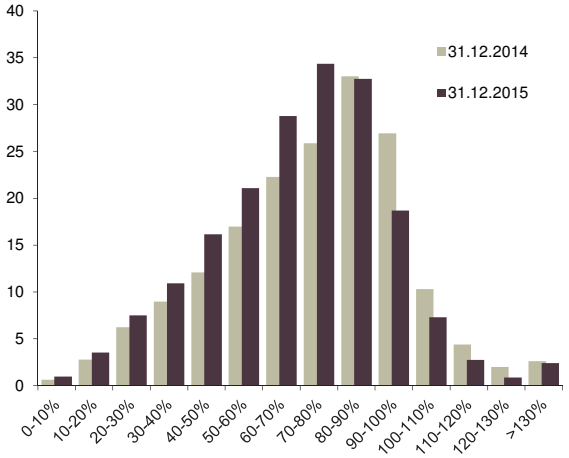

Exhibit 4.15. Breakdown of the mortgage portfolio by the LTV calculated for each property, year-end 2015 and 2014 (carrying amount, ISK bn). Consolidated.

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. Other examples are additional loans for first-time home buyers or loans for home improvements. Term loans are generally not as well collateralised as mortgages and leasing. Problem loans are more frequent in this product type than in other product types available to individuals.

Credit cards and overdrafts to individuals are usually uncollateralised short-term consumer loans. These are typically low amounts per customer used to meet fluctuations in cash flows. Since the exposure involved is relatively small per customer, it is expected that future earning ability of individuals is sufficient for repayment without a formal collateral.

Leasing agreements are provided to individuals for purchases of vehicles, mostly cars and campers. These agreements are usually well collateralised.

Exhibit 4.13 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 4.14 shows the development of this breakdown for loans to individuals at year-end 2010 to 2015.

The loan-to-value (LTV) ratio is an important 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[3]. For mortgages that are not on the first lien, the combined loan to value (CLTV) is the sum of the current carrying amount of the loan under consideration and the outstanding balance of all previous liens, divided by the value of the property. For a portfolio of mortgages, however, the LTV can be represented in various different ways depending on the intended usage. Here, two such representations are presented.

The first representation is from the property point of view. To find the average LTV of a mortgage portfolio 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 the manner described, was 69% at year-end 2015 compared to 74% at year-end 2014. The change between years is mostly explained by an increase in real estate prices and partly by the Government's mortgage relief scheme.

Exhibit 4.15 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.

Another way to represent the LTV of a mortgage portfolio is to consider how each ISK lent is distributed in loan-to-value bands.

[3]In Icelandic: Þjóðskrá Íslands. For detail see Icelandic Property Registry.

LTV band	Mortgages		Term loans		Credit cards & overdrafts		Leasing		Total	
0-50%	144.5	73%	14.0	38%	1.5	5%	8.2	76%	168.1	62%
50-70%	33.7	17%	4.6	12%	0.7	3%	1.4	13%	40.4	15%
70-80%	10.3	5%	2.2	6%	0.3	1%	0.3	3%	13.1	5%
80-90%	3.8	2%	2.7	8%	0.3	1%	0.2	2%	7.0	3%
90-100%	1.7	1%	1.3	4%	0.2	1%	0.1	1%	3.3	1%
100-110%	0.8	0%	0.8	2%	0.1	0%	0.0	0%	1.7	1%
>110%	2.1	1%	5.7	16%	0.8	3%	0.5	5%	9.1	3%
Unsecured	0.5	0%	5.3	14%	23.8	86%	0.0	0%	29.6	11%
Total	197.3	100%	36.7	100%	27.7	100%	10.8	100%	272.6	100%

Exhibit 4.17. Loans to individuals by LTV bands and product type at year-end 2015 (ISK bn). Consolidated.

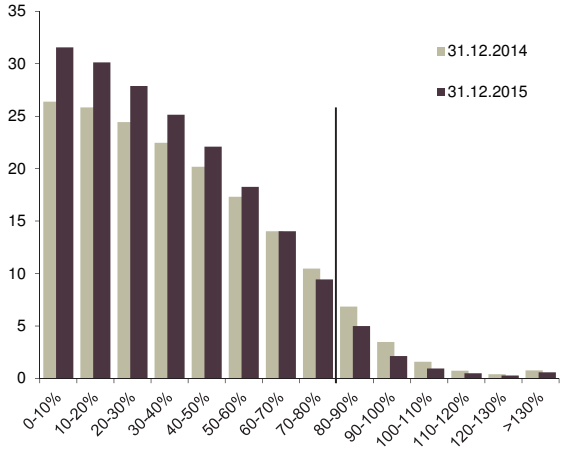

Exhibit 4.16. Breakdown of the mortgage portfolio by LTV bands, year-end 2015 and 2014 (carrying amount, ISK bn). See main text for further explanation. Consolidated.

In the breakdown, every ISK is categorised according to its ranking 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.

Exhibit 4.16 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.[4] One of the benefits of the representation shown in Exhibit 4.16 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 4.16. Such a line cannot be drawn in Exhibit 4.15.

Exhibit 4.17 shows the portfolio of loans to individuals where the exposure is continuously distributed by LTV bands. In the same manner as in Exhibit 4.16, every ISK is categorised according to its seniority in the total debt on the underlying asset.

[4]See more on risk weights in Exhibit 4.42.

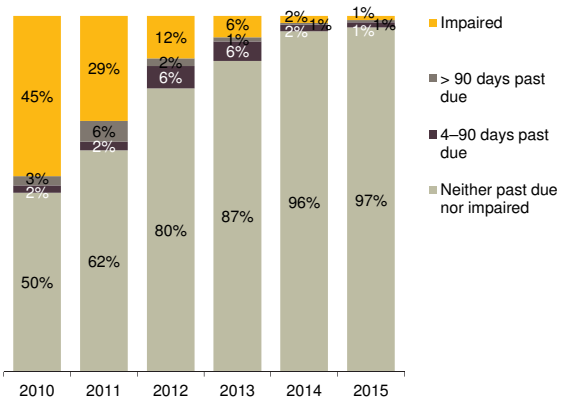

Exhibit 4.18. Loans to companies broken down by number of days past due at year-end 2010–2015 (carrying amount). Consolidated.

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 396 billion at year-end 2015 compared to ISK 375 billion at year-end 2014. New loans and refinancing of outstanding loans amounted to ISK 108 billion in the year 2015.

Credit policies are in place to ensure that companies have the capacity to repay their loans. The Bank also takes collateral to minimise loss in case of default. Collateral is usually more important for loans to companies than for loans to individuals because future earnings ability cannot be relied upon for companies. Loans with exposure in excess of branch managers' authorisation limits are handled by Credit committees where experts review the case.

An overview of the company loan portfolio by sector and number of days past due at year-end 2015 is given in Exhibit 4.19. The development of this breakdown for the portfolio of loans to companies at year-end 2010 to 2015 is shown in Exhibit 4.18. Finally, Exhibit 4.20 depicts the company loan portfolio where the collateralised exposure is distributed in LTV bands as in Exhibit 4.17.

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	87.1	1.3	0.2	1.2	89.8	1.5%
Construction	21.7	0.5	0.0	0.8	23.0	3.6%
Energy	3.7	-	-	-	3.7	-
Financial services	0.1	-	0.0	-	0.1	42.6%
Industrials & transportation	59.3	0.6	0.3	0.6	60.7	1.4%
Investment companies	18.5	0.4	0.1	0.3	19.4	2.3%
Public sector & NPO	13.8	0.0	0.0	-	13.9	0.0%
Real estate	96.2	1.2	0.3	1.3	99.1	1.6%
Seafood	82.5	1.5	1.4	0.4	85.9	2.1%
Total	382.9	5.7	2.4	4.6	395.6	1.8%

Exhibit 4.19. Loans to companies by sector and by number of days past due at year-end 2015 (carrying amount, ISK bn). Consolidated.

LTV band	Commerce & Services		Industrials & Transportation		Public sector & NPOs		Real estate & Construction		Seafood		Other sectors		Total	
0-50%	48.9	54%	28.2	46%	0.7	5%	86.7	71%	65.3	76%	14.3	61%	245.3	62%
50-70%	13.8	15%	6.9	11%	0.1	1%	18.3	15%	12.0	14%	2.7	11%	51.4	13%
70-80%	4.7	5%	2.7	4%	0.0	0%	5.5	5%	1.7	2%	0.5	2%	15.8	4%
80-90%	3.6	4%	1.2	2%	0.0	0%	3.7	3%	0.9	1%	0.2	1%	11.9	3%
90-100%	1.8	2%	0.6	1%	0.0	0%	2.4	2%	0.9	1%	0.0	0%	4.0	1%
100-110%	0.9	1%	0.0	0%	0.0	0%	1.2	1%	0.0	0%	0.0	0%	4.0	1%
>110%	13.5	15%	8.1	13%	0.4	3%	4.3	4%	5.2	6%	4.0	17%	33.6	9%
Unsecured	2.7	3%	12.9	21%	12.6	91%	0.0	0%	0.0	0%	1.6	7%	29.7	8%
Total	89.8	100%	60.7	100%	13.8	100%	122.1	100%	85.9	100%	23.3	100%	395.6	100%

Exhibit 4.20. Loans to companies by LTV bands and industry sector at year-end 2015 (ISK bn). Real estate and construction have a similar LTV distribution and are combined here in one column. The sectors that are combined as *Other sectors* here are Energy, Financial services and Investment companies. Consolidated.

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 can fluctuate considerably between periods due to liquidity management. Exhibit 4.21 shows a breakdown of these exposures at year-end 2015 and 2014.

Cash and balances with the Central Bank 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, for example as part of the Bank's liquidity management and as a result of restructuring activities. Exhibit 4.22 presents the Bank's position in bonds and debt instruments.

Type of institution	31.12.2015	31.12.2014
Central Bank	216.8	103.4
Domestic credit institutions	0.6	1.6
Foreign credit institutions	34.9	33.5
thereof rated AA- and above	1.9	1.7
thereof rated A- to A+	26.6	31.5
thereof rated BBB+ and lower	6.4	0.3
thereof unrated	-	-
Total	252.3	138.5

Exhibit 4.21. Cash and balances with the Central Bank and loans to credit institutions at year-end 2015 and 2014, with ratings based on Standard & Poor's ratings or equivalent (carrying amount, ISK bn). Consolidated.

4.5.4 GUARANTEES AND UNDRAWN COMMITMENTS

The Bank's credit exposure deriving from guarantees and undrawn commitments totalled ISK 37 billion at year-end 2015 compared to ISK 30 billion the year before. The exposure is measured using regulatory credit conversion factors.

Bonds and debt instruments	31.12.2015	31.12.2014
Icelandic government and government guaranteed bonds	31.9	35.6
Foreign government bills	41.3	45.5
thereof rated AAA	35.0	38.6
thereof rated AA+	-	-
thereof rated AA	6.4	6.9
Domestic corporates	2.7	1.3
Domestic credit institutions	2.6	4.9
Foreign credit institutions	-	-
Total	78.6	87.3

Exhibit 4.22. Bonds and debt instruments at year-end 2015 and 2014, with ratings based on Standard & Poor's ratings or equivalent (carrying amount, ISK bn). Consolidated.

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 4.4 billion at year-end 2015 compared to ISK 4.1 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 similar 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, in other words an exposure that is not direct but becomes direct at the event of default of other counterparties. Indirect exposures are classified by the issuer's industry sector. Exhibit 4.23 shows indirect exposure at year-end 2015 and 2014.

4.5.7 COUNTRY RISK EXPOSURE

Exposure to countries other than Iceland amounted to ISK 108 billion at year-end 2015 compared to ISK 103 billion the year before. This exposure relates mainly to the management of the Bank's foreign liquidity reserves.

Type of issuer	31.12.2015	31.12.2014
Central governments	0.4	0.2
Financial services	1.4	6.0
Corporates	8.1	5.1
Total	9.9	11.3

Exhibit 4.23 . Indirect exposure at year-end 2015 and 2014 (ISK bn). Parent.

Exhibit 4.24 shows a breakdown of credit exposure by country of domicile. Exposures to financial institutions, central governments and individuals are shown separately. Loans to individuals are mostly loans that were granted in Iceland but the individual later moved to another country. The Bank has recently increased lending to companies in the United States, Norway and Canada within its North-Atlantic strategy. The Bank has no retail lending activities outside of Iceland.

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 generally unsecured.

In some cases the Bank uses guarantees as 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 they do not reduce credit exposure.

For income producing real estate companies the collateral is sometimes in the form of a charge over the cash flow from 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

Country	Central government	Financial institutions	Individuals	Other obligor types	Total 31.12.2015	Total 31.12.2014
Germany	13.4	11.3	0.2	0.1	25.0	25.0
USA	6.5	8.6	0.5	5.6	21.1	17.9
UK		12.9	0.7	0.0	13.6	10.5
Netherlands	12.0	-	0.2	-	12.2	9.5
Norway	1.5	0.4	2.0	7.3	11.2	7.1
Canada		0.2	0.0	9.1	9.4	7.0
France	6.4	-	0.1	0.0	6.4	6.7
Other countries	-	3.6	4.3	1.2	9.0	19.3
Total	39.8	37.0	7.9	23.3	108.0	103.0

Exhibit 4.24. Credit exposure by country and obligor type at year-end 2015 with 2014 for comparison (carrying amount, ISK bn). Parent.

