Pillar 3 Risk Disclosures

Arion Bank 2021

Disclaimer

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Declaration

The Board of Directors is responsible for the Bank's risk management framework and for ensuring that satisfactory risk policies and governance for controlling the Bank's risk exposure are implemented. The Board reviews on a regular basis the status of risk management issues to assess the management and monitoring of the Bank's risks.

It is the Board's assessment that the Bank has in place adequate risk management arrangements with regard to the Bank's risk profile and risk policy.

Risk Statement

Arion Bank is a strongly capitalized bank. Its purpose is to excel by offering agile and reliable financial solutions which create future value for its customers, shareholders and society as a whole. The Bank provides diverse and value-added services for its customers, guided by sustainability and responsibility, and applies digital solutions for customer convenience. The Bank is committed to supporting the economy and financing of households and corporates notwithstanding challenging and uncertain times.

The Bank's business strategy is aligned with its risk appetite as set by the Board. The business strategy is associated with the Bank's risk profile by ensuring that the Bank's business plan does not violate the risk appetite. The risk appetite is cascaded down to risk limits and targets.

The Bank's business model assumes a return to growth in corporate lending while maintaining sector diversification and limited large exposures, with continued application of the Bank's pricing and syndication strategy. The expected sale of the Bank's subsidiary Valitor hf. and execution of the bancassurance strategy both impact the Group's earnings and risk profile going forward.

Credit risk is one of the Bank's primary risk factors. The Bank's credit policy forms the basis for its credit strategy as integrated in the business plan. Credit risk is managed in line with credit risk appetite metrics, which address single-name and sectoral concentration, and credit quality. At the end of 2021, the Bank's largest exposure was 11.4% of Tier 1 capital and the expected credit loss rate was 24 bps.

The Bank invests its own capital on a limited and carefully selected basis in transactions, underwriting and other activities that involve market risk. Market risk is managed in accordance with the risk appetite and risk limit framework. At the end of 2021, total net equity position in the trading book and total equity position in the banking book was 1.6% and 10.2%, respectively, of normalized own funds.

Liquidity risk is a key risk factor. The Bank follows a conservative approach to liquidity exposure, liquidity pricing and funding requirement. The Bank's funding profile supports its liquidity profile. Liquidity positions are managed on a day-to-day basis by internal limits and targets in line with the risk appetite and regulatory standards. The Bank's liquidity coverage ratio was 203% at the end of 2021, while the regulatory requirement was 100%.

The Bank's business units are primarily responsible for managing their own operational risks with support from control functions. The Bank's operational risk framework integrates risk management practices into processes, systems and culture. The Bank has no tolerance for internal fraud and compliance breaches, and the risk appetite statement further attends to observation of standards of market integrity, good practice and conduct, and minimization of incidents and mistakes.

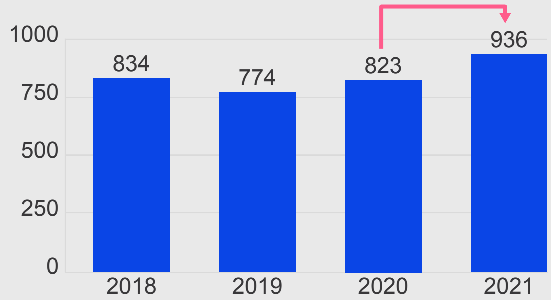
The Bank has integrated sustainability risk into its enterprise risk management framework, thus incorporating environmental, social and governance factors in decision making and strategy. The Bank seeks to ensure that its activities and the financial services it provides do not result in an unacceptable impact on people or the environment and is committed to support the global effort to transition to a net zero carbon economy.

The Bank is well capitalized with capital adequacy ratio of 23.8%, and CET1 ratio of 19.6% at the end of 2021 exceeding both the regulatory requirements and the risk appetite.

The Board of Directors of Arion Bank

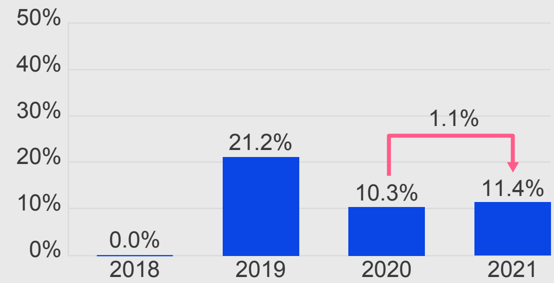
Risk Metrics Overview

Loans to customers



See section 4.3

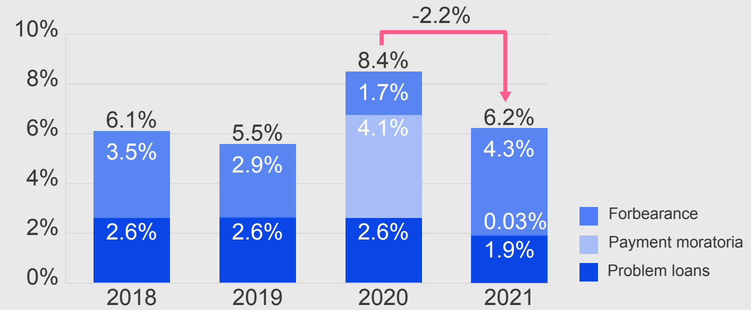
Sum of large exposures*



*net of eligible collateral

See section 4.3.4

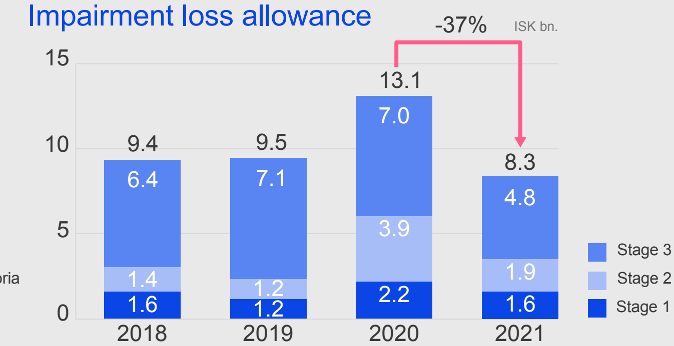
Problem loans and payment moratoria



Problem loans and COVID-19 related payment moratoria, as % of loans to customers at gross carrying value

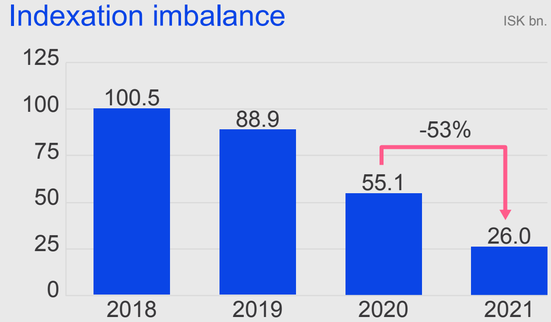
See section 4.6

Impairment loss allowance



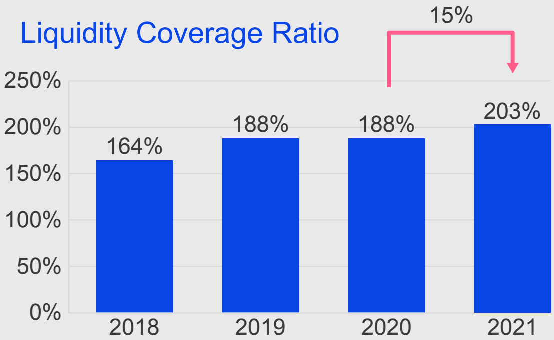
See section 4.6

Indexation imbalance



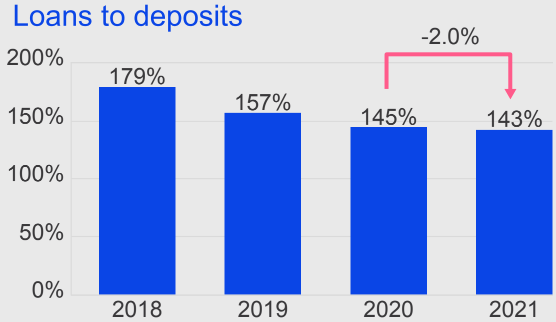
See section 5.6

Liquidity Coverage Ratio



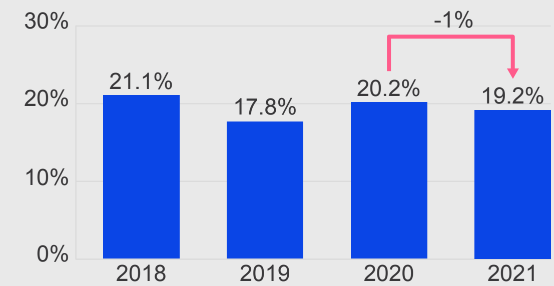
See section 6.4

Loans to deposits



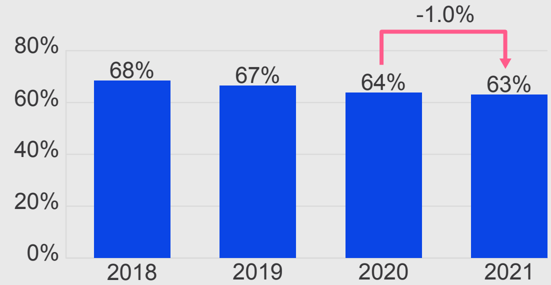
See section 6.5

Asset encumbrance ratio



See section 6.5

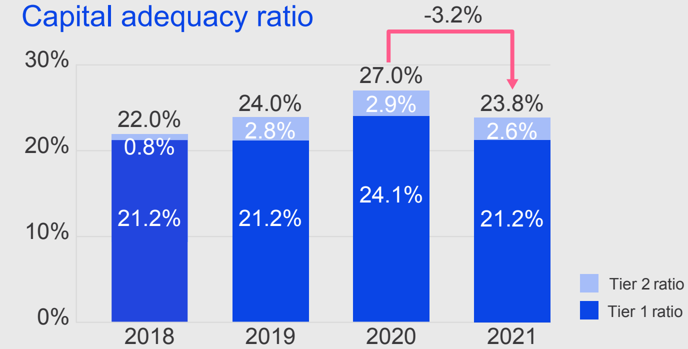
Risk-weight density*



See section 3.4

*Risk-weighted exposure amount divided by total assets

Capital adequacy ratio



See section 3.9

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1 Introduction

1.1 Arion Bank at a Glance
1.2 Highlights of 2021
1.3 Regulatory Framework
1.4 Communication Policy
1.5 Pillar 3 Risk Disclosures

1 Introduction

The Pillar 3 Risk Disclosures comprise information on Arion Bank's risk profile, risk management and capital adequacy. The report is based on disclosure requirements set out in Regulation EU 575/2013 (CRR) and pertains to the conditions of the Bank's prudential consolidation, which excludes insurance subsidiaries. The disclosures contain information on new and forthcoming legislation as well as information on the Bank's remuneration policy.

1.1 Arion Bank at a Glance

Arion Bank ('the Bank') is a well-balanced and diversified universal relationship bank operating in the Icelandic financial market. The Bank is listed on the Nasdaq Iceland and Nasdaq Stockholm regulated markets. The Bank is classified as a domestic systematically important institution (D-SII) by the Financial Supervisory Authority of the Central Bank of Iceland (FSA).

The Bank, whose roots date back to 1930, is built on strong heritage and infrastructure. Arion Bank is a strongly capitalized bank which provides broad banking services to corporations and individuals. The Bank aims to excel by offering smart and reliable solutions which create future value for customers, shareholders and society as a whole.

The Bank operates a number of branches across Iceland but has been optimizing its branch network in recent years by streamlining branch premises and introducing digital branches. Numerous new digital solutions have been launched in the past few years, improving customer convenience and operational efficiency.

Figure 1.1 Arion Bank's branch network

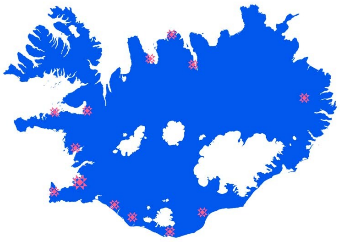
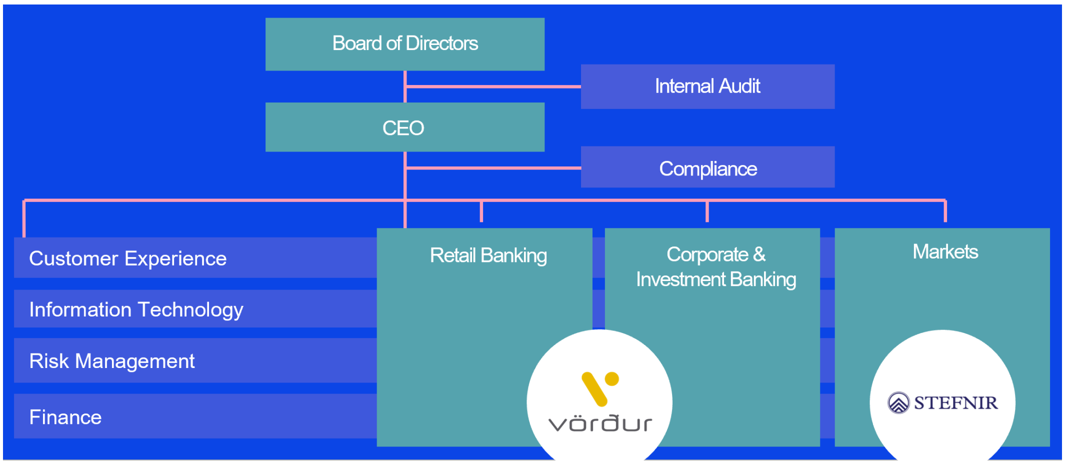


Figure 1.2 Arion Bank's organizational chart



The Bank consists of three business segments: Retail Banking, Corporate & Investment Banking and Markets. There are four support units: Finance, Information Technology, Risk Management and Customer Experience, which was set up in 2021 to coordinate the Bank's strategic advancement in customer journey optimization. Furthermore, the Bank owns strategic subsidiaries that are important for its service offerings. Stefnir is the largest fund management company in Iceland and Vörður is the fourth largest insurance company, providing non-life and life insurance. The diverse service offering at Arion Bank means that the revenue base is broad and the loan portfolio is well diversified between retail and corporate customers and different business sectors. This results in good risk distribution relative to the Icelandic economy.

The Group is in the process of integrating the operations of Arion Bank and Vörður with the aim to apply the Bank's distribution channels to drive the Group's bancassurance strategy, thus creating a 'one-stop shop' with a broad range of financial and insurance products under a strong brand.

Implementation of the Group's bancassurance strategy is underway

As part of the Bank's long-term vision, the Bank sees opportunities to actively participate in the emergence of growth and importance of the Arctic in the global economy. In its activities outside of Iceland, the Bank's focus is on sectors that are familiar to the Bank, primarily segments that relate to the country's knowledge and export industries.

Iceland is uniquely positioned to become the financial hub in the Arctic

At year end 2021 the number of full-time equivalent (FTEs) positions at Arion Bank was 619 with an additional 132 FTEs in subsidiaries.

The Bank's Annual and Sustainability Report 2021 provides further information about the Bank, such as strategy and vision, sustainability policy and corporate governance.

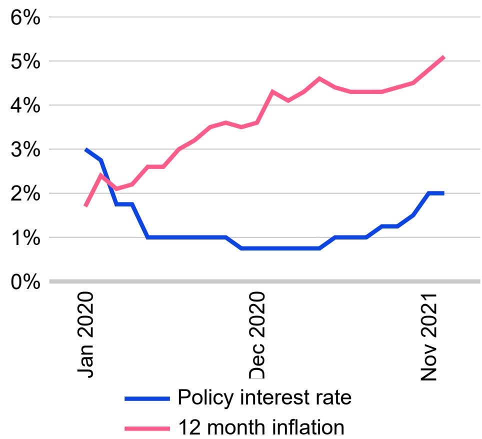
1.2 Highlights of 2021

Several developments influenced Arion Bank's risk profile in 2021. Highlights include:

COVID-19 pandemic: Impact on the economy and the Bank's risk profile

The global economic shock caused by the COVID-19 pandemic is far-reaching. Social distancing measures have disrupted supply chains, altered consumer behavior and resulted in a collapse in tourism activities, which represented Iceland's largest export industry.

Figure 1.3 The Central Bank of Iceland's key benchmark rate and 12 month inflation

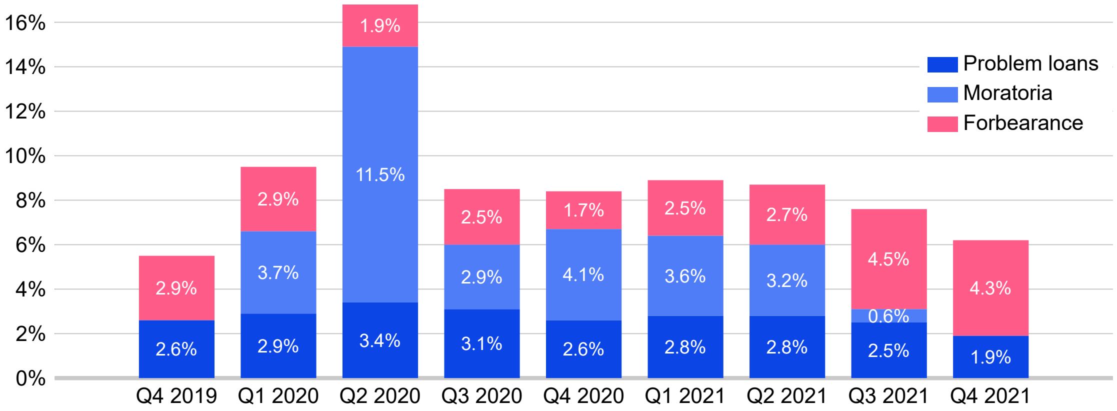


The economic and societal effects have been mitigated to a large extent through various measures. The government has provided part-time unemployment benefits, government guaranteed support loans, resilience subsidies for businesses with significant revenue losses, and various support schemes for individuals. The Central Bank of Iceland lowered its benchmark rate to an unprecedented 0.75% but in May 2021 reverted its stance in light of economic recovery and inflationary pressure. The rate was 2% at year-end 2021 and inflation 5.1%.

The Bank has supported its trusted clients, both corporates and individuals, through the application of payment moratoria and restructuring of loans, which generally leads to forbearance status. As a result of these measures, defaults and problem loans have not increased as otherwise would have been expected.

Introduction

Figure 1.4 Development of problem loans, payment moratoria and forbearance, as % of loans to customers at gross carrying value



The pandemic and associated health measures have hit tourism activities the hardest. In contrast, for a large segment of the economy the economic fallout has been limited and for some segments, credit risk indicators have improved from the outset e.g. as a result of increase to savings, lower borrowing costs and altered consumer behavior. The disproportionate consequences of COVID-19 are reflected in the Bank's impairments, as 48% of the Bank's credit provisions at year-end 2021 are due to exposures that are classified as being dependent on tourism activities. Those exposures however represent only 7.9% of loans to customers.

For a discussion on the Bank's sector concentration, see section 4.3.2. For a discussion and analysis of credit exposures that are assessed as being distinctly affected by the pandemic, see section 4.6.3 and Note 42 in the Bank's Consolidated Financial Statement for 2021.

A recovery is underway, although disrupted by the omicron variant. Following a 6.5% contraction in gross domestic product in 2020, 3.9% growth is projected in 2021 by Statistics Iceland and 5.3% in 2022, largely driven by an increase in private consumption and capital formation. The number of visiting tourists increased by 45% between years, mostly driven by a surge of travelers from the United States starting in May 2021. At the same time, turnover measured from foreign credit card use increased by 82%, indicating a significant incease in expenditure per traveler and length of stay, which is related to demography and complications of travel.

The economic risk from increased interest rates, inflation and wage pressure may negatively affect cost of borrowing, production and remuneration, and thus, coupled with significant rise in real estate and equity markets and supply chain disruptions, affects the Bank's assessment of credit risk going forward.

Figure 1.5 Proportional distribution of credit exposures and impairments by segments at year-end 2021

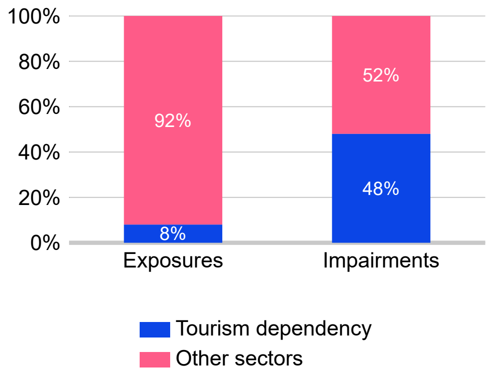


Figure 1.6 Number of visiting tourists and foreign credit card turnover. Source: Icelandic Tourist Board.

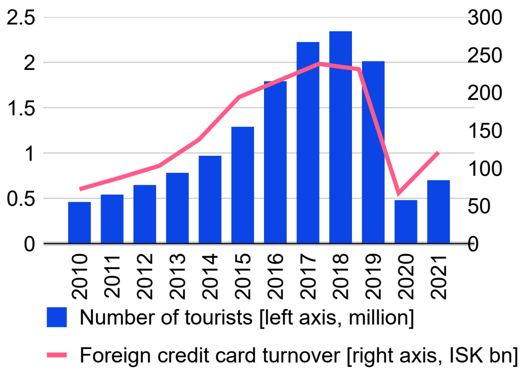
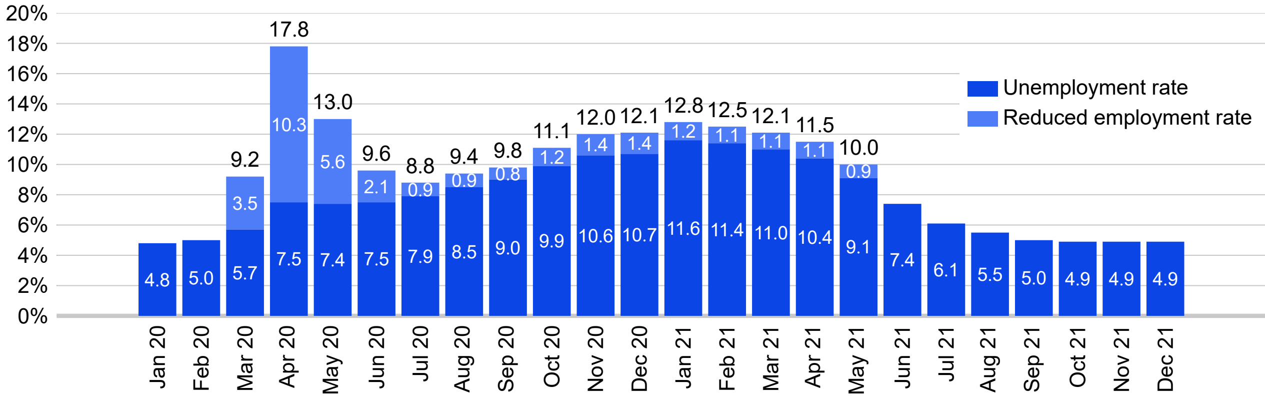


Figure 1.7 Unemployment rate [%] in Iceland 2020-2021, as measured by the Directorate of Labour. Benefits for reduced employment expired in May 2021.



Sale of Valitor

In July 2021, Rapyd, a global Fintech-as-a-service company, entered into a definitive agreement with the Bank to acquire its subsidiary Valitor hf., an Iceland based company which offers holistic payment solutions directly to merchants in Iceland, the U.K. and Ireland, and across Europe. The purchase price is USD 100 million. The transaction is subject to regulatory approval and is expected to close in the first half of 2022. The sale will release capital of up to ISK 11 billion.

Sustainability risk

The Bank has introduced sustainability risk as a primary risk factor in the Bank's risk taxonomy. It is defined as the risk of certain activities or practices compromising the ability of future generations or segments of society to meet their own needs, e.g. due to negative effects on the environment, natural or cultural resources or social conditions.

In 2021, Arion Bank scored 90 points out of 100 in Reitun's ESG risk assessment. This was the highest score given among 34 issuers in the Icelandic market.

Environmental, social and governance risks are now fully incorporated in the Bank's enterprise risk management framework and a dedicated Sustainability Committee has been introduced as part of the Bank's risk governance structure. Its primary role is to review the Bank's perfomance in relation to its commitments in the area of sustainability, and align the Bank's strategy and risk appetite with them. The committee reviews ESG risk assessments and oversees the Bank's Green Financing Framework.

The Bank has set specific objectives in relation to sustainable financing and gender equality. See further information on sustainability risk in Chapter 8 of these disclosures.

Capital adequacy

The Bank's capital ratio at 31 December 2021 was 23.8%, which exceeds the total regulatory requirement of 18.5%. The Bank's Common Equity Tier 1 ratio (CET1) at 31 December 2021 was 19.6% compared to a 13.6% regulatory requirement. Both ratios account for a foreseeable equity reduction of ISK 26.8 billion in the form of a ISK 22.5 billion net dividend distribution and a ISK 4.3 billion buyback of own shares. In addition to the foreseeable equity reduction, the Bank has ISK 21 billion of excess capital relative to its target CET1 capital ratio of 17%.

S&P's long-term rating of Arion Bank is BBB with a stable outlook

The CRD IV/CRR II package was implemented in Iceland in June

2021, see further in the Regulatory Framework section below. The implementation brought about changes to the capital requirement for counterparty credit risk, an expanded SME supporting factor and a redefined threshold for large exposures at 10% of Tier 1 capital as opposed to 10% of own funds. See further information in Chapter 3.

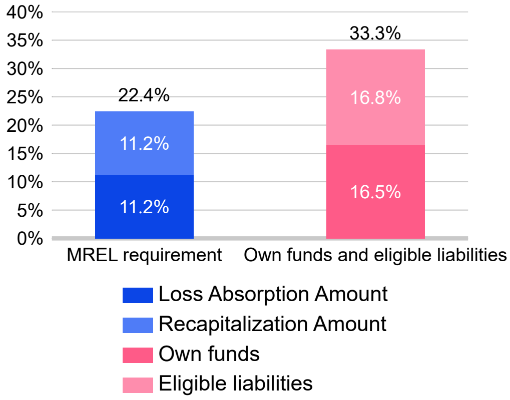
MREL requirement

In December 2021, the Icelandic Resolution Authority published its Policy on minimum requirement for own funds and eligible liabilities (MREL). The Bank's MREL requirement under BRRD I is to be determined by the Resolution Authority in early 2022. The requirement will consist of a loss absorption amount (LAA) and a recapitalisation amount (RCA) and is to be met by own funds, less CET1 capital used to meet capital buffer requirements, and liabilities that are eligible to be bailed in a resolution scenario. The policy indicates that the MREL requirement will be twice the capital requirement under Pillar 1 and Pillar 2, which equals 22.4% of REA for Arion Bank. The requirement may however be adjusted based on the Bank's resolution plan.

No subordination requirement is presented under BRRD I, but it will become mandatory when BRRD II comes into effect which may be as early as 2024. The Resolution Authority has indicated a subordination requirement of 13.5% of REA under BRRD II, which may result in the Bank issuing senior non-preferred bonds.

The Bank comfortably meets the upcoming MREL requirement as indicated in the policy. See further information in Chapter 3 of these disclosures.

Figure 1.8 MREL requirement and MREL position, percent of REA



1.3 Regulatory Framework

Capital and risk management disclosure requirements for financial institutions are stipulated in the Basel framework. The framework is an international accord on capital requirements and is intended to strengthen measurement and monitoring of financial institutions' capital by adopting a more risk sensitive approach to capital management.

The Basel framework encompasses three complementary pillars:

- Pillar 1 - capital adequacy requirements
- Pillar 2 - supervisory review
- Pillar 3 - market discipline

Under Pillar 3, capital adequacy must be reported through public disclosures that are designed to provide transparent information on capital structure, risk exposures, and the risk assessment process.

In 2013, the EU Council adopted the CRD IV/CRR framework, which consists of the Capital Requirements Directive (CRD IV: Directive No. 36/2013) and the Capital Requirements Regulation (CRR: Regulation No. 575/2013). This regulatory framework represented the EU's first major step in implementing the Basel III reforms, aimed to strengthen regulation, supervision and risk management of banks, e.g. with increased level of capital requirements to ensure that banks are sufficiently resilient to withstand losses in times of stress. The framework constitutes the cornerstone of the so-called European Single Rule Book for financial regulation.

The CRD V / CRR II package was implemented in Iceland in 2021

In 2019, the EU Council adopted revised rules on capital requirements (CRD IV/CRR II) and resolution (BRRD/SRM), thus finalizing the Basel III implementation and setting the stage for what is widely refered to as Basel IV.

The CRR was incorporated into the EEA Agreement in late 2019, while since 2015 the implementation in Iceland was brought about through various amendments to the Financial Undertaking Act No. 161/2002 and secondary legislation (Regulation No. 233/2017). In June 2021, CRD IV/CRR II was implemented through Act No. 44/2021 and Regulation No. 749/2021, while BRRD II provisions were excluded. BRRD I is currently in effect in Iceland. The full incorporation of CRR into Icelandic law is expected to be finalized 2022 through an amendment of Act No. 161/2002.

1.4 Communication Policy

The Bank has in place a Communication Policy, approved by the Board of Directors, addressing the requirements laid down by law for information on risk management and capital. Accordingly, the Bank may omit information if it is not regarded as material. Information is regarded as material in disclosures if its omission or misstatement could change or influence the assessment or economic decisions of a user relying on the information.

In addition, if required information is deemed to be proprietary or confidential, the Bank may decide to exclude it from the Pillar 3 Risk Disclosures. The Bank defines information as proprietary which, if shared, would undermine the Bank's competitive position. Information is regarded as confidential if there are obligations binding the Bank to confidentiality.

1.5 Pillar 3 Risk Disclosures

The purpose of Arion Bank's Pillar 3 Risk Disclosures is to fulfill the aforementioned legal disclosure requirements and provide comprehensive information on the Bank's risk management and capital adequacy. The disclosures are prepared in accordance with legislative requirements regarding public disclosure, including EU Regulation 2021/637 which implements technical standards with regard to disclosure requirements under Part Eight of the CRR. EBA standardized disclosure templates can be found in the Additional Pillar 3 Risk Disclosures document on the Bank's website.

Information in the disclosures refers to the Arion Bank's consolidated situation as per CRR, which consists of the parent entity, Arion Bank, and its subsidiaries, excluding insurance subsidiaries; together referred to as the 'Bank'. The Bank is subject to consolidated supervision by the FSA. The basis of consolidation for financial accounting purposes differs from regulatory capital reporting purposes. The differences in the scopes of consolidation are set out in template EU LI3 in the Additional Pillar 3 Risk Disclosures. Where necessary, a distinction is made in the report between the consolidated situation and the parent entity.

All financial figures, calculations and information in the disclosures are based on financial information as at 31 December 2021 and presented in million krona, unless otherwise stated. Due to rounding, numbers in the disclosures may not add up precisely to the totals provided and percentages may not precisely reflect the absolute figures. The disclosures are published on an annual basis in conjunction with the Consolidated Financial Statements and the Annual Report. The EBA standardized disclosure templates are published quarterly, semi-annually or annually in accordance with CRR.

The disclosures are reviewed for accuracy and appropriateness, and verified and approved internally, in line with the Bank's disclosure policy. Information in the disclosures are not subject to external audit. Summarized information on risk management and capital adequacy is presented in the Bank's financial statements.

2 **Risk** Management

2.1 Internal Controls and Lines of Reporting
2.2 Three Lines
2.3 Risk Committees
2.4 The Risk Management Division
2.5 The Compliance Function
2.6 Risk Policies
2.7 Risk Appetite
2.8 Reporting

2 Risk Management

The Bank is in the business of taking enlightened risk. Risk is primarily incurred from extending credit to customers through trading and lending operations. Beyond credit risk, the Bank is also exposed to a range of other risk types such as liquidity risk, market risk, operational risk, compliance risk, sustainability risk and business risks that are inherent in the Bank's strategy, product range and operating environment.

Risk transparency for senior managers helps them make better decisions. The Bank's risk management policy is to maintain a strong culture in which risk is everyone's business.

The Bank's strategy is to have an effective risk management framework which entails the identification of significant risks, the quantification of risk exposures, risk monitoring, and actions and controls to limit risks. Senior management devotes a significant portion of its time to managing the Bank's risk. The Bank's risk exposures are categorized into six primary types; credit, market, liquidity, operational, conduct and compliance, and sustainability risk. Each type is discussed in detail in this report.

2.1 Internal Controls and Lines of Reporting

The Bank is committed to the highest standards of corporate governance in its business, including risk management. The Bank's corporate governance framework is based on legislation, regulations and recognized guidelines in force at each time. The ultimate responsibility for setting the Bank's risk and governance policies and for ensuring effective internal control and management of risk rests with the Board of Directors. The enforcement of the Board's policies is delegated to the Chief Executive Officer (CEO) who in turn has established a risk committee structure on the management level and delegates responsibilities to the Chief Risk Officer (CRO) and the Compliance Officer.