Credit exposure covered by collateral	Residential real estate	Commercial real estate	Vessels	Cash & securities	Vehicles & equipment	Other collateral	Total
Individuals	215,694	7,437	33	688	10,329	45	234,226
Commerce & services	4,487	41,931	422	344	19,902	8,719	75,805
Construction	8,631	12,225	154	208	1,953	2,360	25,531
Energy	-	2,895	-	414	9	88	3,406
Financial services	-	40	-	24	1	-	65
Industrials & transportation	784	22,992	6,208	411	5,797	10,765	46,957
Investment companies	1,124	3,932	10	3,460	91	7,524	16,141
Public sector & NPOs	16	1,018	-	9	105	-	1,148
Real estate	7,529	89,276	-	572	207	562	98,146
Seafood	194	4,848	71,447	286	210	12,587	89,572
Total	238,459	186,594	78,274	6,416	38,604	42,650	590,998

Exhibit 4.25. Financial effect of allocated collateral at year-end 2015 (ISK m). Consolidated.

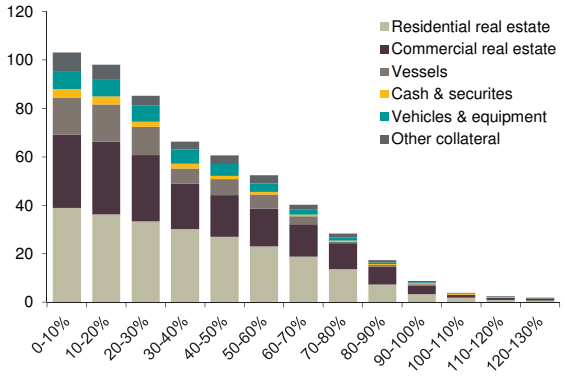

Exhibit 4.26. The continuous LTV distribution of the loan portfolio by type of underlying asset at year-end 2015 (ISK bn). Consolidated.

employees, depending on availability. In the case of fishing vessels the assigned fishing quota is included in the valuation, based on a valuation by the Bank's Collateral Board. Since the price volatility differs between asset classes it is interesting to consider how the LTV distribution of the portfolio is split between asset classes. This LTV distribution is shown in Exhibit 4.26.

To find the financial effect of collateral on maximum credit exposure, the Bank allocates collateral to loans using an elaborate optimisation algorithm. Among other things, the algorithm ensures that collateral is not assigned in excess of its estimated value, in excess of any maximum amount stipulated in a collateral agreement or in excess of the claim value of the relevant loans. The last constraint 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 4.25 shows the financial effect of allocated collateral at year-end 2015 broken down by sector and type of collateral.

4.7 RISK PROFILE

As described in Section 4.2.1, each obligor is assigned a risk class depending on how likely they are considered to default in the next 12 months. Exhibit 4.27 combines the risk classes 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. Not all subsidiaries of the Bank have risk classes for their customers which means that on a consolidated basis some obligors are unrated.

Note that a 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.

Risk group	Neither past due nor impaired	4-90 days past due	>90 days past due	Impaired	Total
Risk classes 1-4	117.1	0.0	-	-	117.1
Risk classes 5-6	289.0	0.5	0.0	-	289.5
Risk classes 7-8	164.7	2.9	0.0	-	167.6
Risk class 9	56.3	11.5	0.1	-	67.9
Risk class 10	4.4	1.7	6.9	7.9	20.9
thereof collateralised	4.2	1.4	6.9	7.9	20.4
Unrated	5.1	-	-	-	5.1
Total	636.7	16.6	7.0	7.9	668.2

Exhibit 4.27. Loans to customers by risk groups and past due status at year-end 2015 (carrying amount, ISK bn). Consolidated.

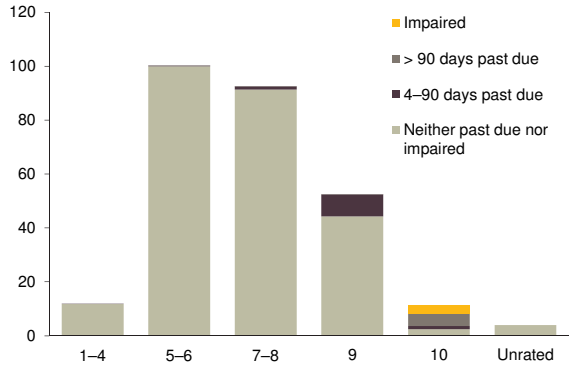

Exhibit 4.28. Loans to individuals by risk groups and number of days past due at year-end 2015 (carrying amount, ISK bn). Consolidated.

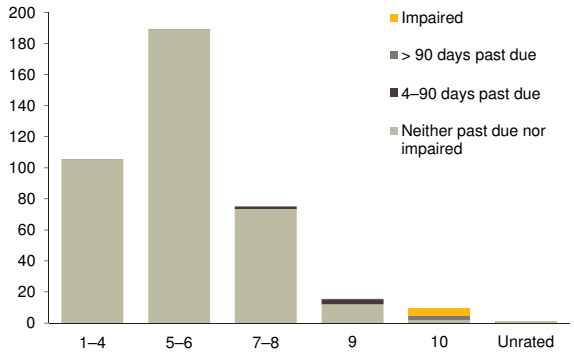

Exhibit 4.29. Loans to companies by risk groups and number of days past due at year-end 2015 (carrying amount, ISK bn). Consolidated.

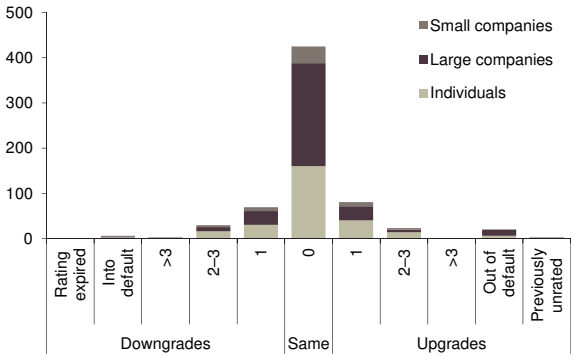

Exhibit 4.30. Migration of risk classes in the year 2015 (carrying amount, ISK bn). Consolidated.

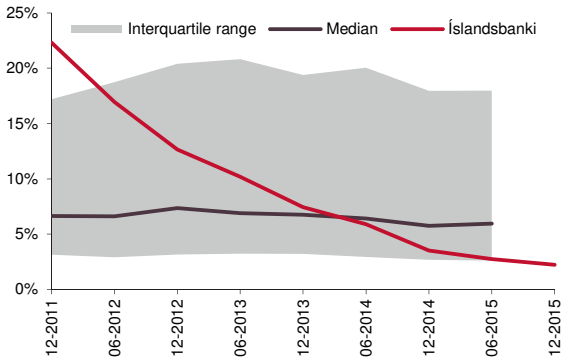

Exhibit 4.32. The Bank's non-performing loans ratio as defined in Exhibit 4.31. Comparison between Íslandsbanki and over 50 large European banks. Data for the European banks not yet available for year-end 2015. Source: Íslandsbanki and the European Banking Authority (EBA).

The portfolios of loans to individuals and companies are shown in Exhibit 4.28 and 4.29 by risk groups, along with information of past-due status at year-end 2015. Past due loans imply higher risk and are more common in higher risk classes. As can be seen in Exhibit 4.30, risk class migration, for the complete loan portfolio, was positive in the year 2015, that is, upgrades exceeded downgrades.

In order to measure asset quality it is convenient to consider non-performing ratios. 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. The Bank's Pillar 3 Report 2014[5] contains a detailed discussion on various definitions of non-performing ratios.

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. The non-performing ratio that the Bank uses, depicted in Exhibit 4.31, is based on impaired loans and loans that are more than 90 days past due. 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.

Exhibit 4.32 shows a comparison between Íslandsbanki and 56 large European banks. The ratio has been decreasing for Íslandsbanki and is now around the 25% quantile for European banks. At year-end 2015 the ratio was 2.2%, compared to 3.5% a year earlier.

4.8 EXPOSURES IN DEFAULT

When there is objective evidence that the Bank will incur losses on loans, their carrying amounts are reduced, through the use of an allowance account, to the present value of expected future cash

[5] www.islandsbanki.is/ir

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 Bank's non-performing ratio indicated with the shaded items.

flows, discounted at their effective interest rate. For on-balance sheet items this is referred to as specific impairment and is one of the two triggers that define defaults. The other trigger is being more than 90 days past due on a material credit obligation. Default criteria are applied per customer and not by facility. Exhibit 4.33 shows the gross and net carrying value of financial assets that are measured at amortised cost, broken into defaulted and non-defaulted exposures.

The Bank now discloses for the first time changes in stock of defaulted loans, see Exhibit 4.34. The changes are tracked on a monthly basis which means that a customer can be marked as defaulted and return to non-defaulted status again within the calendar year. Repeatedly defaulting customers are thus counted as often as the return to default status. The amount under other changes can include accrued interest and CPI or FX movements in addition to partial recovery and instalments.

4.9 FORBEARANCE

Forbearance measures can be granted to customers facing temporary challenges or financial difficulties. Such forbearance measures include temporary payment holidays, capitalisation of arrears, extension of loan terms and waiving of covenants.

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

Exhibit 4.35 presents the carrying amount of loans that received forbearance measures in the year 2015 and are neither impaired nor more than 90 days past due at year-end 2015. Information on forbearance agreements granted by subsidiaries is currently not available.

4.10 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 assist the customer to honour their commitment 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. Assets of disposal groups represents assets of companies in which the Bank holds more than 50% share, without

	Non-defaulted exposures	Defaulted exposures	Allowance for impairments	Credit exposure
	(Gross)	(Gross)	(Gross)	(Net)
Loans to customers	651.4	33.1	13.8	670.8
Individuals	262.6	14.4	4.1	272.9
Commerce and services	88.1	3.1	1.4	89.8
Construction	21.7	3.6	2.2	23.0
Energy	3.7	-	-	3.7
Financial services	0.1	0.0	-	0.1
Industrials and transportation	62.0	1.7	0.8	62.9
Investment companies	18.0	3.5	2.8	19.4
Public sector and NPOs	13.9	0.0	-	13.9
Real estate	97.4	2.6	1.0	99.1
Seafood	83.1	4.0	1.3	85.9
Off-balance sheet exposures	119.0	0.7	0.2	119.5

Exhibit 4.33. Breakdown of gross and net credit exposure of defaulted exposures at year-end 2015 (ISK bn). Consolidated.

Change in stock of defaulted loans	Individuals	Companies	Total
Defaulted loans at end of 2014	22.0	28,9	50.9
Loans that have defaulted in 2015	12.3	12.4	24.7
Returned to non-defaulted status	(14.7)	(19.0)	(33.7)
Amounts written off	(2.9)	(3.8)	(6.7)
Other changes	(2.3)	0.2	(2.1)
Defaulted loans at end of 2015	14.4	18.7	33.1

Exhibit 4.34. Change in stock of defaulted loans, gross carrying value (ISK bn). Consolidated.

	Individuals	Companies	Total
Loans more than 90 days past due or impaired	13.1	9.2	22.3
Performing loans where forbearance agreements were made	4.2	9.1	13.3
of which Temporary payment holidays	1.9	0.9	2.8
of which Capitalisation of arrears	1.6	0.7	2.3
of which Extension of loan terms	0.7	2.1	2.8
of which Waiving of covenants	-	5.4	5.4
Other loans neither 90 days past due nor impaired	245.5	356.5	602.0
Total	262.8	374.8	637.6

Exhibit 4.35. Forbearance measures during the year 2015 (carrying amount, ISK bn). Consolidated.

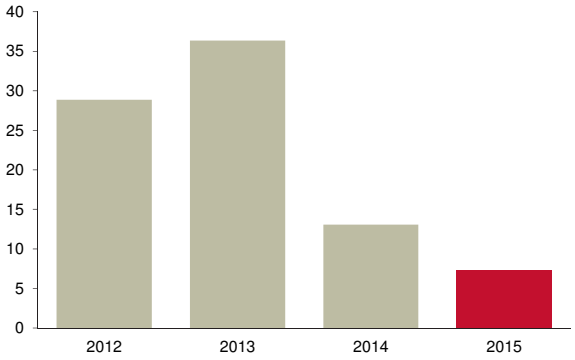

Exhibit 4.36. Assets of disposal groups classified as held for sale at year-end 2012–2015 (carrying amount, ISK bn). Consolidated.

	31.12.2015	31.12.2014
Repossessed collateral	5.8	8.6
of which land and property	5.7	8.2

Exhibit 4.37. Repossessed collateral at year end 2015 and 2014 (ISK bn). Consolidated.

being consolidated subsidiaries. These companies might have corresponding liabilities which are not subtracted here. Assets of disposal groups held for sale has decreased at year-end 2015, compared to previous years, see Exhibit 4.36.