The Bank is committed to the highest standards of corporate governance in its business, including risk management

The CEO, on behalf of the Board of Directors of Arion Bank, interacts with the boards of directors of individual subsidiaries and ensures that the risk appetites of subsidiaries align with the risk appetite of the Bank. Through the group-level Internal Capital Adequacy Assessment Process (ICAAP) and Internal Liquidity Adequacy Assessment Process (ILAAP), the CRO interacts with individual subsidiaries' risk officers and consolidates the assessment of capital requirements for the Bank.

Risk Management

Figure 2.1 Internal control structure

Acting within an authority delegated by the Board, the Board Risk Committee (BRIC), see Table 2.1, is responsible for the overseeing and reviewing of prudential risks and capital adequacy. The BRIC reviews the Bank's risk appetite at least semi-annually, see section 2.7, and makes recommendations thereon to the Board when applicable. Its responsibilities also include reviewing the appropriateness and effectiveness of the Bank's risk management systems and controls, as well as considering the implications of material regulatory change proposals.

The BRIC reviews the Bank's risk appetite and makes recommendations thereon to the Board when applicable

Internal Audit is responsible for the independent review of risk management and the control environment. Its objective is to provide reliable, valuable and timely assurance to the Board and Executive Management of the effectiveness of controls, mitigating current and evolving material risks and in so doing enhancing the risk culture within the Bank. The Board Audit Committee (BAC) reviews and approves Internal Audit's plans and resources, and evaluates the effectiveness of Internal Audit. The Chief Internal Auditor is appointed by the Board and accordingly has an independent position in the Bank's organizational chart.

The Compliance Officer and the Compliance function operate according to a charter for compliance defined by the Board of Directors. The Compliance Officer reports to the CEO with unhindered access to the Board. Compliance also reports quarterly to the BRIC and annually to the Board of Directors.

The CRO and the Risk Management function operate according to a charter for Risk Management defined by the Board of Directors. The CRO is a member of the Executive Management Committee and reports to the CEO with unhindered access to the Board. The CRO has overall day-to-day accountability for risk management in the Bank's parent company and periodic accountability for risk assessment in the Bank's subsidiaries through the ICAAP and the ILAAP. Section 2.4 outlines the organization of the Risk Management division.

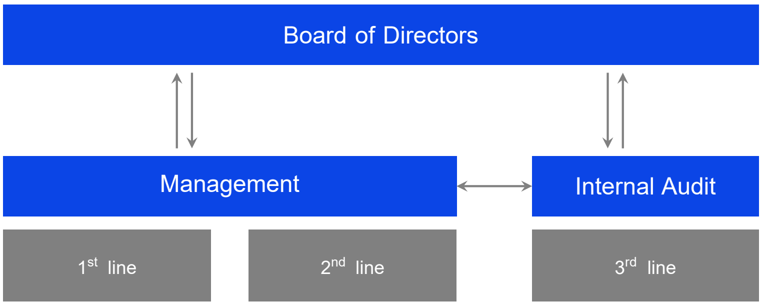
For further information on the Bank's governance arrangements please refer to the Corporate Governance Statement for the year 2021, which provides information on directorships held by Board members, nomination and diversity issues for the selection of Board members, and the number of times BRIC met during the year 2021.

2.2 Three Lines

The Bank looks to the Three Lines Model for organizing internal controls. All lines work together to contribute to the creation and protection of value, as aligned with the prioritized interests of stakeholders. Alignment of activities is achieved through communication, cooperation, and collaboration. This ensures the reliability, coherence, and transparency of information needed for risk-based decision making.

The Bank looks to the Three Lines Model for organizing internal controls

Figure 2.2 Three lines



The role of the Board of Directors

The Board of Directors is ultimately accountable for the internal control system at Arion Bank and accepts accountability for oversight of the organization and engages with shareholders and other stakeholders to monitor their interests and communicate the achievement of objectives. The Board of Directors ensures that appropriate structures and processes are in place for effective governance, in accordance with regulatory requirements and recognized guidelines, and ensures that organizational objectives and activities are aligned with prioritized interests of stakeholders.

The Board of Directors delegates authority and responsibility formally and provides resources to management to achieve the objectives of the organization, while ensuring legal, regulatory and ethical expectations are met. It also determines the Bank's risk appetite and tolerance, and exercises oversight of risk management (including internal control and compliance). Moreover, the Board of Directors oversees an internal audit function to provide clarity and confidence on progress toward the achievement of the Bank's objectives.

For additional oversight, the Board of Directors appoints subcommittees in accordance with established charters.

The role of Management

Management comprises first and second line roles. Its responsibility is to achieve organizational objectives and managing risks by designing and implementing a control system.

First line roles are most directly aligned with the delivery of products and services and include the roles of support functions. They lead and direct actions and application of resources and have primary responsibility for maintaining appropriate structure and processes for the management of operations and risks.

Second line roles, i.e. the Risk management and Compliance functions, support and facilitate management of risk through complementary expertise, support, and monitoring, and through challenging the adequacy and effectiveness of risk management practices. Second line roles are separated from first line roles, and do not have first line responsibilities. Notwithstanding this separation, first line roles may be assigned second line responsibilities for complementary expertise. In order to secure adequate independence, the second line has direct access to the Board of Directors and its risk committee.

The role of Internal Audit

Internal audit provides independent and objective assurance and advice on the adequacy and effectiveness of governance, risk management and controls, through systematic and disciplined processes, expertise and insight. It reports its findings to management and the Board of Directors to promote and facilitate continuous improvement.

2.3 Risk Committees

The Bank operates several committees to manage risk. The structure of risk committees within the Bank can be split into two levels; board level and management level. The committees define lines of responsibility and accountability within the Bank. They are charged with overseeing risk and the delegation of authority and form a control environment for the Bank.

The risk committees define lines of responsibility and accountability within the Bank

Figure 2.3 Risk committee structure

Board level risk committees are established by the Board and composed of members of the Board or external representatives nominated by the Board. An overview of the risk committees at Board level and their responsibilities is shown in Table 2.1.

Table 2.1 Board level committees

Committee	Responsibilities
Board Audit Committee (BAC)	The Board Audit Committee assists the Board in meeting its responsibilities in monitoring the effectiveness of the Bank's internal governance and controls and for meeting its external financial reporting obligations under applicable laws and regulations. The BAC supervises accounting procedures, the organization and function of the Bank's internal audit, and the auditing of the annual accounts and the Bank's consolidated accounts.
Board Risk Committee (BRIC)	The Board Risk Committee advises and supports the Board on the alignment of the Bank's risk policy, high-level strategy and risk appetite, and risk management structure. The BRIC assists the Board in meeting its responsibilities in ensuring an effective system of internal controls and compliance. The BRIC assesses whether incentives which may be contained in the Bank's remuneration system, including variable remuneration, are consistent with the Bank's risk policy.
Board Credit Committee (BCC)	The BCC operates under the authority of the Board, which has delegated to the Committee authority to approve certain material proposals regarding credit origination, debt cancellation, underwriting and investments. The BCC can delegate specific authority to the CEO. The BCC defines credit rules for the ACC.

Besides the three risk committees at Board level, the Board has established the Board Remuneration Committee (BRC) and the Board Tech Committee (BTC). The BRC's main role is to prepare a remuneration policy for the Bank which is reviewed by the Board at least annually and submitted to the Annual General Meeting (AGM) for approval. The BTC's role is to advise the Board on the development of the Bank's IT function, including IT strategy, enterprise architecture and alignment of IT function within the Bank's business.

Executive level risk committees, which are composed of the CEO and Managing Directors, or their designated representative, are shown in Table 2.2.

Table 2.2 Executive level risk committees

Committee	Responsibilities
Arion Credit Committee (ACC)	The Arion Credit Committee makes decisions on credit cases within limits set by the BCC. ACC reviews reports concerning the credit portfolio and has an advisory role to the CEO on credit related matters. Risk Management is authorized to veto all decisions or escalate to the BCC for final approval.
Asset and Liability Committee (ALCO)	The Asset and Liability Committee is responsible for strategic planning relating to the developments of the Bank's balance sheet as well as the planning of liquidity and funding, capital activities, and decides on underwriting and investment exposures within limits set by the BCC. The CRO or their deputy is a non-voting observer in committee meetings.
Operational Risk Committee (ORCO)	The Operational Risk Committee is responsible for managing operational risk and compliance, which includes information security, financial crimes, regulatory compliance and data managmement. The CRO, the Compliance Officer and the Risk Officer for Security and Data are non-voting observers in committee meetings.
Sustainability Committee (SUCO)	The Sustainability Committee promotes the consideration of environmental, social and governance factors in the Bank's decision making. The SUCO reviews risk assessments of ESG factors and climate risk impact and oversees ESG disclosures as well as the Bank's Green Financing Framework.
Arion Composition and Debt Cancellation Committee (ADC)	The Arion Composition and Debt Cancellation Committee deals with applications to reach composition with debtors, within limits set by the BCC.

The Bank also operates a number of sub-committees which report to the executive level risk committees.

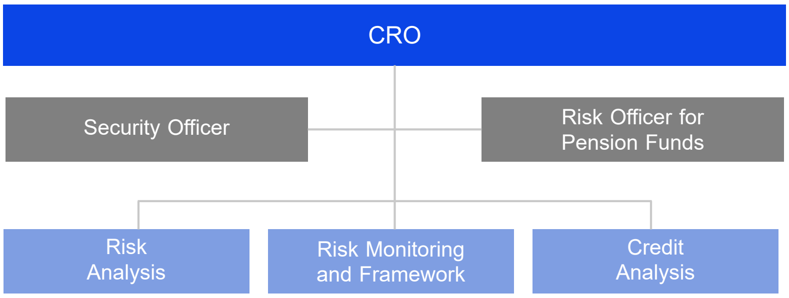
2.4 The Risk Management Division

The Risk Management division focuses on the identification, quantification, monitoring and control of risk. The division facilitates enlightened decision making in all risk areas of the Bank by providing expertise and support. Risk Management ensures compliance with internal and external limits, and standards and regulations. Strong emphasis is placed on reporting risk to the relevant stakeholders in a clear and meaningful manner.

The Risk Management division is divided into three departments; Risk Analysis, Risk Monitoring and Framework, and Credit Analysis.

Risk Management ensures compliance with internal and external limits, standards and regulations

Figure 2.4 Structure of Risk Management division



Risk Analysis

The Risk Analysis department is responsible for analyzing, monitoring and reporting on risks on a portfolio level, including credit risk, market risk and liquidity risk. The department is also responsible for capital adequacy, credit modelling and stress testing.

Within the scope of market risk are risks resulting from balance sheet mismatches, i.e. interest rate risk and foreign exchange risk, and risks stemming from the Bank's trading activities. The department interfaces primarily with the Bank's Treasury, Market Making and Capital Markets and reports its analysis and stress testing results for market, funding and liquidity risk to ALCO.

The department is responsible for the development of credit rating models, assessment of expected credit loss under IFRS 9, the calculation of regulatory capital requirements, development of economic capital models, methodology for allocation of capital and stress tests.

Additionally, the department is in a supportive role for Stefnir Fund Management and the Bank's Asset Management with regards to risk reporting, risk systems and limit surveillance, and provides various quantitative support to the Bank's business units.

Risk Monitoring and Framework

Risk Monitoring and Framework is responsible for the internal control framework and supports the first line in managing risks. The department is responsible for monitoring credit quality of loans on a single-name basis and determining appropriate levels of provisioning for problem loans, and ensures that internal processes and controls minimize the risk of loss as effectively as possible.

Risk Monitoring and Framework ensures that the book value of distressed loans accurately reflects the expected recovery value of loans and is responsible for supervision of collateral valuation. The department is also responsible for developing and maintaining tools for identifying, measuring, monitoring and controlling operational risk, such as Risk and Control Self-Assessment (RCSA) and loss data collection.

Credit Analysis

Credit Analysis ensures Risk Management's involvement in credit transactions and analyzes and monitors credit cases submitted to the Bank's credit committee. Credit Analysis represents Risk Management at ACC meetings and participates in credit decisions and has the power to veto the ACC's credit decisions and escalate to the BCC for final approval. The department also administers and organizes credit committee meetings and advises on changes to the credit rules.

Credit Analysis is responsible for the approval of corporate credit ratings, performed by account managers, by challenging the qualitative input and verifying the quality of quantitative information used to produce the ratings.

Chief Security Officer

The Bank's Chief Security Officer supervises physical and information security management in the Bank's second line. The Chief Security Officer reports to the CRO.

Risk Officer for Pension Funds

The Risk Officer for pension funds managed by Arion Bank is a member of Risk Management and reports to the CRO. The Risk Officer for pension funds performs the duties assigned in the Pension Act No. 129/1997 and Regulation No. 590/2017 on risk management in pension funds.

2.5 The Compliance Function

The Compliance function focuses on the identification, monitoring and control of conduct risk, compliance risk and financial crime risk.

The role of Compliance is to apply effective precautionary measures to ensure that the Bank complies with applicable regulatory requirements, and to foster an affirmative corporate culture in this respect. Key compliance processes include advice and support, training, and compliance monitoring.

The Compliance Officer also serves as the Bank's Data Protection Officer and Money Laundering Reporting Officer.

2.6 Risk Policies

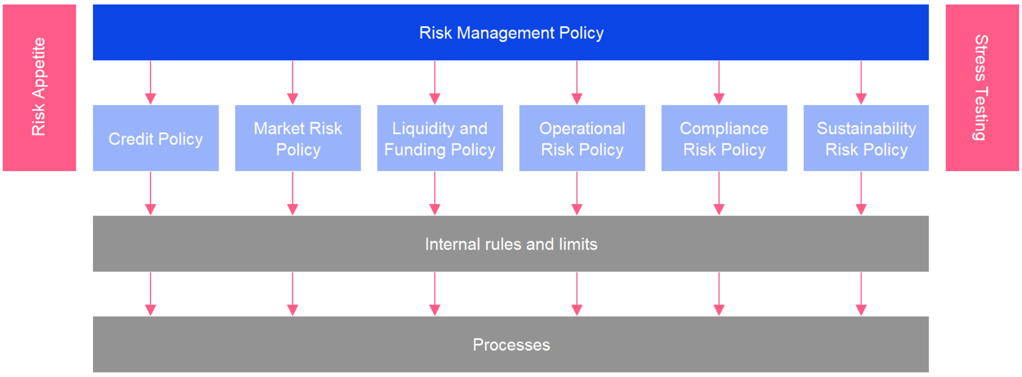
In pursuance of ensuring that existing and potential material risks are identified, managed and monitored, the Bank has an enterprise risk management policy in place. The policy is reviewed and approved by the Board of Directors annually. The policy outlines, at a high level, the key aspects of the Bank's risk management. The Bank recognizes that risk taking is an integral part of its business activities and must therefore be managed in an effective manner and in line with the Bank's risk appetite, see section 2.7.

The Bank recognizes that risk taking is an integral part of its business activities and must therefore be managed in an effective manner and in line with the Bank's risk appetite

The significant risks the Bank is exposed to are defined within the risk management policy. Six risk types have been defined as significant; credit, market, liquidity, operational, compliance and sustainability risk. For each of these risk types the Board sets a specific policy for activities related to that risk type. The policies are reviewed and approved by the Board annually.

The Bank's risk management policy and risk type policies are implemented through the Bank's risk appetite framework, stress testing framework, internal rules and limits, and processes. The policies for each risk type are discussed further in the following chapters.

Figure 2.5 Risk policies implementation



2.7 Risk Appetite

A risk appetite is one of the key components of risk governance. A well-defined risk appetite is critical for managing risk and is essential for reinforcing a strong risk culture. In order to establish, communicate and monitor the Bank's risk appetite, the Bank has in place a risk appetite framework.

The objective of the risk appetite framework is to provide a common framework to the Board and the management to communicate, understand, and assess the types and level of risk that the Board is willing to accept in pursuit of the Bank's strategy. The framework furnishes an appropriate understanding of the Bank's risk profile relative to its risk appetite. The risk appetite framework is reviewed and approved by the Board at least semi-annually. Results of stress tests are incorporated into the review of the Bank's risk appetite and risk limits.

The Bank's risk appetite is articulated through a risk appetite statement and translated into risk limits developed and maintained by the CEO or relevant management level committee. Compliance with the risk appetite is monitored by the Risk Management division to ensure that the Bank's risk profile remains within its risk appetite. The Board and BRIC are promptly notified if any risk appetite metrics are exceeded. Internal and external limits are monitored by the Risk Management division in accordance with the Bank's procedures.

The Bank's risk appetite is taken into consideration and aligned with the Bank's strategic objectives, business plan, operations, recovery plan and remuneration.

An overview of the Bank's quantitative risk appetite metrics are shown in Table 2.3. Additionally, the risk appetite statement includes qualitative criteria such as tolerance statements for various operational risk and regulatory compliance breaches.

A well-defined risk appetite is critical for managing risk and is essential for reinforcing a strong risk culture

Table 2.3 Risk appetite metrics

Category	Risk metrics
Capital adequacy	Capital adequacy ratios Leverage ratio
Liquidity and funding risk	Liquidity coverage ratios Net stable funding ratio Loans to deposits ratio Asset encumbrance ratio
Market risk	Foreign exchange rate risk Interest rate risk and indexation risk Equity risk in the banking book Equity risk in the trading book
Securities financing and counterparty credit risk	Uncollateralized exposure as per stress test
Credit risk	Diversification Sectoral and geographical concentrations Large exposures and single-name concentration Expected credit loss Average loan to value of residential mortgage portfolio
Operational risk	Operational losses KYC adequacy ratio

2.8 Reporting

The Bank's aim is to provide relevant stakeholders with accurate and transparent risk information. Therefore, Risk Management places a strong emphasis on reporting risk and allocating sufficient resources to ensure the fulfillment of the Bank's policy. Risk information is regularly reported to the Board of Directors and its sub-committees. The CEO, the CRO and committees on the executive level, receive risk reports on a regular basis, ranging from daily monitoring reports to the Annual Report. The primary reporting within the Bank is shown in Table 2.4.

The Bank's Annual Report, Financial Statements, and Pillar 3 Risk Disclosures are all available on the Bank's website. Furthermore, the Bank delivers regular reports to the FSA; i.e. a monthly report on the Bank's loan portfolio quality, a quarterly report on the Bank's capital requirements (COREP) and large exposures; and annual reports on the Bank's Recovery Plan, ICAAP, ILAAP and stress testing.

Table 2.4 Primary reporting within the Bank

Primary reporting	Contents	Frequency	Recipient
Credit risk portfolio report	A report containing analysis of the Bank's loan portfolio broken down by various risk factors. Overview of the largest exposures and sector distribution. Thorough analysis of the credit quality of the loan portfolio.	Monthly	ACC
Liquidity and market risk report	A report containing analysis of the Bank's Liquidity Coverage Ratio, information on deposit developments, secured liquidity, funding measures, currency and indexation imbalances, margin trading activities, and other relevant liquidity and market risk information.	Monthly	ALCO
Operational risk report	An overview of relevant risk measures for operational and compliance risk, including a summary of deviation events, major IT incidents, loss data analysis and net promoter score.	Monthly	ORCO
Risk report	An aggregate report containing the credit risk portfolio report, the liquidity and market risk report and the operational risk report as well as information on the Bank's risk appetite, recovery indicators, ICAAP status and other risk management concerns.	Monthly	Board BRIC Exec. Com.
ICAAP	Evaluation of the Bank's total risk exposure and capital adequacy. The report is submitted for review and/or approval.	Annually	Board BRIC Exec. Com.
ILAAP	Evaluation of the Bank's total risk exposure and liquidity adequacy. The report is submitted for review and/or approval.	Annually	Board BRIC Exec. Com.
Recovery plan	A plan providing measures to be taken by the Bank to restore its financial position following a significant deterioration of its financial situation. A status report on recovery indicators is submitted monthly to the ALCO.	Annually	Board BRIC ALCO
Internal bank-wide stress testing	Evaluation of the impacts on the Bank's earnings and own funds, the Bank's capital and liquidity ratios and other risk appetite metrics under various stress scenarios. The report is submitted for review and/or approval.	Annually	Board BRIC Exec. Com.
Compliance updates	An aggregate report covering key events regarding both compliance risk and financial crime risk	Quarterly	BRIC
Compliance report	An annual report summarizing previous year with regards to both compliance risk and financial crime risk	Annually	Board BRIC

3 **Capital** Management

3.1 Governance
3.2 Capital Strategy
3.3 Legal Framework and Calculation Approaches
3.4 Scope of Consolidation and Exposure Amounts
3.5 Own Funds
3.6 Capital Management and Capital Requirements
3.7 Leverage Ratio
3.8 Capital Allocation and Capital Planning
3.9 Capital Position
3.10 MREL
3.11 Regulatory Changes

3 Capital Management

An adequate amount of capital ensures that the Bank is able to absorb losses associated with the risks that are inherent in its operations without its solvency being jeopardized and allows the Bank to remain a going concern, even in periods of stress.

The Bank employs various techniques to estimate adequate capital levels and to ensure that capital is fruitfully deployed. The Bank's ICAAP is the cornerstone of the Bank's capital adequacy assessment and is aimed at identifying and measuring the Bank's risk across all risk types and ensuring that the Bank has sufficient capital in accordance with its risk profile and strategy.

3.1 Governance

The Bank's capital policy and dividend policy are established by the Board of Directors based on recommendations from the Board Risk Committee (BRIC). The policies are reviewed on an annual basis.

The Bank's CEO is responsible for carrying out the Bank's capital strategy in adherence to set policies. As established by the CEO, this responsibility is part of the principal authority of the Asset and Liability Committee (ALCO). The CRO is responsible for compliance with regulatory requirements and supervises the Bank's Internal Capital Adequacy Assessment Process (ICAAP) and allocation of capital. Stress testing, which is integrated with the Bank's business planning and ICAAP, is part of the capital management framework and is used to assess whether capital levels are acceptable under stressed conditions.

At year-end 2021 the Bank's CET1 ratio was 19.6% and total capital ratio 23.8%. The ratios account for a foreseeable equity reduction of ISK 26.8 billion through buyback of own shares and dividend distribution

3.2 Capital Strategy

The Bank's target for Common Equity Tier 1 (CET1) ratio is 17% and maximum utilization of Additional Tier 1 (AT1) and Tier 2 (T2) capital to meet Pillar 1 and Pillar 2 capital requirements, see section 3.6.4. Relative to the total CET1 regulatory requirement of 13.6%, this implies a management buffer of 3.4%. The target is 0.9% above the total regulatory capital requirement assuming the highest possible value for the countercyclical capital buffer. The Bank's management buffer accounts for volatilities in the risk-weighted exposure amount (REA) and own funds and facilitates further flexibility in the management of capital.

The Bank's capital position is in excess of its capital targets. According to the Bank's capital plan, surplus capital is to be distributed to shareholders. The Bank has issued Additional Tier 1 and Tier 2 instruments so that the Bank's AT1 ratio is 1.6% and T2 ratio is 2.6%, which are slightly below the normalized AT1 and T2 values of 2.1% and 2.8% respectively.

The Bank's dividend policy is to pay out approximately 50% of net earnings attributable to shareholders as dividend and in addition use special distributions to bring own funds towards the normalized value. In line with this, the Bank intends to distribute dividends of ISK 22.5 billion and complete the buyback program approved by the FSA in October 2021 of which ISK 4.3 billion remain.

3.3 Legal Framework and Calculation Approaches

The Bank's capital adequacy is determined in accordance with Act No. 161/2002 on financial undertakings and Regulation No. 233/2017 on prudential requirements for financial undertakings, which represent the Icelandic adoption of the EU Capital Requirements Directive and Regulation. In June 2021, amendents to the Act and the Regulation took effect which introduced CRR II into Icelandic law at the same time as it took effect in the EU.

The Bank's calculation of REA is based on standardized approaches for the assessment of credit risk, counterparty credit risk, market risk and operational risk.

The total regulatory capital requirement is presented as a percentage of REA and consists of the items shown in the following table:

Table 3.1 Capital requirements

Source	Description
Pillar 1 requirement	The 8% minimum regulatory requirement
Pillar 2R requirement	The additional capital requirement determined by the Bank's own internal assessment of capital adequacy (ICAAP) and FSA's subsequent supervisory regulatory assessment process (SREP)
Combined capital buffer requirement	The aggregated capital requirement due to four capital buffers, the level of which is determined by law (capital conservation buffer) and by the FSA following guidance from the Financial Stability Council (buffers for systemic risk, systemically important financial institutions (SII), and countercyclical effects)

As part of the SREP, the results of internal or external bank-wide stress tests may result in non-binding additional capital guidance, defined as Pillar 2G.

The capital requirements are described in greater detail in Section 3.6.

The Pillar 1 requirement may be met with different capital instruments, restricted as follows, expressed as a percentage of REA:

- Common Equity Tier 1 (CET1) capital shall exceed 4.5%
- Tier 1 (CET1 and Additional Tier 1) capital shall exceed 6%
- Total capital (Tier 1 and Tier 2) shall exceed 8%

The same proportion applies to the Pillar 2 capital add-on, i.e. it can be composed of 56.25% CET1 capital, 18.75% AT1 capital and 25% Tier 2 capital. The combined capital buffer requirement is to be met solely with CET1 capital.

3.4 Scope of Consolidation and Exposure Amounts

The Bank's consolidated situation for prudential purposes and capital adequacy is different from the accounting consolidation. The Bank owns an insurance subsidiary, Vördur, which is fully consolidated in the group financial statements. For prudential purposes, it is consolidated using the equity method and is excluded from supervision on a consolidated bases as stipulated by

CRR. Vördur is supervised by the FSA and its solvency requirements are calculated in accordance with the Icelandic Insurance Companies Act.

For further details on the companies within the scope of consolidation, please refer to the template EU LI3 in the Group's Additional Pillar 3 Risk Disclosures. Template EU LI1 shows the difference in amounts between the carrying values in the financial statements and the carrying values under the scope of regulatory consolidation and a breakdown of the framework under which these amounts fall.

The main sources of differences between the carrying values as reported in the financial statements and the exposure amounts for regulatory purposes are off balance sheet amounts which fall under the credit risk framework and potential future exposure for items under the counterparty credit risk framework. Template EU LI2 shows a reconciliation between these amounts.

Credit risk accounted for 85% of the Bank's REA at year end 2021. The Bank's REA for credit risk increased by ISK 62 billion in 2021. The increase is mainly due to loans to customers which grew by ISK 113 billion during the year.

In June 2021, the CRR II legislative changes were implemented in Iceland. The most significant impact on the Bank's REA was the expansion of the SME supporting factor which provides a discount to the capital requirements for exposures to small and medium-sized enterprises. The rationale for the SME supporting factor is that SMEs *"are one of the pillars of the Union economy given their fundamental role in creating economic growth and providing employment. The recovery and future growth of the Union economy depends largely on the availability of capital and funding to SMEs established in the Union to carry out the necessary investments to adopt new technologies and equipment to increase their competitiveness."*

Previously, article 501 of CRR stipulated a capital requirements discount for small and medium enterprises (SMEs) in the form of a supporting multiplication factor of 0.7619, which is applied to the relevant risk-weighted exposure amount. It was applicable to SMEs (using only the turnover threshold) with group exposure below EUR 1.5 million, excluding exposures secured on residential property collateral.

With CRR II the scope of this discount was extended, to most SME exposures. The maximum size of the group exposure to the SME for a full application of the factor was raised from EUR 1.5 million to EUR 2.5 million. Also, there is no longer a cliff effect at the size limit, exposures to SMEs above EUR 2.5 million are eligible for an SME supporting factor of 0.85. The effect of this change was a reduction in REA of ISK 14 billion.

A breakdown of the Bank's REA is shown in Note 45 of the Consolidated Financial Statements and in template EU OV1.

Figure 3.1 Development of REA [ISK m]

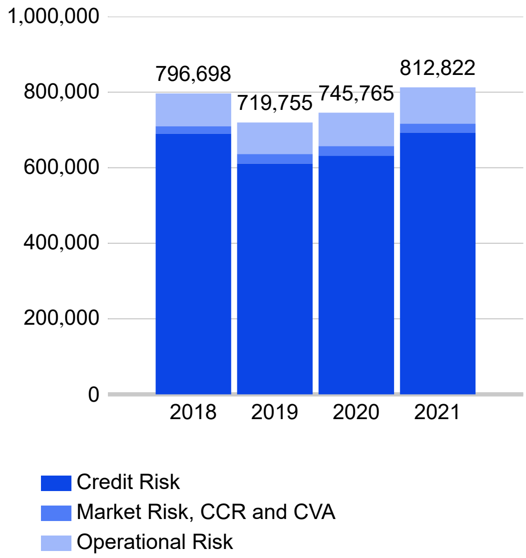


Table 3.2 Overview of risk-weighted exposure amount (EU OV1)

31 December [ISK m]	REAs		Minimum own funds requirements
	2021	2020	2021
Credit risk (excluding CCR)	**666,102**	**608,697**	**53,288**
of which the standardized approach	666,102	608,697	53,288
CCR	**10,141**	**4,304**	**811**
of which the standardized approach	7,761		621
of which mark to market		3,462	
of which CVA	2,379	842	190
Settlement risk			
Securitization exposures in the banking book (after the cap)			
Market risk	**13,649**	**21,632**	**1,092**
of which the standardized approach	13,649	21,632	1,092
Large exposures			
Operational risk	**96,085**	**88,462**	**7,687**
of which standardized approach	96,085	88,462	7,687
Amounts below the thresholds for deduction (subject to 250% risk weight)	26,845	22,670	2,148
Total	**812,822**	**745,765**	**65,026**

The Bank's holdings of the own funds instruments of Vördur which are not deducted from own funds are instead risk weighed at 250%. Template EU INS1 shows these amounts. The Bank is not a part of a financial conglomerate and thus template EU INS2 is not applicable to it.

The Bank does not use the internal ratings based (IRB) approach for any exposures and it does not have any exposure to securitizations. EU templates related to these types of exposures are therefore omitted.

3.5 Own Funds

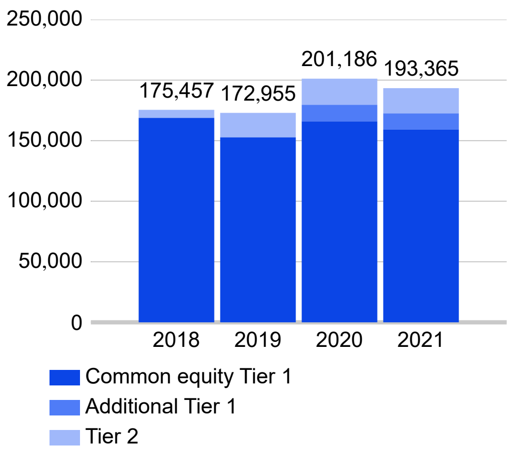
The Bank's own funds are composed of Common Equity Tier 1 (CET1), Additional Tier 1 (AT1) and Tier 2 (T2) issuances and the size of each layer of own funds is presented net of regulatory adjustments.

CET1 capital before regulatory adjustments consists exclusively of equity issued by Arion Bank. The regulatory adjustments to CET1 are primarily the deduction of intangible assets and the deduction of foreseeable dividends. Other items are smaller. The Bank applies the IFRS 9 transitional arrangements, as amended by Regulation (EU) 2020/873, to phase in the effects on capital of the impairments requirements of IFRS 9, in particular the increased impairments related to the effects of the COVID-19 public health crisis. Template EU IFRS9-FL shows the effects on capital and REA if these arrangements were not available.

The Bank uses the simplified approach for the calculation of additional value adjustments and thus template EU PV1 does not apply.

The Bank's Additional Tier 1 capital consists of a USD 100 million subordinated liability issued in Q1 2020.

Figure 3.2 Development of own funds [ISK m]



The Bank's Tier 2 capital consists of subordinated liabilities issued in the period from Q4 2018 to Q4 2019 in SEK, NOK, ISK and EUR, see Note 33 in the Bank's Consolidated Financial Statements 2021. The contractual maturities range from 2028 to 2031, and the first call option becomes active as of November of 2023.

Template EU CCA provides further details on each of the Bank's own funds instruments.

Template EU CC1 presents the composition of the Bank's own funds. The Bank's own funds are reconciled with the balance sheet in the Group's financial statements via template EU CC2 and cross references to the relevant rows in template EU CC1 are provided. Table 3.3 is an extract from EU CC1 with the data that is most relevant to the Bank.

Table 3.3 Reconciliation of own funds

Own funds [ISK m]	2021	2020
Total equity	**194,598**	**197,845**
Non-controlling interest not eligible for inclusion in CET1 capital	-673	-173
Common Equity Tier 1 capital before regulatory adjustments	**193,925**	**197,672**
Intangible assets	-8,435	-13,092
Cash flow hedges	-197	-2,282
Additional value adjustments	-240	-238
Foreseeable dividend and buyback	-26,773	-17,990
Adjustment under IFRS 9 transitional arrangements	920	1,890
Common equity Tier 1 capital	**159,200**	**165,960**
Non-controlling interest eligible for inclusion in T1 capital	133	173
Additional Tier 1 capital	13,225	13,498
Tier 1 capital	**172,558**	**179,631**
Tier 2 instruments	21,863	22,562
Tier 2 instruments of financial sector entities (signif. invest.)	-1,056	-1,007
Tier 2 capital	**20,807**	**21,555**
Total own funds	**193,365**	**201,186**

3.6 Capital Management and Capital Requirements

The Pillar 1 capital requirement for the Bank is 8% of REA. In addition to this, the Bank employs various techniques in its assessment of capital need. The Bank's Internal Capital Adequacy Assessment Process (ICAAP) and stress testing are key elements of the Bank's capital management framework and are performed on an annual basis. In addition to providing quantitative analysis, the processes are an important tool for management that give an insightful understanding of the risks associated with the Bank's operations and business planning.

Following the ICAAP process, the FSA conducts the supervisory review and evaluation process (SREP). In that process the FSA sets the Pillar 2R capital requirement which the Bank must hold own funds for and may, on the basis of stress test results, issue non-binding additional capital guidance, called Pillar 2G. Finally, the Bank must hold own funds to meet the combined capital buffer requirement.

3.6.1 Internal Capital Adequacy Assessment Process

The ICAAP is the Bank's internal assessment of its capital need. The ICAAP is carried out in accordance with the Act No. 161/2002 on financial undertakings with the aim to ensure that the Bank has in place sufficient risk management processes and systems to identify, measure and manage the Bank's total risk exposure. The scope of ICAAP excludes insurance subsidiaries which perform their independent Own Risk and Solvency Assessment (ORSA).

The ICAAP is the Bank's internal assessment of its capital need

The ICAAP is aimed at identifying and measuring the Bank's risk across all risk types and at ensuring that the Bank has sufficient capital for its risk profile. The Bank's ICAAP report is approved annually by the Board of Directors, the CEO and the CRO and submitted to the FSA.

In addition to the above the Bank uses the ICAAP to:

- Raise risk-awareness of all the Bank's activities and to provide a detailed view of the Bank's risk profile for the Board of Directors and the Executive Management Committee.
- Carry out a process to adequately identify and measure the Bank's risk factors.
- Carry out a process to monitor that the Bank's capital is adequate and used in relation to its risk profile.
- Review the soundness of the Bank's risk management systems and controls that are used to assess, quantify and monitor the Bank's risks.

Managing Directors with their key personnel and key personnel from the Bank's subsidiaries participate in the process of identifying and evaluating high risk areas, and discuss their management of risk, in cooperation with Risk Management. The result from the identification phase serves as the basis for the risk assessment within the Bank's ICAAP. Risk categories identified for the operating segments are shown in Table 3.4.

Table 3.4 Risk identification down to operating segment

Business Units	Credit risk	Market risk	Liquidity risk	Operational risk	Compliance risk	Business risk	Political risk
Retail Banking	✓			✓	✓	✓	✓
Corporate and Investment Banking	✓			✓	✓	✓	✓
Markets	✓	✓		✓	✓	✓	✓
Treasury	✓	✓	✓	✓	✓	✓	
Other divisions and subsidiaries	✓	✓	✓	✓	✓	✓	✓

The Bank's ICAAP methodology involves assessing key risks that are not believed to be adequately addressed under Pillar 1. For each risk factor, a capital add-on is applied on top of the minimum 8% regulatory capital requirements. The main risk elements for which additional capital is required are:

- Interest rate risk in the banking book (IRRBB) and indexation risk
- Single name concentration of credit risk
- Credit risk for segments of the loan portfolio that are deemed high risk
- Equity position risk

On the recommendation of the Icelandic Systemic Risk committee (IS: Kerfisáhættunefnd), the Systemic Risk Buffer has been set to 3% for domestic exposures. In its recommendation, the committee cited numerous systemic risk factors to justify the level of the buffer. The Bank does therefore not include these risk factors in its Pillar 2 capital assessment. Among those is the lack of diversification of the Icelandic economy, which is reflected in sector concentration in the Bank's loan portfolio.

As part of the Pillar 2 capital assessment the Bank uses internal models to assess capital needs for credit risk. Meanwhile, the FSA has published SREP guidelines, stating that *"domestic exposures are considered riskier, resulting in higher capital requirements for those institutions that do not use the internal ratings based method",* and has specified elevated Pillar 2 risk weights for certain exposure classes: 24% for Regional government & Institutions, 61% for Commercial real estate, 80% for Retail and 109% for Corporate & other. This results in a considerable SREP capital add-on, not reflected in the Bank's ICAAP result.

The SREP of 2021, which was based on financial figures from 31 December 2020, resulted in a Pillar 2R capital requirement of 3.2% of REA.

The SREP of 2021, which was based on financial figures from 31 December 2020, resulted in a Pillar 2R capital requirement of 3.2% of REA.

3.6.2 Stress Testing

Stress tests provide an important management tool for the Bank. The results of stress tests raise risk awareness and improve general understanding of the Bank's operations and are to be considered for strategic, capital and contingency planning. The results of stress tests are incorporated into the review of the risk appetite and the Bank's limit framework.

Stress tests provide an important management tool for the Bank

The Bank's stress testing framework outlines the scope and responsibilities for stress testing in the Bank. Within the framework's scope are the ICAAP and ILAAP, which are carried out in parallel, the Recovery Plan, as well as firm-wide and regulatory internal stress tests on the Bank's business plan. The framework is aligned with FSA's guidelines No. 2/2015 which are based on EBA's Guidelines on Stress Testing (GL32). Stress testing at the Bank consists of sensitivity analysis and scenario analysis.

Stress testing involves estimating the impact of the stress scenario on the Bank's earnings and capital adequacy as well as the impact for the Bank's liquidity ratios, other risk appetite metrics and recovery indicators. Each business unit contributes to the estimation of its portfolio with the view of identifying the most important risk drivers and suggests relevant stressed scenarios.

Figure 3.3 The stress testing process at the Bank.

Scenario description - the story	Macro economic impact - time series	PD / LGD / IFRS 9 stages	Micro economic impact - translation	Assumptions in business model altered - effects reported	Management actions
Cross department workshops, meetings and collaboration with the Chief Economist	Chief Economist, Risk Management, Finance	Risk Management	Finance, Chief Economist, Risk Management	Finance, Risk Management	Finance, Risk Management

Scenario analyses are carried out on the Bank's business plan. The Bank's Chief Economist contributes an economic base case projection as well as stressed projections that are used in the Bank's capital planning and in preparation of the Bank's five year business plan. The design of the bank-wide internal stress test is challenged and reviewed by the Executive Management Committee and the Board Risk Committee.

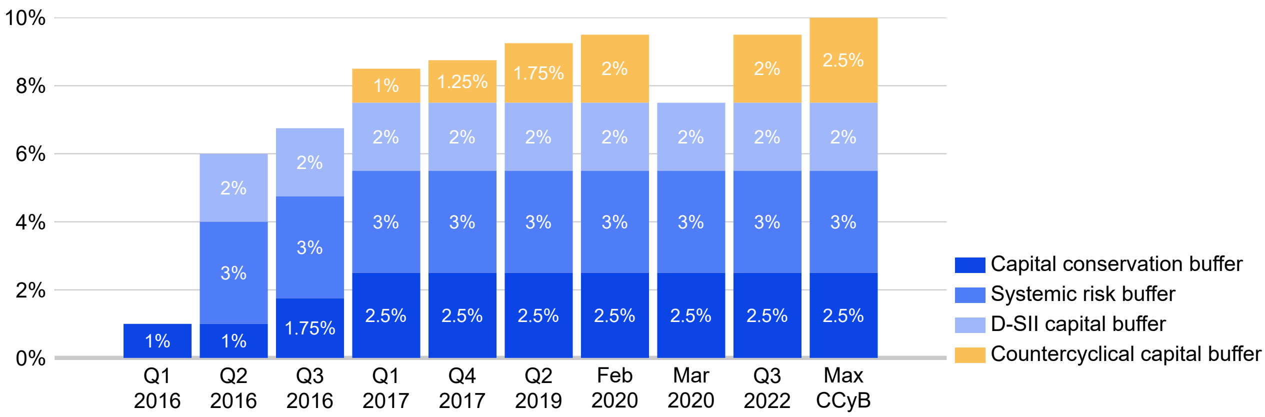
One of the stressed scenarios carried out on the business plan is provided by the Central Bank in collaboration with the FSA. The Bank also performs various regularly scheduled stress tests and targeted ad-hoc stress tests.

3.6.3 Capital Buffers

Capital buffers were incorporated into Icelandic law with the adoption of CRD IV / CRR. The systemic risk buffer only applies to domestic exposures and is therefore applied cumulatively with the D-SII buffer in accordance with Article 133(5) of CRD IV. The countercyclical buffer was then set to 0% in March 2020 as a response to the COVID-19 crisis. The Financial Stability Council has announced that the countercyclical buffer will increase to 2% on 28 September 2022.

The development of the capital buffers is shown in the chart below. The requirements are presented as percentage of REA.

Figure 3.4 Implementation of capital buffer levels for Icelandic D-SIIs, including maximum application of countercyclical buffer



The effective countercyclical capital buffer for the Bank is determined using the weighted average of the respective capital buffer level in the countries where the Bank has exposure and weighting is decided by the percentage of credit risk in REA. The same method is used for the determination of the effective systemic risk buffer where the buffer only applies to domestic exposures. Given the Bank's geographic credit risk profile at year-end 2021, the effective combined capital buffer requirement for the Bank is 7.3%. Templates EU CCyB1 and EU CCyB2 show details regarding the calculation of the countercyclical buffer requirement.

Table 3.5 Arion Bank's capital buffer requirements at year-end 2021

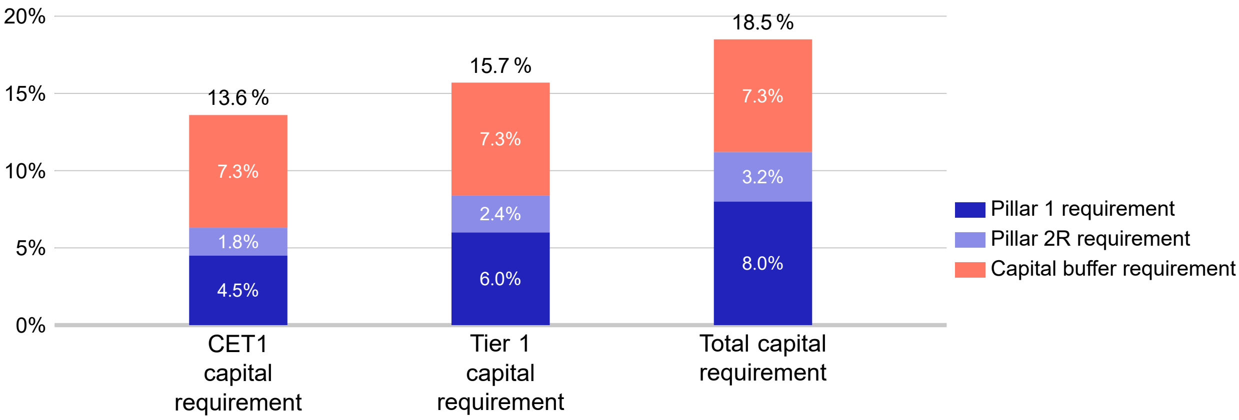
Capital buffer	Domestic exposures	Foreign exposures	Institution-specific buffer rate
Capital conservation buffer	2.5%	2.5%	2.5%
Systemically important institution buffer	2.0%	2.0%	2.0%
Systemic risk buffer	3.0%	0.0%	2.8%
Countercyclical capital buffer	0.0%	CCyB of country	0.0%
Total	**7.5%**	**4.5%+CCyB**	**7.3%**
REA credit risk weight	92.0%	8.0%	

3.6.4 Summary of Capital Requirements

The Bank's total regulatory requirement, comprising Pillar 1, Pillar 2 and the capital buffer requirements, is 18.5%. The following figure shows how this requirement is broken down by type and how it can be met with the different layers of capital. Management's policy is to maintain a CET1 ratio of 17% and utilize AT1 and T2 to the maximum extent to meet the Pillar 1 and Pillar 2 capital requirement. This implies that the target capital adequacy ratio is 21.9%.

The Bank's total regulatory requirement is 18.5% at 31 December 2021. The Bank's capital ratio benchmark is 21.9%

Figure 3.5 Arion Bank's own funds regulatory requirements with combined capital buffer requirements at 31 December 2021



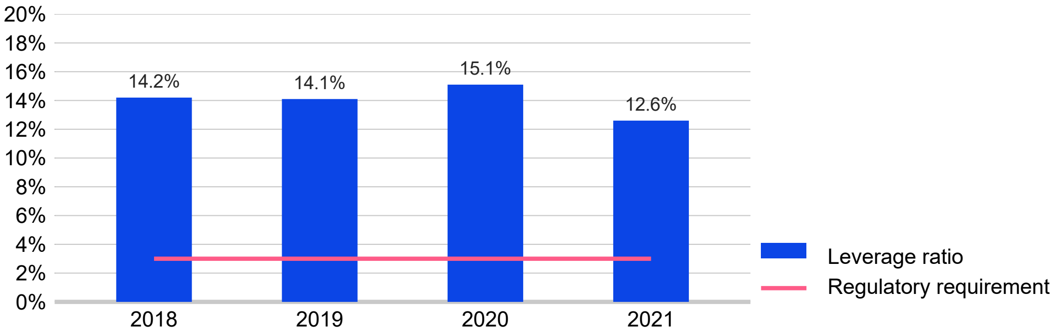
3.7 Leverage Ratio

The leverage ratio is seen as an important complementary measure to the risk-based capital adequacy ratio. Leverage requirements are aimed to prevent banks from building up excessive leverage while possibly maintaining strong risk-based capital ratios. The leverage ratio is a simple measure, weighting the Bank's Tier 1 capital against a measure of its exposures.

At year-end 2021, the Bank had a strong leverage ratio of 12.6%, significantly higher than the 3% minimum prescribed by CRR. The ratio is exceptionally high in international context, and reflects the particular case of the major Icelandic financial institutions, which are classified as systemically important while applying the standardized approach for capital adequacy. As such, Arion Bank has a relatively high combined capital buffer requirement of 7.3%, which is applied to a standardized REA. The Bank's average risk-weight, the ratio of the risk-weighted exposure amount and the exposure measure for the leverage ratio, is 60% for the consolidated situation.

Arion Bank is a rare example of a systemically important institution that applies the standardized approach for capital adequacy. This is reflected in an exceptionally strong leverage ratio in international comparison

Figure 3.6 Development of the Bank's leverage ratio



The Bank's Tier 1 capital and the total exposure increased in 2020 but the rate of increase in Tier 1 capital was significantly higher, leading to an increase in the leverage ratio. In light of the strong leverage ratio, the Bank's management of the risk of excessive leverage is currently confined to the monitoring of the Board of Directors' risk appetite for leverage.

For further details on the Bank's leverage ratio, please refer to templates EU LR1, EU LR2 and EU LR3.

3.8 Capital Allocation and Capital Planning

The Bank allocates capital to its business units based on capital requirements assessed under the ICAAP and SREP. The risk-adjusted performance of the business units is based on the Return on Allocated Capital (ROAC) and reported to ALCO. The ALCO conducts capital planning on a quarterly basis, based on the Bank's rolling business plan for each business unit. Capital is allocated both based on current need and on the basis of a 12 month forward horizon.

Figure 3.8 Allocated capital for Q4 2021, current need and 12 month horizon

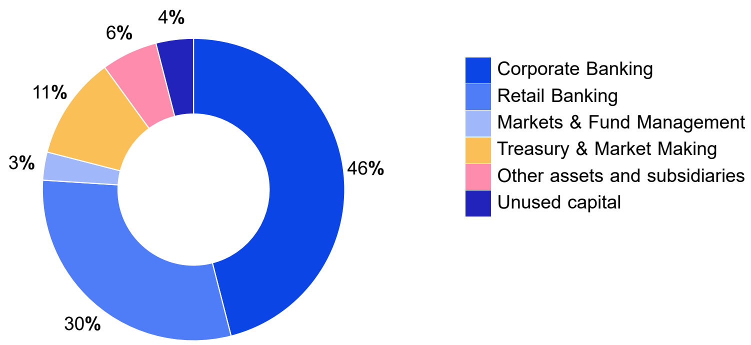
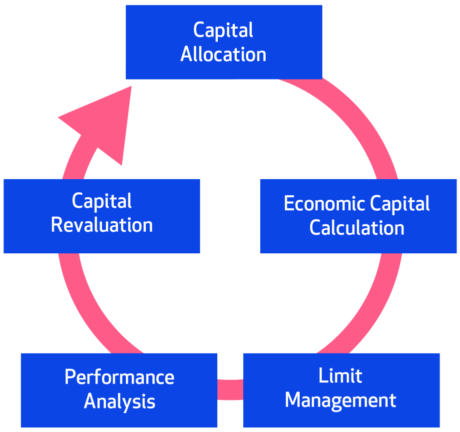


Figure 3.7 Capital planning and monitoring process



The focus of capital management at the Bank is to normalize the capital structure in the medium term and consequently maintain the Bank's capitalization comfortably above the regulatory minimum, including capital buffers and Pillar 2 requirements.

3.9 Capital Position

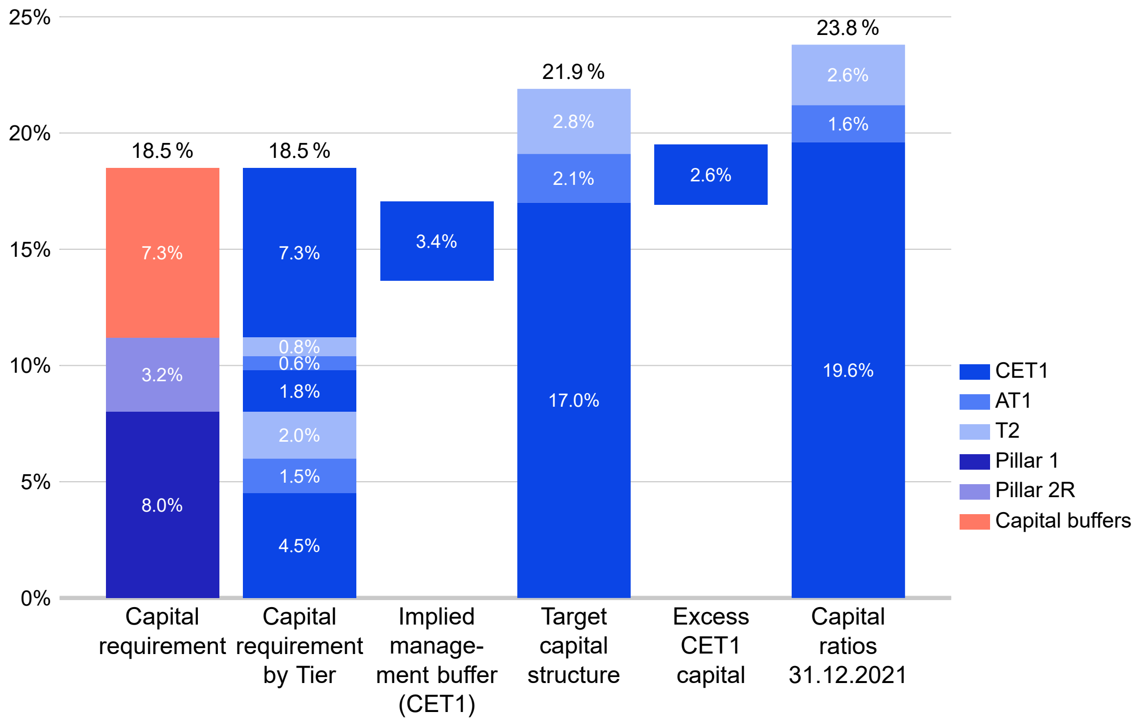
At year end 2021, the Bank's CET1 ratio was 19.6%, well above the target CET1 ratio of 17.0% and the CET1 requirement of 13.6%. The total capital ratio was 23.8%

The following figure shows the Bank's capital position and the capital requirement, along with an normalized capital structure under CRR.

The Bank's own funds at 31 December 2021 take into account a foreseeable equity reduction of ISK 26.8 billion, consisting of a ISK 22.5 billion dividend payment and a ISK 4.3 billion which remains of a buyback program approved in October 2021. Therefore, this distribution will not affect the Bank's capital adequacy ratios.

The template EU KM1 shows the development of key metrics related to own funds, REA, capital ratios, capital requirements and the leverage ratio. The following table shows an extract of this data.

Figure 3.9 Arion Bank's capital requirement, target capital structure and capital ratios



The main driver for the change in capital position in 2021 is the Bank's strategy to normalize own funds. Thus, ISK 31.5 billion of excess capital was paid out to shareholders during the year. The Bank's REA grew by 9.0% during the year but because of the capital distribution, own funds decreased by 3.9%. Included in this number is the foreseeable capital distribution.

Table 3.6 Overview of own funds and capital adequacy

31 December [ISK m]	2021	2020
Own funds		
Common Equity Tier 1 (CET1) capital	159,200	165,960
Tier 1 capital	172,558	179,631
Total own funds	193,365	201,186
Risk-weighted exposure amount	812,822	745,765
CET1 capital ratio	19.6%	22.3%
Tier 1 capital ratio	21.2%	24.1%
Total capital ratio	23.8%	27.0%
Own funds requirement		
Pillar 1: Minimum capital requirement	8.0%	8.0%
of which CET1 requirement	*4.5%*	*4.5%*
of which Tier 1 requirement	*6.0%*	*6.0%*
Pillar 2: Additional capital requirement (ICAAP/SREP)	3.2%	3.1%
of which CET1 requirement	*1.8%*	*1.7%*
of which Tier 1 requirement	*2.4%*	*2.3%*
Combined capital buffer requirement	7.3%	7.3%
of which capital conservation buffer requirement	*2.5%*	*2.5%*
of which systemically important institution buffer requirement	*2.0%*	*2.0%*
of which systemic risk buffer requirement	*2.8%*	*2.8%*
of which countercyclical capital buffer requirement	*0.0%*	*0.0%*
Total CET1 capital requirement	13.6%	13.5%
Total Tier 1 capital requirement	15.7%	15.6%
Total capital requirement	18.5%	18.4%
Leverage ratio		
Exposure measure for leverage ratio calculation	1,364,448	1,189,511
Leverage ratio	12.6%	15.1%

3.10 MREL

The Icelandic law on the resolution of credit institutions and investment funds, Act no. 70/2020, entered into force on 1 September 2020. This transposed the Bank Resolution and Recovery Directive (BRRD) (2014/59/EU) into Icelandic law. On the basis of this law, a Resolution Authority was set up within the Central Bank of Iceland. On 8 December 2021, the Resolution Authority published their MREL policy which details their approach for determining the mininum required amount of own funds and eligible liabilities (MREL) for credit institutions. It must be noted that only BRRD I has been transposed into Icelandic law. BRRD II ((EU) 2019/879) has already entered into force in the EU and will be incorporated into the EEA agreement at some point but that process has not been finished. The Resolution Authority suggests that Icelandic credit institutions should be prepared to meet the MREL requirements according to BRRD II at the same time as institutions in the EU, on 1 January 2024, but it is also possible that this date will be pushed back when BRRD II is incorporated into the EEA agreement.

The MREL requirement is composed of two parts, the loss absorption amount (LAA) and the recapitalization amount (RCA). As the names suggest, the purpose of the LAA is to absorb the losses from events which have happened before the resolution authority steps in. The RCA is then available for the resolution authority to ensure that the institution is fully capitalized from day one after the restructuring.

The LAA is equal to the minimum capital requirement for the institution, i.e. Pillar 1 and Pillar 2 requirement. The RCA should also equal the minimum capital requirement but for the institution post-restructuring so if the resolution plan entails asset sale the RCA should be adjusted down to account for the balance sheet reduction. On the other hand, the RCA could be increased by the so-called Market Confidence Charge (MCC) which is intended to ensure that the institution retains market confidence post-restructuring.

The Icelandic Resolution Authority has announced that for the time being there will not be any MCC supplement to the RCA. Thus, the MREL requirement will generally be twice the size of the Pillar 1 plus Pillar 2 requirement for Icelandic institutions but may in specific cases be revised down to account for expected asset sale during resolution. Furthermore, the capital buffer requirement will be independent of the MREL requirement, so that institutions must meet the capital requirement of Pillar 1 plus Pillar 2 plus buffers using own funds and also the MREL requirement of twice the Pillar 1 plus Pillar 2 using own funds and eligible liabilities, but the same own funds can be used to meet the capital requirement and the MREL requirement.

Under BRRD I, there is no specific subordination requirement for eligible liabilities. Resolution authorities have the power to introduce such a requirement but the Icelandic Resolution Authority does not intend to do so since it considers that the so-called “no creditor worse off” rule is not constraining for it during resolution because deposits already enjoy a priority during resolution according to Icelandic law.

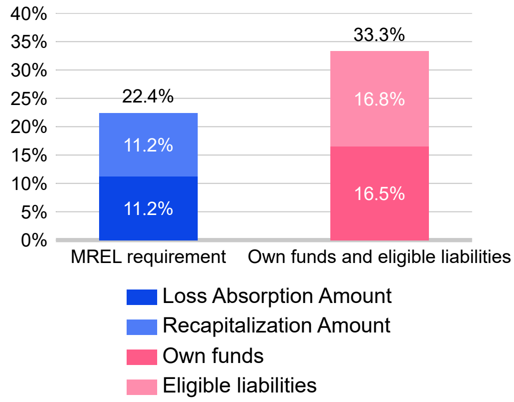
When BRRD II takes effect, it becomes mandatory for some institutions that a part of the MREL requirement is met with own funds or liabilities which are subordinate to ordinary unsecured claims. For this, a new class of securities has been introduced into the liability structure of institutions, the so-called senior non-preferred (SNP) liabilities which are senior to own funds issuances (T1 and T2) but subordinate to ordinary unsecured claims and the so-called senior preferred (SP) liabilities. SP liabilities are defined as liabilities which satisfy all the conditions to be SNP liabilities except the subordination condition. SP liabilities are therefore pari passu with ordinary unsecured claims.

The Bank is neither a G-SII nor does it have assets exceeding EUR 100 billion and so it will not be mandatory that the Resolution Authority assigns a subordination requirement to it. However, the Bank is a D-SII so it is probable that there will be a subordination requirement and the indication in the MREL policy is that the subordination requirement will be 13.5% of REA.

According to BRRD II, only SP liabilities, SNP liabilities and own funds can be used to meet the MREL requirement In line with that, the Bank has ensured that from now on, issuances of unsecured debt meet the conditions to be classified as SP liabilities.

The Bank does not see any hindrance to meet the MREL requirement according to BRRD II as soon as it takes effect.

Figure 3.10 MREL requirement and MREL position, percent of REA



3.11 Regulatory Changes

On 7 December 2017, the Basel Committee on Banking Supervision published an updated Basel III standard which finalizes the Basel III post-crisis reforms. In the EU, a part of these updates are implemented through CRD V and CRR II. Most of the provisions took effect in June 2021 in the EU and were implemented at the same time in Iceland through Act No. 44/2021 and Regulation No. 749/2021.

The changes to the SME supporting factor are discussed above in section 3.4. Other changes include:

- A change in the definition of a large exposure, which will be defined in terms of Tier 1 capital instead of own funds, reducing the threshold for an exposure to be considered large.
- A change of allowed methodologies for the calculation of capital requirements for counterparty credit risk. The Bank has opted to apply the new standardized methodology (SA-CCR).
- The introduction of the net stable funding ratio (NSFR) in Europe. However, the Central Bank introduced rules for the NSFR in Iceland in 2014 so the effect of this changes is limited.
- The introduction of a lower limit of 3% for the leverage ratio in Europe. Again, this is a rule which has been in place in Iceland since 2016.
- A backstop is introduced for non-performing exposures, there will be a minimum coverage requirement for non-performing exposures dependent on whether the exposure is secured or unsecured and length of time since the exposure entered non-performing status.

A primary legislation is being prepared to complete the implementation of CRD V and CRR II in Iceland. Also pending is the implementation of BRRD II in Iceland, although the timeline for that is yet to be fixed.

On the horizon are also the application of the alternative standardized approach for market risk (FRTB) to the calculation of capital requirements which is expected in Q1 2023 and the Banking Package which would complete the implementation of the finalized Basel III reform in the EEA has been published in draft form. This package includes changes to the standardized and IRB framework for credit risk to level the playing field between these two approaches. In 2022, the Bank is taking part in a Basel III monitoring exercise conducted by EBA to assess the impact of these changes on European banks.

4 **Credit** Risk

4.1 Credit Policy
4.2 Credit Granting
4.3 Credit Risk Management
4.4 Credit Risk Exposure
4.5 Collateral Management and Valuation
4.6 Credit Rating
4.7 Portfolio Credit Quality and Provisions
4.8 Counterparty Credit Risk

4 Credit Risk

Credit risk is defined as the current or prospective risk to earnings and capital arising from the failure of an obligor to discharge an obligation at the stipulated time or otherwise to perform as agreed. Credit risk arises anytime the Bank commits its funds to loans, guarantees or other credit instruments, resulting in capital or earnings being dependent on counterparty, issuer or borrower performance. Credit risk is the largest risk in the Bank's operations.

Loans to customers are the primary source of credit risk but credit risk is also inherent in other types of financial assets, such as loans to credit institutions, bonds, derivatives, and in commitments and guarantees such as unused credit lines or limits. Credit risk is inherent in business units connected to lending activities, as well as trading and investment activities, i.e. Corporate and Investment Banking, Retail Banking, Markets and Treasury within Finance.

Table 4.1 Sources of credit risk

Source	Description
Loans to customers	The loan portfolio is the Bank's main asset. Loans to customers comprise loans to individuals and loans to corporates which, for the purpose of this report, include loans to municipalities and public sector entities. Types of instruments include collateralized loans such as property loans, construction loans, mortgages, vehicle loans and uncollateralized short and long term loans such as overdrafts and cashflow loans.
Commitments and guarantees	The Bank often commits itself to ensuring that funds are available to customers as required. The most common commitments to extend credit are allowances on checking account overdrafts, credit cards, and credit lines. Commitments and guarantees are unused amounts and are classified as off-balance sheet exposures.
Balances with the Central Bank and loans to credit institutions	The Bank maintains cash and balances with the Central Bank in the form of certificates of deposits, mandatory reserve deposits, and other balances. Furthermore, the Bank holds money-market deposits and deposits in nostro accounts with credit institutions. Such exposures form a significant part of the Bank's liquidity buffer.
Bonds and debt instruments	The Bank trades and invests in bonds and debt instruments, both listed and unlisted. High quality bonds form a significant part of the Bank's liquidity buffer.
Financial derivatives	Counterparty credit risk arises from forward contracts, swaps and options. The exposures are subject to position limits, hedging requirements and collateral requirements. Eligible underlying market factors are interest rates, foreign exchange rates, securities and commodities. The Bank also uses derivatives for market risk hedging and engages in securities lending. See further information in section 4.7.
Equity risk in the banking book	Equity risk in the banking book arises primarily from investment in positions that are not made for short term trading purposes and assets repossessed as a result of credit recovery i.e. restructuring or collection. For further information on equity risk in the banking book, see section 4.3.5.

4.1 Governance and Policy

The Bank's credit risk policy and credit risk appetite are established by the Board of Directors and reviewed on an annual basis.

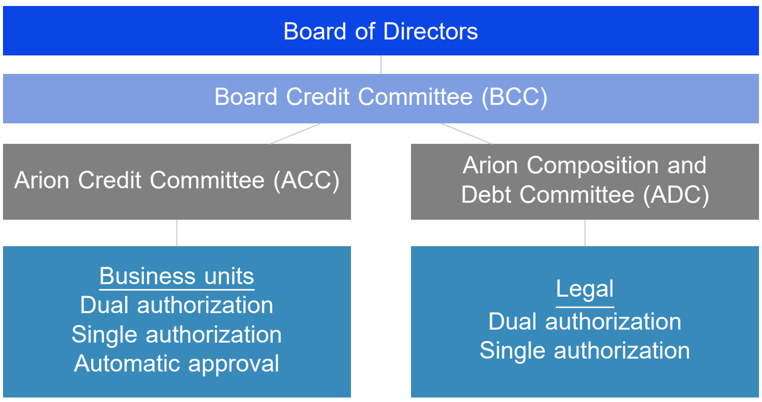
According to the policy, the Bank offers various forms of credit to individuals and organizations, and maintains a diversified loan portfolio composition to avoid excessive risk concentration. The Bank favours long term relationships and sustainable development with emphasis on innovative and export driven companies. The Bank is active in the financing of real estate and as such facilitates home ownership and real estate development. The Bank finances and supports market transactions and market activities of its clients and thus promotes efficiency and liquidity in financial markets.