The second group represents repossessed collateral. The total value of repossessed collateral decreased by year-end 2015, compared to year-end 2014. Furthermore, the value of repossessed collateral is mainly in land or property, as seen in Exhibit 4.37. Part of the properties repossessed are vehicles and residential property.

The development of the number of repossessed vehicles and vehicles for sale is shown in Exhibit 4.38. The number of repossessed vehicles in 2015 has decreased compared to 2014 and 2013, additionally the number of repossessed vehicles, sold vehicles and vehicles held for sale are all similar in dimension.

The development of the number of repossessed residential properties is shown in Exhibit 4.39. There are similar trends in the number of repossessed residential properties, compared to vehicles, that is, there are fewer repossessed residential properties in 2015, compared to the two previous years. However, the number of properties held for sale is vastly greater than the

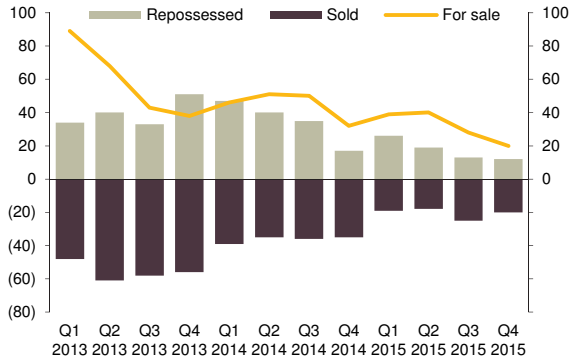

Exhibit 4.38. Number of repossessed and sold vehicles (left hand axis) and vehicles for sale (right hand axis) at quarter-end 2013 to 2015. Consolidated.

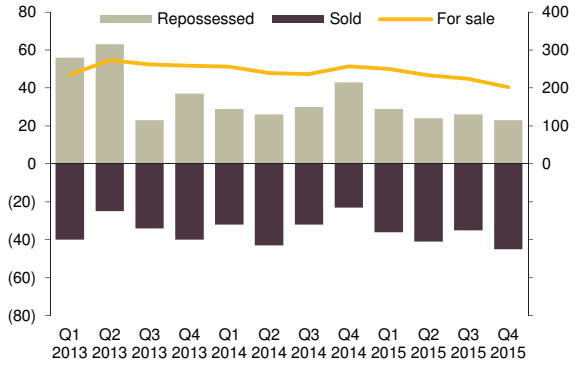

Exhibit 4.39. Number of repossessed and sold residential properties (left hand axis) and residential properties for sale (right hand axis) at quarter-end 2013 to 2015 Consolidated.

	31.12.2015 (number)	31.12.2014 (number)
Residential property	202	257
of which rented out	68	95
of which advertised for sale	113	127
of which not ready	21	35

Exhibit 4.40. Residential properties held for sale at year end 2015 and 2014 (Number). Consolidated.

FINANCING OF GREENER CARS

In the past few years, the Bank has increased its efforts regarding corporate social responsibility. One of its goals is to exert positive influence on society and the environment. In line with that, a decision was made to explore the CO_2 emissions of the Bank's leasing portfolio with the aim to monitor and in the future set goals for the emissions.

In December 2015, the average CO_2 emission for rental cars was 140 g/km while it was 170 g/km for other cars that the Bank has financed. Exhibit 4.41 shows how the emission rate has decreased over the past few years.

For comparison, the green line shows the threshold (100 g/km at the time of writing) that the city of Reykjavík uses for allowing environmentally friendly cars to park for free in the downtown area. It is noticeable that the emissions have been steadily decreasing over the years with a large decrease in the spring when the car rentals renew their fleet.

When looking at the average emission rate by model year, however, it turns out that in general rental cars have higher emission rates than other cars with the same model year. The average emission rate for rental cars is therefore lower than other cars not because car rentals select more environmentally friendly cars than others but rather because they are generally more recent models.

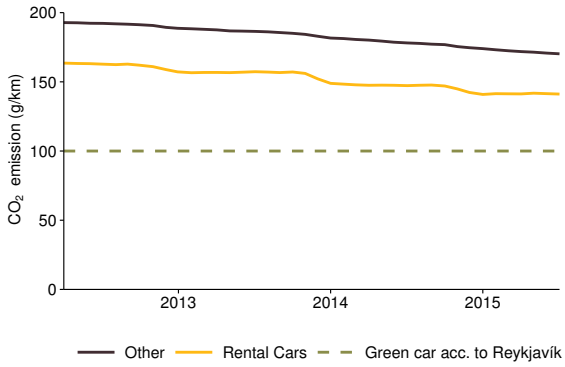

Exhibit 4.41. Development of the average CO_2 emission rate of cars that the Bank has financed. See the boxed section on Financing of greener cars for more detail.

quarterly number of repossessed properties. This difference in number of properties repossessed and number of properties held for sale is at least partly explained by the fact that former owners are by law allowed to rent their homes for a certain time period following foreclosure. Details on the composition of properties held for sale is shown in Exhibit 4.40.

4.11 CAPITAL REQUIREMENTS

The Bank reports its Pillar 1 capital requirements for credit risk according to the standardised Basel approach. Exhibit 4.42 shows exposure amounts, risk weights and corresponding risk-weighted assets for the different portfolios as at year-end 2015. 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 from customers with forbearance agreements.

	On-balance sheet	Off-balance sheet (after CCF)	Guarantees	Financial collateral	Inflow	RWA
Central governments or central banks	248,208	9	-	-	2,810	633
0%	248,208	9	-	-	1,544	-
50%	-	-	-	-	1,267	633
Regional governments or local authorities	12,163	458	-	0	-	2,587
20%	12,085	458	-	0	-	2,508
100%	79	-	-	-	-	79
Financial institutions	38,918	41	-	0	-	8,134
20%	38,532	-	-	-	-	7,706
100%	386	41	-	0	-	428
Administrative bodies and non-commercial undertakings	1,017	76	-	-	-	1,093
100%	1,017	76	-	-	-	1,093
Collective investment undertakings (CIU)	290	-	-	-	-	290
100%	290	-	-	-	-	290
Corporates	328,772	27,285	1,689	867	-	353,501
100%	328,772	27,285	1,689	867	-	353,501
Retail	123,741	11,588	-	550	-	101,084
75%	123,741	11,588	-	550	-	101,084
Secured by real estate	198,238	-	-	-	-	94,459
35%	133,991	-	-	-	-	46,897
50%	2,494	-	-	-	-	1,247
75%	61,753	-	-	-	-	46,315
Past-due items	9,028	7	-	127	-	10,207
50%	415	-	-	-	-	208
100%	5,494	2	-	16	-	5,480
150%	3,119	5	-	111	-	4,519
Other items	32,005	-	-	-	-	34,603
100%	26,811	-	-	-	-	26,811
150%	5,195	-	-	-	-	7,792
Grand total	992,382	39,463	1,689	1,544	2,810	606,591

Exhibit 4.42. 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 2015 (ISK m). Consolidated.

5 MARKET RISK

The domestic stock market grew substantially in 2015. The OMXI8 gross return index increased rather steadily throughout the year 2015 and at year-end the overall rise was 48.7% compared to 6.5% in 2014. Three new companies, Reitir, Eik and Síminn, were listed in 2015 and the average daily turnover increased by roughly 39%. Further listings are expected in 2016. The bond market was quite volatile, especially in the last quarter of 2015, with yields increasing sharply after a significant decrease in the summer months and the average daily turnover increased by roughly 29% over the year. Overall, inflation was 2.0% and the ISK strengthened by 7.9%.

The Bank's market risk profile changed somewhat in 2015 with market risk accounting for 2.4% of the Bank's risk-weighted assets at year-end 2015 compared to 4.8% at year-end 2014. The Bank's average trading equity exposure was considerably lower in 2015 than in 2014. 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) although there was a substantial increase in interest and trading in covered bonds issued by the three commercial banks in 2015. Such issues, along with the gradually increasing corporate bonds market, are expected to play an even bigger role in the coming years. The Bank's currency imbalance remained steady in 2015 until the very end when it was decreased to a low level due to a strategic repositioning of the balance sheet. The banking book inflation imbalance also decreased significantly in 2015 while interest rate risk in the banking book increased modestly according to the Bank's internal measure for interest rate risk.

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. The Bank also takes on market risk in relation to its trading activities or other activities of the Markets or Treasury units. The split between market risk in the banking and trading books may change in line with the Bank's business plan and repositioning of the balance sheet.

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) governs the market risk management of the Bank in accordance with the 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. 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 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, through the Bank's liquidity portfolio and as hedges against customers' derivatives contracts. 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,

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.	• BPV (basis point value). • Total long and short positions in underlying securities. • Open delta position of underlying securities. • Duration of underlying securities.
Inflation risk (CPI risk)	The risk that earnings or capital may be negatively affected from unexpected changes in inflation (the Consumer Price Index or CPI).	• CPI-linked bonds and debt instruments. • CPI-linked loans and deposits. • CPI-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 currency balance. • 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.

or 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.

5.3 MARKET RISK EXPOSURE

The Bank's market risk appetite defines the maximum market risk exposure that the Bank is willing to undertake. 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 2015 with respect to the average quarterly contribution of each risk factor according to the market risk framework. Currency risk was the largest market risk factor in 2015. A strategic decision was made to decrease the currency imbalance towards the end of the year. The CPI imbalance also decreased in 2015. Equity risk[1] increased significantly towards the end of the year but interest rate risk increased moderately.

Exhibit 5.3 displays the main categories of the Bank's market risk trading book exposures in 2015 and 2014, excluding hedges. Since many of these exposures are quite volatile in nature, the figures displayed represent the exposure range by showing maximum, minimum and average levels in each category per year. The year-end exposure is also displayed. Interest rate exposure is measured in terms of basis-point-value (BPV) which 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. As shown in Exhibit 5.3 the average trading book exposure in 2015 was lower in every category than in 2014.

The market risk exposures in the banking book at year-end 2015 and 2014 are displayed in Exhibit 5.4. Direct equity risk in the banking book increased in 2015, although the Bank continued

[1]Equity risk exposures include instruments such as hybrid debt with equity-like features.

Range of exposures in the trading book	31.12.2015	Max.	Min.	Avg. 2015	31.12.2014	Max.	Min.	Avg. 2014
Equity (net position)	3,344	3,344	3	1,550	1,709	4,585	630	3,019
Interest rate BPV (100 bp parallel upward shift)	131	474	62	223	327	521	253	360
Foreign currency (net position)	238	2,531	1	280	1,067	1,601	3	322

Exhibit 5.3. Market risk trading book exposure in 2015 and 2014 (ISK m). Consolidated.

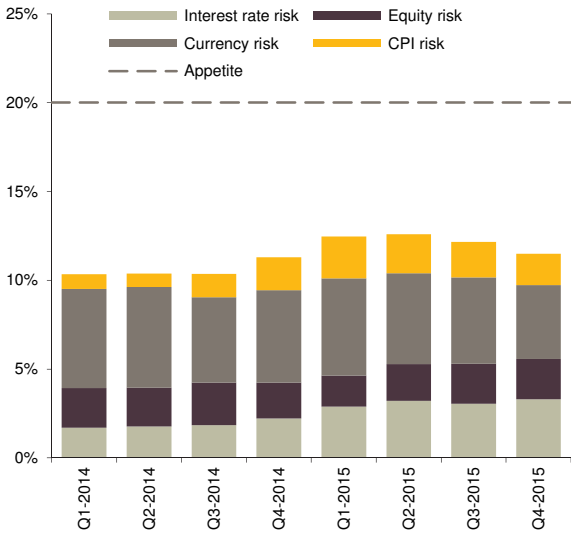

Exhibit 5.2. Market risk exposure and market risk appetite as percentage of Tier 1 Capital, average positions. Consolidated.

to sell shares originally acquired through restructuring as well as transferring equities that were listed on the Icelandic Stock Exchange in 2015 to the trading book. Interest rate risk in the banking book increased modestly in 2015 when measured in terms of a weighted parallel shift in underlying yield curves and according to the Bank's internal measure for interest rate risk which assumes a weighted adverse shift in yield curves.

Further details on the methodology for measurement and changes in market risk exposures can be found in Sections 5.3.1 to 5.3.5.

Exposure	31.12.2015	31.12.2014
Equity (net position)	11,042	6,694
Interest rate BPV (weighted parallel upward shift)	(5,372)	(4,709)
CPI imbalance	41,662	55,083
Currency imbalance	4,085	25,514

Exhibit 5.4. Market risk exposure in the banking book at year-end 2015 and 2014 (ISK m). Consolidated.

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, market making and strategic investments. The equity books are divided into three main portfolios: flow trading, hedge portfolio and equity investments. Most of the shares held are denominated in ISK.