The Bank's risk appetite framework further specifies the desired level of risk exposure through qualitative and quantitiative statements. The framework addresses credit quality, collateral coverage, portfolio composition and single-name, sectoral and geographical concentrations. It is ensured that the Bank's credit strategy and business model conform to its credit risk policy and risk appetite.

In accordance with the credit risk policy, the Bank's CEO has set up a credit risk framework, which outlines responsibilities, rules and criteria for credit risk arising from the Bank's operations. On the management level, the Arion Credit Committee (ACC) is the principal authority for credit origination and credit management, and the Arion Composition and Debt Cancellation Committee (ADC) is responsible for debt cancellation, debt restructuring and composition agreements. The ADC is chaired by the CEO and the ACC is chaired by the CEO and Deputy CEO and delegates. Risk Management administers and attends all committee meetings and is authorized to reject or escalate decisions.

The ACC and the ADC operate within limits set by the Board of Directors, which is the Bank's supreme authority in matters relating to credit risk exposures. The Board delegates credit decisions that exceed the authority of the ACC and the ADC to the Board Credit Committee (BCC) if the exposure does not require risk appetite exemptions.

Figure 4.1 Credit approval hierarchy



In accordance with the credit risk policy, the Bank's CEO has set up a credit risk framework, which outlines responsibilities, rules and criteria for credit risk arising from the Bank's operations

4.2 Credit Risk Management

Credit risk management entails diversification of risk, well informed lending decisions, good oversight of the portfolio performance, and identification of weaknesses to facilitate a timely recovery.

To ensure well informed lending decisions, borrowers' key risk and performance indicators are analyzed and made available for the credit committee. Credit applications address certain elements that serve as a basis for a decision, e.g. the customer profile, financial analysis of the customer, repayment abilities, the proposed collateral, the credit rating of the customer, and related parties and their total exposure. The credit is assessed on its own merit and in context with the Bank's detailed credit framework and criteria. Various controls ensure that a loan is only disbursed following a thorough review of all documents and the registration of all relevant information regarding the loan and collaterals into the Bank's systems.

During the repayment phase, the credit portfolio is closely monitored by the first line and the second line. Credit risk metrics are aggregated monthly, based on consistent criteria, to analyze the credit quality, expected loss, collateral coverage, single-name and sectoral geographical concentrations, and early-warning indicators. For the purpose of measuring credit risk and facilitating manual and automatic credit decision, Risk Management maintains statistical and expert judgement models that assess the likelihood of default and liquidation value of collateral.

Risk Management analyzes loans that have been classified at risk and maintains an independent and centralized overview of distressed credits. Risk Management, based on analysis performed in cooperation with the first line, manages provisions and reviews proposals for write-offs.

Monthly credit risk reports are sent to the ACC, the BRIC and the Board of Directors.

4.3 Credit Risk Exposure

4.3.1 Overview

The Bank is exposed to credit risk from both on-balance sheet exposures and off-balance sheet exposures. The tables in this section do not include exposures on the Bank's trading books or counterparty credit risk (CCR) exposures.

The exposure amounts shown are on different basis: Exposure at default amounts according to the rules on capital requirements are derived from original exposure (gross carrying value including off-balance sheet amounts), net exposure after applying specific credit risk adjustments to the original exposure, adjusted exposure value (net exposure after applying credit risk mitigation (CRM), i.e. exposure net of collateral) and exposure at default (EAD) which is the adjusted exposure value after applying credit conversion factors (CCF) to off-balance sheet items. Also shown are risk-weighted exposure amounts (REA), which is EAD multiplied with the relevant risk-weight.

Credit Risk

Table 4.2 Credit risk exposure and credit risk mitigation effects (EU CR4)

31 December 2021 [ISK m]	Net exposures before CCF and CRM		EAD post CCF and CRM		REAs and REA density	
	On-balance sheet	Off-balance sheet	On-balance sheet	Off-balance sheet	REAs	REA density
Central governments or central banks	182,762	146	186,481	5	62	0.0%
Regional governments or local authorities	3,424	3,227	3,931	1,451	1,067	19.8%
Public sector entities	908	24	608	9	308	49.9%
Multilateral development banks	0	0	531	0	0	0.0%
Institutions	28,753	6,488	28,753	1,323	10,451	34.7%
Corporates	325,461	118,748	313,164	47,066	340,966	94.7%
Retail	122,876	53,246	120,462	11,172	91,293	69.4%
Secured by mortgages on immovable property	475,452	3,757	475,396	1,579	168,056	35.2%
Exposures in default	13,499	308	13,208	85	16,566	124.6%
Exposures associated with particularly high risk	1,599	0	1,599	0	2,398	150.0%
Covered bonds	21,001	0	21,001	0	4,200	20.0%
Collective investments undertakings	5,330	0	5,330	0	5,028	94.3%
Equity	17,859	0	17,859	0	32,518	182.1%
Other items	27,692	0	27,692	0	27,795	100.4%
Total	**1,226,617**	**185,944**	**1,216,016**	**62,689**	**700,710**	**54.8%**

Table 4.2 Continued

31 December 2020 [ISK m]	Net exposures before CCF and CRM		EAD post CCF and CRM		REAs and REA density	
	On-balance sheet	Off-balance sheet	On-balance sheet	Off-balance sheet	REAs	REA density
Central governments or central banks	165,481	158	169,015	4	144	0.1%
Regional governments or local authorities	3,055	3,459	3,444	789	845	20.0%
Public sector entities	1,150	18	864	6	435	50.0%
Multilateral development banks			2,058	131	0	0.0%
Institutions	31,353	2,511	31,353	1,279	8,678	26.6%
Corporates	290,596	67,901	280,568	26,178	303,517	98.9%
Retail	116,499	53,966	114,349	10,374	86,489	69.3%
Secured by mortgages on immovable property	397,424	6,227	397,337	1,984	147,858	37.0%
Exposures in default	14,843	210	14,689	53	19,437	131.8%
Exposures associated with particularly high risk	2,264		2,264		3,396	150.0%
Covered bonds	13,821		13,821		2,764	20.0%
Collective investments undertakings (CIU)	2,892		2,892		2,440	84.4%
Equity	12,925		11,890		24,856	209.1%
Other items	27,445	121	27,445	10	27,953	101.8%
Total	**1,079,748**	**134,572**	**1,071,989**	**40,809**	**628,814**	**56.5%**

By far the largest source of credit risk REA is loans to customers. This exposure mostly falls into the exposure classes Corporates, Retail and Secured by mortgages. The Bank's credit risk-weight density, or REA density, measured as REA relative to EAD, decreased from 56.5% to 54.8% in 2021. There are two main reasons for this decrease. Firstly, the scope of the SME supporting factor increased with the adoption of CRR II in June 2021, which resulted in reduced capital requirements for SMEs. A second key factor is the fact that the Bank's exposure secured by mortgages (post CCF and CRM) grew by 19.4% while the total exposure grew by 14.9%.

Table 4.3 Exposure at Default (post CRM and CCF) by exposure classes and risk-weights (EU CR5). The last column refers to ratings from external rating agencies.

31 December 2021 [ISK m]	Risk weights									Of which
Exposure classes	0%	20%	35%	50%	75%	100%	150%	Other	Total	unrated
Central gov. or central banks	187,984	311	0	0	0	0	0	0	188,295	7,390
Regional governments or local authorities	0	5,382	0	0	0	0	0	0	5,382	0
Public sector entities	0	1	0	615	0	0	0	0	616	0
Multilateral dev. banks	531	0	0	0	0	0	0	0	531	531
Institutions	0	31,788	0	8,130	0	31	0	0	39,948	31
Corporates	0	16	0	5,488	0	358,981	0	0	364,485	367,598
Retail exoposures	0	0	0	0	132,231	0	0	0	132,231	132,629
Exposures secured by mortgages on immovable property	0	0	464,685	7,142	0	5,147	0	0	476,975	477,031
Exposures in default	0	0	0	0	0	6,745	6,548	0	13,293	13,359
Exposures associated with particularly high risk	0	0	0	0	0	0	1,599	0	1,599	1,599
Covered bonds	0	21,001	0	0	0	0	0	0	21,001	0
Units or shares in collective investments undertakings	0	0	0	0	0	189	934	4,207	5,330	5,330
Equity exposures	838	0	0	0	0	6,691	0	10,331	17,859	17,859
Other items	0	0	0	0	2,029	25,256	0	407	27,692	27,692
Total	**189,352**	**58,500**	**464,685**	**21,375**	**134,260**	**403,039**	**9,081**	**14,945**	**1,295,238**	**1,051,049**

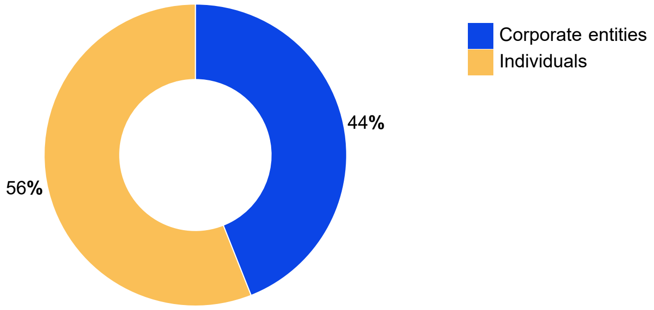
Table 4.3 Continued

31 December 2020 [ISK m]	Risk weights									Of which
Exposure classes	0%	20%	35%	50%	75%	100%	150%	Other	Total	unrated
Central gov. or central banks	167,878	300	0	0	0	0	0	0	169,019	3,135
Regional governments	0	4,233	0	0	0	0	0	0	4,233	0
Public sector entities	0	0	0	871	0	0	0	0	871	0
Multilateral dev. banks	2,189	0	0	0	0	0	0	0	2,189	2,189
Institutions	0	25,452	0	7,180	0	0	0	0	32,631	0
Corporates	0	0	0	0	0	306,746	0	0	306,746	311,453
Retail	0	0	0	0	124,722	0	0	0	124,722	125,082
Secured by mortgages on immovable property	0	0	375,121	11,222	0	12,978	0	0	399,321	399,409
Exposures in default	0	0	0	0	0	5,352	9,390	0	14,742	14,794
High risk exposures	0	0	0	0	0	0	2,264	0	2,264	2,264
Covered bonds	0	13,821	0	0	0	0	0	0	13,821	0
CIU	0	0	0	0	0	2,186	0	706	2,892	2,892
Equity	0	0	0	0	0	3,246	0	8,644	11,890	12,925
Other items	0	0	0	0	551	26,480	0	424	27,455	27,455
Total	**170,067**	**43,806**	**375,121**	**19,272**	**125,274**	**356,988**	**11,654**	**9,774**	**1,112,797**	**901,599**

4.3.2 Credit Risk Exposure by Sector

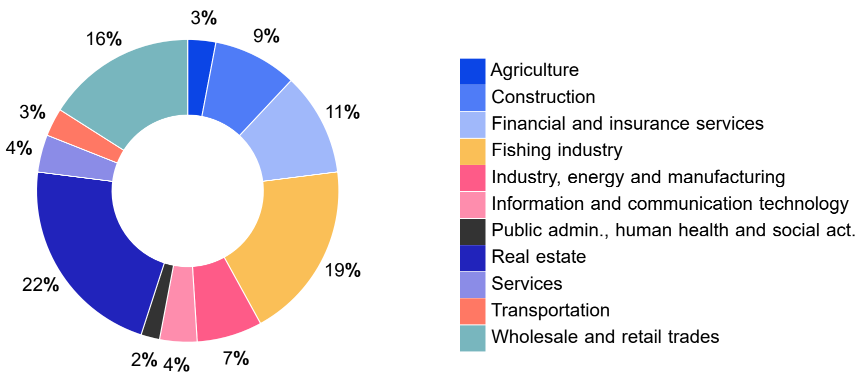
The Bank's loan book is diversified with regard to individuals and industry sectors. Credit exposure to individuals represents 40% of the Bank's total net credit risk exposure and 56% of loans to customers. Mortgage loans are 88% of loans to individuals.

Figure 4.2 Loans to customers, by counterparty type



Real estate activities is the largest industry sector comprising 22% of loans to corporates or 10% of the Bank's total net credit risk exposure. According to the Bank's analysis, the sector distribution of loans to corporates mirrors closely the sector distribution of credit from all lenders in the Icelandic economy. Therefore, the Bank's sector diversification is as good as can be expected for a bank which primarily operates in Iceland.

Figure 4.3 Sector distribution of loans to corporate entities



Arion Bank monitors the risk associated with the tourism industry. The Bank has not modified its standard industry classification to incorporate a separate tourism sector, opting instead to monitor the exposure internally alongside the standard sectors. To define the tourism industry, the Bank has adopted a classification from the Central Bank of Iceland which identifies, primarily, 19 activities from ISAT08 as core tourism activities. According to this definition, the Bank has determined that its exposure to the tourism industry was 8% of loans to customers at the end of 2021, compared to 9% in 2020. The tourism exposure draws mainly from three standard industry sectors: Wholesale and retail trades (59%), Transportation (11%), Real estate (8%), and Services (8%).

8% of loans to customers are related to the tourism industry

For EBA standardized disclosures of credit risk exposure by sectors please refer to template EU CQ5.

4.3.3 Credit Risk Exposure by Geographic Area

The Bank is not significantly exposed to credit in other countries than Iceland. The total net exposure is 91% towards counterparties domiciled in Iceland.

The majority of the 9% foreign credit exposures is due to liquid assets in foreign currencies, which includes short term deposits and money market loans at credit institutions, and sovereign bonds, the counterparties of which have high grade or upper medium grade credit ratings from certified external credit agencies (ECAI).

Figure 4.4 Geographic distribution of total net exposure

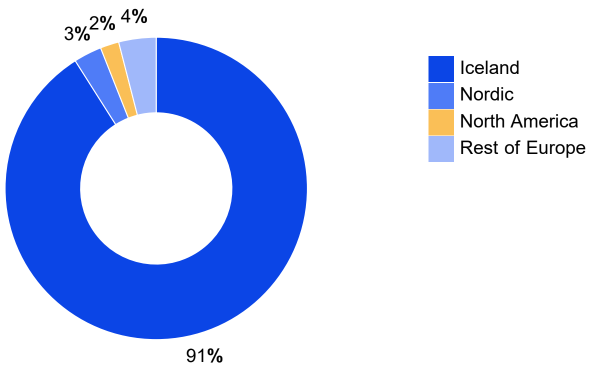
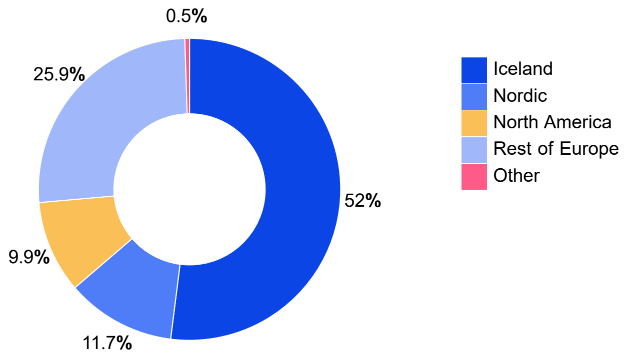


Figure 4.5 Geographic distribution of total net exposure to credit institutions, central governments and central banks



For EBA standardized disclosures of credit risk exposure by geographic area please refer to template EU CQ4.

4.3.4 Related Parties and Large Exposures

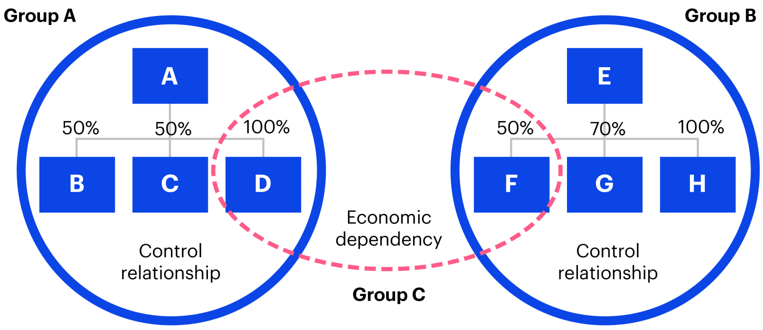
A large exposure is defined as an exposure to a group of related parties which exceeds 10% of the Bank's Tier 1 capital. This definition changed with the adoption of CRR II in June 2021. Previously, the definition was 10% of eligible capital which corresponded to own funds for the Bank. According to CRR, the legal maximum for individual large exposures, net of eligible collateral, is 25% of Tier 1 capital.

The Bank seeks to limit its total credit risk through diversification of the loan portfolio by limiting large exposures to groups of related parties. No single large exposure shall exceed limits expressed in the Bank's risk appetite without special exceptions granted by the Board of Directors.

Credit Risk

The Bank connects related parties according to internal rules that comply with the Act on financial undertakings No. 161/2002 and relevant EBA guidelines. The internal rules define criteria that comply with the regulatory conditions and describe the roles and responsibilities related to the interpretation and maintenance of related parties. The Bank evaluates the relationship of customers with respect to both control and economic dependencies. Economic dependencies between two companies within different groups of related parties do not necessarily combine these groups into one, but could rather result in a seperate group. This relationship is illustrated in Figure 4.6.

Figure 4.6 Related parties



Credit account managers are responsible for maintaining and reviewing party relations both prior to the granting of a loan and during the lifetime of the loan. Risk Management monitors the party relations and manages the Bank's relationship database.

Party relations are monitored both prior to granting a loan and during the lifetime of the loan

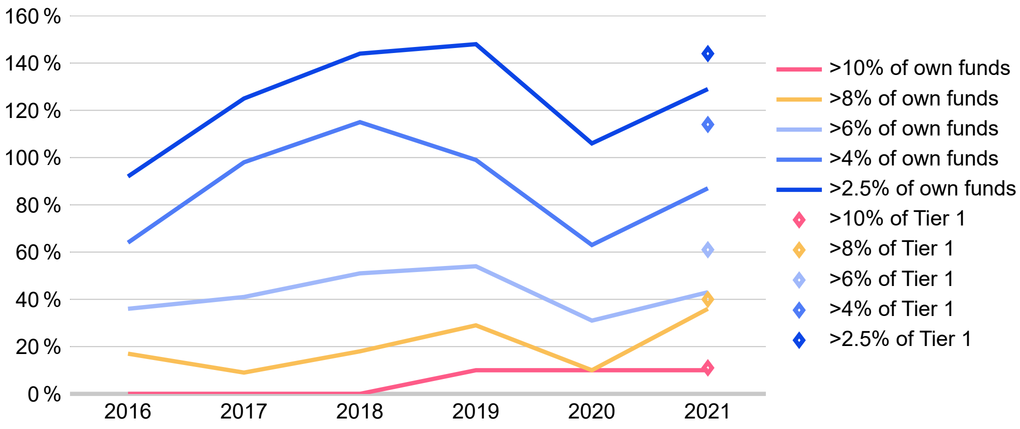
Customers' exposures are updated daily and are available at any time in the Bank's systems. Furthermore, an exposure report for a group of connected clients is updated weekly and is accessible at any time to Risk Management, Corporate and Investment Banking and Retail Banking. Exposures that exceed 5% of Tier 1 capital are reported monthly to the ACC and to the BRIC.

At year-end 2021, the Bank had one large exposure within loans to customers, totaling ISK 19.9 billion before accounting for eligible collateral. At year-end 2020, the Bank had one large exposure.

One exposure to a group of related parties within Loans to Customers was classified as a *large exposure* at year end 2021

The sum of group exposures exceeding 2.5%, net of eligible collateral, increased from 106% to 129% of eligible capital year-on-year, see Figure 4.7. Expressed as a fraction of Tier 1 capital, the sum of exposure exceeding 2.5%, net of eligible collateral, was 144%.

Figure 4.7 Total of net exposures to groups of related parties (excluding loans to financial institutions)



4.3.5 Equity Positions in the Banking Book

Exposure limits for equity positions in the banking book are set in the Bank's risk appetite statement. The banking book is primarily comprised of investments that are not made for short term trading purposes and assets repossessed as a result of credit recovery, i.e. restructuring or collection.

Table 4.4 Equity exposure in the banking book

31 December 2021 [ISK m]	Listed	Unlisted	Total
Investments in associates, non-core		42	42
Equity instruments with variable income	2,164	6,06	8,224
Fund shares - Bonds		2,032	2,032
Fund shares - Other	28	3,341	3,369
Total equity exposure in the banking book	**2,192**	**11,475**	**13,667**
Unrealized gain/loss at year-end 2021			4,061
31 December 2020 [ISK m]	**Listed**	**Unlisted**	**Total**
Investments in associates, non-core		290	290
Equity instruments with variable income	2,668	2,385	5,053
Fund shares - Bonds		811	811
Fund shares - Other	52	2,114	2,165
Total equity exposure in the banking book	**2,720**	**5,600**	**8,320**
Unrealized gain/loss at year-end 2020			1,612

4.4 Collateral Management and Valuation

Accurately valued collateral is one of the key components in mitigating credit risk. The Bank's initial valuation of a collateral takes place during the credit approval process. Credit rules outline the acceptable levels of collateral for a given counterparty and exposure type. The collateral obtained by the Bank is typically as follows:

- Cash and securities: Cash, treasury notes and bills, asset backed bonds, listed equity, and funds that consist of eligible securities
- Real estate: Residential property, commercial real estate and

land
- Vessels: Ships with assigned fishing quota and other vessels
- Other collateral: Fixed and current assets including vehicles, equipment, inventory and trade receivables

In addition to securing collateral, mitigation of credit risk is achieved through use of guarantees, master netting agreements and applicable terms and conditions.

Collateral valuation standards and guidelines have been set by the ACC to ensure coordinated collateral value assessment. Risk Management reviews the standards and guidelines for appropriateness and opines on individual cases as needed.

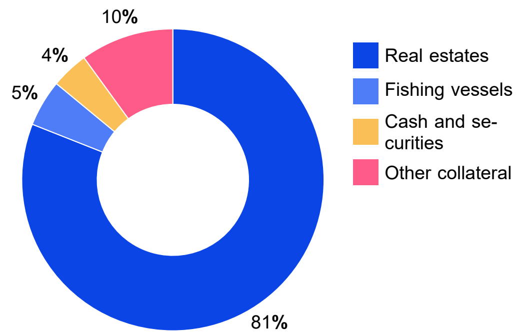
The standards and guidelines cover the following subjects:

- Agriculture
- Fishing vessels and fishing quota
- Inventory, trade receivables and other movable assets
- Project financing
- Real estate
- Securities

The Bank operates a collateral management system (CMS) to consolidate the Bank's collateral data. Table 4.5 shows the collateral held by the Bank for loans to customers, broken down by business sector. Collateral held at year end is to the largest extent real estate collateral, which makes up 82% of the total collateral. At the end of 2021, loans to customers were secured by collateral conservatively valued at ISK 861,428 million, which results in a collateral coverage ratio of 92% compared to 91% at the end of 2020.

The credit exposure towards the Central Bank and financial institutions is unsecured as it is due to the Bank's own deposit accounts and money market loans.

Figure 4.8 Collateral by type



The collateral coverage ratio of loans to customers at the end of 2021 was 92% compared to 91% at the end of 2020

Table 4.5 Collateral for loans to customers

31 December 2021 [ISK m]	Cash and securities	Real estate	Fishing vessels	Other collateral	Total collateral	Unsecured ratio % 2021	Unsecured ratio % 2020
Individuals	712	481,088	15	15,139	496,954	5.6%	6.3%
Real estate activities	329	87,256	0	1,752	89,337	1.1%	18.0%
Construction	486	33,597	48	1,876	36,007	2.7%	2.1%
Fishing industry	1967	12,85	40,999	21,056	76,872	1.6%	1.0%
Information and communication technology	939	1,219	0	1,684	3,842	77.0%	52.3%
Wholesale and retail trade	154	49,874	29	9107	59,164	9.4%	4.8%
Financial and insurance services	24,433	1,814	0	12,877	39,124	14.6%	12.8%
Industry, energy and manufacturing	7	15,206	0	11,04	26,253	6.0%	7.8%
Transportation	0	1556	1556	3,395	6,507	54.1%	61.1%
Services	119	8,559	143	6,235	15,056	12.8%	18.0%
Public sector	13	2,12	7	193	2,333	66.3%	65.5%
Agriculture and forestry	0	9,303	0	676	9,979	2.3%	3.7%
Total	**29,159**	**704,442**	**42,797**	**85,03**	**861,428**	**8.0%**	**9.4%**

Note that the collateral value in the table above is capped by exposure amount.

Figure 4.10 shows the mortgage portfolio broken down by LTV bands based on the face value of the mortgages. At the end of 2021, 90% of the mortgages, by value, had loan-to-value below 80%, three percentage points higher than for the end of 2020. As shown in figure 4.9, the mortgage properties are primarily located in the Greater Reykjavik area or 69% of the portfolio, by value.

Figure 4.10 Loan to value of mortgage loans [ISK m]

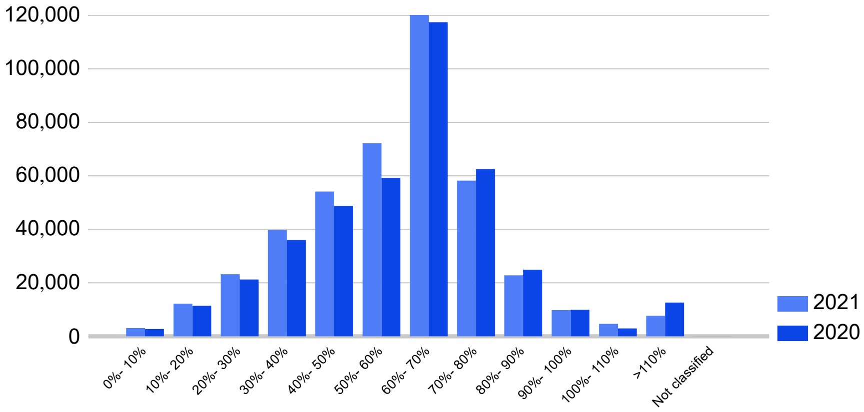
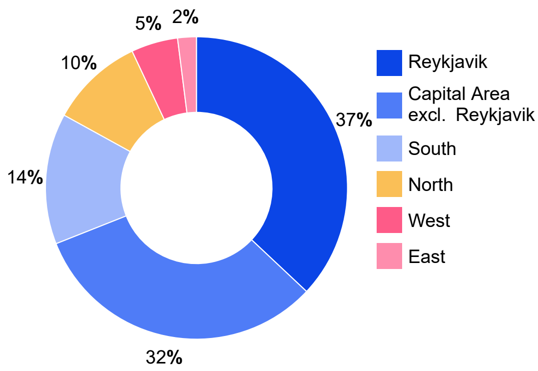


Figure 4.9 Mortgage portfolio by location



4.5 Credit Rating

As outlined in Chapter 3, the Bank uses the standardized approach to calculate capital requirements for credit risk. Nevertheless, it is the Bank's policy to apply sophisticated credit rating models to monitor the development of credit risk and to estimate customers' default probability. These estimates are used extensively within the Bank as they play a role in both the manual and automatic evaluations of loan applications, portfolio monitoring, calculation of loss allowance and internal economic capital calculations.

The Bank applies different credit rating models to different types of borrowers and exposures. The Bank has also created separate application versions of some of the models in order to rate new exposures and loan commitments. The Bank's model structure remained unchanged in 2021.

Table 4.6 Probability of Default models

Model for:	Description
Large corporates	Defined as corporate clients with a) individual exposure over ISK 300 million or b) individual exposure over ISK 150 million and related exposure over ISK 300 million. The model is statistical, runs automatically, based on quantitative information drawn from financial statements as well as qualitative data entered by account managers and approved by lending units.
Retail corporates	Defined as corporate clients with a) individual exposure below ISK 150 million or b) individual exposure between ISK 150 million and ISK 300 million and related exposure below ISK 300 million. The model is statistical, runs automatically, and uses quantitative internal and external information found to be predictive of default.
Other entities	The Bank has different models for other entities - holding companies, state related entities and municipalities, unions, etc.
Individuals, mortgages	Applied to all mortgages, for which there are standard loan collateral agreements. The model is statistical, runs automatically, and based on historical behavior and characteristics of the customer and the exposure.
Individuals, consumer loans	Applied to all consumer loans - credit cards, overdrafts, etc. The model is statistical, runs automatically, and based on historical behavior of customers and characteristics of the customer and the exposure.
Individuals, other exposures	The Bank has different models for other smaller exposure portfolios to individuals - car loans, guarantees, loans for work purposes and other loans.

The Bank's probability of default (PD) models are developed within Risk Analysis, (a department within Risk Management), while the validation of the models is performed independently by Risk Monitoring and Framework.

4.5.1 Credit Exposure by Rating

Table 4.7 shows the portfolio's rating status, by exposure. A default rating grade (DD) is assigned to an exposure when it has been in arrears for over 90 days or the customer is deemed unlikely to pay, see section 4.7. Around 1.4% of the portfolio, by exposure, was assigned a default rating at the end of 2021, which is 0.4 percentage points lower than at the end of 2020. Active PD values are translated into an internal rating scale of letters from AAA to CCC-. The scale is shown in Table 4.8. The Bank has standardized six risk classes that categorize the internal rating scale, shown in the same table.

Figure 4.11 Distribution of exposure by portfolio

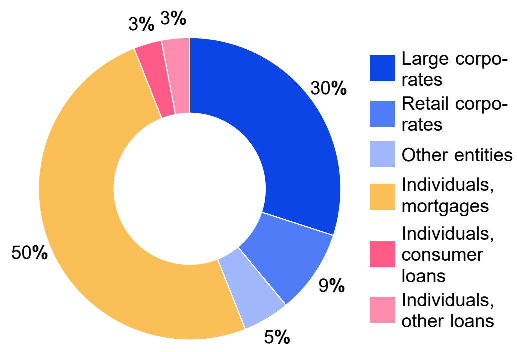


Table 4.7 Breakdown of rating status by exposure

	2021			2020		
Rating Model	% Active credit rating	% DD	% Unrated	% Active credit rating	% DD	% Unrated
Large corporates	97.9%	1.6%	0.5%	97.0%	2.5%	0.6%
Retail corporates	95.7%	4.3%	0.0%	95.5%	4.5%	0.0%
Other entities	99.3%	0.7%	0.0%	94.6%	1.1%	4.2%
Individuals, mortgages	99.1%	0.9%	0.0%	99.1%	0.9%	0.0%
Individuals, consumer loans	99.4%	0.6%	0.0%	99.2%	0.8%	0.0%
Individuals, other exposures	97.1%	2.9%	0.0%	97.8%	2.2%	0.0%
Total	**98.5%**	**1.4%**	**0.1%**	**97.8%**	**1.8%**	**0.4%**

Table 4.8 Rating scale

Risk class	Rating	Lower PD	Upper PD
0	AAA	0.000%	0.006%
	AA+	0.006%	0.018%
	AA	0.018%	0.029%
	AA-	0.029%	0.045%
	A+	0.045%	0.07%
	A	0.07%	0.11%
	A-	0.11%	0.17%
1	BBB+	0.17%	0.26%
	BBB	0.26%	0.41%
	BBB-	0.41%	0.64%
2	BB+	0.64%	0.99%
	BB	0.99%	1.54%
	BB-	1.54%	2.40%
3	B+	2.40%	3.73%
	B	3.73%	5.80%
	B-	5.80%	9.01%
4	CCC+	9.01%	14.00%
	CCC	14.00%	31.00%
	CCC-	31.00%	99.99%
5	DD	100.00%	100.00%

The rating distributions of each of the four largest portfolios are discussed below.

Large corporates

The exposure-weighted average PD for the large corporate portfolio was 2.8% at year-end 2021, compared to 5.8% at year-end 2020. In terms of exposure (figure 4.12), approximately 32% have been upgraded towards a better risk class, in contrast to 23% that have been downgraded. The reason for this decrease in the average PD is due to fewer corporations receiving a COVID-19 specific adjustment, see section 4.6.3. The migration analysis does not cover defaulting customers or customers that were previously unrated (e.g. new customers), or rated by the model for retail corporates.

Figure 4.13 shows the large corporates portfolio broken down by ratings.