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, excluding equity hedges, is presented in Exhibit 5.5. The Bank's trading equity exposure decreased in 2015 with the average position about 50% lower in 2015 than in 2014. The Bank was a market maker for 12 listed companies on the domestic stock exchange at the end of 2015. The equity hedge portfolio consists of hedge positions against customers' equity forward contracts. The net position in equities used for hedging can be seen in Exhibit 5.14.

The market value of direct equity exposures in the equity invesments desk, such as fair value shares and shares held for sale, decreased in 2015 mainly due to the Bank selling a 2.38% share in N1, a 0.64% share in Icelandair Group, a 3.33% share

	Held for trading	Designated at fair value	Non-current assets and disposal groups held for sale	Investments in associates	Total
31.12.2015					
Listed	3,344	3,218	-	-	6,562
Unlisted	-	7,109	-	716	7,825
Total	3,344	10,327	-	716	14,387
31.12.2014					
Listed	1,746	2,917	-	-	4,663
Unlisted	-	2,804	365	608	3,777
Total	1,746	5,721	365	608	8,440

Exhibit 5.5. Shares, equity instruments (excluding equity hedges) and investments in associates at year-end 2015 and 2014 (ISK m). Consolidated.

in Reitir in relation to its listing in April 2015 and a 0.59% share in Síminn in relation to its listing in October 2015. However, by taking into account as well the indirect equity risk arising from instruments such as hybrid debt with equity-like features, the equity risk remained relatively stable in the banking book until the end of the year when it increased substantially.

Sensitivity Analysis

For sensitivity analysis the Bank uses as a reference the 99th percentile shift in the domestic stock index based on historical data of 5 years and a holding period of 20 days for the trading book and six months for the banking book. The result is a shift of 11% in the trading book and 28% in the banking book. At year-end 2015 and 2014 the impact of these shifts was a decrease in book value of ISK 3.3 billion and ISK 1.8 billion respectively.

5.3.2 INTEREST RATE RISK

To manage interest rate risk the Bank uses sensitivity measures like basis point value (BPV).[2] 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. The BPV sensitivity per different yield curves can be scaled up or down with respect to a reference curve to reflect the same estimated likelihood that a certain shift occurs in each underlying curve. The effect of the different shifts can then be aggregated across yield curves to represent a total measure. The Bank refers to this measure as a weighted BPV. The Bank also measures the effect of an adverse shift in yield curves where each yield curve is shifted in a direction that results in a loss for the Bank. This is called a weighted adverse BPV as opposed to a parallel shift or a weighted parallel shift.

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 mainly consists of positions that the Bank takes on as a market maker for highly liquid Icelandic government bonds and government-guaranteed bonds issued by the Housing Financing Fund (HFF) as well as covered bonds issued by the Icelandic banks and some municipal and corporate bonds to a lesser extent. 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. Government bonds can be either non-index linked or CPI-linked. Duration ranges up to ten years for the non-indexed government bonds, while the CPI-linked HFF bonds have duration of up to 13 years. The duration of the covered bonds ranges up to 11 years for the indexed issues but up to 6 years for the non-indexed issues.

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 market making agreements the Bank has access to securities lending which enables the Bank to take short positions in government and government-guaranteed bonds as well as covered bonds.

At year-end 2015, the total BPV of indexed and non-indexed bonds in the flow trading portfolio was ISK -0.1 million compared to ISK -1.8 million at year-end 2014.

[2]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.

Country	Market value	BPV	Market value	BPV
	31.12.2015		31.12.2014	
Canada	-	-	1,094	(0.02)
Denmark	-	-	1,036	(0.02)
France	6,366	(0.14)	6,944	(0.30)
Germany	13,439	(0.30)	15,434	(0.41)
Netherlands	12,025	(0.25)	6,944	(0.18)
Norway	1,471	(0.07)	1,708	(0.04)
Sweden	-	-	4,109	(0.14)
USA	8,030	(0.09)	9,323	(0.24)
Total	41,331	(0.85)	46,592	(1.35)

Exhibit 5.6. Origin of government issued bills and BPV in the Bank's liquidity portfolio (ISK m) at year-end 2015 and 2014. Consolidated.

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 2015 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 six months and the sensitivity measured in BPV was ISK -0.9 million at year-end 2015 compared to ISK -1.4 million at year-end 2014. 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 2015. The net position in bonds used for hedging can be seen in Exhibit 5.14.

The maximum total position in the trading portfolios over the year, excluding the hedge portfolio, was ISK 60.4 billion compared to ISK 53.0 billion in 2014 and mainly originated in the liquidity portfolio. The largest aggregated position in indexed securities was ISK 2.0 billion compared to ISK 5.0 billion in 2014 and the largest aggregated position in non-indexed securities was ISK 58.9 billion compared to ISK 41.3 billion in 2014. Exhibit 5.7 displays the total market value and BPV of the trading portfolios at year-end 2015 and 2014.

Sensitivity Analysis

For sensitivity analysis of the trading portfolios the Bank uses as a reference the 99th percentile shift based on historical data of either 5 years (domestic rates) or 10 years (foreign rates) and a holding period of 20 days. 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 (IRRBB) 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.

	Market value	Duration (years)	BPV	Market value	Duration (years)	BPV
			31.12.2015			31.12.2014
Long positions						
Indexed	1,818	8.08	(1.47)	1,772	8.03	(1.42)
Non-indexed	43,703	0.32	(1.42)	48,260	0.41	(1.96)
Total	45,521	0.63	(2.89)	50,032	0.68	(3.38)
Short positions						
Indexed	1,754	7.04	1.24	-	-	-
Non-indexed	3,057	1.10	0.34	73	7.39	0.05
Total	4,811	3.27	1.58	73	7.39	0.05
Net position	40,710	0.32	(1.31)	49,959	0.67	(3.33)

Exhibit 5.7. Bonds and debt instruments in the trading portfolio at year-end 2015 and 2014 (ISK m). Consolidated.

Currency	Parallel upward shift in yield curve (basis points)	Profit or loss	Profit or loss
		31.12.2015	31.12.2014
ISK, indexed	100	(147)	(142)
ISK, non-indexed	100	(42)	(59)
EUR	25	(17)	(22)
GBP	35	-	(1)
USD	60	(12)	(15)
Other	60	(4)	(4)
Total		(222)	(239)

Exhibit 5.8. Sensitivity analysis for bonds and debt instruments in the trading portfolio at year-end 2015 and 2014 (ISK m). Consolidated.

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.

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 all interest bearing assets and liabilities are bucketed according to their next interest reset as at year-end 2015. The same bucketing for previous years can be seen in previous Pillar 3 reports. 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

	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	> 10 years	Total
Assets							
Balances with Central Bank	216,760	-	-	-	-	-	216,760
Bonds and debt instruments	32,034	458	952	108	426	185	34,163
Loans to credit institutions	35,531	3	-	-	-	-	35,534
Loans to customers	463,177	22,748	38,187	130,927	2,431	8,241	665,710
Total assets	747,502	23,209	39,139	131,035	2,857	8,426	952,167
Off-balance sheet items	73,020	9,571	1,456	35,196	-	-	119,243
Liabilities							
Deposits from CB and credit institutions	25,631	-	-	-	-	-	25,631
Deposits from customers	581,171	1,659	1,778	7,772	865	-	593,245
Debt issued and other borrowed funds	35,360	24,180	19,801	48,505	16,053	6,409	150,308
Subordinated loans	19,517	-	-	-	-	-	19,517
Total liabilities	661,679	25,839	21,579	56,277	16,918	6,409	788,701
Off-balance sheet items	87,095	6,446	5,968	28,872	2,976	-	131,357
Net interest gap on 31 December 2015	71,748	495	13,048	81,082	(17,037)	2,017	151,352

Exhibit 5.9. Interest rate reset periods in the banking book at year-end 2015 (ISK m). Consolidated.

Currency	Parallel upward shift in yield curve (basis points)	Fair value impact	Fair value impact
		31.12.2015	31.12.2014
ISK, indexed	220	(5,735)	(4,902)
ISK, non-indexed	250	267	206
CHF	50	2	6
EUR	60	70	22
GBP	90	(2)	(3)
JPY	45	(2)	(1)
USD	150	(11)	(20)
Other	150	39	(17)
Total		(5,372)	(4,709)

Exhibit 5.10 . Sensitivity analysis for bonds and debt instruments in the banking book at year-end 2015 and 2014 (ISK m). Consolidated.

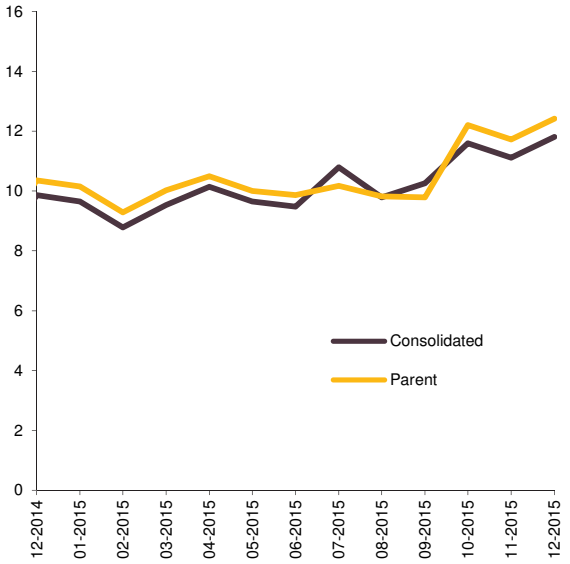

Exhibit 5.11. Monthly development of interest rate risk in the banking book in 2015 (weighted adverse BPV in ISK m). Consolidated and parent.

on the underlying collateral and is thus not affected by changes in the underlying interest rates.

Sensitivity Analysis

For the sensitivity analysis in the banking book the Bank uses as a reference the 99th percentile shift based on historical data of either 5 years (domestic rates) or 10 years (foreign rates) and a holding period of six months. 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 5.10.

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 2015 based on weighted adverse shifts is shown in Exhibit 5.11. The interest rate risk in the banking book based on weighted adverse shifts increased over the year mainly due to new lending and new covered bond issuances.

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

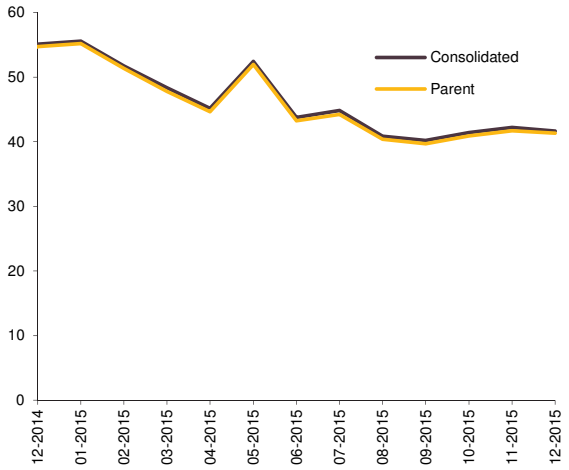

Exhibit 5.12. Monthly development of the banking book inflation imbalance in 2015 (ISK bn). Consolidated and parent.

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 in the banking book is reported to ALCO and is subject to a limit decided by the committee. At year-end 2015 the CPI gap in the banking book amounted to ISK 41.7 billion compared to ISK 55.1 billion at year-end 2014. The banking book inflation imbalance decreased in 2015 mainly due to an increase in CPI-linked liabilities such as covered bonds issuance and derivative contracts. Exhibit 5.12 displays the development of the Bank's banking book inflation imbalance in 2015.

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 is also subject to regulatory limits where the net position per currency and the overall currency imbalance of the Bank may not exceed 15% of the Bank's capital base. Exhibit 5.13 displays the development of the Bank's currency imbalance in 2015. The currency imbalance was relatively stable throughout the year but decreased significantly at the end of the year as a result of a strategic repositioning of the balance sheet. The overall consolidated currency imbalance was ISK 4.3 billion at year-end 2015 or 2.0% of the total capital base. The banking book currency imbalance was ISK 4.1 billion or 1.9% of the total capital base at year-end 2015 compared to ISK 25.5 billion or 12.3% of the total capital base at year-end 2014. The ISK appreciated by 7.9% in 2015, mainly in the second half of 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

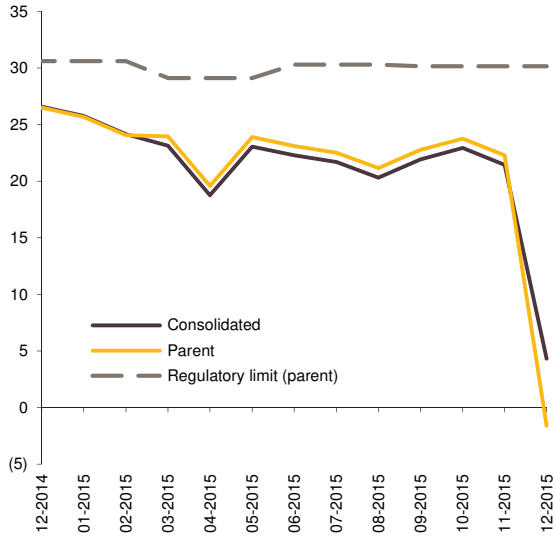

Exhibit 5.13. Monthly development of the currency imbalance in 2015 (ISK bn). Consolidated and parent.