Figure 4.12 Risk class rating migration by exposure between 2020 and 2021 – Large Corporates

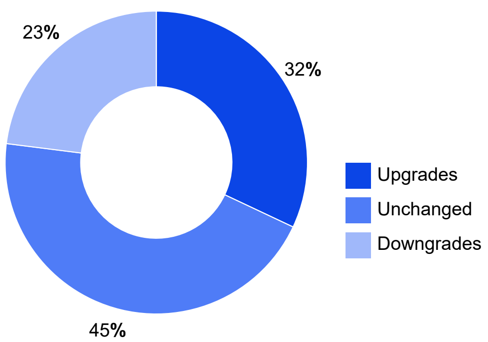
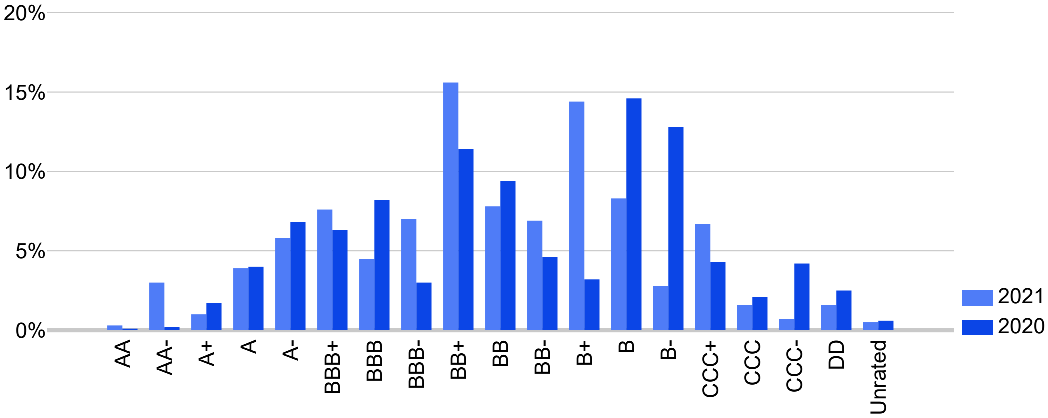


Figure 4.13 Distribution of exposure by rating for large corporates



Retail corporates

The exposure-weighted average PD was 3.6% at the end of 2021, compared to 7.8% at year-end 2020. In terms of exposure (figure 4.14), 37% have been upgraded towards a better risk class whereas 17% have been downgraded. The migration analysis does not cover defaulting customers or customers that were previously unrated.

Figure 4.15 shows the retail corporate portfolio broken down by ratings. The distribution of PD values has shifted towards better values from 2020 to 2021, especially visible for risk class 4. The change can partly be attributed to pure migration but is also due to removal of the COVID-19 shift, see section 4.6.3.

Figure 4.14 Risk class rating migration by exposure between 2020 and 2021 – Retail Corporates

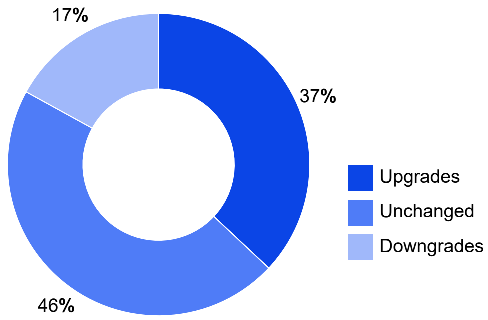
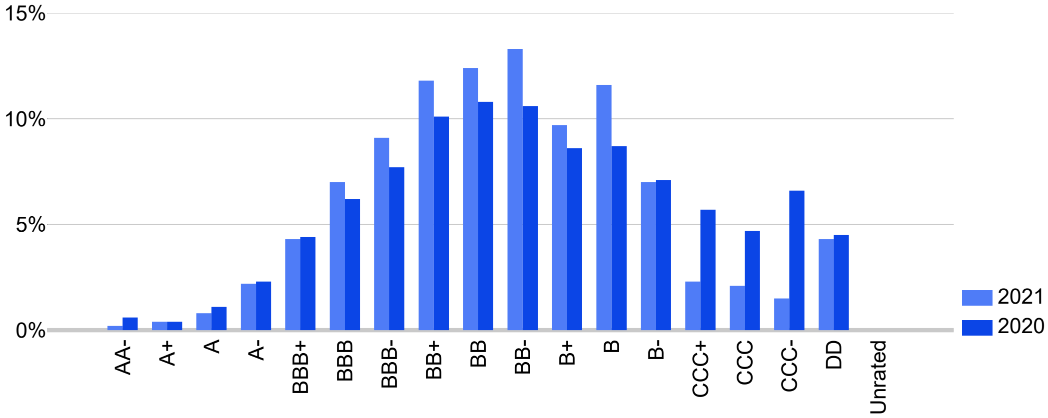


Figure 4.15 Distribution of exposure by rating for retail corporates



Mortgages to individuals

The exposure-weighted average PD for the mortgage portfolio was 0.8% in year-end 2021, compared to 1.0% in year-end 2020. In terms of exposure (figure 4.16), approximately 11% of mortgages have migrated towards an improved credit grade and 4% have been downgraded. The migration analysis does not cover defaulting customers or customers that were previously unrated.

Figure 4.17 shows the mortgage portfolio broken down by ratings. A very similar credit profile is observed between years.

Figure 4.16 Risk class rating migration by exposure between 2020 and 2021 - mortgages to Individuals

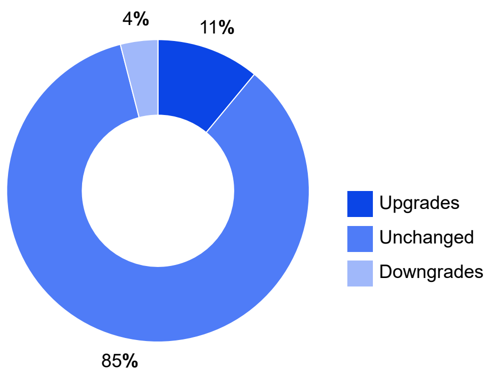
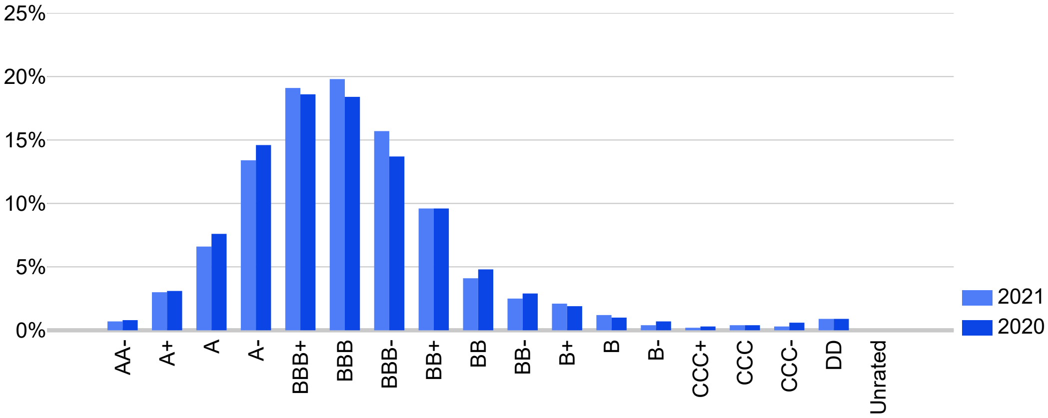


Figure 4.17 Distribution of exposure by rating for mortgages to individuals



Consumer loans

The exposure weighted average PD for the portfolio was 1.7% at year-end 2021 compared to 2.2% at year-end 2020. In terms of exposure (figure 4.18), about 12% have been upgraded towards a better risk class whereas 16% have been downgraded. The migration analysis does not cover defaulting customers or customers that were previously unrated.

Figure 4.19 shows the consumer loans (overdrafts, credit cards and unsecured short-term loans) portfolio to individuals broken down by ratings. A very similar credit profile is observed between years.

Figure 4.18 Risk class rating migration by exposure between 2020 and 2021 - Consumer loans

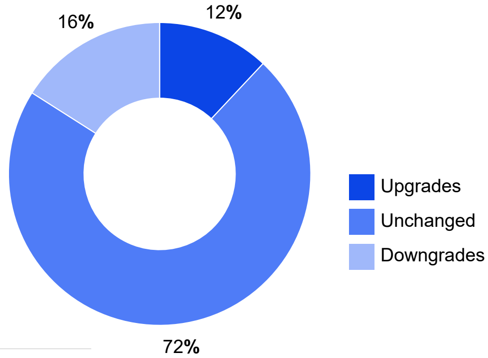
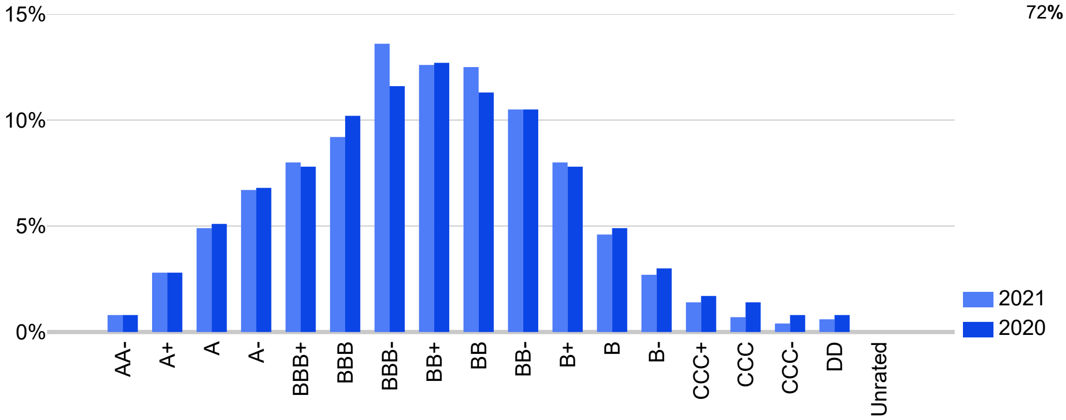


Figure 4.19 Distribution of exposure by rating for consumer loans



Model performance

At the end of 2021, the discriminatory power of the four rating models with the largest exposure is in line with or exceeds the Bank's internal requirements and the prediction accuracy is satisfactory. The comparison values for the exposure weighted average PD estimates at the end of 2020 and exposure weighted observed default rates in 2021 are shown in the following table.

Table 4.9 Model performance. Observed default rates in 2021 compared to probability of default predicted at year-end 2020

Model portfolio	Average PD	Observed avg default rate
Large corporates	2.7%	0.9%
Retail corporates	3.7%	4.1%
Individuals, mortgages	0.9%	0.8%
Individuals, consumer loans	1.3%	1.4%

In figures 4.20 and 4.21, the actual default rate for each rating level in 2021 is compared to the predicted default probability at the end of 2020 for individuals (Mortgages and Consumer loans) and corporates (Large and Retail corporates), respectively.

For both portfolios, ratings BBB- to AAA (Risk class 1 and 0) are grouped together, because of few observed defaults.

Figure 4.20 Comparison of actual default rate in 2021 and predicted default probability - Individuals

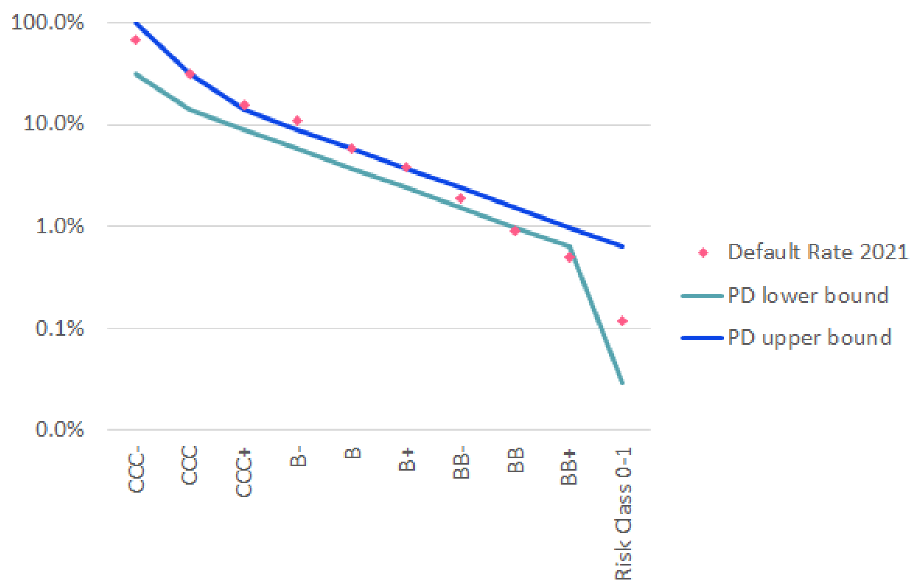
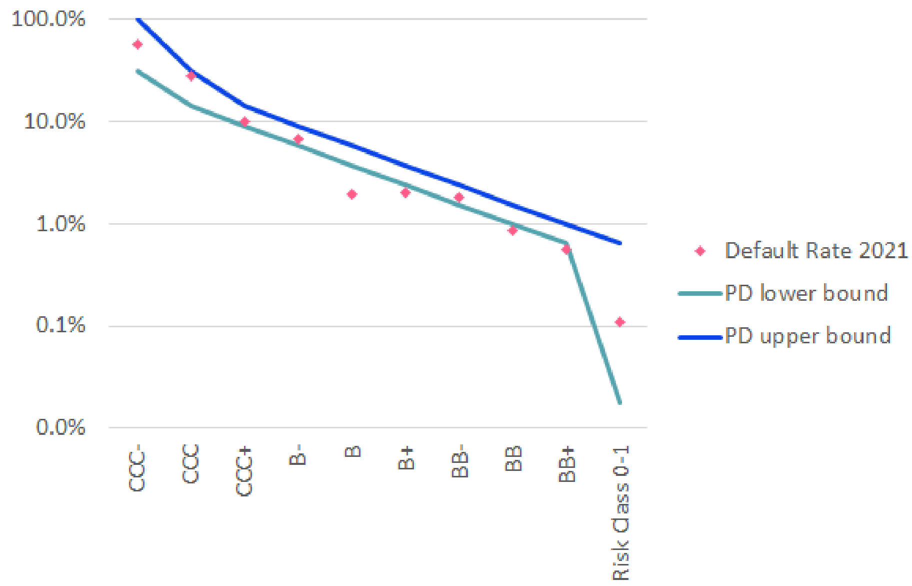


Figure 4.21 Comparison of actual default rate in 2021 and predicted default probability - Corporates



4.6 Portfolio Credit Quality and Provisions

The Bank places great emphasis on monitoring and reporting the quality of its loan portfolio. The credit portfolio quality is regularly aggregated and assessed in terms of industry concentration, single name concentration, product type and credit rating. Risk Management presents its findings to the ACC and the BRIC on a monthly basis.

The Bank places great emphasis on monitoring and reporting the quality of its loan portfolio

From the outset of and throughout the COVID-19 pandemic, the Bank enhanced its monitoring and reporting, internally and externally, to focus on risk factors possibly impacted by COVID-19 and related social restrictions. This includes credit risk, market risk, liquidity risk and operational risk. The FSA monitored the utilization of mitigating measures such as payment moratoria, government sponsored loans and corporates where the district court has approved financial restructuring, in addition to monitoring default ratios, impairments and stage allocation, undrawn-facility ratios and deposit outflow.

4.6.1 Impairment and Provisions

Provisions for credit loss are made according to the IFRS 9 three-stage expected credit loss model. For credit impaired loans, Stage 3 provisions are made based either on a portfolio level assessment or by individual assessment of credits depending on the size of the exposure and other factors which affect whether an individual assessment is warranted. For loans that are not impaired, provisions are either made for a 12-month expected credit loss (Stage 1) or a lifetime expected credit loss (Stage 2). Expected credit loss calculations are based on the borrower's probability of default (PD), loss given default (LGD) and the exposure at default (EAD).

For corporate exposures, a cross-default approach is applied i.e. if a corporate borrower has one impaired credit then all exposures to this borrower are moved to Stage 3 and classified as risk class

5 (DD rating). For individuals, the same applies within each credit model and a default in one portfolio can result in a default in other portfolios if the defaulting exposure is significant.

The level of detail for credit monitoring depends on the size of the exposure, where factors such as delinquency by the borrower, forbearance measurements, and the internal credit rating (see section 4.5) are considered. For larger borrowers, interviews with account managers are also conducted.

For further information on measurement of impairment, see Note 56 on Expected credit losses in the Bank's Consolidated Financial Statements for 2021.

4.6.2 Past Due Exposures

Figures 4.22 and 4.23 show the development of serious defaults from the end of 2016 for individuals and corporates analyzing exposure in default on a facility level and at a cross default level. Until 2020, cross default at obligor level is shown but since the introduction of a new definition of default it is more relevant to study exposure in stage 3. In order to show the effects of this change in viewpoint, both values are shown for two years. The defaults on loans to individuals has continued this decrease this year, while defaults on loans to corporates has decreased this year after two years of significant increase due to large default events.

Customer loans that are more than 90 days past due represent 0.35% of the total loan book at year-end 2021 measured at facility level

Figure 4.22 Development of past due exposures to individuals

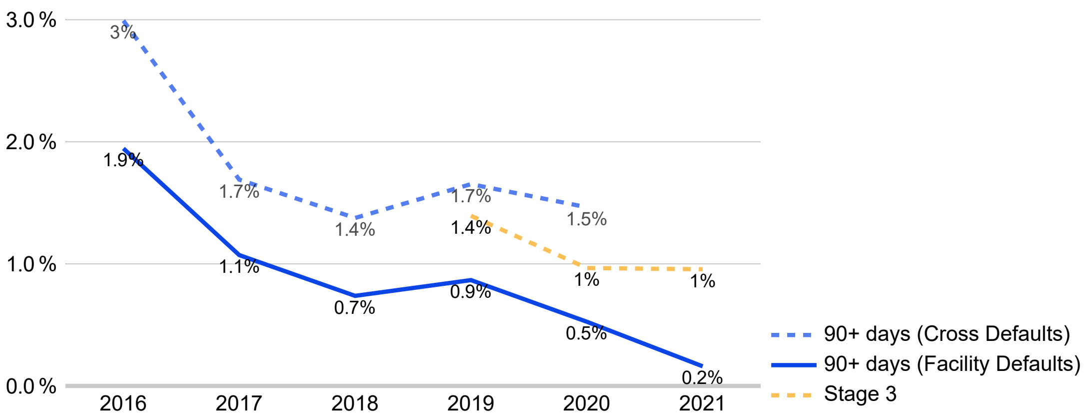
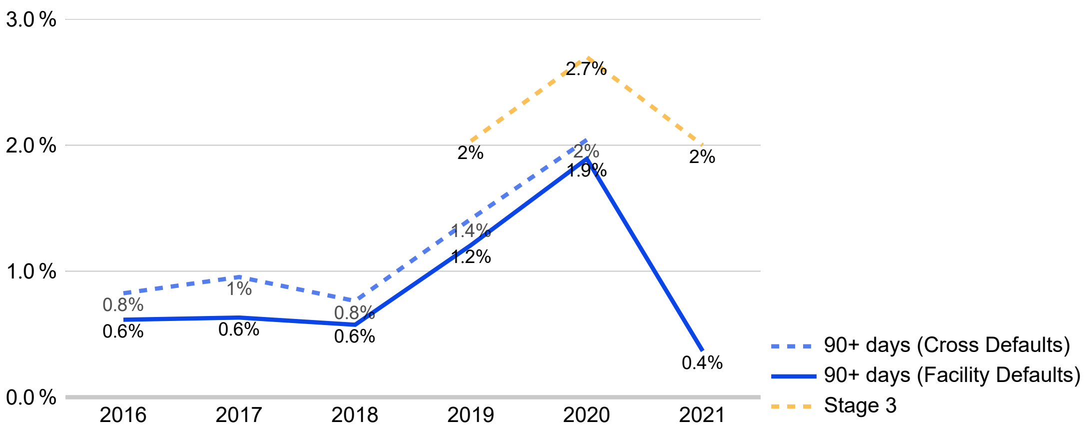


Figure 4.23 Development of past due exposures to companies, parent company



Loans to customers that are more than 90 days past due were 0.35% of the total loan book at year-end 2021 when measured at facility level. The ratio of loans in stage 3 was 1.4%, thereof 1.0% for individuals and 2.0% for corporates.

Template EU CQ3 shows credit quality by past due days.

4.6.3 Moratoria and Forbearance

The Bank has adopted the definition of forbearance listed in article 47b in CRR. According to the definition, an exposure is considered forborne if concessions, such as modification of terms or debt refinancing, have been granted due to the client's current or expected financial difficulties and those concessions would not have been granted in the absence of those financial difficulties.

The Bank is willing to consider forbearance measures in situations when a client is unable to comply with terms and conditions due to financial difficulties if there is a realistic possibility that the terms and conditions can be met again. This is especially considered in cases when the Bank and the client have enjoyed a long-standing business relationship.

The decision to apply a forbearance measure is subject to the Bank's credit granting mechanism, as described in section 4.1 and for potential forbearance cases there is, as a part of the relevant individual's or credit committee's decision, a determination of whether the concession constitutes forbearance.

Credit quality of forborne exposures is shown in templates EU CQ1.

Because of the ongoing global COVID-19 pandemic, the Bank offered general payment moratoria to both individuals and corporates. Initially, these were part of widely available measures offered by Icelandic banks and as such, were not classified as forbearance in accordance with EBA guidelines. In 2021, these EBA-compliant moratoria had mostly expired and were replaced by moratoria which were assessed as forbearance on a case-by-case basis. The number of obligors receiving payment moratoria has decreased steadily over the last two years since it was initiated, whereas forbearance measures have increased.

The following two graphs show how the Bank's exposure in moratoria and forbearance, as well as non-performing exposure, has developed in the past year.

Figure 4.24 Development of non-performing loans, payment moratoria, and forbearance in 2021 for individuals. Shown as percentage of gross carrying amount.

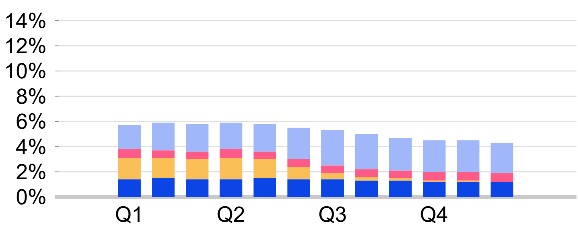
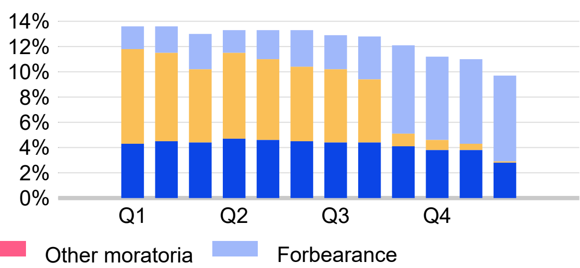


Figure 4.25 Development of Non-performing loans, payment moratoria, and forbearance in 2021 for corporates. Shown as percentage of gross carrying amount.



For further information, see Note 42 on forbearance in the Bank's Consolidated Financial Statements for 2021.

Note 42 also shows the three groups of customers considered as focus groups for the assessment of the impact by the COVID-19 pandemic. The three groups are divided into customers that are tourism related, customers that have had active payment moratoria in the last three months and all recipients of government sponsored loans, both Support and Bridge loans. The exposure and loss allowance to these three groups is shown in Note 42, as well as the exposure amount which is secured by real estate.

Figure 4.27 Segments of loans to customers considered as COVID-19 focus group. Shown as percentage of gross carrying amount.

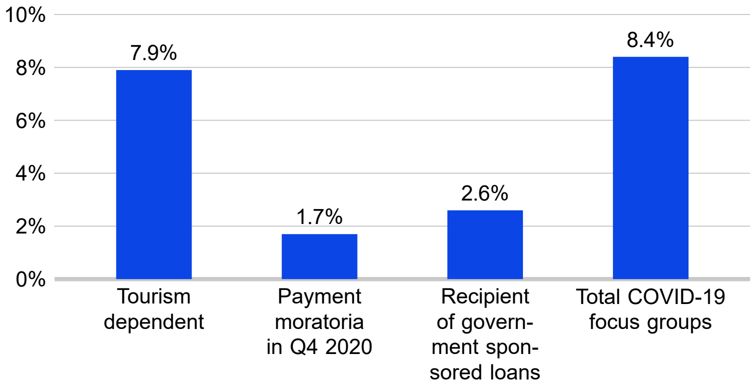
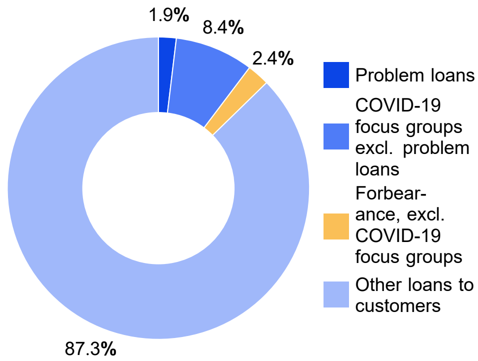


Figure 4.26 Breakdown of loans to customers at year-end 2021



4.6.4 Expected Credit Loss

The 12-month expected credit loss (ECL) is defined as the amount of credit loss that the Bank expects, on average, in the following business year. The Bank accounts for expected credit loss according to the IFRS 9 three stage model. In addition, the Bank holds capital to be able to meet unexpected loss.

The Bank has developed an ECL model for IFRS 9 calculations. This model is also used for impairment predictions in the annual budget and the pricing of credit where credit spreads take into account the exposure's expected loss, cost of capital, and operational cost.

Expected credit loss is calculated using the formula $ECL = PD \cdot LGD \cdot EAD$ where each credit exposure's ECL is derived from the facility's probability of default (PD), loss given default (LGD) and the predicted amount of the exposure at default (EAD). For additional information about the estimation of PD see sections 4.5 and 4.5.1. For impairment calculations, ECL values are calculated in several different scenarios and the impairment is based on the weighted average ECL.

Expected credit loss is calculated using the formula $ECL = PD \cdot LGD \cdot EAD$

The main components of LGD are:

- the *cure-rate* of the exposure, which describes the probability that the customer returns to a non-defaulting status, without a write-off and any loss occurring for the bank within 18 months from the default event
- the *collateral gap* of the defaulted exposure, with haircuts based on historical evidence and expert judgment
- assessment of recoveries of defaulted non-collateralized ex-

posures, conditional on non-cure

The main components of EAD are:

- the *expected outstanding amount* at a given time in respect to the repayments schedule
- the *expected prepayment* to be made based on historic values

Table 4.10 shows the 12 month Expected Loss rate for different customer and exposure classes for exposures in Stage 1 and Stage 2. The PD and LGD values are weighted by the corresponding gross carrying value, taking off-balance sheet items also into account. The ECL values shown are impacted by the IFRS 9 macro-economic forecasts.

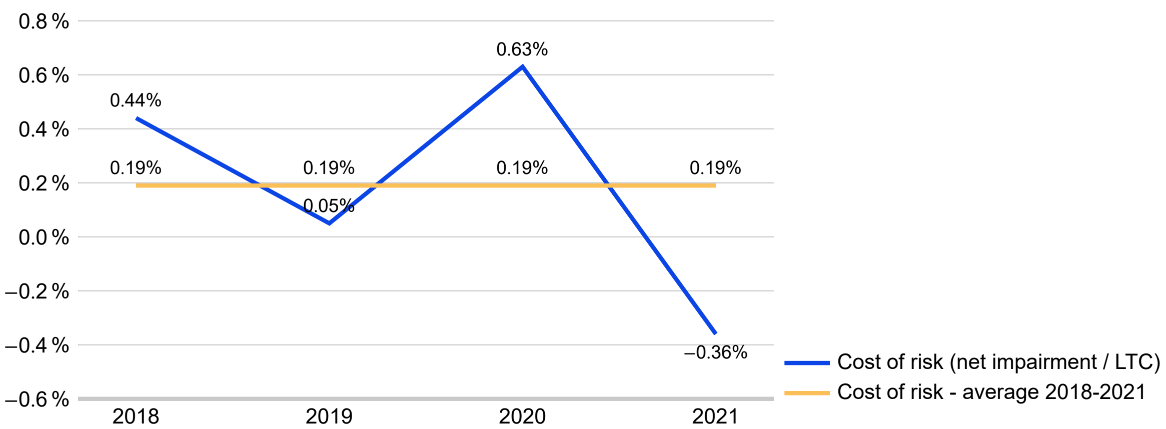
Table 4.10 Expected credit loss by exposure type

31 December 2021	PD	LGD	EL
Large Corporates	2.6%	9.8%	0.34%
Retail Corporates	3.4%	7.0%	0.37%
Individuals, Prime Mortgages	0.8%	1.2%	0.04%
Individuals, Other	1.5%	30.3%	0.59%
Weighted average	**1.8%**	**6.9%**	**0.23%**

31 December 2020	PD	LGD	EL
Large Corporates	5.3%	11.0%	0.63%
Retail Corporates	7.4%	7.6%	0.76%
Individuals, Prime Mortgages	1.0%	1.4%	0.13%
Individuals, Other	2.2%	31.1%	0.73%
Weighted average	**3.3%**	**7.9%**	**0.45%**

To provide a long term view on the Bank's credit losses, the so-called cost of risk measure can be calculated. This is defined as the net impairment from the income statement divided by the average book value of loans to customers at the beginning and the end of the year. Since macroeconomic forecasts affect the calculation of the impairment under the IFRS 9 standard, this measure is rather volatile in the short term but such volatility is averaged out over a longer term. Figure 4.28 shows the development of the cost of risk for the years 2018–2021 along with the average value over the period.

Figure 4.28 Cost of Risk development



4.6.5 Problem Loans

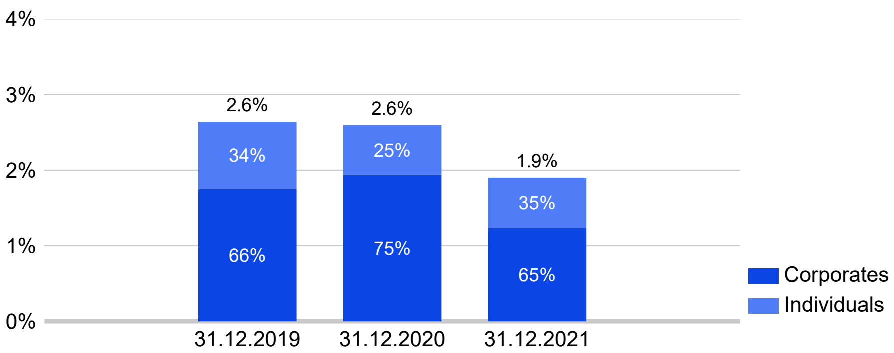
The Bank has implemented EBA/GL/2016/07, the EBA guideline, which provides a further explanation and details of the definition of default in article 178 in CRR. The Bank's implementation complies with the guidelines and is suited to the Bank's size and procedures. The guideline requires the Bank to consider the co-debtor group for a facility and a cross-default mechanism if the obligor is in default on a large obligation.

The definition can be divided into three types of default; unlikely to pay, 90 days past due and cross-default, and probation with or without forbearance. Default is considered on an obligor level for companies. For individuals, default is considered on the level of each PD model and cross default on an obligor level applies when the exposure in default is significant. For 90 days past due, the amount in arrears must be above a relative threshold of 1% and an absolute threshold of ISK 15,000 for retail exposures and ISK 75,000 for other exposures.

The Bank has aligned its definition of *problem loans* with IFRS 9. Problem loans are defined as loans in Stage 3 and the *problem loans ratio* is calculated based on the gross carrying value of loans. At the end of 2021, the problem loans ratio is 1.9% of the loan portfolio, a decrease since the end of 2020. At year-end 2021, 65% of problem loans are, by value, loans to corporates and 35% to individuals.

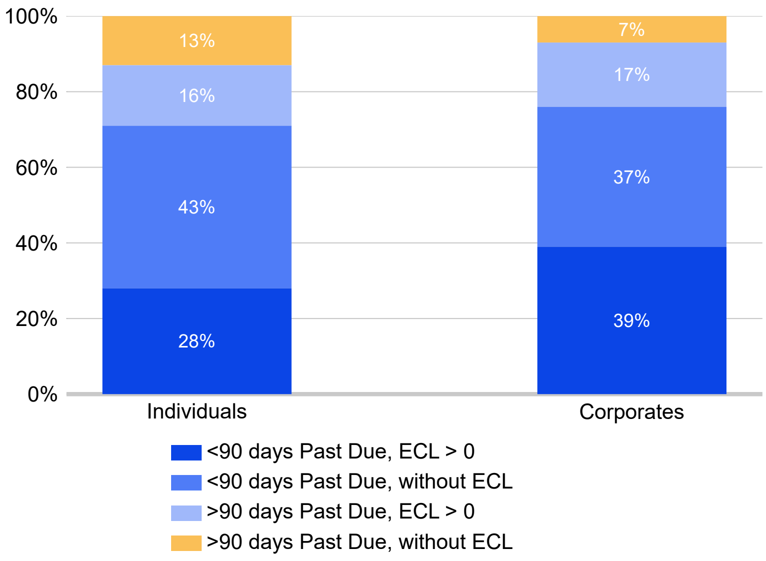
The problem loans ratio is 1.9%, at gross carrying value.

Figure 4.29 Development of problem loans



The breakdown of problem loans by status is shown in Figure 4.30. Around 48% of the problem loans carry no expected credit loss (ECL) due to acceptable collateral cover.

Figure 4.30 Breakdown of problem loans by status



4.7 Counterparty Credit Risk

Counterparty credit risk is the risk of the Bank's counterparties in derivative transactions, securities lending, or repurchase agreement defaulting before the final settlement of the contract's cash flows.

The Bank offers financial derivative instruments to investors. Table 4.11 shows derivative trading activities currently permitted. The derivative instruments are classified according to primary risk factor and type of derivative instrument.

Table 4.11 Permitted derivative trading activities

Primary risk factor	Swaps	Forwards	Options
Interest rate	x		
Foreign exchange	x	x	x
Securities		x	x
Commodities		x	x

To limit and control the counterparty credit risk associated with derivatives trading, the Bank requires collateral and sets limits on customer's total exposure. Generally, collateral is required to cover potential future losses on a contract. Should the net-negative position of the contract fall below a certain level, a call is made for additional collateral. If extra collateral is not supplied within a tightly specified deadline, the contract is closed. The margin-call process is monitored by Risk Management. These exposure limits are generally client-specific and may refer specifically to different categories of contracts.

The margin-call process is monitored by Risk Management

Note 24 in the Bank's Consolidated Financial Statements provides a breakdown of the aggregated underlying notional and fair value by derivative type.

Value changes are made in response to changes in interest rates, exchange rates, security prices and commodity prices. Counterparty credit risk arising from derivative financial instruments is the combination of the replacement cost of instruments with a positive fair value and the potential for future credit risk exposure. The REA for counterparty credit risk is calculated using the standardized method introduced in CRR II. This accounts for the replacement cost, potential future exposure and the credit mitigation from collateral.

Table 4.12 CCR exposures by standardized risk-weights and exposure class (EU CCR3)

31 December 2021 [ISK m]	Risk weights					
Exposure classes	0%	20%	50%	75%	100%	Total
Central governments and central banks	1,809					1,809
Regional governments or local authorities						
Institutions	640	5,329	4,690			10,660
Corporates			244		4,029	4,274
Retail				597		597
Total	**2,450**	**5,329**	**4,935**	**597**	**4,029**	**17,339**

Table 4.13 Composition of collateral for exposures to CCR (EU CCR5)

31 December 2021	Collateral used in derivative transactions				Collateral used in SFTs	
[ISK m]	Fair Value of Collateral received		Fair Value of Collateral posted		Fair Value of Collateral received	Fair Value of Collateral posted
Item	Segregated	Unsegregated	Segregated	Unsegregated		
Cash - domestic currency		3,453			7,209	
Cash - other currency		4,094		1,324		
Domestic sovereign debt		167			766	2,747
Other sovereign debt						
Local government debt		917				
Institutions		936				5,813
Corporate		65				
Equity securities		9,251				
Other collateral		152				
Total		**16,033**		**1,324**	**7,974**	**8,560**

5 **Market** Risk

5.1 Governance and Policy
5.2 Market Risk Management
5.3 Market Risk Measurement
5.4 Capital Requirements
5.5 Foreign Exchange Risk
5.6 Indexation Risk
5.7 Interest Rate Risk in the Banking Book
5.8 Trading Book

5 Market Risk

Market risk is defined as the current or prospective risk that changes in financial market prices and rates will cause fluctuations in the value and cash flow of financial instruments. The risk arises from balance sheet imbalances on the banking book and trading positions in bonds, equities, currencies, derivatives, and any other commitments depending on market prices and rates. The primary market risk factors are interest rate risk, equity risk, currency risk and indexation risk.

5.1 Governance and Policy

The Bank's market risk policy and market risk appetite are established by the Board of Directors and reviewed on an annual basis.

In accordance with the market risk policy, the Bank's CEO has set up a market risk framework, which outlines responsibilities, rules and limit framework for market risk arising from the Bank's operations. On the management level, the Asset and Liability Committee (ALCO) is the principal authority for management and monitoring of market risk.

According to the policy, the Bank invests its own capital on a limited and carefully selected basis in transactions, underwritings and other activities that involve market risk. The Bank aims to limit market exposure and imbalances between assets and liabilities in balance with its strategic goals for net profit.

5.2 Market Risk Management

Market risk controls vary between trading and banking (non-trading) books where the trading book holds positions with trading intent, according to the EU Capital Requirements Regulation (CRR) No. 575/2013, that are actively managed on a daily basis. The limit framework for the trading book is explicit and subject to daily monitoring, while such a framework does not apply to the banking book due to the nature of the exposure. The banking book market risk exposure is monitored and reported on a monthly basis. The Board of Directors has set limits on various market risk exposures in the Bank's risk appetite statement.

Table 5.1 Sources of market risk

Origin	Source	Risk Management
Trading Book	Positions held for market making and proprietary trading purposes. Trading derivatives and associated hedge positions managed within Treasury and Capital Markets.	Explicit position limits and hedging requirements. Daily monitoring.
Banking Book	Balance sheet imbalances, e.g. mismatches between assets and liabilities in terms of currency denomination, indexation and term fixing of interest rates.	Board of Directors' risk appetite and strategic management of ALCO. Natural hedging and explicit derivatives hedging. Monthly monitoring.

Risk Management is responsible for measuring and monitoring market risk exposure and compliance with the limit framework. The performance, exposure and relevant risk measures for the trading book are summarized and reported to the relevant employees and managing directors on a daily basis. Exposures and relevant risk measures are reported on a regular basis to ALCO, BRIC and the Board of Directors.

5.3 Market Risk Measurement

Market risk exposure and price fluctuations in markets are measured on an end-of-day basis. The Bank uses various risk measures to calculate market risk exposure, see Table 5.2.

Table 5.2 Market risk measurement methods

Market risk type	Measurement methods
Equity risk	Exposure to equity is measured with net and gross positions. VaR and stress tests are used to assess risk of loss under current and severe circumstances. Indirect positions are also monitored, e.g. equity collateral.
Interest rate risk	Interest rate risk is quantified as the change in fair value and/or variability in net interest income, after simulating yield curve movements. This is done for all positions sensitive to interest rates. Prepayment risk and behavioral duration of non-maturing deposits is reflected in the Bank's models.
Foreign exchange risk	Foreign exchange risk is quantified using the net balance of assets and liabilities in each currency. This includes current positions, forward positions, delta positions in FX derivatives and the market value of derivatives in foreign currency. The VaR method is used to quantify possible losses.
Indexation risk	Indexation risk is quantified using the net balance of CPI-linked assets and liabilities. In assessing possible loss to earnings due to indexation, the CPI is simulated in conjunction with interest rate movements.

5.4 Capital Requirements

The Bank's capital requirements for market risk under Pillar 1 are calculated using the standardized method as defined in CRR. They are summarized in template EU-MR1.

Table 5.3 Market risk minimum capital requirements (EU MR1)

31 December 2021 [ISK m]	REAs	Capital requirements
Outright products		
Interest rate risk (general and specific)	3,238	259
Equity risk (general and specific)	5,720	458
Foreign exchange risk	4,691	375
Commodity risk		
Options (non-delta)		
Securitization (specific risk)		
Total	**13,649**	**1,092**

In the ICAAP process, the Bank considers various market risk factors where the Pillar 1 capital requirements may not be sufficient. Additional capital requirements are found to be needed for foreign exchange risk, interest rate risk in the banking book which includes indexation risk and the risk that a prolonged stressed period leads to losses from trading book activities.

5.5 Foreign Exchange Risk

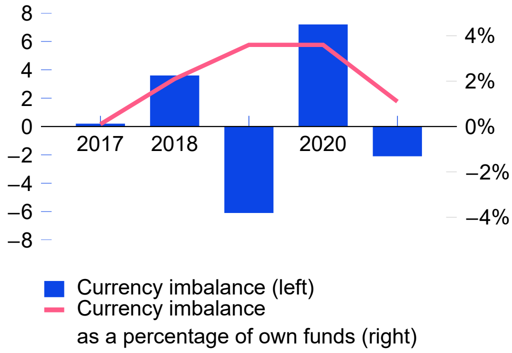
Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Bank is exposed to currency risk due to imbalances between assets and liabilities for different currencies.

Table 5.4 Net position of assets and liabilities by currency and Value-at-Risk results

Foreign currency [ISK m]	Net Exposure	10 day 99%VaR
EUR	1,110	41
USD	-4,259	193
GBP	329	16
DKK	1,086	40
Other	-327	24
Diversification	-	-175
Total	**-2,061**	**139**

At year-end 2021, the Group's currency imbalance was 1.1% of total own funds. According to the Central Bank's rules No. 784/2018, the currency imbalance may not exceed 10% of total own funds or ISK 25bn, whichever is lower.

Figure 5.1 Development of the Bank's Currency imbalance [ISK bn]

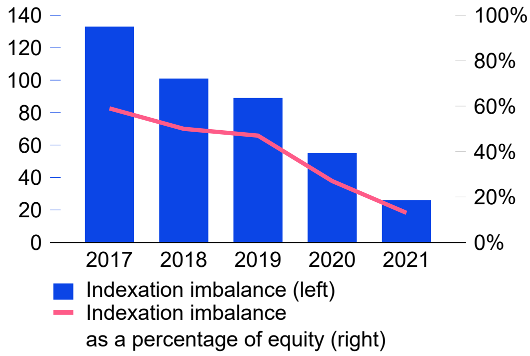


5.6 Indexation Risk

Indexation risk is defined as the risk of loss in earnings due to movements in the Consumer Price Index (CPI), i.e. inflation or deflation. A considerable part of the Bank's balance sheet consists of indexed assets and liabilities, the value of which is directly linked to the CPI. This risk factor should not be mistaken for inflation risk which represents the risk of loss in real value due to inflation.

At the end of 2021, the total amount of CPI-linked assets amounted to ISK 237.7 billion and the total amount of CPI-linked liabilities was ISK 211.7 billion. Therefore, the net CPI-linked imbalance was ISK 26 billion, which means that deflation would result in a loss for the Bank. The indexation imbalance decreased by ISK 29 billion in 2021, primarily due to contraction of indexed loans in excess of that of indexed liabilities. Indexed loans to customers decreased from ISK 257.8 billion in 2020 to ISK 221.9 billion at-year-end 2021. As interest rates lowered significantly in 2020 in response to the economic recession, refinancing of indexed loans to non-indexed loans became the general market trend. This trend from indexed to non-indexed loans has mostly been maintained in 2021 despite rising interest rates.

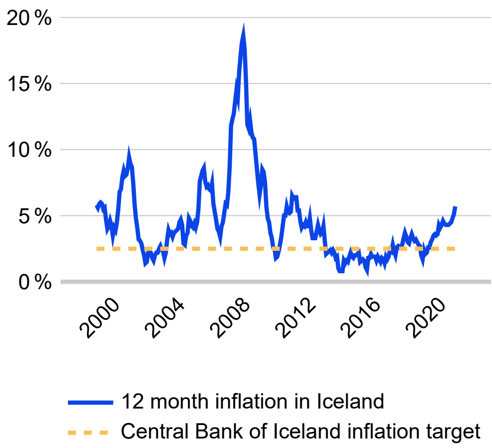
Figure 5.2 Development of the Bank's Indexation imbalance [ISK bn]



The indexation imbalance of the Bank's consolidated situation, which excludes insurance operations, and is the scope of prudential requirements for which these disclosures apply, was ISK 17.4 billion at year-end 2021.

Periods of persistent deflation in the Icelandic economy are unknown in modern history. The period from 2014 to 2020 is largely unprecedented as inflation has been around or below the Central Bank of Iceland target inflation of 2.5%. In 2021, inflation started rising again and was measured at 5.1%. The Bank measures its capital requirements due to indexation risk in conjunction with interest rate risk as inflation is a dominant factor in the dynamics of interest rates and therefore cannot be viewed independently.

Figure 5.3 12 month inflation in Iceland



5.7 Interest Rate Risk in the Banking Book

Interest rate risk is the risk of loss through changes in fair value or net interest income caused by changing interest rates. The

Bank's balance sheet is subject to a mismatch between interest-bearing assets and interest-bearing liabilities, characterized by a gap in interest-fixing periods. A substantial part of liabilities such as deposits have floating interest rates while assets in general have longer interest-fixing periods.

The Bank's balance sheet is subject to a mismatch between interest-bearing assets and interest-bearing liabilities, characterized by a gap in interest-fixing periods

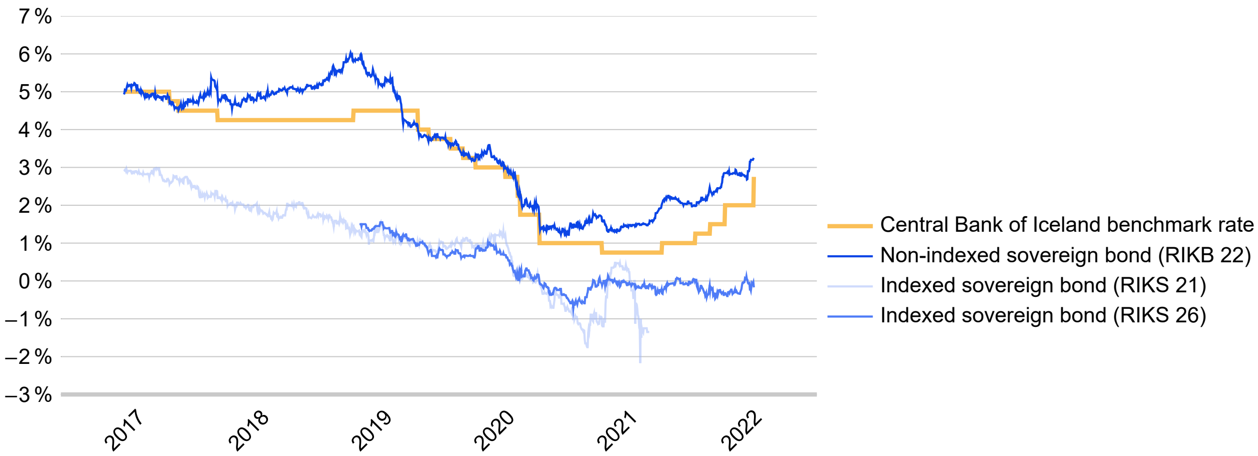
The Bank's strategy for managing interest rate risk is to strive for a balance in the interest fixing profile between assets and liabilities.

The Bank's interest rate risk for foreign currencies is limited as foreign denominated assets predominantly have short fixing periods and the Bank generally applies cash flow hedging for its foreign denominated fixed rate borrowings. For domestic rates, longer fixing periods are more common.

For a breakdown of the Bank's interest-bearing assets and liabilities by interest-fixing periods, see Note 43 of the Consolidated Financial Statements.

Due to favorable refinancing spreads, prepayments and/or refinancing of loans have been considerable over the past few years, resulting in reduced average duration of fixed rates for the Bank's assets. Prepayment risk is mitigated by prepayment fees. The Bank's prepayment of structured covered bonds in the past years is a reaction to mortgage prepayments and mortgage refinancing. Decreasing domestic interest rates in the beginning of 2021 furthermore put pressure on the Bank's net interest income as a result of tighter margins for deposit funding. However, with interest rates rising in 2021 and an outlook of the trend continuing in 2022, a risk in fair value loss due to an increase in fixed rate mortgages has risen.

Figure 5.4 Development of the Central Bank of Iceland benchmark rate and yields of sovereign bonds



Figures 5.5 to 5.6 show the Bank's interest fixing profile for the Bank's mortgages to individuals and covered bonds, indexed and non-indexed.

Figure 5.5 Interest fixing profile of the Bank's indexed mortgages and covered bonds [ISK m]

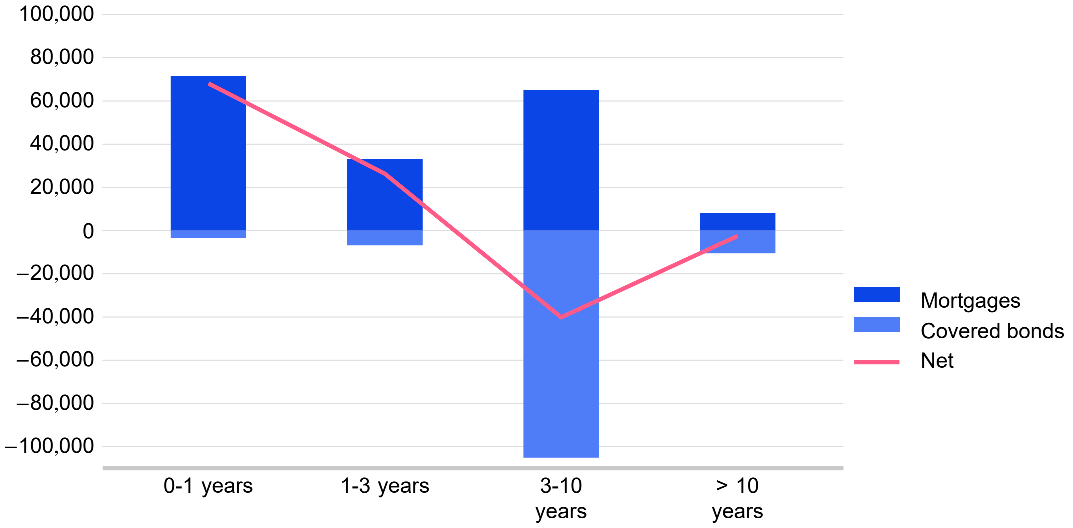


Figure 5.6 Interest fixing profile of the Bank's non-indexed mortgages and covered bonds [ISK m]

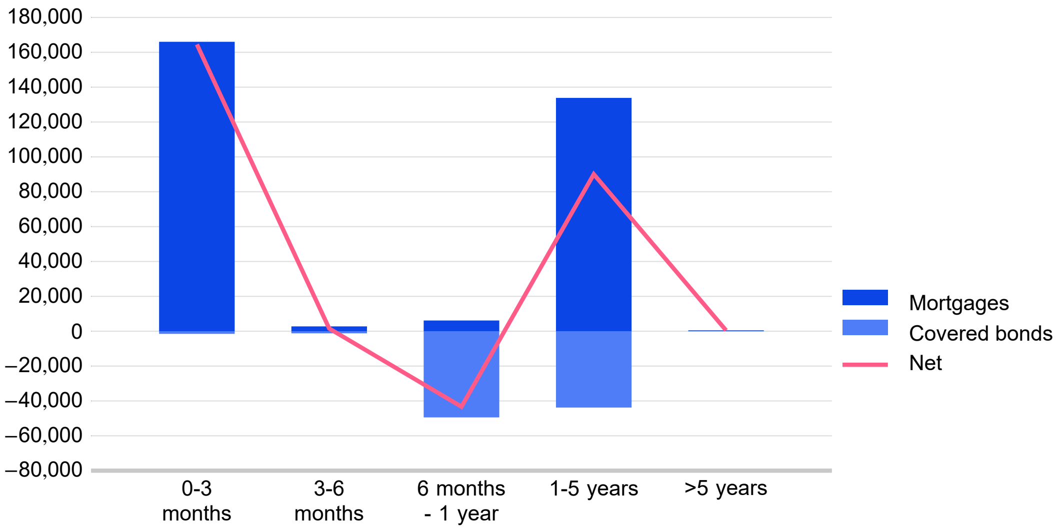


Table 5.5 shows the fair value sensitivity of interest-bearing assets and liabilities in the banking book for different yield curve shifts. The risk is asymmetric as the Bank applies its prepayment models in the fair value calculations, taking into account the prepayment likelihood of loans and matched liabilities and the expected behavior of non-maturing deposits. Note that the Bank's book value is not affected in the same way as the fair value. Due to a sharp reduction in interest rates in 2020 the Bank used its large liquidity reserves at the Central Bank to buy government bonds and covered bonds due to their higher yields. This causes the Bank to now be fair value sensitive to increased rates in non-indexed ISK.

Table 5.5 Sensitivity of the fair value of interest bearing assets and liabilities in the banking book by interest rate base

	2021		2020	
31 December [ISK m]	-100bps	+100bps	-100bps	+100bps
ISK, CPI index-linked	-2,250	2,418	-3,849	3,511
ISK, Non Index-linked	2,308	-2,322	933	-1,002
Foreign currencies	338	-461	301	-327

The capital assessment for interest rate risk in the banking book for domestic rates is calculated through simulations of nominal and real yield curve movements and the value of the CPI. The dynamics between interest rates and the CPI are calibrated to historical data and economic fundamentals. Significant diversification is observed due to the relationship between inflation and interest rates. Prepayment rates are dynamic in the model as changing interest rates affect customers' repayment spreads. Economic capital is the 1% worst loss due to fair value losses and loss to net interest income due to changes to the CPI. For foreign currencies, the Bank applies a 200bps shock interest rate hike.

5.8 Trading Book

The trading book is defined as the Bank's positions held with trading intent, which includes market making and proprietary trading positions and non-strategic derivatives positions and associated hedge positions. The purpose of strategic derivatives is to reduce imbalances on the balance sheet and hedge against market risk. Non-strategic derivatives are however offered to the Bank's customers to meet their investment and risk management needs. Financial instruments in the trading book are exposed to price risk, i.e. the risk that arises due to possible losses from adverse movements in the market prices at which securities in the Bank's holding are valued.

5.8.1 Market Making and Proprietary Trading

Securities positions in relation with the Bank's market making and proprietary trading activities are shown in Table 5.6.

Table 5.6 Positions within the Bank's market making activities and proprietary trading

31 December [ISK m]	2021	2020
Bonds	4,763	5,346
Equity	2,318	3,909
Total	**7,081**	**9,255**

Market making and proprietary trading is subject to a limit framework where possible breaches are monitored daily and reported to relevant parties such as the CEO, CRO, relevant MD and trader. The Bank's trading exposure varies from day to day and the following table shows the end of year exposure along with the 2020 average and maximum exposure in both equity and bonds.

Table 5.7 The Bank's proprietary trading exposure

31 December 2021 [ISK m]	Bonds		
	Long	Short	Net
Year-end	4,763	0	4,763
Average	5,615	-108	5,542
Maximum	8,895	-1,885	8,631

31 December 2021 [ISK m]	Equity		
	Long	Short	Net
Year-end	2,353	-34	2,318
Average	3,844	-42	3,802
Maximum	6,064	-326	6,064

5.8.2 Trading Derivatives

The Bank's derivative operation is twofold: a) a trading operation where the Bank offers a variety of derivatives to customers to meet their investment and risk management needs and b) a strategic operation where the Bank uses derivatives to hedge various imbalances on its own balance sheet in order to reduce risk such as currency risk. This section covers trading derivatives.

Trading derivatives are subject to a rigid limit framework where exposure limits are set per customer, per security, per interest rate etc. Forward contracts on securities are traded within Capital Markets and bear no direct market risk since they are fully hedged. Derivatives for which the Bank takes on market risk are traded within Treasury and are subject to interest rate limits per currency and an open delta position limit for each underlying security.

Table 5.8 Derivatives on the trading book

31 December 2021 [ISK m]	No. of contracts	Assets	Liabilities	Net	Underlying positions	Main risk factor
Forward exchange rate agreements	153	174	266	-92	32,780	Market risk
Interest rate and exchange rate agreements	21	117	171	-54	14,536	Market risk
Bond swap agreements	51	165	20	144	18,029	Credit risk
Share swap agreements	585	348	3530	-3,183	29,772	Credit risk
Options	5	0	14	-14	685	Market risk
Total	**815**	**804**	**4,001**	**-3,199**		

31 December 2020 [ISK m]	No. of contracts	Assets	Liabilities	Net	Underlying positions	Main risk factor
Forward exchange rate agreements	151	803	406	397	36,201	Market risk
Interest rate and exchange rate agreements	31	193	66	127	24,061	Market risk
Bond swap agreements	63	101	41	60	11,138	Credit risk
Share swap agreements	171	1,511	501	1,01	11,031	Credit risk
Options	0	0	0	0	0	Market risk
Total	**416**	**2,608**	**1,014**	**1,594**		

Counterparty credit risk is the risk of the Bank's counterparty in a derivative contract defaulting before final settlement of the derivative contract's cash flows. This risk is addressed in section 4.7.

5.8.3 Trading Book Risk

The trading book's profit or loss is calculated daily. Table 5.9 shows the 10 day 99% Value-at-Risk for the trading book position at the end of 2021, based on historical data collected over the previous 250 business days. The risk of loss is calculated for each instrument and portfolio within the trading book, as well as for the aggregate portfolio. Loss due to currency risk is not taken into account in the loss distribution as it is addressed in the Bank's VaR calculations for currency risk which covers both the banking book and the trading book.

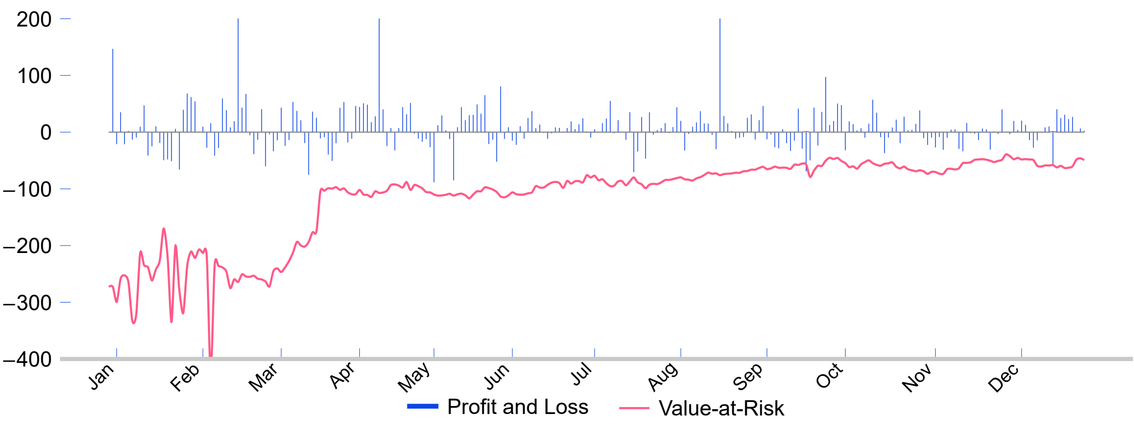
Table 5.9 Value-at-Risk for the trading book with a 99 percent confidence level over a 10 day horizon

31 December 2021 [ISK m]	10 day 99%VaR
Equities	181
Equity options	19
Bonds	78
Bond options	0
Interest rate swaps	38
Diversification effects	-160
Trading book Total	**156**

According to the result, there is 1% likelihood of loss in the trading book that exceeds ISK 156 million over a 10 day period.

Figure 5.7 further shows the daily profit and loss of the Bank's trading book for 2021 along with the evolution of its one-day 1% Value-at-Risk. The trading book's loss exceeded the VaR 1 time during the 250 business days, but exceeding 2.5 times is to be expected by the risk measure.

Figure 5.7 Backtesting of the Bank's one-day 99 percent Value-at-Risk for 2021 [ISK m]



6 **Liquidity** Risk

6.1 Governance and Policy
6.2 Liquidity Risk Management
6.3 Liquidity and Funding Risk Measurement
6.4 Liquidity Position
6.5 Funding

6 Liquidity Risk

Liquidity risk is the current or prospective risk that the Bank, though solvent, either does not have sufficient financial resources available to meet its liabilities when they fall due, or can only secure them at excessive cost. Liquidity risk arises from the inability to manage unplanned changes or loss of funding sources.

An important source of funding for the Bank is deposits from individuals, corporations and institutional investors. As the maturity of loans generally exceeds the maturity of deposits, the Bank is exposed to liquidity risk.

6.1 Governance and Policy

The Bank's liquidity and funding policy and related risk appetite statements are established by the Board of Directors and reviewed annually.

In accordance with the liquidity and funding policy, the Bank's CEO has set up a liquidity and funding framework, which outlines responsibilities, strategy and methods in relation to the Bank's liquidity and funding risk. On the management level, the Asset and Liability Committee (ALCO) is the principal authority for management and monitoring of liquidity and funding.

According to the liquidity and funding policy, the Bank follows a conservative approach to liquidity exposure, liquidity pricing and funding requirement. The Bank maintains a sufficient level of liquid assets in order to meet expected and unexpected cash flows and collateral needs, without it having adverse financial impact on the Bank. The Bank shall have a funding profile that supports its liquidity profile and allows the Bank to withstand extended periods of stress without reliance on volatile funding or external support. The Bank manages its assets and liability mismatches, seeks a balanced maturity profile and diversifies its funding between deposits and wholesale funding.

At year end 2021, Arion Bank's strong liquidity position was reflected in high LCR values, namely 203%, 607% and 136% for total, foreign currency balances and ISK respectively

6.2 Liquidity Risk Management

Liquidity risk is a key risk factor and emphasis is placed on managing it. The Bank's liquidity risk is managed by the Treasury department on a day-to-day basis and monitored by Risk Management. Treasury provides all divisions with funds for their activities in exchange for a charge of internal interest. A small part of the Bank's total liquidity risk is due to subsidiaries which have their own liquidity management.

ALCO is responsible for liquidity management conforming to the policies and risk appetite set by the Board. The committee meets at least monthly to review liquidity reports and make strategic decisions on liquidity and funding matters.

Liquidity Risk

Liquidity risk is controlled by limit management and monitoring. Active management of liquidity is only possible with proper monitoring capabilities. An internal liquidity report is issued daily for Treasury and Risk Management staff and at each ALCO meeting, liquidity and funding ratios are reported as well as information on deposit development and withdrawals, secured liquidity, stress tests and any relevant information or risk management concern regarding liquidity and funding risk.

For best practice liquidity management, the Bank follows FSA's *Guidelines for Financial Institutions' Sound Liquidity Management*, No. 2/2010, which are based on *Principles for Sound Liquidity Risk Management and Supervision*, issued by the Basel Committee in 2008.

6.2.1 Internal Liquidity Adequacy Assessment Process

In conjunction with the ICAAP, see Section 3.6.1, the Bank runs the Internal Liquidity Adequacy Assessment Process (ILAAP) with the purpose of assessing the Bank's liquidity position. The ILAAP is carried out in accordance with the Act on Financial Undertakings with the aim to ensure that the Bank has in place sufficient risk management processes and systems to identify, measure and manage the Bank's liquidity risk.

The Bank's ILAAP report is approved annually by the Board of Directors, the CEO and the CRO and submitted to the FSA. The FSA reviews the Bank's ILAAP report as part of the Supervisory and Review Process (SREP).

6.2.2 Contingency Plan for Liquidity Shortage

The Bank monitors its liquidity position and funding strategies on an on-going basis, but recognizes that unexpected events, economic or market conditions, earning problems or situations beyond its control could cause either a short or long-term liquidity crisis. The likelihood of a large scale funding crisis is relatively small, however, it is important to evaluate this risk and formulate contingency plans should one occur.

The Bank's Contingency Plan for Liquidity Shortage is continuously active and the contingency level is reviewed at ALCO meetings monthly, based on various analyses and stress tests. ALCO reviews a report on liquidity risk from Risk Management and receives projections on sources of funding and the use of funds from Treasury.

6.3 Liquidity and Funding Risk Measurement

In December 2010, the Basel Committee on Banking Supervision issued Basel III: Internal Framework for Liquidity Risk Measurement, Standards and Monitoring. The framework introduced two new liquidity measures, the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), designed to coordinate and regularize liquidity risk measurements between banks.

LCR matches high quality liquid assets against estimated net outflow under stressed conditions over a period of 30 days. Different outflow weights are applied to each deposit category and the measure is thus dependent on the stickiness of each bank's deposit base. The ratio is therefore comparable throughout the banking sector. The LCR is the Bank's key risk indicator for short-term liquidity.

While the focus of LCR is on short term liquidity, the NSFR is aimed at requiring banks to maintain an overall stable funding profile. In the context of NSFR, funding with maturity greater than one year is considered stable. Different weights are applied to funding with shorter maturities depending on the type of funding. The aggregated weighted amounts are defined as the Available Stable Funding (ASF). Similarly, on-balance and off-balance sheet items on the asset side are weighted differently, depending on their liquidity and maturity, to form a bank's Required Stable Funding (RSF) under NSFR. The ratio of the two gives the NSFR. When calculating the ratio for foreign currencies, a negative foreign currency balance is subtracted from the numerator and a positive balance is subtracted from the denominator.