Risk exposure	31.12.2015	31.12.2014
Equities (net position)	4,649	3,064
Bonds (net position)	(1,781)	4,495

Exhibit 5.14. Market value of equities and bonds used for hedging at year-end 2015 and year-end 2014 (ISK m). Consolidated.

interest rate swaps is limited with BPV and duration 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), such as forward agreements on 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. Exhibit 5.14 shows the market value of equities and bonds used for hedging at year-end 2015 and 2014. Exhibit 5.15 shows the Bank's derivatives assets and liabilities and their notional values at year-end 2015.

	Assets	Notional values related to assets	Liabilities	Notional values related to liabilities
Interest rate swaps	533	13,687	1,435	37,340
Cross currency interest rate swaps	1,138	26,212	148	10,209
Equity forwards	56	1,283	588	3,003
Foreign exchange forwards	20	1,551	392	7,687
Foreign exchange swaps	82	9,918	236	17,034
Bond options	-	-	96	25,000
Bond forwards	151	3,015	14	920
Total	1,980	55,666	2,908	101,193

Exhibit 5.15. Derivatives assets and liabilities and their notional value at year-end 2015 (ISK m). Consolidated.

REGULATORY CHANGES

The *Capital Requirements Regulation and Directive (CRD IV)* is being implemented into Icelandic law. Under the new directive the Pillar 1 capital requirements for market risk will increase due to new requirements regarding counterparty risk related to derivatives transactions (CVA or Credit Value Adjustment). Based on positions at year-end 2015 the changes will result in a significant increase in the Pillar 1 capital requirement for market risk. However, this effect has already been accounted for by the Bank in its Pillar 2 capital requirement.

In January 2016 the Basel Committee on Banking Supervision (BCBS) published a revised framwork on *Minimum capital requirements for market risk*. The final standard, also known as the *Fundamental review of the trading book (FRTB)*, is intended to harmonise the treatment of market risk across the banking and trading book and across different jurisdictions. Its implementation, which is due in 2019, will generally result in higher market risk capital requirements although capital requirements already included in the Pillar 2 estimation are likely to mitigate the effect for many banks, including Íslandsbanki.

The *EMIR (European Market Infrastructure Regulation)* No. 648/2012 on OTC derivatives, central counterparties and trade repositories was implemented in the European Union in 2012 and is expected to be implemented by the Icelandic Financial Supervisory Authority (FME) in the fall of 2016. The Regulation increases reporting obligation for OTC derivatives with the aim of ensuring that information on all European derivative transactions will be reported to trade repositories and be accessible to supervisory authorities.

Act No. 132/2015, with Amendments to Act No. 138/1994 on private limited companies, Act No. 2/1994 on limited companies and Act No. 3/2006 on Annual Accounts (statutes, etc.). The act provided for changes regarding limited and private limited companies' permission to purchase own shares. These amendments erased uncertainties regarding the ability of financial institutions to be a market maker for companies for the own account of such companies as well as regarding permissions for companies to purchase own shares through a repurchase program.

The Basel Committee on Banking Supervision (BCBS) has issued a final paper mandating a new standardised calculation of counterparty exposures, *The standardised approach for measuring counterparty credit risk exposures (SA-CCR)*. This standard will replace the current exposure method (CEM) and is expected to come into effect in 2017.

6 LIQUIDITY RISK

The Bank maintained a strong liquidity position throughout 2015 and all regulatory and internal metrics were well above limits. At year-end 2015 the Bank's LCR ratio was 132% for the parent company and 143% for the Group. The deposit balance increased significantly over the year. This increase was mainly due to transfers related to the stability agreements and the Central Bank buying foreign currency in the market but also due to the growth of short-term investment funds. As a result the deposit-to-loan ratios increased significantly, the ratio of customer deposits to loans to customers grew to 89% at the end of 2015 compared to 82% at the end of 2014. The ratio of total deposits to total loans increased from 80% to 88% over the same period on a consolidated level. The deposit-to-loan ratio is expected to lower again following the lifting of capital controls and the finalisation of the stability agreement between the Glitnir and the Icelandic Government.

The Bank issued ISK 24.1 billion in covered bonds in 2015. In addition, the Bank issued short-term unsecured papers throughout 2015 with an outstanding amount at year-end of just over ISK 10 billion. In 2015 the Bank issued a SEK 300 million Floating Rate Note, a NOK 500 million Floating Rate Note and a Euro-denominated bond of EUR 125 million in December 2015.

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 a target credit rating. The Bank takes a conservative and prudent approach to managing 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, also under stressed conditions in the funding markets.
- Maintains a prudent balance between the maturity of assets and liabilities.
- Enforces a prudent amortisation profile on its portfolio of loans to customers to reduce the refinancing risk of both the Bank's customers and the Bank itself.
- Has clear limits with respect to liquidity risk in the main operating currencies.
- Fulfils regulatory 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 the Bank's *Liquidity Risk Policy* which also states the roles and responsibilities regarding liquidity risk management.

The Asset and Liability Committee (ALCO) governs the liquidity risk management of the Bank subject to the risk limits set forth in the *Risk Appetite Statement* and the *Liquidity Risk Policy*.

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 Group's overall liquidity position 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 within the Markets unit.

The Bank complies with FME guidelines on liquidity management[1] based on the Principles for Sound Liquidity Risk Management and Supervision, issued by the Basel Committee on Banking Supervision[2].

6.2 MEASUREMENT AND MONITORING

Key measures for the assessment of liquidity risk are the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) introduced by the Basel Committee on Banking Supervision in 2010 and incorporated into European law through the CRD IV.

The implementation of the LCR and NSFR requirements differs somewhat between countries but full implementation is planned in Europe in 2019. In preparation for the lifting of capital controls in Iceland, the implementation of the LCR and the NSFR has been ahead of that in Europe and special focus has been on setting limits regarding LCR and NSFR in foreign currencies. The Central Bank of Iceland, which is the main supervisory authority regarding liquidity risk, has incorporated the LCR and the NSFR based on the CRD IV standards into the Rules on liquidity ratio[3] and the Rules on funding ratio in foreign currencies[4].

Exhibit 6.1 displays the implementation plan for the LCR and NSFR in Iceland compared to the Basel minimum standards.

According to the Central Bank's rules on liquidity ratios, the Bank submits monthly reports on the LCR and NSFR ratios to the Central Bank. Exhibits 6.2 to 6.5 show the development of these ratios for Íslandsbanki in 2015 as compared to the regulatory

[1] FME Guidelines No. 2/2010 for Sound Liquidity Risk Management and Supervision.
[2] Basel Committee on Banking Supervision, Principles for Sound Liquidity Risk Management and Supervision.
[3] Central Bank Rules No. 1055/2013 on Liquidity.
[4] Central Bank Rules No. 1032/2014 on Funding ratio in foreign currencies.

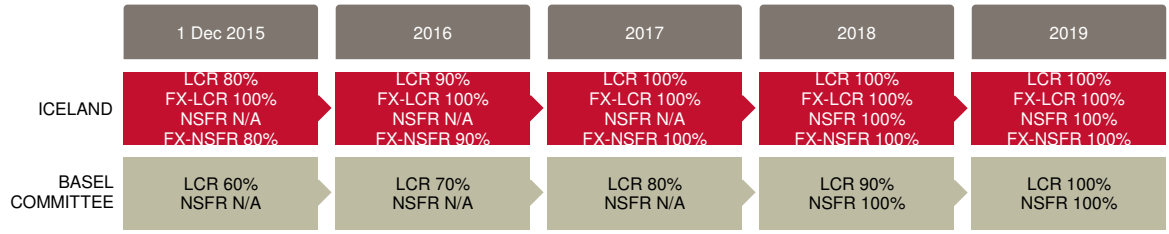

Exhibit 6.1. The planned implementation of the LCR in Iceland compared to the Basel Committee.

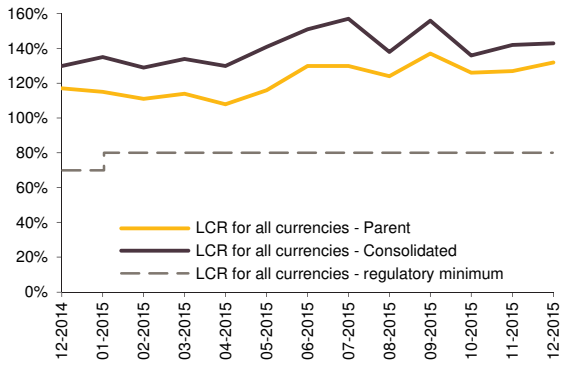

Exhibit 6.2. LCR for all currencies. Consolidated and parent.

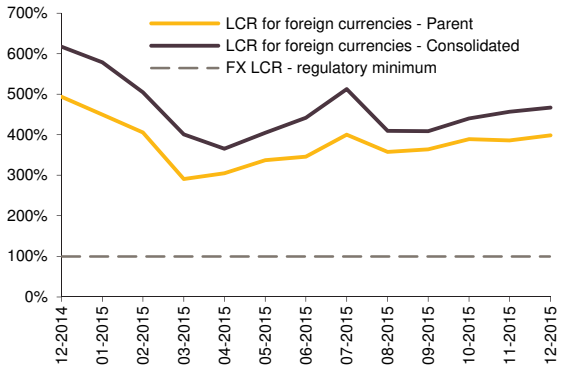

Exhibit 6.3. LCR in foreign currency. Consolidated and parent.

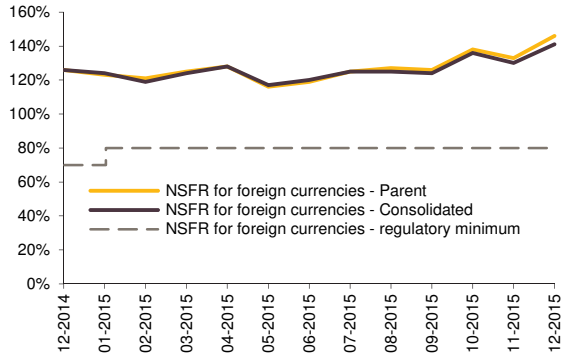

Exhibit 6.4. NSFR for all currencies. Consolidated and parent.

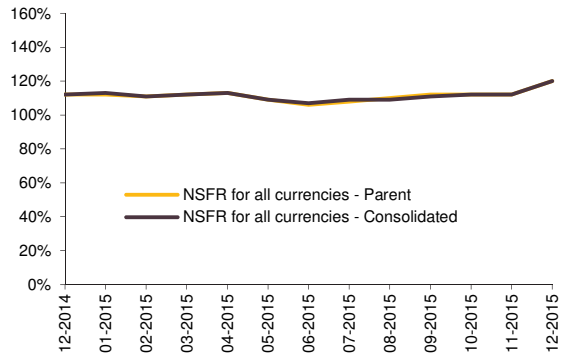

Exhibit 6.5. NSFR in foreign currency. Consolidated and parent.

minimum where applicable. The following sections on Liquidity Position and Funding provide further details on the composition of the LCR and NSFR.

In addition to the regulatory LCR and NSFR measures, the Bank uses various metrics and measures, both static and forward looking, to assess and quantify its liquidity position and thereby its liquidity risk. These measures include:

- Analysis of the mismatch in cash flows from assets and liabilities under normal and stressed business conditions.
- Forecast of the development of the LCR.
- A list of predefined triggers for the assessment of liquidity stage.

The assumptions for the internal liquidity measures are reviewed regularly.

6.3 LIQUIDITY POSITION

The Bank maintained a strong liquidity position throughout 2015 and all regulatory and internal metrics were above limits. In the latter half of the year, the management of liquidity was impacted by the implementation of the stability agreement between Glitnir and the Icelandic Governmentr and changes in the reserve requirements by the Central Bank. To ensure that the Bank would retain liquidity ratios well within its target range a more selective approach towards new lending was adopted, additional long-term funding was raised and more focus was put on terming out demand deposits.

In 2016, the Bank expects to see the loan book grow broadly in line with growth in domestic GDP. General customer deposits are also expected to show modest growth. However, deposits from Glitnir and international investors, which may exit through the CBI auctions, will cause the overall deposit base to shrink during the year. This will however have a positive impact on the LCR as these deposits are currently assumed to have 100% outflow under that measure.