In addition to applying the prescribed 100% minimum for LCR and NSFR, the Central Bank of Iceland has implemented additional requirements for LCR in ISK and LCR in foreign currencies. The minimum requirement for LCR-Total, LCR-FX and NSFR-Total is 100%. A minimum requirement for LCR in ISK was introduced in December 2019. Effective as of January 1 2020, the minimum LCR in ISK is 30% and was scheduled to increase by 10 percentage points in between years until reaching 50% in 2022. The Central Bank decided to extend the adaptation period by one year; i.e., the minimum liquidity ratio in ISK was 30% through 2021. It rose to 40% on 1 January 2022 and will rise to 50% on 1 January 2023.

Minimum NSFR requirements for banks in the EU came into force along with CRR II in June 2021. However, Iceland has had a country specific minimum NSFR requirements for foreign currencies since 2014. The Central Bank has issued updated NSFR rules to align with CRR II. The impact on calculated NSFR is minor. According to CRR II, banks are required to maintain a minimum of 100% for NSFR in total and to monitor the NSFR in significant currencies, i.e currencies having at least 5% share of the Bank's total liabilities.

In addition to the above requirements, the Bank further monitors and reports the LCR for currencies for which aggregated liabilities exceed 5% of its total liabilities. The Bank reports the LCR and NSFR measures to the Central Bank of Iceland on a monthly basis.

In addition to using LCR and NSFR for liquidity and funding measurement, the Bank performs various analyses, including liquidity survival horizons and stress tests in relation to the concentration of deposits.

Liquidity Risk

6.4 Liquidity Position

At year end 2021, the Bank's liquidity buffer amounted to ISK 227,173 million, or 17% of total assets and 35% of total deposits. Composition of the Bank's liquidity buffer is shown in Note 44 of the Bank's Consolidated Financial Statements.

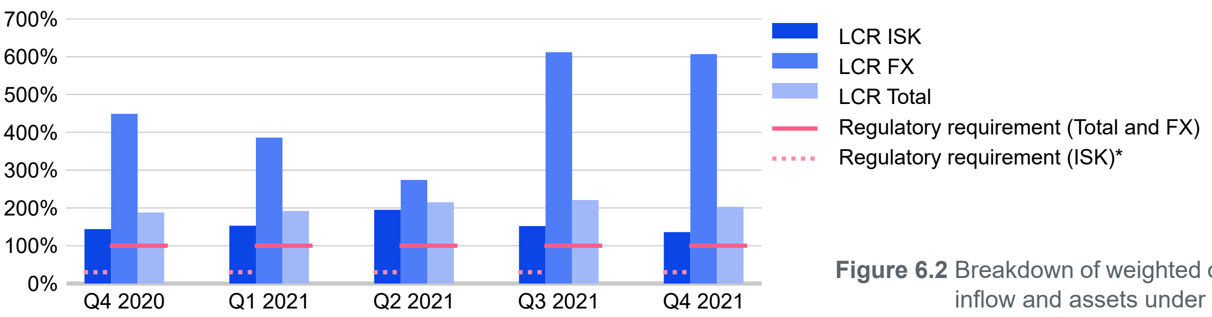
The Bank's strong liquidity position was reflected in high Liquidity Coverage Ratio (LCR) values, namely 203%, 607% and 136% for total, foreign currency balances and ISK, respectively.

Table 6.1 Liquidity Coverage Ratio

31 December 2021	ISK	FX	Total
Liquidity Coverage Ratio	136%	607%	203%
LCR Central Bank requirements	40%	100%	100%

The Bank has held a strong liquidity position throughout 2021, both in foreign currencies and in total, with the LCR well above the regulatory minimum of 100%. The development of LCR-ISK, LCR-FX and LCR-Total is shown in figure 6.1. Standardized disclosure on the calculation of the LCR are provided in template EU LIQ1.

Figure 6.1 Development of the Bank's LCR

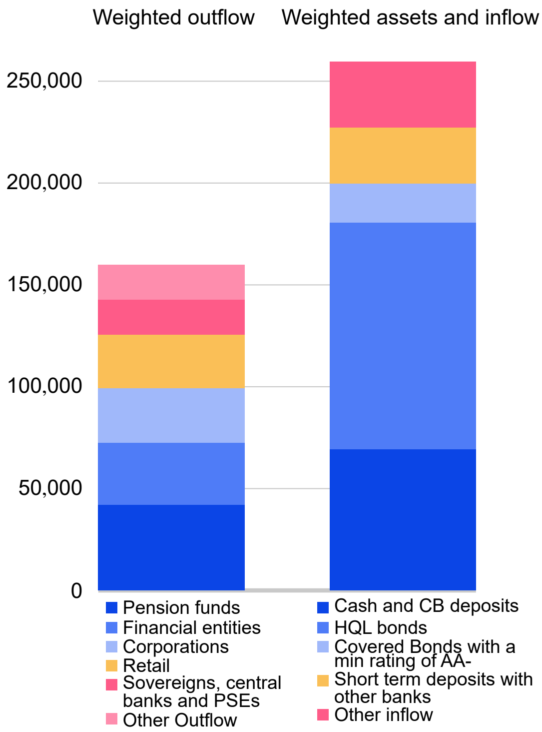


6.4.1 Breakdown of LCR

In general, total inflow is capped at 75% of total outflow. As a result, the Bank's foreign currency position in nostro and money market accounts, which contribute to cash inflow under LCR, is not fully utilized for foreign currency LCR.

At 31 December 2021, under the LCR stressed scenario, the Bank's weighted assets and inflows amount to ISK 259,653 million, substantially exceeding the weighted outflow of ISK 159,907 million. Of the total stressed outflow, ISK 142,380 million are due to deposits which are further analyzed in Section 6.4.2 on deposit categories. Figure 6.2 further shows the contribution of the Bank's main components to the LCR's weighted outflows, inflows and assets.

Figure 6.2 Breakdown of weighted outflow, inflow and assets under LCR's stressed scenario as of 31 December 2021 [ISK m]



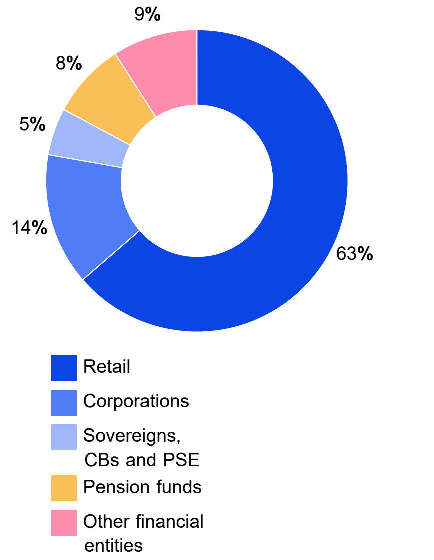
6.4.2 Deposit Categories

As per the LCR methodology, the Bank's deposit base is categorized based on the type of deposit holders. Deposits are also classified as stable or less stable based on business relations and insurance scheme coverage. Each category is given an expected outflow weight based on stickiness, i.e. the likelihood of withdrawal under stressed conditions.

Figure 6.3 shows the distribution of the Bank's deposit base.

At year-end 2021, 63% of the Bank's deposit base are due to retail clients. The Bank has placed emphasis on increasing its retail deposit base.

Figure 6.3 Distribution of deposits by LCR categories at year-end 2021



6.4.3 Concentration of Deposits

As seen in Figure 6.4, 78% of the Bank's deposits mature within 30 days. At year-end 2021, 16% of the Bank's deposits maturing within 30 days belonged to the 10 largest depositors as seen in Figure 6.5.

Figure 6.5 Concentration of deposits on demand within 30 days

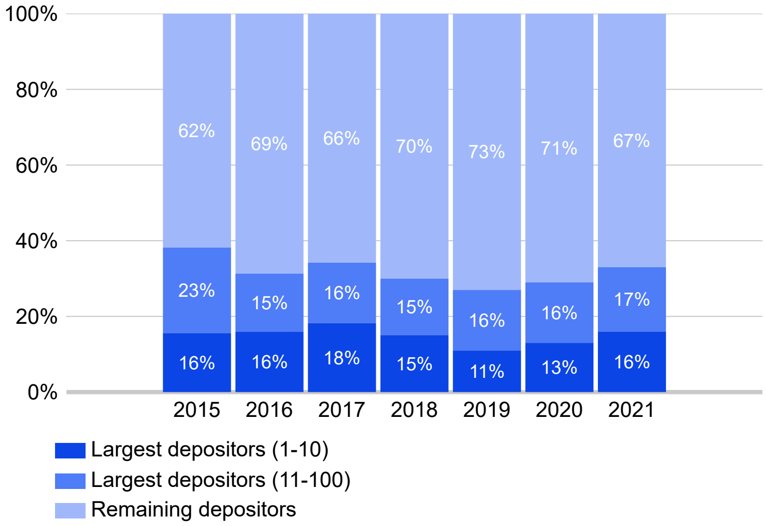
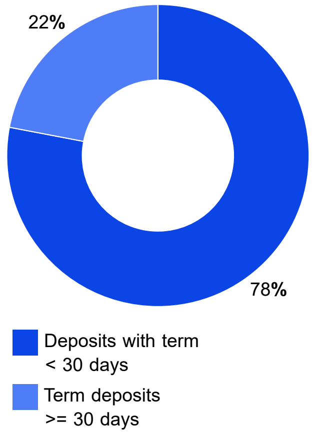


Figure 6.4 Deposit term distribution



6.5 Funding

6.5.1 Overview

Over the past few years, the Bank has taken significant steps to diversify its funding options, issuing green bonds in euros and Icelandic krónur and for the first time issuing covered bonds in euros.

In September 2021, the Bank became the first Icelandic financial institution to issue covered bonds in euros, issuing €300 million. The bonds were sold at rates corresponding to a 0.27% margin over interbank rates, which are the best rates which an Icelandic issuer, including the Icelandic government, has obtained on the international credit markets since the Bank was founded 13 years ago.

In July 2021, the Bank held its inaugural green bond issue in euros. The green bonds were 4-year instruments totalling €300 million. The issue was oversubscribed, attracting offers from more than 70 investors for more than €600 million. The bonds were sold at rates corresponding to a 0.80% margin over interbank rates. The bonds were issued under the Bank's Green Financing Framework. The Framework sets out clearly and transparently the conditions which the Bank's loans need to meet in order to be considered green.

In the domestic market, the Bank held its inaugural green bond issue in Icelandic krónur. The new series, ARION 26 1222 GB, attracted a positive response and bonds amounting to ISK 3,640 million were sold to a broad group of Icelandic investors. The bonds are 5-year instruments and pay fixed interest of 4.70% annually. The bonds were issued under the Bank's Green Financing Framework. At year end 2021, the Bank started to issue covered bonds again in the domestic market. Covered bonds are secured in accordance with the Covered Bond Act No. 11/2008.

Arion Bank renewed its agreement with Kvika, Íslandsbanki and Landsbankinn on market making for covered bonds issued by Arion Bank on Nasdaq Iceland. The purpose of the agreement is to stimulate trading with benchmark covered bonds issued by the Bank.

S&P Global Ratings affirmed Arion Bank's BBB rating and the outlook remains stable. The Bank's short-term rating is A-2. S&P believes that the Bank will remain with a high level of capitalization and strong leverage ratios. Earnings will be supported by increasing cost efficiencies, management of funding costs, strong lending growth on the back of increased demand for mortgages, and solid corporate and investment banking and capital market activity levels. The stable outlook indicates that while S&P sees the Bank as well placed to benefit from a gradual economic recovery in Iceland over the next two years, residual risks relating to the pandemic and the withdrawal of fiscal and monetary policy remain.

Despite progress in diversifying the Bank's funding sources and extending the maturity profile, the deposit base continues to be an important funding source and the focal point of liquidity risk management. The ratio of loans to deposits was 143% as at 31 December 2021 as seen in figure 6.6.

Figure 6.7 shows the development of the Bank's funding profile.

Figure 6.6 Development of loans to deposits

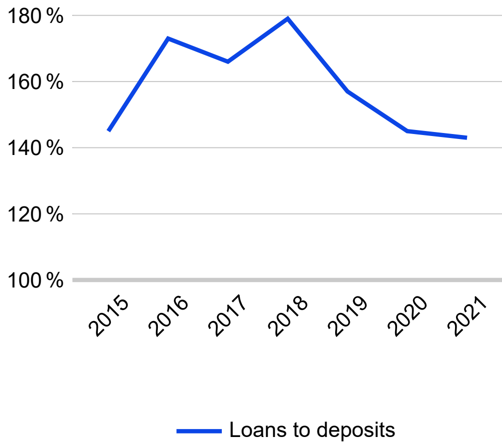
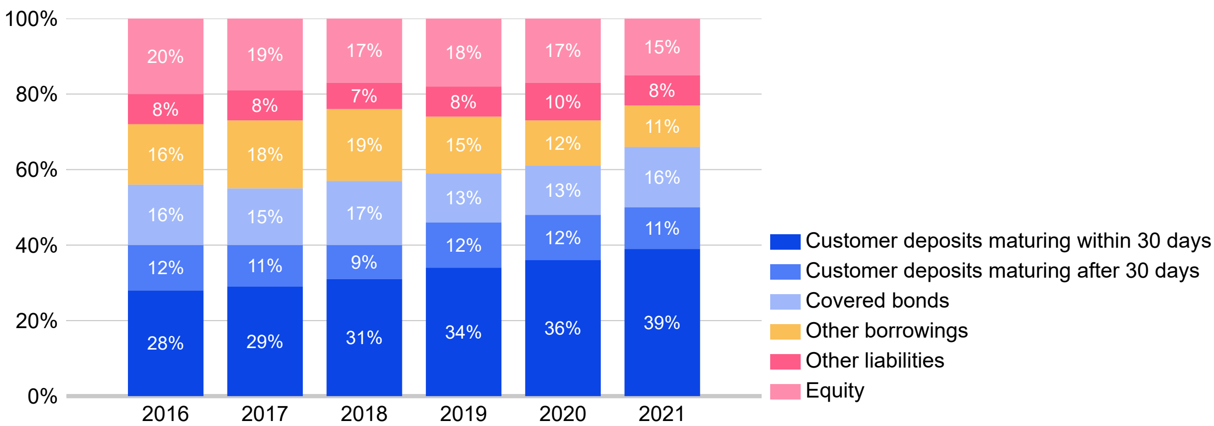


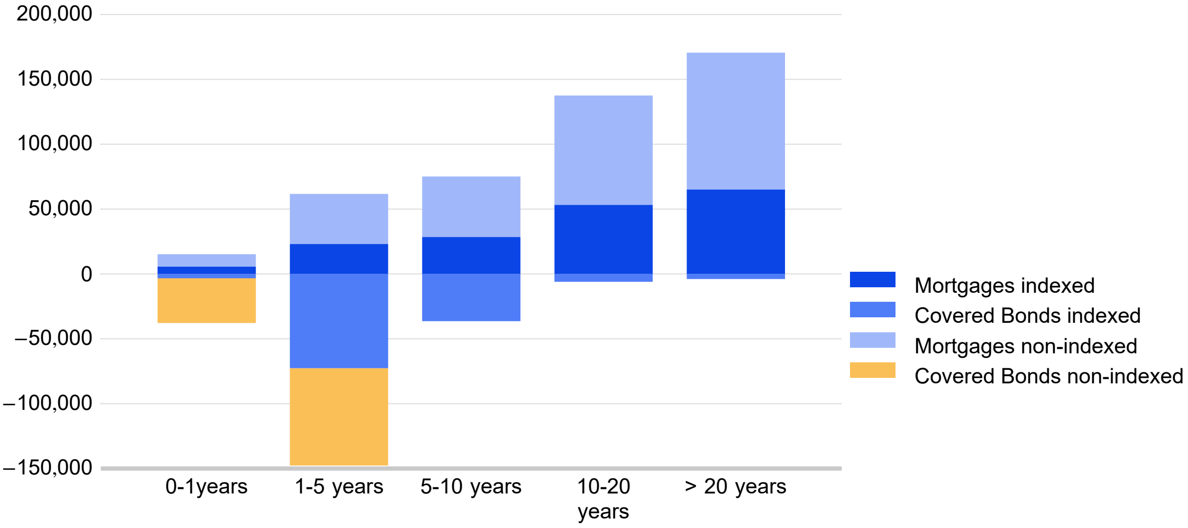
Figure 6.7 Development of funding by type



6.5.2 Secured Liabilities

At year-end 2021, the Bank had an outstanding amount of covered bonds totalling ISK 207 billion. Figure 6.8 shows the contractual payment profile of the Bank's covered bonds and corresponding pledged mortgages. Note that the behavioral maturity of mortgages is generally much shorter than the contractual maturity.

Figure 6.8 Contractual cashflow profile of covered bonds and corresponding pledged mortgages [ISK m]



The Bank's asset encumbrance ratio, the ratio of pledged assets and total assets, decreased by 1 percentage point, going from 20% to 19%, between 2020 and 2021. The development of the asset encumbrance ratio is shown in Table 6.2.

Table 6.2 Development of the Bank's asset encumbrance ratio

31 December	2021	2020
Asset encumbrance ratio	19%	20%

Templates EU AE1, EU AE2 and EU AE3 provide details on encumbered and unencumbered assets and collateral received.

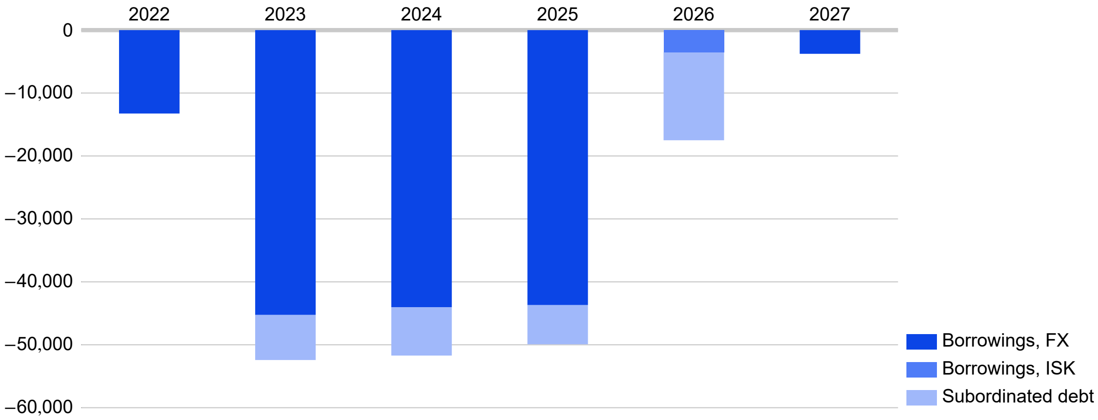
6.5.3 Unsecured Borrowings

Unsecured borrowings are mostly foreign currency denominated. Figure 6.9 shows the Bank's maturity profile of borrowings other than covered bonds. The maturity date for Tier 2 capital instruments are shown at the earliest callable date.

As the Bank's foreign currency deposits are effectively entirely covered by liquid assets, these other FX liabilities are a source of funding for loans to customers in foreign currency. The maturity of those liabilities is greater than that of the loans, so there is low maturity gap risk for the Bank's foreign currency position.

There is low maturity gap risk for the Bank's foreign currency position

Figure 6.9 Maturity profile of borrowings, other than covered bonds [ISK m]



6.5.4 NSFR

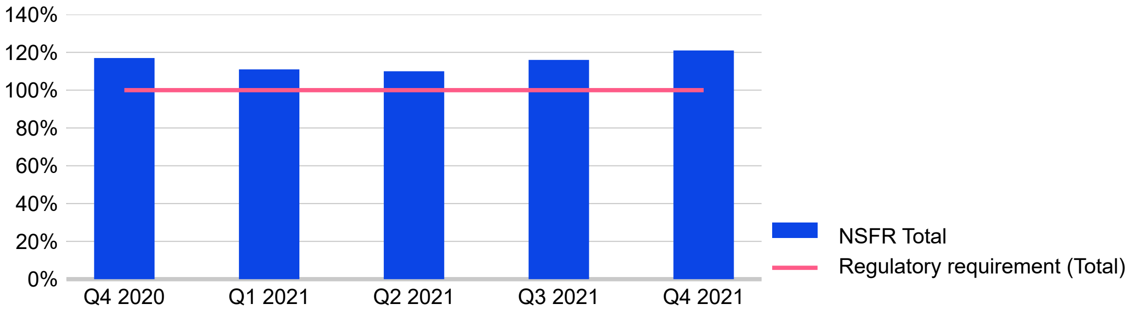
The Bank's NSFR is at 121% at year-end 2021

The Bank's Net Stable Funding Ratio in all currencies (NSFR-Total) was 121% at year-end 2021, well above the regulatory minimum of 100%. The Bank's NSFR has been well above the minimum regulatory requirement in 2021, as seen in Figure 6.10. Template EU LIQ2 provides details on ASF items and RSF items which are the basis for the calculation of the NSFR.

Table 6.3 Net Stable Funding Ratio

31 December 2021	Total
Net Stable Funding Ratio	121%
NSFR Central Bank requirements	100%

Figure 6.10 Development of the Bank's NSFR



7 **Operational** Risk

7.1 Governance and Policy
7.2 Operational Risk Management
7.3 Primary Operational Risks
7.4 Litigation

7 Operational Risk

Operational risk is defined as the risk of direct or indirect financial loss or damage to the Bank's reputation resulting from inadequate or failed internal processes or systems, from human error or external events.

Arion Bank has implemented a framework for assessing operational risk on the basis of the standard risk taxonomy developed by the Operational Riskdata eXchange Association (ORX), which is the largest operational risk management association in the financial services sector. ORX splits operational risks into 16 primary categories and 61 subcategories. The taxonomy includes legal risk, conduct risk and regulatory compliance. By implementing the ORX framework, the Bank has taken steps to further standardize other risk categories for risk assessment and analysis purposes.

The Bank uses the Basel III standardized approach for the calculation of capital requirements for operational risk.

7.1 Governance and Policy

The Bank's policy is to reduce the frequency and impact of operational risk events in a cost-effective manner weighing cost and benefit. The Bank follows the Basel principles of sound management of operational risk. Operational risk is managed through a system of risk assessments, mitigating actions, loss event analysis and corrective actions with focus on key risk areas. For all key risk areas, the Bank reduces its exposure to operational risk with a selection of internal controls, quality management and well-trained and qualified staff.

The Bank's operational risk policy and operational risk appetite are established by the Board of Directors and reviewed on an annual basis.

In accordance with the Bank's Operational Risk Policy, approved by the Board, the Bank's CEO has set up an operational risk framework, which outlines responsibilities, rules and limit framework for operational risk arising from the Bank's operations. On the management level, the Operational Risk Committee (ORCO) is the principal authority for the management and monitoring of operational risk.

An operational risk report is generated by Risk Management on a monthly basis and presented to the ORCO. The report gives an overview of relevant risk measures for operational and compliance risk, such as a summary of deviation events and IT major incidents, loss data analysis and net promoter score. Operational risk is also a subject of the Bank's Risk Report, which is presented to the Board Risk Committee and Board of Directors.

7.2 Operational Risk Management

Each business unit is responsible for managing its operational risks inherent to their operation by identifying, measuring and mitigating those risks. Risk Management and Compliance are responsible for developing and maintaining tools to identify, measure and mitigate risks. The internal control units monitor and report on the Bank's operational and compliance risks.

The Bank's operational risk management framework aims at integrating risk management practices into everyday operations by focusing on key risk areas. Risk is assessed using a predefined three-level risk categories based on the ORX framework. The risk structure is set up to enable the Bank to have a holistic and consistent overview of its risk profile and mitigating actions. As second line functions, Risk Management and Compliance serve as a partner to senior management, supporting and challenging them to align the business environment with the Bank's strategy to maximize potential return for the stakeholders in a cost-effective and risk-minded manner.

Furthermore, the Bank maintains various insurance coverages for the group, its employees and directors. The insurance coverage limits financial loss caused by serious unexpected events, wrongful acts or legal liabilities that occur despite other operational risk management procedures.

Risk assessment

Risk assessments are split into two different categories: ad-hoc project risk assessments and regular operational risk assessments. Project risk assessments are conducted for all major projects and reviewed over the project lifecycle. They are a part of the Bank's new product approval process. Operational risk assessments are generally conducted on a yearly basis starting with the ICAAP / ILAAP risk assessment process. During the risk assessment process, the likelihood and magnitude of each risk is assessed as well as the mitigating capabilities of relevant controls. The risk level is determined based on financial and non-financial effects such as negative impact on the Bank's customers, reputational damage and compliance failure. Based on the overall inherent risk level, actions are planned for all risks assessed as significant or high.

Mitigating actions

Risks that have been identified through the risk assessment process and are assessed inherently as significant or high are mitigated with controls. The controls are documented through processes and procedures built on a uniform methodology to improve efficiency and increase standardization. The goal is to bring relevant risks to acceptable levels by enhancing risk awareness and mitigating activities.

Internal controls are designed to minimize losses from operational risk events to an acceptable level with the goal of optimizing operating efficiency. Controls are furthermore designed to ensure compliance with laws and regulations and to deliver and gather reliable information on a timely basis. The Bank's controls are tested and monitored based on their significance.

As an example, the Bank's Internal Control over Financial Reporting (ICFR) is a set of controls designed to provide reasonable assurance regarding the reliability of financial reporting and reduce the risk of misstatement. Risk management has taken on the role of ICFR coordinator. ICFR controls are tested regularly based on materiality, and the results are presented to the Board Audit Committee.

Loss event analysis

The Bank maintains an extensive database of operational deviations. Operational deviations are events that occur in the day-to-day operation which lead to to direct or indirect financial loss or events which could have caused financial loss but do not, so-called near-misses. Impact from these events can also be in the form of reputational of regulatory damage.

The Bank's employees are ultimately responsible for registering deviation events. Risk Management maintains a platform for employees to register these events. In September 2021, Risk Management implemented an improved and user-friendly platform where the events can be registered and aggregated. The Bank maintains a no-blame policy when it comes to deviation events.

Gathering information on these events provides meaningful information on the Bank's operational risk profile and the effectiveness of its internal controls. All events in the database are categorized as per the Bank's risk taxonomy and assigned to relevant business units. This categorization allows the banks to better identify where the weaknesses within the operation may lie, both down to specific functions of the operation and business units. For severe events more detailed analysis is performed where the exact root cause of the event is identified in order to prevent the event from happening again.

The two figures below show the comparison of registered events/financial loss between 2020 and 2021 down to risk category.

Figure 7.1 Distribution of loss events by number, parent company

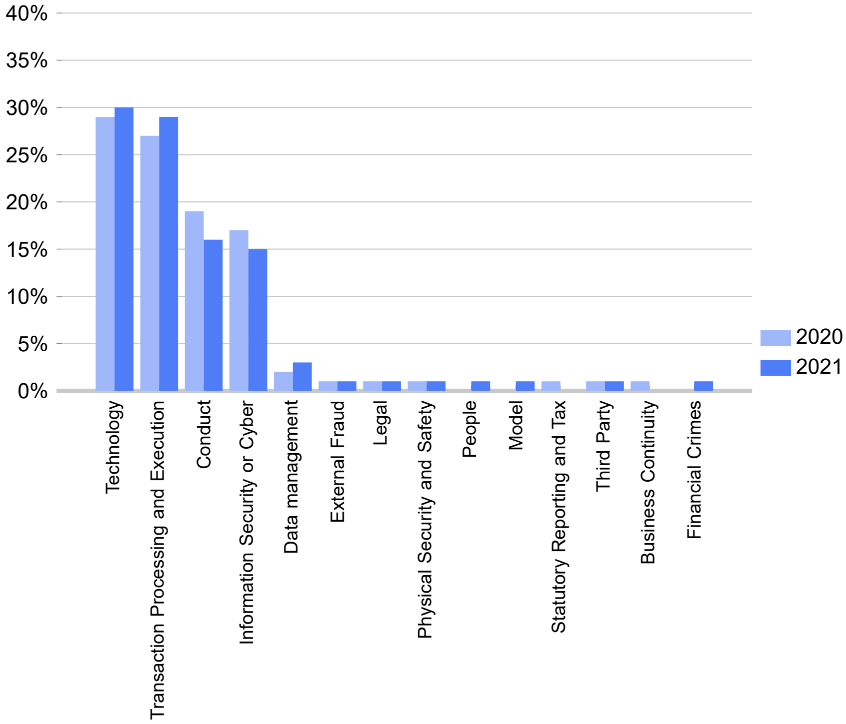
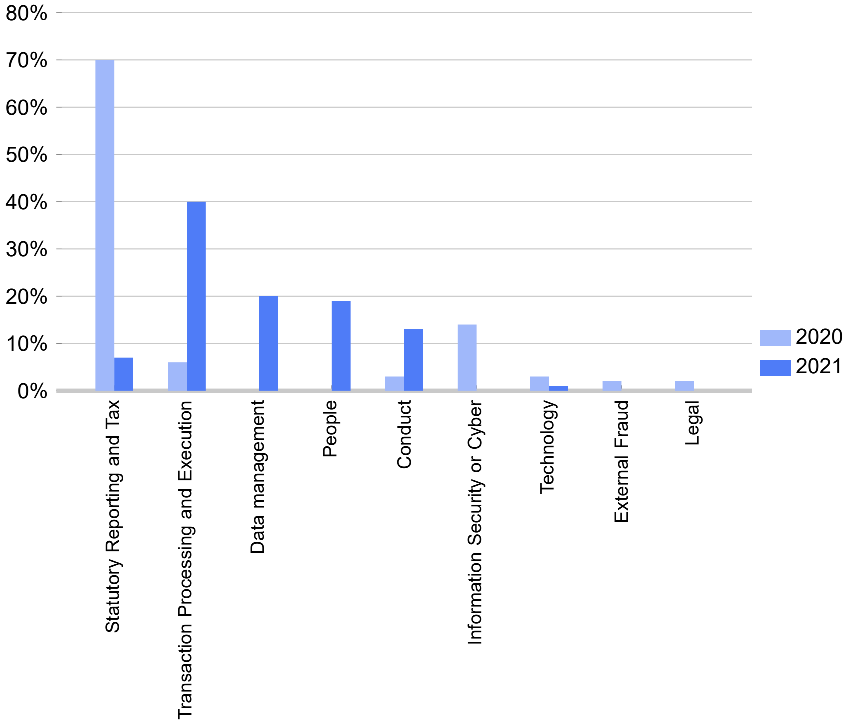


Figure 7.2 Distribution of loss events by amount, parent company



Corrective actions

Any issues arising from the operational risk assessments, loss event analysis, control testing, findings resulting from internal or external audits, or regulatory demands are used to enhance the internal controls of the Bank and improve the Bank's operational risk profile. Once an issue has been identified and the relevant corrective action determined, the work of implementing the action is assigned to a business unit. The business unit is responsible for the completion of the corrective action while Risk Management and/or Compliance provide the business units with support and guidance.

Risk Management is responsible for providing a platform where the corrective actions can be stored, and their progress documented. In September 2021, a new and improved platform was implemented by Risk Management. The new platform allows responsible business units to access their corrective actions more easily and gives Risk Management a better overview of outstanding actions.

7.3 Primary Operational Risks

IT risk and cyber security

Information and cyber security practices within the Bank have a foundation in globally recognized and proven security standards and frameworks, collaboration with trusted partners and vendors in information security, and security awareness amongst employees.

The Bank follows a risk-based approach to information security to ensure business continuity by guarding the confidentiality, integrity, and availability of its data, systems, and services and complying with current laws and regulations. An effective three lines governance model is in place to secure the quality and effectiveness of the Bank's Information Security Program.

The Bank's Chief Security Officer (CSO) is responsible for overseeing IT and security risks and the day-to-day operation of the Bank's information security. The Operational Risk Committee (ORCO) is responsible for implementing and enforcing the Bank's security policy.

Information security risk is managed according to the Bank's Information Security Management System (ISMS) based on best practices and standards.

Conduct and regulatory compliance

The Conduct and Compliance Policy sets out the principles and standards for conduct and compliance and the management of associated risks at Arion Bank.

Conduct risk is defined as the risk of any action of the Bank, or its representatives, leading to customer detriment or having adverse effect on market integrity, whereas compliance risk is defined as the risk of not complying with applicable rules and guidelines. The Bank has no tolerance for breach of compliance which is systemic, severe (e.g. could result in enforcement actions), repeated, intentional, or the result of gross negligence.

The key processes for managing conduct and compliance risk are:

- A process for risk assessment, planning and reporting of conduct and compliance risk
- Suitable procedures and processes, including a detailed process for product development, whistleblowing, and for managing conflicts of interest
- Horizon scanning and change management process
- Providing staff with ready access to training and support on matter relating to conduct and compliance
- Monitoring and testing process

Staff is expected to conduct themselves with integrity and perform their duties with due skill, care and diligence. Staff is also expected to promptly alert of any suspicion or knowledge of misconduct. Each business unit within the Bank is primarily responsible for managing the conduct and compliance risks inherent in their operation, with the Compliance function acting as a second line, providing support and challenge to the business units.

The Bank uses a risk-based approach for managing conduct and compliance risk. In addition to the regluar operational risk assessments, the Bank performs an annual compliance risk assessment, assessing the relative importance of different legal requirements for the Bank‘s operations and the effectiveness of controls in place to ensure compliance. Based on this risk assessment, the Board of Directors approves an annual Compliance Plan to prioritize the Bank's risk mitigating measures.

The Compliance function provides quarterly compliance briefs to the Board Risk Committee on the execution of the Conduct and Compliance Policy, and an annual report to the Board of Directors.

- Arion Bank was not found in violation of any laws or regulations or the subject of any fine or conviction in 2021. Information on the main legal cases relating to Arion Bank is found in the following segment on legal risk

The Bank has a business continuity management system (BCMS) to ensure that critical operations can be maintained and recovered in a timely fashion in the event of significant operational disruption.

- Arion Bank was not denied registration, authorization, membership or permission to conduct certain business activities or operations during the year, nor was it subject to withdrawal, revocation or termination of registration, authorization, membership or permission. There were no issues relating to disclosure obligations in 2021
- In 2021, the Bank received no complaint concerning a breach of data protection from the Data Protection Authority or a third party. The Bank reported 22 incidents to the Data Protection Authority where there was breach of confidentiality. In all cases, the risk to an individual's rights and freedoms were minimal or limited. No incidents of theft or loss of personal data were reported during the year

Financial crime

The Policy on Combating Financial Crime sets out the principles and standards for combating financial crime, i.e money laundering and terrorist financing, financial sanctions, bribery and corruption. The Bank implements and upholds both domestic and internationally recognized standards in this regard.

The Bank uses a selection of measures to combat financial crimes, including:

- A process for financial crime risk assessment, planning and reporting
- Suitable procedures and processes, including a detailed process for customer due diligence, and anti-bribery and corruption procedures
- Providing staff with ready access to training and support on matter relating to financial crime
- Monitoring and testing process, including sophisticated solutions for transaction monitoring, customer screening, and sanction screening
- A process for reporting suspicious transactions and activities

Staff are expected to remain aware of financial crime risk through participation in regular training, and to promptly report any suspicious behaviour or transactions. Each business unit within the Bank is primarily responsible for managing the financial crime risk inherent in their operation, but the Compliance function is responsible for providing complementary expertise and support, for coordinating the Bank's measures and for investigating and reporting any suspicious activities.

The Bank uses a risk-based approach for managing financial crime risk. In addition to the operational risk assessments, the Bank performs a bi-annual holistic financial crime risk assessment, taking into account different risk factors relating to geography, customers, products, and delivery channels, as well as the Icelandic National Risk Assessment. Based on this risk assessment, the Board of Directors approves an annual Compliance Plan to prioritize the Bank's risk mitigating measures.

The Compliance function provides quarterly compliance briefs to the Board Risk Committee on the status of the execution of the Policy on Combating Financial Crime, and an annual report to the Board of Directors.

- Adequate customer due diligence is a key performance metric for the Bank, and was measured at year end 2021 well within the Bank's tolerance, at 96.61 % adequacy

- In 2021, Arion Bank submitted more than 700 reports of suspicion of money laundering to the Financial Intelligence Unit of the Icelandic Police
- No issues relating to bribery or corruption were identified in 2021.

7.4 Litigation

Litigation is not uncommon in the banking industry due to the nature of the business. The Bank has formal controls and policies for managing legal claims. Once professional advice has been obtained and the amount of loss reasonably estimated, the Bank adjusts the account for any adverse effects which the claims may have on its financial standing. The Bank assesses capital need for litigations as part of ICAAP and holds additional capital for exceptional cases.

The largest cases concerning the Bank and possible impact on the Bank's financial position, can be put into two categories: a) court cases and b) cases before supervisory authorities. To the Bank´s knowledge, no administrative procedures are pending or under investigation by supervisory authorities.

Two cases warrant a review:

Firstly, the Bank received a letter from the Consumer's Association of Iceland in April 2020. The letter, which was also delivered to Landsbanki and Íslandsbanki, claimed that contractual terms on variable rate mortgages to individuals were illegal due to lack of transparency and predictability of interest rate decisions. The letter called for revised terms and compensation to borrowers who, according to the Association, have suffered damages. In light of these claims, the Bank conducted a review of its terms and processes for interest rate decisions, concluding that no changes were required and that the Associations claim against the Bank are unfounded. According to information published on the Consumer Association's website, all three banks have rejected the Association's claims. In May 2021, the Consumer's Association issued an article on its website calling for participants in a class action lawsuit. The intention is to commence court proceedings against Icelandic credit institutions to provide court precedents for loans with variable rates. Arion Bank has received information requests from a legal firm representing approximately 1200 individuals, of which 378 are borrowers of Arion Bank, and one case has been filed against the Bank. The Bank has commissioned an external opinion on its legal position and believes it likely that it will be acquitted of the claims. The Bank assesses capital need for litigations as part of ICAAP and holds additional capital for exceptional cases.

Secondly, in July 2020, the FSA decided to levy an administrative fine on the Bank in the amount of ISK 87.7 million, allegedly for failing to disclose inside information in a timely manner. The decision has been published on FSA´s website. Arion Bank paid the fine but filed a claim with the district court of Reykjavik in October 2020 demanding that FSA's decision be annulled. A statement by FSA was submitted in the case in November 2020. Principal proceedings in the case are on the District Court's docket in March of 2022.

Operational Risk

In 2021, there were some legal matters or unresolved legal claims that were considered contingent liabilities. A further description of these cases can be found in Note 37 in the Consolidated Financial Statements for 2021.

8 **Sustainability** Risk

8.1 Governance and Policy
8.2 Sustainability Risk Management
8.3 Environmental Risk
8.4 Social Risk
8.5 Governance Risk

8 Sustainability risk

Sustainability risk is defined as the risk that certain activities or practices compromise the Bank's assets or reputation or the ability of future generations or segments of society to meet their own needs. This can be due to negative effects on the environment, natural or cultural resources or social conditions.

This chapter is prepared with a view to EBA's draft implementing standards on prudential disclosure on ESG risks in accordance with Article 449a in CRR and recommendations from the Task Force on Climate-related Financial Disclosures (TCFD).

8.1 Governance and Policy

Environmental, social and governance (ESG) risks are now incorporated in the Bank's enterprise risk management framework and a Sustainability Committee has been introduced as part of the Bank's risk governance structure. Its primary role is to review the Bank's performance in relation to its commitments and policies in the area of sustainability, and align the Bank's strategy and risk appetite with them. The committee reviews ESG risk assessments and oversees the Bank's Green Financing Framework. The CEO chairs the committee and other members are the CFO, and MDs of Retail Banking, Corporate and Investment Banking, Markets and Customer Journey. The CRO and Sustainability Officer are non-voting members.

The Bank's sustainability risk policy is established by the Board of Directors and reviewed on an annual basis. As stated in the policy, the Bank seeks to ensure that its activities and the financial services it provides do not result in an unacceptable impact on people or the environment, and is committed to supporting the global effort to transition to a net zero carbon economy. The Bank supports Iceland's Climate Action Plan and the UN's Sustainable Development Goals.

The Bank's has a dedicated Sustainability Team which reports to the CEO and is supported by the Risk Management division, which is responsible for sustainability risk reporting.

8.2 Sustainability Risk Management

Sustainability risk is a driver of other risk types, such as credit risk, equity position risk and reputational risk. It can materialize in the short term, the medium term and the long term.

Climate and environmental risks are assessed in the Bank's Internal Capital Adequacy Assessment Process and considered in the Bank's stress testing program.

The Bank's credit policy states that the Bank favors sustainable development and ESG factors are considered in credit decisions as stipulated in the Bank's credit framework. The Bank's Institutional Asset Management division has introduced rules of procedure on responsible investment thus incorporating ESG risks in investment decisions and Stefnir Fund Management operates in accordance with its Policy on Responsible Investments and has its own independent ESG committee.

The Bank seeks to ensure that its activities and the financial services it provides do not result in an unacceptable impact on people or the environment, and is committed to supporting the global effort to transition to a net zero carbon economy

Figure 8.1 Arion Bank's emphasized UN Sustainble Development Goals

In 2022, the Bank aims to introduce sustainability risk statements and metrics into the risk appetite framework. Furthermore, the Bank aims to set sustainability policies for the primary sectors of its loan portfolio, which will outline the Bank's criteria and approach to promote sustainability in the economy through its lending operations and business relationships, in line with the Bank's commitments and risk appetite.

For further information on the Bank's sustainability agenda, profile and objectives, see the Annual and Sustainability Report 2021, which includes various non-financial information on ESG factors.

8.3 Environmental Risk

Environmental risks comprise transition risks and physical risks and the Bank assesses both inside-out risks (the impact from the Bank's operations) and outside-in risks (impact through the Bank's credit and investment portfolios). For example, through its credit exposure to the fishing industry, the Bank is exposed to transition risk as a result of the clean energy transition of vessels and to physical risk as climate changes may result in temperature changes and ocean acidification in the North-Atlantic ocean, which would affect the fishing stock around Iceland and in turn the Bank's credit risk.

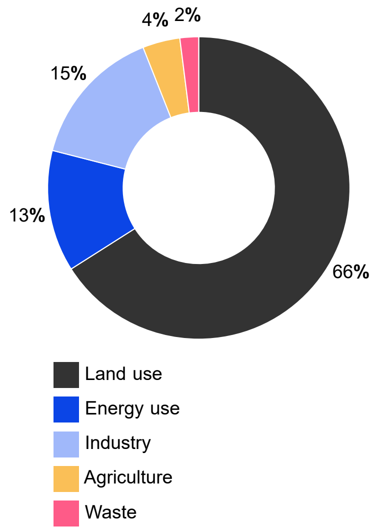
As the Bank's loan portfolio and financial activities reflect the Icelandic economy to a large extent, it is relevant to review the emissions profile of Iceland, which is somewhat atypical. Emissions from energy use is low in comparison to other countries as almost all of Iceland's electricity production and heating comes from renewable sources (hydro and geothermal). According to Iceland's carbon accounting for 2019, 66% of Iceland's emissions was however from land use, land use change and forestry (LULUCF). This ratio is relatively high and indeed in some countries LULUCF is a net carbon sink. Other primary emissions contributors are aluminum and silicon production, energy use from road transportation and fishing vessels, agriculture and waste.

Iceland's Climate Action Plan is focused on these high-impact areas and stipulates clean energy transition in transportation and increased efforts in afforestation, revegetation and wetland reclamation as primary goals. The Bank has approved an environmental and climate policy where it commits to supporting Iceland's goals in relation to the Paris Agreement. One of the Bank's objectives for 2022 is to assess carbon emissions from its loan portfolio.

The Bank has further developed the climate risk assessment of its loan book using TCFD classification. The analysis was first published by the Bank in 2020. The assessment is based on an assumption of a static balance sheet, as the time horizon of many climate risks far exceeds the maturity of the loan book.

In 2021, Arion Bank scored 90 points out of 100 in Reitun's ESG risk assessment. This was the highest score given among 34 issuers in the market

Figure 8.2 Iceland's carbon equivalent emissions in 2019, excluding international transportation. Source: Environmental Agency of Iceland



Key objectives
Introduce sustainability risk appetite statement in 2022
Introduce sustainability policies for high-impact sectors in 2022
Assess emissions from loan portfolio (PCAF) in 2022
By 2023, the Bank only procures electric vehicles and 90% of its waste is sorted
Reduce carbon emissions from the Bank's operations by 55% by 2030 compared to 2015, and offset the rest

Sustainability risk

When considering climate-related risk, the Bank has categorized the risk to short, medium and long term. Short term is up to one year, medium term is up to eight years which is in accordance with the goals of the Paris Agreement and long term is up to thirty years.

Figure 8.3 Climate transition risk assessment - TCFD categories

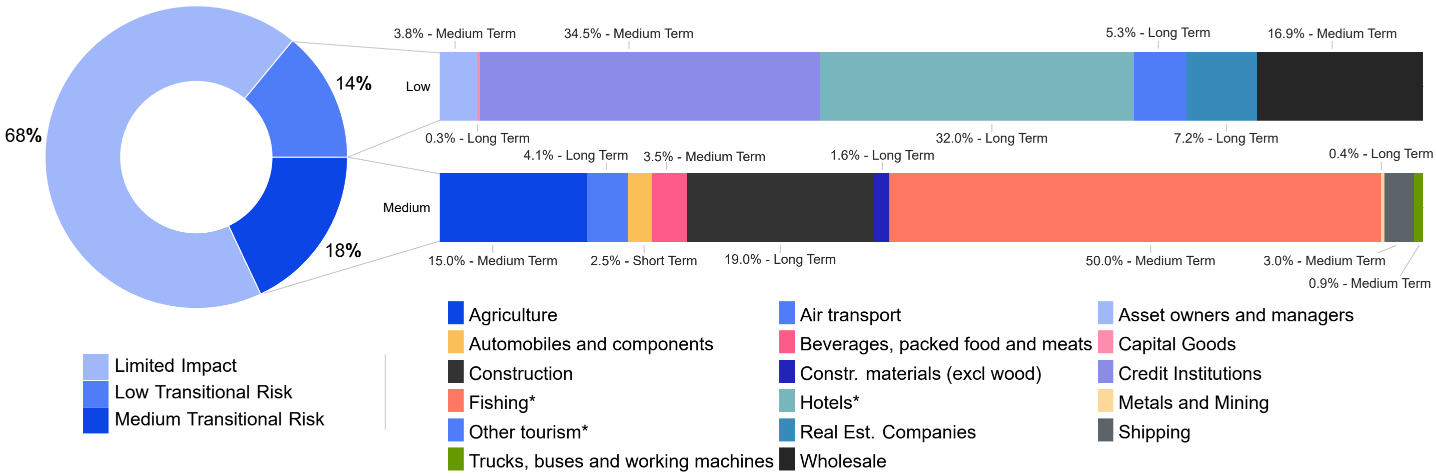
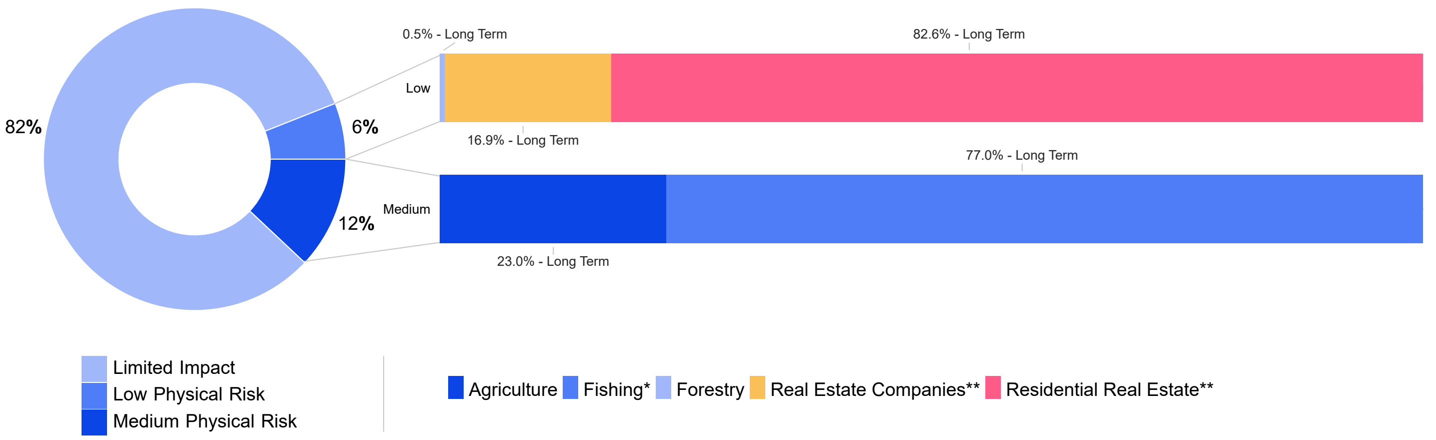


Figure 8.4 Climate physical risk assessment - TCFD categories



* Not part of original TCFD but added due to importance in Iceland
** 10% of exposure due to physical risk (e.g.; sea level rise, etc.)

The Bank has not identified sectors or specific exposures in the Bank's loan portfolio that warrant being classified as significantly exposed to climate transition or physical risk.

8.3.1 Green Financing Framework

In July 2021, the Bank published its Green Financing Framework and accordingly now classifies green loans into eight categories:

- Sustainable fishery and aquaculture
- Sustainable forestry and agriculture
- Renewable energy
- Clean transportation
- Green buildings

Sustainability risk

- Energy efficiency
- Pollution prevention and control
- Sustainable water / wastewater management

The Bank's green deposits were initially used exclusively to finance green car loans but have now been merged into the Green Financing Framework and are thus, along with green bond issuance, used to fund green loans that support the UN Sustainable Development Goals 6, 7, 9, 11, 12, 13, 14 and 15.

In 2021, the Bank provided green project financing to Norðurál, an Iceland based producer of pure aluminum and aluminum alloys. The company has a significantly smaller carbon footprint compared to productions abroad as almost 100% of electricity production in Iceland is renewable energy. The exposure falls within the Energy efficiency category due to the estimated 40% energy reduction achieved through production of value-added aluminum billets, which otherwise would be produced by shipping aluminum ingots abroad and remelting them there.

The Bank's green financing is a key tool to support the objective stated in the EU Commission's Action Plan to Promote Sustainable Growth to *reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth*. The Bank's sustainability policies for high-impact sectors will complement the green framework by focusing on the overall sustainability criteria in the Bank's lending operations, thus avoiding activities that undermine the green agenda (i.e. *"brown"*). The policies also serve as a useful tool to engage with the Bank's customers in a constructive manner and support their transition to more sustainable practices – this is arguably the most significant contribution from financial institutions.

Stefnir Fund Management has introduced a number of investment options which support green solutions and are guided by the principle of sustainability. Stefnir - Scandinavian Fund - ESG has received an AAA ESG rating from MSCI.

The Bank has set a sustainable financing target. At year-end 2021 green loans under the framework accounted for 11% of the total loan portfolio. The Bank's objective is for this ratio to exceed 20% by 2030. This entails that the Bank maintains a rate of growth of green loans under the framework that is more than double the growth rate of total loans to customers until 2030. The progress will be disclosed annually and the target may be revised as further opportunities arise in green financing.

8.4 Social Risk

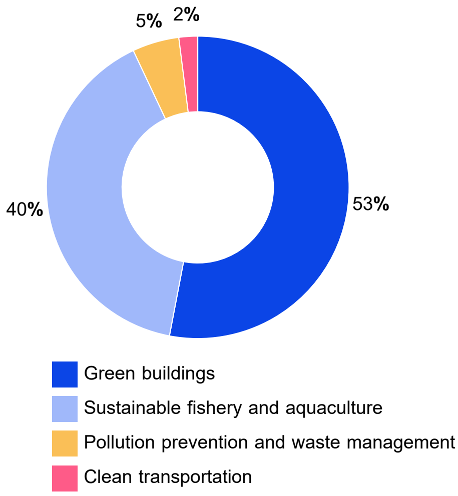
Social risks include factors such as diversity and gender pay equality, health and safety, discrimination and human rights.

The Bank's sustainability policy states the following: *We want to act as a role model by promoting responsible and profitable business practices, which take into account the environment, the economy and the society in which we live and work. We try to see things from our customers' viewpoint and strive to do better today than we did yesterday. We work in an attractive workplace where knowledge creates future value for the benefit of our customers, investors and society as a whole.*

The Bank has approved various policies to support its most valu-

Figure 8.5 Arion Bank's Green Financing Framework published in 2021

Figure 8.6 Green loans under the Bank's Green Financing Framework by category at year-end 2021



The Bank's objective is that in 2030, at least 20% of loans to customers fall under the Bank's Green Financing Framework.

able asset, which is human resources. These include policies on remuneration, equality, human rights and equal pay, education and training, health and security, and work-from-home approach.

In 2021, the Bank announced that it will ensure 80% pay for employees on maternity or paternity leave for six months by supplementing payments from the public Maternity/Paternity Leave Fund. The program is intended to encourage parents, fathers in particular, to utilize their paternity leaves and support equal opportunities for men and women. The Bank aims to increase the proportion of women in senior positions. The impact on society as a whole comes from encouragement to other workplaces to follow in the Bank's footsteps.

The Bank has set the following targets in the area of gender pay equality:

- Medium pay of men / medium pay of women < 1.3 (actual 1.46)
- Gender pay gap within 1% (actual 0.1%) according to the equal pay analysis

The chapter Responsible banking in the Bank's Annual and Sustainability Report outlines the Bank's activities, collaborations and sponsorships, whereby it is giving back to the society.

8.5 Governance Risk

Governance risk touches on consideration of board diversity and independence, ethics and code of conduct, and disclosure practices.

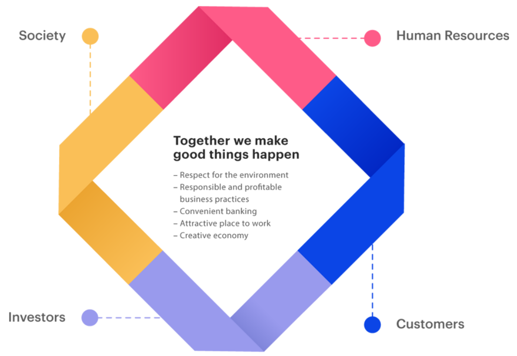
The Bank's is recognized as having achieved excellence in corporate governance by the Icelandic Chamber of Commerce, Confederation of Icelandic Enterprises and Nasdaq Iceland, and complies with various acts and guidelines to that respect as further outlined in the Bank's Corporate Goverance Statement. It states the following: *Good corporate governance helps to foster open and honest relations between the Board of Directors, shareholders, customers and other stakeholders, such as the Bank's employees and the general public. Corporate governance also provides the foundations for responsible management and decision-making, with the objective of generating lasting value. The Board of Directors places great importance on good corporate governance and re-evaluates its governance practices regularly on the basis of recognized guidelines on corporate governance.*

The Bank's Board of Directors consists of independent members and two out of five members are women. In addition to considering independency and diversity within the Board, the role of the Bank's Nomination Committee is to promote good corporate governance and select a team with wide and versatile qualification and experience in accordance with the Bank's Suitability Policy. The Board assesses its work, practices and procedures on an annual basis and evaluates the performance of the CEO, Internal Auditor and other employees as applicable.

According to the Bank's Internal Control Policy, it operates under a three lines model, with dedicated second line control functions and internal audit performing third line duties. See further details in Chapter 2, including committee structure.

The Bank promotes high ethical standards in its work and is conscious of the fact that its operations affect different stakeholders

Figure 8.7 Arion Bank's main focuses in sustainability



and society at large. The Bank's code of ethics is designed to serve as a key to responsible decision-making at Arion Bank. Ethical and code of conduct standards are considered in the Bank's outsourcing arrangements as per the Bank's Outsourcing Policy.

9 Remuneration

10 Abbreviations

9 Remuneration

Arion Bank has a remuneration policy in place in accordance with Act No. 2/1995 on Public Limited Companies, Act No. 161/2002 on Financial Undertakings, and FSA's Rules No. 388/2016 on Variable Remuneration. The policy is an integral part of the Bank's strategy to protect the long-term interests of the Bank's owners, its employees, customers and other stakeholders in an organized and transparent manner. The Bank's subsidiaries also have remuneration policies in place when applicable in accordance with law.

Arion Bank's remuneration policy

Arion Bank's remuneration policy is framed in accordance with regulatory requirements, such as those established in FSA's Rules No. 388/2016 on Variable Remuneration under the Act on Financial Undertakings. The Bank's remuneration policy is reviewed annually by the Board and submitted and approved at the Bank's annual general meeting. Arion Bank's remuneration policy is, furthermore, published on the Bank's website and information on compensation to the Board of Directors and Bank's management is disclosed in the Consolidated Financial Statements for 2021, see Note 12.

Arion Bank's remuneration policy is framed in accordance with regulatory requirements, such as those established by the FSA, and is reviewed and approved annually

The Bank's main objective concerning employee remuneration is to offer competitive salaries in order to attract and retain outstanding and qualified individuals. The Bank, furthermore, aims to ensure that the policy does not encourage excessive risk taking, but rather supports the Bank's long-term goals and sound operation. The policy is an integral part of the Bank's strategy to protect the long-term interests of the Bank's owners, its employees, customers and other stakeholders in an organized and transparent manner. In accordance with Article 79a of Act No. 2/1995 on Public Limited Companies and rules on good corporate governance, the Board of Directors of Arion Bank approves the Bank's remuneration policy with respect to salaries and other payments to the Board Directors, Chief Executive Officer, Managing Directors, Compliance Officer and Internal Auditor.

Remuneration components and parameters

According to the FSA's rules No. 388/2016 on Variable Remuneration, the combined amount of variable remuneration, including deferred payments, may not exceed 25% of annual salary of the recipient employee. The rules require a deferral of at least 40% of the variable remuneration for a period of no less than three years, unless the total aggregate is less than 10% of the fixed salary of the employee, in which case the variable remuneration does not require deferral and may be paid in full.

The combined amount of variable remuneration, including deferred payments, may not exceed 25% of annual salary, with at least 40% thereof deferred for no less than three years

In accordance with the rules, Risk Management and Compliance perform a risk assessment of the incentive scheme and Internal Audit regularly reviews its structure, execution and impact on the Bank's operations.

The current performance-based system was originally approved in December 2020 and reconfirmed by the Board of Directors in

December 2021, to be applied in 2023 based on 2022 performance. Under the scheme all employees of the Bank, excluding internal controls units, are included and can receive up to 10% of their fixed annual salary for 2022 in the form of variable remuneration once the annual financial statement for 2022 has been published, on condition that the targets set out in the scheme have been reached. Managers and those employees who have the greatest influence on the Bank's revenues and costs are eligible to receive an incentive payment of up to 25% of their fixed annual salary, in which case it will be in the form of shares in the Bank which may not be sold for a period of three years.

A restated performance-based variable remuneration system was approved in December 2021 and will apply in 2023 based on performance in 2022

Risk Management, Compliance and Internal Audit are excluded.

The criterion used for the Bank's remuneration system to determine whether incentive payments will be paid in 2023, in part or in full, is whether the Bank's return on equity (ROE) in 2022 is higher than the weighted average ROE of the Bank's main competitors: Íslandsbanki, Landsbankinn and Kvika. Failure to reach this target means that no variable remuneration will be paid. The total amount paid out in incentive payments, furthermore, may not be higher than the amount by which the Bank's ROE exceeds the weighted ROE of competitors.

When estimating the variable remuneration to be paid in respect of 2022 performance, a range of factors will be taken into consideration, such as ROE of the Bank and individual divisions, the cost-to-income ratio, bancassurance ratio, compliance with law and internal rules, knowledge of the customer (KYC/AML) and the number of different services used by the customers.

The objective of the scheme is to reflect the Bank's objectives for good corporate governance as well as sustained and long-term value creation for all stakeholders, including customers, creditors, shareholders and employees. The Board of Directors re-evaluates on an annual basis the incentive scheme and its key targets in accordance with the Bank's remuneration policy, taking into consideration the current status of the Bank, market conditions and that variable remuneration is awarded in a manner which promotes sound risk management in line with the Bank's risk policy and does not induce excessive risk-taking.

The objective of the scheme is to reflect the Bank's objectives for good corporate governance as well as sustained and long-term value creation for all stakeholders, including customers, creditors, shareholders and employees

Corporate governance arrangements

The Board Remuneration Committee (BRC) and the Board Risk Committee (BRIC), which are established by the Board of Directors of Arion Bank, provide guidance to the Board on the Bank's remuneration policy. The BRC advises the Board on the remuneration of the CEO, Managing Directors, the Compliance Officer and Chief Internal Auditor, as well as the Bank's remuneration scheme and other work-related payments.

The BRC convened 4 times in the year 2021. The committee consists of at least three members, the majority of whom must be independent of the Bank and the Bank's day-to-day management. The CEO, Managing Directors, or other employees of the Bank cannot be members of the Committee.

Remuneration

The main responsibilities of the BRC are to review and propose changes to the Board on the Bank's remuneration policy, which proposes the changes to a shareholders' meeting. In addition, the BRC is tasked with ensuring that wages and other employment terms are in accordance with laws, regulations and best practices as current from time to time. The Committee decides on a salary framework for Managing Directors and the Compliance Officer, taking into consideration the size of the relevant division and level of responsibility.

A performance-based variable remuneration system has been in place since 2013 and both BRC and BRIC have a role as regards its design and annual review. BRC reviews and monitors the scheme, before submitting it to the Board, and BRIC's role is to assess annually whether incentives which may be contained in the Bank's system are consistent with the Bank's risk policy.

The Board Remuneration Committee monitors the incentive scheme, ensuring compliance with laws, regulations and best practices. The Board Risk Committee annually assesses whether incentives are consistent with the Bank's risk policy

Quantitative information on remuneration

According to disclosure requirements set out in Art. 450 of the Capital Requirements Regulation (EU) No. 575/2013, financial undertakings are required to provide aggregate quantitative information on total remuneration, broken down by senior management and members of staff whose actions have a material impact on the risk profile of the institution.

The criterion used for the Bank's variable remuneration scheme to determine whether an incentive payment will be paid in 2022, in part or in full, depends on a comparison of the Bank's return on equity (ROE) in 2021 with that of a weighted average ROE of the Bank's main competitors: Íslandsbanki, Landsbankinn and Kvika. For quantitative information on remuneration, please refer to the Bank's Additional Pillar 3 Risk Disclosures.

10 Abbreviations

ACC	Arion Credit Committee
ADC	Arion Composition and Debt Cancellation Committee
AFS	Available Stable Funding
AGM	Annual General Meeting
ALCO	Asset and Liability Committee
AML	Anti Money Laundering
AT1	Additional Tier 1
BAC	Board Audit Committee
BCC	Board Credit Committee
BCMS	Business Continuity Management System
BRC	Board Remuneration Committee
BRIC	Board Risk Committee
BRRD	Bank Recovery and Resolution Directive
BTC	Board Tech Committee
CCF	Credit Conversion Factor
CCR	Counterparty Credit Risk
CEO	Chief Executive Officer
CET1	Common Equity Tier 1
CFO	Chief Financial Officer
CMS	Collateral Management System
COREP	Common Reporting
COVID-19	Coronavirus Disease 2019
CPI	Consumer Price Index
CRD	Capital Requirements Directive
CRM	Credit Risk Mitigation
CRO	Chief Risk Officer
CRR	Capital Requirements Regulation
CSO	Chief Security Officer
CVA	Credit Value Adjustment
D-SII	Domestic Systemically Important Institution
EAD	Exposure at Default
EBA	European Banking Authority
ECAI	External Credit Assessment Institution
EEA	European Economic Area
ECL	Expected Credit Loss
ESG	Environmental, Social and Governance
EU	European Union
FATF	Financial Action Task Force
FRTB	Fundamental Review of the Trading Book
FSA	Financial Supervisory Authority of the Central Bank of Iceland
FTE	Full-time equivalent
G-SII	Global Systemically Important Institution
ICAAP	Internal Capital Adequacy Assessment Process
ICFR	Internal Controls over Financial Reporting
IFRS	International Financial Reporting Standards
ILAAP	Internal Liquidity Adequacy Assessment Process
IRB	Internal Ratings Based
IRRBB	Interest Rate Risk in the Banking Book
ISAT08	Icelandic industry classification based on NACE Rev. 2
ISMS	Information Security Management System
KYC	Know Your Customer
LAA	Loss Absorption Amount
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
LTV	Loan to Value
LULUCF	Land use, land-use change and forestry
MCC	Market Confidence Charge

Abbreviations

MD	Managing Director
MREL	Minimum requirement for own funds and eligible liabilites
NSFR	Net Stable Funding Ratio
ORCO	Operational Risk Committee
ORSA	Own Risk and Solvency Assessment
ORX	Operational Riskdata eXchange Association
PCAF	Partnership for Carbon Accounting Financials
PD	Probability of Default
PSD	Payment Services Directive
PSE	Public Sector Entities
RB	Reiknistofa bankanna hf.
RCA	Recapitalisation Amount
RCSA	Risk Control Self-Assessment
REA	Risk-weighted Exposure Amount, previously referred to as Risk-Weighted Asset (RWA)
ROAC	Return on Allocated Capital
ROE	Return on Equity
RSF	Required Stable Funding
SA-CCR	Standardized Approach for Counterparty Credit Risk
SDRs	Swedish Depository Receipts
SME	Small and Medium Enterprise
SNP	Senior Non-Preferred
SP	Senior Preferred
SREP	Supervisory Review and Evaluation Process
SRM	Single Resolution Mechanism
SFT	Securities Financing Transaction
SUCO	Sustainability Committee
T1	Tier 1
T2	Tier 2
TCFD	Task Force on Climate-related Financial Disclosures
UCITS	Undertaking for Collective Investment in Transferable Securities
UN	United Nations
VaR	Value at Risk

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