LCR breakdown, end-of-month average Q4	2015		2014	
	Balance	LCR weighted	Balance	LCR weighted
High-quality liquid assets (HQLA)				
Cash	3	3	2	2
Balances with central banks	186	186	114	114
Domestic bonds eligible as collateral against borrowing at the CB	23	23	28	28
Foreign government bonds	43	43	43	43
Total stock of Level 1 assets	255	255	188	188
Total stock of Level 2A assets	1	1	-	-
Total stock of Level 2B assets	9	-	7	-
Total high quality liquid assets (HQLA)	-	256	-	188
Cash outflows				
Retail deposits and deposits from small business customers, of which:				
Stable deposits	86	3	81	3
Less stable deposits	184	14	174	13
Unsecured wholesale funding, of which:				
Operational deposits and deposits in networks of cooperative banks	1	0.3	-	-
Non-operational deposits	341	166	303	149
Unsecured debt	109	2	48	2
Secured wholesale funding	85	1	0	0
Additional requirements, of which:				
Outflows related to derivative exposures and other collateral requirements	8	6	7	3
Outflows related to loss of funding on debt products	-	-	-	-
Credit and liquidity facilities	80	8	61	6
Other contractual funding obligations	49	28	36	17
Other contingent funding obligations	49	-	45	-
Total cash outflows	991	229	817	194
Cash inflows				
Secured lending (e.g. reverse repos)				
Inflows from fully performing exposure	552	3	556	8
Loans to credit institutions	48	40	46	36
Other cash flows	42	3	42	4
Total cash inflows	642	47	644	49
Total HQLA	-	256	-	188
Total net cash outflows	-	182	-	145
Liquidity coverage ratio (Q4 end of month avg.)		141%		129%
Liquidity coverage ratio (end of year)		143%		130%

Exhibit 6.6. Composition and amount of liquidity back-up (ISK bn). Consolidated.

6.3.1 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.

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

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.

Exhibit 6.6 shows the breakdown of the Group's liquid assets (HQLA) and the positions underlying the LCR at the end of 2015 and 2014. According to the LCR disclosure standards, the figures

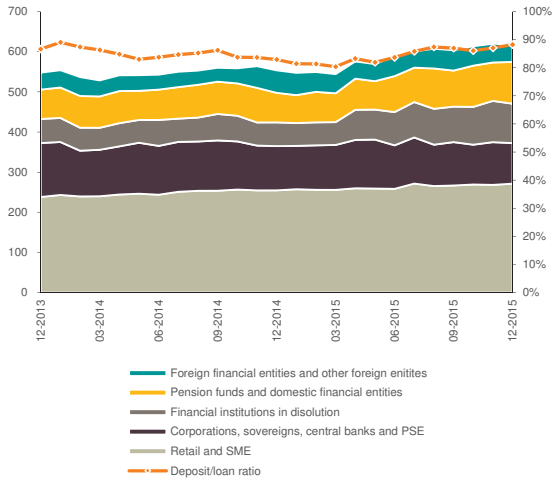

Exhibit 6.7. Deposit development from year-end 2013 to 2015 (ISK bn). Consolidated.

show the average of end-of-month positions in the quarter as opposed to the year-end figures in the financial accounts.

6.4 FUNDING

The Bank continues to be predominantly deposit-funded and the deposit balance increased significantly over the course of the year 2015 as shown in Exhibit 6.7. This increase was mainly due to transfers of funds related to the stability agreements but also due to the growth of short-term investment funds that invest their funds partly in deposits. As a result, the ratio of customer deposits to loans to customers grew to 89% at the end of 2015 compared to 82% at the end of 2014. The ratio of total deposits to total loans increased from 80% to 88% over the same period. The deposit-to-loan ratio is expected to decrease again due to more investment opportunities that are expected to arise in Iceland as financial markets continue to develop following the lifting of capital controls, and the finalisation of the stability agreement between Glitnir and the Icelandic Government.

6.4.1 NET STABLE FUNDING RATIO

A key metric for assessing the long-term viability of the Bank's funding structure is the Net Stable Funding Ratio (NSFR). 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 assumed relative stability of an institution's funding sources reflected in the corresponding ASF factor. The available amount of stable funding is mainly comprised of retail deposits, wholesale deposits with remaining maturity of greater than one year, borrowings with a residual maturity over 1 year and equity.

The amount of Required Stable Funding (RSF) is measured based on 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 and unencumbered assets with maturity of more than one year and other on and off-balance sheet exposures. All categories are weighted by the appropriate RSF factor.

Exhibit 6.8 shows a high level breakdown of the components underlying the Group's NSFR in 2015.

6.4.2 DEPOSITS

Although the current deposit-to-loan ratio is very high in historical terms, and will most likely decline, it is expected that deposits will continue to be the largest source of funding for the Bank in the years ahead. The behaviour of the deposit-to-loan ratio is clearly dependent on a number of factors, not the least of which will be the effect of the lifting of capital controls, anticipated to continue in 2016.

There has been a concerted effort to transfer customers from non-term deposits to deposits with terms of 31 days or longer. Various term products have been offered to customers, with the result that the proportion of term deposits, whether notice accounts or fixed deposits, has increased from 24.8% of total deposits excluding financial institutions in dissolution at the end of 2014 to 26.3% at the end of 2015. This push for term deposits is part of the Bank's overall wish to manage its liquidity risk as effectively as possible.

Exhibit 6.9 shows the composition of deposits by LCR categories, term and the proportion classified as Available Stable Funding (ASF).

6.4.3 BOND ISSUANCE

The Bank established itself as the market leader in the issuance of covered bonds in the domestic market in December 2011 and since then covered bonds have represented an important source of funding for domestic mortgage lending. The Bank issued ISK 24.1 billion of covered bonds in 2015, compared to ISK 8.8 billion the previous year. There was a great increase in liquidity of the Bank's covered bonds in the past year which had a positive effect on their yield. The total outstanding amount of covered bonds at year-end 2015 was ISK 51.5 billion. Exhibits 6.10 and 6.11 show the development of the yield and turnover of Íslandsbanki's covered bond issues in 2015.

In April 2013 the Bank began issuing unsecured short-term 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 2015 the Bank had ISK 10.2 billion of debt outstanding in short-term unsecured bonds, with maturities ranging from one to six months.

In February 2015, the Bank issued a SEK 300 million Floating Rate Note (FRN) due in 2019. Placed with Scandinavian investors by Pareto Securities, the issue pays a spread of 310 basis points over STIBOR. This transaction was increased twice over the course of the year, with taps of SEK 150 million each launched in April and July.

In October, the Bank launched its first NOK denominated bond through lead managers DNB Bank and Pareto Securities. Taking advantage of lead orders from some large Norwegian investors, the Bank issued a NOK 500 million FRN due 2018 at a spread of NIBOR +260 basis points.

NSFR breakdown, end-of-month average Q4	Foreign currency		Total	
	Balance	NSFR weighted	Balance	NSFR weighted
Tier 1 and Tier 2 capital	-	-	196	196
Other capital instruments	19	19	19	19
Unsecured financing	146	92	406	141
Secured financing	-	-	72	66
Less stable deposits (LCR classification)	13	11	190	173
Stable deposits (LCR classification)	2	2	87	83
Other liabilities	16	-	52	1
Available stable funding	197	125	1,023	680
Liquid assets	79	2	297	6
Encumbered assets (loans and securities)	1	0	110	109
Unencumbered assets (loans and securities)	124	97	562	420
Other assets	5	5	51	51
Off-balance sheet	25	1	127	6
Currency imbalance	(15)	(15)	15	-
Required stable funding	234	91	1,147	593
Net stable funding ratio (Q4 end of month avg.)		137%		115%
Net stable funding ratio (end of year)		141%		120%

Exhibit 6.8. Breakdown of the components underlying the Group's NSFR in 2015 (ISK bn). Consolidated.

Composition of deposits	Deposits maturing within 30 days				Term deposits	Total deposits	Whereof ASF
	Less stable	Weight (%)	Stable	Weight (%)			
Retail	93	10%	56	5%	56	206	190
SME	47	10%	13	5%	6	67	61
Operational relationship	2	25%	-	5%	-	2	1
Corporations	66	40%	0	20%	26	92	46
Sovereigns, central-banks and public sector entities	6	40%	0	20%	1	7	4
Financial institutions in composition	58	100%			40	98	36
Pension funds	24	100%			27	51	11
Domestic financial entities	33	100%			21	54	1
Foreign financial entities	19	100%			2	21	0
Other foreign entities	18	100%	2	25%	2	22	16
Total	367		72		180	619	366

Exhibit 6.9. Composition of deposits by LCR categories, term and the proportion classified as Available Stable Funding at year-end 2015 (ISK m). Consolidated.

Foreign currency funding operations concluded in December with a EUR 125 million tap of an existing transaction, the EUR 100 million 2.875% Note due 2018 issued through Deutsche Bank in July. The increase, managed by Bank of America Merrill Lynch, Citibank and Deutsche Bank, was placed with investors in the UK, continental Europe and the Nordic countries, and was priced at a spread of mid-swaps +290 basis points.

The Bank remains keen to issue smaller transactions in a range of currencies with the opportunity to increase deal size as demand increases. This way the Bank ensures the best pricing for itself, and better performance for the investor base.

Exhibit 6.12 gives an overview of the terms of outstanding bonds issued by the Bank and Exhibit 6.13 provides a summary of how the maturity of outstanding bond issues is distributed over the coming years.

Since 2014, the Bank benefitted from a rating from Standard & Poor's (S&P) of BB+ with a positive outlook. In July 2015, as a direct result of the announcement of the Government's roadmap towards the composition of the winding-up of the failed banks' estates and the lifting of capital controls, S&P raised the sovereign's rating, and along with it the ratings of the Icelandic banks. Íslandsbanki's to BBB- with a stable outlook. In January 2016 S&P raised Iceland's ratings to BBB+ on further progress toward capital account liberalisation and declining debt levels and following that Íslandsbanki's ratings were confirmed with a positive outlook.

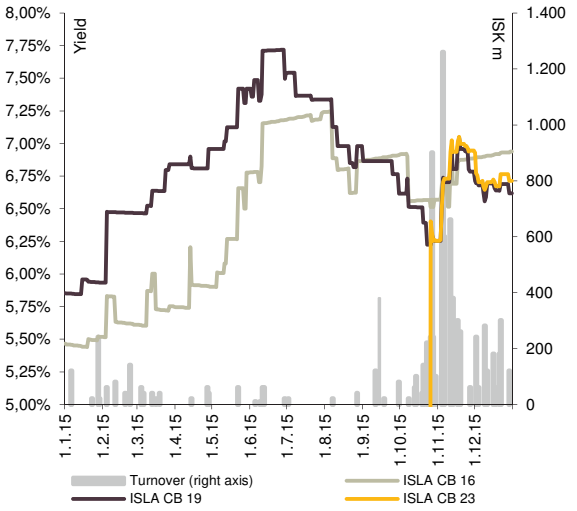

Exhibit 6.10. Development of the yields and turnover of Íslandsbanki's non-indexed covered bonds in 2015.

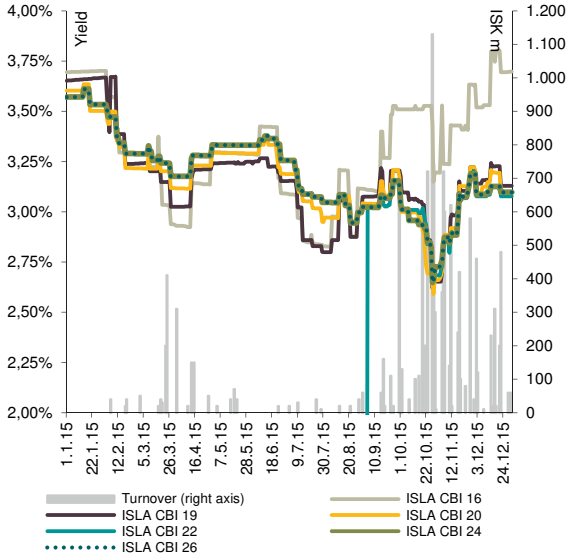

Exhibit 6.11. Development of the yields and turnover of Íslandsbanki's CPI-linked covered bonds in 2015.

Íslandsbanki is the only Icelandic financial institution with a rating from Fitch. Fitch assigned a long-term rating of BBB- to Íslandsbanki in April, making it the first Icelandic bank to be rated investment-grade since 2008.

Íslandsbanki remains the only Icelandic bank that enjoys the additional assurance of two investment-grade ratings. Exhibit 6.14 shows the credit rating history for Íslandsbanki from April 2014 to January 2016.

31.12.2015	Issue year	Maturity year	Type	Interest terms	Currency	Nominal amount (outstanding)	Notional amount (outstanding)
Covered bonds							
ISLA CB 16	2013-2014	2016	At Maturity	Fixed, 6.2523%	ISK	2.8bn	2.9bn
ISLA CB 19	2014-2015	2019	At Maturity	Fixed, 6.9299%	ISK	4.1bn	4.2bn
ISLA CB 23	2015	2023	At Maturity	Fixed, 6.40%	ISK	5.9bn	5.6bn
ISLA CBI 16	2011	2016	At Maturity	Fixed, CPI linked, 3.50%	ISK	4.0bn	4.4bn
ISLA CBI 19	2012-2014	2019	At Maturity	Fixed, CPI linked, 2.84%	ISK	7.5bn	8.4bn
ISLA CBI 20	2014-2015	2020	At Maturity	Fixed, CPI linked, 3.4699%	ISK	3.9bn	4.0bn
ISLA CBI 22	2015	2022	At Maturity	Fixed, CPI linked, 2.98%	ISK	2.8bn	2.8bn
ISLA CBI 24	2012-2014	2024	At Maturity	Fixed, CPI linked, 3.45%	ISK	9.7bn	11.1bn
ISLA CBI 26	2015	2026	At Maturity	Fixed, CPI linked, 3.372%	ISK	6.3bn	6.4bn
Bonds issued under the Bank's GMTN programme							
Senior unsecured bond	2013 and 2014	2017	At Maturity	Floating, STIBOR + 4.00%	SEK	800m	12.4bn
Senior unsecured bond	2014	2016	At Maturity	Fixed, 3.00%	EUR	52.3m	7.4bn
Senior unsecured bond	2015	2019	At Maturity	Floating, STIBOR + 3.10%	SEK	600m	9.3bn
Senior unsecured bond	2015	2018	At Maturity	Fixed, 2.875%	EUR	225m	32.0bn
Senior unsecured bond	2015	2018	At Maturity	Floating, NIBOR + 2.60%	NOK	500m	7.4bn
Other long-term debt							
Central Bank secured bond	2009	2019	Equal Payments	Fixed, CPI linked, 4.50%	ISK	19.8bn	19.8bn
Tier II Capital Instrument	2009	2019	At Maturity	Floating, EURIBOR + 5.00%	EUR	138m	19.5bn

Exhibit 6.12. Terms of outstanding bonds issued by the Bank. The covered bond amounts shown exclude the bonds reserved for securities. Íslandsbanki repurchased own debt during the year for the amount of EUR 47.7m (equivalent to ISK 6,794m) of the Senior unsecured bond in EUR with maturity in 2016. Parent.

	S&P counterparty credit rating (long-term)	S&P outlook	S&P counterparty credit rating (short-term)	Fitch long-term issuer default rating	Fitch outlook	Fitch short-term issuer default rating
April 2014	BB+	Stable	B-3			
October 2014	BB+	Positive	B-3			
April 2015	BB+	Positive	B-3	BBB-	Stable	F3
July 2015	BBB-	Stable	A-3	BBB-	Stable	F3
January 2016	BBB-	Positive	A-3	BBB-	Stable	F3

Exhibit 6.14. Íslandsbanki's credit rating history.

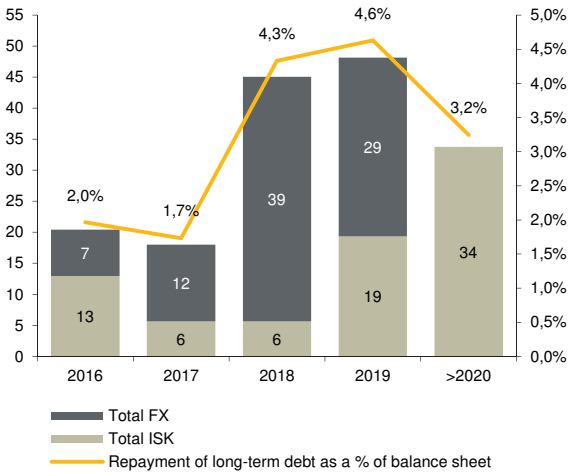

Exhibit 6.13. Maturity profile of long-term funding (ISK bn). Parent.

6.4.4 *ASSET ENCUMBRANCE*

Asset encumbrance ratio, 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.

Íslandsbanki's asset encumbrance ratio stood at 10.4% at year-end 2015 compared to 10.8% at year-end 2014. Exhibit 6.15 shows the development of the ratio since 2010.

6.4.5 *FUNDING OUTLOOK*

Although the Bank anticipates that it will continue to be predominantly deposit-funded for the foreseeable future, there nonetheless remains a range of external factors that will determine the path of its deposit-to-loan ratio. A general movement out of deposits into other asset classes is a likely eventuality as Icelandic financial markets continue to broaden. The Bank's policy is to mitigate these and other possibilities by putting in place a mixed funding platform that encourages deposits of various types, and capital markets funding sourced both domestically and overseas.

Íslandsbanki estimates that the total issuance of benchmark covered bonds will be between ISK 20 and 30 billion in 2016. Two

	Percent of total assets pledged as collateral
2010	8.6%
2011	9.6%
2012	11.5%
2013	12.2%
2014	10.8%
2015	10.4%

Exhibit 6.15. Development of asset encumbrance as a percentage of total assets. Parent.

series, ISLA CB 16 and ISLA CBI 16, are maturing this year and therefore the net issuance is estimated to be ISK 13–23 billion.

The Bank's chief foreign currency funding platform is its USD 750m Global Medium Term Note (GMTN) Programme. The GMTN Programme enables the Bank to issue transactions of all sizes in a range of currencies, with a minimum of cost and process. Bonds issued from the Programme are applicable of being listed on the Irish Stock Exchange. The Bank has issued multiple transactions in 2015 in SEK, NOK and EUR under the GMTN Programme, and anticipates similar activity in the years ahead. The raising of the Bank's ratings to investment grade in 2015 will mean access to a greater range of investors than previously, and an expectation that pricing should continue to improve on current levels.

6.5 LIQUIDITY CONTINGENCY PLAN

The Bank's *Liquidity Risk Policy* stipulates 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 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 stages are 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.

6.5.1 *REGULATORY CHANGES AND OUTLOOK*

As discussed above, the Central Bank of Iceland, has already incorporated the Liquidity Coverage Ratio and the Net Stable

Funding Ratio into the Icelandic liquidity rules – well ahead of the general implementation plan in Europe. The Central Bank has indicated that some changes could be made in the definitions underlying the calculations to reflect changes that have been made in 2016 through the implementation phase in Europe.

REGULATORY CHANGES

New Rules from the Central Bank of Iceland on Reserve Requirements No. 870/2015

On 30 September 2015 the Monetary Policy Committee (MPC) of the Central Bank of Iceland published a statement concerning their decision to increase reserve requirements from 2% to 4% as of the following reserve maintenance period, which began on 21 October 2015. According to the statement the purpose was to strengthen the Central Bank's liquidity management, in the wake of its substantial foreign currency purchases in the recent term and in connection with the composition of the failed bank´s estates and the planned auction to release or tie up offshore ISK balances. The MPC lowered the reserve requirements to 2.5% in December 2015.

7 OPERATIONAL RISK

In 2015, a total of 477 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 "Execution, Delivery and Process Management" accounts for 33% of all loss events, and the categories "External Fraud" and "Business Disruption and System Failures" each accounts for 28% of all loss events. The loss events in the category "Execution, Delivery and Process Management" account for 83% of the total loss amount attributed to operational risk in 2015.

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, in according to Icelandic law[1]. 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*, *Business Continuity Management Framework*, *Security Policy*, *Outsourcing 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 Unit is responsible for the implementation and monitoring of the operational risk framework throughout the Bank. However, each business unit is responsible for managing and controlling its own operational risk.

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.

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 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 reported regularly to the Board of Directors, the Executive Board and relevant business owners.

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 policy also offers coverage for wrongful act claims brought solely against the Directors & officers of the Bank.

The main processes for managing operational risk are; incident reporting 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 and management reporting that provides operational risk reports to relevant functions within the Bank.

7.3 INCIDENT REPORTING

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 and registered in the Bank's loss event database. The database holds information on all significant actual losses, categorised according to Basel categorization and severity, and provides a basis for management reports. Also, the loss event data is 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.

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

7.4 RISK AND CONTROL SELF ASSESSMENT

The Bank uses the Risk and Control Self-Assessment (RCSA) process to identify, assess, control and mitigate operational risk. The purpose of this framework is to improve the way the Bank operates through regular review of policies, processes, models and systems. The RCSA also provides an organized way of

[1] Act. No. 161/2002 on Financial Institution, article 78.

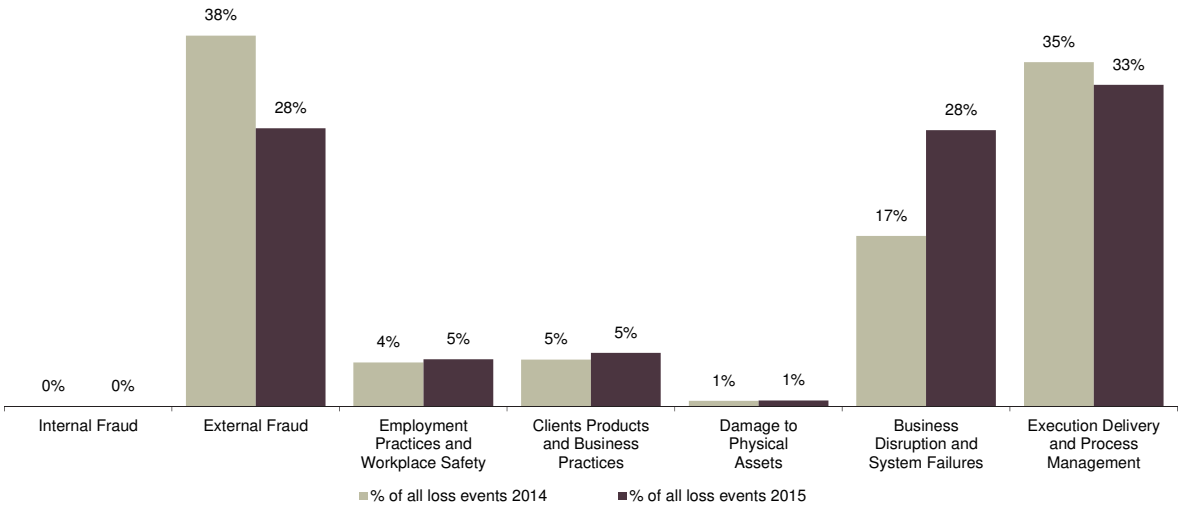

Exhibit 7.1. Number of loss events in 2014–2015 based on Basel event categories. Parent.

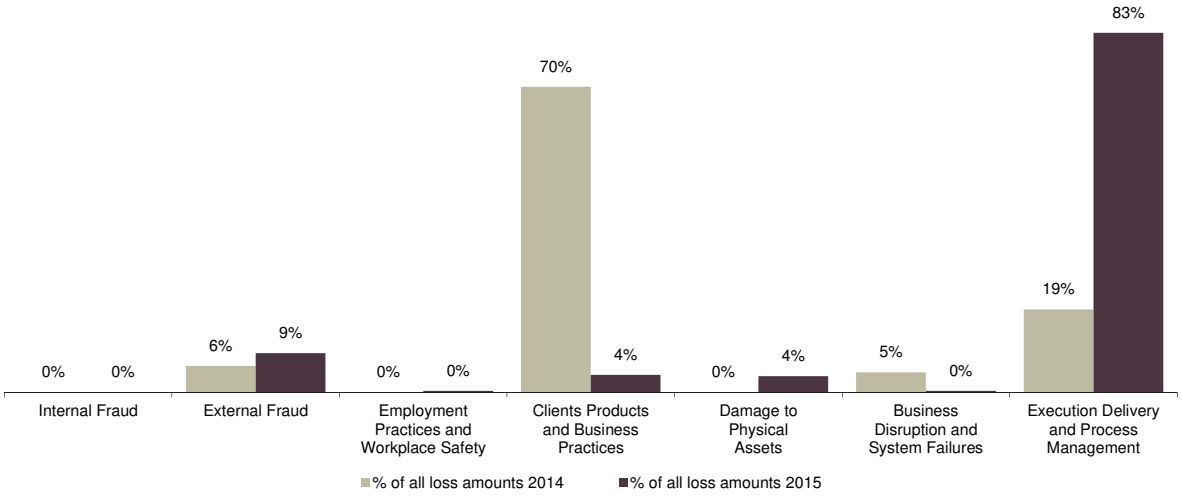

Exhibit 7.2. Loss amounts in 2014–2015 based on Basel event categories. Parent.

identifying controls and the effectiveness of controls by estimating risk before and after controls have been applied.

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. For every weaknesses found, risk score and controls are assessed. For all risks determined unacceptable, a mitigation plan is created and reported to senior management. All risks identified in the RCSA process throughout the Bank are registered in a database, managed by Risk Monitoring. The RCSA database is used for management reporting on the Bank's operational risk profile.

7.5 KEY RISK INDICATORS (KRI)

The Bank monitors Key Risk Indicators (KRI) in order to detect changes in the Bank's operational risk profile. KRIs are carefully selected parameters which can be measured consistently over time and can be indicative of the probability of loss events. The KRIs are used to direct management attention to business units, processes or systems where the operational risk profile is changing, i.e. where the probability of loss events is increasing.

The KRIs are reported monthly to the Executive Board and depending on the estimated severity of operational risk a mitigation plan and/or improvements in controls are reviewed thoroughly.

7.6 BUSINESS CONTINUITY

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 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 annually by each of the Bank's business units, as well as the accompanying alert levels and testing frequencies.

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.

As part of the ICAAP process the Bank gives special consideration to extremely rare, high impact events, Black Swan events, which could cause severe disruptions in the Bank's operations.

7.7 MANAGEMENT OF 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. Reputational risk is managed through KRI, RCSA and incident reporting.

The Executive Board has also approved a *Crisis Communication Policy* where responses to reputational crises are outlined.

7.8 MANAGEMENT OF 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, when contracts are not legally enforceable or rendered illegal by a court's ruling. 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 Bank financial statement[2]. The Bank continually reviews contract documentation in order to mitigate the risk of possible further litigation against 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.

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 takes on appropriate and sufficient measures to prevent money laundering and terrorist financing and reports to the competent authorities any knowledge of such illegal activities

The Bank has implemented a *Competition Policy* approved by the Executive Board. The main objective of the policy is to ensure that the Bank operates in every respect in accordance with the competition laws and regulations. The Bank's legal division is responsible for controlling the Bank's competitive issues by regular risk assessment, monitoring and advisory. The main competition issues are described further in the Bank's financial statement[3].

7.9 MANAGEMENT OF 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 and works according to ISO 27001 and ITIL[4]. Appropriate preventive and monitoring measures are taken in IT operations, and disruptions are handled according to business continuity plans which are updated regularly. The Bank's security managers perform regular security risk assessments on the Bank's IT-systems and certain measures of IT risk are among the KRIs presented to the Executive Board.

IT works according to ISO 27001 and ITIL. Based on ISO 27001, the Bank has an Information Security Management System (ISMS) in place including controls for risk assessment, asset management, human resources security, physical and environmental security, communications and operational management, access controls and business continuity management.

In addition to the aforementioned policies and procedures, the Bank is implementing controls to be compliant with PCI-DSS.

Íslandsbanki is currently taking part in the implementation of new core banking systems together with Reiknistofa Bankanna[5] (RB). RB runs shared infrastructure systems for Icelandic banks. The main motivation for the project is to replace legacy systems for deposits and payments, running on outdated technology platforms. The new systems, provided by Sopra Banking, enable greater flexibility, agility and reliability for Íslandsbanki's customers as well as increasing the Banks systems' operational stability. Concurrently with the implementation of RB's new core banking systems, a modernisation and renewal initiative of the Bank's internal system architecture is taking place. Although these projects will result in a significant reduction of operational risk in the long run, there is increased risk of IT related incidents and business disruptions in the short run. This risk is mitigated through continual risk assessment and contingency planning. The project is closely monitored by FME and the Central Bank.

Foreign exchange transactions have been subject to considerable restrictions since the introduction of capital controls in 2008.

[2] Íslandsbanki Consolidated Financial Statement 2015, note 55.

[3] Íslandsbanki Consolidated Financial Statement 2015, note 55.

[4] ITIL stands for Information Technology Infrastructure Library and is a well-known and well-established framework for best practices in IT service management. ITIL guidelines and best practices align IT actions and expenses to business needs and change them as the business grows or shifts direction.

[5] Reiknistofa Bankanna (RB) is an IT service centre for the Icelandic financial market.

The Icelandic government and the Central Bank have indicated that more rapid progress toward the liberalisation of the capital controls should be expected, now that composition in order to facilitate the conclusion of the failed financial institutions' winding up process has been approved by the Central Bank and the District Courts. In preparation for the liberalisation of the capital controls and the expected subsequent rise in foreign exchange transactions volume, the Bank has conducted a thorough operational risk assessment of systems and processes expected to be subjected to increased stress. Several risk mitigation plans were initiated, and individual system components are being replaced in preparation for the increased volume.

7.10 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.

7.11 PRODUCT APPROVAL PROCESS

The *Product Management Policy* documents the product approval process within the Bank. 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.

7.12 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* is in accordance with Icelandic law and regulations and FME Guidelines[6].

7.13 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 Icelandic law and regulations[7].

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.

[6] FME Rules No. 670/2013 on 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.
[7] FME Rules No. 215/2007 on the Capital Requirement and Risk Weighted Assets of Financial Undertakings.

REGULATORY CHANGES

Amendment to Act No 100/2010 on the Debtors' Ombudsman

The amendment act provides that the Debtors' Ombudsman shall have the authority to obtain any information the Debtors' Ombudsman deems necessary to perform his lawful duties from the government or private legal entities, even though such information is considered privileged information by law. According to the amendment act a daily penalty, ranging from 10,000 ISK to 1,000,000 ISK per day, may be imposed on any party that does not comply with the Debtors' Ombudsman's request for information within a suitable time limit set by the Debtors' Ombudsman. The amount of a daily penalty shall be proportional to the size and number of employees of the concerning party.

Act No. 47/2015 amending acts on criminal procedure and police

The purpose of the act was to transfer responsibility for the Anti Money Laundering (AML) office of the Commissioner of the Icelandic National Police to the new office of District Prosecutor.

Act No. 58/2015 on increased sanctions due to violations of laws regarding financial operations.

The act amended and harmonized provisions for sanctions of various acts regarding financial operations. Amendments were made to the act on foreign exchange, the act on electronic registration of rights of title to securities, the act on interest and indexation, the act on financial undertakings, the act on securities transactions and a few others. The act provided that fines imposed on individuals for violations can range up to 20,000,000 ISK and fines imposed on legal entities can range from 500,000 ISK to 800,000,000 ISK, but fines on legal entities can range up to 10% of total turnover of the legal entity if the entity is part of a group of subsidiaries and the violation is designed to benefit another subsidiary within the same group. The act also stipulates that violations of provisions regarding restrictions on large exposures of financial undertakings are subject to fines or imprisonment for up to 6 years.

FME – Guidelines on outsourcing for supervised entities No. 6/2014

FME published guidelines on outsourcing for supervised entities. The guidelines provide for the main principles that FME considers supervised entities should follow when outsourcing any part of their operation.

Act No. 33/2015 amending various acts on taxation

On 15 June 2015 various acts on taxation and the collection of taxes and tariffs were amended. Among notable changes was an increase of income tax levied on individuals and legal entities having a limited tax liability in Iceland from 18% to 20%.

Agreement on information exchange (FATCA)

On 26 May 2015 an agreement between the governments of Iceland and the USA was signed regarding information exchange due to the US Foreign Account Tax Compliance Act (FATCA). According to the agreement, financial institutions in Iceland are required to inform the Icelandic tax authority (RSK) of all income and assets of US citizens. If a financial undertaking is not compliant with the information exchange, a 30% withholding tax can be levied on all payments made to them originating in the USA.

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) publishes rules on *Remuneration Policy* for financial undertakings.[1] 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.

According to the Basel Pillar 3 disclosure requirements for remuneration the quantitative disclosure of remuneration in the Pillar 3 Report should only cover senior management and other material risk takers. CRD IV defines material risk takers as employees "whose professional activities have material impact on an institutional risk profile".

As described in Section 1.1 the CRD IV framework has not been fully implemented into Icelandic law but was partially implemented by an amendment on the Act on Financial Undertakings.[2] The amended Act provides that the Financial Supervisory Authority (FME) issues further guidance and rules on the remuneration system including disclosure and transparency. FME has yet to publish new rules reflecting this recent change in the law. The current rules on the remuneration system for financial institutions were issued on 4 July 2011 and have not been renewed since.

Since FME has not provided guidance regarding the definition of "material risk takers" the Bank uses the internal classification of "key employees" as defined in the Bank's *Rules on Qualification of key employees*. According to Íslandsbanki's rules, the Bank has defined key employees as employees, other than the CEO, who are empowered to make decisions that can have a material impact on the future development and performance of the Bank, this is in accordance with the definition of a key employee in the aforementioned Act on financial undertakings and the FME rules on the remuneration system. The Board determines which employees are considered to fall under this definition and Compliance maintains a list of the key employees at any given time. Currently, only members of the Executive Board are on the list of key employees.

8.2 REMUNERATION GOVERNANCE

Íslandsbanki's *Remuneration Policy* was 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 six meetings in the year 2015.

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

Íslandsbanki's variable remuneration system is a Budgeted Performance Plan (BPP) where a variable performance payment can materialise if specific budgeted numbers and Key Performance Indicators (KPIs) 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 performance 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 TO KEY EMPLOYEES IN 2015

According to the above definition there are currently 9 key employees at Íslandsbanki, the Chief Executive Officer and 8

[1] Rules No. 700/2011 on Remuneration Policy for Financial Undertakings in accordance with Act No. 161/2002 on Financial Undertakings.
[2] Act No. 57/2015 amending Act No. 161/2002 on Financial Undertakings.
[3] https://www.islandsbanki.is
[4] See Annual Report 2015 for more information about the governance structure.

Total remuneration earned in the financial year 2015 broken down by fixed and performance based remuneration	Board of Directors	Executive Board
Total annual remuneration	51	384
Number of beneficiaries	10	9
Total fixed remuneration	51	324
Total variable remuneration	-	60
Cash	-	60
Shares	-	-
Share-linked instruments	-	-
Other	-	-
Variable remuneration % of fixed	-	18.4%
Outstanding deferred remuneration for the financial year 2015	-	60
Vested	-	-
Unvested	-	60
Total variable remuneration earned in 2014	-	49
Paid out in 2015	-	28
Reduced through performance adjustments	-	2
Deferred	-	19
Sign-on and severance pay granted during the financial year 2015	-	-
Total amount	-	-
Number of beneficiaries	-	-
Highest individual award	-	-

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

Executive Managers. Exhibit 8.1 provides total remuneration for the Board of Directors and the Executive Board in the financial year 2015. Currently, seven Executive Managers are a part of the variable remuneration system. The amounts are broken down into fixed and performance-based remuneration where fixed remuneration figures include pension contributions and other salary related benefits that are not tied to the variable remuneration scheme.

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

Deferred remuneration is split into vested and unvested amounts where the vested amount refers to guaranteed payments earned in 2015 and due to be paid in 2016 or later. The unvested amount is the additional amount that could become vested for the financial year 2015. The unvested amount could at year-end 2015 have been paid, vested and deferred or reduced through performance evaluation.

No sign-on or severance pay was granted to the employees in scope during the financial year 2015.

The salaries and other benefits of the Bank's management and the Board of Directors are disclosed in the Annual Report, according to the IFRS standards[5]. Please note that the amounts displayed in Exhibit 8.1 are not fully comparable to the figures in the Annual Report since the basis for preparation differs.

[5]Note 20 in the Consolidated Financial Statements 2015.

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.

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.

Expected loss (EL) The annual expected loss for an obligor is the probability that the obligor defaults (PD), times the possible loss. The possible loss, is the exposure at time of default (EAD) times the loss given default (LGD).

Exposure at default (EAD) Expected credit exposure of facility at time of default.

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

Herfindahl-Hirschman Index (HHI) A measure of the size of exposures in relation to the portfolio. It is defined as the sum of the squares of exposures dived by the square of the sum.

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-to-value band: The loan-to-value (LTV) of a portfolio can be represented by considering 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 underlying 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.

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.

Non-performing ratios A way to measure asset quality for loans to customers. A facility is non-performing if a facility's loan is either impaired or more than 90 days past due. The ratio is based on the carrying amount.

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

Observed default frequency (ODF) The ratio of customers that defaulted during the observed period.

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

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.

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.

Problem loans Loans that are either more than 90 days past due or specifically impaired.

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 reflect 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 Equity Tier 1 capital and Additional Tier 1 capital less regulatory deductions.

- *Common Equity 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.
- *Additional Tier 1 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.
- Regulatory deductions include f. example holdings in financial institutions and tax assets.

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.

Total capital base Tier 1 capital in addition to Tier 2 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

AGM	Annual General Meeting
ALCO	Asset and Liability Committee
ASF	Available Stable Funding
AT1	Alternative Tier 1
BCBS	Basel Committee on Banking Supervision
BIS	The Bank for International Settlements
BoD	Board of Directors
BPP	Budgeted Performance Plan
BPV	Basis Point Value
BS	Balance Sheet
CAE	Chief Audit Executive
CB	Central Bank
CCF	Credit Conversion Factor
CEO	Chief Executive Officer
CET1	Core Tier 1 Capital
CIRS	Cross Currency Interest Rate Swap
CIU	Collective investments undertakings
CLTV	Combined Loan to Value
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
EEA	European Economic Area
EL	Expected Loss
EU	European Union
FATCA	Foreign Account Tax Compliance Act
FME	Financial Supervisory Authority, Iceland
FX	Foreign Currency
GMTN	Global Medium Term Note
HFF	Housing Financing Fund
HQLA	High Quality Liquid Assets
IAS	International Accounting Standard
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
ISO	International Standards Organization
ITIL	Information Technology Infrastructure Library
KPI	Key Performance Indicators
KRI	Key Risk Indicators
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
LSS	Municipality Iceland (i. Lánasjóður sveitarfélaga)
LPA	Loan Portfolio Analysis
LTV	Loan to Value
NPO	Non-profit Organisation
NSFR	Net Stable Funding Ratio
ODF	Observed Default Frequency
PD	Probability of Default
PSE	Public Sector Entity
PSI-DSS	Payment Card Industry Data Security Standard
RB	Reiknistofa Bankanna
RCSA	Risk and Control Self-Assessment
REPO	Repurchase Agreements
RSF	Required Stable Funding
RSK	Icelandic Tax Authority
ROE	Return on equity
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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